

## Can You Hear Me Now?

# *Bell Atlantic v. Twombly* and the Pleading Standards for Antitrust Conspiracy Claims

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The Supreme Court is preparing this term for another foray into antitrust law. One of the cases it will decide, *Bell Atlantic v. Twombly*,<sup>1</sup> promises to clarify a surprisingly murky area of the law: the standards for pleading an antitrust conspiracy claim based on parallel conduct. In its first term, the Roberts Court decided three antitrust cases, all lopsided victories for defendants.<sup>2</sup> However, it is far from clear how the Court will come out in *Twombly*.

The approaches taken by the *Twombly* district court and the Second Circuit define near-opposite ends of the spectrum. The district court dismissed the plaintiffs' class action complaint, which alleged that the Baby Bells had conspired to thwart upstart local telephone competitors in the Bells' home territories and agreed not to enter each other's territories and compete for local telephone customers. In dismissing, the district court ruled that a plaintiff must allege specific "plus factors," proof of which would ultimately be required for a plaintiff to survive summary judgment against it on parallel conduct claims. The district court also evaluated the plausibility of inferences that could be drawn from the factual allegations in the plaintiffs' complaint and took account of the heavy costs of defending potentially unmeritorious antitrust cases.

By contrast, the Second Circuit's decision reversing the district court applied a relaxed pleading standard based on a literal reading of Rule 8 of the Federal Rules of Civil Procedure, and with canonical roots in *Conley v. Gibson*<sup>3</sup> and modern notice pleading jurisprudence. The Second Circuit rejected any notion that an antitrust conspiracy complaint must allege plus factors or otherwise match up to the summary judgment standards of *Matsushita*.<sup>4</sup> Instead, it defined a pleading threshold that would seem to protect just about any parallel conduct complaint from dismissal: "[T]o rule that allegations of parallel anticompetitive conduct fail to support a plausible conspiracy claim, a court would have to conclude that there is *no set of facts* that would permit a plaintiff to demonstrate that the particular parallelism asserted was the product of collusion rather than coincidence."<sup>5</sup> While the Second Circuit acknowledged the burdens of defending against antitrust claims, it observed that "the remedy to that problem is not to be found in abandoning the rules of notice pleading and raising the bar on plaintiffs in the absence of a legislative mandate to do so."<sup>6</sup>

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<sup>1</sup> *Twombly v. Bell Atl. Corp. (Twombly I)*, 313 F. Supp. 2d 174 (S.D.N.Y. 2003), *rev'd*, *Twombly v. Bell Atl. Corp. (Twombly II)*, 425 F.3d 99 (2d Cir. 2005), *cert. granted*, *Bell Atl. Corp. v. Twombly*, 126 S. Ct. 2965 (U.S. June 26, 2006) (No. 05-1126).

<sup>2</sup> *Texaco Inc. v. Dagher*, 126 S. Ct. 1276 (2006) (8-0 decision); *Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc.*, 126 S. Ct. 860 (2006) (7-2 decision); *Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 126 S. Ct. 1281 (2006) (8-0 decision).

<sup>3</sup> 355 U.S. 41 (1957).

<sup>4</sup> *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

<sup>5</sup> *Twombly v. Bell Atl. Corp. (Twombly II)*, 425 F.3d 99, 114 (2d Cir. 2005) (emphasis added).

<sup>6</sup> *Id.* at 116.

This article explores the nature of the plaintiffs' conspiracy claims, the analytical tensions between the two lower court opinions on those claims, and offers some thoughts about how the Supreme Court might view the case.

### The Case

**The Regulatory Setting.** For decades, AT&T, along with its regional Bell Operating Companies (also known as Baby Bells or "BOCs"), owned 80 percent of all local telephone lines and service in the United States. In 1974, the U.S. Department of Justice sued AT&T under the Sherman Act, alleging that it used its monopoly in the market for local exchange facilities to suppress competition in related markets, including the markets for telephone equipment and long distance services. In 1982, the parties settled under a consent decree, according to which AT&T agreed to divest itself of its ownership of the BOCs. AT&T became an inter-exchange (long-distance) carrier and the BOCs were given monopoly power over local exchange services in their respective regions. The BOCs, however, were prohibited from offering long-distance services. The BOCs were heavily regulated by federal and state authorities, but otherwise existed as legal monopolies, often with exclusive franchise licenses from the states in which they were located.

The Telecommunications Act of 1996<sup>7</sup> was meant to replace regulation with competition in the local exchange market. Under the Act, the BOCs were classified as "incumbent local exchange carriers" or "ILECs" in the regions where they were located. The Act permitted the ILECs to enter the long-distance market but required that they facilitate competitors'—also known as "competing local exchange carriers" or "CLECs"—entry into the local exchange market "on just, reasonable and nondiscriminatory" terms.<sup>8</sup> In particular, the Act mandated that an ILEC (1) sell local telephone exchange services to CLEC at wholesale rates; (2) lease elements of its network to the CLECs on an unbundled basis; and (3) permit the CLEC to connect its network to the ILEC's infrastructure.

A wave of litigation followed the enactment of the '96 Act. Many private plaintiffs sued under Section 2 of the Sherman Act,<sup>9</sup> claiming that ILECs were refusing to share their networks with CLECs as required by the '96 Act. That is how the *Twombly* case began.

**The Plaintiffs' Claims.** In 2002, the Second Circuit decided *Law Offices of Curtis V. Trinko, LLP v. Bell Atlantic Corp.*,<sup>10</sup> which upheld Sherman Act Section 2 monopolization claims premised on an ILEC's alleged failure to comply with its '96 Act obligations to share local exchange networks with CLECs. Soon thereafter, William Twombly filed a complaint against the BOCs in the Southern District of New York alleging exactly that, on behalf of an alleged class of all users of telephone and Internet service in the United States. In particular, the complaint claimed that the defendants had refused to provide potential CLECs with network connections and access to the same level of services that the ILECs provided to their own customers; billed the CLECs' customers to undermine the

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<sup>7</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56.

<sup>8</sup> 47 U.S.C. § 251(c)(3) ("The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252 of this title. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.").

<sup>9</sup> 15 U.S.C. § 2.

<sup>10</sup> 309 F.3d 71 (2d Cir. 2002), *rev'd sub nom.* Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).

CLECs' relationships with them; delayed the provision of network elements; refused CLECs the use of certain facilities; and misused their monopoly power to negotiate unfair agreements.

In the meantime, the Supreme Court granted a petition for certiorari to review the Second Circuit's *Trinko* decision, and in 2004, reversed it. The Supreme Court held that plaintiffs claiming monopolization by ILECs had to meet traditional antitrust requirements for those claims, rather than basing them on alleged violations of the '96 Act.<sup>11</sup> Soon after the Supreme Court's *Trinko* decision, the plaintiffs in *Twombly* amended their claims. They left in the allegations about suppressing entry and competition in local exchange markets but abandoned their Section 2 monopolization claims. In their place, the plaintiffs substituted conspiracy claims under Section 1 of the Sherman Act.<sup>12</sup>

To bring their new complaint within the ambit of Section 1, the plaintiffs claimed that the defendants' exclusionary conduct occurred pursuant to an agreement among all defendants to thwart the competitive threat posed by the CLECs. As evidence of the conspiracy, the plaintiffs alleged that all the defendants mistreated the CLECs in the same ways. The plaintiffs also claimed that the defendants engaged in additional parallel conduct by not competing as CLECs in each other's respective territories, "which would be anomalous in the absence of an agreement among the [defendants] not to compete with one another."<sup>13</sup> In particular, the defendants' service areas were noncontiguous and sometimes surrounded a rival's territory. The plaintiffs alleged that by not attempting to expand coverage in the areas where the defendants appeared to enjoy a geographic advantage, they were acting against their economic self-interest. As further evidence of conspiratorial conduct, the plaintiffs cited statements by Qwest's CEO, Richard Notebaert, that competing in the territory of a rival ILEC "might be a way to make a quick buck, but it didn't make it right."<sup>14</sup>

The defendants' alleged motive for this conspiracy was to maintain exclusive control over their respective territories and to prevent potential CLECs from succeeding. According to the plaintiffs, if CLECs made inroads into any ILEC's territory, it would expose all ILECs' vulnerability to competition. The alleged conspiracy harmed competition by depriving consumers of the opportunity to purchase local telephone or high-speed Internet services from CLECs rather than ILECs. The lack of competition allegedly resulted in consumers, such as the plaintiffs, paying supracompetitive rates for local services.

***The District Court's Decision Dismissing the Claims.*** The defendants collectively moved to dismiss the complaint, arguing that the plaintiffs' allegations of a conspiracy based upon parallel conduct were insufficient to state a claim under Section 1. They argued that parallel conduct is not itself unlawful absent additional evidence that either directly shows, or creates an inference, that the parallel conduct was not independent. The defendants maintained that the absence of factual allegations of so-called "plus factors" in the complaint rendered the plaintiffs' claims fatally defective.

U.S. District Court Judge Gerald E. Lynch agreed that plaintiffs must allege plus factors to withstand a motion to dismiss. Evidence of parallel business behavior, standing alone, is insufficient to establish a conspiracy; indeed, parallel behavior may be entirely consistent with lawful, inde-

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<sup>11</sup> *Trinko*, 540 U.S. at 406–07.

<sup>12</sup> 15 U.S.C. § 1.

<sup>13</sup> *Twombly v. Bell Atl. Corp. (Twombly I)*, 313 F. Supp. 2d 174, 178 (S.D.N.Y. 2003).

<sup>14</sup> *Id.* at 178, 184.

pendent decision making. Thus, the law requires plaintiffs, at least at the summary judgment stage, to offer evidence of “at least one ‘plus factor’ that tends to exclude independent self-interested conduct as an explanation for defendants’ parallel behavior . . . [such as] evidence that the parallel behavior would have been against individual defendants’ economic interests absent an agreement, or that defendants possessed a strong common motive to conspire.”<sup>15</sup> While acknowledging that the plus factor test was developed in the context of summary judgment, the district court held that it also should apply when testing the sufficiency of a complaint:

This requirement is necessary to ensure that plaintiffs actually state a claim on which relief can be granted, by separating complaints that allege simple parallel action that does not suggest a conspiracy and is therefore not actionable under § 1, from complaints that allege parallel action that could be the result of a conspiracy, and that plaintiffs are therefore entitled to explore in discovery.<sup>16</sup>

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In reviewing the plaintiffs’ claims under this test, Judge Lynch began by noting that “[t]he crucial inquiry . . . is what inferences naturally arise from the facts that plaintiffs have pled, taking all facts in the Amended Complaint as true.”<sup>17</sup> The inquiry the court envisioned was anything but cursory:

In the context of parallel conduct claims, the basic requirement that plaintiffs must fulfill is to allege facts that, given the nature of the market, render the defendants’ parallel conduct, and the resultant state of the market, suspicious enough to suggest that defendants are acting pursuant to mutual agreement rather than their own individual self-interest. This determination necessarily entails beginning with background propositions about how the market works when firms are competing, what it might look like if subject to an anti-competitive agreement, the economic interests of the market actors, and how those interests would cause them to act. While these questions resemble the factual issues that would have to be decided in the context of a summary judgment motion, on a motion to dismiss the Court may properly draw these background assumptions only from the facts pleaded in the complaint and the relevant statute, and may rely only on such background facts about the market and its history that are appropriate for judicial notice.<sup>18</sup>

Applying this detailed framework to defendants’ motion to dismiss, the district court found that the plaintiffs failed to state a claim of conspiracy under Section 1.

Judge Lynch first observed that the allegations that the defendants had attempted to keep the CLECs from entering the local services market were not sufficient evidence of an illegal conspiracy because “it is in each ILEC’s individual economic interest to attempt to keep CLECS out of its market. . . . Thus, defendants’ parallel action does not naturally give rise to an inference of an agreement, since the behavior of each ILEC in resisting incursion of CLECs is fully explained by the ILEC’s own interests in defending its individual territory.”<sup>19</sup> Further, the court found unpersuasive the collective motives the plaintiffs suggested for the defendants’ conduct, again finding that those motives were consistent with the defendants’ individual economic interests.

<sup>15</sup> *Id.* at 179 (citations omitted).

<sup>16</sup> *Id.* at 180.

<sup>17</sup> *Id.* at 182.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 183.

The district court also rejected the plaintiffs' second theory of conspiratorial behavior—that an agreement to restrain trade could be inferred from the failure of ILECs to enter their rivals' markets as CLECs. According to the plaintiffs, because it would be in the ILECs' economic interests to gain market share from their rivals by acting as CLECs, the collective failure to do so evidenced a conspiracy. While Judge Lynch found this a "closer question," he ultimately concluded that the plaintiffs' theory failed to acknowledge that "being a CLEC in another ILEC's territory is an entirely different business than being an ILEC."<sup>20</sup> ILECs that attempt "to become CLECs in another ILEC's territory [would] have little competitive advantage over other CLECs" because their success would depend upon cooperation from the ILEC whose territory they were invading.<sup>21</sup> For the same reason, "the ILEC-as-CLEC cannot leverage geographical proximity into independence, and therefore is not materially different from a CLEC without a nearby territory of its own."<sup>22</sup>

Taking this view of the market, the district court went on to find that "[p]laintiffs' own factual allegations, which must be accepted as true for purposes of this motion, establish that ILECs have successfully impeded CLECs' using [the '96 Act] to create viable business opportunities. Thus, plaintiffs themselves refute their theory that becoming a CLEC is an obviously profitable opportunity for an ILEC."<sup>23</sup> Because it was not against the defendants' economic interest to refrain from competing as CLECs, the court concluded that the plaintiffs had failed to allege facts that would create an inference that the defendants' parallel conduct was the result of a conspiracy.<sup>24</sup> Accordingly, the court granted the defendants' motion to dismiss.

***The Second Circuit's Reversal.*** The plaintiffs appealed to the Second Circuit, which reversed. The Second Circuit's test was as liberal as the district court's was strict: pleading facts "indicating parallel conduct by the defendants *can* suffice to state a plausible conspiracy. . . . [T]o rule that allegations of parallel anticompetitive conduct fail to support a plausible conspiracy claim, a court would have to conclude that there is *no set of facts* that would permit a plaintiff to demonstrate that the particular parallelism asserted was the product of collusion rather than coincidence."<sup>25</sup> The Second Circuit acknowledged that "*after* discovery, a plaintiff confronting a summary judgment motion is required to adduce admissible evidence of 'plus factors' if it seeks to have the trier of fact infer an unlawful conspiracy in restraint of trade from consciously parallel conduct."<sup>26</sup> However, "there is no reason . . . to require plaintiffs to include allegations of 'plus factors' in their complaint since they may not be required to establish 'plus factors' at trial—if, for example, they can prove conspiracy directly."<sup>27</sup> Applying Rule 12(b)(6), the Second Circuit found that the plaintiffs' complaint pled facts sufficient to state a claim under Section 1. Accordingly, it vacated judgment and remanded.

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<sup>20</sup> *Id.* at 185.

<sup>21</sup> *Id.* at 186.

<sup>22</sup> *Id.* at 186–87.

<sup>23</sup> *Id.* at 187.

<sup>24</sup> *Id.* at 188.

<sup>25</sup> *Twombly v. Bell Atl. Corp. (Twombly II)*, 425 F.3d 99, 114 (2d Cir. 2005) (emphasis added).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

**On Certiorari.** The defendants filed a petition for writ of certiorari to the U.S. Supreme Court. On June 26, 2006, the Court granted the petition and added the matter to the docket for its current term.<sup>28</sup> The specific question presented in the petition is:

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Whether a complaint states a claim under Section 1 of the Sherman Act, 15 U.S.C. § 1, if it alleges that the defendant engaged in parallel conduct and adds a bald assertion that the defendants were participants in a “conspiracy,” without any allegations that, if later proved true, would establish the existence of a conspiracy under the applicable legal standard.<sup>29</sup>

## The Issues

At its narrowest, the question in *Twombly* is whether an antitrust plaintiff must plead a factual basis for “plus factors” to allege conspiracy based upon parallel conduct. However, as framed by the Second Circuit and the defendants, *Twombly* also brings a more fundamental debate to the Court’s doorstep: Is the nature of the modern antitrust case sufficiently different from other civil litigation that heightened scrutiny at the pleading stage is warranted? And to the extent the Court decides that a more rigorous review of antitrust complaints is warranted, what is the appropriate test and what is the legal basis for it?

**What Is Enough to Plead an Antitrust Conspiracy?** The question in *Twombly* centers on the relationship between substantive antitrust law and the liberal notice pleading requirements embodied in Rule 8 of the Federal Rules of Civil Procedure. While both the district court and the Second Circuit recognized a “tension” between the two, the two courts started from much different reference points. Those starting points essentially predetermined the outcome of their analyses.

**Substantive Requirement of Plus Factors.** The district court began its review by focusing on substantive antitrust law relating to parallel conduct, much of which has been developed in the context of summary judgment. Judge Lynch noted that while parallel conduct by competitors—or what is often referred to as “conscious parallelism”—is probative of a potential agreement, it is not itself conclusive. “[P]arallel action is a common and often legitimate phenomenon, because similar market actors with similar information and economic interests will often reach the same business decisions.”<sup>30</sup> Or, as the Supreme Court held in *Matsushita*:

[C]onduct as consistent with permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy. To survive a motion for summary judgment or for a directed verdict, a plaintiff seeking damages for a violation of § 1 must present evidence “that tends to exclude the possibility” that the alleged conspirators acted independently. Respondents in this case, in other words, must show that the inference of conspiracy is reasonable in light of the competing inferences of independent action or collusive action that could not have harmed respondents.<sup>31</sup>

Under *Monsanto* and *Matsushita*, most courts have required at the summary judgment stage antitrust plaintiffs to establish some “plus factor” that, with parallel conduct, permits the inference

<sup>28</sup> Bell Atl. Corp. v. Twombly, 126 S. Ct. 2965 (U.S. June 26, 2006) (No. 05-1126) (granting certiorari).

<sup>29</sup> Brief for Petitioners at i, Bell Atl. Corp. v. Twombly, No. 05-1126 (U.S. Aug. 25, 2006), available at [http://www.appellate.net/briefs/MeritsBriefforPetitioners\\_BA\\_Twombly.pdf](http://www.appellate.net/briefs/MeritsBriefforPetitioners_BA_Twombly.pdf).

<sup>30</sup> Twombly v. Bell Atl. Corp. (*Twombly I*), 313 F. Supp. 2d 174, 179 (S.D.N.Y. 2003).

<sup>31</sup> Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588 (1986) (citing Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 764 (1984)) (citations omitted).

of a conspiracy.<sup>32</sup> As the Second Circuit noted, these plus factors may include a common motive to conspire; that the conduct was against the apparent economic self-interest of the alleged co-conspirators; or that there was a high level of inter-firm communications.<sup>33</sup>

To the district court, requiring a plaintiff to plead a factual predicate for plus factors was mandated by both substantive antitrust law and pleading requirements under the federal rules. The court noted that “[w]hile there is no special pleading standard for conspiracy, simply alleging that two or more defendants participated in a ‘conspiracy,’ without more, is insufficient to withstand a motion to dismiss.”<sup>34</sup> In a parallel conduct case, not alleging plus factors was akin to a conclusory, “bare bones” claim of conspiracy.<sup>35</sup>

The district court acknowledged that these requirements are “somewhat in tension” with Federal Rule 8.<sup>36</sup> But it resolved the conflict by noting that because parallel conduct is not itself unlawful absent inferences that may be drawn from the plus factors, requiring a plaintiff to allege plus factors in its complaint does not compel pleading beyond what is necessary to state a claim. Further, the plus factor pleading requirement was consistent with Rule 8’s purpose to place the defendant on notice of the basis of the alleged conspiracy. Accordingly, from the district court’s perspective, because plus factors were necessary to prove conspiracy based upon parallel conduct, procedurally a plaintiff was required to plead those facts in the complaint.

**Liberal Notice Pleading Under Rule 8.** The Second Circuit started its review at the other end of the spectrum, focusing on the liberal notice pleading requirements under federal procedural law. Citing to the seminal case of *Conley v. Gibson*, the Second Circuit explained that Rule 8 was meant simply to require plaintiffs to “give defendant fair notice of what the ... claim is and the grounds upon which it rests.”<sup>37</sup> *Conley* commands that the federal pleading rules are meant to facilitate decisions on the merits and not to “screen out complaints based upon a lack of artful lawyering before any facts have been discovered.”<sup>38</sup> According to the Second Circuit, “[a]ntitrust claims are, for pleading purposes, no different”—especially having not been singled out in the rules for more demanding pleading requirements.<sup>39</sup>

The court of appeals acknowledged that a “bare bones” statement of conspiracy was not sufficient to state a claim under Section 1 “without supporting facts.”<sup>40</sup> Accordingly, there must be a factual predicate that includes a conspiracy “among the realm of plausible possibilities.”<sup>41</sup> “But short of the extreme of ‘bare bones’ and utter ‘implausibility,’ a complaint in an antitrust case need only contain the ‘short and plain statement of the claim showing that the pleader is entitled to relief’ that Rule 8(a) requires.”<sup>42</sup>

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<sup>32</sup> See 6 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1434, at 241 (2d ed. 2003).

<sup>33</sup> *Twombly v. Bell Atl. Corp. (Twombly II)*, 425 F.3d 99, 114 (2d Cir. 2005) (citations omitted).

<sup>34</sup> *Twombly I*, 313 F. Supp. 2d at 180.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Twombly II*, 425 F.3d at 107 (quoting *Conley v. Gibson*, 355 U.S. 41, 47 (1957)).

<sup>38</sup> *Id.* (citing *Conley*, 355 U.S. at 48).

<sup>39</sup> *Id.* at 107–08 (referencing Rule 9(b)’s enhanced pleading requirements for averments of fraud).

<sup>40</sup> *Id.* at 109.

<sup>41</sup> *Id.* at 111.

<sup>42</sup> *Id.*

Applying these rules to the context of a Section 1 claim, the Second Circuit concluded that “an antitrust claimant must allege *only* the existence of a conspiracy and a sufficient supporting factual predicate on which that allegation is based.”<sup>43</sup> Parallel conduct is one factual predicate from which conspiracy could plausibly be inferred, and therefore puts the defendant on sufficient notice to answer and prepare for trial. In contrast, the plus factors necessary for a conscious parallelism case are hurdles to be overcome at summary judgment *after* discovery is taken (and assuming no direct evidence of conspiracy is found).

***Whither the Supreme Court?*** How the Supreme Court resolves the issue will likely turn on whether it begins from the perspective of the liberal pleading requirements of *Conley v. Gibson* and Rule 8 or the substantive antitrust law governing conscious parallelism established in *Monsanto* and *Matsushita*. For the defendants-petitioners and the numerous amici curiae<sup>44</sup> who have filed briefs in support, the matter is simply one of requiring factual allegations in a complaint to meet the standards of substantive law—in this case, that consciously parallel conduct without more does not violate Section 1 of the Sherman Act. Alleging anything less amounts to a conclusory statement that is insufficient even under the liberal pleading rules embodied in Rule 8. Thus, from the perspective of the defendants-petitioners and certain amici, the plus factor test is consistent with Rule 8, given the limits of the substantive law.

The counterargument, as embodied in the Second Circuit’s opinion, is that Rule 8 deliberately sets a low threshold, requiring only that a complaint place a defendant on bare notice of the basis for the claims. Parallel conduct is a basis for a conspiracy claim. In this view, the specific facts by which an inference of conspiracy can be drawn from the parallel conduct—e.g., plus factors—are properly the subject of discovery, and the sufficiency of the evidence should be tested at summary judgment, not on a motion to dismiss.

The Supreme Court’s most recent pronouncements on Rule 8 likely will play a significant part in the Court’s analysis. In *Swierkiewicz v. Sorema*,<sup>45</sup> the Court reaffirmed the liberality of notice pleading under Rule 8. In reversing the Second Circuit, a unanimous Court held that a plaintiff alleging discrimination under Title VII was not required to plead facts that would support a prima facie claim under the burden-shifting standard specified in *McDonnell Douglas Corp. v. Green*.<sup>46</sup> The Court found that because the *McDonnell Douglas* framework does not necessarily apply to all discrimination cases—for example, it is also possible to prove discrimination through direct evidence—it was sufficient for a plaintiff to allege discrimination based upon a prohibited ground without the additional facts required under *McDonnell Douglas*.<sup>47</sup> The Court went on to explain that the “simplified notice pleading standard [under Rule 8] relies on liberal discovery rules and summary judgment motions to define facts and issues and to dispose of unmeritorious claims.”<sup>48</sup>

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<sup>43</sup> *Id.* at 114 (emphasis added).

<sup>44</sup> Eight amici curiae filed briefs in favor of certiorari, and to date at least seven amici have filed merits briefs supporting the defendants-petitioners, including the U.S. Government. The American Bar Association has filed a brief in support of neither the defendants-petitioners nor the plaintiffs-respondents, but which argues that the Second Circuit’s test is wrong. See Brief of the American Bar Association as Amicus Curiae in Support of Neither Petitioners Nor Respondents, *Bell Atlantic Corp. v. Twombly*, No. 05-1126 (U.S. Aug. 25, 2006), available at [http://www.abanet.org/amicus/briefs/bell\\_atlantic\\_v\\_twombly.pdf](http://www.abanet.org/amicus/briefs/bell_atlantic_v_twombly.pdf).

<sup>45</sup> 534 U.S. 506 (2002).

<sup>46</sup> 411 U.S. 792, 802 (1973).

<sup>47</sup> *Swierkiewicz*, 534 U.S. at 511–12.

<sup>48</sup> *Id.* at 512.

Three years later, the Court again encountered pleading standards issues, this time in the securities litigation context. In *Dura Pharmaceuticals, Inc. v. Broudo*,<sup>49</sup> a unanimous Court ruled that the district court properly dismissed a securities case for failure to state a claim under Rule 12(b)(6). The Court held that securities plaintiffs must plead facts identifying losses they suffered and a causal connection to the defendant's conduct.<sup>50</sup> The Court noted while Rule 8 generally does not burden plaintiffs with detailed fact pleading requirements, it was not burdensome to require some factual predicate to place a defendant on notice of a plaintiff's alleged loss, or set forth the causal connection between the defendant's actions and the alleged loss.<sup>51</sup>

The outcome here may turn on whether the Court views plus factors as akin to the facts necessary to create an inference of discrimination under *McDonnell Douglas* or something more fundamental like the requirements of pleading economic loss and causation in a securities claim. Further, in undertaking this analysis, the Court will likely need to address the relative burdens placed upon the parties at the pleading stage.

The district court in *Twombly* found that its requirement that a plaintiff allege plus factors "is simply not analogous to the requirement that Title VII plaintiffs allege the *McDonnell Douglas* prima facie case" because, in part, while the basis of a Title VII claim is usually "fairly self-evident," "a plaintiff's factual and economic theory of a conspiracy is not evident from a conclusory allegation of conspiracy, and there is simply no way to defend against such a claim without having some idea of how and why the defendants are alleged to have conspired."<sup>52</sup> This reasoning is in line with the Court's holding in *Dura Pharmaceuticals*, and rests on the idea that the burden should not fall upon defendants to guess plaintiffs' possible theories of conspiracy based only on an allegation of conscious parallelism. Using the language of *Dura Pharmaceuticals*, the defendants-petitioners and certain amici argue that requiring plus factors to be pled in a complaint is not a "burdensome" obligation to place upon antitrust plaintiffs.

By contrast, and while not as directly addressing the applicability of *Swierkiewicz* as did Judge Lynch, the Second Circuit clearly found that the burdens on a plaintiff to plead a sufficient claim under Section 1 were intentionally minimal. For the appellate court, "[a]t the pleading stage, we are concerned only with whether the defendants have 'fair notice' of the claim, and the conspiracy that is alleged as part of the claim, against them—that is, enough to 'enable [the defendants] to, [inter alia,] answer and prepare for trial'—not whether the conspiracy can be established at trial."<sup>53</sup> From this perspective, so long as there is enough in the complaint to permit a defendant to answer, dismissal under Rule 12(b)(6) is improper. Implicit in this analysis is that defendants bear some obligation to divine the plaintiffs' potential theories of recovery at the pleading stage without plaintiffs necessarily having to specify those theories in a complaint. In light of *Swierkiewicz* and *Dura Pharmaceuticals*, it will undoubtedly be significant to see where the Supreme Court places burdens at the pleading stage with respect to a complaint alleging conspiracy under Section 1.

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<sup>49</sup> 544 U.S. 336 (2005).

<sup>50</sup> *Id.* at 346–47.

<sup>51</sup> *Id.* Although the Court noted that there are additional pleading requirements under Rule 9 and the Private Securities Litigation Reform Act, the Court assumed *arguendo* that there were no special pleading requirements with respect to proximate cause or economic loss other than Rule 8. *Id.* at 346.

<sup>52</sup> *Twombly v. Bell Atl. Corp. (Twombly I)*, 313 F. Supp. 2d 174, 181 (S.D.N.Y. 2003).

<sup>53</sup> *Twombly v. Bell Atl. Corp. (Twombly II)*, 425 F.3d 99, 116 (2d Cir. 2005) (citations and internal quotations omitted).

***Should Antitrust Cases Be Judged Differently?*** Adding color to this procedural argument is that, for defendants and many amici, antitrust cases are fundamentally different than other kinds of civil litigation. For example, the U.S. Government, in siding with the defendants, has taken the position that Rule 8 must be applied in the “context of the particular case,”<sup>54</sup> and that with respect to claims of “complex and wide-ranging antitrust conspiracies,” this means facts “sufficiently concrete” to provide “meaningful notice.”<sup>55</sup> This stands in contrast to the “minimal factual allegations [that] may suffice to apprise a defendant of the plaintiff’s claim in a simple case.”<sup>56</sup> The defendants-petitioners and other amici have echoed the sentiment that antitrust cases are different (i.e., more complex, expensive, and socially significant), which begs the question whether any differences merit special treatment on a motion to dismiss.

The Second Circuit made clear its view that for pleading purposes, antitrust cases are not different than other civil litigation.<sup>57</sup> Yet the appellate court conceded that in the context of antitrust litigation the liberal pleading standards sometimes will mean:

[C]olossal expense of undergoing discovery, that such costs themselves likely lead defendants to pay plaintiffs to settle what would ultimately be shown to meritless claims, that the success of such meritless claims encourages others to be brought, and that the overall result may well be a burden on the courts and a deleterious effect on the manner in which and efficiency with which business is conducted.<sup>58</sup>

However, the Second Circuit opined that if the balance between Rule 8 and antitrust law was to be “re-calibrated,” it was for the Supreme Court or Congress to do.<sup>59</sup>

The defendants-petitioners and numerous amici curiae are urging the Supreme Court to do just that. In particular, the defendants and the amici have cited what they see as the staggering costs of antitrust litigation. These costs include not merely the burdens of defending an antitrust lawsuit, but the social costs of firms forgoing legitimate business conduct out of fear of litigation. Moreover, the discovery disputes and heavy motion practice associated with antitrust cases also take a heavy toll on the judicial system. According to these proponents, antitrust cases are so burdensome for the litigants and the economy that heightened scrutiny<sup>60</sup> at the pleading stage is necessary to weed out non-meritorious claims.

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<sup>54</sup> Brief of the United States as Amicus Curiae in Support of Petitioners at 12 (Aug. 25, 2006), *Bell Atlantic Corp. v. Twombly*, No. 05-1126, available at <http://www.usdoj.gov/atr/cases/f218000/218048.htm>.

<sup>55</sup> *Id.* at 19.

<sup>56</sup> *Id.* at 7.

<sup>57</sup> *Twombly II*, 425 F.3d at 108.

<sup>58</sup> *Id.* at 117.

<sup>59</sup> *Id.*

<sup>60</sup> The Second Circuit explained that a “heightened pleading standard” has not been applied to antitrust cases, despite the pleas of “successive generations of lawyers representing clients defending against civil antitrust claims.” *Twombly II*, 425 F.3d at 107–108. The defendants-petitioners and amici do not argue or concede before the Supreme Court that the plus factor test is a “heightened pleading standard.” They do, however, at the very least advocate that antitrust cases require closer or more rigorous scrutiny under Federal Rules 8 and 12(b)(6), given their unique burdens. In contrast, the plaintiffs-respondents are likely to contend that the plus factor test is a heightened pleading standard for antitrust cases—something the Second Circuit squarely rejected in *Twombly* and which would bring the matter closer to the Supreme Court’s holding in *Swierkiewicz*. See *Swierkiewicz v. Sorema*, 534 U.S. 506, 513 (2002) (“declin[ing] to extend” the heightened pleading requirements of Rule 9 to contexts other than fraud or mistake). We use the term “heightened scrutiny” to describe the position advocated by the defendants-petitioners without expressing any opinion as to whether such scrutiny is, in fact, a heightened pleading standard.

However, the “antitrust is different” point could conceivably also be invoked to support more liberal scrutiny of antitrust complaints. As opposed to ordinary civil litigation, which focuses on and may affect only the parties to the dispute, the basic tenet of antitrust law is the protection of competition and, by extension, the welfare of consumers. In this context, antitrust conspiracy cases may implicate a broader public interest than many other types of civil litigation, and some may argue that heightened scrutiny at the pleading stage could weed out too many claims of potential merit before evidence of a conspiracy could be fully exposed.

Finally, added to this mix is the fact that Congress has yet to intervene as it did in the securities litigation context, which perhaps will help the plaintiffs-respondents’ arguments that the Supreme Court should not, or even cannot, apply heightened scrutiny to antitrust cases at the pleading stage without congressional action.

*The challenge of fashioning an appropriate test has eluded consensus even among those advocating heightened scrutiny.*

**A Workable Test?** Assuming the Supreme Court finds that merely pleading parallel conduct without more is insufficient, the ultimate question is what is the appropriate test. The district court’s approach was rooted in substantive law developed for summary judgment and then tweaked for the context of a motion to dismiss. Given its moorings in the summary judgment context, the district court’s test has the benefit of a well-established body of substantive antitrust law to aid litigants and courts in determining what will be sufficient at the pleading stage. Further, there is an inherent logic in requiring a complaint to meet the threshold requirement of the substantive law with respect to a conspiracy claim based upon parallel conduct.

However, the district court’s test is not without potential concerns. First, does a summary judgment-based standard really fit? The detailed evidence presented at summary judgment to aid courts in analyzing plus factors is very different than typical allegations in a complaint. And, importantly, as the district court acknowledged, deciding whether plus factors are sufficient to support a claim of conspiracy based upon parallel conduct will require an understanding of the market, and particularly the behavior to be expected from market participants. In a typical case, such a market analysis would be very hard to do at the pleading stage. Indeed, *Twombly* was arguably unique because the Telecommunications Act of 1996 and the Antitrust Division’s case against AT&T offered such a substantial body of information from which the district court was able to draw in its analysis. Other newly filed cases might be much less susceptible to an analysis of the market’s dynamics and the issue of whether parallel conduct would be in the economic interest of certain competitors.

The challenge of fashioning an appropriate test has eluded consensus even among those advocating heightened scrutiny. The defendants-petitioners and certain amici have essentially championed Judge Lynch’s standard, which requires pleading a factual predicate for plus factors. Other amici, however, have offered what appear to be perhaps slightly looser standards. For example, the government, while not advocating that plus factors necessarily must be pled, has offered instead that a “Section 1 complaint must allege, at a minimum, facts providing concrete notice of the claimed wrongdoing and some objectively reasonable basis for inferring that an unlawful agreement may explain the parallel conduct.”<sup>61</sup> Similarly, the American Bar Association has advocated that an antitrust plaintiff must plead facts that at least “provide a reasonable basis to believe there is an agreement.”<sup>62</sup> Still others have simply advocated that the Supreme Court

<sup>61</sup> Brief of United States, *supra* note 54, at 23.

<sup>62</sup> Brief of the American Bar Association, *supra* note 44, at 3.

require more than what the Second Circuit required, leaving the “more” to be determined by the Court.<sup>63</sup> And some amici are seeking a broader interpretation of Rule 8 that would grant latitude to district courts to dismiss cases beyond the antitrust context.<sup>64</sup>

### Conclusion

The impact of *Twombly* will likely be significant. If the Court requires additional factual allegations to support a conspiracy claim under Section 1, fewer antitrust cases may be filed, or at least fewer may survive motions to dismiss. Even those that are permitted to proceed could see the scope of discovery limited to comport with the theory of conspiracy set forth in the complaint. Some amici even hope that the Court will issue a broader pronouncement on Rule 8 that may affect cases outside antitrust. Alternatively, an opinion that strongly reaffirms the liberal pleading requirements under Rule 8 in this context may pave the way for less well-tailored complaints in the future—perhaps entailing wasteful and expensive litigation and settlements.

In short, whatever the Supreme Court decides in *Twombly*, the case is likely to have significant and far-reaching effects on the world of civil antitrust litigation. Certainly the Court will have much to consider in establishing an appropriate standard that comports both with the basic tenets of Rule 8 and the well-established substantive requirements of Section 1. ●

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<sup>63</sup> See, e.g., Brief of Amici Curiae Economists in Support of Petitioner at 6, *Bell Atlantic Corp. v. Twombly*, No. 05-1126 (U.S. Apr. 6, 2006), available at [http://www.techlawjournal.com/courts/2006/bellatlantic\\_twombly/cert\\_amicus\\_baumol.pdf](http://www.techlawjournal.com/courts/2006/bellatlantic_twombly/cert_amicus_baumol.pdf) (favoring the “plus factor” standard but taking no position as how strong the interference of parallel conduct must be supported by allegations in the complaint).

<sup>64</sup> See, e.g., Brief of Washington Legal Foundation as Amicus Curiae in Support of Petitioners at 13–19, *Bell Atlantic Corp. v. Twombly*, No. 05-1126 (U.S. Apr. 6, 2006), available at <http://www.wlf.org/upload/TWOMBRRF.pdf>.

# Schering-Plough at the Supreme Court: Justices Decline to Resolve the FTC-DOJ Dispute Regarding “Reverse” Payments

**John T. Delacourt and Lee Istrail**

After years of intense litigation in multiple forums, the debate regarding antitrust treatment of “reverse” payments in settlements of patent litigation between manufacturers of branded and generic pharmaceuticals at last reached the Supreme Court . . . almost. In spite of the opportunity to resolve an unusually public disagreement between the nation’s two principal antitrust enforcement agencies—the Federal Trade Commission and the Antitrust Division of the Department of Justice—the Court declined to take the case.

After a setback before the Eleventh Circuit in *Schering-Plough*, the FTC filed a petition for certiorari, asking the Court to review and overturn the decision of the court of appeals. Although the FTC and the DOJ generally proceed in tandem before the high court, in *Schering* the Commission took the rare step of proceeding alone. The disagreement between the two agencies then became even more public when the Court specifically requested the views of the Solicitor General. In response, the Solicitor General—as a representative of the DOJ, and in collaboration with officials from the Antitrust Division—requested that the Court deny the FTC’s petition. The Court’s subsequent decision to deny cert has interesting implications, but almost certainly will not be the last word on the issue.

The disagreement between the FTC and the DOJ reflects widespread uncertainty regarding the competitive impact of brand/generic settlements containing reverse payments (i.e., a payment from the patent holder to the alleged infringer). Both sides agree that the effect of such payments is sufficiently ambiguous that their presence alone should not trigger per se treatment of a settlement agreement. Beyond that, however, positions diverge. The FTC has taken the position that reverse payments should trigger heightened antitrust scrutiny, as they are often made in return for an anticompetitive delay in generic entry. In the absence of such payments, the Commission argues, the parties to the settlement would negotiate the date of entry as a true reflection of the strength of their relative positions in the underlying patent litigation. Others—including both settling defendants and, now, the DOJ—have taken the position that the FTC’s view is unduly restrictive and contrary to the general policy in favor of litigation settlements. While the Supreme Court’s denial of cert in *Schering* is not likely to bring this debate to conclusion, it is likely to have an impact on the future course of the debate in a number of important ways.

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## Background—Brand/Generic Pharmaceutical Settlements and Reverse Payments

The regulatory backdrop for the *Schering* case is the complicated procedure for Food & Drug Administration approval of generic drug products. This procedure is largely governed by the Hatch-Waxman Act,<sup>1</sup> which was enacted to reduce impediments to the introduction of low-cost generic

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<sup>1</sup> Drug Price Competition and Patent Term Restoration Act, Pub. L. No. 98-417, 98 Stat. 1585 (1984).

drugs. Among other features, the Act created a variety of incentives to spur potential generic entrants to challenge questionable drug patents. These incentives were extremely effective, and led to a dramatic increase in patent litigation between branded and generic drug makers.

Not surprisingly, the increase in litigation was accompanied by an increase in litigation settlements. Given the economic incentives in play in the pharmaceutical marketplace, the FTC became concerned that at least some of these settlements were not in the best interest of consumers. The Commission observed that, in many instances, the difference in price between branded and generic drugs was so substantial, and the decline in price after generic entry so rapid, that it would be in the best interests of both the brand and the generic to collude to delay entry while sharing the resulting monopoly profits. The Commission subsequently identified certain categories of “red flag” settlements, where the likelihood of such a collusive arrangement was greatest. These included settlements involving reverse payments.

In March 2001, the FTC filed suit challenging two settlements involving branded drug manufacturer Schering-Plough—one with generic drug maker Upsher-Smith and a second with ESI Lederle. Both settlements involved Schering’s patented extended-release formulation of K-Dur 20, a potassium chloride product primarily used to treat potassium depletion in coronary artery disease patients. Although both agreements contemplated entry prior to the expiration of Schering’s patent, and called for Schering to license other, non-K-Dur 20 drug products from the generic competitor, the FTC was not convinced. According to the complaint, in both instances, the size of the reverse payment was disproportionate and unrelated to the value of the licenses. The quid pro quo for these payments therefore appeared to be the competitor’s delay in entry—an unlawful restraint of trade in violation of both Section 5 of the FTC Act<sup>2</sup> and Section 1 of the Sherman Act.<sup>3</sup>

### The Administrative Law Judge’s Opinion

FTC complaint counsel proceeded through the Part III litigation mechanism, the first step of which is a trial before an Administrative Law Judge—in this case, Judge D. Michael Chappell. The ALJ made extensive factual findings and concluded that there was nothing improper about the reverse payments, which appeared to reflect an arms-length assessment of the litigation settlement, as well as the value of the additional products that Schering had licensed from the alleged infringers.<sup>4</sup> The ALJ explained that, in order to assess the value and purpose of the settlement, it was first necessary to inquire into the strength of the underlying patent claims. Because the strength of those claims could not be reliably determined, complaint counsel simply had no grounds for its assertion that Schering’s payments did not represent fair value for settlement of the claims.<sup>5</sup> The ALJ consequently dismissed the complaint.

### The Commission Opinion

As expected, complaint counsel appealed the ALJ’s decision to the full five-member Commission, sitting as an appellate panel. The Commission saw the case quite differently, and accorded little deference to the ALJ’s extensive findings of fact. In its opinion reversing the ALJ, the Commission interpreted essentially the same evidence as supporting the opposite conclusion, explaining that

<sup>2</sup> 15 U.S.C. § 45.

<sup>3</sup> 15 U.S.C. § 1.

<sup>4</sup> Schering-Plough Corp., 2002 FTC LEXIS 40, 244–60 (June 27, 2002) (Initial Decision).

<sup>5</sup> *Id.* at 240.

*The Commission . . . identified certain categories of “red flag” settlements, where the likelihood of such a collusive arrangement was greatest. These included settlements involving “reverse” payments.*

“many specific findings and the ultimate factual conclusions in the Initial Decision are flawed.”<sup>6</sup> The Commission held, for example, that the size of the settlement payments reflected neither the value of the licenses granted to Schering nor the value of the settled claims.<sup>7</sup> Relying heavily on an analysis of the parties’ respective economic incentives, the Commission concluded that, in the absence of an alternative explanation, the payments must have been made in return for a delay in generic entry.<sup>8</sup> The Commission also rejected the ALJ’s holding that the strength of the underlying patent was the linchpin of any competitive analysis, noting that such an inquiry “would not be necessary, practical, or particularly useful.”<sup>9</sup> Based on this reasoning, the Commission held the defendants liable, reversed and vacated the ALJ’s opinion, and replaced it with a remedial order.

### The Eleventh Circuit Opinion

Schering subsequently appealed to the Eleventh Circuit which, in turn, reversed the Commission.<sup>10</sup> The Eleventh Circuit cited its own prior decision in *Valley Drug*<sup>11</sup> for the proposition that neither per se nor rule of reason analysis governs in antitrust cases involving patents. Rather, a unique third mode of analysis applies, which requires an examination of: (1) the scope of the exclusionary potential of the patent; (2) the extent to which the agreements exceed that scope; and (3) the resulting anticompetitive effects.<sup>12</sup> Applying this test, the court concluded that Schering was entitled to the full exclusionary force of its patent until the Commission demonstrated that the patent was either invalid or not infringed. Absent such a showing, the court reasoned that the Commission could not prove that either of the settlements had an anticompetitive effect, as both contemplated generic entry before expiration of the patent and were therefore within the patent’s “exclusionary potential.” The court also called into question many of the Commission’s findings of fact. Although the court acknowledged its obligation to defer to the agency on issues of fact, in many instances it appeared to substitute the findings of the ALJ for those of the Commission. The court took particular exception to the Commission’s finding that the size of Schering’s payments to Upsher-Smith significantly exceeded the value of the licensed drug products, remarking that “[t]o borrow from the Commission’s own words, we think its conclusion . . . is ‘not supported by law or logic.’”<sup>13</sup> Indeed, the court seemed to question the very integrity of the FTC’s procedure for review, stating that “[i]t would seem as though the Commission clearly made its decision before it considered any contrary conclusion.”<sup>14</sup>

### The Petition for Certiorari

Taking a final bite at the apple, the Commission petitioned the Supreme Court. The Commission’s petition for cert presented two questions for review: (1) whether a settlement payment from a pharmaceutical patent holder to a would-be generic competitor, in return for the generic’s agreement

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<sup>6</sup> Schering-Plough Corp., 2003 FTC LEXIS 187, 189 (Dec. 8, 2003) (Opinion of the Commission).

<sup>7</sup> *Id.* at 169, 173–74.

<sup>8</sup> *Id.* at 60–67.

<sup>9</sup> *Id.* at 79.

<sup>10</sup> Schering-Plough Corp. v. FTC, 402 F.3d 1056 (11th Cir. 2005).

<sup>11</sup> Valley Drug Co. v. Geneva Pharms., Inc., 344 F.3d 1294 (11th Cir. 2003).

<sup>12</sup> *Schering*, 402 F.3d at 1066.

<sup>13</sup> *Id.* at 1070.

<sup>14</sup> *Id.* at 1065.

to delay entry, constitutes an unlawful restraint of trade; and (2) whether the Eleventh Circuit erred in holding that the Commission's decision was not supported by "substantial evidence."<sup>15</sup> With respect to the first question, the Commission argued that Supreme Court review was warranted due to a circuit split between the Sixth and Eleventh Circuits on the reverse payment issue, as well as the compelling public interest in the substantial consumer savings that could potentially result from earlier generic drug entry.<sup>16</sup> As to the second question, the Commission argued that, while the Eleventh Circuit had stated the correct rule on administrative deference, it had failed to follow it, leaving the Supreme Court as the only authority with the power to correct the error.<sup>17</sup>

*Although the views of the federal government were seemingly already represented by the Federal Trade Commission, the Court expressly requested the views of the United States . . .*

In a case characterized by many odd twists and turns, what happened next was perhaps the most surprising development of all. Although the views of the federal government were seemingly already represented by the Federal Trade Commission, the Court expressly requested the views of the United States, as represented by the Solicitor General's Office and the Antitrust Division of the Department of Justice. Even more surprisingly, the FTC's sibling agency then proceeded to argue that the Commission's petition should be denied.

On the reverse payment issue, the DOJ argued that there was no circuit split justifying the Court's review. As the Department pointed out, the Sixth Circuit opinion identified by the FTC was qualitatively different—in that the settlement at issue there encompassed additional, non-patented drugs that were not the subject of the infringement suit—and therefore did not create a circuit split with the *Schering* opinion.<sup>18</sup> As a brief opposing cert, rather than a brief on the merits, one might have expected the DOJ filing to stop there. However, it went on to discuss the reverse payment issue at length, largely adopting the Eleventh Circuit position that reverse payments are a logical response by a pharmaceutical patent holder to the settlement pressures created by the Hatch-Waxman regulatory structure. The DOJ also argued that, although the Eleventh Circuit's review of the Commission's opinion did not comport with the "substantial evidence" test, "plenary review of the court of appeals' application of the substantial-evidence standard in this case would not be an appropriate exercise of this Court's certiorari jurisdiction."<sup>19</sup>

As if the preceding developments had not created sufficient drama, Supreme Court rules provided that the FTC was entitled to file a response to the brief of the United States. The Commission used its supplemental brief to emphasize two principal arguments. First, with respect to the issue of administrative deference, the Commission argued that "[t]he court of appeals' rote utterance of correct legal standards should not insulate its errors from review."<sup>20</sup> The Commission observed that, as recently as the current term, the Court had reversed a court of appeals decision on precisely this basis.<sup>21</sup> In response to the DOJ's arguments that the controversy was not sufficiently ripe, and that the current case was not an appropriate vehicle for addressing the important legal issues raised therein, the Commission pointed to the potentially "staggering" impact of the

<sup>15</sup> FTC Petition for a Writ of Certiorari 1 (Aug. 29, 2005), available at <http://www.ftc.gov/os/2005/08/050829scheringploughpet.pdf>.

<sup>16</sup> *Id.* at 23–25.

<sup>17</sup> *Id.* at 26.

<sup>18</sup> Brief for the United States as Amicus Curiae 17 (May 17, 2006), available at <http://www.usdoj.gov/atr/cases/f216300/216358.pdf>.

<sup>19</sup> *Id.* at 13.

<sup>20</sup> Supplemental Brief for the Petitioner 7 (June 12, 2006), available at <http://www.ftc.gov/os/adjpro/d9297/060612certiorarisupplementalbrief.pdf>.

<sup>21</sup> *Id.* at 8 (citing *Rice v. Collins*, 126 S. Ct. 969, 971 (2006)).

Eleventh Circuit's decision on consumers of prescription drugs. Given that "billions of dollars in added prescription drug costs *annually* are at stake," it would not be appropriate to simply allow additional reverse payment cases to percolate through the federal court system.<sup>22</sup> Instead, the Commission argued, immediate Supreme Court review was needed.

The dispute ended, anticlimactically, with the Court's denial of cert just two weeks later.<sup>23</sup>

### Impact of These Developments

While the showdown between the FTC and the DOJ has certainly been dramatic, it is not clear that this will be the turning point in the reverse payment debate. Although the manner in which the agencies expressed their contrasting views was unexpected—indeed, surprising—the substance of the views expressed in the cert petition exchange is, by now, familiar to many. Nevertheless, the recent developments in the *Schering* case, including the Court's denial of cert, raise a number of interesting questions:

***Is the litigation component of the reverse payment debate coming to a conclusion?*** Probably not. Mere denial of the FTC's petition, while undeniably a victory for proponents of reverse payment settlements, is unlikely to constitute the final word on the reverse payment issue. As the DOJ observed in its brief, private parties (many of them espousing antitrust theories almost identical to the FTC's), have already filed challenges to a number of brand/generic settlements. It is reasonable to assume that these plaintiffs will avoid the Eleventh Circuit with as much determination as pharmaceutical defendants will seek its embrace. Indeed, the DOJ specifically noted that one group of private plaintiffs, along with the State of Pennsylvania, has filed suit in a district court within the Third Circuit to challenge the settlement agreements at issue in *Schering*.<sup>24</sup>

***What are the prospects for a non-litigation solution?*** While it would be a stretch to say that the prospects are good, the possibility of a legislative solution has been raised. Almost immediately following the Court's denial of cert, four U.S. Senators—Charles Grassley (R-Iowa), Herb Kohl (D-Wis.), Patrick Leahy (D-Vt.), and Charles Schumer (D-N.Y.)—vowed to reverse the Eleventh Circuit's *Schering* decision. Specifically, the Senators proposed to amend the Federal Trade Commission Act to define the use of reverse payments as an act of unfair competition. With midterm elections looming, however, any such legislative solution is certainly a long way off.

***Will the FTC continue to play a role in the reverse payment debate?*** Probably, although the Commission's role may be more limited. The Court's denial of the FTC's cert petition is clearly a blow to the agency's enforcement efforts in the reverse payment area. Because the Commission's administrative decisions are reviewable in any circuit in which the defendant resides or does business, the Eleventh Circuit would presumably become the forum of choice for defendants in reverse payment cases, with predictable results for the FTC's success rate. Although this development would not eliminate the antitrust litigation risk associated with reverse payments, the mere possibility of such a result appears to have bolstered the confidence of many potential defendants. The FTC reports that, of brand/generic settlements filed with the agency, zero contained reverse payments in 2004, three contained such payments in 2005 (the year of the Eleventh

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<sup>22</sup> *Id.* at 2.

<sup>23</sup> *FTC v. Schering-Plough Corp.*, 126 S. Ct. 2929 (2006).

<sup>24</sup> *In re K-Dur Antitrust Litig.*, 338 F. Supp. 2d 517 (D.N.J. 2004).

Circuit's *Schering* decision), and six more containing such payments have already been filed in 2006.<sup>25</sup>

***Is the FTC's role likely to change in some significant way?*** At least one FTC Commissioner has indicated that the agency is considering filing future reverse payments cases in federal district court, rather than proceeding through the Part III administrative litigation process, to avoid the otherwise inevitable appeal to the Eleventh Circuit.<sup>26</sup> While it remains to be seen whether the Commission will actually employ this procedural stratagem, recent developments suggest that the agency's commitment to challenging reverse payments remains strong. Just weeks after the denial of cert in *Schering*, the Commission exercised its authority under a pre-existing consent order with Bristol-Myers to deny approval of a brand/generic settlement relating to the blood thinner Plavix, largely on the grounds that the settlement contained a reverse payment.<sup>27</sup> Although the Plavix situation is unique, and is unlikely to be repeated, it nevertheless seems to suggest a continuing willingness on the part of the agency to advance the legal theory rejected by the Eleventh Circuit.

***Can litigants expect less administrative deference to the FTC in future cases?*** Probably not. The Eleventh Circuit's *Schering* decision could very well become the *Bush v. Gore* of administrative deference cases—a closely watched and much discussed opinion that is never subsequently cited. Regardless of whether the FTC is legally empowered to do so,<sup>28</sup> it is unlikely that, barring exceptional circumstances, it would reject the findings of its own ALJ so completely in future cases. Likewise, it is unlikely that any court of appeals, including the Eleventh Circuit, would apply the “substantial evidence” test in a manner that gave so little deference to the Commission. Doubtless, at least some of the Eleventh Circuit's frustration with the Commission resulted from the Commission's refusal to adhere more closely to the court's *Valley Drug* decision, and it was certainly a diplomatic, if not a legal, error for the Commission to characterize certain aspects of that decision as “not supported by law or by logic.” Nevertheless, while the *Schering* case is unlikely to have a lasting impact on the “substantial evidence” test, it could spur a reexamination of the FTC's Part III process—pursuant to which the same Commission that votes to approve the filing of a complaint before an ALJ subsequently hears any appeal of the ALJ's decision—which some litigants have criticized as biased against defendants.

***Do these developments reflect a growing divergence between the FTC and the DOJ?*** It is notable that the DOJ did not weigh in on its own initiative, but only after the Supreme Court expressly requested the views of the Solicitor General. That being said, when considered together with the DOJ's refusal to sign on to the FTC's Second Request reform proposal in February, the *Schering* brief marks the second public disagreement between the two agencies in just a few

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<sup>25</sup> Jon Leibowitz, Commissioner, FTC, Exclusion Payments to Settle Pharmaceutical Patent Cases: They're B-a-a-a-ck!, Address Before the Second Annual In-House Counsel's Forum on Pharmaceutical Antitrust 4–5 (Apr. 24, 2006), available at <http://www.ftc.gov/speeches/leibowitz/060424PharmaSpeechACI.pdf>.

<sup>26</sup> *Id.* at 8.

<sup>27</sup> John Carreyrou, *States Reject Deal on Plavix in Blow to Bristol-Myers*, WALL ST. J., July 29, 2006, at A2.

<sup>28</sup> It is worth noting that, on this point, the FTC gets the better of the argument. The Commission is authorized to review de novo both the factual findings and legal conclusions of an Administrative Law Judge. 16 C.F.R. § 3.54(a). In contrast, an appellate court is obligated to defer to the findings of the Commission when those findings are supported by “substantial evidence,” meaning that those findings are supported by “such relevant evidence as a reasonable mind might accept as adequate,” not that the reviewing court “mak[ing] its own appraisal of the testimony, picking and choosing for itself among uncertain and conflicting inferences” would reach the same conclusion. *FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447, 454 (1986).

months. Furthermore, the DOJ's decision not to simply defer on the issue of an appropriate standard for antitrust analysis of reverse payments is somewhat surprising in light of the longstanding division of responsibilities between the two agencies. Restraints of trade in the pharmaceutical industry are clearly within the purview of the Health Care Products and Services Division of the FTC's Bureau of Competition. The FTC has also done a substantial amount of "competition R&D" in this area.<sup>29</sup>

***Do these developments have implications beyond the pharmaceutical context?*** Had the Court taken the case, the implications could have potentially been more sweeping. One significant issue that has attracted less attention than others is the fundamental disagreement among the three decision makers regarding the core legal rules through which the principles underlying the antitrust laws should be implemented. The ALJ adopted what would certainly be regarded as the most well-established, if not the most desirable, approach by dividing the universe of potential restraints into those subject to per se and those subject to rule of reason analysis. The FTC, in contrast, rejected this formalistic approach, and—relying on both the Supreme Court's *California Dental*<sup>30</sup> opinion and its own *PolyGram*<sup>31</sup> opinion—asserted that antitrust analysis should extend over a continuum responsive to the facts of individual cases. Per se and rule of reason analysis (meaning a fact intensive definition of markets, calculation of shares, etc.) are two points on that continuum, but a full rule of reason analysis is not required where more direct evidence of competitive effects is available. The Eleventh Circuit, in contrast, insisted that neither per se nor rule of reason analysis was appropriate, but rather a third approach, unique to antitrust cases involving patents, should be applied. Had the Court taken the admittedly ambitious step of using the *Schering* case as the vehicle to address this big picture issue, its guidance would have been most welcome. Due to the denial of cert, this fundamental issue will likely continue to be analyzed differently in different forums.

*One significant issue that has attracted less attention than others is the fundamental disagreement among the three decision makers regarding the core legal rules through which the principles underlying the antitrust laws should be implemented.*

## Conclusion

Although the *Schering* case ultimately did not answer the fundamental question at issue—whether or not the antitrust laws should condemn reverse payments in the pharmaceutical context—it did provide an interesting and revealing glimpse into the imperfect process by which such questions are resolved. Indeed, the case constituted a kind of worst case scenario, highlighting not only the potential flaws of the FTC's Part III process, but of the entire dual agency structure for federal antitrust enforcement. While these flaws are well known, rarely have they been exposed so dramatically, and in a single case. It is perhaps this fact, more than any other, that makes the anticlimactic finale of the case so surprising, as it seems to suggest that reverse payments present legal issues of such uncommon difficulty that even the nation's antitrust enforcers could not agree on a common approach. Such an intractable controversy, one would think, is ripe for resolution by the Supreme Court. ●

<sup>29</sup> See, e.g., Bureau of Competition, Federal Trade Commission, *Agreements Filed with the Federal Trade Commission Under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003: Summary of Agreements Filed in Fiscal Year 2005* (Apr. 2006), available at <http://www.ftc.gov/os/2006/04/fy2005drugsettlementsrpt.pdf>; Press Release, Federal Trade Commission, FTC Proposes Study of Competitive Impacts of Authorized Generic Drugs (Mar. 29, 2006), available at <http://www.ftc.gov/opa/2006/03/authgenerics.htm>; Federal Trade Commission, *Generic Drug Entry Prior to Patent Expiration* (July 2002), available at <http://www.ftc.gov/os/2002/07/genericdrugstudy.pdf>.

<sup>30</sup> *California Dental Ass'n v. FTC*, 526 U.S. 756 (1999).

<sup>31</sup> *PolyGram Holding, Inc.*, 5 Trade Reg. Rep. (CCH) ¶ 15,453 at 22,453–58 (FTC 2003).

## Reverse Payment Settlements: Structure, Purpose, and Reform

**Jonathan D. Putnam**

The recent *Schering-Plough* decision<sup>1</sup> is one species of a difficult antitrust genus—a “reverse payment settlement” (RPS)—of pharmaceutical patent litigation that is governed, in part, by the Hatch-Waxman Act.<sup>2</sup> In RPS cases, the patent owner/licensor pays the accused infringer/licensee not to manufacture the patented product, contrary to the usual relationship between licensor and licensee. Much legal ink has been spilled in the advocacy and analysis of RPS cases, the result of which has been a highly unusual and public divergence of opinion between the Federal Trade Commission and the Antitrust Division of the Department of Justice. This divergence reflects not only different interpretations of the facts in *Schering-Plough*, but differences in approach to the genus itself.

As a discipline, economics is better suited to analyzing the genus than the species. When the devil resides in the details of each case, this focus on the general may obscure, or actively hinder, the proper resolution of each case on its antitrust merits. And yet the economists have rushed in to support or oppose the proposition that a very particular case, *Schering-Plough*, stands for something larger in antitrust policy.

I have abstracted from the details of particular cases in the hope of illuminating their common structure and at least contributing to a common resolution of what has proved to be a nasty split among antitrust policymakers. I have also chosen to emphasize the dynamic nature of the policy problem, which depends heavily on the role of intellectual property. Although the federal agencies’ Antitrust Guidelines for the Licensing of Intellectual Property<sup>3</sup> declare that IP and antitrust policies have the same objective, that declaration is true only in the tautological sense that a benevolent central planner theoretically maximizes social welfare over an infinite planning horizon using both IP and antitrust policy instruments. In the finite world of case law and precedent, the antitrust and IP laws co-exist in, at best, creative tension.<sup>4</sup> RPS agreements illustrate the more general point

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<sup>1</sup> *Schering-Plough Corp. v. FTC*, 402 F.3d 1056 (11th Cir. 2005), *cert. denied*, 126 S. Ct. 2929 (2006).

<sup>2</sup> Drug Price Competition and Patent Term Restoration Act of 1984, 15 U.S.C. §§ 68b–68c, 70b (1994); 21 U.S.C. §§ 301 note, 355, 360cc (1994); 28 U.S.C. § 2201 (1994); 35 U.S.C. §§ 156, 271, 282 (1994) (Hatch-Waxman Act).

<sup>3</sup> U.S. Dep’t of Justice & Federal Trade Comm’n, Antitrust Guidelines for the Licensing of Intellectual Property (1995), available at <http://www.usdoj.gov/atr/public/guidelines/0558.htm>.

<sup>4</sup> Although the proof of this claim is outside the scope of this article, it is easy enough to outline. The goal of the antitrust laws is, in effect, to choose the optimal price *level* at a given point in time. The goal of the IP laws is, in effect, to choose the optimal price *path* over time. If one can increase consumer welfare in the long run (through lower quality-adjusted prices) by reducing it in the short run (through higher nominal prices) then these two policy instruments are in tension. That there exists at least one modification to an otherwise optimal antitrust regime that increases the current (nominal) price level but that reduces the long-run (quality-adjusted) price path is easy to demonstrate: the patent system is itself one such modification. But if there exists one such modification, there may be others. In short, there exist acts that violate the antitrust laws but may, if generally permitted, induce a welfare-improving dynamic investment program.

that, because antitrust policymakers are not central planners, they lack both the analytical means and institutional authority to articulate the optimal combination of policies.<sup>5</sup>

Although I have acquiesced to common terminology by referring to “reverse” payments, this terminology embodies the presumption that payments should flow in the opposite direction. That presumption is incorrect in general; my argument below challenges it at the outset. I describe the unusual (from the point of view of all patent infringement litigation) set of circumstances that gives rise to RPS agreements. Because the overriding characteristic of these circumstances is extreme legal and business risk, I characterize RPS agreements as bilateral risk mitigation mechanisms, i.e., insurance. It is in that context that the magnitude and direction of “reverse” payments should be evaluated.

*But if legal indeterminacy is enough to escape liability in any particular case, it does nothing to resolve the underlying policy indeterminacy: when do private settlements protect social welfare?*

But, as I then argue, even after one properly understands the nature of the agreement as a *private* contract, there is little analytical reason to think that the resulting bargain should be *socially* optimal. Probably the most concrete manifestation of that belief is the claim that the generic “would” or “should” have entered when it was free to do so, an error that I also explore in this article. As I discuss, the basis for that claim is not well-posed, either in theory or empirically. Among other things, this means that the contracting firms should not be found liable based on what the generic “would” have done. But if legal indeterminacy is enough to escape liability in any particular case, it does nothing to resolve the underlying policy indeterminacy: when do private settlements protect social welfare? Rather than testing RPS agreements for that property, I advance a proposal that obviates the need for these agreements. This proposal simultaneously recognizes the parties’ legitimate interests in risk mitigation, and the antitrust agencies’ equally legitimate interests in protecting competition, by mandating that private parties contract with the government, rather than each other, for the protection of intellectual property rights.

### The Irrelevance of Licenses

“Property” typically comprises a bundle of rights: the right to exclude, the right to use, the right to transfer, the right to grant rights to others, etc. These rights may be conveyed together or separately. For example, a license conveys the right to use the property, but not the right to transfer title to it. In the language of property law, a patent license is a contractual “burden” on the owner’s property, personal to the licensee, which grants to the licensee one or more of the rights in the owner’s bundle, such as the right to use the patented invention.<sup>6</sup> Other rights in the bundle, such as the right to transfer the patent or to exclude others besides the licensee, remain with the owner.

RPS agreements are not licenses. They arise in the context of patent infringement litigation, in which a contractual right to use is generally not in dispute. Rather, the dispute is whether or not

<sup>5</sup> The current antitrust regime has little or no institutional capacity to evaluate welfare-improving price increases because it is essentially unconcerned with the dynamic effects of the current price level on future productivity-improving investments. (The time horizon employed in the FTC/DOJ Horizontal Merger Guidelines is: (a) directed at *entry*, not *investment*, decisions; (b) truncated at two years, much shorter than the R&D development cycles in most industries; and (c) defined statically (relative to current or easily foreseeable production technologies), not dynamically (relative to the induced rate of technical change).) U.S. Dep’t of Justice & Federal Trade Comm’n, Horizontal Merger Guidelines (1992, revised 1997), available at <http://www.ftc.gov/bc/docs/horizmer.htm>.

<sup>6</sup> Precisely speaking, a patentee does not possess the right to use his own invention, but only the right to exclude others from using it. For example, if B is a patented improvement of A, the owner of A may prevent the owner of B from using B because it infringes the claims of A. Not having the affirmative right to use the invention himself, the patentee cannot convey it to another, but only conveys the right not to be excluded. In casual usage, one often says that the licensor conveys the right to use the invention.

the plaintiff possesses the right to exclude certain acts of the defendant. That question has one of two answers: either the plaintiff does possess that right, in which case the defendant is normally enjoined from entry (because there is no license), or the plaintiff does not have any such right, in which case the defendant is free to enter (even in the absence of a license).

The overriding goal of a legitimate RPS agreement is to allocate risk—not to transfer the right to use and not to allocate market share. That risk arises because neither party knows whether the plaintiff does possess the right to exclude. That uncertainty creates several critical problems, both for the parties and for proper antitrust analysis. Because the status of the plaintiff's right to exclude is unknown,

- either party may harm the other;
- the effects of miscalculation may be asymmetric, in the sense that the gain to the acting party may be greater or less than the harm to the party acted upon;
- the harm may be legally or economically uncompensable;
- either party's actions may hurt consumers; and
- neither party has the correct incentives to protect either the other, or consumers, from uncompensable harm.

These individual negative contingencies interact in complex ways. In addition, they share one overriding characteristic: they are bilateral. If each party can harm the other without compensation, each party will pay the other to prevent that harm. Given the bilateral insurance mechanism of an RPS contract, there is nothing necessarily “reverse” about the (net) payment, except in the intellectually and legally undisciplined comparison to a unilateral license grant.

### The Common Fact Pattern

The cases in question all involve litigation by an incumbent (a “brand”) against an entrant (a “generic”). This particular market structure is essential to the problem. Each case is really a “perfect storm” that results from an unusual (from the perspective of all patent litigation) confluence of most or all of the following facts:

1. the expiration of the brand's patent on an active chemical ingredient;
2. infringement litigation by the brand against the generic over a secondary improvement patent, such as an improved delivery mechanism (“once-a-day” pills, etc.);
3. the expiration of the 30-month stay of entry provided under the Hatch-Waxman Act following the generic's notification of intent to enter, prior to the resolution of the brand's infringement suit;
4. increasing sales over the lifetime of the invention;
5. severe price competition once entry occurs;
6. the prospect of a damages award that would bankrupt the infringing entrant; and
7. the prospect of an entry delay that would bankrupt the otherwise (non)infringing (non)entrant.

Although these facts, and the challenged agreements they have produced, appear to arise with surprising frequency, they are in fact quite unusual in the context of general patent litigation. Precisely because antitrust law is driven by economics, and because both law and economics strive for generality of application, it is worth reviewing the reasons why these facts are unusual and why idiosyncratic policies supposedly tailored to a subset of their features may have unintended and undesirable consequences elsewhere.

1. **Expiration of the brand's patent on an active chemical ingredient.** An infringement allegation over a patented active ingredient is relatively rare. Chemical compounds are defined by

a well-known set of rules, which give chemical patent claims relatively precise boundaries. For the same reason, infringement is relatively easy to define and to verify. The precision of pharmaceutical invention boundaries deprives defendants of a principal defense to infringement, i.e., claim ambiguity.

2. **Infringement litigation by the brand against the generic over a secondary improvement patent.**

a. *Claim ambiguity.* By contrast, an improvement to an active ingredient (such as a pill coating that causes the pill to dissolve over a longer period of time, permitting once-a-day dosing) is much more like a mechanical invention. Being defined by its function, its terms may have multiple constructions.<sup>7</sup> The practical effect of ambiguity is that, unlike the outcome of litigation over active ingredients, the outcome of litigation over improvement patents is much harder to predict *ex ante*.

b. *Control of improvements.* From the point of view of stimulating both innovation and competition, it is critical to note the difference between pharmaceutical improvements and other improvements. In many fields, it is not necessary to practice an invention to invent an improvement to it; alternatively, a rival firm may simply purchase the invention and tinker with it. But a putative improver cannot simply make the invention as a precursor to researching an improvement. Because the brand controls the manufacture of the active ingredient, it often controls the research on improvements, particularly when the improvement is defined in terms of altering the interaction of the active ingredient with the human body.

Given the alternatives of improving the ingredient patent early on, or waiting until the patent has nearly expired, many brands find it more profitable to extend the effective life of the ingredient patent by serially introducing patented improvements to it, a practice known as “evergreening.”<sup>8</sup> In short, the brand’s control of the active ingredient may retard competitive innovation by inhibiting competition for complementary improvements and forestalling their introduction until the original patent has almost expired.

c. *Insurance and standards of care.* It might seem that (as with most patents) the vast majority of pharmaceutical improvements, such as changing from twice-a-day to once-a-day dosing, would be relatively trivial from an economic point of view. After the ingredient patent expires, anyone can manufacture the ingredient, so the marginal value of the improvement is the marginal benefit of, for example, more con-

*In short, the brand’s control of the active ingredient may retard competitive innovation by inhibiting competition for complementary improvements and forestalling their introduction until the original patent has almost expired.*

<sup>7</sup> Even apparently straightforward claims may be ambiguous under patent law. For example, in the patent infringement litigation between HMRI (the brand) and Andrx, which underlay the FTC’s complaint in Hoechst Marion Roussel, FTC Docket No. 9293 (*Andrx*), <http://www.ftc.gov/opa/2001/04/hoechst.htm>, HMRI’s extended-release patent defined a “dissolution profile” that resulted in 0–45% of the prescribed active ingredient being released within 18 hours. Andrx applied for FDA approval for a version that averaged 55% release after 18 hours. Since 55% is outside the 0–45% range, Andrx moved for summary judgment of noninfringement. HMRI continued to claim literal infringement, however, because some of Andrx’s production sub-lots allegedly fell into the infringing range. HMRI also claimed infringement under the doctrine of equivalents (which allows courts to find infringement even when the accused product does not fall within the literal claims of the patent but “an accused device performs substantially the same function in substantially the same way to obtain substantially the same result.”). The doctrine of equivalents continues to be an especially unpredictable area of patent law. “Absent legislation, the doctrine will remain a significant factor in infringement analysis, with most of its attendant uncertainties. For example, the [Supreme C]ourt left open the question of how equivalence should be determined.” Stephen L. Sulzer & Leo J. Jennings, *Doctrine of Equivalents Is Not Limited to Piracy: High Court, in “Hilton Davis” Holds that Proof of Intent Plays No Role in Applying Doctrine*, NAT’L L.J., May 12, 1997, at 32.

<sup>8</sup> Evergreening is pervasive in the pharmaceutical sector because, despite competition in the same antitrust market, pharmaceuticals often remain sufficiently differentiated in their treatment profiles that competitive pressures do not force the brand to improve its product until it is faced with generic entry. In addition, all but the most trivial improvements require additional clinical trials, which are both costly and risky.

venient dosing. Patients who are willing to forgo this convenience can obtain the active ingredient itself from one or more generic manufacturers, at a substantial discount to the ingredient-plus-improvement offered by the brand.

If this were the case, the controversy over RPS cases would lose much of its economic significance. But the introduction of an improvement tends to shift the medical standard of care for many therapies. This is especially true when the improvement increases patient compliance with the dosing regimen, and compliance is an important determinant of patient outcomes.<sup>9</sup> But the observation applies more generally when the improved version is offered at the same price as the original version. Whether the improved version is nominally more expensive or not, it is always more expensive than the original version if the original has become generic. In such cases, there exists the well-known problem that, because neither patients nor physicians bear the cost of prescribing therapies to insured patients, neither has the correct incentive to weigh the marginal benefits of the improvement against its marginal cost. Conversely, a physician may well bear the cost of malpractice litigation if it could be shown that he or she did not adhere to the new “standard” of care.

Further, because the improved version is not generic, formulary rules that mandate generic substitution except on a doctor’s express orders do not apply, so a doctor who prescribes “improved brand X” need not justify her decision not to prescribe “generic X.” In short, there is little institutional incentive to switch to the “plain” generic when the “improved” brand is available, even if the relative price ratio of the two products does not reflect the ratio of marginal benefits. The result is that the private value of the improvement patent may be as great as or greater than the patent on the active ingredient, even if that value greatly exceeds the social value of the improvement invention.

3. **Expiration of the 30-month stay of entry provided under Hatch-Waxman.** As is well-known, the Hatch-Waxman Act provides for a 30-month stay of entry when a patent owner alleges that entry would infringe one or more (generally, improvement) patents.<sup>10</sup> This provision is, itself, unusual: most patent owners must seek a preliminary injunction under standard rules that weigh the magnitude and compensability of harm to each of the parties from allowing or enjoining entry. Across all infringement litigation, the entry of a preliminary injunction is the exception; thus, an automatic injunction is unusual.

Most of the antitrust controversy surrounding RPS cases is embodied in the following counterfactual question: what would have happened when the 30-month stay expired, in the absence of an RPS, given that the underlying patent infringement claim remains unresolved? In essence, the legal claim of antitrust injury arises from the factual proposition that the generic would have entered the market once the 30-month stay expired. By forestalling that entry, so the argument goes, the RPS restrains trade.

It is worth noting that, as an empirical matter, it is unusual to observe generics entering upon expiration of the stay (sometimes referred to as “launching at risk”). This is true

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<sup>9</sup> Compliance tends to be important for treatments that require constant therapeutic dosage. Perhaps the most well-known example is in the so-called “AIDS cocktails.” When therapeutic levels decline, even briefly, the HIV virus may mutate and multiply into a strain that resists the therapy. But the same principle applies to a wide range of therapies (cardiovascular, psychotropic (“Prozac”), etc.).

<sup>10</sup> Hatch-Waxman Act, 21 U.S.C. § 355(j)(5)(B)(iii).

for a variety of reasons, beyond the obvious fact that various RPS-type arrangements have contracted away the possibility. For example, if the underlying patent litigation has been resolved before the stay expires, then that resolution determines both the legality and timing of entry, and the question of what to do upon expiration is moot. But in the cases that remain unresolved when the stay expires, an important, if not dispositive, determinant of entry is the magnitude of the risk, as the remaining “unusual facts” underscore.

4. **Increasing sales over the lifetime of the invention.** The vast majority of patented inventions demonstrate little or no economic value *ex post*. They are, as Pakes observed, merely expired options on a state of the world that never materialized.<sup>11</sup> Of those few that actually generate value, the large majority do so mainly or exclusively in the early years of their lifetimes. This value depreciates over time, often at a relatively high rate, as subsequent technical change (often induced by the invention and/or its disclosure) renders the invention increasingly obsolete.<sup>12</sup>

Again, pharmaceuticals are different. Many pharmaceuticals do not receive FDA approval until half or more of their potential patent life has expired. Having expended hundreds of millions of dollars to surmount the legal, technical, and regulatory obstacles to approval for at least one indication, the brand is usually counting on using the clinical and market data obtained after market introduction to expand the number and scope of indications for which the invention may be prescribed. The brand's rivals face similar obstacles to offering a competing product, and their incentive to do so depends on the first product's market success, which is hard to predict *ex ante*. Between the patentee's endogenous use of past sales to expand applications, and the long time horizon for rival entry, it is not uncommon to observe that a patented pharmaceutical's greatest sales occur in the last year of the ingredient patent's life or, in the case of evergreened products, even later. This means that, unlike the usual case, the decision to enter upon expiration of the ingredient patent potentially assumes economic significance well out of proportion to the relatively trivial “improvement” patent at stake.

5. **Severe price competition once entry occurs.** By definition, a generic product exhibits the same bioactivity (in particular, the same safety and efficacy profiles) as the patented product that it imitates. Thus, unlike competition in differentiated products—in which the incumbent retains the ability to differentiate its product from the entrant's, at least in dimensions unrelated to the disputed patent—an allegedly infringing generic enters the market as a certified perfect substitute for the brand (at least for many consumers). This substitutability is institutionalized by private, state, and federal insurance formulary guidelines that mandate substitution of generics for brands unless the prescribing physician orders otherwise. Combined with generally inelastic demand, perfect substitutability results in a generic price about 70 percent or less of the brand's pre-entry price, and a market share of 70 percent or more of shipments shortly after entry.

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<sup>11</sup> Ariel Pakes, *Patents as Options: Some Estimates of the Value of Holding European Patent Stocks*, 54 *ECONOMETRICA* 755 (1986).

<sup>12</sup> For example, among the European patents studied by Pakes, much fewer than 10% were renewed throughout their statutory maximum lifetime. *See id.*

6. **The prospect of a damages award that would bankrupt the infringing entrant.** Large patent damages awards (in excess of \$100 million) are relatively rare, and awards that expose the defendant to bankruptcy are rarer still.<sup>13</sup> But it is easy to construct such awards in RPS cases.<sup>14</sup>

More generally, the significant possibility of bankruptcy challenges the typical assumption that firms are risk-neutral. Risk neutrality simply means that a firm is willing to take an actuarially fair bet, while risk aversion means that a firm will pay to avoid such a bet.<sup>15</sup> But, if it applies at all, this assumption applies to relatively small disturbances around the mean of expected profits. In general (start-up firms being a prominent exception), firms view an extreme negative outcome (which results in bankruptcy) as not symmetric with the equivalent extreme positive outcome: when bankruptcy occurs, managers lose jobs, reputations, and (to the extent they are shareholders) compensation.<sup>16</sup> When bankruptcy is a significant possibility, the claim that a generic would have launched at risk is equivalent to a claim about the (mostly unobservable, and mostly nonfinancial) negative value that its managers place on bankruptcy.

On the other hand, bankruptcy also shields managers from certain incrementally riskier choices—when theft is a hanging offense, one may as well be hanged for a sheep as a lamb.<sup>17</sup> In the present context, this means that, holding the probability of bankruptcy constant, a generic manager may increase his possible gains, but does not increase his private costs, by choosing a strategy that results in greater damages to the brand, with which the generic manager competes fiercely and to which he owes no duty of care. Once bankruptcy occurs, the brand becomes merely another creditor.

*When bankruptcy is a significant possibility, the claim that a generic would have launched at risk is equivalent to a claim about the (mostly unobservable, and mostly nonfinancial) negative value that its managers place on bankruptcy.*

<sup>13</sup> Probably the largest such award was the \$200 million judgment that Procter & Gamble obtained against Paragon Trade Brands in 1997. *Procter & Gamble Co. v. Paragon Trade Brands, Inc.*, 989 F. Supp. 547 (D. Del. 1997).

<sup>14</sup> Suppose the brand sells \$1 billion per year, and that its marginal cost is 20% of its price. Then its gross profits are \$1 billion – (\$1 billion)(0.2) = \$800 million. Suppose that aggregate demand is completely inelastic, that the generic sells at 70% of the brand price and that it obtains a 70% market share, by shipments. Then the generic's revenues are (\$1 billion)(0.7)(0.7) = \$490 million. Its production costs (assuming it has the same marginal cost as the brand) are (\$1 billion)(0.2)(0.7) = \$140 million, so its profits are \$490 million – \$140 million = \$350 million. Assuming that the brand maintains its price after generic entry (which, to a first approximation, is the usual pattern), the brand's revenues are (\$1 billion)(1)(0.3) = \$300 million, which implies costs of (\$300 million)(0.2) = \$60 million, and gross profits of \$240 million. These calculations imply that the brand's incremental lost profits from one year of infringement are \$800 million – \$240 million = \$560 million, or \$210 million more than the generic's gross profits.

<sup>15</sup> For example, suppose that a firm faces a choice between two alternatives. If it accepts the first alternative, there is a 50% chance that the firm's profits will increase by \$100, and a 50% chance that they will decrease by \$100. In other words, the expected value of the first alternative is zero. By choosing the second alternative, the firm can pay to avoid this risk. If the firm prefers to pay more than zero to avoid a gamble whose expected outcome is zero, then it is risk-averse. If the firm is indifferent between accepting a gamble having an expected value of zero and a fixed payment of zero, then it is risk-neutral. Economists often assume that firms are risk-neutral with respect to the outcome of a given project, but that the firm's shareholders are risk-averse to an equivalent project, mainly because firms are better able to diversify their risks over multiple projects.

<sup>16</sup> In general, economists explain the higher returns earned by equity holders (relative to debt holders) as compensation for the additional risk they bear. The demand to be compensated for bearing risk is evidence in favor of risk aversion and against risk neutrality.

<sup>17</sup> For example, suppose that a firm has \$50 in cash, and it can choose between two strategies. Strategy A has a 50% chance of paying \$100 and a 50% chance of paying –\$50, in which case the firm exhausts its cash reserves and goes bankrupt. The expected value of the strategy is (0.5)(\$100) + (0.5)(–\$50) = \$25. Strategy B has a 50% chance of paying \$200 and a 50% chance of paying –\$150. If bankruptcy were not a possibility, the expected value of strategy B would also be \$25. Because it has the same expected payoff, but is clearly more risky, strategy B should be inferior to strategy A. But because bankruptcy shields the firm from losing more than \$50, the expected value of strategy B is \$75, and its maximum downside (bankruptcy with 50% probability) is no worse. Because the firm does not bear the full cost of its actions it chooses strategy B, which is privately optimal but socially suboptimal.

In sum, the prospect of bankruptcy distorts behavior in ways that belie the claim that firms are risk-neutral. As I explain below, the assumption of risk-neutrality is critical to computing the expected value of entry and, therefore, to the counterfactual claim regarding what the generic firm would have done if an RPS agreement were not in place.

7. **The prospect of an entry delay that would bankrupt the (non)infringing (non)entrant.** Although not a necessary condition for RPS cases, the costs of entry delay for the generic are often not measurable in lost profits alone. The magnitude of these forgone profits may be such that, once again, risk-neutrality is not an accurate assumption. After enough time has passed, a generic that otherwise would not launch (because a realistic damages award may bankrupt it with some probability) may launch anyway (because continued delay will bankrupt it with certainty), in much the same way that a losing football team makes high-risk plays in the closing minutes, rather than “play safe” and lose with certainty. Under these circumstances, the probability that a generic will enter varies, perhaps discontinuously, over time. Unlike football, however, the “game” between the brand and the generic has no definite end point, which makes it harder to calculate the generic’s optimal strategy on any given date, and therefore to predict what it would have done in the absence of an RPS.<sup>18</sup>

### The Nature of “Reverse Payments”

These seven characteristics of brand-generic patent competition under the Hatch-Waxman Act transform what is already an unusually high-stakes decision into what is, for many patent owners and imitators, an unacceptable business risk. But it is not a completely uninsurable risk, and that is the antitrust problem.

The essential problem that an RPS contract addresses is the failure of public institutions to provide information sufficient for private parties to make informed decisions, and to compensate them when the resulting uninformed decisions prove erroneous. The RPS contract is, in other words, a partial *private* response to a negative *social* externality. This failure manifests itself initially in the uncertainty surrounding the validity of patents granted by the Patent and Trademark Office (PTO), and continues in the uncertainty surrounding both the patent owner’s allegation of infringement and the accused infringer’s invalidity defenses, pled in district court. While it is true that the private response to public failure may not be optimal for consumers, that observation should be unsurprising, unless one is given to the (analytically unsupportable) view that the social welfare properties of competitive equilibrium must also be found in the settlement of private litigation.

The average patent infringement suit takes around three years to try. Of those that proceed to trial, fewer than 60 percent find validity and infringement.<sup>19</sup> Appeal to the Court of Appeals for the Federal Circuit generally requires another year. The probability of reversal of some or all of the district court’s decision is relatively high (33 percent in one recent study<sup>20</sup>). Thus, a realistic time horizon for resolution of the uncertainty is four years, not counting the possibility of remand for further proceedings.

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<sup>18</sup> Moreover, it may not be simple to reconstruct the counterfactual market structure (which determines the generic’s lost profits and hence the reasonability of the payments it receives under the RPS), because that structure depends in general on the behavior of other generics and their evolving beliefs about whether the first generic will launch, settle or “wait and see.”

<sup>19</sup> Kimberly A. Moore, *Judges, Juries, and Patent Cases—An Empirical Peek Inside the Black Box*, 99 MICH. L. REV. 365 (2000).

<sup>20</sup> Kimberly A. Moore, *Are District Court Judges Equipped to Resolve Patent Cases?*, 15 HARV. J.L. & TECH. 1, 2 (2001).

In the interim, the parties involved face the possibility of two errors. These errors potentially have huge private costs. The first error is entry by the generic when the brand's patent is valid and infringed, which as I explained above can easily result in a damages award in the hundreds of millions of dollars in the interval between expiration of the Hatch-Waxman stay (at 30 months after litigation commences) and the expected date of disposition by the Federal Circuit (say 48 months). The second error is the generic's failure to enter when the patent is invalid or not infringed, which may deprive the generic of hundreds of millions of dollars in forgone profits. Although these errors are conceptually symmetric, and rooted in the same underlying uncertainty, they reflect a particular legal asymmetry: it is not illegal to attempt to enforce (what turns out to be) an invalid patent, but it is illegal to infringe (what turns out to be) a valid one.

These errors are also likely to be economically asymmetric: the harm that a generic inflicts on a brand from erroneous entry is different from, and usually greater than, the harm that a brand can inflict on a generic from erroneous patent enforcement.<sup>21</sup>

An RPS agreement is, in principle, a bilateral insurance contract against the possibility of these errors.<sup>22</sup> Although the brand and the generic each has sound reasons to pay the other not to err, the particular asymmetries can easily imply that net consideration runs from the patent owner to the accused infringer, especially when each party promises specific performance under the contract.<sup>23</sup>

The net payment may run in "reverse" for several sound reasons:

1. Although the brand is entitled to "damages adequate to compensate for the infringement," the generic's sharply lower prices mean that its profits from infringement will not be adequate to compensate the brand if infringement is found (fact #5 in the "common fact pattern" above). That means the generic must fund damages out of its cash reserves. Because damages are large in absolute magnitude (fact #4), there is a high likelihood that damages will exhaust reserves, i.e., that they will bankrupt the generic (fact #6). In that case, the brand will not receive "damages adequate to compensate for the infringement." The "reverse" payment recognizes and insures the brand against the large positive probability that statutory compensation will prove inadequate.
2. The generic might also pay the brand not to err against it, i.e., for the right to enter before the patent is found invalid or not infringed. But, unlike the brand, the generic does not have a right or a remedy against error. Its *only* mechanism for insurance is to purchase the right to enter, i.e., to contract for a license. But for the same reasons that the generic's profits are inadequate to compensate for infringement, they are inadequate to induce the brand to surrender its exclusivity early. Thus, both the law and the economics ensure that there is no "regular" license from the brand under which the generic contracts for the right to enter.

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<sup>21</sup> The basic reason is that the generic causes the brand to lose monopoly profits, but the brand causes the generic to lose duopoly profits.

<sup>22</sup> A fully specified insurance contract identifies both the conditions that give rise to a claim (one of the errors), as well as the conditions that do not ("no error," i.e., entry when the patent is invalid / not infringed, or no entry when the patent is valid and infringed). A necessary condition of such a contract is that it addresses the ultimate question: is the patent valid and infringed, or not? Because they settle the underlying litigation, many RPS agreements do not reach this ultimate question. Other things equal, such agreements should attract greater antitrust scrutiny because they lack this important attribute of insurance.

<sup>23</sup> "Ordinary" patent settlements may or may not result in a license, and, whether they do or not, they may or may not result in payments from the accused infringer to the patent owner. While it is normally true that patent settlements do not result in a payment from the patentee to the infringer, it is also normally true that the patentee is statutorily entitled, and can expect, to recover "damages adequate to compensate for the infringement." 35 U.S.C. § 284. As I explain below, that key expectation is normally missing in RPS cases.

3. The only other currency that the generic possesses that has any value to the brand is forbearance—in this case, forbearance of erroneous entry. The generic may forbear to enter (erroneously) in exchange for a later license to enter (legally), but the license is incidental: the generic's compensation might also take the form of cash, with no license at all. Similarly, the generic may also accept compensation in cash and/or competitive profits for the informationally symmetric possibility that its forbearance was erroneous.

When the generic pays for entry with (potentially unjustified) forbearance, it is incorrect to characterize the contract as a “license” or the payments as “reverse.”<sup>24</sup> That these characterizations should give rise to a finding of per se antitrust liability simply shows the inability of the antitrust agencies to distinguish legitimate mutual insurance from illegitimate market sharing.

In short, both the brand and the generic are “victims” of a set of public policies that, taken together, do not provide them with sufficient information and do not compensate them adequately or at all for the errors that they may impose on each other in the face of insufficient information. Within the realm of competitive decision making, these are among the largest and most costly errors that firms can make.<sup>25</sup>

More importantly, from a public policy perspective, it bears repeating that only some of the costs that each firm imposes on the other are the “costs” of vigorous competition, from which consumers benefit. As I explain below, some of these costs, which are imposed jointly on the parties as a negative externality, also injure consumers. In other words, they are social costs.

### The Social Costs of Private Insurance

As large as the private costs of error are, they do not take account of the additional social costs of error. For that reason, we cannot expect private agents to contract optimally around social costs when making their private decisions. In particular, it is inaccurate to argue that RPS contracts “deprive the public of the competition to which it is otherwise entitled” because—once again unlike the usual case—the public does not necessarily gain from increased private competition.

While it is true that the second error—the generic's failure to enter when the patent is invalid or not infringed—deprives the public of competition, it is not true that the public is “entitled” to such competition. Patent policy contemplates the possibility that patents will be enforced erroneously. In the short run, this outcome unambiguously has negative competitive consequences for consumers. Under the assumption that the patent system itself is procompetitive—an assumption expressly adopted by the IP Guidelines—the erroneous temporary enforcement of patent rights must be regarded as a necessary concomitant of promoting progress in the long run.<sup>26</sup>

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<sup>24</sup> Again in principle, the size of the payment to the generic should depend on the ultimate resolution of the dispute. If the patent is found valid and infringed, the generic had no right to enter and therefore no right to compensation. RPS agreements that do not condition the payment to the generic on the resolution of the underlying dispute demand greater antitrust scrutiny.

<sup>25</sup> In characterizing the parties to RPS contracts as “victims,” I do not imply that these contracts are never anticompetitive in intent or effect. But whether they are anticompetitive or not, the structural externality that begets these contracts arises independently.

<sup>26</sup> That consumers permit patentees to receive windfalls from erroneous patent enforcement, without demanding compensation in return, obviously does not imply that such errors are desirable. On the contrary, these errors highlight the premium that consumers should place on accurate initial examination by the patent office. See Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 Nw. U.L. Rev. 1495 (2001) (arguing that the patent office is, and should be, “rationally ignorant” about the objective validity of patents). Such errors also point to the implicit consumer demand for speedier resolution of pharmaceutical patent disputes, perhaps through a specialized tribunal like the International Trade Commission (which adjudicates a claim for injunctive relief from infringement within one year after the claim is filed).

But the exclusive focus on the “competition that might have been” also ignores the social costs of the first error—the generic’s erroneous entry when the patent is valid and infringed, for which it may not offer adequate compensation. According to the IP Guidelines, uncompensated competition from imitators is itself an injury to consumers, not just to the inventor:

The intellectual property laws and the antitrust laws share the common purpose of promoting innovation and enhancing consumer welfare. . . . In the absence of intellectual property rights, imitators could more rapidly exploit the efforts of innovators and investors *without compensation*. Rapid imitation would reduce the commercial value of innovation and erode incentives to invest, *ultimately to the detriment of consumers*.<sup>27</sup>

In other words, the IP Guidelines themselves contradict a claim often made implicitly or explicitly against RPS agreements, which is that uncompensated patent infringement is simply part of the hurly-burly of competition, operating to the benefit of consumers. The prospect of bankruptcy means that an infringer may not pay full compensation for patent infringement—an injury to consumers—and therefore may take a socially inefficient level of care to prevent such injury. Given the policies adopted by the IP Guidelines, it is perverse to argue that the inadequate compensation for patent infringement amounts to a consumer benefit. For the same reason, one cannot conclude that steps to contract around such inefficiency are anticompetitive per se. If consumers lose from the failure to compensate patent rights adequately, then consumers must gain when the compensation is more adequate.

In sum, many antitrust analyses make one or more of the following types of errors:

- they compare performance under a license (a grant of property) to performance under an insurance policy (a contingent payoff);
- they mistake bilateral (on balance, “reverse”) insurance premiums for a unilateral license payment;
- they ignore the fact that the two potential errors (erroneous entry and erroneous forbearance), produce symmetric harms, but asymmetric liabilities;
- they fail to locate either the source of uncertainty or the private and social costs of erroneous responses to it; and
- they omit the competitive gains to consumers that arise from the enforcement of a valid patent right.

At various points in time, the FTC’s analysis has succumbed to one or more of these errors. To prove the existence, rather than catalogue the history, of these errors, one can simply look to the FTC’s brief in support of certiorari in *Schering*: “The court of appeals’ reasoning ignores the fact that a firm ‘certain that a patent was valid . . . would have no incentive whatsoever to pay another firm to stay out of the market.’”<sup>28</sup> The prior discussion shows that the FTC has failed to grasp the essential economics of the situation:

1. Given the intrinsic randomness of the judicial process (from the litigant’s point of view),<sup>29</sup> no rational firm can believe “with certainty” that a patent is valid. But whether the brand’s beliefs accurately reflect the underlying uncertainty or not is irrelevant. What matters to

<sup>27</sup> IP Guidelines § 1.0 (emphasis added).

<sup>28</sup> *FTC v. Schering-Plough*, Petition for Writ of Certiorari 18 (citing HERBERT HOVENKAMP, ANTITRUST LAW, ¶ 2046, at 339 (2004 Supp.)), available at <http://www.ftc.gov/os/2005/08/050829scheringploughpet.pdf>.

<sup>29</sup> See, e.g., the studies cited *supra* notes 19 and 20.

the generic's entry decision is (a) the generic's belief, which in turn depends on (b) the probability that the trial court will find in favor of the brand, which in turn depends in part on (c) private information, some possessed by the generic and other by the brand, about the patent's validity.<sup>30</sup>

2. Because the generic cannot commit credibly to compensating the brand should the generic enter the market erroneously, the brand has a direct "incentive . . . to pay another firm to stay out of the market". This incentive arises independently of the patent's probability of invalidity, or the brand's beliefs about it.
3. Conversely, the generic's demand for payment derives from its own belief that the patent may not be valid or infringed, which harms the generic if the generic stays off the market. The demand for compensation is backed by the credible threat to enter and thereby to harm the brand irremediably if the generic goes bankrupt. Again, the brand's assessment of the probability that its patent will be enforced may differ from the generic's belief, and from the true probability, but that is irrelevant.

### Would the Generic Have Entered When the Stay Expired?

As I stated previously, the legal claim of antitrust liability derives from the factual claim that a generic would enter at the expiration of the 30-month Hatch-Waxman stay, based on whether the expected value of entry was positive. As an empirical matter, I believe computing any such expected value is probably indefensible, except in extreme circumstances. At bottom this calculation requires assigning a probability distribution to the patent's validity and infringement, which is a notoriously subjective exercise even when the parties do not have private information. In addition, the payoff calculations are not likely to conform to the assumptions of risk-neutrality for "bet the company"-level decisions. Further, for reasons I have alluded to above, the various probabilities and payoffs are likely to be changing over time. But even in theory, there are reasons to think that this calculation might be a fool's errand.

To claim that the generic "would have entered," one must claim that, in the game between the generic and the brand, there is an equilibrium in pure strategies and those strategies (from the generic's perspective) are "entry" and "no entry." This roughly means that the generic invariably would find one of these two strategies more profitable than the other, and would have picked it. If "entry" were more profitable, based on the relevant empirical modeling, then that strategy could be imputed to the generic in the absence of the challenged RPS. Hence, the RPS "deprived the public of competition" that otherwise "would have occurred."

It is well known, however, that games often have no equilibrium in pure strategies. Instead, the equilibrium is in "mixed strategies," which in the present case means that the generic may choose either "entry" or "no entry" with some probability.

To give this abstract notion some substance, consider a hypothetical generic's claim that it "never" would have entered at the expiration of the 30-month stay. If that were true, then of course there would have been no need for the brand to enter into any RPS that forestalled entry. Because we in fact observe an RPS, it must be the case that the brand believed that there was some probability that the generic would enter; the generic uses that belief to induce the brand to insure itself against (erroneous) entry. Hence, the RPS itself leads us to infer that "no entry" was not the dom-

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<sup>30</sup> That the generic may have private information about the patent's validity is sufficient, by itself, to moot the possibility that the brand is "certain that a patent was valid."

inant strategy for the generic.<sup>31</sup> Therefore, we conclude that the generic's claim after the fact that it never would have entered is not credible, and infer instead that entry would have occurred with some positive probability. Then the remaining question is whether that probability was 1, i.e., whether the generic's entry was certain (because "entry" was the dominant strategy). As an empirical matter, this polar opposite position also seems unlikely, given the dearth of examples of generics launching at risk.

We are left with the conclusion that there was some probability between zero and one that the generic would enter, but we do not know what it is. But it is critical to understand that this uncertainty is not simply the usual *empirical* uncertainty that confronts all regulatory agencies. It is a much deeper structural uncertainty: when a firm mixes strategies, it randomizes between them. In effect, the generic flips a coin and enters if the coin comes up heads. But instead of choosing one strategy and rejecting the other, the firm chooses both strategies, each occurring with some optimal probability. Obviously, in these circumstances, there will be evidentiary support for *both* strategies. But the critical theoretical point is that asking what the firm "would have done" in these circumstances is the wrong factual question—because the firm itself does not know.

Although I believe strongly that the antitrust agencies must recognize the possibility of this essential indeterminacy, this recognition merely makes it more difficult to find antitrust liability in any given case. That there exists an intellectual "safe harbor" for some defendants does little to advance the broader policy debate, especially if that safe harbor also protects truly anticompetitive agreements. Accordingly, I offer a proposal that allows for both the underlying structural uncertainty and for the agencies' legitimate interest in inducing competitors to behave non-collusively.

### **A Proposal for Policy Reform**

Based on both the legal and economic contexts in which RPS contracts arise, I believe these contracts demand rule of reason rather than per se treatment. Advocates of a per se rule do not seem to consider adequately either the dynamic consumer benefits of enforcing intellectual property rights or the very real high-stakes dilemma that litigation uncertainty imposes upon both brands and generics.

At the same time, rule of reason treatment is vulnerable to the very real criticism that antitrust economists may not be able to distinguish, in any empirically tractable way, a procompetitive agreement from an anticompetitive agreement. Of course, if either the agencies or the courts were to admit that this is the case, they would virtually invite firms to draft anticompetitive or otherwise socially inefficient agreements. And that is the crux of the problem: when market structure is determined by government policy (as in the case of a patent), and that policy is itself subject to delayed interpretation (as in the case of infringement litigation), it is unrealistic to expect competing private firms to enter into contracts that reproduce the social benefits of the policy.

The essential policy problems are these: "Error" of the kinds I have described only exists because the courts do not determine validity and infringement instantaneously. Both the private parties and consumers are inadequately insured against the costs of error. Even after the parties contract by an RPS, their mutual insurance does not and cannot take adequate account of consumer interests.

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<sup>31</sup> From a theoretical point of view, this claim may be more subtle, because it depends on whether there exists private information, beliefs about others' beliefs, etc. Although these complexities are theoretically important, they are unlikely to have any empirical application except in circumstances that are too particular to generalize about.

Consumer interests are aligned both with the generic (the facilitation of whose entry promotes competition) and with the brand (the protection of whose property rights promotes innovation).

For their part, the antitrust agencies do consumers no favors by implicitly or explicitly preferring competition to the enforcement of intellectual property rights. Such preferences belie the agencies' own guidelines and, if anything, weigh the static welfare gains from incremental competition more heavily than the dynamic welfare gains from incremental innovation. In addition to going well beyond the agencies' institutional competence and jurisdiction, that weighting implicitly answers a productivity-based question on which, to say the least, the jury is still out.

Rather than rely on counterfactual arguments about expectations and entry at the expiration of the 30-month Hatch-Waxman stay, it would be conceptually consistent for the FTC, and others who favor that generics enter when the stay expires, to promise to insure a brand against uncompensated patent infringement in the events that (a) entry was erroneous, and (b) the brand obtains a damages award in excess of the generic's ability to pay. This payment would be funded out of the (*ex post* illegal) gains that consumers received from the erroneous competition.

Needless to say, the notion that the government should pay hundreds of millions of dollars to patentees who already may have reaped many times that in profits from their patents is politically intractable, however analytically correct.

But there is a similar insurance mechanism that may be both politically and analytically feasible, while obviating the need for an RPS. Unlike most litigants, a brand automatically receives 30 months of freedom from infringement. At the expiration of 30 months, Congress could require the brand to post a bond equal to the sum of the loss to consumers and to the generic from further delayed competition, perhaps updated quarterly. In effect, the brand funds its own insurance policy by placing its profits into escrow, and retrieving them if and only if its legal position is vindicated. In the event that the patent is eventually found invalid or not infringed, the brand forfeits the bond.<sup>32</sup>

If the brand refuses to post such a bond, Congress would relieve the entrant of any liability for erroneous competition between the expiration of the stay and the final determination of the patent's status.<sup>33</sup> Most brands would find this option unattractive. Not incidentally, this option removes any legitimate incentive for a generic to enter into an RPS.

In return for a guarantee of full compensation (in the event that the patent is valid and infringed), the brand gives up the right to settle the litigation (perhaps by granting the Commission intervenor status) by an RPS or any other means. This provision ensures that the public receives the important social benefit of a final determination regarding validity and infringement, a determination that has value, not only between the litigating parties, but as political justification for the observed prices and market structure. Perhaps most importantly, from an economic point of view, the cor-

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<sup>32</sup> After compensating the generic for its lost profits, the remainder of the bond either enters the general treasury, or funds rebates to consumers who, in hindsight, have overpaid. Although it would be administratively simpler to transfer the funds to all taxpayers, it is preferable distributionally to correct past overpayments by the affected consumers. This method of forfeit is also likely to be more transparent politically, and may even be preferred by the brand itself, insofar as it wishes to use the rebate as an opportunity for future marketing and cultivating customer goodwill. As a practical matter, most such overpayments will have been made by health insurers, who already have well-developed relationships with pharmaceutical suppliers and who have a clear interest in obtaining rebates on behalf of their policyholders.

<sup>33</sup> Nothing essential ties the posting of the competition bond to the expiration of the 30-month Hatch-Waxman stay. Congress could also choose to require the competition bond at any other prior point, including at the outset of the litigation. Once the competition bond is in place, of course, the stay becomes redundant.

rect determination of a patent's status provides the correct basis for entry decisions by third-party generics, and for efficient dynamic investments by next-generation competitors.<sup>34</sup>

In effect, requiring a competition bond in lieu of an RPS makes the RPS per se illegal, not on the ground that consumer harm is inevitable, but on the ground that procompetitive and anti-competitive RPS contracts are observationally equivalent under any rule of reason analysis currently feasible to the antitrust agencies. Recognizing that private parties are served imperfectly by the patent office and the courts, and that these parties do not have the correct social incentives to remedy that deficiency, the government compels the patentee to contract for patent insurance with itself, not a potential competitor.

Because the mechanics of computing a competition bond, and its distribution in the event of forfeiture, are similar to those of computing patent infringement damages, they are analytically tractable and, in fact, supported by considerable precedent.<sup>35</sup> And because the bond is privately funded, the antitrust agencies avoid two politically charged positions: either appearing to subsidize already valuable property rights, or appearing to advocate the diminution of those rights via misplaced insistence on competition.

By demanding a competition bond in exchange for continued preliminary relief from infringement, the antitrust agencies preserve the ability to return each interested party—brand, generic and consumer—to the position it would have occupied had the judicial determination of validity and infringement been instantaneous. In short, the regulatory agencies undo the negative externality imposed by the courts on the property rights—and the innovation policy they implicitly define—established by Congress. They thereby assume their proper role as guarantors of legitimate dynamic competition—without overreaching to determine what that competition should be. ●

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<sup>34</sup> Advocates of RPS settlements often note that public policy favors the settlement of litigation. While that policy also applies here, it applies with less force when consumer interests are directly implicated by the settlement. In addition to consumers' interests in short-run competition, consumers also have an interest in efficient dynamic investment in the next generation of products. Both of these interests are directly implicated when a patent's status is left undetermined.

<sup>35</sup> In the (overly) simple example given in footnote 14, the difference between the brand's profits without competition (\$800 million) and with competition (\$240 million) is \$560 million. That would be the amount of the competition bond (which the brand could post in the quarter following the protected sales). In the event of forfeiture, these funds are divided between the generic's lost profits (\$350 million) and the refund to consumers (\$210 million). The refund to consumers is the difference between what consumers actually paid under the erroneous monopoly (\$1 billion), and what they would have paid under competition (\$490 million to the generic and \$300 million to the brand, or a total of \$790 million).

Of course, this analysis neglects entirely many other issues, such as the role of advertising in computing incremental profits, as well as any dynamic effects that advertising may have on future sales. A proper counterfactual analysis would have to take these issues into account. But the larger point is that the counterfactual issues that must be addressed when competition is erroneously denied are conceptually symmetric to those that are routinely addressed when competition is erroneously permitted—i.e., in the damages phase of patent infringement litigation.

# The FTC's Report on Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases: Some Comments

**Elizabeth M. Bailey**

As gasoline prices at the pump in the United States have risen to over \$3.00 for a gallon of regular unleaded in the summer of 2006 from a low of about \$1.00 in 1998, the Federal Trade Commission has been under pressure from consumers and from Congress to investigate the reasons for the increase. Of particular interest has been whether transactions in the petroleum industry that government agencies had reviewed contributed to the higher prices. Some of the recent transactions that have taken place in the petroleum industry include Shell-Texaco (1998), Exxon-Mobil (1999), BP-Amoco (1998), BP-ARCO (2000), Chevron-Texaco (2001), Phillips-Tosco (2001), Valero-UDS (2001) and Conoco-Phillips (2002). The FTC is the antitrust agency that reviewed most, but not all, of the petroleum industry transactions reported under the Hart Scott Rodino Act in the past decade; the U.S. Department of Justice reviewed the remainder.

The FTC has released a lengthy list of reports over the past few years addressing the results of its investigations into the causes of gasoline price increases.<sup>1</sup> On May 22, 2006, the FTC released its most recent report, *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases*.<sup>2</sup> The report provides the FTC's findings on an investigation that responds to two mandates from Congress, one general on the behavior of refiners and distributors of gasoline in the United States and the other specific to the events in the wake of Hurricane Katrina.

The report is divided into three parts. Part I of the report addresses the mandate in the 2005 Energy Policy Act, which required the FTC to investigate whether the price of gasoline is being "artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging."<sup>3</sup> The report defines price manipulation as including "(1) all transactions and practices that are prohibited by the antitrust laws . . . and (2) all other transactions and practices, irrespective of their legality under the antitrust laws, that tend to increase prices relative to costs and to reduce output."<sup>4</sup> Part II of the report addresses the mandate in the FTC's 2006 appropriation legislation, which required the FTC to investigate "nationwide gasoline prices and possible price gouging in the aftermath of Hurricane Katrina."<sup>5</sup> Part III of the report provides, in part, a policy discussion of the merits of federal price gouging legislation.

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<sup>1</sup> Those reports include: THE MIDWEST GASOLINE PRICE INVESTIGATION (Mar. 2001); THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT: A REPORT OF THE STAFF OF THE FEDERAL TRADE COMMISSION BUREAU OF ECONOMICS (Aug. 2004); and GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (June 2005). All of these reports can be found at [http://www.ftc.gov/ftc/oilgas/competn\\_reports.htm](http://www.ftc.gov/ftc/oilgas/competn_reports.htm).

<sup>2</sup> Available at <http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf>.

<sup>3</sup> *Id.* at i.

<sup>4</sup> *Id.* at ii.

<sup>5</sup> *Id.* at i.

This article summarizes the report's findings and offers some comments on what the report's findings tell us—and don't tell us—about market power in the petroleum industry.

### **Market Manipulation in the Supply and Distribution of Gasoline**

The FTC report addresses two questions related to whether there is any evidence of market manipulation in the supply and distribution of gasoline in the United States. First, is there any evidence that refiners and distributors of gasoline in the United States attempted historically to manipulate gasoline prices? Second, is there any evidence that refiners and distributors of gasoline in the United States attempted to manipulate gasoline prices in the wake of Hurricanes Katrina?

To answer these questions, the FTC analyzed voluntary interviews conducted with firms in the petroleum industry, sworn investigational hearings, data and documentary responses to Civil Investigatory Demands, and data on wholesale and retail gasoline prices obtained from Oil Price Information Service, a third party which sells data on prices in various segments of the petroleum industry.<sup>6</sup>

Based on an analysis of that information, the first part of the report concludes that refiners and distributors in the United States petroleum industry have “behaved competitively.”<sup>7</sup> With the exception of upstream exploration, development, and production of crude oil, the first part of the report provides a detailed discussion of the stages of the petroleum industry that relate to gasoline supply. These include refining, pipeline supply, marine shipments, and terminal services. The FTC bases its conclusion that refiners have behaved competitively on a lack of evidence that refiners in the United States underinvested in new refining capacity. Likewise, the report states that no evidence was found that refiners’ planned (or unplanned) refinery outages were strategically timed or that refiners’ adjusted the mix of refinery output in order to attempt to manipulate gasoline price. In addition, the FTC found no evidence that firms exported gasoline to less profitable markets nor evidence that the distribution infrastructure—such as marine transportation services, pipeline services, and terminalling services—manipulated gasoline prices via rate structures and/or forgone expansions. Finally, the FTC found no evidence that the firms in the petroleum industry reduced inventory holdings in order to manipulate gasoline prices. The report concludes that one of the largest contributors to the increase in gasoline prices at the pump were increases in crude oil costs.<sup>8</sup>

The second part of the report concludes that the responses by firms in the petroleum industry to the negative shock to the supply of gasoline caused by Hurricane Katrina were “consistent with competition.”<sup>9</sup> The FTC based these conclusions on an absence of evidence that firms adjusted their refinery output mix, diverted gasoline supplies, or withheld inventories in order to manipulate gasoline prices in reaction to the supply shortage created by Hurricane Katrina.

The second part of the report also concludes that the increases in gasoline prices after Hurricanes Katrina and Rita “were consistent with the standard supply and demand competitive paradigm.”<sup>10</sup> This conclusion, however, says little about whether the firms have market power

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<sup>6</sup> *Id.* at iv–v.

<sup>7</sup> *Id.* at vi.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at ix.

<sup>10</sup> *Id.*

*The elephant in the room in this report is whether the investments in capacity and infrastructure made by firms in the petroleum industry would have been any different absent the consolidation that has taken place over the past decade.*

because it is a true statement for firms with no market power and for firms that possess market power. For example, one would expect to see supply being diverted from lower-priced areas to higher-priced areas in an industry in which firms possess market power. Similarly, one would expect to see firms with market power drawing down inventory in the face of a negative supply shock. As well, one would expect to see refineries that possess market power and that were not affected by the hurricanes to increase output. The difference between the response in an industry characterized by no market power compared to the response in an industry characterized by participants with market power is in the magnitude of the response (e.g., how much supply is diverted, how much inventory is depleted, how big an increase in refinery output). Based on the information contained in the report, it is not possible to conclude whether the firms' responses to the gasoline supply disruption caused by Hurricane Katrina were closer to the magnitude expected in an industry characterized by no market power or closer to that expected in an industry characterized by market power.

The elephant in the room in this report is whether the investments in capacity and infrastructure made by firms in the petroleum industry would have been any different absent the consolidation that has taken place over the past decade. Similarly, absent the consolidation in this industry, would the magnitude of the responses to the negative supply shock from Hurricane Katrina been any different? If so, would those different investments and strategies have resulted in a slower rise in gasoline prices over the past several years and/or smaller price increases post-Hurricane Katrina?

Of course, it is also possible that the consolidation that has taken place over the past decade has generated cost savings, improvements in best practices, or other efficiencies. If so, these improvements may have in fact allowed firms in the petroleum industry to make investments and implement strategies that have resulted in a slower rise in gasoline prices over the past several years, including potentially smaller price increases post-Hurricane Katrina, none of which would have been possible absent consolidation.

Understanding what price levels, investments, and strategic decisions would have been observed had consolidation in the petroleum industry not taken place over the last decade is a difficult analysis and one that was not explicitly included in the mandates that Congress imposed on the FTC. One of the primary reasons the analysis is difficult is that in order to evaluate what investments and strategic decisions would have taken place if, counterfactually, there had been no consolidation, one would have to define a "but for" state of the world that incorporates decisions and actions that were never observed and never took place. Moreover, the exact structure of what that unobserved state would have looked like would be the subject of much debate. For example, is that unobserved state of the world one in which a particular merger was blocked? Is it one in which additional divestitures were required? Or is it one in which no additional divestitures were required, but that the required divestitures were different than those that actually took place?

On the question of whether consolidation has had any effect on the potential for price manipulation, the report only states that the FTC staff reviewed "all of the company documents obtained in this investigation" including specific requests for "any formal internal report or study analyzing the effects of any past merger or joint venture" and found that there was "no evidence that past mergers contributed significantly to the potential for price manipulation."<sup>11</sup> To the extent these firms were aware of the possible scrutiny their actions would receive and thus did not document

<sup>11</sup> *Id.* at 58.

these types of thoughts on paper, it is unlikely the FTC staff would have found any evidence. In most industries, particularly one as operationally complex as the petroleum industry, the number of dimensions along which a firm could attempt to exercise market power seem only to be limited by the boundless ingenuity of a clever human mind.

### Proposals on Possible Price Gouging Legislation

In addition to the qualitative and quantitative discussion of the investment and inventory decisions made by participants in the petroleum industry and how these firms responded to the negative supply shock caused by Hurricane Katrina, Congress directed the FTC to recommend possible anti-price-gouging legislation to Congress.<sup>12</sup> Part III of the report provides a policy discussion of the FTC's views on the merits of federal price-gouging legislation.

*Any test to determine whether a firm is engaged in price-gouging behavior must be predicated on the firm having market power, however persistent or transitory that market power may be.*

The report demurs from providing its own affirmative definition of price gouging due to the difficulty of doing so and the lack of consensus on how to do so.<sup>13</sup> Rather, the report adopts the definition provided to it by Congress. The congressionally mandated definition characterizes price gouging according to a two-step approach.<sup>14</sup> First, a firm's monthly average sales price for gasoline in a particular area must be higher than that in a previous month. Second, the higher price must not be explainable by higher costs or market trends. While the report notes that several refiners and retailers would be categorized as price gouging post-Hurricane Katrina according to the first step of the test, the investigation finds very few of these firms would be categorized as price gouging once the second step of the test is implemented.

The FTC's concerns about defining an empirical test for price gouging is reminiscent of the debate during the 1970s and 1980s over whether and how to structure a legal test to identify predatory pricing. The large amount of academic literature generated on the topic of predatory pricing indicates that, like the debate over price-gouging legislation today, there was no consensus among economists and lawyers as to what behavior constituted predatory pricing. Ultimately, several tests for predatory pricing emerged, each with its own strengths and weaknesses.<sup>15</sup>

Another obvious parallel between an empirical test for predatory pricing and an empirical test for price gouging is the cost-based nature of the empirical test. As with the issues that arose with several predatory pricing tests, any empirical test for price gouging that is cost-based is likely to be subject to great debate about which costs are relevant to the analysis and how to accurately measure those costs.

A key component of any test for price gouging is the ability of the firm alleged to be price gouging to have power over price, albeit temporarily. Without the ability to exercise market power, however temporary, any attempt by the firm to price gouge would result in customers quickly and easily substituting to other sources of supply, thus defeating any attempt to profit from the pricing strategy. Any test to determine whether a firm is engaged in price-gouging behavior must be predicated on the firm having market power, however persistent or transitory that market power may be.

<sup>12</sup> *Id.* at 183.

<sup>13</sup> *Id.* at 137 n.2, 190–91, 196.

<sup>14</sup> *Id.* at 137–38.

<sup>15</sup> Several well-known versions of these tests include the Areeda-Turner test, the Joskow-Klevorick test, and the Ordovery-Willig test. See Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975); Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979); Janusz A. Ordovery & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981).

### **A Resource**

The latest FTC report on gasoline prices, while leaving some questions unanswered, is nevertheless likely to serve as a useful resource for many years to come to students of the petroleum industry. Collectively, the tables and charts gather together a comprehensive collection of numerous sources of data and anecdotes available on the petroleum industry. The report also provides a well thought-out discussion of the economic issues that arise in an attempt to pin down the behavior that constitutes price gouging. The report will also provide a jumping off point for future studies assessing the investment and strategic decision that have been made in this industry. ●

## Paper Trail: Working Papers and Recent Scholarship

**Editors' Note:** One indication of the level of interest in antitrust in Europe is the rate of publication of books on the subject. In this installment of the Paper Trail, we briefly note the publication of seven new books on various aspects of European competition law. (We thank Elina Gonikberg, a law student at the University of Florida, for research assistance in the preparation of this note.)

Send suggestions for papers to review, or your comments, to Editors William Page: [page@law.ufl.edu](mailto:page@law.ufl.edu) or John Woodbury: [jwoodbury@crai.com](mailto:jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

### Recent Books

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**Oliver Black, *Conceptual Foundations of Antitrust*** (Cambridge University Press 2005)

**Gustavo Ghidini, *Intellectual Property and Competition Law. The Innovation Nexus***  
(Edward Elgar Publishing 2006)

**European Merger Control: Do We Need an Efficiency Defence?** (Fabienne Ilzkovitz & Roderick Meiklejohn eds., Edward Elgar Publishing 2006)

**Valentine Korah, *Intellectual Property and the EC Competition Rules*** (Hart Publishing 2006)

**Robert O'Donoghue & A Jorge Padilla, *The Law and Economics of Article 82 EC*** (Hart Publishing 2006)

**Michael A. Utton, *International Competition Policy: Maintaining Open Markets in the Global Economy***  
(Edward Elgar Publishing 2006)

**Frank Wijckmans, Filip Tuytschaever & Alain Vanderelst, *Vertical Agreements in EC Competition Law***  
(Oxford University Press 2006)

Although all of these books deal with some aspect of European competition law, they vary widely in approach, ranging from practical to theoretical, short to long, and narrow to general. The most theoretical of the seven is Oliver Black's *Conceptual Foundations of Antitrust*, which applies the tools of analytical philosophy to antitrust's fundamental concepts and methods of analysis. In the first half of the book, Black, a practitioner and professor at King's College London, examines the meaning of "competition" and "welfare" and the roles of per se and rule of reason analysis. The latter half of the book focuses on "agreements" and "concerted practices," which Black distinguishes from each other and from independent or consciously parallel conduct. Black proposes an ascending hierarchy of degrees of "correlation" between rivals' actions, with the highest representing joint or concerted action. He identifies communication as the critical factor that distinguishes consciously parallel and concerted action. (I found this part of the book sufficiently persuasive that I attempted to apply it to the American law of concerted action in a paper that I recently presented at a conference at Loyola Chicago's Institute for Consumer Antitrust Studies.)

Of the books surveyed here, Michael A. Utton's, *International Competition Policy: Maintaining Open Markets in the Global Economy* is the shortest at only 144 pages, but the broadest in geographic scope. Utton, an emeritus economics professor at the University of Reading, advocates the internationalization of competition policy to keep pace with the globalization of the world economy. He emphasizes the role that a more harmonious world competition policy can play in promoting international trade. To this end, he surveys the effects that a variety of practices, government-sponsored and otherwise, can have in inhibiting trade. He devotes chapters to government-sponsored and private cartels, voluntary export restraints, vertical restraints, dominant firm pricing strategies (including predatory pricing and dumping), and mergers. In the latter part of the book, Utton examines the many impediments to harmonizing competition policies, especially countries' widely divergent economic interests and antitrust policy goals. He then reviews past and present efforts at harmonization through a variety of international organizations.

Two of the recent volumes examine the relationship of intellectual property and European competition law. Valentine Korah's *Intellectual Property and the EC Competition Rules* combines a technical discussion of the full range of EC sources of law on IP licensing with consistent advocacy of a more economic (and less formalistic) approach to the relevant antitrust issues. A central chapter provides a detailed analysis of the 2004 "fourth group exemption [from Article 81 of the European Treaty, the EC counterpart to Section 1 of the Sherman Act] for technology transfer" and its amplifying guidelines. Korah, an emeritus law professor at Cambridge, argues that the final regulation is more restrictive than comparable U.S. limits on IP licensing and may well encourage European firms to move R&D efforts out of Europe. A later chapter analyzes cases on the legality of refusals to license IP under Article 82, the counterpart to Sherman 2 of the Sherman Act.

Gustavo Ghidini's *Intellectual Property and Competition Law: The Innovation Nexus* also addresses the relationship of IP and antitrust, but focuses much more on what Ghidini, a law professor at Luiss Guido Carli University in Rome, views as the undue expansion of the scope of patent, copyright, and trademark rights. Only in a final chapter does he examine competition law as means of limiting the effects of unduly broad IP rights. Ghidini approves the use of compulsory licensing of IP rights in "exceptional" circumstances to assure market access.

By far the longest and most ambitious of the new books at almost 800 pages is Robert O'Donoghue & A Jorge Padilla's *Law and Economics of Article 82 EC*. Article 82 covers roughly the same territory as the American law of monopolization, but has been interpreted to condemn a much greater range of large-firm conduct. The book, written by an economist and a lawyer, includes chapters on market definition, monopoly power (or "dominance"), and specific "abuses," either exclusionary or exploitative practices. Each chapter begins with a survey of the economic literature and then discusses legal standards. American readers will be particularly interested in the departures from Sherman Act standards. The chapter on dominance, for example includes a discussion of "collective dominance," which resembles the concept of "shared monopoly" that U.S. enforcers advanced and then abandoned as a basis for liability during the 1970s. The names of most of the chapters on abuses correspond to U.S. legal categories—predatory pricing, exclusive dealing, refusals to deal, tying, and price discrimination—but the EC standards of legality are often quite different. Most strikingly, dominant firms are subject to far broader obligations to deal with rivals than under American law. There is also a chapter on "excessive prices," which apparently can constitute an abuse of dominant position under EC law. The authors provide appropriate critical analysis in each of these instances. The final chapter addresses remedies and briefly examines the reasons for the dearth of private antitrust litigation in Europe.

Frank Wijckmans, Filip Tuytschaever & Alain Vanderelst's *Vertical Agreements in EC Competition Law* analyzes vertical agreements within and outside the scope of Regulation 2790/99, a block exemption for all vertical agreements except those covered by the motor vehicle distribution block exemption, Regulation 1400/2002. The book is very much a practitioner's volume, with virtually no discussion of economics, except to the extent that economic concepts like the "free-rider problem" and "experience goods" have been incorporated into regulatory guidelines. The authors, all partners in a Brussels law firm, first review the application of Articles 81 and 82 to vertical restraints, recount the adoption of the two block exemptions, and explain the relevance of "soft" or persuasive legal principles. The second part of the book examines in detail the geographic and temporal scope of Regulation 2790/99 and the conditions that various types of restraints (including "hardcore" restraints like vertical minimum price fixing) must meet in order to qualify. The third part deals with agreements that fall outside of the exemption because they involve companies with market shares in excess of the exemption's thresholds, and with the motor vehicle block exemption.

The final book we note, *European Merger Control: Do We Need an Efficiency Defence?*, edited by Fabienne Ilzkovitz and Roderick Meiklejohn, two policy officials at the European Commission, contains five chapters by various authors considering how best to account for economic efficiencies in merger analysis under the 2004 EU merger regulations and the EC's guidelines for horizontal mergers. In chapter 1, Meiklejohn examines data on merger activity and merger control between 1991 and 2004, a period he describes as "the last merger wave." He finds that European enforcers closely scrutinized six percent of mergers and blocked one percent. He identifies determinants of merger activity, and suggests that during the period, European mergers were more likely than American mergers to have been driven by efficiency concerns. In chapter 2, both of the book's editors consider whether an efficiencies defense is the best way of making the familiar welfare tradeoff in merger analysis. They identify what sorts of efficiencies can flow from mergers and describe how enforcement authorities in various OECD countries, including the United States, have addressed the many dimensions of the issue. They propose a list of principles of merger analysis (e.g., to measure the effect on consumer welfare rather than total welfare, to consider both dynamic and static efficiencies, and to require that efficiencies be merger-specific) and a "sequential" approach to applying the principles. The sequence includes initial screens, qualitative analysis of efficiencies, and a quantitative cost-benefit analysis. In chapter 3, Lars-Hendrik Röller, Johan Stennek, and Frank Verboven cover much of the same ground, but with different emphases. In chapter 4, the longest chapter at over 100 pages, Johan Stennek and Frank Verboven examine empirical data on various claimed efficiencies from mergers and offer an extended discussion of how to measure whether cost savings from mergers are passed on to consumers. A brief final chapter argues that enforcement authorities should consider "synergies" from mergers. ●

—WHP