

A Competition Policy Perspective on Patent Law: The Federal Trade Commission's Report on the Evolving IP Marketplace

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It is well recognized that intellectual property and competition laws share the fundamental goals of promoting innovation and consumer welfare. Patents encourage innovation by preventing others from appropriating the value of the patent owner's investment. The antitrust laws preserve competition among new products and technologies, ensuring that consumers share in the gains from innovation. Both encourage firms to compete in the marketplace by investing in technologies that generate more efficient methods of production and new products and services for consumers.

Modern antitrust law has translated these broad goals into practice by examining the way the law is likely to affect incentives to innovate and compete. Attention to economic incentives began in earnest in the 1970s, with the rise of the Chicago School and its emphasis on the power of markets to drive efficient conduct and promote consumer welfare.¹ Economics has been especially influential in shaping the analysis of conduct involving the exercise of patent rights, leading, for example, to rule of reason treatment for most licensing arrangements.² Today, many economists advocate more nuanced approaches to antitrust that take into account the impact that imperfect information and complex business strategies can have on markets.³ But while economic tools and thinking have evolved, the effort to use economics to shape rules that discourage anticompetitive behavior and preserve incentives to innovate has remained the driving force behind antitrust law and policy for nearly forty years.

The Federal Trade Commission has long been a leading voice for adopting a similar economically grounded approach to patent law. The Commission issued its first major report on the patent system in 2003, focusing on the impact of patent quality on innovation and competition.⁴

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¹ See generally William E. Kovacic & Carl Shapiro, *Antitrust Policy: A Century of Economic and Legal Thinking*, 14 J. ECON. PERSP., Winter 2000, at 43; Daniel L. Rubinfeld, *On the Foundations of Antitrust Law and Economics*, in HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST 51, 54 (Robert Pitofsky ed., 2008).

² See Abbott B. Lipsky, *Current Antitrust Division Views on Patent Licensing Practices*, 50 ANTITRUST L.J. 515 (1981) (recognizing the pro-competitive benefits associated with licensing arrangements). In 1995, the Commission and the Department of Justice issued enforcement guidelines recognizing that licensing promotes more efficient arrangements for combining IP with other necessary inputs such as manufacturing expertise or complementary technologies. See U.S. Dep't of Justice & Fed. Trade Comm'n, *Antitrust Guidelines for the Licensing of Intellectual Property* (1995), available at <http://www.ftc.gov/bc/0558.pdf>. In 2007, the Commission and the Department of Justice jointly issued a report addressing a broader range of antitrust issues associated with the exercise of intellectual property rights that reflects many of these same economic principles. See U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION* (2007) [hereinafter 2007 Report], available at <http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf>.

³ Kovacic & Shapiro, *supra* note 1, at 54–57; Rubinfeld, *supra* note 1, at 55–56.

⁴ U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY* (2003) [hereinafter 2003 Report], available at <http://www.ftc.gov/os/2003/10/innovationrpt.pdf>.

Examining how trivial and overbroad patents undermine competition with no offsetting benefit to consumers, the Commission proposed reforming the patent examination process and the obviousness standards applied by courts. Some progress has been made in this area, with the Supreme Court tightening standards for obviousness⁵ and eliminating the presumption that had led to nearly automatic injunctive relief as an infringement remedy.⁶

In its latest study, *The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition*,⁷ the Commission builds on its prior examination of the patent system by considering how patent notice and remedies affect innovation, competition, and consumer welfare in light of two important trends in technology markets: the growth of open innovation business strategies and the expansion of a secondary market for patents. Drawing on input from the business, legal, and academic communities, the Commission recommends changes to the rules on patent notice and remedies to encourage the efficient transfer of technology and limit the risks to innovation and competition that arise when patents are asserted after substantial investments are made to bring a product to market. By focusing on notice and remedies, the Commission addresses a number of the critical issues facing the IP marketplace today and continues the important dialogue on incorporating economic principles into the framework of patent law.

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Recent Developments in Technology Markets

Two broad trends in the technology marketplace are important to understanding the role the patent system currently plays in fostering innovation and competition. The first is the growth of open innovation business strategies. Manufacturing firms that traditionally developed technologies in-house now more often acquire technologies from specialized design firms or start-ups through technology transfer agreements and acquisitions.⁸ Technology transfer, which typically occurs “ex ante” or before the acquiring firm obtains the technology through other means or makes investments in development or commercialization, lowers barriers to entry for inventors who do not have access to the resources or capital necessary to bring a product to market. In addition to allowing for the efficient division of labor between inventors and manufacturers, there is also evidence that diverse research efforts increase the speed and likelihood of innovation.⁹

The patent system plays an important role in fostering open innovation by helping manufacturers identify promising technologies. By defining the scope of the rights at issue, patents can also make it easier for the parties to draft and enforce technology transfer agreements. This enables start-ups to attract funding more easily prior to licensing and encourages manufacturers to invest in development after acquiring those rights.¹⁰

⁵ *KSR Int’l Co. v. Teleflex, Inc.*, 550 U.S. 398, 415 (2007) (rejecting the rigid “teaching, suggestion or method” test for obviousness and finding that a combination of known elements that is predictable to a person having ordinary skill in the art is obvious).

⁶ *eBay v. MercExchange*, 547 U.S. 338, 394 (2006). The Commission also recommended various legislative reforms, including the elimination of the presumption of patent validity. 2003 Report, *supra* note 4, ch. 5 at 28. The Supreme Court recently declined to adopt a more lenient standard for invalidating a patent—preponderance of the evidence—preserving instead the presumption of validity and clear and convincing standard for challenges. Noting the policy arguments advanced by the Commission and others, the Court held that the presumption was well embedded in the law and that any change in standard should be left to Congress. *Microsoft Corp. v. I4I Ltd. Partnership*, 131 S. Ct. 2238, 2252 n.11 (2011).

⁷ U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, *THE EVOLVING IP MARKETPLACE: ALIGNING PATENT NOTICE AND REMEDIES WITH COMPETITION* (2011) [hereinafter 2011 Report], available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf>.

⁸ *Id.* at 34–36.

⁹ 2003 Report, *supra* note 4, ch. 2, at 9.

¹⁰ 2011 Report, *supra* note 7, at 40–43.

But in many instances patent licensing and sales take place “ex post,” after there has been an accusation of infringement, and, critically, after the accused firm has made a large irreversible investment in creating, developing, or commercializing the technology. Because patent infringement is a strict liability offense, the accused firm needs to avoid liability even if it invented the technology independently of the patent owner. The result can be “patent hold-up,” a situation in which the patentee can use the licensee’s sunk costs as leverage to negotiate a higher royalty than it would have been able to get ex ante. The increased uncertainty and higher costs resulting from ex post licensing and hold-up can in turn deter innovation and thereby harm consumers.

The risks associated with patent hold-up are particularly acute in light of another significant development in the IP marketplace—the growth of a secondary market for patents.¹¹ This development has led to the rise of firms, referred to in the Report as “patent assertion entities” (PAEs), that are in the business of buying and asserting patents. PAEs are middlemen that do not engage directly in research, development, or technology transfer but instead facilitate the ex post assertion of patents, often against manufacturers that have acquired the technology through independent means and made large investments in development and commercialization.¹²

Although PAEs share certain characteristics with other nonpracticing entities (NPEs), such as start-ups, design firms, and universities, their unique business model has generated considerable controversy. Infringement lawsuits, particularly in the information technology (IT) sector, have grown rapidly in the last decade, and some attribute that rise mainly to lawsuits filed by PAEs.¹³ The increased number of lawsuits, coupled with the rise in the number of landmark damage awards,¹⁴ have raised significant concerns about the potential adverse impact of PAE activities on innovation. PAEs claim they serve a vital role in the patent system, whether by compensating small inventors who might not otherwise have the resources to enforce their patents or reducing the investment risks associated with early stage technologies by acting as a ready buyer for the patents of failed start-ups. Detractors respond that the amounts paid to inventors and defunct start-ups are too small to affect investment incentives and that PAEs merely impose an inefficient tax on innovation.¹⁵

The rise of the PAE business model raises a number of important policy questions, as PAEs may exacerbate the risks associated with patent hold-up. However, it is also important to recognize that PAEs are largely a response to the incentives generated by the patent system, making them a symptom and not the disease. In fact, increasingly, manufacturers are themselves using patent portfolios to participate in the secondary market.¹⁶ And the line between PAEs and NPEs more

¹¹ *Id.* at 58–62.

¹² PAEs, derisively referred to as “patent trolls,” may take a variety of forms. They may buy and assert patents or engage in other activities that indirectly facilitate ex post patent assertions, such as funding litigation or acting as patent brokers. *Id.* at 62–66.

¹³ *Id.* at 58–60. There is little empirical evidence that looks specifically at litigation activity by PAEs. One study found that PAE initiated lawsuits accounted for 26 percent of the defendants sued for infringement of computer-related patents between 2000 and 2008. *Id.* at 62.

¹⁴ *Id.* at 161–62. While some of these damage awards have been reversed on appeal, the risk of an outsized payday encourages PAEs to acquire patents to either sell or license to manufacturers. Even aside from the potential exposure, IT sector representatives note that evaluating offers and defending litigation diverts attention and resources from more productive activities.

¹⁵ *Id.* at 52–53.

¹⁶ *Id.* at 64.

¹⁷ Innovating NPEs share at least one critical characteristic with PAEs: they are not typically vulnerable to a counterattack in a patent lawsuit. Thus, practicing entities cannot effectively protect themselves against patent hold-up by NPEs by holding defensive patent portfolios.

broadly often becomes blurred.¹⁷ For these reasons, the Commission does not make any recommendations directed uniquely to PAEs and instead proposes flexible reforms aimed at reducing the incentives to engage in patent hold-up for all participants in the IP marketplace.

Patents, Innovation, and Competition

These market developments have important implications for patent policy. Patents encourage investment in new technologies by enabling the patentee to appropriate the economic value of its innovation by either licensing its technology or selling a patented product.¹⁸ In some cases, a patent will confer monopoly power in a product or technology market. In most cases, however, the patented product or technology will compete with substitutes and generate a reward that reflects the competitive alternatives available to buyers.

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Innovation often proceeds as a cumulative process, with new technologies building on prior work. If an innovator is aware of a patent before making irreversible investments in a potentially infringing new technology, he can attempt to design around the patent, pursue a different business strategy, or negotiate a license before investing. However, if the innovator only learns about the patent after he invests, these alternatives can become costly relative to the status quo, a situation known as “lock in.” After lock in, a patentee can use his enhanced bargaining power to extract a royalty that reflects the value of the licensee’s sunk costs rather than the alternatives the licensee faced at the time the investments were made. This same dynamic applies where the infringer is a firm that invests in a complementary technology or makes irreversible investments in commercializing or manufacturing what it only later learns is an infringing product. This ex post shift in bargaining power can encourage inefficient strategic behavior by patentees and distort the incentives of firms to invest in follow-on technologies or the resources needed to bring a product to market. Moreover, the additional royalty payments may be passed along to consumers in the form of higher prices on final products.

Patent hold-up is a specific example of opportunism in the face of sunk costs, a problem that is well recognized in the economic literature.¹⁹ Because ex ante technology transfer agreements are negotiated before the licensee commits to a particular technological path, such agreements largely eliminate the opportunity for patent hold-up. But while ex ante licensing generates a number of positive benefits for innovation, it is unrealistic to assume that all licensing can occur at the ex ante stage. At the same time, blunt limits on a patentee’s ability to enforce its rights ex post degrade the value of the exclusive right conferred by the patent and risk harming incentives to innovate.

Recognizing the different incentives at stake, the Commission proposes reforms to the rules regarding patent notice and remedies to encourage ex ante licensing and reduce the negative effects that ex post licensing and patent hold-up can have on innovation and competition, without disrupting the central role that exclusivity plays in the patent system. Firms that have clear notice of the patent landscape at the time they invest in new technologies can take steps to shield

¹⁸ However, it is an overstatement to say that patents are necessary to appropriate the economic value of innovation in all cases. The extent to which firms rely on patents varies significantly by industry. For instance, patents play a more significant role in the pharmaceutical and biotechnology industries, where innovation is characterized by high fixed costs and easy imitation, than in the computer hardware and software sectors, where lead-time and trade secrecy have are more important. 2003 Report, *supra* note 4, ch. 3 at 14, 29, 43, 55–56.

¹⁹ 2007 Report, *supra* note 2, at 35 n.11; Carl Shapiro, *Patent Reform: Aligning Reward and Contribution*, in INNOVATION POLICY AND THE ECONOMY 111, 120 (Adam Jaffe et al. eds., 2007) (“The economics of opportunism are well understood and there is nothing at all exceptional about applying these ideas to patent licensing.”).

themselves from patent hold-up by designing around the patent or negotiating a license before committing to the patented technology.

Remedies also play a powerful role. To create efficient incentives to invest in innovation, patent law should seek to broadly align the reward from innovation with the incremental contribution a technology makes to economic value. Remedies that reflect the ex ante market value of a technology support these incentives while discouraging opportunistic efforts to exploit the hold-up value of a patent, including opportunistic behavior by PAEs.

It is worth noting that the Commission is not claiming that the ex ante market value will always reflect the full economic contribution of a patent. In certain cases, an important patent may disclose information that spurs invention falling outside the scope or duration of the patent.²⁰ Moreover, where innovation proceeds cumulatively, or many patented technologies contribute synergistically to the value of a product, it may not be feasible for each innovator to capture the full economic contribution of his technology. However, remedies that permit a patentee to capture the hold-up value of the patent do nothing to improve the alignment between economic value and reward in these situations because the hold-up value of the patent has nothing to do with the economic contribution of the patented technology and everything to do with the sunk costs of the infringer. Adopting the ex ante market value of a patent as the benchmark for infringement remedies thus improves incentives relative to the status quo.²¹

Because patent infringement is a strict liability offense, an uncertain or unpredictable patent landscape may cause firms to shy away from otherwise procompetitive investments that could give rise to an infringement claim.

The Challenge of Creating Effective Notice

For there to be effective notice, firms making investment decisions involving technology must be able to identify relevant patents and patent applications, as well as understand the scope of the claims. Because patent infringement is a strict liability offense, an uncertain or unpredictable patent landscape may cause firms to shy away from otherwise procompetitive investments that could give rise to an infringement claim. Poor notice also makes it more difficult for the parties that would benefit from a technology transfer arrangement to identify each other, and more difficult to reach agreement on the key terms if they do.

But the difficulty of obtaining effective notice varies considerably by industry. Those in the IT sector voice the greatest concern, noting that merely identifying the large number of patents that could be relevant to complicated, multi-component products is often cost-prohibitive. They also complain that even when they are able to identify relevant patents, claims are often too ambiguous to provide clear guidance.²² The patent prosecution process creates other problems. Even when applications are public, it is often difficult to predict from the specification the scope of claims that might ultimately issue.²³ Others identify fewer problems in each area. In the pharmaceutical and chemical industries, typically less than a few dozen patents may be relevant to a new compound.²⁴ And, while clearance efforts in the biotechnology and medical device sectors may

²⁰ Where these kinds of externalities exist, the patent system may under reward groundbreaking invention. *See, e.g.*, W. KIP VISCUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON, *ECONOMICS OF REGULATION AND ANTITRUST* 800–14 (3d ed. 2000).

²¹ *See* Shapiro, *supra* note 19, at 123–25; *see also* Joseph Farrell, John Hayes, Carl Shapiro & Theresa Sullivan, *Standard Setting, Patents and Hold-Up*, 74 *ANTITRUST L.J.* 603, 622–24 (2007).

²² 2011 Report, *supra* note 7, at 81–82.

²³ *Id.* at 87–89.

²⁴ *Id.* at 91.

potentially involve thousands of patents, a standardized vocabulary makes computerized searches relatively easy.²⁵

The Commission focuses on challenges in the following three areas that interfere with patent clearance: identifying and reviewing published patents and applications; understanding the boundaries of existing claims; and predicting claims that may issue from pending applications. It proposes reforms to the patent examination process and judicial standards governing claim interpretation and validity.

The U.S. Patent and Trade Office (PTO), for example, could improve the ease and accuracy of patent searches if it classified patents by industry, in addition to using its current internal classification system.²⁶ The Commission also recommends passage of legislation mandating public recordation of patent assignments and published patent applications.²⁷ Identifying patent assignees, including real parties in interest, would enable firms to navigate burdensome “patent thickets” by narrowing their searches to relevant patents owned by competitors.

The interpretation of existing claims is also a key challenge. Patent claims must describe the scope of patent rights with sufficient clarity that a person having ordinary skill in the art (PHOSITA) can reliably determine whether there is freedom to operate, but this often plays out poorly in practice. The Commission proposals to improve notice include use by the PTO of the *Miyazaki* test for indefiniteness to weed out ambiguous claims,²⁸ requiring patent applicants to define key terms and designate a dictionary for undefined terms, further encouraging patent examiners to build a prosecution history record that improves the clarity of claims, and judicial use of a fact-based PHOSITA standard that is better tailored to the technology at issue.²⁹

An effective clearance search also entails a review of pending applications. Requiring that the majority of applications be published within eighteen months of filing, irrespective of whether the applicant has also sought foreign protection, is one answer to the difficulties firms currently face from “submarine” patents.³⁰ Another is greater attention to notice problems resulting from the addition of new claims and claim amendments during the patent prosecution process. The Commission recommends more robust enforcement of the written description and enablement requirements, with a view toward ensuring that a PHOSITA is reasonably able to predict future claims from the specification.³¹

If implemented, the Commission’s proposals to improve notice should reduce the costs and uncertainty associated with patent clearance efforts in the biotechnology and pharmaceutical industries, where the current system appears to be manageable, albeit challenging. However, as the Report acknowledges, the recommendations are unlikely to remedy the problems in the IT industry, which faces unique and daunting notice issues. Foremost is the sheer volume of patents likely to be at issue. Products in the IT sector typically incorporate a large number of components,

²⁵ *Id.* at 92.

²⁶ *Id.* at 128.

²⁷ *Id.* at 130–31.

²⁸ In contrast to the Federal Circuit requirement that claims be “insolubly ambiguous” to be deemed invalid due to indefiniteness, see *Exxon Research & Eng’g Co. v. United States*, 265 F.3d 1371, 1375 (Fed. Cir. 2001), the PTO Board of Patent Appeals and Interferences in *Ex Parte Miyazaki* adopted a lower ambiguity threshold, holding that a claim may be indefinite if it is “amenable to two or more plausible claim constructions.” 89 U.S.P.Q. 2d 1207, 2008 Pat. App. LEXIS 26, at *13 (Bd. Pat. App. & Interf. Nov. 19, 2008).

²⁹ 2011 Report, *supra* note 7, at 101–02, 107–09, 112–16.

³⁰ *Id.* at 117–18.

³¹ *Id.* at 120–22.

each potentially covered by hundreds or even thousands of patents. IT firms operating in these patent thickets typically adopt strategies of “mutually assured destruction” to create a patent detente with other players in the industry.³² However, these defensive strategies are typically ineffective against PAEs that are not vulnerable to countersuit. And even this partial solution of mutually assured destruction has costs since the need to generate large defensive patent portfolios contributes to the problem of poor quality patents that may find their way into the secondary market.

In light of the overwhelming notice issues facing the IT sector, some commentators argue in favor of modifying the strict liability standard for inadvertent infringement. Proposals take a variety of forms, but recent attention has focused on an “independent invention” defense that would apply where invention is nearly simultaneous.³³ Under this proposal, an accused infringer would have a complete defense to infringement if it could prove it created the accused technology through independent means before the patent or patent application was public. There are mixed views on the wisdom of such a shift, which would be a dramatic departure from the current system. Some favor the defense, particularly in the IT arena, claiming that strict liability does little to deter infringement because most infringement is inadvertent.³⁴ Others argue that limits to strict liability would encourage firms to consciously disregard the patent landscape. Still others question the impact the defense would have on product development.³⁵ In the face of limited understanding of the possible impact of an independent invention defense, and concern about its merits outside of the IT industry, the Commission recommends further investigation into the costs and benefits of the various proposals. While the notice recommendations may not be a complete solution to the patent clearance issues facing the IT sector, the Commission’s recommendations on patent remedies, along with the recommendations to improve patent quality and tighten standards for obviousness proposed in the 2003 Report, would go a long way toward reducing the hold-up risks in the IT sector that are the corollary of poor notice.

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Getting the Incentives Right on Remedies

The principle that remedies should place the patentee in the position he would have been but for the infringement is well embedded in patent law and is largely consistent with efficient economic incentives. But courts applying the law do not always take into full account the likely competitive environment the patentee would have faced in the counterfactual world. A more nuanced application of this principle will better align economic contribution and reward in the patent system, encouraging more efficient investment in innovation and deterring opportunism.

Lost Profits and Reasonable Royalties. A patentee that competes with an infringer in a relevant market for the patented product may be able to recover lost profits for sales it would have made absent infringement.³⁶ To properly align reward with contribution, lost profits should reflect the competitive conditions the patentee would have faced absent infringement, including any competition from noninfringing alternatives. Some of the prevailing standards, however, leave courts

³² 2003 Report, *supra* note 4, ch. 2, at 30.

³³ 2011 Report, *supra* note 7, at 131–34.

³⁴ The evidence suggests that most litigated patent infringement claims are against inadvertent infringers. *Id.* at 131 n.337.

³⁵ Mark Lemley, *Should Patent Infringement Require Proof of Copying?*, 105 MICH. L. REV. 1525, 1531 (2007) (questioning the impact an independent invention defense would have on the pharmaceutical industry where it may be efficient for a single firm to make the investment necessary to take a compound from invention to market).

³⁶ *Rite-Hite Corp. v. Kelly Co.*, 56 F.3d 1538, 1545 (Fed. Cir. 1995).

little room for market facts. Under the four-factor *Panduit* test,³⁷ for example, courts deny lost profits to patentees facing competition from noninfringing substitutes, even if they could establish lost sales to an infringing competitor. The *Panduit* test thus risks undercompensating patentees that lost sales to an infringing competitor. The Commission recommends reconsideration of this rule to enable a patentee facing competition from noninfringing substitutes to show that its product was the next-best alternative for some customers that purchased the infringing product and recover lost profits on those sales.³⁸ Conversely, where the patented technology is one element in a multi-feature product, the “entire market value rule” permits the patentee to recover lost profits based on the value of all infringing sales, even where noninfringing substitutes for the patented feature were available. This mechanistic approach likely overcompensates patentees facing meaningful competition from noninfringing alternatives. Instead, the Commission recommends that patentees claiming lost profits based on infringement of a patented technology should be required to provide evidence of customer demand for the patented feature over noninfringing alternatives.³⁹

Patentees that cannot establish lost profits from infringement can recover reasonable royalties.⁴⁰ Royalties are the largest category of patent damages and the focal point in the current controversy surrounding the size of damage awards.⁴¹ Reasonable royalties that are based on the ex ante market value of the technology can discourage ex post infringement claims by patentees merely attempting to capitalize on the investments of others but will not discourage valid claims to protect patented technologies that an infringer would have valued over ex ante alternatives. To achieve these goals, royalty awards must place the patentee in the position he would have been in absent infringement.⁴² Courts direct litigants to reconstruct this but-for world by reference to a “hypothetical negotiation” between a willing licensee and a willing licensor at the time of the infringement under the seminal *Georgia-Pacific* framework.⁴³

Although courts recognize this framework in principle, they depart in practice in a number of crucial respects. In several cases, the Federal Circuit has allowed patentees to recover a reasonable royalty exceeding what a willing licensee and licensor would have negotiated on the grounds that additional damages are necessary to provide adequate compensation to the pat-

³⁷ *Panduit Corp. v. Stahl Bros. Fibre Works, Inc.*, 575 F.2d 1152, 1156 (6th Cir. 1978) (holding that to establish lost profits on a patented product, a patentee must show demand for the product, absence of noninfringing substitutes, the capability to exploit existing demand, and the amount of lost profits).

³⁸ 2011 Report, *supra* note 7, at 152.

³⁹ *Id.* at 156.

⁴⁰ *Rite-Hite*, 56 F.3d at 1554 (“A patentee is entitled to no less than a reasonable royalty on an infringer’s sales for which the patentee has not established entitlement to lost profits.”).

⁴¹ Many in the IT sector complain that excessive royalty awards for low quality patents depress innovation and encourage entry by PAEs. But others caution that systematically reducing damages would encourage infringement and undermine incentives to invest in risky but promising technologies. Representatives from the pharmaceutical and biotechnology industries also warn against reforms that would systematically reduce damages. Both sides dispute the meaning of the statistical evidence. 2011 Report, *supra* note 7, at 161–67.

⁴² *Id.* at 142.

⁴³ *Georgia-Pacific* delineates the governing standard for reasonable royalty awards, identifying fifteen factors that may be relevant to the factfinder’s determination of a reasonable royalty. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970). Because the hypothetical negotiation is an exercise to determine the appropriate remedy for infringement, courts require that the negotiation occur under the assumption that the patent is valid and infringed. *Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301, 1325 (Fed. Cir. 2009).

entee or to punish infringement.⁴⁴ But excessive royalty awards that are a backdoor attempt to compensate patent owners for unproven lost profits or willful infringement allow patentees to capitalize on the hold-up value of the patent. The Commission urges against the use of reasonable royalty awards as a proxy for unproven lost profits and recommends instead that courts adopt a more flexible approach to lost profits to compensate patentees fully.

The Commission also warns against an overly expansive application of the *Georgia-Pacific* factors used to establish reasonable royalties. To align royalty awards with the market value of the technology, courts should adopt a hypothetical ex ante negotiation between the parties as the analytic framework for royalty calculations and treat the remaining *Georgia-Pacific* factors as nonexclusive categories of evidence that may be relevant to predicting the outcome of that negotiation. Most importantly, the outcome of a hypothetical negotiation should reflect competition from alternative technologies that may have existed prior to infringement. Royalty damages that exceed the additional value the patented technology creates for the licensee over the next best alternative, which is the maximum royalty rate a willing licensee would accept, should not be awarded. Moreover, courts should exercise their gatekeeping function more vigorously by excluding expert opinions that are based on facts or methods that have no bearing on the outcome of a hypothetical negotiation between the parties in the case.⁴⁵

[T]he Commission

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Injunctive Relief. The standards for awarding injunctive relief also provide courts with an opportunity to improve existing incentives. Where exclusive use is necessary to maintain the full value of the patented technology, injunctive relief can provide important incentives for innovation. But injunctive relief for minor technologies incorporated into multi-component products encourages opportunism by allowing the patentee to extract a settlement that far exceeds the value of its technology.

The Supreme Court's 2006 decision in *eBay v. MercExchange*,⁴⁶ which rejected a presumption in favor of injunctions, provides a flexible and useful framework for weighing these concerns. In applying the traditional equitable test for injunctions adopted in *eBay*, the Commission urges courts not to make unfounded assumptions about irreparable harm and the adequacy of money damages based solely on whether the infringer practices the invention. Where the patent covers a minor component in an infringing product facing competition from noninfringing alternatives, infringement is not likely to cause a practicing entity irreparable harm. In these instances, the ex ante value of the patented invention is likely to be small as compared to the potential hold-up costs relating to the product as a whole. Conversely, NPEs competing in technology markets may suffer irreparable harm if they are forced into licensing arrangements that undermine selective licensing strategies. By contrast, PAEs that license patents widely are unlikely to suffer irreparable harm if denied injunctive relief.⁴⁷

⁴⁴ 2011 Report, *supra* note 7, at 166–70. The Commission cites two problematic lines of cases: First, those in which the Federal Circuit expressly affirmed awards that included compensatory damages exceeding a reasonable royalty rate in order to provide the patentee with adequate compensation. *Id.* at 168 (citing *H.M. Stickle v. Heublein*, 716 F.2d 1550 (Fed. Cir. 1983), and *Maxwell v. J. Baker, Inc.*, 86 F.3d 1098 (Fed. Cir. 1996)); and second, cases in which the award was plainly inconsistent with the willing licensee/willing licensor model because the royalty exceeded the cost of using a noninfringing alternative. *Id.* at 169 (citing *Monsanto v. McFarling*, 488 F.3d 973 (Fed. Cir. 2007), and *Monsanto v. Ralph*, 382 F.3d 1374 (Fed. Cir. 2004)).

⁴⁵ Until very recently, courts allowed expert opinions, relying on a rule of thumb that set reasonable royalty rates at 25 percent of expected profits for the infringing product. Expert opinion based on the so-called “25 percent rule” has now been held to be unreliable and inadmissible. *See Uniloc USA Inc. v. Microsoft*, 632 F.3d 1292, 1318 (Fed. Cir. 2011).

⁴⁶ 547 U.S. 338 (2006).

⁴⁷ 2011 Report, *supra* note 7, at 229.

Patent hold-up should also be considered when balancing the relative hardships between the parties and evaluating the impact of injunctive relief on the public interest. While injunctions should not be denied every time switching costs exceed the ex ante value of the patent, a denial is appropriate when the harm to innovation and consumers from patent hold-up swamps other concerns. This is likely to be the case if the infringer did not copy the technology, the patented technology covers a minor component in a complex product, and the patentee and infringer do not compete in a product or technology market.⁴⁸

A related issue concerns the standards for injunctive relief applied by the International Trade Commission, which has the authority to bar the entry of infringing products into the United States under Section 337 of the Tariff Act of 1930. Patent owners have in recent years increasingly turned to the ITC for relief, raising concerns that they may seek injunctions and exclusion orders from the ITC in situations where the possibility of obtaining an injunction in federal court is unlikely. In an effort to avoid inconsistent results, the Commission offers two suggestions. The first relates to Section 337's prerequisite that there be "an industry in the United States" relating to the patented invention. The Commission suggests that ex post licensing activity that is focused only on obtaining rents from existing products should not be deemed to satisfy this "domestic industry" requirement.⁴⁹ The Commission also recommends that the ITC consider the impact of hold-up under Section 337's public interest factor when deciding on the propriety of granting injunctive relief.⁵⁰ Doing so would help to reduce the potential for different results in ITC proceedings and federal courts.

Conclusion

Increasingly sophisticated business strategies based on exploiting the hold-up value of patents threaten to slow the pace of innovation and clog the patent system with inefficient litigation. The risks are greatest for the IT sector, where patents for minor technologies embedded in multicomponent products can be used to extract sizeable damage awards and settlements from firms that play a critical role in bringing these products to market. Because tailored reforms to notice may not be enough to solve the problems facing the IT sector, reforming the current approach to remedies is vital to ensure that patents promote rather than deter or impede innovation. Although not a complete solution to the many complex problems facing the patent system, the Commission's recommendations provide a roadmap for both current reform and further dialogue on the key challenges facing the IP marketplace today. ●

⁴⁸ In the standard-setting context, where an entire industry may be impacted, concerns about hold-up are magnified. These concerns, as well as whether there is a prior RAND commitment by the patent owner, should also be part of the injunction analysis. *Id.* at 234–35.

⁴⁹ *Id.* at 243.

⁵⁰ *Id.*

Invention Is Not Innovation and Intellectual Property Is Not Just Like Any Other Form of Property: Competition Themes from the FTC's March 2011 Patent Report

Henry C. Su

By now, every antitrust lawyer who has studied in the intellectual property monastery can reliably recite the catechism: (1) that “[t]he intellectual property laws and the antitrust laws share the common purpose of promoting innovation and consumer welfare,”¹ and (2) that “the same general antitrust principles [apply] to conduct involving intellectual property as . . . [they do] to conduct involving any other form of tangible or intangible property.”² These two statements have come to be widely regarded as bedrock principles, to be remembered and repeated whenever one is confronted with questions at the interface of the intellectual property and antitrust laws—often questions of quasi-theological dimensions.³

The doctrinal underpinnings of these two statements lend themselves to critical analysis. This article undertakes such an analysis using the Federal Trade Commission's March 2011 report, *The Evolving IP Marketplace: Aligning Patent Notice and Remedies with Competition* (Patent Report).⁴ In the course of this analysis, I will identify key competition themes that pervade the Report's otherwise patent-law intensive discussion and analysis, expand upon those themes, and invite fellow antitrust lawyers to ponder on them.

Invention vs. Innovation

The Patent System May Not Always Promote Innovation. The statement that the intellectual property and antitrust laws serve a common purpose of promoting innovation and consumer welfare can be fairly well traced to a few decisions handed down by a young Federal Circuit in 1985, when

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¹ U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property § 1.0 (1995) [hereinafter IP Guidelines] (citing Atari Games Corp. v. Nintendo of Am., Inc., 897 F.2d 1572, 1576 (Fed. Cir. 1990)), available at <http://www.ftc.gov/bc/0558.pdf>.

² *Id.* § 2.1.

³ An example of a question of arguably quasi-theological dimension is the one posed by the Eleventh Circuit in *Schering-Plough Corp. v. FTC*, 402 F.3d 1056, 1066 (11th Cir. 2005), which is the extent to which a “pay-for-delay” agreement exceeds “the scope of the exclusionary potential of the patent.” If the “exclusionary potential” of a patent refers to any settlement (or litigated) outcome that a patent owner can obtain with a lawsuit filed in good faith, then under what circumstances, if ever, can a settlement be considered anticompetitive? This question has bedeviled judges sitting in other circuits. See *Ark. Carpenters Health & Welfare Fund v. Bayer AG*, 625 F.3d 779, 781–82 (2d Cir. 2010) (Pooler, J., dissenting from the denial of a petition for rehearing en banc) (recognizing the “troubling dynamic” of permitting exclusion payments to protect patent monopolies that are perhaps undeserved).

⁴ FED. TRADE COMM'N, THE EVOLVING IP MARKETPLACE: ALIGNING PATENT NOTICE AND REMEDIES WITH COMPETITION (2011) [hereinafter PATENT REPORT], available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf>. See also Press Release, Fed. Trade Comm'n, FTC Report Recommends Improvements in Patent System to Promote Innovation and Benefit Consumers (Mar. 7, 2011), <http://www.ftc.gov/opa/2011/03/patentreport.shtm>.

***This observation—
that invention is not
the same thing as
innovation—is one of
the key competition
themes in the Patent
Report.***

it was asserting itself as the national patent appeals court.⁵ This view—that the patent system, like the antitrust laws, is intended to encourage innovation, industry and competition—would be repeated again by the Federal Circuit over the years, including in its oft-cited *Atari Games* decision⁶ and the well-known *Intergraph* decision.⁷ It would also make its way into the IP Guidelines,⁸ as well as the Agencies’ reports relating to the interplay between the patent and antitrust laws.⁹

This statement holds true only so long as the intellectual property laws actually promote innovation, i.e., the development, commercialization, and diffusion of new products, processes, and services, and the creation of new, more competitive, or more efficient markets.¹⁰ It is not enough if the intellectual property laws merely encourage invention, however, because invention and innovation are not the same thing. Rather, invention is only *the first step* in a much longer, and potentially more arduous and risky, process of innovation. The Patent Report makes this critical observation in the context of discussing whether patents, standing alone as naked rights to exclude that may be asserted by “patent assertion entities” (PAEs) against others,¹¹ necessarily promote innovation.¹²

As the Patent Report observes, “Invention is the first step of innovation, but innovation often requires significant additional development activity beyond that first step in order to get new products and services to consumers.”¹³ This observation—that invention is not the same thing as innovation—is one of the key competition themes in the Patent Report. While it is not a new observation—for example, Jean Tirole has made it in his *Theory of Industrial Organization* textbook¹⁴—most patent and antitrust lawyers, and indeed the media, still casually refer to invention and innovation interchangeably.

⁵ See *Loctite Corp. v. Ultraseal Ltd.*, 781 F.2d 861, 877 (Fed. Cir. 1985) (quoting from Paulik and Patlex and concluding that “the patent and antitrust laws are complementary”); *Paulik v. Rizkalla*, 760 F.2d 1270, 1276 (Fed. Cir. 1985) (en banc); *Patlex Corp. v. Mossinghoff*, 758 F.2d 594, 599 (Fed. Cir. 1985). This is not to say that other circuits did not also express the same view. See, e.g., *Int’l Wood Processors v. Power Dry, Inc.*, 792 F.2d 416, 427 (4th Cir. 1986).

⁶ *Atari Games Corp. v. Nintendo of Am., Inc.*, 897 F.2d 1572, 1576 (Fed. Cir. 1990) (reaffirming that the patent and antitrust laws “are actually complementary, as both are aimed at encouraging innovation, industry and competition”).

⁷ *Intergraph Corp. v. Intel Corp.*, 195 F.3d 1346, 1362 (Fed. Cir. 1999).

⁸ IP Guidelines, *supra* note 1, § 1.0.

⁹ U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION 13 & n.29 (2007) [hereinafter ANTITRUST REPORT], available at <http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf>; FED. TRADE COMM’N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY ch. 1, § I.B., at 7 & n.42 (2003) [hereinafter INNOVATION REPORT], available at <http://www.ftc.gov/os/2003/10/innovationrpt.pdf>.

¹⁰ See, e.g., JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION ch. 10, at 389 (1988) (describing four stages of innovation); PATENT REPORT, *supra* note 4, at 32; IP Guidelines, *supra* note 1, § 3.2.3, at 11; see also *International Wood Processors*, 792 F.2d at 427 (describing the public benefit from the patent laws in terms of the entry of new products and the increased competition such products bring to the marketplace); *Paulik*, 760 F.2d at 1276 (referring to “innovation and its fruits” as “new jobs and new industries, new consumer goods and trade benefits”); *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195, 1203 (2d Cir. 1981); *Mannington Mills, Inc. v. Congoleum Indus., Inc.*, 610 F.2d 1059, 1070 (3d Cir. 1979).

¹¹ Patent assertion entity, the term that the Patent Report uses to refer to business entities that have no intention of practicing the patented inventions themselves and acquire patent rights for the sole purpose of asserting them against others. See PATENT REPORT, *supra* note 4, at 8 n.5, 50 n.2, 60 & n.47, 162 n.10 & 220 n.21. More familiar to readers will be the terms “patent troll” and “non-practicing entity” (NPE).

¹² *Id.* at 9.

¹³ *Id.* at 227.

¹⁴ TIROLE, *supra* note 10, ch. 10, at 390.

The differences between invention and innovation are not a trivial matter of semantics. The patent laws regard invention as principally a mental activity. An inventor is someone who “conceives” a patented invention,¹⁵ and “conception” is defined as “the formation in the mind of the inventor, of a definite and permanent idea of the complete and operative invention, as it is hereafter to be applied in practice.”¹⁶ Once an inventor has conceived her invention, she “may use the services, ideas, and aid of others in the process of perfecting [her] invention without losing [her] right to a patent.”¹⁷ In sum, the patent laws credit and reward the mental act of invention, and not the efforts that may come afterward to perfect the invention for commercial use.

The patent laws do not require that an invention be reduced to practice or commercialized before it may be patented,¹⁸ and the grant of a patent is therefore only prima facie evidence of some inventive activity that has been determined to meet the legal thresholds of patentability.¹⁹ All that the public receives as a result of the grant is a disclosure of what an inventor claims to have invented.²⁰ This disclosure concededly fulfills the constitutional quid pro quo underlying the patent system.²¹ From the standpoint of innovation and competition policy, however, there is as yet no new product, process, or service that benefits consumers—unless the inventor has separately done, or has others do, the work of developing and commercializing her invention.²²

While it is correct, then, to say that the patent and antitrust laws operate in a complementary manner if they both promote innovation, that synergistic relationship potentially breaks down if the former laws are in fact promoting only invention. Although some social benefit flows from public disclosure of inventions (in the form of issued patents) as “additions to the general store of knowl-

¹⁵ *C.R. Bard, Inc. v. M3 Sys., Inc.*, 157 F.3d 1340, 1352 (Fed. Cir. 1998) (citing *Collar Co. v. Van Dusen*, 90 U.S. (23 Wall.) 530, 563–64 (1874)); *Burroughs Wellcome Co. v. Barr Lab., Inc.*, 40 F.3d 1223, 1227–28 (Fed. Cir. 1994).

¹⁶ *Hybritech, Inc. v. Monoclonal Antibodies, Inc.*, 802 F.2d 1367, 1376 (Fed. Cir. 1986) (quoting 1 ROBINSON ON PATENTS 532 (1890)).

¹⁷ *Shatterproof Glass Corp. v. Libbey-Owens Ford Co.*, 758 F.2d 613, 624 (Fed. Cir. 1985) (quoting *Hobbs v. U.S. Atomic Energy Comm'n*, 451 F.2d 849, 864 (5th Cir. 1971)).

¹⁸ *See, e.g., Ariad Pharms., Inc. v. Eli Lilly & Co.*, 598 F.3d 1336, 1352 (Fed. Cir. 2010) (en banc) (“We have made clear that the written description requirement does not demand either examples or an actual reduction to practice[.]”). Evidence of the commercial success of an invention typically comes into play only if the non-obviousness of the invention is challenged in litigation. *See Graham v. John Deere Co.*, 381 U.S. 1, 17–18 (1966) (identifying the commercial success of an invention as a secondary consideration of non-obviousness).

¹⁹ *See* 35 U.S.C. §§ 101, 102, 103, 112 & 116. Not all inventive activity should be patentable, as Justice Breyer observed in his dissent from the Court’s dismissal of the writ of certiorari in *Laboratory Corp. of America Holdings v. Metabolite Laboratories, Inc.*, as having been improvidently granted. 548 U.S. 124 (2006). Notably, laws of nature, natural phenomena, and abstract ideas are not eligible for patent protection even though “research into such matters may be costly and time-consuming” and “that research may prove of great benefit to the human race” because overprotection by patents “would too often severely interfere with, or discourage, development and the further spread of useful knowledge itself.” *Id.* at 128 (Breyer, J., dissenting).

²⁰ *See, e.g., Ariad*, 598 F.3d at 1353 (“Requiring a written description of the invention limits patent protection to those who actually perform the difficult work of ‘invention’—that is, conceive of the complete and final invention with all its claimed limitations—and disclose the fruits of that effort to the public.”). I use the word “claims” in the sentence above not to suggest that an inventor has not in fact engaged in some inventive activity, but to emphasize that the patent document, standing alone, is literally a claim being made by the inventor over what is described therein to be the invention. With the exception of biological materials that are subject to a deposit requirement, and excerpts of software source code that are attached to an issued patent, the public does not get access to other work product that might be associated with the inventive activity, such as engineering drawings, laboratory notebooks, or prototypes.

²¹ *Universal Oil Prods. Co. v. Globe Oil & Ref. Co.*, 322 U.S. 471, 484 (1944).

²² American history is replete with famous examples of inventions that have been commercialized by others besides the inventor. *See, e.g.,* Henry C. Co, Faculty, Tech. & Operations Mgmt., Cal. Poly & State Univ., Pomona, *Technology and Innovation* (slides prepared for a course entitled Management of Technology) (citing the vacuum cleaner, sewing machine, and telegraph as examples of inventions commercialized by others), available at <http://www.csupomona.edu/~hco/MoT/01aTechnologyInnovation.ppt>.

edge,”²³ the broader societal expectation underlying the patent system is that the “risk-laden” efforts undertaken by inventors²⁴ “will have a positive effect on society through the introduction of new products and processes of manufacture into the economy, and the emanations by way of increased employment and better lives for our citizens.”²⁵ Consequently, if a particular situation arises in which a case can be made that the patent system is not being used to promote innovation, then perhaps the transaction or conduct being challenged in the context of that situation should be subject to heightened antitrust scrutiny. For example, the IP Guidelines are wary of patent pooling arrangements and grantbacks that deter or discourage the parties involved from engaging in research and development.²⁶

This is not to say that a failure of the patent system to promote innovation automatically gives rise to a violation of the antitrust laws. Rather, it is that such a failure arguably should dispel the standard notion that the patent laws are necessarily working in harmony with the antitrust laws. In some cases they may well be working in conflict. In such cases, a transaction or conduct being challenged as anticompetitive arguably should not be entitled to hide behind a patent-based presumption of per se legality under, or immunity from, the antitrust laws.²⁷

Non-Practicing Entities Present a Conundrum. A situation in which the patent laws may not be promoting innovation arises in the context of non-practicing entities (NPEs)—or PAEs, as the Patent Report calls them.²⁸ If a patent owner does not itself practice the invention in commerce but instead asserts the patent against other firms, with the goal of obtaining either royalty-bearing licenses or infringement damages, is innovation being promoted, or is it instead being discouraged? The Patent Report poses this very question.

While increased invention and patenting activity will lead to increased innovation in many contexts, it can decrease innovation in others. The risk that patentees that have made no technical contribution to a product can extract hold-up value from manufacturers increases uncertainty and costs and discourages innovation by those manufacturers.²⁹

As the Report highlights, the potential harm to innovation is two-fold: not only has there been *no contribution* by the patent owner to the commercialization of what it claims to be its invention in the accused products or services,³⁰ but the assertion of its patent potentially *levies a tax* on an accused infringer’s commercialization that is unrelated to the economic value of the invention—the so-called hold-up value tied to the accused infringer’s costs of switching to a non-infringing alternative.³¹

Furthermore, the potential harm to innovation is arguably exacerbated by the fact that a significant percentage of NPEs have acquired the patents that they are asserting through a sec-

²³ *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 481 (1974).

²⁴ *Id.* at 480.

²⁵ *Id.* See also *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538, 1562 (Fed. Cir. 1995) (en banc) (Nies, J., dissenting in part).

²⁶ IP Guidelines, *supra* note 1, § 5.5, at 29, & § 5.6, at 30.

²⁷ Past court decisions urging caution in applying the antitrust laws to patent-based transactions and conduct have done so out of a concern for frustrating or upsetting the goals of the patent system, i.e., promoting innovation. *Int’l Wood Processors v. Power Dry, Inc.*, 792 F.2d 416, 427 (4th Cir. 1986); *Mannington Mills, Inc. v. Congoleum Indus., Inc.*, 610 F.2d 1059, 1070 (3d Cir. 1979).

²⁸ See *supra* note 11 and accompanying text.

²⁹ PATENT REPORT, *supra* note 4, at 227.

³⁰ See *id.* at 40 n.43.

³¹ See *id.* at 22 & 191 n.61.

ondary market that allows patent rights to be sold, bartered, or auctioned between or among firms.³² When a patent changes hands in a secondary market, there is often only a transfer of the naked legal right to exclude, which is what principally drives the market value for the patent. Whatever work product that might have resulted from the inventive activity may not get transferred (apart from perhaps the patent prosecution files); indeed, the inventor may already be out of the picture as well.

As a result, when an NPE asserts a patent against an accused infringer, it may not have any inventor-created knowledge in its possession (aside from what has been disclosed to the Patent Office) to provide to the accused infringer as part of any bargained-for settlement.³³ Such a settlement, which would be called an “ex post patent transaction” in the Patent Report, arguably does not promote innovation because the accused infringer acquires nothing in the way of technical know-how or data from the NPE that it can apply, in an additive manner, to the accused products or services already in the marketplace.

An anticipated rejoinder in defense of NPEs is that there is no requirement under the patent system that an inventor practice her invention during the term of the patent monopoly. The case law is clear on this point.³⁴ It stems from the fact that an inventor has a common law right to make, use, and sell what she has invented and discovered,³⁵ and may therefore choose not to put the invention to any use at all.³⁶

This legal principle does not mean that NPEs do not adversely impact innovation and competition. The same case law also makes clear that Congress, exercising its power under the Patent Clause,³⁷ has decided to create a patent system that would give inventors a legal right to exclude others from practicing their inventions, in the hope that such a monopoly will provide enough incentive to inventors to put their inventions to use for the public benefit during the term of the monopoly.³⁸ In other words, although an invention or discovery has always been the inventor’s absolute property, to do with as she will, the patent grant is what gives to her the added right to exclude.³⁹ One, therefore, cannot think about patents as property without considering the statu-

³² *Id.* ch. 2, § IV.B, at 62–67 (describing the different players in a burgeoning secondary market for patents).

³³ *See id.* at 60 n.46 (quoting Professor Robert Merges on his observation that “in a lot of patent troll situations [] what’s bothersome about them is that, in fact, there is no information changing hands; it’s strictly a legal relationship. It’s strictly an agreement to make a lawsuit go away”).

³⁴ *Woodbridge v. United States*, 263 U.S. 50, 55 (1923) (“It is true that a patentee is not obliged either to make, use or vend his invention during the period of his monopoly.”) (citing *Crown Die & Tool Co. v. Nye Tool & Mach. Works*, 261 U.S. 24 (1923), and *Continental Paper Bag Co. v. Eastern Paper Bag Co.*, 210 U.S. 405 (1908)).

³⁵ *Crown Die & Tool Co. v. Nye Tool & Mach. Works*, 261 U.S. 24, 36 (1923). This common law right should not be confused with the patent right that Congress has created pursuant to the Constitution. *See infra* note 39.

³⁶ *Continental Paper Bag Co. v. Eastern Paper Bag Co.*, 210 U.S. 405, 425 (1908).

³⁷ U.S. CONST. art. I, § 8, cl. 8.

³⁸ *Woodbridge*, 263 U.S. at 55–56; *Bement v. Nat’l Harrow Co.*, 186 U.S. 70, 90 (1902).

³⁹ *Crown Die*, 261 U.S. at 36 (“It is the fact that the patentee has invented or discovered something useful and thus has the common law right to make, use and vend it himself which induces the Government to clothe him with power to exclude everyone else from making, using or vending it.”); *Continental Paper Bag*, 210 U.S. at 424 (“And it was further said in that case that the inventor could have kept his discovery to himself, but to induce a disclosure of it Congress has, by its legislation, made in pursuance of the Constitution, guaranteed to him an exclusive right to it for a limited time, and the purpose of the patent is to protect him in this monopoly—not to give him a use which he did not have before, ‘but only to separate to him an exclusive use.’”); *Gayler v. Wilder*, 51 U.S. (10 How.) 477, 494 (1851) (“The monopoly did not exist at common law, and the rights, therefore, which may be exercised under it cannot be regulated by the rules of the common law. It is created by the act of Congress; and no rights can be acquired in it unless authorized by statute, and in the manner the statute prescribes.”).

tory right to exclude, its underlying constitutional bargain, and its impact on innovation and competition.⁴⁰

On the question of whether NPEs truly promote innovation, it is also worth reviewing the facts in *Continental Paper Bag Co. v. Eastern Paper Bag Co.*,⁴¹ which has been cited many times over for the proposition that a patent owner should not be denied injunctive relief for infringement on the sole basis that it does not practice its patent.⁴² *Continental Paper Bag*, however, does not help the cause of NPEs because in that case, Eastern, the patent owner and respondent, did in fact operate a paper bag-making business,⁴³ and on this record, the Supreme Court concluded that Eastern's decision not to practice the patented invention was not unreasonable or contrary to the public interest.⁴⁴ Specifically, the Court considered Eastern's alleged nonuse of its patent from the standpoint of potential harm to competition (decrease in output or increase in price) and found Eastern's procompetitive business justification (i.e., cost savings) to be substantial and sufficient.

The facts in *Continental Paper Bag* stand in stark contrast to the situation presented by NPEs today and give credence to Justice Kennedy's cautionary note in *eBay Inc. v. MercExchange, LLC* that "[i]n cases now arising trial courts should bear in mind that in many instances the nature of the patent being enforced and the economic function of the patent holder present considerations quite unlike earlier cases."⁴⁵ Justice Kennedy was referring to NPEs, of course.⁴⁶

Intellectual Property v. Other Forms of Property

Intellectual Property Is Unlike Other Forms of Property. The statement that the same general antitrust principles apply to conduct involving intellectual property as they do to conduct involving any other form of tangible or intangible property is best exemplified by the Supreme Court's 2006 repudiation of the market power presumption in tying claims involving patented products in *Illinois Tool Works Inc. v. Independent Ink, Inc.*⁴⁷ Before *Independent Ink* was handed down, the long-held view in the case law was that a patent is unique, conferring on its owner special bargaining power that would force an unwanted, tied product on a buyer.⁴⁸

⁴⁰ See *Crown Die*, 261 U.S. at 36 ("The error in the position of the respondent and the court below is in a failure to distinguish between the property or title or interest in a patent capable of assignment and the chief incident of that property, title or interest, an incident which can only pass by assignment when attached to the right to make, use and vend.").

⁴¹ 210 U.S. 405 (1908).

⁴² See, e.g., *eBay Inc. v. MercExchange, LLC*, 547 U.S. 388, 393 (2006).

⁴³ As the Court noted, Eastern made a simple business decision "to make more money with the existing old reciprocating Lorenz & Honiss machines and the existing old complicated Stilwell machines than could be made with new Liddell machines, when the cost of building the latter was taken into account[.]" *Continental Paper Bag*, 210 U.S. at 428.

⁴⁴ *Id.* ("There was no question of a diminished supply or of increase of prices, and can it be said, as a matter of law, that a non-use was unreasonable which had for its motive the saving of the expense that would have been involved by changing the equipment of a factory from one set of machines to another? And even if the old machines could have been altered, the expense would have been considerable.").

⁴⁵ 547 U.S. at 396 (Kennedy, J., concurring).

⁴⁶ *Id.* ("An industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees. . . . For these firms, an injunction, and the potentially serious sanctions arising from its violation, can be employed as a bargaining tool to charge exorbitant fees to companies that seek to buy licenses to practice the patent.") (citing INNOVATION REPORT, *supra* note 9, ch. 3, at 38–39); see also *Foster v. Am. Mach. & Foundry Co.*, 492 F.2d 1317, 1324 (2d Cir.) (affirming the denial of an injunction to a patentee who did not manufacture any product, explaining that an injunction "is not intended as a club to be wielded by a patentee to enhance his negotiating stance"), *cert. denied*, 419 U.S. 833 (1974).

⁴⁷ 547 U.S. 28, 46 (2006).

⁴⁸ See, e.g., *Jefferson Parish Hosp. Dist. v. Hyde*, 466 U.S. 2, 16 (1984) (dictum).

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Yet the issue is not completely settled. Patents unquestionably have all the attributes of personal property, including assignability.⁴⁹ More importantly, however, patents are an *amalgam* of an inventor's common law right to her invention or discovery, to do with as she will, and a statutory right to exclude, bestowed by Congress with the expectation that the inventor will be sufficiently motivated to put her invention or discovery to use during the term of the monopoly.⁵⁰ If all that were at issue is an inventor's common law right to her invention or discovery, then the ensuing antitrust analysis would indeed be straightforward.⁵¹ It would be no different from someone buying a car and then choosing not to drive it. Even the acquisition of a portfolio of inventions would be subject to the same set of antitrust principles as the acquisition of a fleet of cars.

A patent's right to exclude, however, complicates the analysis. The fact that one person owns a car but chooses not to drive it does not prevent another person from owning a car or being able to ride in one. A patent is different. Its owner can still exclude others from allegedly practicing the claimed invention or discovery even if the owner does not use the invention.

The concern here, as raised in the Patent Report and mentioned above, is that a patent owner's exercise of its right to exclude against companies that produce products or services may in fact discourage or harm innovation.⁵² Even if the patent owner's ultimate intent is to license the use of the invention to others, and not to exclude them, such licenses may in fact not be enhancing innovation through the contribution of any inventor-created technology and know-how to the licensees' development of new products or services, as the patent system had originally intended. Moreover, to add injury to insult,⁵³ such licenses may in fact harm innovation by imposing an unwarranted tax on the licensees' commercialization of new products or services—the so-called hold-up value paid in order to avoid the extra cost associated with switching to a non-infringing alternative.

There is, however, another aspect of the right to exclude that is not given any discussion in the Patent Report but deserves some attention here. Specifically, the right to exclude is a negative right because it is *not* about what the inventor, or anyone else for that matter, can do with the claimed invention. Rather, it is about what the public cannot do during the term of the patent monopoly.

One way to visualize patent rights is to think of them as the holes that form in Swiss cheese, within which there can be no public use of inventive subject matter during the term of any given patent. Viewed from the public's perspective, one can see that what is really valuable is the

⁴⁹ 35 U.S.C. § 261.

⁵⁰ See *supra* notes 38–40 and accompanying text.

⁵¹ See *United States v. Dubilier Condenser Corp.*, 289 U.S. 178, 186 (1933) (“He may keep his invention secret and reap its fruits indefinitely.”); *United States v. Am. Bell Tel. Co.*, 167 U.S. 224, 250 (1897) (“The inventor is one who has discovered something of value. It is his absolute property. He may withhold the knowledge of it from the public[.]”). *Accord* *Bd. of Trustees of Stanford Univ. v. Roche Molecular Sys., Inc.*, 180 L. Ed. 2d 1, 12, 2011 U.S. LEXIS 4183, at *16–18 (2011) (“Our precedents confirm the general rule that rights in an invention belong to the inventor.”) (citing prior cases).

If an inventor chooses to keep her invention or discovery to herself, to be enjoyed privately and in secret, and not to share it with the public, then trade secret law, rather than patent law, provides any remedies for unauthorized use. Trade secrets, in contrast to patents, have all the attributes of private property with none of the public obligations and consequences. Instead of a right to exclude, statutory or common law provides only remedies for acts of misappropriation, which may involve theft and conversion of the alleged secrets as private property or a breach of some contract or other obligation. See UNIFORM TRADE SECRETS ACT (amended 1985), available at <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/utsa85.pdf>.

⁵² See *supra* notes 28–33 and accompanying text.

⁵³ I have intentionally switched the words around in this common expression. The failure of an ex post patent transaction (see *infra* notes 68–71 and accompanying text) to provide any actual technology transfer may be viewed as an insult, and the extraction of the hold-up value as an injury, to the innovation process.

cheese itself, i.e., the public domain, which is the storehouse of knowledge and information that is free for everyone to use.⁵⁴ Everyone gets to eat the cheese. A patent's right to exclude may not appropriate what is already in the public domain,⁵⁵ and when the term of the patent monopoly expires, that subject matter too passes into the public domain.⁵⁶

Inherent in the right to exclude is a delineation, to be ascertained from the patent specification and claims, of what an inventor claims to be her invention from what is in the public domain. No less important than the inventor's ability to exclude others from practicing her claimed invention during the term of the patent monopoly is the public's ability to be able to identify and continue using what has been in the public domain. As the Supreme Court declared in *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, "[T]he purposes behind the Patent Clause are best served by free competition and exploitation of either that which is already available to the public or that which may be readily discerned from publicly available material."⁵⁷ In other words, the patent system is designed to promote innovation and competition in two fundamental but distinct ways—by encouraging inventors to engage in inventive activity and to disclose and put their inventions to use under a guarantee of exclusivity, and by allowing anyone, inventors included, to use what is in the public domain to compete freely in the marketplace.⁵⁸

As the preceding point implies, innovation does not depend solely on inventive and patenting activities. There are other forces that can drive innovation—*provided* that businesspeople are able to freely take full advantage of knowledge and information residing in the public domain. Not all patented inventions lead to innovation, and not all innovations are patentable or patented, as *Aronson v. Quick Point Pencil Co.* exemplifies.⁵⁹

The Supreme Court more recently embraced this view in *KSR International Co. v. Teleflex Inc.*,⁶⁰ which reaffirmed the legal standard for evaluating the non-obviousness of a patentable invention.⁶¹ The Court observed that a patent system that promotes innovation must be able to distinguish "the results of ordinary innovation" from patentable products of extraordinary ideas and genius, noting:

We build and create by bringing to the tangible and palpable reality around us new works based on instinct, simple logic, ordinary inferences, extraordinary ideas, and sometimes even genius. These advances, once part of our shared knowledge, define a new threshold from which innovation starts once more. And as progress beginning from higher levels of achievement is expected in the normal course, the results of ordinary innovation are not the subject of exclusive rights under the patent laws. Were it otherwise patents might stifle, rather than promote, the progress of useful arts.⁶²

⁵⁴ See *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 151 (1989).

⁵⁵ *Graham v. John Deere Co.*, 381 U.S. 1, 6 (1966); *Great Atl. & Pac. Tea Co. v. Supermarket Equip. Corp.*, 340 U.S. 147, 152–53 (1950).

⁵⁶ *Dubilier Condenser*, 289 U.S. at 186–87.

⁵⁷ *Bonito Boats*, 489 U.S. at 150.

⁵⁸ *Id.* at 151. See also *Bd. of Trustees of Stanford Univ. v. Roche Molecular Sys., Inc.*, 180 L. Ed. 2d 1, 18, 2011 U.S. LEXIS 4183, at *34 (2011) (Breyer, J., dissenting). Although Justice Breyer was writing in dissent in *Stanford*, his views on how patents can sometimes stifle or suppress innovation echo those he expressed in *Laboratory Corp.*, see *supra* note 19, and conceivably could be regarded as reflecting his appreciation of the nature of innovation based on his experience as a former professor of antitrust law.

⁵⁹ 440 U.S. 257, 261–62 (1979) ("Quick Point apparently placed a significant value on exploiting the basic novelty of the device, even if no patent issued; its success demonstrates that this judgment was well founded.") (upholding a royalty-bearing agreement between the inventor, Mrs. Aronson, and Quick Point, on a new design for a keyholder that did not receive patent protection).

⁶⁰ 127 S. Ct. 1727 (2007).

⁶¹ *Id.* at 1739.

⁶² *Id.* at 1746.

New products and services may result from design forces and market incentives that would expectedly lead a businessperson, through the application of ordinary skill and common sense, to make the desired variations or improvements.⁶³ Even though such products and services are not patentable, they nevertheless constitute innovation and can enhance consumer welfare.

In summary, the right to exclude is what distinguishes a patent from other forms of tangible or intangible property. An inventor had at common law the right to use her invention or discovery. What a patent provides is a right to exclude, which protects the common law right from infringement by others. Although an inventor who avails herself of the patent process does not assume “the position of a quasi trustee for the public,”⁶⁴ the very nature of the right to exclude imbues a patent with aspects of a public good.⁶⁵ The right to exclude not only functions to encourage an inventor to put her invention to use for the benefit of the public, but it also serves to delineate what an inventor regards as her invention or discovery from that which belongs in the public domain. These aspects should not be ignored in antitrust analysis because of the co-equal importance of both inventive subject matter and knowledge in the public domain to innovation and competition.

Ex Post Patent Transactions and Secondary Markets Upset the Private/Public Aspects of Patents. Another one of the key themes in the Patent Report is the distinction between what the Report calls ex ante and ex post patent transactions. The Report uses the “ex ante” label to refer to “[p]atent transactions that occur as part of a technology transfer agreement . . . because they occur *before* the purchaser has obtained the technology through other means.”⁶⁶ In the view of the Report, ex ante patent transactions (such as patent licenses) should be favored because they “have great potential for advancing innovation, creating wealth and increasing competition among technologies.”⁶⁷

By contrast, the “ex post” label is applied to patent transactions that occur “*after* the firm accused of infringement has invested in creating, developing or commercializing the technology.”⁶⁸ A firm still needs a license “to avoid liability, even if it invented or obtained the technology independent of the patentee, because patent infringement is a strict liability offense.”⁶⁹ The Report takes the position that ex post patent transactions should be minimized because they can “distort competition in technology markets and deter innovation.”⁷⁰ A principal reason is that ex post patent transactions are fraught with the potential of creating a hold-up situation, in which a firm must pay more than the economic value of the patented invention in order to avoid infringement liability and the costs and delays associated with switching to an alternative, non-infringing technology in its products or services.⁷¹

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invention or discovery
from that which belongs
in the public domain.*

⁶³ *Id.* at 1740–41, 1742; *Bonito Boats*, 489 U.S. at 146.

⁶⁴ *United States v. Am. Bell Tel. Co.*, 167 U.S. 224, 250 (1897) (“Counsel seem to argue that one who has made an invention and thereupon applies for a patent therefor, occupies, as it were, the position of a quasi trustee for the public; that he is under a sort of moral obligation to see that the public acquires the right to the free use of that invention as soon as is conveniently possible. We dissent entirely from the thought thus urged.”).

⁶⁵ In *Bonito Boats*, the Supreme Court repeatedly refers to the patent system as a federal demarcation between private property and public access. 489 U.S. at 162–63.

⁶⁶ PATENT REPORT, *supra* note 4, at 7–8, 40.

⁶⁷ *Id.* at 40.

⁶⁸ *Id.* at 8, 50.

⁶⁹ *Id.*

⁷⁰ *Id.* at 50.

⁷¹ *See, e.g., id.* at 5, 26.

The distinction between ex ante and ex post patent transactions also highlights a problem with the perspective of treating patents purely as private property rights—a perspective actively promoted by those in favor of secondary markets for patents. If patents are just a species of intangible property (like securities, for example), then it should make no difference who owns them and who licenses them, and how often and when patent transactions occur. The market will set the price based on the perceived economic value of the invention.

But it is not that simple. Under the patent system as originally conceived by the Framers and the First Congress, the incentives associated with the right to exclude are directed at the inventor (or the original assignee at issuance).⁷² She is encouraged to put the invention to use during the term of the monopoly, or to license the invention to others for profit.⁷³ If the latter occurs, the licensee receives not only the legal right to practice the invention free of infringement liability, but also whatever work product the inventor has in her possession relating to her inventive efforts. A patent license accompanied by some technology transfer is the model of an ex ante patent transaction espoused in the Patent Report.⁷⁴

When a patent changes hands in a secondary market,⁷⁵ however, there is a real risk that what is being sold, and what is driving the patent's market value, is the right to exclude. The prospective buyer, especially if it is an NPE, may have no interest in the economic value of the underlying invention, apart from how well the described field of the invention matches up with the perceived scope of the right to exclude. The net result, therefore, may be that a patent sold or bartered in a secondary market finds itself in the hands of an owner who does not respond, and has no interest in responding, to the incentives that were planted by the Framers and the First Congress. All that the new owner cares about instead is maximizing a return on its monetary investment; this is the financial strategy associated with monetizing patent assets.

Such a strategy, however, arguably perverts the original conception of patent rights. True, patents do have all of the attributes of private property. But they are also a means to achieve an end, namely, a public benefit that is far greater than the interests of any individual inventor. Only recently, the Supreme Court reiterated the point that “the primary purpose of our patent laws is not the creation of private fortunes for the owners of patents but is ‘to promote the progress of science and useful arts’”⁷⁶ In other words, the reward to the inventor is a secondary consideration.⁷⁷ There has been an unfortunate tendency, however, to view patents as property rights “in absolute terms to the exclusion of all else.”⁷⁸

⁷² *Grant v. Raymond*, 31 U.S. 218, 241–42 (1832) (Marshall, C.J.).

⁷³ *Woodbridge v. United States*, 263 U.S. 50, 55–56 (1923).

⁷⁴ See *supra* note 66. In *Board of Trustees of Stanford University v. Roche Molecular Systems, Inc.*, Justice Breyer expressed a similar view in dissent that the Bayh-Dole Act intentionally puts the rights to a federally funded invention in the hands of the institutional recipient of the federal funds, as opposed to the individual inventor, because “it seeks to encourage those institutions to commercialize inventions that otherwise might not realize their potentially beneficial public use.” 180 L. Ed. 2d 1, 19, 2011 U.S. LEXIS 4183, at *37 (2011) (Breyer, J., dissenting). The Bayh-Dole Act, as construed by Justice Breyer, is another example of Congress's efforts to incentivize ex ante patent transactions involving technology transfer and to discourage patent assignments (in this case, effected by the individual inventor to a third party) that may lead to ex post patent transactions.

⁷⁵ I am therefore excluding from this discussion patent assignments that occur as a result of corporate reorganization, acquisition, or merger.

⁷⁶ *Quanta Computer, Inc. v. LG Electronics, Inc.*, 128 S. Ct. 2109, 2116 (2008) (quoting *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 511 (1917)).

⁷⁷ *Sony Corp. v. Universal City Studios, Inc.*, 464 U.S. 417, 429 (1984); *Kendall v. Winsor*, 62 U.S. 322, 327–28 (1859).

⁷⁸ *Sony*, 464 U.S. at 432 n.13 (citing the Court's earlier copyright and patent cases).

To state the problem succinctly, a secondary market for patents may misdirect the focus from the economic value of the invention to the financial value of the right to exclude. In so doing, it has the effect of decoupling the legal right to exclude granted by the Congress from the common law right to practice one's own invention, which the former was intended to protect. It thus upsets the delicate balance of private incentives and public benefits that the patent system intends to strike in order to promote innovation.

Such concerns are neither imagined nor new. In *Crown Die & Tool Co. v. Nye Tool & Machine Works*,⁷⁹ the Supreme Court considered the question of whether “the patent is only the power to exclude all from making, using and vending,” and therefore “the power to exclude some particular person from doing so [being] a part of that power of exactly the same nature . . . is a definite interest in the patent that can be assigned.”⁸⁰ The Court answered no. It held that although the right to exclude is what has been given to an inventor by the Congress, that right is incident to the inventor's common law right to make, use, or sell an invention.⁸¹ The right to exclude “can not be enjoyed save with the common law right.”⁸²

Based on this reasoning, the *Crown Die* Court concluded that the right to exclude cannot be splintered from the patent and assigned by the patent owner to others as a right to sue for damages for infringement.⁸³ The practical implication of this ruling is that the patent owner must be joined in any infringement lawsuit brought by one who is not the exclusive licensee. The policy implication of this ruling, however, is what is relevant to the discussion here. Importantly, the Court was concerned that “divid[ing] up the monopoly of patent property” so as to place the legal right to exclude granted by a patent in the hands of third parties would lead to the patent being used as a vehicle for stirring up litigation without expense or detriment to the patent owner.⁸⁴

NPEs arguably present concerns similar to that voiced in *Crown Die*. Although it has ostensibly purchased the entire patent and not just the right to exclude, an NPE may have no interest at all in the underlying invention. Its primary and obvious interest is in the right to exclude, which can be used to “stir up litigation.”⁸⁵ Moreover, unlike a patentee who builds a business around practicing the invention and therefore has to decide what resources and monies to allocate to infringement litigation, an NPE may not have much of a downside, if any, by bringing a lawsuit. An NPE may be using returns from prior successful lawsuits to fund future lawsuits.

In an attempt to realign infringement damages with the economic value of the invention as opposed to the financial value of the right to exclude, the Patent Report makes some useful and sensible recommendations relating to reasonable royalty damages.⁸⁶ For example, it urges courts to recognize that “the incremental value of the patented invention over the next-best alternative establishes the maximum amount that a willing licensee would pay in a hypothetical negotiation” and not to “award reasonable royalty damages higher than this amount.”⁸⁷ Reference to the

⁷⁹ 261 U.S. 24 (1923).

⁸⁰ *Id.* at 34.

⁸¹ *Id.* at 35–37.

⁸² *Id.* at 36.

⁸³ *Id.* at 39.

⁸⁴ *Id.* at 38–39.

⁸⁵ See PATENT REPORT, *supra* note 4, at 61 (quoting the testimony of hearing participants who describe NPEs as having business strategies built around “being infringed” and operating as “opportunistic litigation mills” that do not innovate).

⁸⁶ See *id.* at 19–25; see generally *id.* chs. 6 & 7, at 159–212.

⁸⁷ *Id.* at 189.

accused infringer's "next-best alternative" steers the damages discussion back to the economic value of the invention because it stands to reason that if an invention truly has economic value, then the accused infringer's "next-best alternative" may be relatively costly to implement.

Concluding Observations

The Patent Report is the latest installment in the FTC's continuing dialogue with the other branches and agencies of the federal government, the industry, and the public regarding what might be done to ensure that our patent system promotes innovation and competition, in harmony with the antitrust laws. This particular installment addresses issues of patent notice and patent remedies that have taken center stage in the courts, before Congress, and among industry circles as a result of an "evolving patent marketplace" fueled by the growing phenomenon of NPEs.⁸⁸ Purchases of patents and patent portfolios have garnered heightened public attention because of the fear that the buyers will use infringement litigation, or the threat of litigation, to obtain a strategic advantage vis-à-vis their rivals.⁸⁹ Depending on how the litigation card is played, that strategic advantage may be based—at least in part—on a patent's potential for creating a hold-up problem.

The Patent Report makes several practical (and largely modest) recommendations relating to patent notice and patent remedies aimed at ameliorating the problem of patent hold-up. Specifically, more effective and reliable patent notice might help firms steer clear of a hold-up problem in the first place, before they have sunk investments into commercial development and production. Furthermore, changes in the way infringement damages based on lost profits or a reasonable royalty are calculated and awarded, and the circumstances under which permanent injunctions are issued, might minimize the hold-up value that firms have to pay for patents being asserted against them in litigation.

The Patent Report leaves for future debate, however, the nagging competition questions underlying the "evolving patent marketplace." Importantly, the evolving marketplace may reflect a broken patent system in which invention is often confused with innovation, and the financial value of the right to exclude (which is a function of a patent's hold-up potential) has overshadowed the economic value of the underlying invention. Although reforms in the areas of patent notice and remedies can alleviate some of the symptoms, they do not provide a long-term cure for a broken system.

The development of a secondary market for patents places undue emphasis on the financial value of the right to exclude and largely ignores the economic value of the underlying invention. This is not what the patent system intended. Individual inventors should be duly rewarded for their risk-taking and their ingenuity, but the Framers and the First Congress envisioned that such rewards would flow principally from the exploitation of their inventions and the introduction of new and improved products and services to the marketplace. By contrast, the exploitation of the right to exclude through infringement lawsuits not only perverts these incentives but dampens the entrepreneurial spirit that depends as much on free competition as it does on innovation.

Accordingly, antitrust analysis should take care to distinguish between invention and innovation when evaluating whether a challenged conduct or transaction involving intellectual property harms competition and consumer welfare. The fact that a patented invention is not being prac-

[T]he evolving marketplace may reflect a broken patent system in which invention is often confused with innovation, and the financial value of the right to exclude (which is a function of a patent's hold-up potential) has overshadowed the economic value of the underlying invention.

⁸⁸ See *id.* ch. 2.

⁸⁹ See, e.g., Chris V. Nicholson, *Apple and Microsoft Beat Google for Nortel Patents*, N.Y. TIMES, July 1, 2011, <http://dealbook.nytimes.com/2011/07/01/apple-and-microsoft-beat-google-for-nortel-patents/>.

ticed by its owner may inform the view that a particular conduct or transaction does not promote innovation, and hence would have a net anticompetitive effect. Similarly, antitrust analysis should consider whether the patent right to exclude is being manipulated by its owner so as to deny competitors access to knowledge and information that is in the public domain. For example, a patent owner may be asserting its right to exclude in order to squelch legitimate design-around or reverse engineering efforts. Such a use of the right to exclude might be viewed as exclusionary and therefore anticompetitive. ●

The Sixth Circuit's Application of the Rule of Reason in *Realcomp II*—Less About the Rule's Reasonableness Than the Reason for the Rule

David L. Meyer

The Federal Trade Commission scored a significant victory when the Sixth Circuit applied the rule of reason to uphold the FTC's order in the *Realcomp II* case.¹ The FTC had found that a real estate multiple listing service (MLS) violated Section 1 of the Sherman Act by adopting and enforcing a "website policy" that allegedly restricted the dissemination of certain kinds of MLS content via third-party websites.

The decision offers some important lessons about the way courts approach rule of reason analysis, particularly because it is one of relatively few recent decisions reaching the merits in a rule of reason challenge.² One key lesson is that the lack of a cognizable procompetitive justification—or evidence of actual procompetitive benefits—will tend to lower the burden plaintiffs bear in making a threshold showing (often called a *prima facie* case) of unreasonableness. The Sixth Circuit's decision is also noteworthy for the question it did not reach—namely, whether the FTC properly applied its "inherently suspect" variant of the quick-look doctrine to the restraint at issue in the case.

How We Got Here

In 2006, the FTC sued the Realcomp II MLS, alleging that several of its policies were anticompetitive. The thrust of the complaint was that the challenged policies hindered the ability of real estate brokers to adopt nontraditional business models, such as offering home sellers a limited slate of brokerage services for a flat fee, instead of the traditional model that entailed offering a full array of services in exchange for a 5, 6, or 7 percent commission.³

The case ended up focusing on Realcomp's "Website Policy," which governed the scope of MLS data that could be disseminated to third-party websites capable of being accessed by potential home buyers. The challenged Website Policy distinguished between two types of listings: "exclusive right to sell" (ERTS) listings, favored by traditional brokers, and "exclusive agency" (EA) listings, preferred by nontraditional brokers, sometimes referred to as "discount" brokers. An ERTS listing guarantees that the listing agent will receive a commission no matter how the seller happens to arrange a buyer for her property. An EA listing allows the seller to avoid paying a percentage commission to the listing agent by selling the property herself, while taking advantage of the services the listing agent has provided, especially the placement of the listing

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¹ *Realcomp II, Ltd. v. FTC*, 635 F.3d 815 (6th Cir. 2011), *petition for cert. filed* (U.S. June 28, 2011) (No. 11-16).

² Many such cases are resolved against plaintiffs on other grounds, among them the plaintiff's lack of standing or antitrust injury or its failure to plead or prove a proper antitrust market in which the defendant possesses market power.

³ A copy of the FTC's Complaint is available at <http://www.ftc.gov/os/adjpro/d9320/061012admincomplaint.pdf>.

in the MLS database. Under either scenario, the MLS listing typically includes an offer of compensation (often 3 percent) to an agent who delivers a successful buyer.

Realcomp's Website Policy allowed ERTS listings to be disseminated to numerous third-party websites that Realcomp authorized to display MLS listings, but did not allow the dissemination of EA listings as part of that MLS data feed. An EA listing posted by a nontraditional broker on the MLS thus could reach other agents who had access to the MLS itself, and in turn buyers represented by those agents, but it would not be disseminated by Realcomp to any third-party public websites accessible directly by buyers. The FTC challenged this Policy as unreasonably hampering competition by nontraditional brokers and limiting consumer choice.

After an administrative trial, the FTC's Administrative Law Judge (ALJ) rejected the FTC's claim, finding both that "the evidence [did] not establish that the nature of the restraint is such that it likely precluded discount brokers from competition or eliminated consumer choice"⁴ and also that "Complaint Counsel ha[d] not presented reliable evidence that demonstrates actual adverse harm to competition as a result of the Realcomp Website Policy."⁵ The ALJ concluded instead that the Website Policy had at most de minimis effects on the ability of nontraditional brokers to offer EA listings.⁶ He also credited Realcomp's proffered justifications for the policy, the core of which was that EA listings were appropriately treated less favorably because they allowed home sellers to bypass the services of the brokers who had established the MLS in the first place, thereby "free riding" on the venture.⁷

Complaint Counsel appealed to the full Commission,⁸ which reversed the ALJ and found that the Website Policy violated Section 1 of the Sherman Act under three separate theories.⁹ First, the policy was deemed "inherently suspect" on its face and thus condemned when Realcomp failed to present a cognizable justification for the policy.¹⁰ The Commission's application of the "inherently suspect" framework departed (perhaps controversially)¹¹ from Complaint Counsel's own theory of the case¹² and thereby dispensed with the need for the FTC to prove market power or actu-

⁴ Realcomp II Ltd., FTC Docket No. 9320, 2007 FTC LEXIS 200, at *228 (Dec. 10, 2007) (Initial Decision), *rev'd*, 2009 FTC LEXIS 250 (Oct. 30, 2009), *review denied sub nom.* Realcomp II, Ltd. v. FTC, 635 F.3d 815 (6th Cir. 2011), *petition for cert. filed* (U.S. June 28, 2011) (No. 11-16). A copy of the ALJ's Initial Decision is available at <http://www.ftc.gov/os/adjpro/d9320/071213decision.pdf>.

⁵ *Realcomp II*, 2007 FTC LEXIS 200, at *237.

⁶ *Id.* at *289–91.

⁷ *Id.* at *303–04. As Realcomp would explain, rules limiting how EA listings could make use of MLS tools were appropriate: the MLS "was not created to help property owners who wish to procure their own buyers." Answering Brief of Respondent at 56, Realcomp II Ltd., FTC Docket No. 9320 (filed Feb. 29, 2008), *available at* <http://www.ftc.gov/os/adjpro/d9320/080229realcompansweringbrief.pdf>.

⁸ Although we generally use the acronym "FTC" to refer to the Commission, we use "Commission" to refer to the agency in its adjudicative capacity with respect to the decision reviewed by the Sixth Circuit.

⁹ Realcomp II Ltd., FTC Docket No. 9320, 2009 FTC LEXIS 250 (Oct. 30, 2009) (Opinion of the Commission), *review denied sub nom.* Realcomp II, Ltd. v. FTC, 635 F.3d 815 (6th Cir. 2011), *petition for cert. filed* (U.S. June 28, 2011) (No. 11-16). A copy of the Commission's opinion is publicly available at <http://www.ftc.gov/os/adjpro/d9320/091102realcompopinon.pdf>.

¹⁰ *Realcomp II*, 2009 FTC LEXIS 250, at *52–89.

¹¹ The author has previously noted that the Commission's decision marked a meaningful potential expansion of the inherently suspect rubric to condemn restraints farther afield from the sort of horizontal restraints typically condemned as per se unlawful in past cases. See David L. Meyer, *The FTC's New "Rule of Reason": Realcomp and the Expanding Scope of "Inherently Suspect" Analysis*, ANTITRUST, Spring 2010, at 47.

¹² See *Realcomp II*, 2009 FTC LEXIS 250, at *53–55. According to the Commission, Complaint Counsel at oral argument "disclaimed reliance on this mode of analysis, on the basis that courts have not had much experience with the particular restraint at issue here, albeit acknowledging that they have had a great deal of experience with closely analogous restraints." *Id.* at *54. The Commission said that Complaint Counsel was "mistaken in this regard." *Id.*

With all of these options, the Sixth Circuit took the path of least resistance, affirming the Commission's decision "on the basis of the more extended rule of reason analysis, without reaching the question of whether to apply quick-look analysis" in the form of the Commission's inherently suspect framework.

al anticompetitive effects. Second, under the rule of reason, the Commission condemned the Website Policy because Realcomp was found to have market power in the market for the "supply of residential real estate brokerage services" in southeastern Michigan as well as the separate market for "multiple listing services,"¹³ and the Website Policy posed a significant potential threat to competition.¹⁴ That threat carried the day in the absence of any showing of valid procompetitive benefits.¹⁵ Finally, the Commission found evidence of actual anticompetitive effects, which again were not offset by any countervailing procompetitive benefits.¹⁶

The Commission rejected Realcomp's justifications for the Policy, concluding, *inter alia*, that there could be no free riding because nontraditional brokers who posted EA listings also paid fees to participate in the MLS in accordance with MLS rules.¹⁷ The Commission also rejected Realcomp's suggestion that traditional brokers ought to be entitled to preserve their separate stream of revenues from commissions paid to brokers assisting homebuyers, viewing this argument as a frontal attack on competition itself.¹⁸

Realcomp appealed the Commission's ruling. In defending the decision on appeal, the FTC hedged its bets, arguing that Realcomp's conduct was anticompetitive "under any variation of the rule of reason," including the inherently suspect approach as well as the full rule of reason.¹⁹

The Sixth Circuit's Opinion

With all of these options, the Sixth Circuit took the path of least resistance, affirming the Commission's decision "on the basis of the more extended rule of reason analysis, without reaching the question of whether to apply quick-look analysis"²⁰ in the form of the Commission's inherently suspect framework. The court described the Website Policy as "an internal rule within an MLS regarding its distribution of certain types of real-estate listings to the public," and commented that it "need not and [did] not decide whether this policy is sufficiently analogous to practices already deemed by courts to be anticompetitive for it to qualify as a facially anticompetitive restraint."²¹

The court of appeals had no difficulty agreeing with the Commission's application of the full rule of reason in this case. It concluded that there was sufficient evidence supporting all of the Commission's key findings: (a) the MLS had market power, (b) its Website Policy had a tendency to harm competition, (c) the Policy had actual anticompetitive effects, and (d) the MLS's proffered "justifications were insufficient."²²

The Sixth Circuit's conclusion that Realcomp's Website Policy ran afoul of the rule of reason was unsurprising once the court agreed with the Commission's findings that the Policy produced actu-

¹³ *Id.* at *28–29; *see id.* at *90–92.

¹⁴ *Id.* at *114–15.

¹⁵ *Id.* at *89–116.

¹⁶ *Id.* at *116–27.

¹⁷ *See id.* at *77–78.

¹⁸ *See id.* at *81–84. Particularly telling was the Commission's quotation from *Premier Electrical Construction Co. v. National Electrical Contractors Association*, 814 F.2d 358 (7th Cir. 1987), in which the Seventh Circuit observed: "A group of firms trying to extract a supra-competitive price therefore hardly can turn around and try to squelch lower prices—as the Association may have done—by branding the lower prices 'free riding!'" *Id.* at 370 (quoted in *Realcomp II*, 2009 FTC LEXIS 250, at *83).

¹⁹ *See* Brief of Respondent Federal Trade Commission at 20–54, *Realcomp II, Ltd. v. FTC*, 635 F.3d 815 (6th Cir. 2011).

²⁰ *Realcomp II, Ltd. v. FTC*, 635 F.3d 815, 826 (6th Cir. 2011), *petition for cert. filed* (U.S. June 28, 2011) (No. 11-16).

²¹ *Id.* at 827.

²² *Id.* at 836; *see also id.* ("Realcomp offers no meritorious procompetitive justification . . .").

al anticompetitive effects but had no cognizable procompetitive benefits. When the score at the end of the game is “Harm One, Benefits Zero,” the plaintiff ought to win. Nonetheless, four features of the court’s analysis stand out as noteworthy.

The “Potential” for Harm Arising from the Combination of Market Power and the Anticompetitive Nature of the Restraint—How Much “Potential” Is Enough? The decision is perhaps most noteworthy for its explicit holding that a plaintiff in a rule of reason case need not prove that “actual anticompetitive effects” resulted from the defendants’ conduct, or even that any particular quantum of concrete harm was “likely.” According to the Sixth Circuit, it is instead sufficient if the nature of the alleged restraint, viewed in the context of the defendants’ market power, makes it “likely” that the conduct would have some “adverse impact on competition.”²³ The court described the FTC’s burden as one of showing only that there was an “adverse potential” flowing from a finding of “market power and the anticompetitive tendencies of [Realcomp’s] policy.”²⁴

As applied by the Sixth Circuit, satisfying this “adverse potential” test was not a high bar. The market power finding was rather uncontroversial and not contested on appeal (although this may have been a missed opportunity for defendants, for reasons discussed below). The test for determining whether the Website Policy had a sufficient “adverse potential,” however, was somewhat more ineffable and was not spelled out with clarity by the court of appeals. The *nature* of the anticompetitive potential is easy to glean from the court’s discussion: the Website Policy “limited access to internet marketing and imposed additional costs on the marketing of discount listings,” listings which “exert price pressure on the full-service brokerage model.”²⁵

But what of the magnitude of this potential? The court’s analysis suggests that a mere scintilla—some tiny chance of reduced price pressure—may be enough. The court credited the fact, as found by the ALJ, that nontraditional brokers could reach 90 percent of potential buyers by placing EA listings on the MLS itself (as MLS rules allowed) and by posting the same listings on a single website, Realtor.com. Nonetheless, the court observed that a reduction of only 10 percent in the number of home buyers exposed to EA listings could make the restraint unreasonable.²⁶ Why? The “emerging competitive impact” of the discounted brokerage model posed a “‘nascent threat[,]’” the exclusion of which was “‘reasonably capable of contributing significantly’ to anticompetitive effects.”²⁷

The court’s opinion does not offer any further explanation of how a 10 percent reduction in potential audience “excludes” this nascent threat (and even that 10 percent no doubt overstates degree of foreclosure, since it ignores all other potential distribution channels available to discount brokers). All that we learn from the opinion is that the Website Policy places “limits” or “restrictions”

²³ *Id.* at 831. To be sure, there was precedent for this approach, especially in the context of real estate MLS services. See *United States v. Realty Multi-List, Inc.*, 629 F.2d 1351, 1370–76 (5th Cir. 1980). But few courts have allowed plaintiffs to make the requisite showing of anticompetitive harm in a rule of reason case based on a showing of mere tendencies or potential. Instead, they require plaintiffs to show how and to what extent the competitive process has been harmed, or likely would be harmed, by the restraint. In *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) (en banc), for example, in applying a rule of reason sort of analysis under Section 2 of the Sherman Act, the court spoke of the plaintiff’s need to demonstrate anticompetitive harm that could be weighed against potential procompetitive benefits, see *id.* at 58–59 (though the court conducted no actual weighing), and found such effects demonstrated only where there was in fact substantial foreclosure from primary channels of distribution that materially impeded rivals, see *id.* at 61, 70–72, 75–76.

²⁴ *Realcomp II*, 635 F.3d at 834.

²⁵ *Id.* at 830.

²⁶ See *id.*

²⁷ *Id.* (quoting *Microsoft*, 253 F.3d at 79).

Although the Sixth Circuit does not say so, its rule is implicitly limited to horizontal combinations of competitors that purport to act collectively to resist procompetitive forces of change.

on—and perhaps adds some unquantified costs to—the dissemination of discount listings.²⁸ This potential is unreasonable, one must infer, because it risks disrupting price competition posed by discount brokerage services that are held in such high esteem.

Policymakers may well regard such a conclusion as reflecting sound competition policy when applied to the “nascent” efforts of some brokers to challenge the long-standing orthodoxy of the full-service, full-commission, real estate brokerage model, for which consumers can easily spend tens of thousands of dollars in exchange for seemingly modest amounts of effort.²⁹ But is there a limiting principle? Surely this rule cannot apply to every agreement on the part of a firm with market power that excludes rivals (even price-cutting rivals) from 10 percent or more of some market. Such a holding would be squarely inconsistent with well-settled principles applicable to exclusive dealing arrangements in both the Section 1 and Section 2 setting.³⁰

Although the Sixth Circuit does not say so, its rule is implicitly limited to horizontal combinations of competitors that purport to act collectively to resist procompetitive forces of change. Such a limitation is consistent with the thrust of the FTC’s case, as well as the principal precedents relied upon by the court, including *Northwest Wholesale Stationers*³¹ and *Realty Multi-List*.³²

Actual Anticompetitive Effects—Are We So Sure? The Sixth Circuit opinion’s discussion of the Commission’s findings of actual anticompetitive effects is also informative.³³ The Commission found such effects based on two key sets of conclusions reached by Complaint Counsel’s economist. First, he presented a cross-sectional analysis showing that the Detroit area, where Realcomp operates, had a relatively lower percentage of EA listings (the sort allegedly discouraged by Realcomp’s policy) than a few comparable cities where MLSs imposed no similar restrictions.³⁴ The FTC’s economist also presented closely related regression analyses that purported to identify an inverse correlation between restrictive listing policies and the share of EA listings in a market, controlling for various factors.³⁵ Second, the FTC’s economist presented a time-series analysis showing that the number of EA listings declined after the Website Policy was adopted.³⁶

²⁸ See *id.* at 830–31.

²⁹ See generally U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, COMPETITION IN THE REAL ESTATE BROKERAGE INDUSTRY (2007), available at <http://www.justice.gov/atr/public/reports/223094.pdf>.

³⁰ The Supreme Court has held that exclusive dealing arrangements are not unlawful under the antitrust laws unless they “foreclose competition in a substantial share of the line of commerce affected.” *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961). Some more recent cases have suggested that the degree of foreclosure required for exclusive dealing to run afoul of Section 2 may be less than that required to violate Section 1, but those cases do not support liability even under Section 2 when the arrangements affect only a small minority of available distribution outlets. See, e.g., *B&H Med., L.L.C. v. ABP Admin., Inc.*, 526 F.3d 257, 266–67 (6th Cir. 2008) (affirming summary judgment dismissing exclusive dealing claims where suppliers accounted for only 12.5% of relevant sales; noting that foreclosure below 40% unlikely to raise competitive issues); *United States v. Microsoft Corp.*, 253 F.3d 34, 70 (D.C. Cir. 2001) (en banc) (exclusive contracts may violate Section 2 where they “foreclose less than the roughly 40% or 50% share usually required in order to establish a § 1 violation”).

³¹ *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284 (1985). See *Realcomp II*, 635 F.3d at 830 (citing *Northwest Wholesale Stationers*, 472 U.S. at 295 n.6).

³² *United States v. Realty Multi-List, Inc.*, 629 F.2d 1351 (5th Cir. 1980). See *Realcomp II*, 635 F.3d at 826–27, 830–31 (citing *Realty Multi-List*, 629 F.2d at 1388–89).

³³ See *Realcomp II*, 635 F.3d at 831–34.

³⁴ *Realcomp II Ltd.*, FTC Docket No. 9320, 2009 FTC LEXIS 250, at *121–26 (Oct. 30, 2009), *review denied sub nom.* *Realcomp II, Ltd. v. FTC*, 635 F.3d 815 (6th Cir. 2011), *petition for cert. filed* (U.S. June 28, 2011) (No. 11-16).

³⁵ *Id.* at *93, *118–19.

³⁶ *Id.* at *93, *119–20.

Realcomp vigorously disputed the FTC's evidence on these issues, and the ALJ sided with Realcomp in concluding that the economic evidence was insufficient.

In contrast, the court of appeals found the FTC's economic evidence to be adequate. The court first observed that the time-series analysis showing a drop in EA listings could not "rule out the influence of other economic factors that might have caused the decline," but then found support in "other evidence" for the "conclusion that the drop was at least in part caused by Realcomp's restrictive policies."³⁷ This other evidence consisted of the FTC expert's cross-sectional and regression analyses. The expert selected six cities with MLSs that did not impose restrictive policies on EA listings and three cities (in addition to Detroit) with MLSs that did have such policies, and then compared the degree of EA penetration.³⁸ Despite an obvious concern that this analysis might have involved cherry-picking of markets, the court of appeals did not hesitate to find it persuasive.³⁹ The court also held that the expert's regression analyses provided support for a finding that restrictive policies lead to fewer EA listings, rejecting Realcomp's vigorous arguments that the analyses left out important variables, which the FTC's ALJ had credited.⁴⁰

Among the avenues the court did not explore—perhaps because Realcomp had no good story to tell—was the potential explanation that the differences in EA penetration might have resulted from procompetitive aspects of the Website Policy. If Realcomp's policies allowed traditional brokers to provide better service, or otherwise distinguish themselves in some positive way (rather than by impeding EA brokers), one would expect to see the same lower EA penetration rates as found by the expert's various statistical analyses, but with procompetitive rather than anti-competitive implications.

Perhaps of equal significance, the supposed evidence of "actual effects" did not amount to much more than evidence of anticompetitive *tendencies*. The court did not demand any *quantification* of consumer harm or harm to the competitive process other than to note that Realcomp's Website Policy inhibited the penetration of EA listings, which tended to put downward competitive pressure on commissions. In accepting the FTC's cross-sectional evidence, for example, the court acknowledged the tiny magnitude of the difference in EA penetration between Detroit and Dayton, the "Control" market that was otherwise "most statistically similar" to Detroit—the gap was only 0.23 percentage points.⁴¹ Ultimately, the most that the court could say about the magnitude of the harm was that there likely would have been some additional EA listings absent the restrictive Website Policy and in turn that if one *assumed* that "EA listings save home sellers half of the typical 6% commission," home sellers would save substantial money if there were more EA listings, and spend more if EA listings were inhibited.⁴²

³⁷ *Realcomp II*, 635 F.3d at 832.

³⁸ Specifically, the economist compared the "Control MSAs" in which MLSs had non-restrictive policies—namely, Charlotte, North Carolina; Dayton, Ohio; Denver, Colorado; Memphis, Tennessee; Toledo, Ohio; and Wichita, Kansas—with Detroit and three other "Restriction MSAs"—Williamsburg, Virginia; Green Bay/Appleton, Wisconsin; and Boulder, Colorado—where MLSs applied restrictive policies. *Realcomp II*, 2009 FTC LEXIS 250, at *120–21 & nn.46–47.

³⁹ See *Realcomp II*, 635 F.3d at 832–33. The court's solicitude for the FTC evidence on this score was also reflected in the court's tolerance of shortcomings in the expert's methodologies, one of which was brushed aside with the observation that there was no evidence that correcting the errors would yield different results. *Id.* at 832 n.11.

⁴⁰ *Id.* at 833–34.

⁴¹ *Id.* The 0.23 percentage point gap between Detroit and Dayton was based on EA listings having achieved 1.24% penetration in Dayton but only 1.01% in Detroit. *Id.* The court emphasized that this was a 22.7% difference, *id.*, but without information on the number of EA listings in these markets, it is impossible to say whether this percentage difference is at all meaningful.

⁴² *Id.* at 832–33 & n.9.

The Lack of Any Redeeming Procompetitive Virtues. Having found that the FTC had established a prima facie case under the rule of reason, the Sixth Circuit next considered whether “Realcomp might still prevail . . . by demonstrating ‘some countervailing procompetitive virtue.’”⁴³ The court agreed with the Commission that none of the justifications proffered by Realcomp was “meritorious,” and as a result those justifications could not overcome the “prima facie case of adverse impact.”⁴⁴

The court hewed closely to the Commission’s reasoning, in essence concluding that all of Realcomp’s supposed justifications reflected a deliberate effort to “protect[] established commissions and prevent[] the reduction in the cost of selling a home.”⁴⁵ First, there was no free riding on MLS services because all brokers—including nontraditional brokers posting EA listings—paid fees for access to the MLS.⁴⁶ Second, the court rejected Realcomp’s argument that the Policy addressed free riding by home sellers on the efforts of MLS member brokers. As Realcomp had explained, MLS fees were not designed to compensate the MLS’s participants for the “additional benefits” of using the MLS to “compet[e] with member cooperating brokers” (i.e., those representing buyers).⁴⁷ The court observed, however, that EA sellers in fact usually *did* contract with cooperating brokers, and the cooperating brokers were compensated in those cases. The court also observed that when buyers were unrepresented, no compensation would be paid to a cooperating broker regardless of whether the listing was of an EA or ERTS variety. The court did not care that under a discount EA listing, no listing broker would receive a percentage commission—in this scenario “listing brokers are not losing money through free riding; they are losing money through competition.”⁴⁸

The court also evaluated and found wanting Realcomp’s “bidding disadvantage” argument, which posited that homebuyers represented by brokers faced a disadvantage when bidding against unrepresented buyers in EA transactions. Again, in the court’s view, this justification was no more than a plea for insulation from the effects of price competition.⁴⁹

The *Realcomp II* case highlights a scenario that is especially tricky for joint venturers. A “restraint” that is initially uncontroversial can come to be seen as protecting stodgy, well-heeled incumbents against transformational change in the marketplace. Consider a group of retailers who come together to build a warehouse that allows them to benefit from distributional economies. Reflecting the era when the venture is formed, all of these retailers sell to the public from actual “brick and mortar” stores with physical addresses. Are they justified in adopting a membership or other rule that limits use of the warehouse to shipments destined for physical store locations? When conceived, such a rule likely would be seen as unremarkable and presumptively valid, since the whole purpose of the venture would be seen as making more efficient the warehousing of product destined for sale in retail stores. Conversely, such a requirement would not be perceived merely as a mechanism for preserving the members’ retail profits. After all, the members presumably would be competing against one another at retail from their various stores.

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⁴³ *Id.* at 834 (quoting *FTC v. Indiana Fed’n of Dentists*, 476 U.S. 447, 459 (1986)).

⁴⁴ *Id.* at 836.

⁴⁵ *Id.*

⁴⁶ *Id.* at 835.

⁴⁷ Reply Brief of Petitioner at 8, *Realcomp II, Ltd. v. FTC*, 635 F.3d 815 (6th Cir. 2011).

⁴⁸ *Realcomp II*, 635 F.3d at 835 n.16 (quoting *Realcomp II Ltd., FTC Docket No. 9320*, 2009 FTC LEXIS 250, at *82 (Oct. 30, 2009), *review denied sub nom. Realcomp II, Ltd. v. FTC*, 635 F.3d 815 (6th Cir. 2011), *petition for cert. filed* (U.S. June 28, 2011) (No. 11-16)).

⁴⁹ *Id.* at 835–36.

But what if the venture continues to enforce the rule in the face of requests for access to the warehouse by Internet mail-order retailers—perhaps even “discount” affiliates of some of the venture’s traditional members who wish to drop-ship directly to consumers, bypassing retail stores? Does the legitimacy of the original restriction disappear just because there is now a new, non-traditional source of competition to which access is denied?

Realcomp II suggests that rules grounded in the character of the original venturers and perhaps justified based on then-existing business realities or market conditions may come to be viewed skeptically as market conditions evolve. But at the same time, there are ways that venturers can improve their chances of overcoming such skepticism. In the hypothetical warehouse venture, one approach would be to point to practical limitations on the warehouse’s capacity, and the congestion or other problems that would be caused by admitting new members, or allowing new kinds of uses, especially if the new needs would require costly changes in business patterns or additional investments by the venturers. Such a path likely was unavailable to the venturers in *Realcomp II*, since there is no reason to think (much less evidence) the MLS could not easily have accommodated electronic feeds of EA listing data to public websites.

Another approach may be for the hypothetical warehouse venturers to set up their warehouse with explicit up-front limits on its functionality, leaving for later any decisions about whether to expand that functionality to accommodate new forms of distribution. The subsequent failure of the venturers to agree to add functionality to accommodate Internet distribution likely would not pose nearly the degree of antitrust risk as the enforcement of a collective rule prohibiting it. In the *Realcomp II* setting, such an approach might have involved the MLS venturers refraining from authorizing the MLS to make *any* electronic dissemination of MLS data, leaving any aggregation of listing data for these purposes to some separate agreement among the venturers. In such a scenario, one possible (and perhaps likely) outcome would have been that MLS members would have recognized the benefits of Internet dissemination and thus agreed to contribute their data for that purpose but only in exchange for economic consideration that compensated them for the commission revenues that would be lost once listings were made widely available to unrepresented home buyers.

An array of other strategies may be available if joint venturers pay careful attention to the likely evolution of their relationship well into the future. On the other hand, they should not hold out much hope if their story sounds like a plea for protection from competition.

The Court Sidestepped Any “Balancing,” Much Less Any Consideration of How the Analysis Would Have Proceeded Had There Been “Some” Redeeming Virtue. Although the court described its approach as a “full rule-of-reason analysis”⁵⁰—and at least one commentator has dubbed it the “Full Monty”⁵¹—the Sixth Circuit’s analysis is not nearly so complete. Because the procompetitive justifications were rejected outright, the court never carried out any balancing of benefits against harms, and indeed never scrutinized carefully the quantum of harm caused by the Policy.

The court of appeals confirmed that it did not complete a rule of reason analysis when it referred to its conclusion as flowing from *Realcomp*’s failure to rebut the FTC’s *prima facie* case.⁵²

⁵⁰ *Id.* at 819.

⁵¹ See Ken Glazer, *FTC Victory in Rule of Reason MLS Case*, ABA Section of Antitrust Law and Social Media blog (Apr. 12, 2011) (quoting Stephen Calkins), <http://abasal.tumblr.com/post/4557857097/ftc-victory-in-rule-of-reason-mls-case>. The use of this term in the antitrust context originates with Stephen Calkins, *California Dental Association: Not a Quick Look But Not the Full Monty*, 67 ANTITRUST L.J. 495 (2000).

⁵² See *Realcomp II*, 635 F.3d at 836.

This burden-shifting approach harkens back to the D.C. Circuit's seminal ruling in *Microsoft*, which analogized the showing required to establish anticompetitive conduct under Section 2 to the rule of reason inquiry under Section 1. That court divided the inquiry into three steps: (1) the plaintiff's burden to come forward with a showing of anticompetitive effects; (2) the defendant's burden to "proffer a 'procompetitive justification' for its conduct"; and (3) the plaintiff's ultimate burden to prove, "if the . . . procompetitive justification stands un rebutted . . . that the anticompetitive harm of the conduct outweighs the procompetitive benefit."⁵³ Here, the Sixth Circuit, like the D.C. Circuit before it, never got to the third step.

Because it never reached that step, the court did not need to explain, among other things, how a balancing of harms and benefits might have been attempted. Had the court relied on the anticompetitive "potential" of Realcomp's Website Policy, how would it have weighed some magnitude of cognizable efficiencies against the mere "potential" of harm? Would that assessment have involved a probabilistic comparison of expected net present values, and if so, what would be the source of the estimate of the quantum of harm that "potentially" might be incurred? With respect to the findings of "actual effects," where would the court have found a quantification of the harm to consumers or the competitive process to use in this balance where the Commission's decision contains no such measure? The Sixth Circuit's decision does not begin to answer these questions.

Practical Implications

The Sixth Circuit's decision in *Realcomp II* demonstrates that it is possible for a plaintiff to win a rule of reason challenge to joint conduct, even in the Sixth Circuit.⁵⁴ The decision also suggests that, in the right circumstances, precious little evidence may suffice to establish the anticompetitive tendencies or effects needed to condemn joint conduct under the rule of reason. But it would be wrong to interpret the case as declaring open season on joint venture conduct. Instead, the outcome teaches three key lessons regarding the ingredients for a successful rule of reason challenge, and in turn three related lessons for venturers seeking to avoid adverse antitrust outcomes.

The first lesson is that when the issues involve tendencies, effects, and purposes, the Commission's findings and analysis will receive substantial deference on a petition for review. The Sixth Circuit emphasized that its review was limited to determining whether the Commission's "informed judgment" was "supported by substantial evidence."⁵⁵ And the court took seriously the limited nature of its review. In its ready acceptance of the Commission's analysis and factual findings,

⁵³ *United States v. Microsoft Corp.*, 253 F.3d 34, 58–59 (D.C. Cir. 2001) (en banc).

⁵⁴ Antitrust plaintiffs alleging Section 1 claims have fared rather poorly in the Sixth Circuit over the past few decades. Among the notable decisions rejecting such claims (on a wide variety of grounds): In 2009, the court affirmed dismissal of claims that airlines had conspired to reduce, cap, and eventually eliminate the payment of base commissions to travel agents in a concerted effort to drive plaintiffs out of business. *In re Travel Agent Commission Antitrust Litig.*, 583 F.3d 896 (6th Cir. 2009). The same year, it affirmed dismissal of a Section 1 claim that NASCAR had conspired with International Speedway Corp., the owner of racetracks, to deny Kentucky Speedway access to a Sprint Cup race. *Ky. Speedway, LLC v. Nat'l Ass'n of Stock Car Auto Racing, Inc.*, 588 F.3d 908 (6th Cir. 2009). In 2007, the en banc court affirmed dismissal of exclusive dealing claims despite the defendant having entered such arrangements with a majority of large distributors, on the ground that plaintiff could have competed for comparable contracts. *NicSand, Inc., v. 3M Co.*, 507 F.3d 442 (6th Cir. 2007) (en banc). In 2004, the court reversed a district court decision enjoining an NCAA rule restricting men's basketball teams to two certified tournaments over four years because the plaintiff failed to allege a proper market definition. *Worldwide Basketball & Sports Tours, Inc. v. NCAA*, 388 F.3d 955 (6th Cir. 2004). And in 2003, the court affirmed dismissal of a Section 1 challenge to rules of the Ontario Hockey League. *NHL Players' Ass'n v. Plymouth Whalers Hockey Club*, 325 F.3d 712 (6th Cir. 2003). To be sure, plaintiffs have also occasionally won Section 1 cases in the Sixth Circuit, including *In re Cardizem CD Antitrust Litigation*, 332 F.3d 896 (6th Cir. 2003), where the court deemed the alleged agreement to be per se unlawful.

⁵⁵ *Realcomp II*, 635 F.3d at 823 (quoting *FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447, 454 (1986)).

the court's opinion at times reads more like one rejecting a petition for review of an agency's plenary rulemaking under the Administrative Procedure Act than an appeal from an administrative adjudication.

It is of course impossible to know how the court would have reacted to a comparable decision rendered by a federal district court. But it does not seem a stretch to think that a district court's reasoning along these lines would have been met with much greater skepticism, and its reliance on rather paltry evidence of anticompetitive tendencies would have been scrutinized more thoroughly. In antitrust cases, district court conclusions are often treated as involving "mixed questions" and thus afforded substantially less deference than the Commission received in *Realcomp II*.⁵⁶ This means that parties facing FTC investigations of joint ventures and other joint conduct should regard the FTC as a potentially formidable adversary if litigation ensues, and thus devote considerable attention to persuading the agency's decision makers why, as a policy matter, they should not want to commence such litigation.

A second lesson is that the absence of any compelling (or cognizable) procompetitive justification is crippling. It is fair to read every step in the Sixth Circuit's analysis as having been influenced (or one might say infected) by the court's perception that there was a complete absence of any valid procompetitive justification for—much less quantified benefits from—the Website Policy. Against that backdrop, it is not so hard to understand why any anticompetitive tendency, or any risk of disadvantaging nascent rivals, would weigh heavily against overturning the Commission's decision. When venturers are heard to say that they wanted to make life harder for the competition or wanted to protect high prices, and then defend their actions by arguing about the lack of any real impact, they will probably lose.

The corresponding lesson for joint venturers is that the rationale for the restraint can often be even more important than the actual benefits that result. Careful attention to the procompetitive story needs to be paid at the very outset of the venture's formation, and the participants should think far ahead to whether that story will remain valid once the venture achieves its hoped-for success in the marketplace.

Finally, *Realcomp II* shows that the deck is stacked against joint ventures that are the "only game in town." The outcome likely turned, to a considerable extent, not merely on Realcomp's "market power"—a malleable concept that has been found to exist even when firms have market shares as low as 35 percent—but on the fact that there was no other MLS serving Detroit. Had there instead been three—each with a one-third share—it seems likely the case would have come out much differently. Competition from listings on other MLSs likely would have transformed the court's (and the agency's) perception of any rules established by the "traditional" MLS from "anti-

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⁵⁶ Had a district court granted summary judgment to plaintiff on its Section 1 claims, of course, the court of appeals would have reviewed that decision de novo, giving no deference to the lower court's findings. *E.g.*, *Plona v. UPS, Inc.*, 558 F.3d 478 (6th Cir. 2009). Had the lower court entered judgment for plaintiff after trial, or let stand a jury verdict, the standard of appellate review would have been somewhat closer to the "substantial evidence" standard that applied to review of the Commission's decision in *Realcomp II*. The Sixth Circuit "reviews a district court's findings of fact for clear error." *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n*, 442 F.3d 410, 420 (6th Cir. 2006), *rev'd on other grounds*, 551 U.S. 291 (2007). But it is not quite so simple: "conclusions of law, questions of mixed law and fact, and 'findings of ultimate facts which result from the application of legal principles to subsidiary factual determinations' are all subject to *de novo* review." *Id.* (citation omitted). Likewise, a district court's decision to grant a permanent injunction is reviewed on an "abuse of discretion" standard. *See CSX Transp., Inc. v. Tenn. State Bd. of Equalization*, 964 F.2d 548, 553 (6th Cir. 1992). "A district court abuses its discretion when it relies on clearly erroneous findings of fact or when it improperly applies the law." *Herman Miller, Inc. v. Palazzetti Imports & Exports, Inc.*, 270 F.3d 298, 317 (6th Cir. 2001) (citing *Christian Schmidt Brewing Co. v. G. Heileman Brewing Co.*, 753 F.2d 1354, 1356 (6th Cir. 1985)).

competitive restraints” into measures likely aimed at differentiating their services and attracting consumers who valued what those brokers offered—or else merely hastening that MLS’s extinction in the face of marketplace change.

Ironically, perhaps, the FTC succeeded in making the case about the MLS’s overwhelming market power even though the alleged effects had little to do directly with the MLS’s own power, but instead with the extra costs entailed in placing EA listings on both the MLS and third-party websites. To be sure, EA brokers needed access to the MLS in order to survive, but they got it: recall that Realcomp allowed EA listings to be disseminated *via the MLS itself*. The nub of the harm was the impact on distribution via channels other than the MLS, yet there was no evidence suggesting that the MLS had any market power vis-à-vis these other channels. And indeed, had the MLS not existed and given access to EA listings, EA brokers’ costs of distribution would have been astronomically higher. It is thus fair to ask whether the “market power” finding was misdirected. Nonetheless, having perceived the MLS as the only game in town, the court’s evaluation of the venture’s rules—like the analysis carried out by the Commission—gave short shrift to arguments that there were other ways for nontraditional brokers to compete effectively with MLS members. ●

The Failing Firm Defense: Alive and Well

Thomas D. Fina and Vishal Mehta

The failing firm defense exempts an otherwise anticompetitive acquisition from liability under Section 7 of the Clayton Act where failure of one of the merging parties is imminent. Despite the defense's longevity, the stringent standards underlying the doctrine have limited its use over time. The defense has seldom been raised by merging parties in courts or before the Agencies and, when invoked, has rarely succeeded.¹

This article provides an overview of the failing firm defense and highlights two recent investigations by the Federal Trade Commission and the Department of Justice, in which the defense has succeeded. Together, these cases suggest that the failing firm defense, in its current, longstanding incarnation, is alive and well. Moreover, the cases illustrate the importance of a "shop" of the allegedly failing firm's assets and the extent to which the Agencies, in the right case, may act quickly and creatively in validating the defense.

Overview of the Failing Firm Defense

Since its debut in 1930, the failing firm defense has remained remarkably consistent in its formulation.² The defense was first recognized in the Supreme Court's decision in *International Shoe Co. v. FTC*.³ In that case, as a result of shrinking demand, declining revenues, excess capacity, and extensive debt, dress shoe manufacturer H.W. McElwain faced imminent, involuntary liquidation. To avoid this outcome, the company sold its voting stock to International Shoe, a capacity-constrained competitor. The FTC concluded that the transaction substantially lessened competition in the relevant market in violation of Section 7 of the Clayton Act, and the First Circuit affirmed. The Supreme Court reversed, holding that because H.W. McElwain faced a grave probability of business failure and lacked any alternative purchaser, the transaction did not substantially lessen competition.

Nearly forty years after its decision in *International Shoe*, the Supreme Court clarified the failing firm defense in *Citizen Publishing Co. v. United States*,⁴ which involved a joint venture between

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¹ David Scheffman, Malcolm Coate & Louis Silvia, Bureau of Economics, Fed. Trade Comm'n, 20 Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective 51 (June 4, 2002) ("The FTC has successfully challenged a number of mergers where a failing firm defense was alleged."), <http://www.justice.gov/atr/hmerger/12881.pdf>; Debra A. Valentine, Deputy Dir., Policy Planning, Fed. Trade Comm'n, Horizontal Issues: What's Happening and What's on the Horizon (Dec. 8, 1995) (the standards of the defense "are strict . . . [and] rarely all satisfied, and, as a result, the defense is seldom invoked. In fact, the Supreme Court has not upheld its application since its 1930 *International Shoe* decision."), <http://www.ftc.gov/speeches/other/dvhorizontalissues.shtml>; Richard D. Friedman, *Untangling the Failing Company Doctrine*, 64 TEX. L. REV. 1375, 1376 (1986) ("[The failing firm defense] has often been ignored or scorned, and [is] rarely invoked with success in litigation.").

² Friedman, *supra* note 1, at 1375–76 ("Whatever else can be said about it, the failing company doctrine is a survivor. Judicially created more than half a century ago, it emerged unscathed when the Celler-Kefauver Act of 1950 tightened up Section 7 of the Clayton Act, and it even endured the antimerger jurisprudence of the 1960s.").

³ 280 U.S. 291 (1930).

⁴ 394 U.S. 131 (1969).

In both investigations, the dispositive issue appears to have been how thoroughly the allegedly failing firm's assets had been marketed, or "shopped," in an effort to find an alternative purchaser.

two competing newspapers in Tucson, Arizona. Prior to entering into the joint venture, the *Citizen* had suffered declining sales. In contrast, the *Star* recorded significant annual profits. Following the sale of the *Citizen*, the firm's new owners negotiated a joint operating agreement with the *Star* providing for (1) acquisition of *Star* stock by *Citizen* shareholders; (2) joint establishment of subscription and commercial advertising rates; (3) profit pooling between the *Star* and the *Citizen* according to an agreed-upon ratio; and (4) non-compete agreements between and among stockholders, officers, and executives for each publication. The DOJ sued, alleging, *inter alia*, that the joint operating agreement substantially lessened competition in violation of Section 7 of the Clayton Act. Finding for the government, the district court ordered the parties to submit a plan for divestiture and re-establishment of the *Star* as an independent competitor. The Supreme Court affirmed. Citing *International Shoe*, the Court explained that the failing firm defense applies only where it can be proven that (1) the target company is in imminent danger of failure; (2) the failing firm has no realistic prospect for a successful reorganization;⁵ and (3) there is no viable alternative purchaser posing less anticompetitive risk.⁶

The most recent formulation of the failing firm defense can be found in the 2010 Merger Guidelines.⁷ Building on the standards articulated in *International Shoe*, *Citizen Publishing*, and prior versions of the Guidelines, the 2010 Guidelines provide that a "merger is not likely to enhance market power if imminent failure . . . of one of the merging firms would cause the assets of that firm to exit the relevant market."⁸ The Guidelines set forth a three-prong test that an allegedly failing firm must meet in order to qualify for the defense. The firm must: (1) be unable to meet its financial obligations in the near future; (2) be unable to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) have made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than would the proposed merger. The third prong has historically been the most difficult element to demonstrate. Under the Guidelines, reasonable offers include any offer above the liquidation value of the target's assets. The Guidelines note that the defense "is an extreme instance of the more general circumstance in which the competitive significance of one of the merging firms is declining: the projected market share and significance of the exiting firm is zero."⁹

Recent Applications of the Failing Firm Defense

Two recent merger investigations by the FTC and DOJ illustrate the continuing vitality of the failing firm defense. In both investigations, the dispositive issue appears to have been how thoroughly the allegedly failing firm's assets had been marketed, or "shopped," in an effort to find an alternative purchaser.

On April 1, 2009, Scott & White Healthcare merged with Texas-based King's Daughters Hospital in a non-reportable transaction. For over a century prior to the merger, King's Daughters had oper-

⁵ See *id.* at 138 ("[W]e know from the broad experience of the business community since 1930, the year when the *International Shoe* case was decided, that companies reorganized through receivership, or through Chapter X or Chapter XI of the Bankruptcy Act often emerged as strong competitive companies.").

⁶ See *id.* at 137–38 ("The failing company doctrine plainly cannot be applied in a merger or in any other case unless it is established that the company that acquires the failing company or brings it under dominion is the only available purchaser. For if another person or group could be interested, a unit in the competitive system would be preserved and not lost to monopoly power.").

⁷ U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 11 (2010) [hereinafter 2010 Merger Guidelines], available at <http://www.justice.gov/atr/public/guidelines/hmg-2010.html>.

⁸ *Id.*

⁹ *Id.*

ated as a general acute care hospital. Through the acquisition, Scott & White planned to convert King's Daughters into a freestanding children's hospital, which would thereby eliminate Scott & White's only independent acute care competitor in Bell County, Texas.¹⁰ The FTC began an investigation of likely competitive effects jointly with the Texas Attorney General's Office. The FTC found that King's Daughters' "poor, and deteriorating, financial condition" at the time of the transaction "would have caused the hospital to close at some point in the future if it was not acquired by another hospital or health system."¹¹ The investigation thus turned on the issue of whether the transaction qualified for the failing firm defense and, in particular, whether an alternative purchaser existed at the time of the transaction that might have maintained King's Daughters as a general acute care hospital in competition with Scott & White.¹²

The FTC found that the Seton Family of Hospitals had also been interested in acquiring King's Daughters, but that its opportunity to complete due diligence had been foreclosed by the agreement between King's Daughters and Scott & White.¹³ As a proxy for determining whether an alternative buyer existed, the FTC required Scott & White to offer King's Daughters to Seton on terms that would require its continued operation as a general acute care hospital. These terms were embodied in an asset purchase agreement presented to Seton in October 2009.¹⁴ After conducting additional due diligence, Seton declined to purchase King's Daughters, citing "a significant reduction in the value of the [hospital's] assets from an operational perspective" post-merger.¹⁵ In December 2009, the FTC closed its investigation, satisfied that King's Daughters qualified for the failing firm defense based on Seton's rejection of the offer.¹⁶

More recently, the DOJ accepted the failing firm defense in connection with Hercules Offshore, Inc.'s \$172 million acquisition of the assets of Seahawk Drilling, Inc. Founded in 2008, Houston-based Seahawk operated twenty shallow-water jackup drilling rigs, providing contract drilling services to the oil and natural gas exploration and production industry throughout the Gulf of Mexico. Since 2008, industry demand for shallow-water drilling services had declined sharply as a result of the global financial crisis and federal moratoria on offshore drilling in the aftermath of the Deepwater Horizon disaster. By October 2010, only three of Seahawk's twenty rigs were

¹⁰ Richard Feinstein, Dir., Bureau of Competition, Fed. Trade Comm'n, Statement on the FTC's Closure of Its Investigation of Consummated Hospital Merger in Temple, Texas (Dec. 23, 2009), available at <http://www.ftc.gov/os/closings/091223scottwhitestmt.pdf>.

¹¹ *Id.* at 1.

¹² *Id.* at 2 ("This investigation was unusual, as a single issue—*did King's Daughters qualify for the failing firm defense?*—was likely dispositive as to whether the merger violated Section 7 of the Clayton Act.").

¹³ *Id.*

¹⁴ Press Release, Seton Family of Hospitals, Seton Family of Hospitals Must Reject Scott & White Offer to Acquire Assets of King's Daughters Hospital (Nov. 30, 2009), http://www.seton.net/about_seton/news/2009/11/30/seton_family_of_hospitals_must_reject_scott_and_white_offer_to_acquire_assets_of_kings_daughters_hospital_2.

¹⁵ *Id.*

¹⁶ See Feinstein, *supra* note 10, at 1.

¹⁷ Press Release, Seahawk Drilling, Inc., Seahawk Drilling, Inc. Announces Review of Strategic Alternatives (Nov. 2, 2010), <http://www.seahawkdrilling.com/investor-relations/news-releases> ("Seahawk's liquidity and revenue generation have been adversely affected by the dramatic slow-down in the issuing of shallow water drilling permits in the U.S. Gulf of Mexico following the Macondo well blowout, the continued low prices for natural gas, the general economic slowdown and other factors . . ."); see also Seahawk Emergency Motion at ¶¶ 5–7, *In re Seahawk Drilling, Inc.*, No. 11-20089 (Bankr. S.D. Tex. Feb. 12, 2011), ECF No. 9 [hereinafter Seahawk Emergency Motion] ("The decline in the United States jackup rig market since 2009 has been one of the sharpest downturns for domestic jackup rig activity over the past 30 years . . . On April 20, 2010, the demand for offshore drilling services in the Gulf of Mexico was further negatively impacted by the Macondo well blowout . . . [as a result of which] Seahawk customers are experiencing significant delays in the issuance of drilling permits and very few new drilling permits have been issued.").

working under contract. These factors, combined with continued operating losses, exhausted Seahawk's liquidity.¹⁷

In November 2010, Seahawk initiated and publicly announced a formal process to explore a wide range of potential strategic alternatives to address its liquidity problem, including additional funding, recapitalization, the sale of assets, or a sale or merger of the business.¹⁸ Seahawk retained an investment bank, which engaged in an extensive shop of the company over a three-month period, contacting more than one hundred potential merger partners, strategic acquirers, and financial investors.¹⁹ As detailed in its bankruptcy filings, Seahawk first contacted a select group of seventeen high-graded financial investors, of which six signed confidentiality agreements and four received presentations from the company. Seahawk next contacted another group of 115 financial entities and strategic buyers, of which fifty-one received summary memoranda, thirty-seven received confidentiality agreements, and eleven received management presentations.

Ultimately, eleven companies, including Hercules—a leading global provider of offshore contract drilling, liftboat, and inland barge services for exploration and production (i.e., oil) companies²⁰—submitted indications of interest or term sheets to Seahawk. With the exception of Hercules, these offers were too vague, contingent, or presented an unacceptable risk of protracted due diligence, which Seahawk was unlikely to survive. Thus, at the time of sale, Hercules was the only viable purchaser of Seahawk's assets.²¹ In early February 2011, Hercules entered into an asset purchase agreement with Seahawk to acquire substantially all of Seahawk's assets through a sale under Section 363 of the Bankruptcy Code.²² Seahawk subsequently filed for bankruptcy on February 11, 2011.

The parties filed under the Hart-Scott-Rodino Act in early March 2011, and the DOJ obtained clearance. A shortened, fifteen-day initial waiting period applied because the assets would be purchased under Section 363 of the Bankruptcy Code. In mid-March, Hercules pulled and refiled its notification to provide the DOJ with additional time to review the proposed transaction. The DOJ alleged that Hercules' acquisition of Seahawk's rigs would have resulted in a post-merger share of approximately 80 percent in drilling rigs used in soft seabeds in the Gulf of Mexico. Because of the parties' high combined market share in the Gulf of Mexico, a second request and a protracted investigation seemed possible. Given Seahawk's precarious financial condition, a lengthy investigation would have likely forced the company into liquidation and its assets out of the market. Working quickly, the DOJ, after conducting its analysis, accepted the parties' contention that Seahawk was a failing firm. The HSR waiting period was terminated prior to the end of the second fifteen-day waiting period, and the parties closed the transaction shortly thereafter. It appears that Seahawk's extensive shop of its assets and the lack of a viable alternative purchaser were critical to the DOJ's decision to close its investigation.

Conclusion

The Hercules and Scott & White transactions demonstrate that the failing firm defense is alive and well at the Agencies, and that the Agencies are able to move quickly (Hercules) and creatively

The Hercules and Scott & White transactions demonstrate that the failing firm defense is alive and well at the Agencies, and that the Agencies are able to move quickly (Hercules) and creatively (Scott & White) in analyzing whether the defense applies.

¹⁸ Seahawk Emergency Motion, *supra* note 17, ¶ 8.

¹⁹ Stille Decl. at ¶¶ 17–19, *In re Seahawk Drilling, Inc.*, No. 11-20089 (Bankr. S.D. Tex. Feb. 12, 2011), ECF No. 4.

²⁰ Hercules' jackup rig fleet is the fourth-largest in the world and the largest in the Gulf of Mexico. In addition to barge rigs, liftboats, and marine support vessels, at the time of the Seahawk acquisition, Hercules' fleet consisted of thirty shallow-water jackup drilling rigs.

²¹ Seahawk Emergency Motion, *supra* note 17, ¶ 16.

²² Section 363(b)(1) of the Bankruptcy Code provides that, in connection with a reorganization under Chapter 11, "[a] trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1).

(Scott & White) in analyzing whether the defense applies. The transactions suggest that in evaluating the defense, the Agencies are sensitive to parties' concerns that delay could prove fatal to the allegedly failing firm. In the Hercules transaction, Seahawk's rapidly deteriorating financial condition informed the Antitrust Division's expedited review and grant of early termination. Similarly, in the Scott & White transaction, because of the exigency created by King's Daughters' financial condition, the FTC took an innovative and targeted approach in determining whether a viable alternative purchaser existed. Furthermore, the Scott & White transaction underscores the Agencies' willingness to "unring the bell" post-merger in vetting the target's search for reasonable alternative offers. Finally, both the Hercules and Scott & White transactions illustrate the critical importance of a thorough and well-documented shop to a successful assertion of the defense. ●

The 2011 Changes to the HSR Act Notification Form: A Guide for Practitioners

Gregory L. Kinzelman

On July 7, 2011, the Federal Trade Commission¹ announced final rules adopting changes to the Notification and Report Form (Form) required for certain transactions under the Hart-Scott-Rodino (HSR) Antitrust Improvements Act of 1976.² These Form changes, which will become effective in mid-August 2011,³ are the most significant ones to be made since the introduction of the program.⁴

The FTC first put out these changes for public comment on August 13, 2010.⁵ In response to public comments, several important clarifications and adjustments were made. The resulting final changes eliminate requirements for certain information that the Agencies found to be of little use as well as impose requirements for additional information potentially relevant to antitrust review.

The antitrust bar will no doubt welcome the many changes that reduce the burden for filing parties. Most significantly, these reductions include:

- Elimination of the need to list asset classifications and values in asset and non-corporate acquisitions. (Item 3(b)(i), (ii), and (iii))⁶
- Elimination of the need to list and provide information for all the classes of securities of an acquired issuer (a benefit for funds that take partial positions in companies). (Item 3(c))
- Elimination of the need to list each SEC filing made by the person filing the Form. (Item 4(a))
- Elimination of the need for a balance sheet (a benefit to equity funds that do not consolidate and to natural persons who are extremely reluctant to disclose such information). (Item 4(b))
- Elimination of the base year, manufactured products added and deleted, and elimination of the need to double count certain manufacturing revenues. (Item 5(a), (b)(i), and (b)(ii))
- Elimination of the need to provide the address, description of contracts, and credit guarantees for joint venture formations. (Item 5(d)(i), (d)(ii)(B), and (d)(ii)(C))

¹ With the concurrence of the Department of Justice (DOJ).

² The HSR Act requires parties to notify the FTC and the DOJ of proposed transactions that meet the Act's jurisdictional thresholds and to observe a statutory waiting period while the Agencies review the potential impact of the transaction on competition. *See* 15 U.S.C. § 18a.

³ 76 Fed. Reg. 42,471 (July 19, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-07-19/pdf/2011-17822.pdf>. By operation of law, the new rules take effect thirty days after publication, which will be August 18, 2011.

⁴ Significant prior changes to the Form include the elimination of an annex for insurance providers and an item related to vendor-vendee (vertical) relationships between the acquired and acquiring persons. 66 Fed. Reg. 23,561 (May 9, 2001); 66 Fed. Reg. 8680, 8686 (Feb. 1, 2001). Given the recent revival of what had seemed a minimal interest in vertical mergers by the DOJ, the latter change may have been premature. Other prior significant changes pertained to the acquisition of non-corporate interests, the implementation of annual changes to the HSR thresholds, and increased filing fees.

⁵ 75 Fed. Reg. 57,110 (Sept. 17, 2010).

⁶ Item numbers reflect those of the current Form.

While the elimination of these items from the Form is significant, there will no doubt be greater interest among practitioners in the interpretation and administration of the additional requirements for documents and information by the FTC's Premerger Notification Office (PNO).

- Elimination of the need for acquiring persons to list foreign subsidiaries without a U.S. nexus and to provide street addresses. (Item 6(a))
- Elimination of the need to list shareholders and other owners of all controlled entities other than the ultimate parent and the actual entity making the acquisition or being acquired. (Item 6(b))
- Elimination of the need for acquiring persons to list minority holdings in other entities that do not have overlapping NAICS industry codes with the acquired person. (Item 6(c))

While the elimination of these items from the Form is significant, there will no doubt be greater interest among practitioners in the interpretation and administration of the additional requirements for documents and information by the FTC's Premerger Notification Office (PNO). The changes that increase the information required from filers have been the subject of vigorous comment from the private bar. These additional requirements include:

- Parties must now provide three additional classes of documents. (Item 4(d))⁷
- Parties must now provide most recent year NAICS codes at the 10-digit level for products that the filing person manufactures in a foreign country. (Item 5(a))
- Acquiring persons must now determine their "associates" and provide certain information regarding their holdings that overlap with the target. (Items 6 and 7)

Given these changes, practitioners should carefully review the revised Form, the instructions, and the Statement of Basis and Purpose published in the Federal Register as a starting point. The PNO is expected to provide additional guidance in the form of speeches and additional written materials, and may post additional information on the FTC website. It also is expected that the ABA's *Premerger Notification Manual* will soon be revised to take into account the new changes,⁸ though that will likely take several months. Filing parties who have specific questions not answered by these sources may contact the PNO to determine its position with respect to specific situations.

The following discussion and assessment of the new requirements is based on consultation with the PNO and comments from the private bar.

Item 4(d) Documents

Item 4(c) of the HSR notification requires submission of documents prepared by or for an officer or director "for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, potential for sales growth or expansion into product or geographic markets." The new Item 4(d) may in some cases add to the Item 4(c) list of documents "prepared by or for an officer or director" that must be submitted with the Form.⁹

⁷ Item numbers reflect those of the revised Form.

⁸ ABA SECTION OF ANTITRUST LAW, *PREMERGER NOTIFICATION MANUAL* (4th ed. 2007).

⁹ There has been a history of agency efforts to expand the scope of Item 4(c) documents parties are required to submit with the Form. The original Form proposed for HSR notifications called for a significant volume of documentary attachments, including, for example, "any documents that pertain to markets, competitors, expansion, etc., into any product or services manufactured or sold by the other reporting company." 43 Fed. Reg. 33,526 (July 31, 1978). In the end, in response to public comments the Agencies concluded that the Second Request process was the proper tool for them to obtain such documents, not the initial filing. *Id.* In 1994, the Agencies proposed a new Item 4(c)(ii) requiring submission of "all investment bankers' books, offering memoranda, and similar documents which have been prepared by any person for the purpose of soliciting expressions of interest from prospective purchasers of the assets or entity to be acquired." 59 Fed. Reg. 30,545, 30,549 (June 14, 1994). The 1994 proposed changes also would have expanded Item 4(c) to require submission of documents relating to "the integration of the operations of the acquiring person and the business enterprise to be acquired." *Id.* Neither was adopted.

New Item 4(d) will require filing parties to provide:

- i. All Confidential Information Memoranda (CIMs) that specifically relate to the sale of the acquired entity or assets. If no such CIM exists, parties must submit any document(s) given to the buyer's officers or directors that is meant to serve the same purpose as a CIM;
- ii. All studies, surveys, analyses, and reports prepared by investment bankers, consultants, or other third-party advisors during an engagement or for the purpose of seeking an engagement for any officer(s) or director(s) of the filing person that meet the competitive information prong of Item 4(c) and that specifically relate to the sale of the acquired entity or assets; and,
- iii. All studies, surveys, analyses or reports evaluating or analyzing synergies or efficiencies, prepared by or for any officer(s) or director(s) for the purpose of evaluating or analyzing the acquisition.

The same formal and informal interpretations that apply to Item 4(c) documents will likely also apply to Item 4(d) documents.

Items 4(d)(i) and 4(d)(ii) require the filing person to provide responsive documents prepared within one year of the HSR filing date.

Several public comments interpreted the language first proposed for Item 4(d), particularly Item 4(d)(ii), as requiring submission of ordinary course studies and competitive analyses prepared within two years¹⁰ prior to HSR filing, even if they had no connection to the notified transaction. In adopting the final rules, the FTC stated in the Statement of Basis and Purpose that the comments received overstated the intended scope of the requirement, and consequently language was added to ensure that only documents related to the sale of the assets or business being reported would be required.

As explained in the Statement of Basis and Purpose for the final rules, the FTC was reluctant to use the terms “transaction” or “acquisition” in Items 4(d)(i) and 4(d)(ii) and instead referred to the “acquired entity or assets” to prevent filers from claiming that certain documents were not required. For example, the PNO has long interpreted Item 4(c) as requiring parties to submit offering memoranda and other documents prepared by an investment banker for purposes of soliciting expressions of interest from potential buyers of the target if they evaluate competitive topics listed in the Item 4(c) instruction. Nonetheless, in the FTC’s experience some parties have taken the position that these documents do not fit within Item 4(c) because they may not have been prepared “for the purpose of evaluating or analyzing” the notified transaction between the seller and the specific identified buyer.¹¹ One could view Items 4(d)(i) and (ii) as closing a potential Item 4(c) loophole, in that they create little, if any, additional burden for parties that do not take such an aggressive position on such documents.

The same formal and informal interpretations that apply to Item 4(c) documents will likely also apply to Item 4(d) documents.¹² In particular, as applied to Item 4(d) in general, this would suggest that:

¹⁰ The final change scaled this requirement back from two years to one.

¹¹ Of course, in some instances offering memoranda do not contain an evaluation of competitive issues, and in such cases the offering memoranda are properly not included in an HSR filing under Item 4(c) but are nonetheless responsive to Item 4(d)(i).

¹² The author consulted with the PNO in the preparation of this section. Because informal interpretations by the PNO are not binding on the Agencies, and may evolve over time in response to Agency experience, parties are cautioned to consult the latest information when preparing a notification. For a more extensive overview of the PNO’s informal interpretation process, see Gregory L. Kinzelman, *United States v. Malone—Lessons for HSR Practitioners on FTC Premerger Notification Office Informal Interpretations*, ANTITRUST SOURCE, Feb. 2010, http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/Feb10_Kinzelman2_25f.authcheckdam.pdf.

- The term “officer” remains limited to those positions designated by the bylaws or articles of incorporation, or appointed by the board of directors (or to individuals designated in a similar way by an unincorporated entity).¹³
- Draft documents are not called for so long as the final or most recent superseding version is submitted (unless a draft is found in the files of a member of the board of directors, in which case it must be produced).
- The same rules on attorney-client communication and attorney work product apply, and a privilege log is required for documents withheld (or redacted) from production under 4(d) in the same format as for Item 4(c).
- If an officer or director never receives a document and it is not found in his or her files, then it does not qualify for inclusion even if it was prepared for an officer or director by someone else.
- Where parties break off negotiations or agree not to pursue a transaction but subsequently do enter into a transaction, a document prepared prior to the breakoff is not responsive to Item 4(d). Of course, just as with Item 4(c), whether a clear breakoff occurred would be a question of fact that would depend on individual circumstances. Given the one year look-back limit for Item 4(d), as a practical matter it may be difficult to show that a clear stop and restart occurred within such a short period, so parties should be careful when applying this informal interpretation.
- Rule 803.8(a)¹⁴ applies to all “documentary materials,” and thus there is no requirement to translate foreign language Item 4(d) documents into English, although if an English language version or summary exists, that must be submitted.

More specifically, as applied to the sub-items of Item 4(d), the current body of informal interpretations relating to Item 4(c) leads to the following conclusions:

Item 4(d)(i) CIMs.

- For Item 4(d)(i), only one version of the CIM need be produced regardless of whether there are other copies of the same presentation that contain extra handwritten marginalia of an officer or director (so long as any such writing does not reference Item 4(c) topics, which could make it a separate Item 4(c) document).
- If a CIM (or equivalent) was given to the buyer, that version should be produced, with no need to produce the versions given to unsuccessful bidders. (However, if a CIM was not given to the buyer, but one exists, it must be produced.)
- If an investment bank prepares both a short “teaser” and a full-length CIM, the “teaser” does not need to be submitted under Item 4(d)(i) because it was superseded by the final full CIM. Note that if the teaser was never followed up with a more recent full CIM, however, the teaser would need to be submitted under Item 4(d)(i).
- CIMs containing information limited to non-reportable assets/businesses, such as non-U.S. assets without U.S. sales, need not be included in a notification. (For example, a seller with operations in Germany, the United States, and Brazil is selling each of these three businesses separately and prepares a CIM for each. Only the acquisition of the U.S. operations

¹³ Given the broader scope of documents now required, it may be worth the effort for HSR counsel to obtain a specific list of such positions from their clients rather than to presume that all senior management at the VP level or above are so invested.

¹⁴ 16 C.F.R. § 803.8(a).

is HSR reportable, so the seller need only include the CIM for the U.S. portion, not the other two CIMs.)

- CIMs from a prior acquisition of the same company or assets are not called for under Item 4(d)(i). (For example, if an equity fund acquired Company A in January 2011 and then proposes to flip (sell) Company A to another party in October 2011, a CIM prepared by the first seller for the fund would not be required to be included in the October HSR filing.)

In sum, based on the Statement of Basis and Purpose and prior informal interpretations regarding Item 4(c) documents, at most only one document would need to be submitted under Item 4(d)(i) if there is a CIM.¹⁵ Once that document is found, then that is the end of the search under this Item. Where there is no CIM, parties may in some circumstances need to produce more than one document. Given the usual purpose of a CIM, however, it is likely that there would only be one or a limited number of documents given to a buyer that would specifically serve the same purpose. Most parties already collect and review all CIMs and other documents prepared by investment bankers when preparing a notification, so Item 4(d)(i) should not impose any additional burden on filers. CIMs often contain a competitive assessment in order to provide potential buyers with information they need to consider and value an acquisition and therefore should, in most instances, be produced already under Item 4(c).

Item 4(d)(ii) Third Party Advisor Documents. The purpose of this requirement, according to the FTC, is to require submission of bankers' books that might not be submitted under Item 4(c) if a filing party takes the view that documents prepared before a specific buyer emerges are not responsive to Item 4(c). Thus, for parties interpreting Item 4(c) commensurate with the PNO's longstanding position, Item 4(d)(ii) should not require the production of any additional documents.

Item 4(c) requires only those documents found in the files of an officer or director. Item 4(d) does not expand this: there is no requirement under Item 4(d) that the files of a third-party advisor be separately searched for responsive materials.¹⁶ Thus, Item 4(d)(ii) does not expand the scope of the search for the kinds of documents already being filed with most HSR notifications.

Item 4(d)(iii) Efficiencies Documents. Based on prior informal interpretations relating to Item 4(c) documents, we can conclude the following with respect to Item 4(d)(iii):

- Press releases do not qualify even if they analyze or discuss efficiencies and/or synergies expected from the transaction.
- Filings made for other regulatory agencies (U.S. or foreign) that contain an analysis of efficiencies are not responsive.
- Only relevant portions of board minutes related to efficiencies need be supplied and not the entire board minutes. (In other words, the 4(c) allowance for redaction of non-responsive material applies to Item 4(d)(iii)).

¹⁵ An exception would be if there were separate CIMs for different parts of an acquisition. For example, where a buyer acquires (in the same transaction) two divisions from a seller and that seller had offered the two divisions for sale separately and prepared separate CIMs for each, then both CIMs would need to be produced.

¹⁶ Both Agencies have served civil investigative demands (CIDs) to filing parties' advisors, such as management consultants involved in integration planning and investment bankers, as part of in-depth merger investigations. Given this practice, the addition of Item 4(d)(ii) calling for third-party advisor documents at the initial filing stage may cause concern among some practitioners that Item 4(d)(ii) may provide the Agencies with another opportunity to "bounce" a filing for non-compliance if third-party documents not submitted with the initial filing are produced in response to a Second Request or CID to a third-party advisor.

Often synergies are analyzed in Item 4(c) documents, and, where this is the case, Item 4(d)(iii) will not require any additional search effort. As companies often create stand-alone efficiency or synergy documents, particularly in connection with due diligence or integration planning, Item 4(d)(iii) may require a more careful search of the files of officers who deal with these considerations. While the Item 4(d)(iii) search universe remains limited to the files of officers and directors (and in some cases those reporting to them¹⁷), efficiency-related documents may be found in the files of officers who may not ordinarily be expected to have Item 4(c) documents, such as a Vice President of Human Resources or a Chief Information Officer, given the usual goal of achieving synergies through elimination of “overhead” and consolidation of IT systems.

Because ordinarily efficiencies are taken into account only once a competitive issue has been identified, it is questionable whether the Agencies will be able to do a better job of conducting an initial review of the proposed transaction by obtaining these documents with the initial filing rather than through a voluntary access letter or Second Request. At best, having an efficiency analysis up front may marginally aid the Agencies’ preliminary review by showing a “good guy” story that justifies a merger for reasons other than raising prices or reducing output. At worst, some HSR counsel are concerned that the new Item 4(d)(iii) requirement may be more often used by the Agencies to discount efficiencies documents and analyses presented after submission of the notification, or to argue that any efficiencies claims that the parties did not first disclose via an Item 4(d)(iii) document should be discounted or viewed with suspicion.¹⁸

While the requirement to submit documents related to the efficiencies of a proposed transaction is new, in many instances Item 4(d) should not require more effort than most parties already devote to searching for Item 4(c) documents when preparing a HSR notification. In fact, where there are potential antitrust concerns with a transaction, counsel should already be reviewing efficiency-related documents to prepare a case as to how the efficiencies relate to the transaction, either to show that these efficiencies outweigh any harm to competition or to explain to the Agencies a procompetitive rationale for the transaction. However, for transactions with no conceivable competitive issue, the search for efficiencies documents may be an additional burden for filers, without any corresponding benefit to the Agencies.¹⁹ In all instances, though, parties will not be required to search for documents beyond those prepared by or for an officer or director involved in the acquisition. Because CIMs, third-party consultant documents, and efficiencies documents are often already collected and reviewed by counsel to determine whether they meet the Item 4(c) criteria (and indeed they often do), the practical result of adding Item 4(d) is that most parties will produce a few more additional documents.

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Item 5 NAICS Code Revenue Information

The FTC has expanded the Item 5 revenue information requested for the most recent completed year’s operations in two significant ways. First, a filing person is required to allocate manufacturing data by a detailed 10-digit NAICS code, rather than by a 7-digit NAICS code. Second, the filing person is required to provide information on products manufactured outside the United States

¹⁷ Cautious filers will often search direct reports to some officers in a “belt and suspenders” approach to better ensure that a responsive document “prepared for an officer” is not overlooked.

¹⁸ Indeed, publicly traded companies are often more focused on preparing synergy documents and calculations to show to the investment community that a merger makes financial sense than to do so for the benefit of antitrust regulators. Thus, companies may continue to create better informed synergy documents as due diligence and integration planning progress, well after an HSR filing is submitted.

¹⁹ A possible solution for this problem would be to limit Item 4(d)(iii) to filings in which there is an Item 7 overlap.

but sold in or exported to the United States by a 10-digit NAICS code. Filers should note that, going forward, reporting for the most recently completed year will require use of the most recent version of the NAICS codes, meaning that the applicable codes will switch from the 2002 edition to the 2007 edition starting August 18, 2011.

The new rules also eliminate the need for double counting revenues for manufactured goods that are sold at the wholesale or retail level for both domestic and foreign manufactured goods. The new instruction requires that any manufacturer, whether foreign or domestic, report revenues from the sale of its manufactured products only under 10-digit manufacturing product codes. Products not manufactured by the parties but only sold by them would continue to be reported under 6-digit wholesale or retail codes.

Under the prior rules for reporting revenues for Item 5, the Census Bureau required that there be a U.S. “establishment” involved in order for there to be NAICS revenue. These revisions to Item 5 eliminate the concept of “establishment” as that term is used by the Census Bureau from HSR reporting for manufactured goods.²⁰

The new rule regarding the inclusion of U.S. sales of foreign-manufactured goods without regard to a U.S. establishment is only applicable to manufacturing, and not to sales of non-manufactured products. For example, if a filing person owns a farm in a foreign country and sells wheat directly to a U.S. customer, or owns a foreign oil well or mine and sells crude oil or iron ore to a U.S. customer from its foreign facility, the seller would still not report any revenues for that sale in Item 5 under the new rules.

While potentially burdensome to filers that manufacture their products abroad and then sell them into the United States, this rule change will not impose a new requirement on the many U.S. companies that use contracts with third-party manufacturers in or outside of the United States. Products sourced from contract manufacturers, such as those in China, will continue to be reported under wholesale or retail codes to the extent they are resold in the United States.

Item 6 and 7: Introduction of “Associates”

Perhaps the most significant change to the HSR rules is the introduction of the concept of “associates.” The current HSR form requires only information about the ultimate parent entities of the parties to the transaction and any entities they “control.”²¹ Under the HSR definition of control, certain filers, such as investment funds, do not have to report information about related or affiliate entities, such as their general or managing partners. For example, often several investment funds are managed by the same general partner for organizational structure and decision purposes, but the general partner is not considered the controlling entity of the funds for HSR purposes because it does not satisfy the HSR definition of control. As a result, if one fund makes an acquisition, its HSR Form will not reveal information regarding the operations of the other funds or the identity of the general partner. Indeed, the Agencies often have received notifications from funds, particularly funds newly formed within a larger family of funds, that were largely blank and therefore did not provide sufficient information to assess the competitive significance of the transaction.

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²⁰ For example, under the old rules, if a party sold a manufactured product from a European facility directly to a U.S. customer from a sales office located in Europe, the sales would count toward the size-of-transaction test because the sales are “in or into the U.S.” See 16 C.F.R. § 802.51(a)(2). However, because the sales were not made from a U.S. “establishment,” no revenues were required to be reported for Item 5 under the old rules. In contrast, under the new rules, the sales to U.S. customers would be applicable to the § 802.51 exemption limits and reportable in Item 5.

²¹ For non-corporate entities, control is defined as “having the right to 50 percent or more of the profits of the entity, or having the right in the event of dissolution to 50 percent or more of the assets of the entity.” 16 C.F.R. § 801.1 (b)(1)(ii).

The Agencies view this lack of disclosure as a significant shortcoming of the current HSR Form. The information reported on the current Form does not allow the Agencies to assess the potential competitive impact of acquisitions by entities that have minority stakes or are managed by other entities with overlapping interests in the same industry as the target. To address these concerns and gather relevant information, the FTC's revised rules introduce the concept of "associates." The definition of associate is meant to capture entities under common management, as well as those entities controlled or managed by an associate. "Associate" is defined as an entity that:

- (A) has the right, directly, or indirectly, to manage the operations or investment decisions of an acquiring entity (a "managing entity");
- (B) has its operations or investment decisions, directly or indirectly, managed by the acquiring person;
- (C) directly or indirectly, controls, is controlled by, or is under common control with a managing entity; or
- (D) directly or indirectly, manages is managed by or is under common operational or investment management with a managing entity.²²

With respect to associates, the new rules will require acquiring parties to report the following information:

- Associates' significant minority holdings (i.e., more than 5 percent but less than 50 percent) of entities that have revenues with NAICS code overlaps with the acquired business. (Item 6(c)(ii))
- The names of those entities that associates control and that the acquiring person believes derive revenues in those NAICS codes that overlap with the acquired business, and the geographic areas in which the associates derive those revenues. (Item 7(b)(ii) and 7(d))

The reaction to the concept of associates has focused on the increased burden for some filers. The addition of these reporting requirements for associates will affect only acquiring persons that have associates. Acquired person filers are unaffected. The Statement of Basis and Purpose estimates that perhaps only 20 percent to 25 percent of acquiring person filers are investment funds, Master Limited Partnerships, or other entities that would be potentially affected by the addition of the associate reporting requirements.

The PNO has indicated that for strategic fund acquisitions, it is often the case that the filer's Item 4(c) documents themselves will assess the relationship of an acquisition target to other entities already held in the same industry. Also, investment fund families often organize themselves by industry, making it easier for such filers to assess holdings within the same industry. For investment funds that invest across a wide spectrum of industries, for example, funds that specialize in distressed companies, there may be no associates that have holdings in the same NAICS codes. In such cases, the changes would not impose additional reporting obligations.

For Item 6(c)(ii), the acquiring person may rely on its regularly prepared financials, provided that they are no more than three months old. This should allow funds to rely on information they already collect in the ordinary course of business and not require a complete top-to-bottom organizational review every time an HSR filing is made.²³ The FTC recognizes that because associates

²² 16 C.F.R. § 801.1(d)(2).

²³ This would imply that a party would need to determine the identity and NAICS activity of its associates and their holdings at most four times per year.

are not controlled by the acquiring person, the acquiring person may not have full access to information regarding the operations of their associates. As such, acquiring persons are only required to supply information about associates based on their knowledge and belief.

In connection with the associate concept, the FTC also has expanded Items 7(b)(ii) and 7(d) to require acquiring persons to identify any NAICS code overlaps between the acquired entity and associates of the acquiring person. If NAICS codes are unavailable, the filing person may limit its response to the holdings in entities that have operations in the same industry based on its knowledge and belief.

Conclusion

The elimination of a number of items on the HSR Form will save a considerable amount of effort for some filers. For other filers, the significant additional burden imposed by Items 4(d)(iii), 5, 6, and 7 will increase the amount of effort and expense that they must incur to supply additional data and documentation.

Some of the early reactions to the proposed version of the changes predicted that these changes would have an unduly burdensome impact on filers. As originally proposed, the wording for new Item 4(d) rightly caused alarm by requiring the search of two years' worth of documents, omitting any requirement for officer and director involvement, and calling for ordinary course documents that merely "referenced" the other party. Such changes would have significantly expanded both the number of officers whose files would have needed to be searched and the volume of documents produced. As adopted, Items 4(d)(i) and (ii) largely serve to codify the Agencies' interpretation of Item 4(c) scope, leaving Item 4(d)(iii) as the only significant expansion to the documentary requirements.

The need in revised Item 5 to provide revenue figures for foreign-manufactured products sold in the United States may create substantial work for some filers with significant foreign manufacturing operations. For most other filers, the elimination of the base year will result in significantly less work in calculating the filing party's Item 5 revenues.

For filers affected by the new associate requirements, namely investment funds and Master Limited Partnerships, it will be interesting to see whether the additional disclosures in Items 6 and 7 provide the Agencies with information that helps their review. Given the lack of transparency and public reporting for some private equity entities, these items may help provide information that would otherwise be difficult for the Agencies to obtain. On the other hand, the number of transactions in which competition is adversely affected by an associate holding a minority interest in a competitor may be small. It remains to be seen if the benefit of being able to identify such relationships will outweigh the greater burden on a number of filers.

Going forward, companies that sell a significant amount of foreign manufactured goods in the United States may choose to be proactive and compile annual Item 5 data as soon as it becomes available rather than wait until a deal is on the horizon. Companies with complicated ownership structures, such as investment funds or Master Limited Partnerships, also may be well advised to keep quarterly up-to-date lists of their associates so that they can more readily comply with Items 6 and 7 as reportable acquisitions arise. ●

Antitrust in the 112th Congress

Anant Raut

Eight months have passed since the start of the 112th Congress,¹ enough time for an informed observer to paint in broad strokes how antitrust has fared this term, and sketch out what might lie ahead over the next year and a half.

Looking Back at Antitrust in the 111th Congress

Evaluations are meaningless in a vacuum; as a starting point, we need to take a critical look back at antitrust on Capitol Hill during the 111th Congress. The start of the 111th brought a popular new President into the White House—Barack Obama, whose party, the Democrats, controlled both the House of Representatives and the Senate. During his campaign, candidate Obama promised to “reinvigorate antitrust enforcement”² and promised an Antitrust Division “that actually believes in antitrust law.”³ Yet, on the legislative front, not a single piece of antitrust legislation was passed by both houses of Congress and signed into law from 2008 through 2010, save a relatively non-controversial ten-year extension of the Antitrust Criminal Penalty Enhancement and Reform Act of 2004 (ACPERA), a popular and fruitful cartel whistleblowing act.⁴ The many other antitrust bills introduced during the 111th languished. Support and opposition for antitrust legislation seemed to operate independently of party lines.

A backlash vote against the President’s economic policies during the 2010 midterm elections has now split control of Congress. A wave of spending-conscious freshman Republicans formed the vanguard of the GOP’s takeover of the House. The pundits commenting on the current term would lead one to expect little to be accomplished legislatively over the sixteen remaining months, with both parties predicted to spend the 112th taking positions more ideological than pragmatic to better position themselves for the next set of elections. Consistent with these predictions, the jobless numbers, the economy, the national debt, the wars, and the Middle East have dominated the headlines and the talk-shows in the first quarter of the 112th, while antitrust issues were relegated to a secondary role, if that. The shift has been more pronounced in the House, which witnessed a more dramatic leadership shakeup.

From what we have seen to date in his public comments, the Chairman of the House Judiciary Committee, Representative Lamar Smith (R-Texas), has declared patent reform a key driver of job

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¹ A Congressional term lasts for two years, framed by elections in the House of Representatives, and divided into two annual sessions. The 112th Congress began January 2011, and its Session 1 began on January 5th. See http://www.gpoaccess.gov/help/congress_table.html.

² Statement of Senator Barack Obama for the American Antitrust Institute (Sept. 27, 2007), http://www.antitrustinstitute.org/files/aai-%20Presidential%20campaign%20-%20Obama%209-07_092720071759.pdf.

³ Jeff Mason, *Obama Eyes Media with Promise of Antitrust Push*, REUTERS UK, May 18, 2008, <http://www.reuters.com/article/latestCrisis/idUSN18498319>.

⁴ Pub. L. No. 111-190, 124 Stat. 1275 (2010)(amending Pub. L. No. 108-237, 118 Stat. 665 (2004)).

creation. He has not singled out any antitrust issues among his legislative priorities, aside from some pro forma comments about the concerns raised by a couple of large mergers announced this year. The House Judiciary Committee's Subcommittee on Intellectual Property, Competition, and the Internet⁵ similarly has been more focused on intellectual property protection than antitrust to date.

However, the House Subcommittee's published agenda features a broader range of antitrust topics, which usually provide fertile ground for later hearings and legislation. Given the sympathetic ear that Republicans have already lent to the U.S. Chamber of Commerce and other business groups this session, one might expect the Committee to take a close look at the effects on business posed by (1) the merger clearance process, (2) challenges to consummated mergers, (3) differing procedural standards for the Department of Justice's Antitrust Division and the Federal Trade Commission's Bureau of Competition (the Agencies), and (4) divergence between the U.S. and international competition agencies. But one issue that may unexpectedly draw bipartisan support in the new anti-regulatory climate on the House side is whether to limit the effects of the *Credit Suisse*⁶ and *Trinko*⁷ decisions to the extent that they curtail antitrust enforcement in regulated industries.⁸

On the Senate side, the venerable Senator Herb Kohl (D-Wisconsin) chairs the antitrust subcommittee for a third consecutive Congress. He has already introduced some of his stalwart bills from previous Congresses, including legislation to remove the antitrust exemption for railroads, create a presumption against the legality of resale price maintenance agreements, expand the DOJ's authority to encompass alleged cartel behavior by OPEC, and prohibit payment arrangements among pharmaceutical manufacturers to delay introduction of generic competitors. The Committee has already passed some of these bills, and they await a vote before the full Senate. Yet, even in the unlikely event that these bills pass the Senate, the chances that a divided Congress would enact them are scant, given that they failed to be enacted when Democrats controlled both Houses for the past two Congresses.

Senator Kohl has also stated his intention to continue investigations commenced in the last Congress into the competitiveness of the broadband, cable and satellite, and cellular service markets, as well as to bring a new investigation regarding Google's alleged use of its market power in the search market to foreclose competition in other markets. However, the fact that Senator Kohl does not intend to run for reelection next year⁹ both weakens him, as it reduces his political clout, and frees him to push for passage of some of his pet bills to solidify his legacy.

With a divided Congress, and Republicans facing pressure from their base to focus on cutting spending, it is doubtful whether major antitrust legislation will be a priority for the House. More likely, we can expect a stalemate for existing law until at least after the 2012 elections.

Overview of the Legislative Process

By way of background, the committee holding jurisdiction over a subject area has primary authority to conduct hearings and advance legislation within that subject area. In both the House and

⁵ This is the subcommittee within the Judiciary Committee with primary jurisdiction over antitrust issues.

⁶ *Credit Suisse Sec. (USA) LLC v. Billing*, 551 U.S. 264 (2007).

⁷ *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004).

⁸ See *infra* notes 24–28 and accompanying text.

⁹ Press Release, Senator Herb Kohl, Senator Kohl Announces He Will Not Seek Another Term in 2012 (May 13, 2011), http://kohl.senate.gov/newsroom/pressrelease.cfm?customel_dataPageID_1464=4454.

With a divided Congress, and Republicans facing pressure from their base to focus on cutting spending, it is doubtful whether major antitrust legislation will be a priority for the House.

Senate, jurisdiction over antitrust falls under its respective Committee on the Judiciary. As a practical matter, each Judiciary Committee interprets its jurisdiction liberally to best accommodate the agenda of its Chair. While any member of Congress can introduce legislation on any topic at any point, the bill can only advance to a vote on the floor of the chamber after being debated and approved by the Judiciary Committee.¹⁰

Committees often allocate parts of their activities to subcommittees. Allocation of a subject matter within a committee's structure will influence the types of hearings held, as well as the number of steps, and consequent opportunities for obstruction, before a bill can pass into law. Subcommittee chairs operate independently from, though rarely in conflict with, the full committee chair and control the nature and order of their subcommittee hearings. Legislation that falls within the subject matter jurisdiction of a subcommittee generally must be debated and passed by the subcommittee before it can be considered by the full committee, which presents an additional hurdle that is not faced by bills when the legislation falls within subject matters at the full committee level.

Within the House Judiciary Committee, responsibility for antitrust has, over the past three Congresses, moved vertically between the Committee and its various subcommittees. Reasons for this may include the Chair's interest, the fundraising potential of issues likely to arise in that subject area during a particular term, and closed-door intraparty negotiations.¹¹ Specifically, jurisdiction over antitrust on the House side had been held at a Committee-wide level during the 110th before it moved into a subcommittee (along with courts and intellectual property issues) in the 111th, where it remains in the 112th. In contrast to the changing structures in the House, antitrust has consistently remained within Senator Kohl's subcommittee on the Senate side.

After Midterms, New Faces in Both Chambers

In the Senate, where the Democrats retained their majority, Senator Leahy (D-Vermont) remains Chair of the Judiciary Committee and Senator Kohl remains Chair of the Antitrust, Competition Policy and Consumer Rights Subcommittee. The Subcommittee changed ranking members, however, with Senator Mike Lee (R-Utah) taking the place of Senator Orrin Hatch (R-Utah). Senator Lee is a first-time lawmaker, having been elected to the Senate last year after upsetting Senator Bob Bennett in the Republican primary. Senator Lee enjoyed grassroots support from the Tea Party movement, as well as financial backing from conservative power broker Senator Jim DeMint (R-South Carolina), and is expected to be sympathetic to the reduced role for the federal government favored by the Tea Party.

¹⁰ "In modern practice, the Speaker may refer an introduced bill to multiple committees for consideration of those provisions of the bill within the jurisdiction of each committee concerned." H.R. Cong. Res. 139, 108th Cong. (2003), at *10, http://www.opencongress.org/wiki/How_a_bill_becomes_a_law/iv_Introduction_and_referral_to_committee. This can result in a situation in which each committee must approve it. However, when a bill falls primarily within the jurisdiction of one committee and tangentially touches others, the other committees typically waive their right of process, or may leverage it politically. For example, in the 111th Congress, House legislation to remove the antitrust exemption for railroad companies fell primarily under the jurisdiction of the Judiciary Committee. However, since the bill also affected transportation law, the committee with primary jurisdiction over the transportation statutes cited, the Transportation & Infrastructure Committee (T&I), had concurrent jurisdiction. Thus, when the Judiciary Committee wanted to move the bill to a vote by the full House of Representatives, the Committee had to work with T&I, which, had it wanted to, could have exercised its jurisdiction and blocked attempts to take it to the floor of the House for a vote.

¹¹ In addition, the political parties internally limit the number of committees their members can belong to in a given Congress. As a result, there is always some calculation by the chairs of committees in deciding which subject matters they want the most direct control over.

The House witnessed a more profound shift, as Republicans regained the majority after a four-year absence. The former ranking member and chairman of the House Judiciary Committee switched positions, with Representative Smith taking the chairman's gavel from Representative John Conyers, Jr. (D-Michigan), who assumed the ranking member position. There was more of a shakeup in the subcommittee with jurisdiction over antitrust, as two veteran lawmakers took the chairman and ranking member positions, Representative Bob Goodlatte (R-Virginia) and Representative Mel Watt (D-North Carolina), respectively, replacing Representatives Hank Johnson (D-Georgia) and Howard Coble (R-North Carolina), respectively.

More tellingly, substantive patent reform legislation has been pushed by Chairman Smith, whereas the antitrust issues explored by Subcommittee Chairman Goodlatte on the House side have been confined largely to merger oversight hearings.

Antitrust Footprint of 2010 Elections Will Be More Visible in the House of Representatives

House Republicans Focus More on Intellectual Property, Less on Antitrust. The House Judiciary Committee has signaled a greater interest in intellectual property than antitrust issues, judging from the initial slate of hearings held by its Subcommittee on Intellectual Property, Competition, and the Internet: Within the first three months of 2011, the House Subcommittee held eight hearings, six of which were patent and intellectual property-related, and one of which was on antitrust. By the six-month mark, the Subcommittee had held four hearings on antitrust, compared to seven on intellectual property. Chairman Smith has stated that patent reform will be part of the GOP's job-creation agenda,¹² and the early focus on IP fits with this agenda. Chairman Smith has said little about antitrust issues this term apart from expressing concerns regarding the AT&T-T-Mobile¹³ and NYSE-Deutsche Boerse¹⁴ mergers. His disappointment with conditions of the DOJ's approval of NBC-Universal had less to do with disagreement over antitrust theory and more about what he views as the Administration's regulatory overreach in imposing its net neutrality standards on the deal.¹⁵ More tellingly, substantive patent reform legislation has been pushed by Chairman Smith, whereas the antitrust issues explored by Subcommittee Chairman Goodlatte on the House side have been confined largely to merger oversight hearings. Still, the number of antitrust hearings may increase before the session ends.

¹² In the five-point agenda he published prior to the start of the 112th, Chairman Smith singled out patent reform as one of his top priorities. "The theft of intellectual property costs Americans billions of dollars and thousands of jobs. . . . The American economy benefits . . . by the jobs these patents create. We need to improve our patent system to better protect intellectual property and help ensure that good patents are approved more quickly." Andrew Ramonas, *Likely Chairman of House Judiciary Panel Outlines Agenda*, MAIN JUSTICE (Nov. 4, 2010, 2:43 PM), <http://www.mainjustice.com/2010/11/04/texan-on-house-judiciary-panel-outlines-agenda/>.

¹³ "The proposed AT&T and T-Mobile merger raises important questions about competition in the telecom industry and the effect on American consumers." Press Release, House Judiciary Comm., HJC to Examine AT&T and T-Mobile Proposed Merger (Mar. 21, 2011), <http://judiciary.house.gov/news/2011/march/03212011.html>. Senator Kohl, who chairs the antitrust subcommittee of the Senate Judiciary Committee, has taken a more vocal and definitive stance on the merger, however. In a letter to Attorney General Eric Holder and FCC Chairman Julius Genachowski, he has asked that the deal be blocked, expressing the view that "we cannot turn a blind eye to the dangerous possibility that this acquisition could ultimately result in a duopoly in the national cell phone market . . . a wholly unacceptable outcome." Letter from Sen. Herb Kohl to Att'y Gen. Eric Holder & FCC Chairman Julius Genachowski 6 (July 20, 2011), <http://kohl.senate.gov/ATT-TM%20LT%20to%20DOJ%20and%20FCC.pdf>.

¹⁴ "As with any merger of this size and significance, the Justice Department and Congress should diligently review the potential effect on competition." Press Release, House Judiciary Comm., Smith Statement on Proposed NYSE-Deutsche Boerse Merger (Feb. 15, 2011), <http://judiciary.house.gov/news/Statement02152011b.html>.

¹⁵ "I am concerned that the Justice Department and the FCC used [the NBC Universal-Comcast merger] to impose the Obama Administration's net neutrality agenda on Comcast and its customers. The merger review process is designed to protect competition and the public interest, not to expand the power of federal regulators over the private economy." Press Release, House Judiciary Comm., Smith Statement re: DOJ Approval of Comcast-NBC Universal Merger (Jan. 18, 2011), http://judiciary.house.gov/news/2011/jan/110118_doj.html.

Senate Sets Sights on Google. A Senate Subcommittee hearing on Google's market practices is tentatively scheduled for September, the culmination of a longstanding interest from its Chairman and its Ranking Member. In the public agenda for his Senate Subcommittee, Senator Kohl announced his intention to examine the alleged use by Google of its market power to foreclose competition in unrelated markets.¹⁶ Sharing his sentiment is Ranking Member Senator Lee, who earlier this year issued a public letter to Chairman Kohl urging the Subcommittee to explore Google's business practices. "The powerful position Google occupies in the general search arena creates myriad opportunities for anticompetitive behavior," stated Lee in his release,¹⁷ specifically questioning whether Google's acquisition of ITA Software creates a "disadvantage [for] competing horizontal and vertical search sites to the detriment of advertisers and internet users" as well as whether "Google's powerful position as an internet gatekeeper reduces the company's incentive to compete with other search engines" in terms of privacy.¹⁸

Google's initial reluctance to have a top executive testify before the Senate prompted a threat of subpoenas from Chairman Kohl. Google blinked, and the company's chairman, Eric Schmidt, has agreed to testify at a hearing expected to take place in September.¹⁹

House Targets Google for Allegedly Facilitating Intellectual Property Theft. Although the House leadership has not been as vocal about Google's alleged anticompetitive behavior as its counterpart in the upper chamber, Google remains a target there as well. The topic of "search neutrality" has generated interest with the European Commission,²⁰ as well as domestically with Texas State Attorney General Greg Abbott²¹ on antitrust grounds. The House Subcommittee's interest in Google's search results, however, is likely to be more focused on Google's profits from alleged copyright infringement, consistent with the House's general focus on intellectual property.

During a March 1, 2011 Subcommittee oversight hearing concerning the U.S. Intellectual Property Enforcement Coordinator, Representative Howard Berman (D-California) wondered why, inasmuch as Google could manually tweak organic search results and the advertising next to it, as its modifications to its search algorithm in February 2011 demonstrate, the company could not or would not take a more active role in policing the prominence of sites facially engaged in intellectual property theft.²² Representative Debbie Wasserman-Schultz (D-Florida) went further, citing an example of Google placing an advertisement for a facially infringing site in a wholly owned Google property (blogspot.com), to make the argument that "[o]nline advertising is making piracy profitable, . . . and makes [it] seem falsely legitimate."²³

¹⁶ Press Release, Senator Herb Kohl, Kohl Announces Antitrust Subcommittee Agenda for the 112th Congress (Mar. 10, 2011), http://kohl.senate.gov/newsroom/pressrelease.cfm?customel_dataPageID_1464=4332.

¹⁷ Press Release, Senator Mike Lee, Lee Calls for Antitrust Oversight Hearings on Google (Mar. 11, 2011), <http://lee.senate.gov/record.cfm?id=331843>.

¹⁸ Letter from Sen. Michael S. Lee, Ranking Member, Senate Judiciary Antitrust Subcommittee, to Sen. Herb Kohl, Chairman, Senate Judiciary Antitrust Subcommittee (Mar. 10, 2011), <http://lee.senate.gov/record.cfm?id=331843>.

¹⁹ Thomas Catan, *Google to Send Schmidt to Hill*, WALL ST. J., July 9, 2011, http://online.wsj.com/article/SB10001424052702303365804576434242590555286.html?mod=googlenews_wsj.

²⁰ Press Release, European Comm'n, Antitrust: Commission Probes Allegations of Antitrust Violations by Google (Nov. 30, 2010), <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1624>.

²¹ Claire Cain Miller, *Texas Probes Google on Ranking of Search Results*, N.Y. TIMES, Sept. 3, 2010, <http://www.nytimes.com/2010/09/04/technology/04google.html>.

²² *Oversight of the Office of the U.S. Intellectual Property Enforcement Coordinator: Hearing Before the Subcomm. on Intellectual Property, Competition, and the Internet of the H. Comm. on the Judiciary*, 112th Cong. 35–36 (Mar. 1, 2011) (comments of Rep. Howard Berman), http://judiciary.house.gov/hearings/printers/112th/112-33_64856.PDF.

²³ *Id.* at 48 (comments of Rep. Debbie Wasserman-Schultz).

The same bipartisan support for strengthening antitrust enforcement in regulated industries may give the Judiciary Committee a hook to advance its agenda of reducing “over-regulation” of certain industries.

Antitrust Exemptions in the New Congress Will Fare No Better, May Fare Worse. In its public agenda, the House Subcommittee has signaled its intention to critically review existing antitrust exemptions. Indeed, the 2010 elections may have the unforeseen consequence of spurring limits on the effects of the *Credit Suisse* and *Trinko* decisions to preempt antitrust enforcement in regulated industries. A number of Republican lawmakers campaigned in 2010 against “excessive” government regulation, arguing that overregulation has choked innovation and stifled industry, inhibiting job creation in turn.²⁴ The issue of competition in regulated industries, and the impact of *Trinko* and *Credit Suisse*, has already been broached in a House Subcommittee oversight hearing regarding net neutrality. During the hearing, Republican members were critical of vesting the Federal Communications Commission with regulatory authority over network neutrality.²⁵ Subcommittee Chairman Goodlatte warned of the diminished role of antitrust in regulated industries post-*Trinko*, stating that “the vitality of our antitrust laws would be stronger and more effective if we do not have additional FCC regulation of the Internet.”²⁶

The issue has arisen before among Republicans—then-full Committee Chairman Jim Sensenbrenner (R-Wisconsin) introduced legislation in 2004, shortly after the *Credit Suisse* decision, that would have minimized the restrictions on antitrust enforcement in the telecommunications industry.²⁷ Similarly themed legislation was drafted but not introduced in the 111th. Indeed, bipartisan concern was raised over the impact of *Credit Suisse* and *Trinko* during a House Subcommittee hearing in the second session of the 111th Congress,²⁸ with members from both sides of the aisle expressing concern about what they believed was overreliance on regulation and its effect on antitrust enforcement. The same bipartisan support for strengthening antitrust enforcement in regulated industries may give the Judiciary Committee a hook to advance its agenda of reducing “over-regulation” of certain industries.

Familiar Bills from Prior Congresses Have Been Reintroduced, But with Hazier Prospects than Before. In the last two terms of Congress, the House and Senate could be relied upon to roll out comparable versions of major antitrust legislation at the same time. With the change in leadership in the House, however, the Senate has taken a more active role in introducing antitrust legislation than the lower chamber.

Senator Kohl has predictably reintroduced three of his legislative priorities from the past Congresses—a bill to criminalize payment by a drug company to prevent a competitor from introducing a generic into the market,²⁹ a bill to eliminate the antitrust carve-out for the freight rail industry,³⁰ and a bill to make resale price maintenance presumptively illegal.³¹ Versions of these bills in

²⁴ Louis Peck, *Republicans Vow War on Government Red Tape*, FISCAL TIMES, Dec. 30, 2010, <http://www.thefiscaltimes.com/Articles/2010/12/30/Republicans-Vow-War-on-Government-Red-Tape.aspx>.

²⁵ As a political matter, one should also realize that members of the House Judiciary Committee and the Subcommittee have a vested interest in keeping network neutrality an antitrust issue, as the FCC and its regulations falls outside of the Judiciary Committee’s jurisdiction and under that of the Energy & Commerce Committee.

²⁶ *Ensuring Competition on the Internet: Net Neutrality and Antitrust: Hearing Before the Subcomm. on Intellectual Property, Competition, and the Internet of the H. Comm. on the Judiciary*, 112th Cong. 74 (Feb. 15, 2011) (comments of Rep. Bob Goodlatte), available at http://judiciary.house.gov/hearings/printers/112th/112-13_64583.PDF.

²⁷ Clarification of Antitrust Remedies in Telecommunications Act of 2004, H.R. 4412, 108th Cong. (2d Sess. 2004).

²⁸ *Is There Life After Trinko and Credit Suisse? The Role of Antitrust in Regulated Industries: Hearing Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary*, 111th Cong. (June 15, 2010), available at http://judiciary.house.gov/hearings/printers/111th/111-119_56952.PDF.

²⁹ Preserve Access to Affordable Generics Act, S. 27, 112th Congress (1st Sess. 2011).

³⁰ Railroad Antitrust Enforcement Act of 2011, S. 49, 112th Congress (1st Sess. 2011).

³¹ Discount Pricing Consumer Protection Act, S. 75, 112th Congress (1st Sess. 2011).

previous Congresses, in some instances, were passed out of the Senate Judiciary Committee, but none was ever voted on by the entire Senate. Last term, parallel bipartisan legislation for all three issues was introduced in the House, with differences in allocation of the burden of proof—the House version of the generics bill³² and the resale price maintenance bill³³ imposed per se prohibitions, whereas the Kohl versions would have employed a rule of reason approach but shifted the burden of proof onto the defendant to satisfy the anticompetitive concerns alleged. Historically, Republicans have favored a rule of reason approach to most antitrust prohibitions, and the House approach of past terms would likely generate even less support in the new Republican House majority. Regardless, legislation comparable to the Kohl bills discussed above has not been introduced this term in the House, which, as stated earlier, may reflect a shifting priority of the House towards intellectual property with its linkage to job creation (patent reform legislation having already been passed separately in both chambers).

The railroad antitrust bill has already been passed by the Senate Judiciary Committee and reported to the floor, which means that this bill can be called for a vote by the full Senate. However, there is no guarantee as to when, if ever, such a vote might take place; bills frequently pass through committee in both chambers without ever being voted upon by the entire body, for a variety of political reasons. In the case of the Senate, scheduling of floor time for voting on bills is decided by Majority Leader Harry Reid (D-Nevada). Because part of the bill affects transportation statutes that are under Senator Jay Rockefeller's (D-West Virginia) purview as Chairman of the Senate Committee on Commerce, Science, and Transportation, scheduling the bill for a vote may involve some proverbial horsetrading between Senators Kohl and Rockefeller to ensure fifty-one votes.

Senator Kohl has also reintroduced legislation that would give DOJ extraterritorial jurisdiction over OPEC for illegal cartel behavior with respect to fixing oil output.³⁴ The "NOPEC" bill has been passed by the Senate Judiciary Committee and reported to the floor. Similar legislation has been introduced by Representative Steve Chabot (R-Ohio) in the House,³⁵ with the House version giving enforcement authority to both the FTC and the DOJ (although neither bill provides for a private right of action). Even if enacted, this legislation would likely have only symbolic effect, as it is unclear how the Agencies could enforce a judgment against OPEC.

Representative Paul Gosar (R-Arizona) and Representative Peter DeFazio (D-Oregon) have introduced separate bills targeted at eliminating the McCarran-Ferguson exemption with respect to health insurance companies.³⁶ In the last Congress, a McCarran repealer (limited in scope to health insurance and medical malpractice insurers) was incorporated into the House-passed version of the health care reform bill³⁷ but this provision was ultimately stripped from the final bill that was passed into law. Negative publicity regarding health insurance companies at the time of the health care bill's debate generated bipartisan support favoring repeal of the exemption. A standalone bill modeled after the provision in the House bill was then introduced and passed

³² Protecting Consumer Access to Generic Drugs Act of 2009, H.R. 1706, 111th Congress (1st Sess. 2009).

³³ Discount Pricing Consumer Protection Act of 2009, H.R. 3190, 112th Congress (1st Sess. 2011).

³⁴ No Oil Producing and Exporting Cartels Act of 2011, S. 394, 112th Congress (1st Sess. 2011).

³⁵ No Oil Producing and Exporting Cartels Act of 2011, H.R. 1346, 112th Congress (1st Sess. 2011).

³⁶ Competitive Health Insurance Reform Act of 2011, H.R. 1150, 112th Congress (1st Sess. 2011) (Gosar Bill) and Health Insurance Industry Fair Competition Act, H.R. 1943, 112th Congress (1st Sess. 2011) (DeFazio Bill).

³⁷ Patient Protection and Affordable Care Act, H.R. 3590, 111th Congress (2d Sess. 2009).

by the House by a vote of 406–19.³⁸ However, the Senate never took up the bill, so it never became law.

The Gosar bill differs from last term's version in that it limits class action suits against insurers. Historically, a legislative priority for Republicans on the Judiciary Committee has been to eliminate "frivolous" lawsuits by, among other measures, capping punitive damages and raising the bar for bringing class action suits. (Republicans deride such suits as benefiting the attorneys who bring them more than the plaintiff class they represent.) The inclusion of a Republican-friendly section may reflect a tactical maneuver to garner bipartisan support for the legislation. The DeFazio bill closes a potential loophole in the definition of "Corporation" in Section 4 of the FTC Act by making clear that the removal of the exemption would apply to not-for-profit insurers as well as for-profit insurers. Once again, however, the Senate has yet to introduce comparable legislation.

Chairman Smith has stated that the Committee has no interest in taking up a bill "that attempts to interject Congress into the private dispute' between the NFL and the NFL Players Association" . . .

Representative Conyers has introduced a bill that would strip the NFL of its antitrust exemption under the Sports Broadcasting Act of 1961.³⁹ Chairman Smith has stated that the Committee has no interest in taking up a bill "that attempts to interject Congress into the private dispute' between the NFL and the NFL Players Association,"⁴⁰ which means that it will likely not go anywhere, as a bill must be voted out by the committee of jurisdiction before it can go to the floor of the House for a vote. In all likelihood, Representative Conyers, long a champion of labor unions, introduced the bill to exert pressure on the NFL and the NFL Players Association to reach a deal while their collective bargaining agreement was still being negotiated. The lack of co-sponsors as of mid-July, with reports of an imminent, new collective bargaining agreement, suggest that most Members of the House are content to allow the League and its players to resolve their labor dispute themselves without interference from Congress.

Representative Conyers has also introduced legislation to create an antitrust exemption to allow physicians to collectively bargain with insurers for reimbursement.⁴¹ Members of the House, both Republicans and Democrats, have attempted at different times over the past ten years to introduce similar bills, which have progressed to varying degrees within the House, but never achieved approval by the Senate.⁴² The most successful iteration by far was the Campbell-Conyers bill of 1999, a bipartisan effort that would have treated negotiations between physicians and insurers as governed by the National Labor Relations Act (NLRA), thus effectively carving those negotiations out of the scope of the antitrust laws. By contrast, the 112th Congress' iteration proposes to create an express exemption from the antitrust laws. Campbell-Conyers passed the House, but was not taken up by the Senate. Subsequent versions of the bill have been introduced nearly every term, none of which have made it out of committee.

³⁸ Health Insurance Industry Fair Competition Act, H.R. 4626, 111th Congress (2d Sess. 2010).

³⁹ Prevent Lockout of Athletes This Year Act of 2011, H.R. 1060, 112th Congress (1st Sess. 2011).

⁴⁰ See *Rep. Plays Ref: Dem Wants "Prevent Lockout" Bill*, CBS NEWS (Mar. 14, 2011, 4:12 PM), <http://www.cbsnews.com/stories/2011/03/14/sportsline/main20043019.shtml>.

⁴¹ Quality Health Care Coalition Act of 2011, H.R. 1409, 112th Congress (1st Sess. 2011).

⁴² See Quality Health-Care Coalition Act of 1999, H.R. 1304, 106th Congress (1st Sess. 1999) (passed House 276–136, with 2 Members voting "Present"); Health Care Antitrust Improvement Acts of 2002, H.R. 3897, 107th Congress (2d Sess. 2002) (not passed out of Committee); Health Care Antitrust Improvements Act of 2003, H.R. 1120, 108th Congress (1st Sess. 2003) (not passed out of Committee); Quality Health Care Coalition Act of 2003, H.R. 1247, 108th Congress (1st Sess. 2003) (not passed out of Committee); Quality Health Care Coalition Act of 2005, H.R. 3074, 109th Congress (1st Sess. 2005) (not passed out of Committee); Quality Health Care Coalition Act of 2007, H.R. 3341, 110th Congress (1st Sess. 2007) (not passed out of Committee); Quality Health Care Coalition Act of 2009, H.R. 1493, 111th Congress (1st Sess. 2009) (not passed out of Subcommittee).

Two nearly identical bills have already been introduced in the House to provide collective bargaining rights under the NLRA for independent pharmacists in their negotiations with health insurers.⁴³ Similar legislation was introduced in the 108th,⁴⁴ 109th,⁴⁵ 110th,⁴⁶ and 111th Congresses;⁴⁷ only the bill in the 110th Congress made it through Committee, and that one was never voted on in the House. The Senate introduced comparable legislation only in the 110th Congress,⁴⁸ and that never passed through Committee.

Other Topics of Interest

The House and Senate have publicly stated an interest in exploring a number of other antitrust issues. As a general matter, Committees draw up lists of potential hearing topics in advance of the start of the next Congress. These lists are generally based upon their priorities at the time. Usually, these lists are a grab-bag of topics, more than can be accommodated in a two-year term, and new ones typically get added as circumstances change.

Senate List⁴⁹

- Competitive effects of consolidation in the pharmaceutical benefits management business
- Oversight of FTC's efforts to police alleged anticompetitive practices in the oil and gas markets
- Competitive effects of consolidation in the agriculture sector, including consolidation in the dairy market, competition for genetically modified seeds, and the findings and next steps from the nationwide series of workshops conducted last year jointly by the Department of Agriculture and the Antitrust Division
- Competitive effects of consolidation in the media market, including the degree of diversity in ownership
- Competition in the cable and satellite television market, including emerging forms of video competition via Internet distribution
- Implementation of conditions imposed upon the Comcast-NBCU merger
- Competition in broadband, including net neutrality
- As part of the new health care bill, the proper treatment of accountable care organizations (ACOs) under the antitrust laws and whether additional guidance is needed from the Agencies to assist providers with their implementation
- Competition in the airline industry, including the competitive effects of the proposed Southwest-AirTran merger, as well as the effects of the Department of Transportation's jurisdiction over awarding antitrust immunity to airlines entering code-sharing arrangements
- Continuation of the Subcommittee's investigation into the competitive effects of hospital group purchasing organizations (GPOs)
- Oversight of the Agencies

⁴³ Preserving Our Hometown Independent Pharmacies Act of 2011, H.R. 1946, 112th Congress (1st Sess. 2011); Community Pharmacy Fairness Act of 2011, H.R. 1839, 112th Congress (1st Sess. 2011).

⁴⁴ Community Pharmacy Preservation Act of 2004, H.R. 5278, 108th Congress (2d Sess. 2004).

⁴⁵ Community Pharmacy Fairness Act of 2005, H.R. 1671, 109th Congress (1st Sess. 2005).

⁴⁶ Community Pharmacy Fairness Act of 2007, H.R. 971, 110th Congress (1st Sess. 2007).

⁴⁷ Community Pharmacy Fairness Act of 2009, H.R. 1204, 111th Congress (1st Sess. 2009).

⁴⁸ Community Pharmacy Fairness Act of 2007, S. 2161, 110th Congress (1st Sess. 2007).

⁴⁹ Press Release, Senator Herb Kohl, Kohl Announces Antitrust Subcommittee Agenda for the 112th Congress (Mar. 10, 2011), http://kohl.senate.gov/newsroom/pressrelease.cfm?customel_dataPageID_1464=4332.

- Effects on American businesses of having to comply with different antitrust laws internationally

House List⁵⁰

- Methods of making the inter-Agency merger clearance process more efficient
- Examining recent trends in consummated merger challenges, and whether the antitrust laws need to be amended to ensure that the Agencies have sufficient flexibility to investigate potential anticompetitive behavior while providing a measure of certainty to the business community
- Whether the procedural divergence between the Agencies, in particular, whether the FTC's ability to bring a case before its own administrative law judge while pursuing an injunction in federal court, results in different substantive standards for antitrust review
- Whether the Agencies are doing enough to harmonize U.S. antitrust law with competition law in foreign countries
- Whether antitrust exemptions continue to serve the public interest

Conclusion

So far, we have yet to see major antitrust legislation coming out of the Republican House. As the legislative calendar creeps toward increasingly safer votes as it nears another Presidential election, there is little expectation of any antitrust legislation for the remainder of the 112th. The Senate under Chairman Kohl's final hurrah may pass some of its antitrust legislation, but only a *Credit Suisse/Trinko* curtailer, and possibly a generics bill, have a chance of drawing sufficient Republican support on the House side to be taken up.

In lieu of legislation, however, one should expect traditionally robust oversight hearings over large mergers in both the House and the Senate. The business-friendly House may explore perceived inefficiencies in antitrust oversight, including the merger clearance process, differing procedural standards between the Agencies, and divergence between domestic and international competition agencies. And most Congresses find a way to work in an oversight hearing over the Agencies, likely to result in a spirited bipartisanship alternately chiding the Agencies for not doing enough or for overreaching when they do. ●

⁵⁰ At the beginning of this session, an agenda for the 112th Congress was circulated by the House Judiciary Committee to outside parties, including the author, but it was never published on the committee website.

Volume of Commerce and Criminal Sentences for Antitrust Violations—Alternative Interpretations in the Air Cargo Fuel Surcharge Cases

Melissa H. Maxman and Elizabeth L. Holdefer

“Volume of commerce” is a critical determinant of criminal sentencing for defendants convicted of violating the U.S. antitrust laws. Under Section 2R1.1 of the U.S. Sentencing Guidelines (Guidelines), an individual’s base fine and period of imprisonment are set by the volume of commerce “affected by the violation.”¹ The Guidelines’ commentary, however, offers no clear explanation of this phrase. Because of its tremendous impact on sentences, prosecution and defense attorneys frequently argue vigorously about how to measure the volume of commerce in any given case.

Defense counsel have argued that the only fair reading of the plain language of the Guidelines mandates that a defendant be sentenced based on the volume of commerce “affected” by his or her unlawful actions. In other words, they argue that a defendant’s sentence should be based on only the amount of commerce for which the illegal activity raised prices to consumers.

The Department of Justice Antitrust Division, however, has taken the position that the appropriate measure of volume of commerce is a “total-price” definition of the volume of commerce, such that all components of the commerce are calculated to be the base level of commerce on which subsequent calculations are made. This can often result in a much higher base calculation, and correspondingly higher sentences and fines in plea agreements, than would be set if the Antitrust Division agreed to measure the volume of commerce using the subset of the total price “affected” by the illegal activity.

Moreover, the Antitrust Division has refused to bargain plea agreements with defendants that challenge the government’s method for calculating the volume of commerce. Because the alternatives to a plea agreement risk consequences even less desirable than the high fines and potential incarceration levied pursuant to an agreement, defendants have little incentive to challenge the Antitrust Division’s formulation.

Defendants’ unwillingness to litigate the issue means that courts only infrequently have had the opportunity to weigh in on the various concerns that arise as parties seek the most advantageous conception of the volume of commerce. As a result, there is almost no case law on this topic, leaving a gray area in criminal antitrust sentencing.

The “air cargo fuel surcharge” cases are a good example of the practical implications of this legal dispute. The positions taken by the government and the corporate and individual defendants illustrate how the strategies employed and the risk factors involved predetermine outcomes. While there are no easy answers to the problems presented by the dilemma, we attempt to set forth the competing perspectives for solutions.

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¹ U.S. SENTENCING GUIDELINES MANUAL § 2R1.1(b)(2) (2010).

The Guidelines' Standard for Measuring Volume of Commerce

Section 2R1.1 of the Guidelines instructs that “in lieu of the pecuniary loss” under the Guidelines’ Base Fine provision, an organization’s base fine should be calculated as “20 percent of the volume of affected commerce.”² The commentary to Rule 1.1 explains the rationale for this approximation:

It is estimated that the average gain from price-fixing is 10 percent of the selling price. The loss from price-fixing exceeds the gain because, among other things, injury is inflicted upon consumers who are unable or for other reasons do not buy the product at the higher prices. Because the loss from price-fixing exceeds the gain . . . 20 percent of the volume of affected commerce is to be used in lieu of pecuniary loss The purpose for specifying a percent of the volume of commerce is to avoid the time and expense that would be required for the court to determine the actual gain or loss.³

[T]he total price of a good may be made up of the sum of several components, some of which may not be impacted by a defendant's anti-competitive conduct.

Beyond this general description, however, the Guidelines give no further guidance as to how parties should measure the amount of commerce actually affected by a defendant’s illegal conduct.

Total-Price Versus Component-Only Volume of Commerce. In certain price-fixing situations, the total price of a good may be made up of the sum of several components, some of which may not be impacted by a defendant’s anticompetitive conduct. For example, the price of a good may include a seller’s manufacturing and transportation costs. If the seller colludes with competitors to fix the price of the transportation component but continues to compete on the basis of manufacturing, then defendants may argue that the volume of commerce should encompass only the price-fixed transportation component. Defendants would argue that the Guidelines’ 20 percent estimate of pecuniary loss should be based solely on the volume of commerce that reflects the consumer’s actual injury for the increased price of transportation and not the manufacturing component over which defendants continued to compete to offer the lowest price.

Competing Interpretations of the Volume of Commerce in the Air Cargo Fuel Surcharge Cases

The air cargo fuel surcharge cases provide an illustration of how different methods of calculating volume of commerce can lead to vastly different sentences under the Guidelines. In 2006, the Antitrust Division began a series of criminal investigations into multiple airlines’ suspected conspiracy to fix the price of fuel surcharges for international passenger and air cargo transportation.⁴ The government brokered its first plea agreements in August 2007, when British Airways and Korean Air Lines each agreed to plead guilty to violations of Section 1 of the Sherman Act and to pay criminal fines of \$300 million.

The factual background of the dispute is noteworthy. In early 2000, airlines began responding to the rising cost of fuel by adding, among others, a surcharge to the base rate for cargo shipments. Generally, airlines determined fuel surcharges using an index of spot prices and charged consumers by the kilogram weight of goods shipped, regardless of the distance the goods were

² *Id.* § 2R1.1(d)(1).

³ *Id.* § 2R1.1, cmt. 3.

⁴ Press Release, U.S. Dep’t of Justice, British Airways PLC and Korean Air Lines Co. Ltd. Agree to Plead Guilty and Pay Criminal Fines Totaling \$600 Million for Fixing Prices on Passenger and Cargo Flights (Aug. 1, 2007), available at http://www.justice.gov/atr/public/press_releases/2007/224928.htm.

carried.⁵ Thus, the surcharge bore no proportional relationship to the amount of fuel consumed during shipping.⁶ Under this system, the fuel surcharge for shipping 1000 kilograms of cargo from New York to London would be the same as shipping 1000 kilograms of cargo from New York to Hong Kong. However, other components of the price for shipping air cargo (e.g., labor costs) were not subject to price fixing and the Antitrust Division did not allege that the base rate was affected by the airlines' illegal conduct.

The Antitrust Division's Position. Korean Air Lines' August 2007 plea agreement is typical of the subsequent plea agreements between the government and defendant airlines. The Antitrust Division required a total-price definition of the volume of commerce so that all of the commerce was used to calculate the airline's fine. As a result, the agreement stated that, had the case proceeded to trial, the government would have presented evidence sufficient to prove that Korean Air Lines conspired with competitors between January 1, 2000 and February 14, 2006 to eliminate competition by fixing rates for international passenger transport and air cargo shipments.⁷ To date, the Antitrust Division has charged twenty-two airlines and twenty-one executives, collecting more than \$1.8 billion in fines and sentencing four executives to imprisonment.⁸

The Antitrust Division has applied a total-price definition of the volume of commerce in all air cargo fuel surcharge plea agreements. For example, the Korean Air Lines plea agreement employed this definition to calculate a \$763.6 million volume of commerce for the airline's sales of air cargo services. This figure was based on the total price to ship air cargo, which "consisted of a base rate and, at times during the relevant period, various surcharges and fees, such as a fuel surcharge and a security surcharge."⁹

Defendants' Arguments. A defendant undoubtedly benefits from a definition of the volume of commerce that lowers the base calculation to include only the components affected by the price fixing to which it pled guilty. Thus, defendants would call for an approach that ties fines directly to the consumer harm caused by anticompetitive conduct.

Defendants would argue that the Antitrust Division's invariable application of a total-price volume of commerce punishes defendants for conduct that is not illegal. Criminal sentencing based on the total-price volume of commerce therefore creates a peculiar inequity of treatment among defendants with different levels of culpability. If a calculation based on total price is appropriate for defendants that conspire to fix only the price of fuel surcharges, then how should the volume of commerce be calculated in a situation where defendants fix all components of the total price? The latter, arguably more culpable group, receives the same base calculation as those who have less culpability, contrary to the Guidelines' stated objective to deter crime through effective and fair sentencing.¹⁰

The Antitrust Division has applied a total-price definition of the volume of commerce in all air cargo fuel surcharge plea agreements.

⁵ See Dustin Appel, *Comment: Air Cargo Fuel Surcharges and Tacit Collusion Under the Sherman Act: What Good Is Catching a Few Bad Guys If Consumers Still Get Robbed?*, 73 J. AIR L. & COMM. 375, 392-402 (2008).

⁶ *Id.*

⁷ See Plea Agreement at 3, *United States v. Korean Air Lines Co.*, Criminal No. 07-184 JDB (D.D.C. Aug. 1, 2007), available at <http://www.justice.gov/atr/cases/f225500/225524.htm>.

⁸ Press Release, U.S. Dep't of Justice, *EVA Airways Corporation Agrees to Plead Guilty and to Pay \$13.2 Million Fine for Price Fixing on Air Cargo Shipments* (May 27, 2011), available at http://www.justice.gov/atr/public/press_releases/2011/271857.pdf.

⁹ See Plea Agreement at 3, *United States v. Korean Air Lines Co.*, Criminal No. 07-184 JDB (D.D.C. Aug. 1, 2007), available at <http://www.justice.gov/atr/cases/f225500/225524.htm>.

¹⁰ U.S. SENTENCING GUIDELINES MANUAL § 1(A)(3) (2010).

Moreover, Title 18 of the United States Code, pertaining to criminal sentencing, instructs courts to impose sentences that are “sufficient, but not greater than necessary to punish defendants and deter future crime.”¹¹ Thus, defendants would claim that the Antitrust Division’s definition fails to satisfy Congress’s aim that the Guidelines achieve “proportionality in sentencing through a system that imposes appropriately different sentences for criminal conduct of differing severity.”¹²

Policy Considerations Weighing in Favor of Defendants’ Arguments

The Antitrust Division has made the argument that calculation of component-only volume of commerce will be complex, inefficient, and expensive. Cumbersome sentencing calculations and proceedings are frowned upon by the U.S. Sentencing Commission, which has noted the tension between fairness and efficiency in sentencing. The Commission continues to seek “a practical way to reconcile the need for a fair adjudicatory procedure with the need for a speedy sentencing process given the potential existence of hosts of adjudicated ‘real harm’ facts in many typical cases.”¹³

However, the argument that component-only calculation of the volume of commerce would thwart the Guidelines’ efficiency objectives has not been tested. The very feature that enabled the fuel surcharge price-fixing conspirators to monitor competitors—the imposition of a flat surcharge and the use of a predetermined spot index to set prices—might make overcharges from this type of illegal conduct easier for the Antitrust Division to calculate. Given that airlines publicly list their surcharges as a flat rate, defendants may reason that the Antitrust Division likely would not need to engage in complex economic analysis to determine the value of the anticompetitively affected component. Thus, at least in the air cargo fuel surcharge cases, there is an argument that assessing a component-only volume of commerce would not be onerous, complicated, or otherwise unreasonably time consuming and expensive.

Both the ABA Section of Antitrust Law and the Antitrust Modernization Commission have questioned whether determining gain or loss is as difficult as the Antitrust Division has asserted.¹⁴ If determining consumer injury is less complex than supposed, a different method for calculating pecuniary loss may provide a better approximation, while maintaining the efficiency achieved under the present rules. Any argument in favor of using the total-price definition of volume of com-

¹¹ 18 U.S.C. § 3553(a) (2010):

Factors to Be Considered in Imposing a Sentence. The court shall impose a sentence sufficient, but not greater than necessary, to comply with the purposes set forth in paragraph (2) of this subsection. The court, in determining the particular sentence to be imposed, shall consider -

- (1) the nature and circumstances of the offense and the history and characteristics of the defendant;
- (2) the need for the sentence imposed -

(A) to reflect the seriousness of the offense, to promote respect for the law, and to provide just punishment for the offense; (B) to afford adequate deterrence to criminal conduct; (C) to protect the public from further crimes of the defendant; and (D) to provide the defendant with needed educational or vocational training, medical care, or other correctional treatment in the most effective manner.

¹² U.S. SENTENCING GUIDELINES MANUAL § 1(A)(3) (2010).

¹³ *Id.*

¹⁴ See ABA Section of Antitrust Law, *Comments of the ABA Section of Antitrust Law in Response to the Antitrust Modernization Commission’s Request for Public Comment on Criminal Remedies—The Alternative Fine Statute—18 USC § 3571(d)* at 14–17 (June 30, 2006) (“[T]he Section questions whether the U.S. Sentencing Commission’s stated reason for adopting this special methodology for calculating organizational antitrust fines—to avoid the time and expense required to determine actual gain or loss in individual cases—remains viable today, if it ever was.”), available at http://govinfo.library.unt.edu/amc/public_studies_fr28902/criminal_pdf/060630-ABA_Criminal_Remedies.pdf; ANTITRUST MODERNIZATION COMM’N, REPORT AND RECOMMENDATIONS 301 (2007) (Recommendation 52) (“The degree of difficulty of proving gain or loss, and the burdens it would impose on the sentencing process, are worthy of renewed consideration by the Sentencing Commission.”), available at http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

merce should be weighed against the cost of making rough approximations that are potentially inequitable.

Empirical Considerations Weighing in Favor of Defendants' Arguments

Aside from its significant effect on the establishment of criminal fines, the volume of commerce also heavily impacts an individual defendant's term of imprisonment. Price-fixing violations carry a base offense level of twelve under the Guidelines, which carries a sentence of 10 to 16 months. If, for example, the volume of affected commerce is more than \$1 million and up to \$10 million, the offense level is raised by two,¹⁵ which yields a term of imprisonment between 15 to 21 months.¹⁶

The impact of the volume of commerce in the plea agreements with airline executives in the air cargo fuel surcharge cases has been significant. A May 2008 plea agreement between the government and a former executive at Quantas Airways applied a volume of commerce of more than \$250 million but less than \$500 million.¹⁷ Without other adjustments, the volume of commerce raised the executive's sentencing level to twenty-two, which entails 41 to 51 months of imprisonment.¹⁸ For a price-fixing violation, the base offense level of twelve places an offender in Zone C of the Sentencing Table, which requires that at least half of the sentence be satisfied by incarceration.¹⁹

Practical Issues Arising from the Antitrust Division's Position

Defendants indicted for price fixing confront three options, each with significant disadvantages: (1) negotiate a plea agreement, (2) go to trial, or (3) plead to the indictment. Given the drawbacks of the alternatives, it is unsurprising that defendants in the fuel surcharge cases have consistently chosen to enter into plea agreements.

The Plea Negotiation Process—Sentencing Considerations. Typically, the government and a defendant will engage in sentence bargaining when negotiating a plea, which involves an agreement as to the sentence the parties will recommend to the court.²⁰ The parties may agree to a plea pursuant to Federal Rule of Criminal Procedure 11(c)(1)(B), where each party submits a sentencing recommendation to the court, or the government agrees to recommend a particular sentence or to endorse the defendant's requested sentence. A court presented with a Rule 11(c)(1)(B) plea has the discretion either to accept or amend the proposed plea agreement. By contrast, Rule 11(c)(1)(C) explicitly provides that the parties' agreement to a specific sentence, sentencing range, or guideline factor is binding on the court upon acceptance of the plea, so that the judge

¹⁵ U.S. SENTENCING GUIDELINES MANUAL § 2R1.1(b)(2) (2010).

¹⁶ *Id.* § 5A.

¹⁷ Plea Agreement, United States v. McCaffrey, Criminal No. 08-CR-135 JDB (D.D.C. May 15, 2008), available at <http://www.justice.gov/atr/cases/f233200/233234.htm>.

¹⁸ Over the last decade, median prison terms for individual antitrust offenders has fluctuated but has not exceeded one year, despite substantial increases in both statutory and guideline penalties for antitrust violations during this time period. By contrast, median fines imposed on organizational antitrust offenders dramatically increased in FY 2008. See Beryl A. Howell, *Sentencing of Antitrust Offenders: What Does the Data Show?* at 11 (Nov. 2009), available at http://www.uscourts.gov/About_the_Commission/About_the_Commissioners/Selected_Articles/Howell_Review_of_Antitrust_Sentencing_Data.pdf. It is not clear whether these trends are reflective of the volume of commerce dispute or other factors.

¹⁹ See U.S. SENTENCING GUIDELINES MANUAL § 5C1.1(d)(2) (2010).

²⁰ See Barry Boss, *Negotiating Federal Plea Agreements Post-Booker: Same as It Ever Was?*, ABA CRIMINAL JUSTICE MAGAZINE, Summer 2006, at 23–24, available at http://www.americanbar.org/content/dam/aba/publishing/criminal_justice_section_newsletter/crimjust_cjmag_21_2_negotiatingfederalplea.authcheckdam.pdf.

may not amend the agreement.²¹ Thus, this type of agreement eliminates disinterested modification of the plea by an Article III judge. To date, we have been unable to locate any air cargo fuel surcharge cases in which the Antitrust Division has offered defendants a plea other than that under Rule 11(c)(1)(C).²²

The Antitrust Division has taken steps to limit defendants' leverage in negotiations by refusing to enter into plea agreements with those that challenge the government's definition of the volume of commerce. Antitrust Division Deputy Assistant Attorney General Scott Hammond has articulated this policy, stating, "If a defendant wants to contest gain or loss, it will have to wait until the end of the investigation for its day in court. The Division will not engage in plea agreements with a company that desires to litigate gain or loss."²³ Thus, defendants that desire the relative certainty in sentencing provided by a plea agreement are concomitantly unable to challenge an important determinant of their final offense level. In this way, the Antitrust Division has been able to extend its influence over the terms of plea agreements in the air cargo fuel surcharge cases.

The Plea Negotiation Process—Other Considerations for Defendants. The Antitrust Division has numerous additional tools available to it—both legal and strategic—to persuade defendants to plead guilty rather than proceed to trial. For example, the Antitrust Division is unlikely to agree not to prosecute the executives of a company that chooses trial over a plea agreement, inducing the defendant company to plead guilty to a high volume of commerce in order to stave off the possibility of incarceration for individuals.

Also adding to defendants' unwillingness to challenge the Antitrust Division is the risk that they may have to litigate additional unresolved legal questions about the interpretation of the volume of commerce. For example, although all of the plea agreements in the air cargo fuel surcharge cases have based the volume of commerce on outbound sales from the United States, the agreements acknowledge that the question of whether inbound sales should also be included is an open issue. The plea agreement of Korean Air Lines states:

The volume of affected commerce calculation . . . does not include commerce related to the defendant's cargo shipments on routes into the United States. The defendant takes the position that any agreements reached with competitors with respect to cargo shipments on routes into the United States should not be included in the defendant's volume of affected commerce calculation pursuant to U.S.S.G. § 2R1.1(d)(1). The United States disputes the defendant's position and contends that the defendant's cargo shipments on routes into the United States during the charged conspiracy period for Count One violated the U.S. antitrust laws. Moreover, the United States asserts that a Guidelines fine calculation that fails to account for cargo shipments into the United States affected by the conspiracy charged in Count One would understate the seriousness of, and the harm caused to U.S. victims by, the offense and would not provide just punishment.²⁴

²¹ *Id.*

²² See, e.g., Plea Agreement at 1, *United States v. Singapore Airlines Cargo PTE Ltd.*, Criminal No. 10-CR-00322 JDB (D.D.C. Feb. 8, 2011), available at <http://www.justice.gov/atr/cases/f267500/267545.htm>; Plea Agreement at 1, *United States v. Asiana Airlines, Inc.*, Criminal No. 09-CR-00099 JDB (D.D.C. May 5, 2009), available at <http://www.justice.gov/atr/cases/f245600/245615.htm>; Plea Agreement at 1, *United States v. Packer*, Criminal No. 08-cr 304-01 (D.D.C. Nov. 10, 2008), available at <http://www.justice.gov/atr/cases/f241400/241463.htm>.

²³ Scott D. Hammond, Risks Remain High for Non-Cooperating Defendants, Address Before the ABA Section of Antitrust Law Spring Meeting (Mar. 30, 2005), available at <http://www.justice.gov/atr/public/speeches/208354.htm>.

²⁴ Plea Agreement at 10, *United States v. Korean Air Lines Co.*, Criminal No. 07-184 JDB (D.D.C. Aug. 1, 2007), available at <http://www.justice.gov/atr/cases/f225500/225524.htm>.

Another unresolved legal issue involves determining whether sales that fall below price-fixing competitors' target price during the period of an alleged conspiracy should be included in the volume of commerce. To date, the Second,²⁵ Sixth,²⁶ and Seventh²⁷ Circuits have weighed in and offered differing opinions as to how to answer the question. Thus, a defendant that chooses to assert a component-only interpretation of volume of commerce at trial must recognize that the Antitrust Division may litigate every disputed aspect of the phrase. And, even if a defendant wins the component-only argument, a loss on other aspects of the definition might overwhelm the benefits of a victory on that one issue.

Defendants may also be discouraged from challenging the volume of commerce because the government's burden of proof for sentencing issues, such as establishment of the measure of pecuniary loss, is the "preponderance of the evidence" rather than "reasonable doubt" standard. The fact that the Antitrust Division's burden is the less vigorous of the two standards is an additional hurdle to successfully countering the government's asserted volume of commerce.

Finally, the Antitrust Division has a persuasive basis in the Guidelines for its contention that an exact measure of the volume of commerce is unnecessary. The Guidelines' commentary to Rule 1.1 states, "The offense levels are not based directly on the damages caused or profit made by the defendant because damages are difficult and time consuming to establish. The volume of commerce is an acceptable and more readily measurable substitute."²⁸ Thus, the fact that the Guidelines do not insist on a meticulous or robust demonstration of consumer injury²⁹ tends to support the government's position that "punishment for antitrust violations [does] not need to be based on precise calculations of gain or loss."³⁰

Deputy Assistant Attorney General Scott Hammond succinctly explained why defendants are reluctant to opt for court over a plea agreement:

Not only will the company go to the end of the line, but so will its executives, unless they desire to approach the Division on their own and negotiate separately with the Division, which will obviously strengthen the Division's case against the company. Thus, many companies are likely to continue to forgo the litigation of gain or loss because of the many positive consequences resulting from early cooperation, such as fine reductions, non-prosecution coverage for some executives and favorable plea agreements for others, and possible limitations in the scope of the charged offense or attributable commerce.³¹

Defendants that decline litigation have likely recognized not only the inherent costs of a difficult and lengthy trial but also the detriment of setting bad precedent that could foreclose negotiations

[E]ven if a defendant wins the component-only argument, a loss on other aspects of the definition might overwhelm the benefits of a victory on that one issue.

²⁵ United States v. SKW Metals & Alloys, Inc., 195 F.3d 83, 90–91 (2d Cir. 1999) (reversing trial court's judgment that only sales at or above the target price were included in the volume of commerce, but holding that sales completely unaffected by the conspiracy "should be excluded from the volume of commerce calculation").

²⁶ United States v. Hayter Oil Co., 51 F.3d 1265, 1273 (6th Cir. 1995) (volume of affected commerce included all sales "during the period of the conspiracy, without regard to whether individual sales were made at the target price").

²⁷ United States v. Andreas, 216 F.3d 645, 678 (7th Cir. 2000) ("the presumption must be that all sales during the period of the conspiracy have been affected by the illegal agreement").

²⁸ U.S. SENTENCING GUIDELINES MANUAL § 2R1.1(d)(1) cmt. background (2010).

²⁹ *Id.* § 1(A)(3).

³⁰ DOJ Antitrust Division Deputy Assistant Attorney General for Criminal Enforcement Scott D. Hammond, Statement at Antitrust Modernization Commission Criminal Remedies Hearing 7 (Nov. 3, 2005), available at http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Statement_Hammond.pdf.

³¹ Hammond, *supra* note 23.

with the Antitrust Division over the features of a plea agreement where the government is willing to bargain.

Conclusion

While defendants have, predictably, taken the position that the volume of commerce on which a defendant can be sentenced should be only the volume of commerce “affected” by his or her unlawful actions, the Antitrust Division has, as a practical matter, avoided participating in the debate through careful strategic use of the procedural tools available to it. By accepting plea agreements only under Federal Rule of Criminal Procedure 11(c)(1)(C), and refusing to negotiate plea agreements with defendants that challenge its definition of volume of commerce, the Antitrust Division has presented defendants with a Hobson’s choice. A defendant can accept the Antitrust Division’s definition of volume of commerce or go to trial. While the former option is not optimal, it is generally seen as better than the latter.

Given the risks facing a defendant that seeks to contest the government’s definition of volume of commerce, it is unlikely that this issue will be litigated in the near future. In addition, because the current administration is unlikely to reopen the policy dispute, challenges to the Antitrust Division’s interpretation of volume of commerce are doubtful, barring a change of administration or reconsideration of the issue by the Sentencing Commission.●