ARE ANTICOMPETITIVE CONTRACTS ENFORCEABLE? THE ILLEGALITY DEFENSE AND MODERN ANTICOMPETITIVE CONTRACTS

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This Article argues that contracts that violate Section 1 of the Sherman Act should not be enforceable. Although seemingly modest, courts do not accept this proposition. When a defendant in a breach of contract action raises the defense of "illegality" under the Sherman Act, courts will likely reject the defense unless the contractual provision at issue is unlawful "on its face." The practical consequence of this rule is that the antitrust illegality defense will likely fail in most litigated breach of contract cases. Parties only rarely attempt to enforce obvious violations of Section 1 of the Sherman Act, like price fixing or other per se unlawful agreements, in court. However, parties do attempt to enforce agreements that are potentially unlawful under antitrust's "rule of reason." These sorts of agreements are not typically unlawful on their face, like agreements to fix prices, but may be found unlawful after an examination of the markets at issue. The resources required to conduct such a market examination, however, can be significant. As a result, courts have been reluctant to allow defendants to transform "simple" breach of contract actions into complex antitrust cases and will accordingly reject the defense that a contract is unenforceable because it violates the Sherman Act under the rule of reason. This practice is wrong. It reflects not only bad policy, but also misapplications of federal common law and preemption law.

No academic commentator has published in any depth on this topic. But it is a topic that should be engaged because locking parties into anticompetitive contracts is a significant problem in today's economy. This Article attempts to provide a rigorous analysis of the origins and implications of today's

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problematic doctrine. It argues that agreements that violate Section 1 of the Sherman Act, whether under the per se rule or rule of reason, should not be enforceable. It proposes a new framework for assessing the defense of antitrust illegality specifically but also assessing the defense that a contract violates a federal law generally.

Introduction

Agreements that violate the antitrust laws are often found in formal, written contracts. These sorts of contracts are not secret. Companies may commit anticompetitive contracts to writing because they are not aware that the contract is potentially unlawful, or a company with market power may take a calculated risk and impose an anticompetitive restraint on a relatively helpless contracting partner.

Consider a typical example based on a relatively recent case.[1] Suppose there is one dominant supplier of large truck transmissions. This supplier manufactures over 90% of the truck transmissions purchased in the United States. The main purchasers of truck transmissions are four truck part distributors ("distributors"), middlemen who sell bundles of component parts to truck manufacturers. The vast majority of truck transmissions are sold to truck manufacturers via the distributors because truck manufacturers prefer one-stop shopping for their component parts. Wary of any potential competition in the truck transmission market, the dominant supplier insists on including a clause in its contracts with distributors that each distributor cannot purchase truck transmissions from any other truck transmission supplier. Although the distributors would rather not agree to this exclusive arrangement, there is no viable alternative truck transmission supplier that could fulfill the distributors' needs. Thus, each distributor reluctantly agrees to purchase the transmissions exclusively from the dominant supplier.

During the term of these exclusive agreements, a new transmission supplier enters the market. It has so far succeeded in making direct sales to truck manufacturers, bypassing the distributors. But that direct sales route accounts only for a small sliver of potential transmission sales. In order to generate economies of scale, the new supplier must do business with at least one of the large distributors. The distributors in turn would prefer to do business with the new supplier. The new supplier could potentially create price competition with the dominant supplier, driving prices down for the distributor, which the distributor could pass along to truck manufacturers and thereby compete more vigorously with the other distributors.

The new supplier approaches a distributor and makes an attractive offer. The distributor's employees approach the general counsel and ask if there is any way to circumvent the dominant supplier's exclusive deals. The general counsel determines that the exclusive deals likely violate Section 1 of the Sherman Act: the dominant supplier has market power in the truck transmission market, and the exclusive deals foreclose

1 This example uses simplified facts from ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 263–66 (3d Cir. 2012).

a substantial amount of competition in that market.[2] Rival transmission suppliers cannot compete effectively without selling to the distributors. The general counsel assumes therefore that the exclusive dealing provision is unenforceable. She bases this assumption on the first-year law school principle that unlawful contracts are unenforceable. For the distributor's business employees, this fact (if it were true) would be ideal. They would prefer not to sue the dominant supplier for violating the antitrust laws, even if there were a viable claim. The risk of bad blood resulting from a public dispute with a dominant supplier would be too high. However, explaining to the dominant supplier that the exclusivity provisions are unenforceable and therefore the distributor is going to do business with the new rival would be more palatable.

The general counsel's assumption is a sensible one, and it is the conclusion this Article advances. The dominant supplier's exclusive deals are harming the truck transmission market. Were it not for these series of exclusive contracts, rival transmission suppliers would be more likely to gain a foothold in the market. More vigorous competition in the truck transmission market would likely lead to lower prices and better-quality truck transmissions.

But the law seems to have gone in a different direction. If the distributor breached the contract and then invoked the defense that the contract is unlawful and unenforceable, the distributor would likely lose a breach of contract action. Courts have developed a surprisingly dim view of the defense of illegality under the Sherman Act (what this Article refers to as "antitrust illegality"). Unless a contract is anticompetitive "on its face," courts will likely reject the defense at the pleading stage.[3] In the words of the D.C. Circuit, this is to avoid "[t]he complexity of proof and speculative nature" involved with the market analysis necessary to show a contract is, in fact, anticompetitive.[4] To the D.C. Circuit and others, courts should be "hesitant to interpose complex antitrust issues in a simple suit for breach of contract."[5]

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2 *See* Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law: An Analysis of Antitrust Principles and Their Application ¶ 1802d5 (5th ed. 2022).

3 Hemlock Semiconductor Operations, LLC v. SolarWorld Indus. Sachsen GmbH, 867 F.3d 692, 702 (6th Cir. 2017). *Hemlock* is the most recent appellate court discussion of antitrust illegality.

4 Nat'l Souvenir Ctr., Inc. v. Historic Figures, Inc., 728 F.2d 503, 516 (D.C. Cir. 1984).

5 *Id.* at 514 (citing Mullins v. Kaiser Steel Corp., 642 F.2d 1302, 1311 (D.C. Cir 1981), *rev'd*, 455 U.S. 72. (1982); Viacom Int'l, Inc. v. Tandem Prods., Inc. 526

On this reasoning, courts will strike the defense when it is necessary to analyze market conditions to determine if a contract is anticompetitive.[6] The practical effect of this reasoning goes beyond what any court or academic commentator has acknowledged: the antitrust illegality defense will likely only succeed in cases of *per se* illegality and will likely fail if the contract at issue is unlawful only under antitrust's "rule of reason." The *per se* rule makes certain types of agreements between competitors unlawful without analysis of market conditions.[7] These agreements, like price fixing, "always or almost always tend to restrict competition and decrease output."[8]

A *per se* unlawful agreement likely *is* anticompetitive "on its face."[9] But *per se* unlawful agreements are not typically memorialized in formal contracts and are not typically enforced in court. They are the sorts of agreements made on the golf course or in a "smoke filled room" between executives who know the agreement is unlawful. Thus, because one would not expect someone to sue for breaching a *per se* unlawful agreement, one would not expect the issue of antitrust illegality to arise regarding such agreements.

However, companies do memorialize and enforce anticompetitive agreements.[10] This Article discusses three types of agreements that are common in the modern economy: exclusive deals, anti-steering provisions, and most favored nations provisions.[11] These agreements are not necessarily anticompetitive, but they can be. To prove agreements of this sort are unlawful will typically require some analysis of market conditions—for example, whether one of the contracting parties has market power over a sufficiently defined product market and whether there is some sort of anticompetitive effect (*e.g.*, actual or likely higher prices, reduced output, or reduced quality) as a result

F.2d 593 (2d Cir. 1975)); *see also Hemlock*, 867 F.3d at 700–01; Diamond Crystal Brands, Inc. v. Food Movers Int'l., Inc., No. CV407-42, 2008 WL 2513806, at *2–3 (S.D. Ga. June 20, 2008) (rejecting antitrust illegality defense); *In re* Universal Serv. Fund Tel. Billing Pracs. Litig., No. 02-MD-1468, 2003 WL 21254765, at *3–5 (D. Kan. May 27, 2003) (rejecting antitrust illegality defense); Baker's Carpet Gallery, Inc. v. Mohawk Indus., Inc., No. Civ.A. 4:94-CV-0101, 1996 WL 888222, at *4–5 (N.D. Ga. Sept. 23, 1996) (rejecting antitrust illegality defense).

6 *See, e.g.*, *Hemlock*, 867 F.3d at 701.

7 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 886 (2007).

8 Broad. Music, Inc. v. CBS, 441 U.S. 1, 19–20 (1979).

9 *Hemlock*, 867 F.3d at 701.

10 *See infra* Section II.C.

11 *See infra* Section III.A.

of the conduct entailed by the contract.[12] If a company breaches one of these agreements, even if the agreement violates Section 1 of the Sherman Act, the company will likely be liable for the breach of contract.

This Article will argue that provisions of contracts that violate Section 1 of the Sherman Act should not be enforceable. The Article proposes a new framework for assessing not only the defense of antitrust illegality specifically, but also how courts approach the affirmative defense that a contract is unlawful under federal law generally ("federal illegality"). The framework courts presently use for assessing the defense of federal illegality is simple—and wrong. Courts will apply federal law to the question of whether the contract actually violates the federal law, but also to the question of the *effect* of illegality (*i.e.*, to what extent, if any, the contract can be enforced notwithstanding illegality).[13] State law typically governs the latter question, but the Supreme Court stated broadly that federal common law governs the effect of illegality for contracts that violate federal law.[14]

At the center of the federal illegality puzzle is a theoretical problem regarding the interaction of federal and state law. Whenever a defendant invokes federal illegality, a court must balance the policy concerns animating both state contract law and the federal law a contract arguably violates. On the one hand, state contract law tends to favor the enforcement of contracts.[15] On the other hand, enforcement of a contract may be incompatible with the policies embodied in the federal statute. The theoretical dilemma occurs when a court must weigh the policy concerns underlying those two competing laws. Which law should the court choose *to govern the weighing itself*? Should the court choose state contract law? Or should the court choose federal law?

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12 Ohio v. Am. Express Co. (*Amex*), 138 S. Ct. 2274, 2282–85 (2018).

13 *See infra* Parts I.B.1.b, IV.

14 *Id.*

15 5 Richard A. Lord, Williston on Contracts § 12:4 (4th ed. 2016) ("Although the power of the courts to invalidate the bargains of parties on grounds of public policy is unquestioned and is clearly necessary, it ought to be exercised cautiously, that is, only when the impropriety of the transaction is convincingly established. This is so because public policy also requires that parties of full age and competent understanding enjoy the greatest freedom of contracting; and that contracts, when entered into freely and voluntarily, be upheld and enforced by the courts." (footnotes omitted)).

The Supreme Court emphatically chose federal law with reasoning resembling the doctrine of field preemption.[16] That decision was mistaken and unnecessary. The enforceability of unlawful contracts is an issue the common law has grappled with for centuries.[17] The Supreme Court unceremoniously jettisoned that common law and replaced it with a body of undeveloped federal common law.[18] That decision allowed for the sweeping and surprising outcome that the antitrust illegality defense should fail in most cases.

This Article proposes that state common law should govern the effect of federal illegality in the first instance.[19] However, because the enforcement of an unlawful contract could directly conflict with a federal statute, state law should be supplanted when that would be the result of a classic preemption analysis.[20] In other words, state law should govern the federal illegality inquiry up to the point that federal law preempts state law. This framework is preferable to the current one because it applies the bodies of law that were specifically designed to address each stage of the analysis. State common law addresses situations when a party to an unlawful agreement should receive some degree of relief, and federal preemption law addresses any potential conflict between state and federal law.

Application of this framework results in the conclusion that contracts that violate Section 1 of the Sherman Act are unenforceable. A straightforward conflict preemption analysis precludes the enforcement of contracts that violate Section 1 of the Sherman Act.[21] Section 1 declares a rule specifically for "contract[s]": contracts that restrain trade are illegal (and potentially criminal).[22] That is a clear textual basis for preempting the enforcement of anticompetitive contracts.[23] Further, the conclusion that anticompetitive contracts are unenforceable accords with the important rule that acquiescence to an anticompetitive contract is not a defense to a Sherman Act

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16 *See* discussion *infra* Section I.B.1.b and case cited *infra* note 54.

17 *See infra* Section I.A.

18 *See infra* Section I.B.1.b.

19 *See infra* Part IV.

20 *Id.*

21 *Id.*

22 Sherman Act § 1, 15 U.S.C. § 1.

23 *Infra* Part IV.

claim.[24] Thus, in the example above, the distributor is not precluded from suing the dominant truck transmission supplier merely because it agreed to the exclusive deal. In that context, the Supreme Court understood that we want to encourage the nullification of anticompetitive contracts, not lock them in.[25] The same should be true when the parties are on the other side of the "V."

This Article proceeds in four parts. Part I provides an overview of the illegality defense generally and the doctrinal complications that federal illegality poses, particularly after the demise of the general common law. Part II reviews the major antitrust illegality cases that have left us with the current doctrine. Part III identifies the major problems of the contemporary antitrust illegality doctrine and discusses three common types of anticompetitive restraints contained in commercial agreements. Part IV concludes by providing an alternative framework for analyzing both antitrust illegality and federal illegality.

I
BACKGROUND

A. The Illegality Defense Generally

"Illegality" is a defense to a breach of contract action.[26] The defense essentially holds that even if one party to a contract breached the agreement, a court cannot enforce the contract because the substance of the agreement is unlawful.[27] On its face, the defense is sensible. If I hire a hitman to murder my spouse, I should not be able to enforce the agreement in court if the hitman fails to live up to his end of the bargain. We do not want courts promoting, or perhaps mandating, illegal and immoral behavior. Given humanity's penchant for both contracting and unlawful conduct, it is not surprising that the proposition that illegal contracts are not enforceable dates

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24 *Id.*; *see also* Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 139–40 (1968) (rejecting defense of *in pari delicto* for Sherman Act claims), *overruled by* Copperweld Corp. v. Indep. Tube Corp., 467 U.S. 752 (1984); Tidmore Oil Co. v. BP Oil Co./Gulf Prods. Div., 932 F.2d 1384, 1388 (11th Cir. 1991) ("[B]ecause the Supreme Court has rejected the application of the doctrine of *in pari delicto* in antitrust actions, an agreement may be challenged even by one of the parties who has acquiesced in the unlawful agreement." (citing *Perma Life*, 392 U.S. at 139)).

25 *See Perma Life*, 392 U.S. 134.

26 RESTATEMENT (SECOND) OF CONTRACTS § 178 (AM. L. INST. 1981).

27 *Id.*; *see also* RESTATEMENT (FIRST) OF CONTRACTS § 512 (AM. L. INST. 1932).

back to antiquity[28] and was firmly established in the English common law at the founding.[29]

That paradigm case, however, is easy to address. Hiring a hitman is unlawful and immoral across jurisdictions and cultures; it is not at the margins of illegality. There are no compelling policy reasons to enforce the murder-for-hire agreement. We are not concerned about the "unfairness" of the would-be murderer not receiving the benefit of his bargain. But that is not the typical posture of a litigated illegality dispute. Parties do not typically attempt to enforce blatantly illegal and immoral contracts in court.[30] The illegality problems courts address usually involve more difficult questions. What if both parties reasonably believed that the contract was legal, but it turns out they were wrong? What if the conduct is illegal in some jurisdictions but not others?[31] What if only part of a contract is unlawful, and the rest is permissible?

Consider the following example.[32] Joe conducts a for-profit raffle without getting the raffle permit required in his state. The prize is 100 lottery tickets. Susan purchases a raffle ticket and wins, but Joe refuses to turn over the lottery tickets—one of which is the winner. Joe invokes illegality as a defense to Susan's breach of contract suit, claiming, correctly, that the raffle he administered was unlawful. At worst, Joe argues, he should only be made to return Susan's money. Susan argues that she had no idea that the raffle was unlawful, and it would be unfair for Joe to retain the winning ticket.

This example highlights common considerations in illegality cases. The party invoking the illegality defense, Joe, is more at fault than Susan and seems to be acting in bad faith. Joe

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28 REINHARD ZIMMERMANN, THE LAW OF OBLIGATIONS 698–702 (1996) (discussing evolution of this doctrine from the late Roman Republic through the Empire period).

29 *Cf.* Holman v. Johnson (1775) 98 Eng. Rep. 1120, 1121; 1 Cowp. 341, 343 (holding that when contracts are legally made abroad, the laws of the country where the cause of action arose will govern).

30 But see *Everet v. Williams* (1725), where, perhaps apocryphally, an English equity court refused to adjudicate a dispute regarding the agreed-upon allocation of the proceeds of a highway robbery and sanctioned the lawyers for bringing the suit. The robbers were subsequently executed. *See* Note, *The Highwayman's Case*, 9 L.Q. REV. 197 (1893).

31 The earliest common law case usually cited for the proposition that illegal contacts are unenforceable, *Holman v. Johnson*, actually addressed this jurisdictional question and took for granted that the contract would be unenforceable if it violated English law. *Holman* (1775) 98 Eng. Rep. at 1121.

32 These facts are taken in somewhat simplified form from *Smith v. Williams*. *See* Smith v. Williams, 698 F.2d 611 (3d Cir. 1983).

knew his raffle was illegal while Susan did not. He appears to have used this knowledge to maximize his position; he makes money on the raffle in the event that none of the lottery tickets win, and he claims that he actually owns the tickets in the event that one of the tickets wins. Absent an unusually compelling public policy reason that unlawful raffles should not be enforced under any circumstances, it is fairer to enforce the agreement such that Susan obtains title to the winning lottery ticket rather than Joe.

Another complication courts frequently address occurs when the contract concerns subject matter that is only somewhat related to illegal conduct. A contract may facially cover lawful conduct, but there may be an underlying illegal purpose. This particular issue (and the jurisdictional question previewed above) is currently confronting the marijuana industry in the United States. Several states have legalized medicinal or recreational marijuana distribution, but it remains illegal to grow, sell, and distribute marijuana under the federal Controlled Substances Act.[33] As the legal marijuana industry grows, commercial disputes have grown as well. The business of managing supply chains, financing, employment, insurance, shareholders, and the like has created run-of-the-mill breach of contract litigation.[34] Defendants in these cases have claimed the contractual obligations they have taken are unenforceable because the contract relates to activity that is illegal at the federal level.[35]

Generally speaking, the main principles courts consider when addressing unlawful contracts in breach of contract cases are as follows:[36]

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33 *See, e.g.*, Kush, Inc. v. Van Vranken, No. 2:20-CV-649, 2020 WL 8371452, *4–5 (D. Nev. June 19, 2020).

34 *E.g. Kush, Inc.*, 2020 WL 8371452; Ginsburg v. ICC Holdings, LLC, No. 3:16-CV-2311-D, 2017 WL 5467688 (N.D. Tex. Nov. 13, 2017); Mann v. Gullickson, No. 15-cv-03630-MEJ, 2016 WL 6473215, (N.D. Cal. Nov. 2, 2016); Energy Labs, Inc. v. Edwards Eng'g, Inc., No. 14 C 7444, 2015 WL 3504974 (N.D. Ill. June 2, 2015), *remaining claims dismissed without prejudice on procedural grounds*, No. 14 C 7444, 2017 WL 818855 (N.D. Ill. Mar. 2, 2017); Tracy v. USAA Casualty Ins. Co., No. 11-00487 LEK-KSC, 2012 WL 928186 (D. Haw. Mar. 16, 2012).

35 *See supra* note 34.

36 This discussion is based on the Restatement (Second) of Contracts. Section 178 proposes that courts should employ a multifactor balancing test:

> (1) A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms.

- Fairness and the parties' expectations: Even assuming the contract is illegal, traditional contract principles ask whether one party is morally less at fault than the other, and whether the more culpable party will experience a windfall. In certain cases, courts will award some form of relief despite the illegality. Often this will take the form of restoring the parties to the status quo through remedies like restitution.

- Severability: Traditional contract principles examine whether the court can sever the illegal portion of the contract and enforce the remainder. A court will analyze how important the term is to the overall contract; the Restatement (Second) of Contracts asks whether the illegal term is "essential" to the contract as a whole.[37] For example, a defendant may breach multiple provisions of a contract, only one of which is unlawful. If the illegal term is severable, one option for the court is to allow recovery for everything other than the breach of the illegal term. This outcome makes sense for contracts involving complex commercial relationships. Contracts like the hired-hitman example are likely not severable since, presumably, murder-for-hire is the essence of the agreement.

- Seriousness of the illegality: Perhaps the most powerful driver of intuitions is the seriousness of the illegality. The hired-hitman example is one extreme end of the spectrum. On the other end would be contracting to do something that results in getting the equivalent of a parking citation. Suppose I hire a

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(2) In weighing the interest in the enforcement of a term, account is taken of

(a) the parties' justified expectations,

(b) any forfeiture that would result if enforcement were denied, and

(c) any special public interest in the enforcement of the particular term.

(3) In weighing a public policy against enforcement of a term, account is taken of

(a) the strength of that policy as manifested by legislation or judicial decisions,

(b) the likelihood that a refusal to enforce the term will further that policy,

(c) the seriousness of any misconduct involved and the extent to which it was deliberate, and

(d) the directness of the connection between that misconduct and the term.

RESTATEMENT (SECOND) OF CONTRACTS § 178 (AM. L. INST. 1981).

[37] *Id.* § 184.

> contractor to build an addition on my house. Both the contractor and I fail to recognize that the project requires a permit for $1,000 from the city. The contract is therefore "illegal," but clearly that illegality should not result in either me or the contractor experiencing a windfall.[38]

Depending on how a court weighs these factors, it may decide to enforce part or all of a contract notwithstanding that it contains an unlawful provision.

B. Federal Illegality

For the purposes of this Article, "federal illegality" refers to the defense that a contract violates federal law and is therefore unenforceable. Consider the marijuana issue raised above. When a plaintiff claims a defendant breached a contract, and the defendant argues that the contract violates the Controlled Substances Act, that is an invocation of federal illegality. As discussed below, courts have deviated from traditional contract principles when assessing federal illegality, largely as a result of antitrust cases. Below I discuss the evolution of federal illegality case law and the policy implications shaping that evolution.

1. *Interaction of State and Federal Law*

Federal illegality necessarily involves an interaction between state and federal law. First, the plaintiff must plead facts that give rise to a claim for breach of contract. Chronologically, this will usually be the first question presented to the court and will be a question of state law.[39] Next, the defendant will raise the defense of federal illegality. Procedurally, the mechanism by which a defendant raises the defense of illegality will depend on whether the case is in federal or state court.[40] Substantively, whether a contract in fact violates a federal law is a question of federal law.[41] One can imagine closely related

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38 *See id.* § 181.

39 Federal statutory and regulatory law can govern contracts between the federal government and private parties—such as government contracts for the provision of goods and services—and what constitutes a breach will be a question of federal law. *See* 41 U.S.C. §§ 7101–7109. Unusual scenarios aside, state law will typically govern what constitutes a breach of contract between private parties.

40 In federal court, Federal Rule of Civil Procedure 8(c)(1) controls how a defendant raises affirmative defenses, including illegality.

41 Bassidji v. Goe, 413 F.3d 928, 936 (9th Cir. 2005); Kelly v. Kosuga, 358 U.S. 516, 519 (1959).

questions that are not obviously federal- or state-law questions, and these will be discussed in this Article. But the narrow question, whether the contract violates federal law is—and should be—a federal question.[42]

Beyond those two clear issues, which law should govern is less clear and has, in part, led to today's problematic doctrine. Suppose a contractual provision requires conduct that violates a federal statute.[43] Does that mean the plaintiff should not be able to recover regardless of the facts? Traditional contract law principles have much to say about that question, and those principles are typically creatures of state law. When the illegality is federal, however, it is not clear whether these considerations ought to be questions of state or federal law. On the one hand, the common law has developed and refined these principles over centuries, and that common law tradition now belongs to the states; it would be unwise to jettison that common law development unless there is a good reason.

On the other hand, federal illegality raises federalism concerns that are relatively novel in the common law tradition. With federal illegality, we are concerned with (1) making sure state contract law does not undermine federal law, but also that (2) states are able to make their own policy up to the point of conflicting with federal law. It is not difficult to imagine a court using the considerations above to undermine a federal law with which the state court does not agree. That concern would support a broad view of which questions are within federal law's purview. However, suggesting the opposite view is that federal law generally attempts to leave state law unaltered when possible.[44]

42 *See supra* note 41.

43 The idea of a contractual provision "violating" a federal statute is vague. It could refer to a provision requiring conduct that would violate a statute if undertaken, or it could refer to the act of contracting itself violating the statute. In the context of an affirmative defense to breach of contract, the distinction does not matter. The defense contemplates either option—if the defendant claims that breaching the contract is inextricably linked with *conduct* that would violate the federal statute if undertaken, the defense should be successful, and so too with the defense that the provision itself violates a federal statute without further conduct. At the end of the day, the question before a court is whether a provision should be enforceable—if that provision requires unlawful conduct or is itself a violation may be relevant for considering the seriousness of the illegality, but either formulation could be unenforceable. *See* RESTATEMENT (SECOND) OF CONTRACTS § 181 cmt. d (AM. L. INST. 1981).

44 *E.g.* N.Y. State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 654 (1995) (discussing the presumption against preemption and stating that "we have never assumed lightly that Congress has derogated

a. *Erie and the Balance Between Federal and State Law*

Locating the source of the law, whether federal or state, to address these federalism concerns took on greater importance after the Supreme Court's landmark *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938) decision.[45] Prior to *Erie*, federal courts and state courts both interpreted questions arising under the "general common law," and federal courts could disagree with state courts on "general common law" issues.[46] The exact nature and content of the "general common law" was never particularly clear and evolved over time.[47] That said, in a commercial breach of contract case, both state and federal courts would likely apply the general common law of commercial transactions rather than the distinct local law of the state in which the court was sitting.[48] Thus, prior to *Erie*, when a defendant raised federal illegality as a defense to a breach of contract, all state and federal courts would tend to apply the same laws: the general laws of contracts and the law derived from the federal statute. And, indeed, that is what we see in the early cases addressing antitrust illegality under the Sherman Act.[49] Take the case of *United Artists Corp. v. Odeon Building, Inc.*, 248 N.W. 784 (Wis. 1933).[50] In *United Artists*, the Supreme Court of Wisconsin addressed whether an arbitration clause that the United States Supreme Court had held unlawful under the Sherman Act in *Paramount Famous Lasky Corp. v. United States*, 282 U.S. 30 (1930) was severable from the remainder

state regulation, but instead have addressed claims of pre-emption with the starting presumption that Congress does not intend to supplant state law").

45 *See* Erie R.R. Co. v. Tompkins, 304 U.S. 64, 71 (1938); *see also* Caleb Nelson, *State and Federal Models of the Interaction Between Statutes and Unwritten Law*, 80 U. CHI. L. REV. 657, 732–33 (2013) ("In the aftermath of *Erie*, federal courts had to decide how to handle a host of topics that involved the implementation of federal statutes, but on which courts had previously drawn the necessary rules of decision from general law.").

46 *Erie*, 304 U.S. at 71; Swift v. Tyson, 41 U.S. 1, 18 (1842); *see also* Ernest A. Young, Erie *as a Way of Life*, 52 AKRON L. REV. 193, 194 (2018).

47 William A. Fletcher, *The General Common Law and Section 34 of the Judiciary Act of 1789: The Example of Marine Insurance*, 97 HARV. L. REV. 1513, 1532–33 (1984).

48 *Id.* at 1519 ("All American courts, state and federal, relied on the general law merchant in commercial cases."); *Swift*, 41 U.S. at 18–19.

49 D.R. Wilder Mfg. Co. v. Corn Prods. Refin. Co., 236 U.S. 165, 172–78 (1915); *e.g.*, Connolly v. Union Sewer Pipe Co., 184 U.S. 540, 550–52 (1902).

50 United Artists Corp. v. Odeon Bldg., Inc., 248 N.W. 784, 786–87 (1933).

of the contract.[51] Drawing on federal, state, and founding-era English cases (all seemingly as persuasive rather than binding authority), the Court held the clause was not severable. However, other courts confronting the same contract and same severability question came out the other way.[52] The Wisconsin Supreme Court reasoned that the diverging courts did not interpret *Paramount* correctly.[53] For the Wisconsin Supreme Court in 1930, that was the main option available. If courts considering the same facts and laws were reaching different outcomes, then someone must be reaching the *wrong* result.

Today, that is not necessarily true. Under contemporary jurisprudence, a court confronting divergent outcomes regarding the same contract would need to know whether the severability holding was based on the Sherman Act or state contract law. If the court concluded that it was a Sherman Act question, then reaching a different result would require the conclusion that one set of diverging courts reached an incorrect decision interpreting the Sherman Act. If, however, the question was one of state law, then the court could conclude that the diverging courts were not *wrong*, but rather, as a matter of state contract law, the law of the state in which the court was sitting differed.

b. *The Supreme Court Tips the Balance Toward Federal Law*

The Supreme Court's first major case bearing on federal illegality post-*Erie* was *Sola Electric Co. v. Jefferson Electric Co.*, 317 U.S. 173 (1942).[54] *Sola* concerned whether a patent licensee could sue the licensor for including an anticompetitive provision in the license agreement. Two doctrines made the question complicated. First was the "scope of the patent" immunity to antitrust liability. The strength of this doctrine has since eroded,[55] but, at the time, conduct that was within "the scope of the patent" was immune from antitrust liability.[56] To

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51 *Id.*

52 *Id.*

53 *Id.* at 788.

54 Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173 (1942). Rather than raising the defense of federal illegality, the defendant filed counterclaims, including a declaratory judgment action that was the functional equivalent of an affirmative defense. *Id.* at 174.

55 *See, e.g.*, FTC v. Actavis, Inc., 570 U.S. 136, 150–52 (2013).

56 Herbert Hovenkamp, *The Rule of Reason and the Scope of the Patent*, 52 SAN DIEGO L. REV. 515, 526–28 (2015).

get around this hurdle, the licensee argued that the patent was invalid because it was not sufficiently novel.[57] This argument, however, raised the old common law doctrine of "licensee estoppel," which generally holds that a licensee who takes the benefit of a license is estopped from contesting the validity of the licensor's patent.[58]

The court of appeals had applied licensee estoppel and therefore affirmed the denial of the antitrust counterclaim.[59] The Supreme Court reversed. In sweepingly broad language, the Court stated:

> It is familiar doctrine that the prohibition of a federal statute may not be set at naught, or it benefits denied, by state statutes or state common law rules. In such a case our decision is not controlled by [*Erie Railroad v. Tompkins*]. There we followed state law because it was the law to be applied in the federal courts. But the doctrine of that case is inapplicable to those areas of judicial decision within which the policy of the law is so dominated by the sweep of federal statutes that legal relations which they affect must be deemed governed by federal law having its source in those statutes, rather than by local law. When a federal statute condemns an act as unlawful the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted. To the federal statute and policy, conflicting state law and policy must yield. Constitution, Art. VI, cl. 2.[60]

This broad declaration—resembling modern-day field preemption[61]—set the stage for federal courts to create federal

57 *Sola*, 317 U.S. at 174.

58 *Id.* For a history of this doctrine in England and the United States, see William C. Rooklidge, *Licensee Validity Challenges and the Obligation to Pay Accrued Royalties: Lear v. Adkins Revisited (Part III)*, 69 J. PAT. & TRADEMARK OFF. SOC'Y 63 (1987). The Supreme Court rejected this doctrine in *Lear, Inc. v. Adkins*, 395 U.S. 653 (1969).

59 *Sola*, 317 U.S. at 174–75.

60 *Id.* at 176 (citations omitted).

61 *Sola*'s language is notably similar to the language courts use when discussing field preemption. *See, e.g.*, Arizona v. United States, 567 U.S. 387, 399 (2012) ("The intent to displace state law altogether can be inferred from a framework of regulation 'so pervasive . . . that Congress left no room for the States to supplement it' or where there is a 'federal interest . . . so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject.'" (alterations in original) (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947))).

rules that had traditionally been rooted in the common law of contracts. The Court's concern regarding the supremacy of federal law is not controversial. Of course, federal statutes should not be rendered "naught" by state statutes or common law rules. In those situations, federal law should preempt state law, as discussed in Section V. But to reach the decision in *Sola*—that licensee estoppel unduly thwarted the reach of the Sherman Act—the Court did not have to hold that all questions regarding the effects of federally illegal contracts are federal questions. At this time, the Supreme Court had already articulated the framework for modern preemption doctrine. The prior year, the Court decided *Hines v. Davidowitz*, 312 U.S. 52 (1941), in which the Court stated: "Our primary function is to determine whether, under the circumstances of this particular case, Pennsylvania's law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[62] The Court could have applied *Davidowitz*'s framework as to whether the application of licensee estoppel in *Sola* was an obstacle to the enforcement of the Sherman Act. Under the peculiar doctrines of the time, it arguably did, and the Court could have reached the same result. Instead, the decision set the Court down a path of transforming traditional contract doctrines into questions of first impression for a new federal common law of contracts.

This is a strange and notable result. So far as I have been able to determine, no academic commentator has thoroughly considered the interaction between state and federal law when a defendant invokes federal illegality in a breach of contract action.[63] The most thoughtful identification of the issue I have found is in the Ninth Circuit decision *Bassidji v. Goe*,[64] which

62 *Hines*, 312 U.S. at 67.

63 Certain academics have touched on the issue, most notably Professor Caleb Nelson. Nelson, *supra* note 45. Professor Nelson would categorize the defense as an "implementation" of a federal statute, and therefore, properly a matter of federal law. *Id.* at 734–35. Professor Nelson does not conceive of *Sola* as a preemption decision, but rather a decision about an unwritten canon of statutory construction. *Id.* Although I wonder how he would explain the *Sola* Court's citation of the Supremacy Clause and language regarding preemption, the characterization does not matter for the purpose of my analysis. The upshot of *Sola* is that courts should not look to state contract law to determine the effect of federal illegality and instead should rely on unwritten federal law (whether characterized as "federal common law" or not). Others have merely noted as a descriptive matter that courts will apply federal law to federal illegality defenses. *E.g.*, H. Justin Pace, *The "Free Market" for Marijuana: A Sober, Clear-Eyed Analysis of Marijuana Policy*, 24 LEWIS & CLARK L. REV. 1219, 1226–27 (2020).

64 Bassidji v. Goe, 413 F.3d 928, 935–36 (9th Cir. 2005).

did not concern the Sherman Act. The Court cited the Supreme Court's broad, categorical statements from *Sola* and *Kelly v. Kosuga*, 358 U.S. 516 (1959)[65] (discussed in the next Section), but noted that courts have often applied state law without considering whether federal law should apply.[66] Seemingly uncomfortable with the broad language from *Kelly* and *Sola*, the Court avoided the issue, deciding that California state and federal law would reach the same result, and so did not ground its decision in either one.[67]

II
Development of Antitrust Illegality Doctrine

Congress enacted the Sherman Act in 1890. Section 1 of the Sherman Act provides that "[e]very contract, combination . . . , or conspiracy, in restraint of trade . . . is declared to be illegal."[68]

Modern cases addressing the affirmative defense of antitrust illegality analyze two Supreme Court cases: *Kelly v. Kosuga*, 358 U.S. 516 (1959), and *Kaiser Steel Corp. v. Mullins*, 455 U.S. 72 (1982).[69] In *Kelly*, the Court rejected the defense of antitrust illegality, and in *Kaiser*, approved it.[70] Modern courts treat these cases as two ends of a spectrum and ask whether the facts of the case they are considering are closer to *Kelly* or *Kaiser*.[71] This approach is difficult to implement, and as will be seen, set the stage for Courts of Appeals in *National Souvenir Center, Inc. v. Historic Figures, Inc.* and *Hemlock Semiconductor Operations, LLC v. SolarWorld Industries Sachsen GmbH* to elaborate on *Kelly* and *Kaiser* in problematic ways.

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65 Kelly v. Kosuga, 358 U.S. 516 (1959).

66 *Bassidji*, 413 F.3d at 936.

67 *Id.*

68 Sherman Act § 1, 15 U.S.C. § 1.

69 *E.g.*, Hemlock v. SolarWorld Indus. Sachsen GmbH, 867 F.3d 692, 698 (6th Cir. 2017) ("Two Supreme Court cases govern the inquiry of when courts should refuse to enforce contracts that violate antitrust law."); Nat'l Souvenir Ctr. v. Historic Figures, Inc., 728 F.2d 503, 514–15 (D.C. Cir. 1984); *In re* Universal Serv. Fund Tele. Billing Pracs. Litig., No. 02-MD-1468, 2003 WL 21254765, at *3 (D. Kan. May 27, 2003); Baker's Carpet Gallery v. Mohawk Indus., Inc., No. 94-CV-0101, 1996 WL 888222, at *4 (N.D. Ga. Sept. 23, 1996).

70 *Kelly*, 358 U.S. at 521; Kaiser Steel Corp. v. Mullins, 455 U.S. 72, 77–83 (1982).

71 *See supra* note 69.

A. *Kelly v. Kosuga*

Kelly was a breach of contract case concerning nonpayment for the delivery of onions.[72] The case was in federal court based on diversity jurisdiction.[73] The defendant raised antitrust illegality as an affirmative defense, and the plaintiff filed a motion to strike.[74] The defendant had purchased fifty carloads of onions from the plaintiff.[75] After paying for some of the cars, the defendant stopped paying and refused to take possession of the remaining cars.[76] Attempting to mitigate damages, the plaintiff sold what he could at a lower price than the contract price.[77] The plaintiff sued to recover the difference between what the defendant promised and what the plaintiff was able to get.[78]

The defendant raised the defense of antitrust illegality.[79] He alleged that the purchase of the onions was part of a broader output restriction conspiracy.[80] According to the defendant, the plaintiff and another onion grower had 1000 carloads of onions. They allegedly told the defendant and other onion traders that unless they (1) purchased a certain number of onions from the defendant and the other grower and (2) refrained from selling these onions on the "futures exchange" that the plaintiff and the grower would flood the futures market, drive the futures prices down, and cause the defendant and others "considerable loss."[81] The plaintiff, defendant, and other onion traders all agreed to withhold their onions from the futures market, which the plaintiff argued was an agreement to restrict output on the futures market.[82] As a result, the defendant claimed the contract was illegal and unenforceable. The Supreme Court met this argument with remarkable hostility.

> As a defense to an action based on contract, the plea of illegality based on violation of the Sherman Act has not met with much favor in this Court. This has been notably the case

72 *Kelly*, 358 U.S. at 516.
73 *Id.*
74 *Id.*
75 *Id.*
76 *Id.* at 518.
77 *Id.*
78 *Id.*
79 *Id.* at 516.
80 *Id.* at 516–17.
81 *Id.* at 518.
82 *Id.*

> where the plea has been made by a purchaser in an action to recover from him the agreed price of goods sold.[83]

The Court cited three cases for that proposition: *Connolly v. Union Sewer Pipe Co*, 184 U.S. 540 (1902); *D.R. Wilder Manufacturing. Co. v. Corn Products Refining Co*, 236 U.S. 165 (1915), and *A.B. Small Co. v. Lamborn & Co.*, 267 U.S. 248 (1925).[84] All three of those cases addressed the same argument. The defendant purchased a product, failed to pay, and then claimed that the plaintiff-seller was in fact a member of an unlawful cartel that had fixed the price of the good the defendant purchased.[85] To illustrate the posture of these cases, imagine a car manufacturer enters into a contract with a tire manufacturer to purchase a large quantity of tires. After taking possession of the tires, the car manufacturer learns that tire manufacturers have allegedly been fixing tire prices, including on the tires the car manufacturer purchased. The car manufacturer argues that it does not have to pay for the tire because the contract with the tire manufacturer violates the Sherman Act.

Those cases all reached the correct result that antitrust illegality is not available to avoid paying for a price-fixed good. The Court reasoned that purchasing the good was "collateral" to the allegedly unlawful cartel, and thus irrelevant to the question of liability under the contracts at issue.[86] A perhaps more modern way of characterizing these cases is that the purchase of the price-fixed product *injures* the purchaser, but the unlawful *agreement* was the agreement to fix prices. In other words, to successfully invoke "illegality" as a defense, the agreement at issue has to be the competition-reducing agreement. Whether the competition-reducing agreement is the one that gives rise to a particular injury is not relevant in assessing illegality. The defendant-purchasers in these cases may have had antitrust claims for damages against members of the cartel, but they did not have defenses for the failure to pay for the price-fixed good.

Those cases were not particularly relevant to the defense in *Kelly* and the Court's reliance on them was unpersuasive. The defendant in *Kelly* claimed that the agreement to restrain output was actually part of the consideration for the purchase

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83 *Id.* (footnote omitted).

84 *Id.* at 518–19.

85 Connolly v. Union Sewer Pipe Co., 184 U.S. 540, 547 (1902); D.R. Wilder Mfg. Co. v. Corn Prods. Refin. Co., 236 U.S. 165, 171–17 (1915); A.B. Small Co. v. Lamborn & Co., 267 U.S. 248, 251–52 (1925).

86 *See supra* note 86.

of the onions; the defendant alleged that the seller threatened him with flooding the futures market unless he (1) agreed to purchase a limited amount of onions and (2) agreed not to sell any onions on the futures market for a set amount of time.[87] The question presented to the Court was whether (2) actually was a non-severable part of the overall agreement. Rather than addressing the issue in traditional severability terms, the Court created a rule that resembles severability but has a different scope.

> Past the point where the judgment of the Court would itself be enforcing the precise conduct made unlawful by the Act, the courts are to be guided by the overriding general policy, as Mr. Justice Holmes put it, "of preventing people from getting other people's property for nothing when they purport to be buying it." Supplying a sanction for the violation of the Act, not in terms provided and capricious in its operation, is avoided by treating the defense as so confined.
>
> Accordingly, while the nondelivery agreement between the parties could not be enforced by a court, if its unlawful character under the Sherman Act be assumed, it can hardly be said to enforce a violation of the Act to give legal effect to a completed sale of onions at a fair price.[88]

Thus, the rule from *Kelly* is that the Court will examine whether the plaintiff is seeking to enforce the "precise conduct" made unlawful by the Sherman Act. Here, in the Court's view, that was the alleged output restriction agreement. That was evidently a distinct agreement from "the purchase of onions at a fair price." Separating the agreements in such a way seems to assume the Court would have reached the conclusion that the output-restriction aspect of the agreement was severable,[89] but it did not engage in the typical "materiality" analysis

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87 *Kelly*, 358 U.S. at 516–17.

88 *Id.* at 520–21 (citations omitted) (quoting Cont'l Wall Paper Co. v. Louis Voight & Sons Co., 212 U.S. 227, 271 (1909) (Holmes, J., dissenting)).

89 Perhaps the Court's oblique invocation of "divisibility" at the end of the opinion is doing precisely that. *Id.* at 521. When the *Kaiser* Court later characterized *Kelly*, it stated "In [*Kelly*], there were two promises, one to pay for purchased onions and the other to withhold onions from the market. The former was legal and could be enforced, the latter was illegal and unenforceable." *Kaiser*, 455 U.S. at 82. That is certainly a clearer articulation than anything stated in *Kelly*. Nonetheless, it does not explain *how* the Court concluded that there were "two promises" rather than one.

entailed by severability doctrine, though it was established at the time.[90]

Clearly motivating the Court was a policy concern that unscrupulous defendants would invoke antitrust illegality to avoid legitimate commercial obligations. That concern, of course, is not unique to the Sherman Act or federal illegality; it was (and remains) a key policy concern influencing the development of the common law of contracts.[91] But rather than relying on Illinois law to supply the rule, the Court created its "precise conduct" rule, a rule ostensibly derived from the Sherman Act:

> Obviously, state law governs in general the rights and duties of sellers and purchasers of goods, and, while the effect of illegality under a federal statute is a matter of federal law, *Sola Electric Co. v. Jefferson Electric Co.*, 317 U.S. 173, 176–177, even in diversity actions in the federal courts after *Erie R. Co. v. Tompkins*, 304 U.S. 64, still the federal courts should not be quick to create a policy of nonenforcement of contracts beyond that which is clearly the requirement of the Sherman Act.[92]

The Court therefore found in the Sherman Act a policy favoring the enforcement of commercial agreements notwithstanding an antitrust illegality defense.

B. *Kaiser Steel Corp. v. Mullins*

Twenty-three years later the Court reached the opposite conclusion in *Kaiser Steel Corp. v. Mullins*.[93] In *Kaiser*, the United Mine Workers union ("UMW") brought a breach of contract claim against Kaiser Steel, a vertically integrated steel manufacturer that was also a coal producer.[94] The Union's collective bargaining agreement with coal producers, including Kaiser Steel, required the coal producers to pay into employee retirement and medical funds based on the amount of coal produced and purchased.[95] Kaiser Steel evidently made

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90 *E.g.* Restatement (First) of Contracts § 603 (Am. L. Inst. 1932) ("A bargain that is illegal only because of a promise or a provision for a condition, disregard of which will not defeat the primary purpose of the bargain, can be enforced with the omission of the illegal portion by a party to the bargain who is not guilty of serious moral turpitude unless this result is prohibited by statute.").

91 *E.g. id.* § 599.

92 *Kelly*, 358 U.S. at 519.

93 *Kaiser*, 455 U.S. 72.

94 *Id.* at 75–76.

95 *Id.* at 74–76.

no payments based on the amount of coal it *purchased* from non-UMW coal producers.[96] The Union sued, and Kaiser Steel raised the defense of antitrust illegality.[97] Kaiser argued that the provision of the collective bargaining agreement requiring contributions tied to purchasing non-UMW coal was anticompetitive because it "puts non-UMW producers at a disadvantage in competing for sales to concerns like Kaiser" and "because it penalizes Kaiser for shopping among sellers for the lowest available price."[98]

The Court reasoned that this provision, unlike the provision in *Kelly*, was in fact the precise conduct that would be unlawful under the Sherman Act: "If the purchased-coal agreement is illegal, it is precisely because the promised contributions are linked to purchased coal and are a penalty for dealing with producers not under contract with the UMW."[99] Putting to one side whether the Court articulated a plausible theory of competitive harm,[100] the Court was correct that the defense turned on the enforceability of the purchased-coal provision. But the "precise conduct" rule is (unsurprisingly) a less helpful way of thinking about an illegality defense than traditional contract law principles. Indeed, Justice Brennan, the author of *Kelly*, dissented and argued that making the contributions to

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96 *Id.* at 76.

97 *Id.*

98 *Id.* at 78.

99 *Id.* at 82.

100 The Court suggested, though was not entirely clear, that this provision suppressed competition in a relevant market for the sale of coal. In a footnote explaining how the provision could be anticompetitive, the Court stated, "In order to sell coal to Kaiser, a non-UMW producer must lower its price such that when added to the amount Kaiser must pay under the purchased-coal clause, the price is still competitive with those charged by UMW producers." *Id.* at 78 n.5. A number of assumptions have to be true in order for this theory to make sense. Consider that this provision only applied to *coal producers*. Kaiser was affected by it because it was vertically integrated as both a steel and coal producer; it was therefore both a producer and purchaser of coal. The number of coal producers that are also coal purchasers would have to be sufficient to harm competition in the coal-sales market. Second, assuming that the number of coal purchasers affected under the UMW collective bargaining agreement could be sufficient to harm competition, the amount money at issue would have to be large enough to significantly affect the purchase price. If the contribution to the employees' funds was not enough to affect the purchaser's decision to buy from the lower cost producer, then the contribution wouldn't have affected the competitive environment. Without these allegations, it is hard to see how the provision would harm competition.

The *Kaiser* Court certainly appeared less concerned with the policy considerations fueling the *Kelly* Court's skepticism of antitrust illegality. Cynically, one wonders if the identity of the parties shaped the differing intuitions.

the employer plans would not be the precise conduct made unlawful, even under Kaiser Steel's view, because the payments were not of themselves "inherently illegal."[101] Instead, Justice Brennan argued they were part of the mechanism by which a subsequent restraint of trade, presumably choosing not to purchase non-UMW coal, would occur.[102] As discussed more below, focusing on "conduct" creates a vagueness that allowed for the disagreement between the *Kaiser* majority and dissent.

In any event, subsequent lower courts would transform these opinions into something much less defensible.

C. *National Souvenir Center, Inc. v. Historic Figures, Inc.*

The D.C. Circuit decided *National Souvenir Center v. Historic Figures, Inc.*[103] in 1984, two years after *Kaiser. National Souvenir* concerned wax museum franchise agreements.[104] According to the plaintiffs (the franchisees), the franchise agreements contained unlawful tying provisions.[105] The franchisor was a wax figure manufacturer that would provide franchisees with wax figures.[106] The relationship did not resemble a traditional franchisor-franchisee arrangement. The franchisees did not share a common name; there was no common advertising; there were no common standards or business practices.[107] Instead, the relationship was more akin to a supplier arrangement. However, the franchisees were required to pay an ongoing "franchise fee."[108] What the franchisees received in return for the franchise fee was at issue in the case. The plaintiffs alleged that the franchise fees purchased "start-up" advice and marketing in addition to a retainer to provide such advice as needed on an ongoing basis.[109] The plaintiffs alleged that the

101 *Id.* at 98 (Brennan, J., dissenting).

102 *Id.*

103 Nat'l Souvenir Ctr., Inc. v. Historic Figures, Inc., 728 F.2d 503, 503 (D.C. Cir. 1984).

104 *Id.* at 506.

105 *Id.* at 507–08. "Tying" is a type of antitrust claim when the seller of good or service (the "tying product") has market power and requires a buyer to purchase a separate good or service (the "tied product") in order to purchase the tying product. The act of tying must harm competition in the tied market. *See* Eastman Kodak v. Image Tech. Servs., Inc., 504 U.S. 451, 461–62 (1992); AREEDA & HOVENKAMP, *supra* note 2, ¶ 1702.

106 *Nat'l Souvenir*, 728 F.2d at 506–07.

107 *Id.* at 507.

108 *Id.* at 507–08.

109 *Id.* at 510.

franchisor "tied" the provision of marketing advice to the sale of the wax figures; the plaintiffs did not want to purchase the marketing advice but had to in order to get the wax figures.[110] The plaintiffs stopped paying the franchise fee and filed antitrust claims.[111] The defendant filed counterclaims for breach of contract for failing to pay the franchise fees.[112] In response, the plaintiffs (counterclaim defendants) raised the affirmative defense of antitrust illegality—the defensive invocation of the antitrust theory upon which they filed their original claims.[113]

The complicating and ultimately dispositive fact about the plaintiffs' affirmative claims was that the plaintiffs waited between ten and fifteen years after they entered into the agreement to file suit.[114] Private claims for damages under the Sherman Act are subject to a four-year statute of limitations.[115] The D.C. Circuit determined that even though the plaintiffs continued paying the franchise fees within the limitations period, the franchisor did not in fact obligate itself to perform any ongoing services beyond the initial provision of start-up advice and marketing.[116] Therefore, even if the agreement initially constituted an anticompetitive tie, the plaintiffs only had four years to bring that claim; having not done so within that period, the statute of limitations barred the claims.[117]

However, the statute of limitations holding had no bearing on the antitrust illegality defense. Whether or not something violates Section 1 of the Sherman Act does not turn on the statute of limitations. Policy considerations other than the illegality of the conduct at issue—considerations like repose and incentivizing diligent prosecution of claims—justify statutes of limitations.[118] There are not similar policy considerations governing a defense of illegality.

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110 *Id.*

111 *Id.* at 506.

112 *Id.*

113 *Id.* at 514.

114 *Id.* at 506.

115 15 U.S.C. § 15b. Claims for injunctive relief—for example, an injunction to prohibit anticompetitive conduct—are not subject to the four-year statute of limitations but are instead governed by the equitable defense of laches. *See, e.g.*, Oliver v. SD-3C LLC, 751 F.3d 1081, 1085–86 (9th Cir. 2014).

116 *Nat'l Souvenir*, 728 F.3d at 511–13.

117 *Id.* at 513.

118 *See, e.g.*, AREEDA & HOVENKAMP, *supra* note 2, ¶ 320a ("Limitation serves the same functions in antitrust as elsewhere in the law: to put old liabilities to rest, to relieve courts and parties from 'stale' claims where the best evidence may no longer be available, and to create incentives for those who believe themselves

The court, therefore, had to apply *Kelly* and *Kaiser*, which it did by characterizing the decisions as standing for the proposition that a court would "refuse[] to enforce a promise to pay that was itself a mechanism to police anticompetitive conduct."[119] Here, the court reasoned, the franchise fees did not play such a role (note that the court refers to *Kaiser* by the other party name, Mullins):

> Unlike the "illegal promise" in *Mullins*, the promises to pay franchise fees in this case do not appear on their face to be primarily means to enforce the allegedly illegal tie-ins between the wax figures and start-up services. They appear rather to be a consideration for goods and services, to be paid for on an installment basis, *i.e.*, a routine exchange which *Mullins* was careful to distinguish from the penalty-like agreement it refused to enforce. *See Mullins*, 455 U.S. at 80, 102 S.Ct. at 857 (antitrust defense disfavored in action to recover agreed price for goods sold). This is not a case where the appellants turned to an alternative supplier of start-up services and now object to paying a "penalty" for doing so.[120]

This explanation is not plausible. The "goods and services" for which the plaintiffs paid the franchise fees were the allegedly anticompetitive tie-ins. To argue the payment was not part of the illegal conduct is akin to arguing that the payment for a murder-for-hire contract is separate from the murder. This type of argument is possible because of the Supreme Court's focus on the "precise conduct" at issue rather than the contractual provision. However, this is a strained interpretation even of the already vague *Kelly* and *Kaiser* decisions, which perhaps explains why the court went on to provide an additional gloss:

> To transform the contracts here into illegal tie-ins would require complex proof of monopoly power in the tying market and leverage of that power in the tied market. Even then, their vice would extend only to the amount that the agreed prices exceeded the fair value of the goods and services received and consumed—the portion of the prices that could be traced to the illegal practice. The complexity of proof and speculative nature of appellants' defenses seem to us to place them outside of the *Mullins* exception and clearly within the ambit of disfavor for such defenses articulated in *Kosuga*. . . . The remote danger, in a case such as this, that the court will

wronged to investigate and bring their claims promptly, particularly when they are known or can be determined.").

119 *Nat'l Souvenir*, 728 F.3d at 515.

120 *Id.*

> be a party to enforcing an illegal restraint, seems far outweighed by the probability that allowing the defense would let the buyer escape from its side of a bargain long after it had secured exactly what it had bargained for, as well as involve the courts in a prolonged controversy over whether an illegal tie-in existed due to the seller's market power and how that tie-in affected the agreed price for goods and services.[121]

Here, the D.C. Circuit injected a distinct consideration: whether the antitrust defense would require "complex proof." The court did not attempt to reconcile this reasoning with the Supreme Court's treatment of the collective bargaining agreement in *Kaiser*. There, the purchased-coal provision could have only harmed competition if there was some sort of market power in a relevant market, and the Supreme Court nonetheless found the defense of antitrust illegality well plead.[122]

The D.C. Circuit's "complex proof" addition essentially gutted the defense of antitrust illegality. As will be discussed further below, the sorts of contracts that plaintiffs will attempt to enforce in court will generally not contain antitrust violations that would be subject to the *per se* rule of illegality. In order to show they are anticompetitive, a defendant would typically need to resort to "complex proof" of market power and anticompetitive effects.

D. *Hemlock Semiconductor Operations, LLC v. SolarWorld Industries Sachsen GMBH*

The most recent appellate court to consider antitrust illegality was the Sixth Circuit in *Hemlock Semiconductor Operations, LLC v. SolarWorld Industries Sachsen GmbH*.[123] The plaintiff and defendant in *Hemlock* were both manufacturers of solar power components, and Hemlock was a supplier of polycrystalline silicon ("polysilicon") to SolarWorld.[124] The companies entered into a 10-year contract where Hemlock would make polysilicon available to SolarWorld at a fixed price throughout the duration of the contract.[125] The contracts contained a "take-or-pay" provision, which required SolarWorld to actually purchase a specified quantity of polysilicon each year

121 *Id.* at 515–16.

122 *See supra* note 100.

123 Hemlock Semiconductor Ops, LLC v. SolarWorld Indus. Sachsen GmbH, 867 F.3d 692, 692 (6th Cir. 2017).

124 *Id.* at 695.

125 *Id.* at 696.

even if it didn't need it or take possession of it.[126] If SolarWorld failed to pay the specified amount in the take-or-pay provision, Hemlock could terminate the contract and collect the full remaining balance owed to it for future years under the take-or-pay provisions.[127]

Locking in a fixed rate for ten years was a gamble by both companies. If the market price was above the fixed price, SolarWorld got the better end of the bargain, and if the market price went below the fixed price, Hemlock got the better end of the bargain. For the first few years of the contract, the market price was well above the fixed price, and SolarWorld was content with the arrangement.[128] Starting in year four, however, the Chinese government began subsidizing its national production of polysilicon, causing the market price to plummet.[129] SolarWorld subsequently stopped paying under the take-or-pay provisions, and Hemlock filed a breach of contract action in federal court in Michigan to collect the remaining balance on its contract.[130] SolarWorld raised a number of affirmative defenses in response, including illegality.[131] SolarWorld, a German company, argued that the take-or-pay provisions both individually and combined with a restriction on resale, violated German and E.U. competition law.[132]

Peculiarly, the District Court, Court of Appeals, and the parties all agreed that the foreign antitrust defense should be assessed under *Kelly* and *Kaiser*.[133] For example, the Sixth Circuit stated "[t]wo Supreme Court cases govern the inquiry of when courts should refuse to enforce contracts that violate *antitrust law*."[134] By "antitrust law" the court apparently meant the competition laws of other jurisdictions. *Kelly* and *Kaiser* said no such thing. The holdings of *Kelly* and *Kaiser* are explicitly grounded in federal statutory law (*i.e.* the Sherman Act).[135]

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126 *Id.*

127 *Id.*

128 *Id.*

129 *Id.*

130 *Id.*

131 *Id.* at 697.

132 *Id.*

133 *Id.* at 699; Hemlock Semiconductor Corp. v. Deutsche Solar GmbH, 116 F. Supp. 3d 818, 823–24 (E.D. Mich. 2015); *see* Brief for Appellant SolarWorld Indus. Sachsen GmbH at 19, *Hemlock*, 867 F.3d 692 (No. 16-2181); Brief. of Plaintiff-Appellee Hemlock Semiconductor Ops. LLC at 18, *id.* (No. 16-2181).

134 *Hemlock*, 867 F.3d at 698 (emphasis added).

135 Kaiser Steel Corp. v. Mullins, 455 U.S. 72, 77 (1982); Kelly v. Kosuga, 358 U.S. 516, 519–21 (1959).

They are not statements about "antitrust law" generally, regardless of jurisdiction.[136] The contracts at issue seemingly contained Michigan choice-of-law provisions,[137] so the courts and parties should have analyzed the extent to which Michigan law would recognize a foreign illegality defense.[138]

Nonetheless, the court applied *Kelly*, *Kaiser*, and *National Souvenir*. The court considered the illegality defense to have two distinct theories: that the combination of the take-or-pay provision with the resale provision was unlawful and that Hemlock "tied" its "predominant demand for polysilicon to a single seller."[139] The court first rejected the "combination" theory on the ground that Hemlock was not trying to enforce the "precise conduct" EU law prohibits:

> Here, as with the sale of onions between the parties in *Kelly*, there is nothing illegal about the payments pursuant to the take-or-pay provision. . . . Hemlock is suing to enforce only the take-or-pay provision—in other words, to require Sachsen to make the promised payments for polysilicon.[140]

Next, the Court addressed the "tying" argument. This most closely resembles a species of exclusive dealing under U.S. antitrust law, where a seller imposes a de facto exclusive deal on a purchaser. The Sixth Circuit agreed with the District Court that this theory of illegality would only work if Hemlock possessed a certain market share that would imply market power and forced SolarWorld to purchase a certain percentage of its required polysilicon.[141]

> Allowing Sachsen's illegality defense would open the door to a dispute about the extent of Hemlock's market power, which would involve facts that are "entirely unrelated to" the underlying breach-of-contract claim at issue here. *See Nat'l*

136 Indeed, the difficulties in applying such a rule become clear in trying to define what "antitrust law" even means across jurisdictions. What counts as "antitrust," "unfair competition," or consumer protection is not always clear in the United States; categorizing these laws for foreign jurisdictions would be even harder.

137 Brief. of Plaintiff-Appellee Hemlock Semiconductor Ops. LLC, *supra* note 134, at 18. The contracts themselves were filed under seal, and the parties do not state explicitly whether there was a Michigan choice-of-law provision. However, the analysis in the briefing and decisions is consistent with a Michigan choice-of-law clause.

138 Restatement (Second) of Conflict of Laws § 202 (Am. L. Inst. 1971); Chrysler Corp. v. Skyline Indus. Servs., Inc., 528 N.W.2d 698, 706–07 (Mich. 1995).

139 *Hemlock*, 867 F.3d at 698–702.

140 *Id.* at 699.

141 *Id.* at 700–02.

> *Souvenir*, 728 F.2d at 516. *National Souvenir* correctly determined that *Kelly* and *Kaiser Steel* stand for the proposition that the courts should be reluctant to allow litigation over speculative, complex antitrust issues to infiltrate simple breach-of-contract claims when the contract on its face does not violate antitrust law.[142]

Thus, *Hemlock* crystallized *National Souvenir's* "complex proof" rule. As interpreted by the Sixth Circuit, antitrust illegality should only be a viable defense when a plaintiff is trying to enforce a "facially" illegal provision.[143] If a provision would only be anticompetitive after an investigation of market conditions extrinsic to the contract, then the defense should fail.

III
Problems with Contemporary Antitrust Illegality Doctrine

No modern academic commentator has meaningfully examined antitrust illegality doctrine.[144] As I see it, there are two primary problems with contemporary antitrust illegality doctrine. First, courts reject the defense if, to prove the provision could harm competition, it is necessary to investigate market conditions. I refer to this as the "extrinsic evidence prohibition." By far the most problematic aspect of contemporary antitrust illegality doctrine, the extrinsic evidence prohibition essentially makes the defense a dead letter. Second, the courts' focus on conduct, rather the contract itself, creates unnecessary vagueness problems. I refer to this as the "precise conduct rule." The precise conduct rule creates problems for courts by focusing on conduct entailed by a contract rather than the text of the contract itself.

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142 *Id.* at 701–02.

143 *Id.* at 701.

144 The most thorough treatment is a student Comment from 1960, which predates *Kaiser* and subsequent lower court developments. Comment, *The Defense of Antitrust Illegality in Contract Action*, 27 U. Chi. L. Rev. 758 (1960). The Comment argues that *Kelly*'s holding, that courts should tend toward striking the defense, is unduly harsh. The Comment argues that courts should apply traditional common law principles to anticompetitive contracts, and that the reasons identified for nonapplication of the defense really counsel in favor of applying a remedy like restitution. *Id.* at 768–73. Other academic works have noted the doctrine because it may serve as the basis for (at least historical) judicial skepticism for antitrust defenses in copyright-infringement litigation. Scott A. Miskimon, *Divorcing Public Policy from Economic Reality: The Fourth Circuit's Copyright Misuse Doctrine in* Lasercomb America, Inc. v. Reynolds, 69 N.C. L. Rev. 1672, 1687 (1991); Roger Arar, Note, *Redefining Copyright Misuse*, 81 Colum. L. Rev. 1291, 1292–93 (1981).

A. The Extrinsic Evidence Prohibition

The lower courts' interpretation of *Kelly* requires the allegedly anticompetitive contractual provisions to be illegal "on their face."[145] From that requirement follows the prohibition into investigating market conditions to determine whether a provision could plausibly be anticompetitive.[146] The consequence of this interpretation, which has not been lost on the antitrust bar, is that any antitrust illegality defense based on a rule-of-reason theory must fail.[147]

And, because most antitrust illegality defenses will be based on rule-of-reason claims, the defense should fail most of the time regardless of the merits of the antitrust theory. To understand why requires some discussion of modern anticompetitive contracts.

1. *Anticompetitive Formal Contracts*

A defendant will only raise antitrust illegality when a plaintiff sues it for breaching a contract. In this situation, there will be a contract between a plaintiff and defendant that is legitimate enough that the plaintiff is not concerned about disclosing it to a court, and likely by extension, the public. So, one would not expect a plaintiff to attempt to enforce an agreement that is blatantly unlawful—like those subject to antitrust's *per se* rule of illegality. The *per se* rule declares that certain types of agreements between competitors, like price fixing, output restrictions, market allocation, and the like violate the Sherman Act without inquiry into market conditions.[148] Plaintiffs

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145 Nat'l Souvenir Ctr., Inc. v. Historic Figures, Inc., 728 F.3d 503, 515 (D.C. Cir. 1984); *Hemlock*, 867 F.3d at 698–702.

146 *Hemlock*, 867 F.3d at 698–702.

147 *E.g.*, Plaintiff Dish Network L.L.C.'s Reply Memorandum in Support of Motion for Judgment on the Pleadings or, in the Alternative, Motion to Strike Affirmative Defenses at 5–6, Dish Network L.L.C. v. WLAJ-TV, LLC, No. 6:16-cv-00869-CJB-DMD (W.D. La. Apr. 8, 2019), ECF No. 91 ("Where, as here, a contract would contravene antitrust principles only under certain market conditions depending on a rule-of-reason analysis, the contract is not illegal on its face and an antitrust defense does not lie." (citing *Nat'l Souvenir*, 728 F.2d at 515–16)).

148 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 886 (2007); NCAA v. Bd. of Regents of Univ. of Okla., 468 U.S. 85, 100 (1984); United States v. Topco Assocs., Inc., 405 U.S. 596, 608 (1972). Other agreements subject to the *per se* rule include group boycotts, Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 212 (1959), bid rigging, United States v. Joyce, 895 F.3d 673, 677 (9th Cir. 2018), "no-poach" agreements, *In re* Ry. Indus. Emp. No-Poach Antitrust Litig., 395 F. Supp. 3d 464, 481 (W.D. Pa. 2019), and wage-fixing, United States v. Jindal, No. 4:20-CR-00358, 2021 WL 5578687, at *5-8 (E.D. Tex. Nov. 29, 2021),

need not establish that the defendants have market power or that their conduct actually caused higher prices so long as they can prove the *per se* unlawful agreement occurred.[149] These sorts of agreements are not typically memorialized in written contracts; these are the agreements that take place in the figurative smoke-filled rooms between business executives.[150] The executives typically know the agreements are illegal (though not always),[151] so they will take steps to avoid detection.

But a great many contracts are anticompetitive, memorialized, and enforced. These contracts are entered into with varying degrees of knowledge of the risk of liability. Some companies may have no idea that the agreement could be unlawful—they think they are just doing smart business. Others may take a calculated risk. There are too many varieties of these sorts of provisions to discuss.[152] But one particularly common category of agreement that is likely to raise an antitrust illegality problem occurs when one party to a contract imposes restrictions on its counterparty regarding with whom the counterparty can do business. These types of contracts are "vertical," meaning they are agreements between companies that are typically at different levels in a supply chain and do not compete with each other. Vertical agreements can pose a threat to competition if the party imposing the restraint has market power, and the restriction prevents that party's competitors from effectively competing.[153]

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as well as other forms of direct and indirect price-fixing. *See* AREEDA & HOVENKAMP, *supra* note 2, ¶ 1906.

149 *Leegin*, 551 U.S. at 886.

150 *See* Scott D. Hammond, *"Caught in the Act: Inside an International Cartel,"* U.S DEP'T OF JUST. (Oct. 18, 2005), https://www.justice.gov/atr/speech/caught-act-inside-international-cartel [https://perma.cc/69Y7-J9SX].

151 For example, a court held that the arrangement governing health insurance providers in the Blue Cross Blue Shield network was potentially a per se unlawful market allocation agreement. *In re* Blue Cross Blue Shield Antitrust Litig., 308 F. Supp. 3d 1241, 1266-67 (N.D. Ala. 2018).

152 *Cf.* Caribbean Broad. Sys., Ltd. v. Cable & Wireless PLC., 148 F.3d 1080, 1087 (D.C. Cir. 1998) ("'Anticompetitive conduct' can come in too many forms, and is too dependent upon context, for any court or commentator ever to have enumerated all the varieties.").

153 *E.g.*, Interface Grp., Inc. v. Mass. Port Auth., 816 F.2d 9, 11 (1st Cir. 1987) (Breyer, J.) ("Exclusive dealing arrangements may *sometimes* be found unreasonable under the antitrust laws because they may place enough outlets, or sources of supply, in the hands of a single firm (or small group of firms) to make it difficult for new, potentially competing firms to penetrate the market. To put the matter more technically, the arrangements may 'foreclose' outlets or supplies to potential entrants, thereby raising entry barriers. Higher entry barriers make it easier for existing firms to exploit whatever power they have to raise prices above

Three variants are particularly common in the modern economy: (1) exclusive dealing, (2) "most favored nations" provisions ("MFNs"), and (3) anti-steering provisions. Generally speaking, all three will be subject to the "rule of reason" to determine if they are unlawful. The rule of reason consists of a burden-shifting framework:

> [T]he plaintiff has the initial burden to prove that the challenged restraint has a substantial anticompetitive effect that harms consumers in the relevant market. If the plaintiff carries its burden, then the burden shifts to the defendant to show a procompetitive rationale for the restraint. If the defendant makes this showing, then the burden shifts back to the plaintiff to demonstrate that the procompetitive efficiencies could be reasonably achieved through less anticompetitive means.[154]

The first step generally requires proof of market power, otherwise it would be unlikely to be possible that the restraint *could* harm competition.[155] The first step will also require proof that the restraint has caused or is likely to cause an "anticompetitive effect," which is typically defined as "reduced output, increased prices, or decreased quality in the relevant market."[156] The particularities of how the rule of reason operates are not important for the purposes of this Article; what *is* important is that simply looking at the words of a contract will not allow anyone to discern whether the contract is anticompetitive. Instead, some analysis of market conditions is required.

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the competitive level because they have less to fear from potential new entrants. Thus, for example, one might worry about long term exclusive dealing contracts between a small group of firms making most of the nation's light bulbs and the firms that make light bulb filaments; if potential light bulb manufacturers are deterred from entering the market by a fear that they will be unable to obtain filaments, the existing light bulb manufacturers may be able to keep prices high." (citations omitted)).

154 Ohio v. Am. Express Co. (*Amex*), 138 S. Ct. 2274, 2284 (2018) (citations omitted).

155 Copperweld Corp. v. Indep. Tube Corp., 467 U.S. 752, 768 (1984) (noting that the rule of reason is "an inquiry into market power and market structure designed to assess the combination's actual effect"); Daniel A. Crane, *Market Power Without Market Definition*, 90 Notre Dame L. Rev. 31, 31 (2014) ("Market power is an indispensable element in all antitrust cases except those arising under the Sherman Act's rule of per se illegality. Merger, monopolization, and rule of reason cases—the bulk of antitrust—require proof of market power to establish liability." (footnotes omitted)).

156 *Amex*, 138 S. Ct. at 2284.

a. *Exclusive Dealing*

"Exclusive dealing" describes a set of practices that have the effect of forcing a buyer to purchase goods or services from a particular seller for a certain period of time.[157] Exclusive dealing is common and generally lawful.[158] The paradigmatically anticompetitive exclusive dealing contract will involve a supplier ("Supplier") who forces a purchaser ("Purchaser") to buy only from Supplier. Supplier has market power, and the contract with Purchaser is large enough that it forecloses a substantial percentage of the market such that Supplier's competitors are negatively affected.[159]

Suppose for example that a dominant supplier of electric car batteries required electric car manufacturers to deal exclusively with it or not at all for a period of ten years. When first entering the deal, an electric car manufacturer felt it had no choice but to accept exclusivity. But after several years go by, there are some nascent competitors who are offering more attractive deals than the dominant battery supplier. The electric car manufacturer would prefer to purchase its batteries from suppliers offering better deals.

Now, it turns out the dominant battery supplier has been imposing identical exclusivity on other electric car companies as well. As a result, the nascent battery competitors are struggling to gain traction because there is not robust demand for their batteries. They therefore may go out of business. This state of affairs would lock in the dominant battery supplier's market power. As a matter of public policy, the car manufacturer and others similarly situated should be able to obtain a more attractive offer if the only obstacle is an exclusivity provision. From the perspective of competition law, one of the options available to it should be simply ignoring the exclusivity

157 *See* ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 270 (3d Cir. 2012); 1 ANTITRUST LAW DEVELOPMENTS § 1D-2-b (9th ed. 2022).

158 U.S. DEP'T OF JUST., *Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act: Chapter 8*, at n.2, https://www.justice.gov/archives/atr/competition-and-monopoly-single-firm-conduct-under-section-2-sherman-act-chapter-8#:~:text=Exclusive%20dealing%20is%20common%20and%20can%20take%20many%20forms.&text=It%20often%20requires%20a%20buyer,products%20of%20the%20manufacturer's%20competitors [https://perma.cc/BP5S-XNRJ]; FED. TRADE COMM'N, *Exclusive Dealing or Requirements Contracts*, https://www.ftc.gov/advice-guidance/competition-guidance/guide-antitrust-laws/dealings-supply-chain/exclusive-dealing-or-requirements-contracts [https://perma.cc/5HET-376G].

159 AREEDA & HOVENKAMP, *supra* note 2, ¶ 1802d5.

provision without potential liability for breach of contract if, in the real world, exclusivity is anticompetitive.

Now this is certainly not a license for companies to avoid their contractual duties with reckless abandon. The car manufacturer would have to be *correct* that the provisions are anticompetitive—that is, under the rule of reason, the exclusivity provision along with those like it harm the market for electric car batteries.[160] But in a case where competition is being harmed, it does not make sense to force the car manufacturer to comply with the exclusivity provision and bring an affirmative antitrust claim. The car manufacturer should be able to breach without liability.

Even with such a change in law, the ability to avoid an anticompetitive exclusive deal may be limited. Many, maybe most, exclusive deals are structured differently from the simplified electric car battery example. One common type of contract does not explicitly mandate exclusivity, but rather will condition some type of benefit on exclusivity. For example, purchasers may be entitled to rebates—rebates that make the difference between being financially attractive and not—on the condition of dealing exclusively with a supplier.[161] In that case, violating the exclusivity provision may result in forfeiting the rebate, which is probably a worse outcome than simply sticking with the deal. Other contracts may permit the supplier to cut off the purchaser if the purchaser violates the exclusivity provision.[162] Depending on the facts, getting completely cut off may be a worse outcome than sticking with the exclusive supplier. Nonetheless, in the cases where breach is attractive, the purchaser should have that option.

b. *Antisteering Provisions*

"Steering" refers to the practice of firms encouraging customers to use goods or services that are cheaper for the steering firm.[163] Disputes regarding steering have occurred in hospital-

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160 *Cf. ZF Meritor*, 696 F.3d at 271.

161 *E.g. id.* at 265; McWane, Inc. v. FTC., 783 F.3d 814, 820–21 (11th Cir. 2015); LePage's Inc. v. 3M, 324 F.3d 141, 147 (3d Cir. 2003).

162 *E.g.* United States v. Dentsply Int'l., Inc., 399 F.3d 181, 185–86 (3d Cir. 2005).

163 *E.g.* Ohio v. Am. Express Co. (*Amex*), 138 S. Ct. 2274, 2282–83 (2018); Benitez v. Charlotte-Mecklenburg Hosp. Auth., No. 3:18-cv-00095-RJC-DCK, 2019 WL 1028018, at *1 n.2 (W.D.N.C. Mar. 4, 2019), *aff'd*, 992 F.3d 229 (4th Cir. 2021).

insurance contracts[164] and various technology platforms[165]; although most famously, the Supreme Court recently addressed steering in the context of credit card-merchant contracts.[166] Hospital-insurance contracts provide the clearest illustration. Health insurance providers operate in multi-sided markets.[167] On one side, they deal with health insurance subscribers, often employer groups and individuals.[168] On the other side, they deal with healthcare providers, often hospital systems, clinics, and the like.[169] The insurance company and the providers will reach agreements over the costs that the health insurance provider will pay for certain procedures.[170] A health insurance company may want to "steer" subscriber members (*i.e.* patients) to particular hospitals where the cost of procedures is lower. The insurance company can do this in several different ways, but a common way is to offer financial incentives, like making the patient on the hook for much less of the cost.[171] In theory, this sort of steering should benefit both the health insurance company and consumer: the savings from using a cheaper hospital are split between the consumer and health insurance company. The hospitals are in turn incentivized to compete with each other to offer cheaper and higher quality services so they can be the beneficiaries of steering.[172]

Hospitals also have an incentive to oppose steering. All things being equal, eliminating competition for steering results in increased profits through supracompetitive pricing for the hospital services.[173] So, one would expect hospitals to resist steering in their negotiations with insurers. Unless one side

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164 *E.g. Benitez*, 2019 WL 1028018, at *1.

165 *E.g.* Epic Games, Inc. v. Apple Inc., 559 F. Supp. 3d 898, 944 (N.D. Cal. 2021).

166 *Amex*, 138 S. Ct. at 2282–83.

167 *See generally* Nicholas A. Widnell & Brian A. Hayles, *Post-*Amex *Steering Restrictions: Lingering Questions from* United States v. Charlotte-Mecklenburg Hospital Authority, 34 ANTITRUST 77, 78–79 (2019).

168 *Id.*

169 *Id.*

170 *Id.* If an insurance provider and a hospital system are unable to come to an agreement, a person with that health insurance will only be able to use that hospital system if he pays out of pocket. In some instances, that is why a hospital system will be "out of network."

171 *See, e.g.*, Complaint ¶¶ 5–10, United States v. Charlotte-Mecklenburg Hosp. Auth., No. 16-cv-00311 (W.D.N.C. June 9, 2016), ECF No. 1.

172 *Id.* ¶ 10.

173 *Id.* ¶¶ 12–14.

or the other has market power, however, competitive pressures would likely push these negotiations toward a pro-consumer result. Whether that pro-consumer result is steering or something else is difficult to say, but in the absence of market power, both hospitals and insurers should compete to offer cheaper and better services to individuals.

The anti-steering problem arises when the hospital system has market power. Anti-steering can result in the same competitive harms as exclusivity. Suppose, as is often the case, there is one dominant hospital system in a particular metropolitan area with at least one non-dominant competitor. In order for an insurance company to be a viable option for people who live in that metropolitan area, it must do business with the dominant hospital system. If the dominant hospital system prohibits steering, it may be commercially rational for the insurer to acquiesce—that is the cost of doing business in that particular area. Steering, like most favored nations provisions discussed in the next section, harms competition in a similar way to exclusivity. Absent a prohibition on steering, insurers would steer patients toward the non-dominant hospital systems, increasing their revenues and competitive viability. While the number of patients affected is almost certainly less than if the dominant hospital system insisted on outright exclusivity, the steering prohibition could damage the non-dominant rival systems enough to affect competition.

If a dominant hospital system forecloses competition through the use of anti-steering provisions, the hospital system should not be able to enforce those anti-steering provisions. Once again, whether the anti-steering provisions harm competition or are capable of harming competition requires an analysis of market conditions. Under the extrinsic evidence prohibition, an insurer would have no defense to a breach of contract action if it ignored the anti-steering provision. That is not a sensible result.

c. *Most Favored Nations Provisions*

Most favored-nations provisions ("MFNs") are a common provision in commercial contracts. The typical structure of an MFN requires one party to a contract ("Buyer") to promise its contracting partner ("Seller") that if Buyer enters into a deal with Seller's competitor for the same good or service on better terms, Seller will have the option to apply those better terms to the parties' contract.[174] A more problematic variant would be if the MFN requires Buyer to always offer a more attractive deal to Seller than Seller's rivals (an "MFN+").[175]

To illustrate, take the example of the electric car battery supplier discussed before.[176] Rather than impose exclusivity, a dominant supplier of electric car batteries imposes an MFN on an electric car manufacturer. The car manufacturer may be forced to do business with the dominant supplier of electric car batteries because, otherwise, it cannot find enough car batteries. In order to do business with the battery supplier, the car manufacturer accepts an MFN stating that if the car manufacturer purchases car batteries from another battery supplier for more money per battery, the dominant manufacturer must have access to that better rate, perhaps even retroactively. Suppose an upstart rival battery supplier makes an offer to the car manufacturer that it will sell a battery that lasts significantly longer, but costs 10% more than the dominant battery supplier. Absent the MFN, the car manufacturer would agree to purchase many of these batteries. With the MFN though, the car manufacturer must consider whether it made financial sense for it to offer a 10% increase on all its car batteries across the board. Very likely the answer would be no, and the car manufacturer would decline doing business with the rival battery supplier.[177] In this situation, the MFN could

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174 AREEDA & HOVENKAMP, *supra* note 2 ¶ 1807b1.

175 *See* Jonathan Baker & Judith A. Chevalier, *The Competitive Consequences of Most-Favored-Nations Provisions*, 27 ANTITRUST 20, 24 (2013).

176 *See supra* Section III.A.1.a.

177 Baker & Chevalier, *supra* note 176, at 24 ("[A]n MFN can harm competition through exclusion by making it impossible for a dominant incumbent firm's rivals, including entrants, to bargain with input suppliers or distributors for a low price. When the suppliers or distributors have an MFN with a large incumbent, they would lose too much if they made that kind of deal with a small rival or entrant. In this way, the MFN discourages the rivals from lowering their own costs, and so prevents them from competing aggressively.").

The car battery example here highlights that an MFN can be problematic when the terms of the MFN ignore competition on certain dimensions. In this example, the MFN takes account of price and quantity, but not quality. The example discussed in Professors Baker and Chevalier's article, where a dominant dental insurer required dentists to accept an MFN on reimbursement rates, has a similar structure. In that example, if a dentist accepted lower reimbursement rates from another dental insurer, the dominant insurer would have the option to pay those lower reimbursement rates. In Professor Baker and Chevalier's article, the rival insurers may have offered to steer additional patients toward the dental insurer, which would have explained why the dentist would have accepted lower reimbursement rates (*i.e.* the additional volume of patients would make the net income greater). *Id.* at 24. Thus, the MFN in their example did not account for steering as an additional dimension of competition. In the real-world example on harm competition in the same way that outright exclusivity would. If the effect of the MFN or series of MFNs is de facto exclusivity, then the MFN would harm competition under the same circumstances as exclusivity: namely, when the company imposing it has market power, and the effect of the exclusivity is the substantial foreclosure of competition.[178]

Performing this analysis will, once again, require an assessment of market conditions. Whether the MFN has the effect of exclusivity and whether that exclusivity could result in substantial foreclosure both are questions that go beyond the four corners of the contract. But the claim is quite plausible, and an anticompetitive term like this should not be enforceable.

B. The Precise Conduct Rule

The purpose of the precise conduct rule is to determine whether the plaintiff is trying to enforce a lawful portion of a contract that may have a separate anticompetitive component.[179] This is a legitimate and important purpose. The Supreme Court described the precise conduct test as asking whether "the judgment of the Court would itself be enforcing the precise conduct made unlawful by the Act."[180]

This test presents an immediate difficulty. A court can "enforce" a *contract* in a breach of contract action; it does not enforce conduct. The default method of enforcement is through money damages. A court could also mandate conduct through specific performance, but the test contemplates "enforcement" beyond asking whether the remedy is specific performance. To illustrate, suppose Rhode Island Corp. and Massachusetts Inc. are potential competitors and agree to stay out of each other's service areas. Massachusetts Inc. breaches the agreement and Rhode Island Corp. seeks damages for lost sales due to Massachusetts' entrance into Rhode Island Corp.'s historic service area (Rhode Island). The "precise conduct" that is

which their example is likely based, *United States v. Delta Dental of Rhode Island*, the promise of steering was not as straightforward. *See United States v. Delta Dental of R.I.*, 943 F. Supp. 172, 183–84 (D.R.I. 1996). The Department of Justice alleged that potential competitors could have contracted with a smaller number of dentists than Delta Dental, and presumably, the steering would have occurred structurally because subscribers would have fewer options, thus forming a natural funnel. *See* Complaint ¶¶ 11, 18–21, *id.* (No. 96-113/P), ECF No. 1.

178 *See* Aerotec Int'l, Inc. v. Honeywell Int'l, Inc., 836 F.3d 1171, 1180–81 (9th Cir. 2016).

179 Kelly v. Kosuga, 358 U.S. 516, 520–21 (1959).

180 *Id.* at 520.

unlawful does not involve the exchange of money, so enforcing the provision through an award of money damages would not be mandating *conduct* that is unlawful. It would be, however, enforcing an illegal provision, and it is hard to imagine any court enforcing such a provision.

While this criticism may seem pedantic, this mismatch invites confusion when courts use the precise conduct test as an analytical framework. Recall the disagreement between the majority and Justice Brennan in *Kaiser*.[181] That case turned on the enforceability of the "purchased-coal" provision that, in the coal producers' view, anticompetitively discouraged vertically integrated, union coal and steel producers from purchasing coal from non-union plants.[182] The provision required the union plants to make payments into union health and benefit plans based on coal purchased from non-union plants.[183] The defendant plant stopped making payments and raised antitrust illegality as a defense to breach of contract.

The majority had no problem finding that the provision implicated the "precise conduct" the antitrust laws make unlawful:

> If the purchased-coal agreement is illegal, it is precisely because the promised contributions are linked to purchased coal and are a penalty for dealing with producers not under contract with the UMW. In *Kosuga*, withholding onions from the market was not in itself illegal and could have been done unilaterally. But the agreement to do so, as the Court recognized, was unenforceable. Here, employer contributions to union welfare funds may be quite legal more often than not, but an agreement linking contributions to purchased coal, if illegal, is subject to the defense of illegality.[184]

Justice Brennan, however, disagreed. In dissent, he argued that the illegality defense should only be available if the payment was "inherently illegal"—for example, if the payment were a bribe—and not if there is some broader "connect[ion] with illegal activities or results."[185]

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181 Kaiser Steel Corp. v. Mullins, 455 U.S. 72, 98 (1982) (Brennan, J., dissenting); *supra* Section II.B.

182 *Kaiser*, 455 U.S. at 75–82.

183 *Id.*

184 *Id.* at 82.

185 *Id.* at 92–93 (Brennan, J., dissenting) (emphasis omitted). Justice Brennan argued that the basis for this distinction was the Multiemployer Pension Plan Amendments Act of 1980. *Id.* at 90–93.

Recall, too, that the D.C. Circuit confronted a similar difficulty in *National Souvenir Center v. Historic Figures, Inc.*[186] In that case, wax museum "franchisees" claimed that a monopolist manufacturer tied the provision of consulting services to the provision of wax figures.[187] In return for the unwanted consulting services, the franchisees had to pay an ongoing franchise fee. Rejecting the antitrust illegality defense the franchisees raised when the manufacturer sued for unpaid franchise fees, the D.C. Circuit reasoned that "the promises to pay franchise fees in this case do not appear on their face to be primarily means to enforce the allegedly illegal tie-ins between the wax figures and start-up services. They appear rather to be a consideration for goods and services, to be paid for on an installment basis."[188]

Justice Brennan and the D.C. Circuit both advanced counterintuitive views of illegal conduct. Both appear to concede that certain conduct could be *part* of an anticompetitive scheme, but for them, merely being a component of an illegal course of conduct should not be sufficient to raise the illegality defense. In other words, they appear to impose a view that the conduct in isolation must satisfy the elements of a Sherman Act claim in order for the illegality defense to be available. That will rarely be the case when examining "conduct" in such microscopic granularity. Illegal conduct will generally be comprised of several constituent parts. The precise conduct rule under this interpretation requires a court to translate a contractual provision into particular conduct, and if it is merely a constituent part of a larger course of conduct, it fails the test.

But, approaching the problem from a different angle, what is the "precise conduct" that the Sherman Act makes illegal? A case in which a party raises antitrust illegality will typically concern Section 1 of the Sherman Act because there will always be a contract at issue.[189] Section 1 of the Sherman Act prohibits contracts, combinations, or conspiracies that unreasonably restrain trade.[190] Thus, the *conduct* Section 1 targets is actually the *agreement* itself (*i.e.* the "concerted action" requirement). Whether the agreement is unlawful turns on

186 Nat'l Souvenir Ctr., Inc. v. Historic Figures, Inc., 728 F.2d 503, 508 (D.C. Cir. 1984).

187 *Id.*

188 *Id.* at 515.

189 Section 2 of the Sherman Act does not have a concerted action requirement. *See* Sherman Act § 2, 15 U.S.C. § 2.

190 1 ANTITRUST LAW DEVELOPMENTS § 1B (9th ed. 2022).

the *consequences* of the agreement—specifically, whether the agreement causes, is likely to cause, or presumptively causes, harm to competition. In antitrust illegality cases, the concerted action requirement will always be satisfied because there is a contract that has allegedly been breached. What makes the agreement illegal is what the agreement entails. The precise conduct test therefore requires a judge to think about "consequences" in terms of "conduct" when in the first instance the judge is analyzing a contractual provision.

That is an analytical framework destined to fail. The judge should only analyze whether the breach of contract requires *enforcement* of an anticompetitive contractual provision (*i.e.* a contractual provision that plays a causal role in harming competition).

C. Bringing an Antitrust Counterclaim

In many cases, a defendant in an antitrust illegality case could bring an antitrust counterclaim when sued for breaching an anticompetitive contract. Consider the exclusive dealing example from above concerning the electric car battery manufacturer.[191] The dominant battery supplier required the electric car manufacturer to agree to exclusivity for ten years. At some point, the car manufacturer wants out of the contract in order to deal with nascent competitors offering more attractive deals. If the car manufacturer breaches and gets sued, could it not just bring a Section 1 counterclaim? And if so, doesn't that mean the availability of antitrust illegality as an affirmative defense is irrelevant?

The answer is that the car manufacturer may be able to bring a counterclaim, but there are non-trivial policy reasons for not forcing it to. Non-enforcement of anticompetitive provisions, as opposed to actions for damages, may often be the preferred remedy from a public policy standpoint. Even if the antitrust counterclaimant could be more than made whole through treble damages, implementing and enforcing the anticompetitive provision will likely harm third parties (*e.g.* consumers) and the competitive process generally. Moreover, recall the example from the introduction regarding the dominant truck transmission supplier. The option to tell a vertically related firm with market power that its contracts are unenforceable may be better for the long-term relationship than threatening

191 *See supra* Section IV.A.1.a.

to sue. It gives a firm on the receiving end of an anticompetitive contract another potential tool in its toolbelt.

There are more practical considerations as well. If the car manufacturer breached and was sued in year seven, there is a significant chance that the four-year statute of limitations (or laches) will bar a counterclaim.[192] That was nearly the posture in *National Souvenir Center v. Historic Figures, Inc.*, 728 F.2d 503 (D.C. Cir. 1984). There the plaintiffs raised antitrust claims that the court held were barred, but it allowed the plaintiffs to defend counterclaims for breach of contract on an antitrust illegality theory.[193] Or consider one court's preferred method of handling the defense: forcing the defendant to bring an antitrust counterclaim, and if both the breach of contract and antitrust claims are successful, the court would impose a monetary set-off.[194] Perhaps the antitrust claim for damages is not possible to quantify and therefore may fail for an inability to prove non-speculative damages.[195] Or perhaps the defendant may not have standing to bring a claim for damages, as in the case of associations in many circumstances.[196]

But the more important point is that the enforcement of anticompetitive contracts harms competition, which harms market participants beyond the parties to the contract. Regardless of the money that changes hands between the contracting parties, the law should favor a policy of nonenforcement of anticompetitive contracts.

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192 *See* AREEDA & HOVENKAMP, *supra* note 2, ¶ 320c3 ("The best solution to the problem of long-term contracts that are unlawful, if at all, from the beginning but also known to the plaintiff, is to use the statute of limitation to bar the tardy damage action but to give flexibility in equity to permit the injunction against continued enforcement. To illustrate, suppose that the defendant imposes a 20-year requirements contract on the plaintiff that was challengeable as exclusive dealing from its inception. The purchaser who suffers injury but delays its damage action for six years has lost its opportunity to collect damages; but the public as well as the purchaser still profit from the termination of an anticompetitive arrangement. The court should permit an action declaring the contract unlawful and unenforceable. This approach may be precluded if the court woodenly adopts the principle that the period for determining whether laches bars an injunction is the same as that for the statute of limitation." (footnote omitted)).

193 *See supra* Section II.C.

194 *See* Diamond Crystal Brands, Inc. v. Food Movers Int'l, Inc., No. CV407-42, 2008 WL 2513806, at *2 (S.D. Ga. June 20, 2008).

195 *See* Bigelow v. RKO Radio Pictures, Inc., 327 U.S. 251, 264–65 (1946).

196 United Food & Com. Workers Union Local 751 v. Brown Grp., Inc., 517 U.S. 544, 553–54 (1996).

IV
State Law Should Govern Federal Illegality, Including Antitrust Illegality, with Preemption Doctrine as a Failsafe

The illegality defense will almost always require balancing the interests animating two different laws. First, there is the law giving rise to the breach of contract claim—state contract law. Second is the law the contract potentially violates. When those two laws come from different jurisdictions, the question is which jurisdiction's law should govern *the balancing* to determine the effect of the illegality. For federal illegality after the demise of the general common law, the *Sola* Court answered that question readily, choosing federal common law.[197] That decision was a mistake.

The decision reflects a departure from typical choice-of law-principles. When the law that makes a contract illegal comes from a different jurisdiction than the law giving rise to the breach, the usual choice-of-law analysis will choose one overarching body of contract law to analyze the breach and *effect* of illegality.[198] This is in contrast to the *existence* of illegality, which is a question based on the jurisdiction giving rise to the law that makes the contract potentially illegal.[199] Once the court determines that a contract is illegal, the effect of that illegality will usually be analyzed according to the jurisdiction that governs the interpretation of the contract as a whole.[200]

That is a sensible policy. The effect of illegality on contractual obligations is a notoriously difficult problem, and traditional common law contract principles grant the court significant discretion in balancing various, difficult-to-quantify considerations.[201] That flexibility should be informed by the single body of law equipped to take account of all those various considerations. That will be a single jurisdiction's contract law, and choice-of-law principles dictate that jurisdiction

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197 Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173, 176 (1942).

198 *See* Restatement (Second) of Conflict of Laws § 202 (Am. L. Inst. 1971); *see also id.* §§ 187–188.

199 *Id.* § 202 cmt. c.

200 *Id.* § 202; *id.* §§ 187–188; *see also* Escobio v. Am. Int'l. Grp., Inc., 262 F.3d 1207, 1211 (11th Cir. 2001) ("[I]n cases where foreign law is violated, the *existence* of illegality is to be determined by the local law of the jurisdiction where the illegal act is done while the *effect* of illegality upon the contractual relationship is to be determined by the law of the jurisdiction which is selected under conflict analysis.") (citing Dornberger v. Metropolitan Life Ins. Co., 961 F. Supp. 506, 533 (S.D.N.Y. 1997)).

201 *See, e.g.*, Restatement (Second) of Contracts § 178 (Am. L. Inst. 1981).

will be either the one the parties chose or the jurisdiction that has the most significant relationship to the contract and the parties.[202]

The *Sola* Court took a different path. For federal illegality, it concluded that simply by virtue of being a federal law, the effect of illegality on a contract is a federal question.[203]

> When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted. To the federal statute and policy, conflicting state law and policy must yield. Constitution, Art VI, cl. 2.[204]

This conflates two fundamentally different inquiries, the existence of illegality and the effects of illegality on the contract under examination. Although apparently grounding the holding that federal law governs the effect of federal illegality on contracts on the Supremacy Clause and conflict preemption, the actual rule articulated is far broader than conflict preemption would yield. The *Sola* rule preempts all state law governing the effects of federal illegality. For all federal statutes and for all breach of contract claims, regardless of any conflict, federal law preempts.

That is an extraordinary preemption holding—under modern doctrine and probably for the time as well.[205] Modern preemption doctrine starts by examining whether Congress has

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202 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 188 (AM. L. INST. 1971).

203 Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173, 176–77 (1942).

204 *Id.* at 176 (citations omitted).

205 Prior to the New Deal era, courts approached federalism questions through the lens of "dual federalism," a framework that envisioned federal and state governments as having mutually exclusive authority over "local" and "national" issues. This system required courts to draw lines between state and federal authority. The Supreme Court replaced dual federalism with modern doctrine, including the presumption against preemption over the course of the New Deal and its wake. Some of those decisions predate *Sola*, which was decided in 1942. *See, e.g.*, Mintz v. Baldwin, 289 U.S. 346, 350 (1933) (holding that Cattle Contagious Diseases Acts did not preempt state action and stating "[t]he purpose of Congress to supersede or exclude state action against the ravages of the disease is not lightly to be inferred. The intention so to do must definitely and clearly appear."). Rice v. Santa Fe Elevator, 331 U.S. 218, 230 (1947), the origin of the *Rice* presumption against preemption—"[W]e start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress"—was decided five years after *Sola*. Perhaps *Sola*'s extraordinary preemption analysis reflected a holdover of the previous dual federalism regime. For an in-depth discussion of dual federalism and the shift to modern preemption doctrine, *see* Ernest A. Young, *"The Ordinary Diet*

indicated a "pre-emptive intent" in the federal statute that may preempt a state law, and often applies a presumption against preemption.[206] By contrast, the rule from *Sola* preempts all state contract law without an examination of the federal law giving rise to the potential illegality or an examination of the potential conflict between the federal law and state contract law.

This Article proposes that, in the first instance, the common law of contracts governing the breach analysis should also govern the effects-of-illegality analysis.[207] This is not because every state's common law of contracts is a beacon of clarity, but rather because it is the typical mode of analysis for which there should be a compelling reason to depart. Here, there is none.

The reason given for departing from the default rule is the possibility of state subversion of federal law. But there is no need for a separate body of law to deal with that concern. The law governing actual and potential conflicts between state and federal law is preemption law. If there is an actual conflict between a state's illegality analysis and a federal statute, then the court should follow modern preemption doctrine. Notably, the *Sola* court did not identify a specific conflict between the application of state contract law and any federal statute; it merely noted the possibility of a conflict. That is not a good reason for preempting all state illegality law and creating a substitute body of federal common law. This Article proposes that the court follow state common law to determine the effects of federal illegality. Then, once the court has decided on a remedy, the court should ask whether federal law preempts the proposed remedy.

Some discussion of preemption law follows to illustrate how this would work in practice. My goal here is not to provide an exegesis on preemption law but rather give its broad contours. As mentioned, preemption starts with an analysis of the federal statute at issue and consists of two broad types, express and implied preemption.[208] A federal statute expressly

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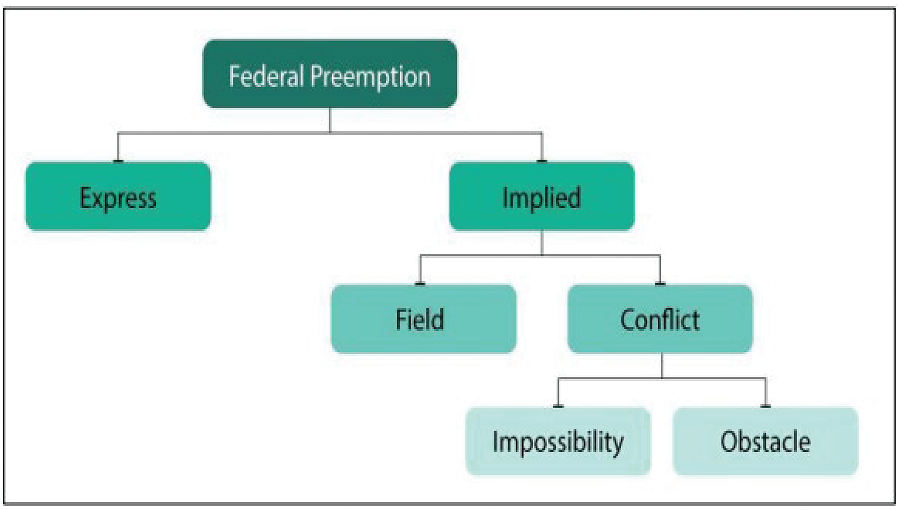
of the Law": The Presumption Against Preemption in the Roberts Court, 2011 Sup. Ct. Rev. 253, 257–269.

206 Altria Grp., Inc. v. Good, 555 U.S. 70, 76–77 (2008).

207 Note that this proposed rule does not effectively change even if one were to conceive of the effect of federal illegality as necessarily being a federal question embodied by the federal statute at issue. That is the way Professor Nelson thinks about the issue. Nelson, *supra* note 45, at 732–33. Assuming that characterization is right, I would argue that courts should choose state contract law as a matter of federal common law. *See* United States v. Kimbell Foods, Inc., 440 U.S. 715, 727–28 (1979).

208 Gade v. Nat'l Sold Wastes Mgmt. Ass'n, 505 U.S. 88, 98 (1992); *Altria Grp., Inc.*, 555 U.S. at 76–77.

preempts state law when the statute contains "explicit pre-emptive language."[209] If a statute does not contain such language, it still may impliedly preempt state law through "field pre-emption" or "conflict pre-emption."[210] Field preemption occurs when the "scheme of federal regulation . . . [is] so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it."[211] Recent examples considered at the Supreme Court include the regulation of immigration and, perhaps less obviously, locomotive equipment.[212] Conflict preemption occurs when a federal law conflicts with a state law and comes in two varieties: impossibility preemption and obstacle preemption.[213] Impossibility preemption refers to when "compliance with both federal and state regulations is a physical impossibility,"[214] and obstacle preemption refers to when state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[215] The Congressional Research Service has created this useful illustration of the various preemption theories:[216]



209 *Gade*, 505 U.S. at 98.

210 *Id.*; *see also* Arizona v. United States, 567 U.S. 387, 399 (2012).

211 Rice v. Sant Fe Elevator Corp., 331 U.S. 218, 230 (1947).

212 *See Arizona*, 567 U.S. at 400; Kurns v. R.R. Friction Prods. Corp., 565 U.S. 625, 631 (2012).

213 *Gade*, 505 U.S. at 98.

214 Fla. Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142–43 (1963).

215 Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

216 BRYAN L. ADKINS, ALEXANDER H. PEPPER & JAY B. SYKES, CONG. RSCH. SERV., FEDERAL PREEMPTION: A LEGAL PRIMER 3 (2023), https://sgp.fas.org/crs/misc/R45825.pdf [https://perma.cc/JK7D-TUB6].

Although preemption analysis often involves conflicts between federal law and state legislative enactments or regulations, federal law can also preempt applications of state common law.[217] To be sure, the nature of the common law at issue is relevant for preemption analysis. State tort law, for example, often imposes duties that are "public" in nature by requiring people to refrain from conduct vis-à-vis the world, whereas state contract law typically reflects "private ordering" between parties in privity.[218] Thus, a court examining the potential preemption of the application of contract law would have to consider whether the preemptive effect of a federal statute was broad enough to displace state contract law.[219] Because contracts tend to reflect this "private ordering," one would expect federal statutes to preempt applications of state contract law less often than tort law and certainly less frequently than obligations imposed by state legislation or regulation.[220] Nonetheless, federal law does preempt applications of state contract law. In particular, courts have not been shy in finding that the Federal Arbitration Act preempts state contract law.[221] And with anticompetitive contracts in particular, parties beyond those to the contract are harmed. All the market participants who must deal with anticompetitive effects are affected. Thus, it is wrong to think of anticompetitive contracts as merely reflecting private ordering.

In practice, when a court is confronted with the defense of antitrust illegality, it should apply state law in the first instance

[217] *See, e.g.*, Bates v. Dow Agrosciences LLC, 544 U.S. 431, 443 (2005) (finding that the Federal Insecticide, Fungicide, and Rodenticide Act "may pre-empt judge-made rules, as well as statutes and regulations"); Riegel v. Medtronic, Inc., 552 U.S. 312, 324–25 (2008) (holding that the Federal Food, Drug, and Cosmetic Act preempted state tort law).

[218] *See* Christina Bohannan, *Copyright Preemption of Contracts*, 67 MD. L. REV. 616, 617 (2008).

[219] *See, e.g.*, Am. Airlines, Inc. v. Wolens, 513 U.S. 219, 228–30 (1995).

[220] *Id.*; *see also* Bohannan, *supra* note 218, at 631–34.

[221] *See, e.g.*, THI of N.M. at Hobbs Ctr., LLC v. Patton, 741 F.3d 1162, 1167 (10th Cir. 2014) (preempting state unconscionability law and noting that "just as the FAA preempts a state statute that is predicated on the view that arbitration is an inferior means of vindicating rights, it also preempts state common law—including the law regarding unconscionability—that bars an arbitration agreement because of the same view."); *see also* Marmet Health Care Ctr., Inc. v. Brown, 565 U.S. 530, 532 (2012) (holding that the FAA preempted a West Virginia Supreme Court ruling that agreements to arbitrate personal injury or wrongful death claims in nursing home admission contracts were unenforceable as a matter of public policy); AT&T Mobility LLC v. Concepcion, 563 U.S. 333, 341–44 (2011) (holding that the FAA preempted a California Supreme Court rule that class action waivers in contracts of adhesion are unenforceable).

to analyze the effect of antitrust illegality or potential antitrust illegality. Thus, there would be no federal imposition of the extrinsic evidence prohibition. The extrinsic evidence prohibition is a tool to reduce the scope of breach of contract cases. That policy concern is one that, if it came from anywhere, should come from state law or, if in federal court, from the Federal Rules of Civil Procedure.[222] Of the many factors traditional illegality doctrine considers, the extent to which adjudicating illegality annoys the court or the plaintiff because the defense enlarges the scope of the case is not one of them.[223] And even if a state did want to impose a rule like the extrinsic evidence rule, Section 1 of the Sherman Act should likely preempt it.

For antitrust illegality cases in federal court, the court should examine first whether the affirmative defense of illegality is properly pled under Rule 8. Rule 12(f) supplies the primary vehicle for attacking defectively pled affirmative defenses: the motion to strike.[224] The exact standard for pleading an affirmative defense is not settled. Particularly, courts have not reached a consensus on whether *Twombly*'s plausibility standard applies to affirmative defenses.[225] In certain courts, including all of those in the Second Circuit, *Twombly* does apply to affirmative defenses and would apply to an antitrust illegality defense.[226] District courts outside the Second Circuit apply *Twombly*'s plausibility standard to affirmative defenses as well.[227] This Article takes no position on whether *Twombly* or

222 Rule 8(c)(1) deals with affirmative defenses including illegality. Fed. R. Civ. P. 8(c)(1).

223 *See* RESTATEMENT (SECOND) OF CONTRACTS § 178 (AM. L. INST. 1981); *see generally* 15 CORBIN ON CONTRACTS §§ 89.1-89.23 (2023).

224 Fed. R. Civ. P. 12(f). A party can also file a motion under Rule 12(c) for judgment on the pleadings for defective affirmative defenses. *See* EEOC v. Star Transp., Inc., No. 13-cv-1240, 2014 WL 12736151, at *1 (C.D. Ill. Sept. 20, 2014) (discussing the relationship between motions to strike and motions for judgment on the pleadings). This practice is less common than filing a motion to strike because so long as the defense is part of the case, the parties can both seek discovery concerning the defense. Thus, a litigant would most commonly seek to remove it as early as possible.

225 *See* GEOMC Co., Ltd. v. Calmare Therapeutics Inc., 918 F.3d 92, 97–98 (2d Cir. 2019) (discussing the disagreement and holding that *Twombly* applies to affirmative defenses).

226 *Id.*

227 *See, e.g.,* Neo4j, Inc. v. PureThink, LLC, 480 F. Supp. 3d 1071, 1075 (N.D. Cal. 2020) (collecting cases); Goldsmith v. Lee Enters., Inc., No. 4:19CV1772 HEA, 2019 WL 5188951, at *4–5 (E.D. Mo. Oct. 15, 2019) (applying *Twombly* as articulated by Second Circuit to an affirmative defense).

something less should apply to affirmative defenses.[228] But it is worth noting that merely pleading antitrust illegality without alleging facts that substantiate the defense may be insufficient.

Assuming the invocation of antitrust illegality is not so threadbare as to be stricken, a court should then proceed to determine if the defendant breached the contract, whether the contract is anticompetitive, and whether the provision breached is severable from the anticompetitive portion of the contract (not necessarily in that order). In the event that the defendant breached the contract, the contract is anticompetitive, and the breached portion of the contract is not severable from the anticompetitive portion of the contract, then the court should not enforce the contract.

To illustrate, take the truck transmission example from the Introduction. A dominant truck transmission supplier has imposed exclusive deals on the major distributors of truck component parts, and one of the distributors wants to breach its exclusive contract by dealing with an upstart truck transmission supplier. Assume the distributor goes ahead, breaches the contract, and gets a better deal on truck transmissions from the rival upstart. The dominant transmission supplier learns about the breach. In an ideal world (and adopting this Article's proposed framework), the distributor could persuade the dominant supplier that a breach of contract action would be unsuccessful, and the supplier would not file suit. The distributor could do business with the upstart rival supplier, and over the long term, the upstart rival could gain market share and compete effectively with the dominant supplier.

But if the dominant supplier filed a breach of contract claim against the distributor, the distributor should raise the affirmative defense of illegality under the Sherman Act. The distributor should argue and allege facts sufficient to show that the dominant supplier's series of exclusive deals forecloses a substantial amount of competition in the truck transmission market. Any motion to strike should fail because there is no source of law that would authorize striking a legitimate illegality defense in this context other than the (mistaken) extensions of *Kelly* and *Kaiser*. If the distributor is able to prove the dominant supplier's exclusive deals have harmed competition, then the illegality defense should prevail. And if the court were inclined to provide some relief, like restitution, notwithstanding

228 For more discussion of this disagreement, *see* 5 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & A. BENJAMIN SPENCER, FEDERAL PRACTICE AND PROCEDURE § 1274 (2021).

the illegality, the Sherman Act would preempt such relief (and therefore the court would not order it).

This conclusion, that non-severable anticompetitive contracts cannot be enforced, does not necessarily follow for all instances of federal illegality. Rather, a court will have to analyze the federal statute at issue and determine whether that statute necessarily preempts judicial enforcement of a federally illegal contract. For contracts relating to the marijuana industry, a court should examine the preemptive nature and scope of the Controlled Substances Act to determine whether the statute fairly displaces enforcement of such contracts. For Section 1 of the Sherman Act, however, the preemptive nature is straightforward. Section 1 of the Sherman Act provides:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $100,000,000 if a corporation, or, if any other person, $1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.[229]

Like the Federal Arbitration Act, Section 1 of the Sherman Act mandates a rule for contracts specifically, and the command from the statute is that "every" contract that restrains trade is unlawful.[230] The consequences of making such a contract can be criminal. Thus, unlike other federal statutes, this statute specifically targets "private ordering" that harms the public and does not leave room for potential judicial enforcement after a finding of illegality.[231] Like the Federal Arbitration

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[229] 15 U.S.C. § 1. The original language of Section 1 varies only slightly, most notably by declaring violations are misdemeanors rather than felonies. Sherman Act, ch. 647, § 1, 26 Stat. 209, 209 (1890). That language was modified in 1974.

[230] Of course, the Supreme Court held that Section 1 only proscribes contracts that *unreasonably* restrain trade, rather than all contracts that restrain trade, as the statute states literally. Standard Oil Co. N.J. v. United States, 221 U.S. 1, 60 (1911). This holding, along with the common law nature of Sherman Act jurisprudence generally, may make the textual interpretive task required for examining the preemptive nature of the Sherman Act somewhat inapposite. That is a fair observation. The Sherman Act was also passed well before modern preemption doctrine, so the entire enterprise is somewhat inapposite. Such is the nature of applying new legal rules to old laws.

[231] *See* Alan J. Meese, *Federalism, Free Competition, and Sherman Act Preemption of State Restraints*, 16 VA. L. & BUS. R. 115, 119, 179–80 (2021) (noting that ordinary application of preemption standards would yield preemption

Act, Section 1 of the Sherman Act should preempt enforcement of contracts that violate Section 1.

This conclusion is in keeping with the doctrine of state-action immunity (so-called *Parker* immunity), which addresses the preemptive effect of the Sherman Act. *Parker* immunity holds that states may, through an exercise of sovereign authority, authorize anticompetitive conduct when that conduct is "clearly articulated and affirmatively expressed as state policy" and "actively supervised by the State itself."[232] This doctrine originates from the decision *Parker v. Brown*.[233] In *Parker*, the Supreme Court held that a California regulatory scheme designed to limit competition regarding the production and sale of raisins in order to "stabiliz[e]" raisin prices was immune from Sherman Act condemnation.[234] In holding that the state was immune, the Court drew a bright line between the state acting as sovereign and individuals acting in a private capacity. Assuming rightly that the Sherman Act would prohibit the California regulatory scheme if it were organized by private contract, the Court stated that it found "nothing in the language of the Sherman Act or in its history which suggests its purpose was to restrain a state or its officers or agents from activities directed by its legislature."[235] Rather, the Court reasoned that the Sherman Act's purpose is "to suppress combinations to restrain competition and attempts to monopolize by individuals and corporations."[236]

For cases where the Sherman Act would preempt enforcement of an anticompetitive contract, the only state action would be the application of the state's common law. This is not the sort of clear articulation and supervision contemplated under *Parker* and its progeny. Indeed, *Parker* and its progeny make clear that Section 1's main purpose is to prohibit unlawful restraints made between private parties.

That the Sherman Act preempts enforcement of anticompetitive contracts is also in keeping with the rule that mere acquiescence to an anticompetitive restraint is not a defense to

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of conflicting state law but observing that the state-action immunity doctrine wrongly departs from ordinary preemption and federalism principles).

232 Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 105 (1980) (quoting *City of Lafayette v. La. Power & Light Co.*, 435 U.S. 389, 410 (1978)).

233 Parker v. Brown, 317 U.S. 341 (1943).

234 *Id.* at 346–48, 352.

235 *Id.* at 350–51.

236 *Id.* at 351.

a Sherman Act claim.[237] Recall the contracts discussed in Section IV.A.1: exclusive dealing, anti-steering, and most favored nations agreements. When the party imposing these sorts of restrictions has market power, the contracting partner may feel it does not have an alternative but to accept the restriction. Importantly, the party on the receiving end of this exercise of market power will not be precluded from filing a lawsuit merely because it knowingly acquiesced to the anticompetitive restraint.[238] The Supreme Court appreciated that the policy of promoting competition overrode any concern about the potential unfairness to a defendant that the plaintiff knowingly acquiesced to an anticompetitive arrangement.[239] We want to encourage the nullification of anticompetitive contracts, not lock them in.[240]

That policy preference applies to preempting the enforcement of anticompetitive contracts. A rule like the extrinsic evidence prohibition cannot be reconciled with the Supreme Court's reasoning for rejecting the defense of acquiescence. Preempting the enforcement of anticompetitive contracts makes the treatment of parties on the receiving end of an anticompetitive contract more parallel.

Conclusion

After *Erie*, the Supreme Court was forced to decide which law governed the affirmative defense of illegality under a federal statute for breach of contract actions. Rather than follow typical choice-of-law principles that would point toward federal law governing the *existence* of illegality, but state law governing the *effect* of illegality on the contract, the Supreme Court held that both inquiries were questions of federal law, the latter of which evidently a species of federal common law. That federal common law has evolved in particularly problematic ways when applying the Sherman Act. Seizing on unclear Supreme

237 Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 139–40 (1968) (rejecting defense of *in pari delicto* for Sherman Act claims), *overruled on other grounds by* Copperweld Corp. v. Indep. Tube Corp., 467 U.S. 752 (1984); Tidmore Oil Co. v. BP Oil Co./Gulf Prods. Div., 932 F.2d 1384, 1388 (11th Cir. 1991) ("[B] ecause the Supreme Court has rejected the application of the doctrine of *in pari delicto* in antitrust actions, an agreement may be challenged even by one of the parties who has acquiesced in the unlawful agreement." (citing *Perma Life*, 392 U.S. at 139 (1968))).

238 *Id.*

239 *Perma Life*, 392 U.S. at 138–40.

240 *Id.*

Court decisions, lower courts have created a rule that seemingly prohibits courts from allowing a defense that a contract violates the Sherman Act when proving that violation would require an investigation of market conditions. Most contracts that are written and enforced will only be anticompetitive under the rule of reason, which requires an investigation into market conditions. As a result, most invocations of antitrust illegality should fail under prevailing case law. That is a difficult state of affairs to reconcile with the Sherman Act's command that all restraints of trade are unlawful.

Rather than creating a new branch of federal common law, the Court should have allowed the state common law of contracts to govern up to the point that federal law would preempt the enforcement of an unlawful contract. That framework allows the appropriate doctrines to govern the multiple inquiries presented by invocations of federal illegality: state common law for traditional illegality concerns and preemption law for federalism concerns.