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# ANTITRUST

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SUMMER 2018

# *from the Section Chair*

## The "Patent Monopoly"

Dear Colleagues,

ANTITRUST LAW, WE ARE told, strives to prevent the willful acquisition of monopoly power.[1] Patent law, we are also told, confers a limited "monopoly."[2] Sounds like an irreconcilable conflict, does it not? Historically, intellectual property protection was viewed as an exception to the antitrust laws.[3] The modern view is a bit different, that the antitrust and IP are complementary ways of promoting innovation.[4] In an economy increasingly driven by innovation and the commercialization of ideas, the relationship between antitrust and intellectual property laws plays a prominent role in competition policy and enforcement. This edition of ANTITRUST explores that dynamic interface.

The role of IP in antitrust matters has two polar extremes. The laissez-faire view, championed by Joseph Schumpeter, is that greater innovation comes from firms with monopoly power in part because they have greater resources to invest.[5] The classic contrary view came from Kenneth Arrow, who argued that smaller firms have more to gain and so are prone to greater and more focused investment.[6] This almost metaphysical debate has no conclusion, but analysis has nevertheless come a long way over the years. As demonstrated by the diminishing role of the "scope of the patent" test, antitrust has learned from deep exploration of these issues, and has developed a more rigorous, empirical approach that allows enforcers to look beyond the bare IP rules and to focus more on actual or likely competitive effects as well as the incentive to innovate.

Traditionally, practices that fell within the terms of a patent grant were immune from antitrust scrutiny and practices that went beyond the patent (e.g., temporally or physically) were subject to challenge. The original formulation of this concept pre-dates antitrust laws and is the product of patent policy—indeed, it was the basis for first sale doctrine in patent law.[7] But the use of the concept in antitrust matters took time.

Initially, in the early 20th century, antitrust and IP law were deemed largely incompatible, and patents were simply assumed to confer government-endorsed monopoly power. In a 1902 decision, the Supreme Court held that product price fixing within a licensing agreement did not violate the Sherman Act, declaring that "the general rule is absolute freedom in the use or sale of rights under the patent laws."[8] And in 1912, the unfortunate decision in *Henry v. A.B. Dick Co.*,[9] held that tying of unpatented articles (mimeograph paper) to a patented product (mimeograph machines) could not be challenged under the Sherman Act. Practically speaking, patents and agreements related to those patents were beyond antitrust's reach.

Then, with the passage of the Clayton Antitrust Act in 1914, Congress for the first time made clear that antitrust had a specific role to play even where IP rights are involved, legislatively overruling *Henry v. Dick* in the process.[10] As courts began to bridge the isolation of patents from antitrust, the scope of the patent took form as a defense to antitrust scrutiny. By the middle of the 20th century, the types of conduct that were considered within the scope and immune from antitrust scrutiny narrowed. For example, the Supreme Court condemned the resale price maintenance of gasoline containing a patented additive in *Ethyl*[11] and the tying of salt to the licensing of a patented salt-injection machine in *International Salt*.[12] As framed by the Court in *United States v. Line Material*,[13] the "precise terms of the grant define the limits of a patentee's monopoly and the area in which the patentee is freed from competition."

Antitrust's increased activity in the field of IP was at times perceived as overly restrictive. Congress passed the Patent Act in 1952, which listed specific patent practices that did not constitute patent misuse.[14] Antitrust intervention receded for a time in response, but by the 1970s had returned to its aggressive stance, highlighted by the DOJ's "nine no-nos" of patent licensing.[15] Following then-DAAG Tad Lipsky's memorable repudiation of the no-nos in 1981,[16] Congress answered again in 1988 by expanding the list of practices immune from patent misuse claims.[17]

Two more recent decisions have provided some needed clarification on important contested issues. First, in 2006, *Illinois Tool Works v. Independent Ink Co.*,[18] jettisoned the concept that a patent necessarily confers monopoly power in the antitrust context. Numerous cases were overruled as a result.

Second, the Court sharply limited the scope of the patent defense in *FTC v. Actavis*.[19] Under the Hatch-Waxman statutory scheme, patent owners and first-in-time generic filers are sometimes incentivized to avoid costly patent litigation using settlements whereby the patentee pays the generic manufacturer to delay entry for some amount of time that is less than the remaining patent duration. In this way, the companies are able to share in the patentee's preserved monopoly profits without expanding the temporal scope of the patent.

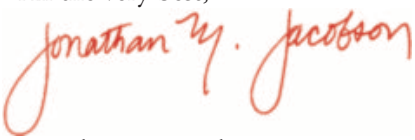
In *Actavis*, the Court addressed a pay-for-delay reverse settlement, explicitly discussing the scope of the patent test. First, the majority acknowledged that while the effects of the reverse settlement agreement would likely have fallen within the scope of the patent *assuming* it was valid and not infringed, that fact does not immunize the settlement agree-

ment from antitrust attack.[20] Next, addressing the assumptions of validity and non-infringement, the majority stated "it would be incongruous to determine antitrust legality by measuring the settlement's anticompetitive effects solely against patent law policy, rather than by measuring them against procompetitive antitrust policies as well."[21] For the dissenting Justices, issues of patent validity and infringement were within the exclusive purview of patent policy, and anticompetitive effects falling within the scope of a patent are beyond antitrust's reach.[22]

The *Actavis* majority held that whether a practice lies beyond the scope of the patent point is a question for a rule of reason analysis. In subjecting the scope of the patent to rule of reason analysis, the court also made clear that reverse payment settlements are not presumptively unlawful. As a result of *Actavis*, both patent and antitrust factors, including issues of patent validity and infringement where appropriate, will be considered in antitrust's rule of reason analysis to determine the scope of a patent.

Antitrust courts are now more experienced and willing to critically analyze conduct through the rule of reason lens, allowing for more sophisticated enforcement of both antitrust and IP laws. There will be many future developments. The articles in this issue provide a great start. ■

All the very best,



Jonathan M. Jacobson
Chair, ABA Section of Antitrust Law
2017–2018

1 United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1966).

2 *E.g.*, Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. 405, 423–24 (1908).

3 *E.g.*, SCM Corp. v. Xerox Corp., 645 F.2d 1195 (2d Cir. 1981).

4 *See, e.g.*, U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property § 1.0 (2017).

5 *See* Joseph Schumpeter, Capitalism, Socialism, and Democracy 81–106 (3d ed. 1942).

6 *See* Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, *in* The Rate and Direction of Economic Activities: Economic and Social Factors 609 (Universities-Nat'l Bur. Comm. for Econ. Research, Comm. on Econ. Growth of the Soc. Sci. Research Council (Princeton Univ. Press 1962).

7 Patentee attempts to enforce patent rights in goods already sold are no longer within the limits of the monopoly. Herbert Hovenkamp, *Antitrust and the Patent System: A Reexamination*, 76 Ohio St. L.J. 467, 476 (2015) (citing *Adams v. Burke*, 84 U.S. (17 Wall.) 453, 460 (1873)); *see also* Herbert Hovenkamp et al., IP and Antitrust: An Analysis of Antitrust Principles Applied to Intellectual Property Law § 1.03 (3d ed. 2017).

8 E. Bement & Sons v. Nat'l Harrow Co., 186 U.S. 70, 91 (1902).

9 224 U.S. 1 (1912).

10 15 U.S.C. § 14 (prohibiting anticompetitive tying or exclusive dealing in goods "whether patented or unpatented").

11 Ethyl Gasoline Corp. v. United States, 309 U.S. 436 (1940). *But see* United States v. Gen. Elec. Co., 272 U.S. 476 (1926) (lawful to condition patent license on agreement to resale price maintenance).

12 Int'l Salt Co. v. United States, 332 U.S. 392 (1947). The Supreme Court earlier recognized the overruling of *Henry v. Dick* in *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 517 (1917).

13 United States v. Line Material Co., 333 U.S. 287, 300 (1948).

14 35 U.S.C. § 271.

15 Bruce B. Wilson, *Patent and Know-How License Agreements: Field of Use, Territorial, Price and Quantity Restrictions*, *in* Antitrust Primer: Patents, Franchising, Treble Damage Suits 11, 11–21 (1970).

16 Abbott B. Lipsky, Jr., *The Nine No-Nos, Address Before the ABA Section of Antitrust Law* (Nov. 5, 1981), *in* 4 Trade Reg. Rep. (CCH) ¶ 13,129.

17 Patent Misuse Reform Act, 35 U.S.C. § 271(d)(4)–(5).

18 547 U.S. 28.

19 FTC v. Actavis, Inc., 133 S. Ct. 2223 (2013).

20 *Id.* at 2230–31.

21 *Id.* at 2231.

22 *Id.* at 2239–40.

# Editor's Note: IP Remedies and Big Data at the Antitrust-IP Interface

BY GREGORY G. WROBEL

THE COVER THEME FOR THIS ISSUE focuses on antitrust law issues arising from enforcement of intellectual property rights. This Note comments briefly on two issues that relate to the cover theme and may command growing attention in the future.

## IP Remedies in Global Markets

U.S. antitrust standards accommodate IP rights largely from the standpoint of U.S. IP law and procedure. This approach seems sensible given that U.S. antitrust laws apply to U.S. commerce and protect U.S. consumers, and because enforcement goals under U.S. antitrust law must be balanced with rights granted to IP owners under the Constitution and U.S. patent/copyright statutes.

Global markets and business models may challenge this domestic market focus, in particular when IP owners seek injunctive relief against alleged infringers. U.S. courts frequently address tensions between U.S. and foreign antitrust laws in private antitrust cases seeking damages, with rulings on the jurisdictional reach of U.S. antitrust laws and on whether (typically private) plaintiffs alleged or proved the requisite anticompetitive effect on U.S. domestic commerce and consumers.[1]

For IP owners with global business models, however, the ability to obtain injunctive relief blocking the sale of allegedly infringing products is an important tactical tool that may impact global markets and supply chains beyond the jurisdiction in which the relief is sought or granted. Injunctive relief is frequently sought in patent and copyright infringement cases filed in U.S. courts, and in proceedings at the International Trade Commission seeking to block allegedly infringing products from being imported to the United States. Alleged infringers often respond with antitrust claims asserting that the IP claims are a sham and that injunctive remedies (threatened or actual) eliminate lawful competition.

These disputes sometimes play out with standard essential patents (SEPs), where the alleged infringer is willing to license the SEPs on fair, reasonable, and non-discriminatory (FRAND) terms, but the parties dispute the appropriate royalty payment. The alleged infringer may challenge the IP owner's royalty demands as an anticompetitive tactic aimed at excluding competition that would be viable if the royalty rate is set at a proper level.

U.S. courts most often face these disputes in claims among private parties focused on the domestic U.S. market; the FTC's pending case against Qualcomm is a current example of agency antitrust enforcement challenging an IP owner's licensing and FRAND royalty conduct.[2] The DOJ/FTC Antitrust Guidelines for the Licensing of Intellectual Property do not offer direct guidance on how courts should resolve disputes over IP remedies that are alleged to threaten or cause competitive harm. Nor do the Guidelines (or court decisions in agency enforcement actions) provide clear guidance to IP owners and users on when injunctive relief should be granted, or whether and how courts in antitrust cases should address FRAND royalty disputes.

On the U.S. domestic front, a public debate of sorts is unfolding through speeches by agency leaders and open letters by antitrust scholars, focused mostly on the U.S. antitrust-IP interface.[3] As with consent decrees and orders in agency enforcement actions, this debate will not yield settled law on which courts can rely, but the debate still warrants careful attention by antitrust practitioners who must shape arguments in actual antitrust cases that present issues about IP remedies and FRAND royalty determinations.

On the international front, antitrust enforcement agencies do not appear to be actively engaged in working toward convergence over standards for injunctive relief to protect IP owners, or on whether and how courts (or enforcement agencies) should step into FRAND royalty disputes. This stance contrasts with merger enforcement, where a great deal of attention has focused on the need for convergence over both substantive standards and procedure, perhaps because antitrust enforcement oversight of merger transactions is almost exclusively the domain of government enforcement agencies.

Review of the case docket in *FTC v. Qualcomm* reveals the factual complexities that arise in antitrust disputes over enforcement of IP rights, which are magnified by global supply chains that drive the parties to other jurisdictions for document discovery and testimony. These complexities will be further magnified where antitrust disputes over IP remedies or FRAND royalties play out in multiple jurisdictions under potentially divergent local standards, where rulings in one jurisdiction may impact the rights and obligations of IP owners and users in other jurisdictions as well.[4]

*Gregory G. Wrobel, Editorial Board Chair of* ANTITRUST, *is a shareholder and head of the Antitrust Practice Group of Vedder Price P.C. All opinion expressed herein are his alone and do not necessarily reflect those of his firm or any of its clients.*

Photo: SuperStock

Sorting out these complexities is beyond the scope of this Note, but we will look for opportunities to discuss these issues in future articles.

## IP Rights and Big Data

The collection and use of data generated through Internet usage (and perhaps the Internet of Things), may be challenging conventional views of the IP rights that matter most at the antitrust-IP interface.

The U.S. case against Microsoft over bundling its web browser and operating system software may serve as a conventional example, where licensing practices for proprietary IP rights were shown to harm competition in markets for products that use the IP (i.e., personal computers, web browsers).

Antitrust enforcement is now focusing on business models that rely on the aggregation and use of Big Data through Internet search activity and social media platforms. Whether these services are viewed as two-sided platforms or more traditionally as outlets for advertisers of products and services to reach consumers, the focus of competitive concern is not the IP owner's licensing practices for its own proprietary software (whether web browser, operating system, or proprietary data analytics algorithms), but rather on the use of Big Data, the accumulation of which is driven by network effects and/or general popularity that draw users to the IP owner's website.

How does this new enforcement focus (and business model) fit within established standards for anticompetitive conduct involving the use and licensing of IP rights? The Microsoft case was grounded on licensing practices with businesses (computer makers), and the IP owner was shown to have unlawfully exercised monopoly power over operating systems software, through IP licensing conduct to exclude rival suppliers of Internet browsers. The competitive concerns in that case had little if anything to do with Microsoft's collection or use of data generated by users of personal computers on which Microsoft operating system and web browser software were installed.

Are competitive concerns with Big Data business models grounded on similar concerns with IP licensing practices? If not, is there a comparable basis to show that the IP owner has monopoly power grounded on its IP rights and has unlawfully exercised monopoly power, even though the Big Data used in the business model may be available (at no direct cost) to would-be rivals who wish to compete with the IP owner?[5]

As with the comments above on IP remedies, analysis of these questions is beyond the scope of this Note, but we will look for opportunities to discuss these issues in future articles. ■

---

[1] *See generally* ABA Section of Antitrust Law, Antitrust Law Developments 1158 et seq. and cases cited therein (8th ed. 2017) [hereinafter Developments] (discussing extraterritorial reach of Sherman Act and Foreign Trade Antitrust Improvements Act of 1992).

[2] *See* FTC v. Qualcomm Inc., No. 17-CV-00220, 2017 U.S. Dist. LEXIS 98632 (N.D. Cal. June 26, 2017) (denying motion to dismiss).

[3] *See, e.g.*, Makan Delrahim, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Competition, Intellectual Property, and Economic Prosperity, Remarks at the U.S. Embassy in Beijing (Feb. 1, 2018), https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-us-embassy-beijing; Makan Delrahim, Assistant Att'y Gen., Antitrust Div., Dep't of Justice, Take It to the Limit: Respecting Innovation Incentives in the Application of Antitrust Law, Remarks as Prepared for Delivery at USC Gould School of Law (Nov. 10, 2017), https://www.justice.gov/opa/speech/file/1010746/download (raising concerns that antitrust enforcement has been too accommodative of IP users, undermining incentives for IP creators); Letter to Makan Delrahim from companies, trade associations, and professors (Jan. 24, 2018), http://www.iam-media.com/files/ImplementerLetterDelrahim.pdf (presenting views that positions stated in Nov. 10, 2018 speech by Delrahim would undermine FRAND obligations and harm competition); Letter to Makan Delrahim from Michael Carrier, Timothy Muris, and other former enforcers and professors (May 17, 2018), https://www.competitionpolicyinternational.com/wp-content/uploads/2018/05/DOJ-patent-holdup-letter.pdf (presenting views on why recent speeches by AAG Delrahim are not consistent with legal and economic consensus about antitrust issues with standard setting); Letter to Michael Carrier and Timothy Muris from Makan Delrahim (May 17, 2018), https://www.competitionpolicyinternational.com/wp-content/uploads/2018/05/2018-05-18-Delrahim-Letter-to-Carrier-and-Muris1.pdf (brief response to Carrier-Muris letter, inviting debate and attaching letter dated May 13, 2018, from professors and others presenting views in support of evidence-based approach to patent holdup and FRAND royalty disputes).

[4] There appears to be little if any judicial guidance on IP remedies that may give rise to competitive harm outside the United States. *See generally* Developments, *supra* note 1, at 1154–55 (discussing equitable remedies in agency antitrust cases challenging IP licensing conduct, none of which involve global market considerations; *id.* at 1246–48 (discussing U.S. antitrust cases in which injunctive relief was imposed affecting conduct outside the U.S., most of which are agency consent decrees dating back 25 years or more); *id.* at 1249 (discussing policy of DOJ and FTC under International Guidelines for International Enforcement and Cooperation to consider impact on significant interests of foreign sovereigns in determining whether to seek particular remedies in a given case, and policy under 1991 EU bilateral agreement to consider comity-related factors for enforcement actions affecting the EU).

[5] *See, e.g.*, Makan Delrahim, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, All Roads Lead to Rome: Enforcing the Consumer Welfare Standard in Digital Media Markets, Remarks as Prepared for Delivery at the Jevons Colloquium in Rome (May 22, 2018), https://www.justice.gov/opa/speech/file/1065096/download (discussing application of consumer welfare standard for analysis of digital platforms and markets, including use of innovation, choice, and quality metrics to analyze competitive effects where price and output effects are difficult to measure; expressing need for careful evidence-based approach to analyzing entry barriers and exclusionary conduct).

INTRODUCTION

# Antitrust and Intellectual Property in a Neo-Populist Age

BY MICHAEL A. LINDSAY

WHATEVER ONE THINKS OF THE Trump administration's antitrust policies, antitrust lawyers can take pride in the fact that antitrust is both "cool" and "sexy" again.[1] But when the rush of pride wears off, antitrust lawyers still must ask what the Trump administration's antitrust policy really is, and what it means for counseling and litigation. This issue of ANTITRUST offers one article that broadly overviews Trump antitrust enforcement policies, along with five articles covering different aspects of antitrust enforcement and case law in the last few years, particularly with reference to the intersection of antitrust and intellectual property.

## Overview of Antitrust Enforcement in the Trump Administration

Is there a philosophy that underlies and unifies antitrust enforcement in the Trump Administration? John Harkrider tries to answer this question. He surveys more than a dozen aspects of antitrust enforcement, ranging from merger enforcement to international cooperation. He rejects the hypothesis that antitrust enforcement under Trump will be substantially more lax or permissive than it has been under Democratic administrations. Indeed, he sees evidence that the Trump's administration will continue the vigorous enforcement of antitrust laws.

Harkrider does identify one notable difference between Obama and Trump antitrust enforcement. In the past, some administrations have been willing to accept remedies that regulate a party's conduct ("behavioral" remedies) instead of changing a party's structure (e.g., through an asset divestiture). Trump's Assistant Attorney General Makan Delrahim has made clear his view that antitrust enforcement should take a less "regulatory" approach and instead be more "enforcement"-oriented (by seeking to change structures, and then letting the market function). In addition to a stated preference for structural remedies instead of behavioral remedies,[2] AAG Delrahim has also launched an initiative to review and potentially eliminate scores of consent judgments dating back as far as the 1920s.[3]

Specifically in the realm of antitrust and intellectual property, Harkrider describes one other area where Trump enforcement may differ not only from Obama enforcement but from competition law enforcement in other jurisdictions as well: standards development. Harkrider suggests that the Trump administration (or at least the Antitrust Division's portion of the administration) seems to be pulling back from policies of the Obama administration (and of agencies in other jurisdictions) toward standards development organizations, although he questions the practical significance of the Antitrust Division's shift, given recent Federal Circuit precedent on the limited ability of standards-essential patent holders to obtain injunctions.

## Standards, Patents, and Antitrust

As consumers, we are all happy that our computers and smartphones can talk with each other and with all manner of websites. And we all have an interest in ensuring that our systems of incentives will encourage the development and commercialization of new technology that can be incorporated into interoperability standards without imposing avoidable costs that are then passed on to consumers.

But what role, exactly, should antitrust law play in regulating the conduct of the various players in standards development organizations (SDOs)? This question is not new, and over the last decade ANTITRUST has dedicated many pages to the debate. Developments in the last year (including the arrival of AAG Makan Delrahim), however, warrant another episode of this continuing debate. Three of the articles in this issue address topics in the standards area.

***Standards-Essential Patents, Hold-Up, and Hold-Out.*** Creating a market for interoperable products requires standards for interoperability. This means that companies (often competitors) or individuals must come together and reach

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agreement on what technology to include in a standard. Sometimes the choice can be from among relatively fungible technologies, and the act of choosing one is more important than the one chosen. At other times one technology might offer a technically more elegant solution, but if that technology is covered by patents, then it may not be the most appropriate technology for the standard (because patents may add to the expected cost of adopting that technology). Then again, it may be exactly the right technology for the standard, because the expected royalty costs are outweighed by superior performance or by cost-savings in other inputs. If a standard incorporates patented technology, then it becomes impossible to implement the standard (or at least that portion of the standard) without infringing the patent. This has become known as a "Standard-Essential Patent" (SEP).

Over the last 70 years, SDOs have taken different views on whether a standard could include patented technology at all. For example, the original patent policy of the American National Standards Institute (now just called ANSI) in 1932 provided that "as a general proposition patented designs or methods should not be incorporated in standards," but it recognized that "each case should be considered on its merits and if a patentee is willing to grant such rights as will avoid monopolistic tendencies, favorable consideration to the inclusion of such patented designs or methods in a standard might be given."[4]

What is a "monopolistic tendency"? Including a patented technology in a standard creates the risk that the patent holder will refuse to license its SEP (and thus "monopolize" by being the sole implementer of the standard) or license it only on terms that unreasonably favor the patent holder (thus extracting "monopoly" rents from other firms). In the contemporary debate, this phenomenon has been referred to as the "hold-up" problem: the concern that a patent holder will extract royalties greater than what it could have obtained had its technology not been incorporated in the standard. More recently, the debate has expanded to include the concept of "hold-out"—the unwillingness of implementers to negotiate or accept licenses from the holders of ostensibly essential patents.

These two phenomena—claims of "hold-up" and "hold-out"—reflect the twin uncertainties that have plagued standards development. The first uncertainty (referenced in the Simmons-Celli-Hendricks-Nogues article in this issue) is the vagueness of a commitment to license an SEP or portfolio of SEPs at "reasonable" rates and on reasonable terms and conditions. In discussing the issue of patent hold-up this spring, then-FTC Commissioner Terrell McSweeny noted that in two recent cases "F/RAND royalty rates offered by SEP-holders were *orders of magnitude* higher than what a neutral arbitrator found to be fair and reasonable."[5] Even assuming that the patent holders in these two cases were acting in good faith, the fact that parties viewing the same evidence can have such disparate valuations confirms that a commitment to license on "reasonable" rates is not a good or accurate predictor of future royalty costs.

The second uncertainty (also referenced in the Simmons, Hendricks, and Nogues article) is the problem of identifying true SEPs—that is, determining which patents or patent claims are in fact valid, infringed by, and essential to an implementation of the standard. It is rare that a standard will expressly state "practice the art claimed in Patent No. XYZ." Rather, the standard specifies a technological path that may or may not be covered by a patent. The patent holder may well claim that the standard cannot be implemented without infringing the patent, but that claim does not always prove true.[6]

In a recent working paper, Professors Lemley and Simcoe reported what they considered a surprising result from their study of SEPs that go into infringement litigation. They had "expected that proving infringement of a SEP would be easy—they are, after all, supposed to be essential—but that the breadth of the patents might make them invalid."[7] In fact, however, they found exactly the opposite: "SEPs are more likely to be held valid than a matched set of litigated non-SEP patents, but they are significantly less likely to be infringed. Standard-essential patents, then, don't seem to be all that essential, at least when they make it to court."[8] Faced with a claim for infringing an ostensibly essential patent, a standard's implementer may well doubt that the claimed SEP is in fact infringed. Likewise, a patent holder acting in good faith could be mistaken in believing that its patent is essential and infringed.

***Madison and Schumpeter.*** David Teece reviews and analyzes several speeches that AAG Delrahim has delivered over the last six months dealing with several antitrust issues, including the intersection of antitrust and standards. Delrahim himself describes his view as Madisonian (as opposed to Jeffersonian), and without denying that characterization, Teece argues that Delrahim's approach is also "Schumpeterian" (after economist Joseph Schumpeter). Teece discusses the distinction between static (that is, short-run) and dynamic (longer-run) competition, along with the importance of fostering innovation in order to enable dynamic competition.

Teece (along with Delrahim) argues below that there is no hold-up problem and that, in any event, the hold-out problem is greater. Of course, one can hardly disagree with the general proposition that incentives matter (to innovators and everyone else) or that a society that under-incentivizes innovation (or anything else) is going to see less of it. But these general principles tell us nothing about whether our current patent system as it actually functions in the real world sets incentives at an appropriate level. Nor does it address the risk that over-rewarding holders of SEPs might reduce other firms' incentives to innovate in non-essential product features.

A group of 77 antitrust scholars and former antitrust enforcers recently took issue with the views that AAG Delrahim has been expressing in his speeches on SEP issues—the same speeches that the Teece article discusses.[9] These

scholars argue that the hold-up problem is real and has been recognized by both courts and SDOs—and by both Republican and Democratic administrations. They also reject Delrahim's ranking of hold-out as the greater problem; they argue that hold-up is a greater problem because the risk is asymmetric—"implementers are vulnerable to paying supracompetitive royalties based on the entire value of the product, not on the value of the patented technology."[10] They also take issue with AAG Delrahim's views on related issues, such as the sufficiency of contract remedies as the exclusive remedy for breaching a FRAND commitment and the availability of injunctions for infringing SEPs (where the views that AAG Delrahim seems to be expressing are, "for good reason, no longer the law"[11]).

***Reasonableness of Reasonable Rates.*** No one questions that the holder of a patent that is valid, infringed, and essential to an implementation of standard is entitled to receive a reasonable royalty (unless the holder has waived that right, of course, by committing to non-assertion or royalty-free licensing). Courts have critiqued SDOs for failing to explain what "reasonable" means in the context of an SEP,[12] and over the last five years, courts have tried to determine what "reasonable" means for specific SEPs.[13]

Patents are creatures of national law, as are the rights that the patents confer, and a royalty in one jurisdiction might not be reasonable in another. (Indeed, an Antitrust Division official recently reiterated that the Division "would have concerns . . . where a [non-US] court imposes a [worldwide] license . . . using theories that aren't supportable under US law," although she added that the circumstances in which this concern might arise are narrow.[14]) Courts in different jurisdictions might reach different results as to the appropriate royalty for a given SEP for any number of reasons, either procedural (such as differences in evidentiary rules) or substantive (different market value in different countries).

Deng, Leonard, and Lopez offer a careful review of how courts in different jurisdictions reached somewhat different results for one company's SEP portfolio for LTE technology. Although the determination of royalty rates is not itself an antitrust issue, a patent system that predictably and efficiently determines such rates is less likely to create room for antitrust concerns about potential use of SEPs to extract supracompetitive royalties.

***International Divergence or Convergence?*** Of course, substantive rules and nonmonetary remedies can vary across jurisdictional lines as well. Simmons, Celli, Hendricks, and Nogues consider one such area of potential divergence—the European Commission's November 2017 communication on SEPs. In some areas, there is convergence without clarity. The EC Communication's set of "signposts" for reasonableness in FRAND rates contains no surprises or substantial differences from U.S. law, but it also does not provide much additional clarity.

Other parts of the statement suggest both convergence and divergence. For example, the EC Communication agreed with AAG Delrahim's emphasis on the importance of enforcement tools as a key aspect of intellectual property, but the Communication also recognizes that a FRAND commitment imposes limits on the SEP holder's enforcement rights.

**If standards development involves the collision of two legal regimes (patent law and antitrust), then the pharmaceutical industry is more of a pile-up of three regimes: patent law, antitrust, and drug regulation.**

Finally, some parts of the EC Communication suggest—through silence—areas of potential divergence from U.S. policy (or at least from the direction in which AAG Delrahim seems to want to take it). For example, the EC Communication says nothing about relying on contract law (instead of competition law) to enforce FRAND commitments—which AAG Delrahim has said should be the primary or even exclusive tool for enforcing FRAND commitments.

## Pharmaceutical Patents and Antitrust

If standards development involves the collision of two legal regimes (patent law and antitrust), then the pharmaceutical industry is more of a pile-up of three regimes: patent law, antitrust, and drug regulation. Years ago Congress tried to solve one set of problems through the Hatch-Waxman Act. But the law of unintended consequences has never been repealed, and two unintended consequences are "reverse settlements" and "product-hopping."

***Post-*Actavis *Decisions on Reverse-Payment Settlements.*** In its 2013 *Actavis* decision, the Supreme Court seemingly resolved a tension between patent law and antitrust. In a patent infringement suit, the prevailing patent holder can seek and sometime obtain an injunction excluding a rival from selling an infringing product. Since the law encourages settlements, it stands to reason that the parties could settle the litigation by compromise—the parties agree to an injunction, but with a shorter term than the maximum that the patent holder might have won. In the weird world of Hatch-Waxman, however, that also means that a second or third rival would be barred from entering the market, so the stipulated injunction creates or preserves a noncompetitive market. The patent holder and its rival have an incentive to preserve and divide the monopoly rents. *Actavis* found that patent settlement agreements could violate the antitrust laws under the rule of reason if there is a "large and unjustified payment" flowing from the patent holder to the infringer.

Fales, Feinstein, and Varshovi review the case law over the five years since *Actavis*, subdividing the *Actavis* phrase into its component part: what is a "payment," when is a payment "large," and when is it "unjustified"? As Fales, Feinstein, and

Varshovi explain, lower courts have split on whether these questions place an initial burden on the plaintiff or are instead part of the rule of reason itself. In other words, must a plaintiff first demonstrate a large and unjustified payment before a court will even consider the rule of reason, or is the "large and unjustified payment" simply incorporated into the rule of reason analysis. They also discuss the role that the doctrine of antitrust injury has played in the analysis—after all, if the patent holder would probably have won its case and secured its injunction, then how has the antitrust plaintiff been injured by something prohibited under the antitrust laws?

***Product Hopping.*** The Hatch-Waxman Act permits a generic drug manufacturer to launch a generic version of an already-approved drug by demonstrating that its generic drug is "bioequivalent" to the approved (branded) drug. But what happens when the branded manufacture withdraws its product from the market and replaces it with a somewhat different version (protected, perhaps, by a more recent patent on the "improvement"), referred to as "product hopping"? Just as reverse-payment settlements present a clash of values (a policy favoring settlement vs. a policy against market allocations), so too does product hopping: we want to encourage innovation (and the replacement of older products with new and improved versions), but what if that has the effect of excluding generic competition?

Pace and Adams discuss the two product-hopping cases that have reached the appellate courts. In one case the Second Circuit affirmed issuance of a preliminary injunction preventing product discontinuation, and in the other case the Third Circuit affirmed summary judgment for a product-discontinuing defendant. Pace and Adams try to reconcile the law underpinning the outcomes in these two cases. They also explore courts' use of the "coercion" concept derived from tying-arrangement cases, and they argue that a better test would be a requirement that a plaintiff show that a claimed improvement was a mere sham.

## Conclusion

Is "populist" really the correct label for the current era, and if so, how do we reconcile that label with a "Madisonian" approach to intellectual property rights, and what role should antitrust play? Whatever political label one chooses for it, our era is still generating debate over antitrust treatment of intellectual property and forcing us to reflect deeply on the values underlying the antitrust and intellectual property regimes. ■

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[1] David Balto & Matthew Lane, *"Hipster Antitrust" Movement Is All Action, No Plan*, The Hill (Mar. 16, 2018, 12:30 PM EDT), http://thehill.com/opinion/judiciary/378788-hipster-antitrust-movement-is-all-action-no-plan ("Antitrust is cool again"); Carl Shapiro, *Antitrust in a Time of Populism* (Oct. 24, 2017), https://faculty.haas.berkeley.edu/shapiro/antitrustpopulism.pdf, Berkeley ("Antitrust is sexy again. Where does this take us?").

[2] Makan Delrahim, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Antitrust and Deregulation (Nov. 16, 2017) (transcript available at https://www.justice.gov/opa/speech/file/1012086/download) ("Antitrust is law enforcement, it's not regulation. At its best, it supports reducing regulation, by encouraging competitive markets that, as a result, require less government intervention.").

[3] Press Release, U.S. Dep't of Justice, Department of Justice Announces Initiative to Terminate "Legacy" Antitrust Judgments (Apr. 25, 2018), https://www.justice.gov/opa/pr/department-justice-announces-initiative-terminate-legacy-antitrust-judgments. One consent judgment proposed for termination dates back to 1913. *See* Judgements Proposed for Termination in Utah, District of, https://www.justice.gov/atr/JudgmentTermination.

[4] The 1932 ANSI patent policy is quoted in relevant part in ANSI Executive Standards Counsel Summary Decision at p. 4 (Feb. 5, 2018), https://share.ansi.org/Shared%20Documents/Standards%20Activities/American%20National%20Standards/Procedures,%20Guides,%20and%20Forms/ANSI%20Executive%20Standards%20Council%20(ExSC)%20Interpretations/ExSC_087_2017_091417_patent%20policy_022318%20amended.pdf.

[5] Terrell McSweeny, Comm'r, Fed. Trade Comm'n, Holding the Line on Patent Holdup: Why Antitrust Enforcement Matters, (Mar. 21, 2018) (transcript available at https://www.ftc.gov/system/files/documents/public_statements/1350033/mcsweeny_-_the_reality_of_patent_hold-up_3-21-18.pdf).

[6] Professor Teece acknowledges this when he refers to patent holders having to resort to "risky patent litigation" to enforce their rights. *See* David J. Teece, *Pivoting Toward Schumpeter: Makan Delrahim and the Recasting of U.S. Antitrust Towards Innovation, Competitiveness, and Growth*, *infra* this issue, Antitrust, Summer 2018, at 32. That litigation is risky (from the patent holder's perspective) precisely because the claim of a valid and infringed SEP may be wrong, and the patent holder's claimed royalty may be excessive.

[7] Mark A. Lemley & Timothy Simcoe, How Essential Are Standard-Essential Patents? 2 (Mar. 22, 2018) (unpublished working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128420&download=yes).

[8] *Id.*

[9] The Letter was reported in *77 Bipartisan Former Antitrust Enforcers, Academics Critique Delrahim on Patent Holdup*, Competition Pol'y Int'l (May 17, 2018), https://www.competitionpolicyinternational.com/77-bipartisan-former-antitrust-enforcers-academics-critique-delrahim-on-patent-holdup/; *see also* Letter from Professor Michael A. Carrier & Professor Timothy J. Muris, Former Chairman, Fed. Trade Comm'n to Makan Delrahim, Assistant Att'y Gen. for Antitrust (May 17, 2018), https://www.competitionpolicyinternational.com/wp-content/uploads/2018/05/DOJ-patent-holdup-letter.pdf [hereinafter 77 Enforcers-Scholars]. AAG Delrahim's response is reported at *AAG Makan Delrahim Responds to Critique on Patent Holdup*, Competition Pol'y Int'l (May 22, 2018), https://www.competitionpolicyinternational.com/us-delrahim-responds-to-critique-of-his-patent-holdup/; *see also* Letter from Makan Delrahim, Assistant Attorney General for Antitrust, to Professor Michael A. Carrier & Professor Timothy J. Muris, Former Chairman, Fed. Trade Comm'n (May 18, 2018), https://www.competitionpolicyinternational.com/wp-content/uploads/2018/05/2018-05-18-Delrahim-Letter-to-Carrier-and-Muris1.pdf.

[10] 77 Enforcers-Scholars, *supra* note 9, at 2.

[11] *Id.* at 3.

[12] Ericsson Inc. v. D-Link Sys., Inc., No. 6:10-CV-473, 2013 WL 4046225, at *25 (E.D. Tex. Aug. 6, 2013) ("The paradox of RAND licensing is that it requires a patent holder to offer licenses on reasonable terms, but it offers no guidance over what is reasonable."), *aff'd in part and rev'd in part*, 773 F.3d 1201 (Fed. Cir. 2014); Microsoft Corp. v. Motorola, Inc., No. C10-1823JLR, 2013 WL 2111217, at *10, *99 (W.D. Wash. Apr. 25, 2013) (noting that IEEE's 2007 patent policy does not clarify "what constitutes a reasonable royalty rate or what other terms and conditions are reasonable or nondiscriminatory for any license between interested parties").

[13] Deng, Leonard, and Lopez cite cases in their article *infra* this issue. *See* Fei Deng, Gregory K. Leonard & Mario A. Lopez, *Comparative Analysis of Court-Determined FRAND Royalty Rates*, Antitrust, Summer 2018, at 47.

[14] Leah Nylen, *Court-Ordered Global Frand Rates May Raise US Concerns, DOJ Official Says*, MLex (May 7, 2018).

# Antitrust in the Trump Administration: A Tough Enforcer That Believes in Limited Government

BY JOHN D. HARKRIDER

GIVEN THE BROAD BIPARTISAN support for antitrust, changes between administrations typically tend to be at the margins. Historically, Republican administrations were expected to be less regulatory and more deal friendly than Democratic administrations. Empirically, this has manifested itself in a decline in the frequency of Second Requests in some Republican administrations. It is too early in the Trump administration to assess whether the frequency of Second Requests—or the burdens they impose—will decline. However, recent actions in both antitrust agencies appear to favor aggressive antitrust enforcement.

While enforcement levels may or may not change, what is clear, even at this early stage, is that the focus of antitrust merger enforcement is shifting at both agencies from regulation to law enforcement. The clearest indication of this can be found in the Department of Justice decision to bring suit in the proposed AT&T/Time Warner vertical merger and not to accept a behavioral consent decree, in large part, because such decrees impose significant conduct obligations on the industry and force the DOJ to become a de facto regulator of such provisions.[1] No less significant, however, is the decision of the agencies to move away from the more regulatory approach taken by the Obama Administration with respect to Standard Essential Patents.

Given these initial trends, one would expect that the new administration is likely to focus on areas where harm to consumer welfare is clear and established, and less likely to trod new ground where harm to consumer welfare is more ambiguous.

## The Players and Governing Philosophy

The DOJ's Antitrust Division is now led by Makan Delrahim. He also served as a Deputy AAG in the Antitrust Division during the Bush Administration. Other familiar faces, such as Andrew Finch, Luke Froeb, and Barry Nigro, each of whom was at the FTC or DOJ during the Bush administration, now serve in the Antitrust Division. The FTC now has a full staff of Commissioners for the first time in over two years following the recent confirmations of Joseph Simons, who is serving as the Chairman, Noah Phillips, Rohit Chopra, and Rebecca Slaughter. Christine Wilson was confirmed to replace Maureen Ohlhausen and will likely take that position soon, pending Ohlhausen's upcoming hearing to be a Judge of the United States Court of Federal Claims. Joseph Simons and Christine Wilson were at the Commission under Chairman Timothy Muris during the Bush administration.[2]

AAG Delrahim has made clear the Division's position that "antitrust is law enforcement" and "not regulation."[3] This is consistent with the position taken by former Acting Chairman Maureen Ohlhausen, that the Commission should be governed by "regulatory humility."[4] This does not mean that the antitrust agencies will not take aggressive action to protect consumer welfare, but rather that "vigorous antitrust enforcement" can "play[] an important role in building a less regulated economy in which innovation and business can thrive."[5] Or, put another way, "proper and timely antitrust enforcement helps competition police markets instead of bureaucrats in Washington, D.C. doing it."[6]

During the FTC nomination hearings, Simons indicated his intention to vigorously police anticompetitive conduct and prevent anticompetitive consolidation to safeguard consumer welfare.[7] Throughout the course of the hearing, Simons indicated that he will be attentive to anticompetitive monopolization in consolidated sectors and anticompetitive conduct in the pharmaceutical industry, focusing FTC resources on areas where the potential for harm is the greatest. Wilson raised similar concerns about the pharmaceutical industry and drug pricing, recognizing that the FTC has been an active enforcer in the pharmaceutical space.

Notably, some of Simons' answers seem to show a willingness to bring cases under Section 2 of the Sherman Act,[8] which have not been a focus of previous Republican administrations. For example, Simons expressed a desire for the FTC to vigorously attack conduct by firms with market

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**[T]he new administration's policy position on SEPs also appears to be contrary to the positions of several agencies in other jurisdictions, such as the European Commission and certain agencies in Asian jurisdictions.**

power using anticompetitive means to stay big. Wilson also indicated her belief that "anticompetitive or exclusionary conduct can and should be closely scrutinized by the FTC."[9] It will be important to watch for changes in the scope of Section 2 enforcement once the new leadership is installed at the FTC.

## Merger Review

The frequency of Second Requests is often used as an indication of the expected level of antitrust enforcement.[10] Numerical comparisons, however, must be made with some caution. The fact that an agency issues more Second Requests does not mean that it is better protecting consumer welfare. Indeed, enforcement can actually harm consumer welfare where the challenged deal creates significant efficiencies.

In any event, the numbers for 2017 are not out yet, but as the current administration has not suggested that merger enforcement was too aggressive during the Obama administration, there is no indication that the frequency of Second Requests will decline.

The administration has made clear that it wants to reduce the merging parties' burden in responding to Second Requests.[11] That being said, the current Model Second Request has gotten longer.[12] The DOJ's updated Model Second Request dated November 28, 2016, increased the number of specifications from 20 to 38, though a number of the additional requests are optional. Many of the additional questions are significant, even if not especially burdensome, because they seek disclosure of the parties' strategy for getting clearance. For example, the DOJ Second Request now asks for information on the parties' contacts with other branches of government (which would disclose the parties' lobbying efforts), as well as efforts to remedy the antitrust issue (which may make it more difficult to "litigate the fix" because the government will have a window into the parties' strategy in developing a remedy that may address a district court's concern—though not the agencies' concerns).

Similarly, the FTC's previous Model Second Request from 2010 was 20 pages, compared to the current 31-page version. Among other things, the new Model also requires parties to indicate all other antitrust jurisdictions that the parties notified or will notify and the timing of those investigations, which is certainly a fair question given the rise of multijurisdictional review.

That said, these model Second Requests were issued before the Trump administration was in place and it is not at all clear that they reflect the new administration's interest in streamlining the merger review process. In fact, former Acting Chairman Ohlhausen suggested the FTC should narrow the scope of Second Requests.[13] With the new leadership at the FTC now installed, it remains to be seen whether the antitrust agencies are serious about reducing the burden of Second Requests.

## Merger Remedies

Another notable distinction of this administration's antitrust enforcement may be a greater willingness to challenge vertical mergers instead of accepting behavioral remedies. In previous administrations, the DOJ accepted non-discrimination provisions to address anticompetitive concerns involving vertical mergers. The DOJ's 2011 case against Comcast's vertical merger, for example, relied upon behavioral remedies, specifically non-discrimination provisions, which included requiring Comcast to treat all Internet traffic the same, to address its concerns.[14] Moreover, the DOJ's Merger Remedies guidelines explicitly state that "conduct remedies often can effectively address anticompetitive issues raised by vertical mergers."[15] This is especially true in telecom deals.

The DOJ under the current administration, however, was not willing to agree to non-discrimination and must-supply provisions to allow the AT&T/Time Warner transaction to be consummated. While some have suggested political reasons for doing so,[16] this claim has not been substantiated. Perhaps a more likely explanation is that the administration does not want the DOJ to become a regulator with an ongoing role policing market conduct. This seems to be a principled conservative approach.

Furthermore, the DOJ has taken the position that it disfavors conduct remedies in vertical mergers.[17] Indeed, AAG Delrahim explained that antitrust is at its best when "it supports reducing regulation."[18] The fact that there were significant concerns about violations of the behavioral remedies that occurred after the Comcast merger lends support to the DOJ's position regarding the difficulty of behavioral remedies.

AAG Delrahim has described the problems with accepting behavioral remedies from the DOJ's standpoint. In a recent speech he explained that monitoring the parties' compliance with behavioral remedies is inefficient, hard to police, and can lead to anticompetitive effects if the requirements no longer reflect the marketplace dynamics.[19]

That said, Delrahim was clear that the DOJ may accept behavioral remedies where an otherwise "unlawful vertical transaction generates significant efficiencies that cannot be achieved without the merger or through a structural remedy," though he noted it would be "a high standard to meet."[20]

The Director of the FTC's Bureau of Competition, Bruce Hoffman, has also reiterated that structural remedies are preferred, even in vertical mergers. Hoffman echoed the DOJ's position, stating, "First and foremost, it's important to remember that the FTC prefers structural remedies to struc-

tural problems, even with vertical mergers . . . . But in some cases we believe that a behavioral or conduct remedy can prevent competitive harm while allowing the benefits of integration."[21] A current FTC matter involving Northrop/Orbital's merger may indicate how closely aligned the FTC and DOJ will be on this point.

The DOJ has also taken the position that asset carve-outs are inherently suspect.[22] The FTC has similarly expressed concern about asset carve-outs and, in its 2016 suit challenging Valeant Pharmaceuticals' acquisition of Paragon Holdings, it required that Valeant divest assets outside of the business to restore competition.[23] While this is not a new position, it is a sign that this particular Republican administration may be less accommodating than previous administrations in the sale of less than an ongoing business to remedy a merger.

### Minority Ownership

The current administration's potentially strict approach to antitrust enforcement is also seen in its position on minority ownership. For example, in Red Ventures' acquisition of Bankrate, the FTC prevented Red Ventures, an Internet marketing firm, from acquiring a senior citizen referral site (Caring.com) because two private equity investors in Red Ventures (which collectively owned about 34 percent of the company) had just acquired a competing senior citizen referral site (A Place for Mom).[24] The FTC's action was unusual in that it did not accept board recusal, a firewall, or other behavioral remedy and, instead, required divestiture of Caring.com. The FTC also included a "nurturing provision" that prevented Red Ventures from having any commercial relationship with A Place for Mom for a period of time, on the theory that Red Ventures had learned something about Caring.com, demonstrating the FTC's concerns about information exchanges in the context of minority ownership in competing companies.

### Consent Decrees

The DOJ is also making it easier to sue for violations of consent decrees. Specifically, it has added three provisions to decrees: first, reducing the burden of demonstrating a violation of the decree from clear and convincing to preponderance of the evidence; second, requiring the acquiring party to agree to pay the Division's attorneys' fees in the case of a violation; and third, allowing the DOJ to extend or terminate the term of the decree.[25]

It also does not appear that there are any differences as yet in the HHIs that trigger antitrust enforcement. Comparing the average HHIs in deals with consent decrees from 2017 and 2016 shows only slight differences. For example, in 2016 the agencies entered into 25 consent decrees. Nine of those did not discuss market share or HHI information. The average post-merger HHI in the remaining 16 consents was approximately 7,600, and 7 involved mergers to monopoly. In comparison, in 2017, the agencies also entered 25 consent decrees. Five did not discuss market share or HHI information. The average post-merger HHI in the remaining 20 consents was approximately 7,100. Ten involved mergers to monopoly. That said, the FTC entered a consent decree in 2018 in a merger involving HHIs in the 2,500 HHI range, with a delta of roughly 500 points.[26] Again, it is too early to tell, but there does not seem to be a material difference in the types of horizontal deals that the current DOJ is challenging.

### Contact with Witnesses

It is not unusual for merging parties to contact customers to give them notice that their names were given to the reviewing agency in responding to a Voluntary Access Letter or Second Request. Nor is it unusual for the buyer to contact the customer to give its view of the market and the rationale for the deal and to see if there is any way to address its customer's concerns with the merger, such as a long-term supply agreement (in the case of a vertical merger) or a new contract conditioned upon deal closing that passes some of the synergies on to the customer.

In the FTC's view, some contacts with non-parties have crossed the line during merger reviews. The Director of the FTC's Bureau of Competition indicated that the FTC will be attentive to any efforts to threaten witnesses.[27] Thus, merging parties should be mindful that their contacts with non-parties, including customers, should be narrowly tailored to give customers notice of the deal, to explore commercial ways of addressing their concerns, and to give the customers the merging parties' view of the marketplace and rationale for the transaction. While this type of contact is completely appropriate, merging parties should be careful not to suggest or imply that they will retaliate against customers that complain or do not support the merger.

### Litigation

The Trump administration's litigation track record demonstrates that they have no fear of litigation. The DOJ has brought litigation against the mergers of Time Warner/AT&T,[28] noteworthy because it is a vertical acquisition, and Parker Hannifin/Clarcor,[29] also noteworthy because the DOJ brought the case after the HSR waiting period expired. In the wake of the DOJ's aggressive litigation approach, the recently proposed Sprint/T-Mobile merger is being scrutinized in the media,[30] while it remains to be seen what the agency's position will be. The FTC has also pursued litigation against mergers in several industries, including fantasy sports,[31] physician services,[32] microprocessor prosthetic knees,[33] titanium dioxide manufactured through the chloride process,[34] and most recently, canola and vegetable oils.[35]

### *Noerr-Pennington*

Yet another example of the current administration's seemingly stricter antitrust enforcement—at least relative to other Republican administrations—is the FTC's stance on the *Noerr-Pennington* doctrine. In February 2017, the FTC filed

a case against Shire ViroPharma seeking to narrow the immunity under *Noerr-Pennington*.[36] Part of the FTC's reason for bringing this case is to further cement the *California Motor*[37] "pattern of petitioning" exception to the *Professional Real Estate Investors* decision's "objectively baseless" test.[38] Narrowing the scope of immunity is very much in line with a policy objective Muris set out in the 1980s and early 2000s. With recent nominations of individuals who were at the FTC under Muris, the case against Shire ViroPharma is a good indication that the future full Commission will have a similar policy objective.

### *Illinois Brick* and *Hanover Shoe*

Further in line with the current administration's emphasis on increasing antitrust enforcement, the DOJ has signaled a willingness to argue against *Illinois Brick*[39] and *Hanover Shoe*,[40] two Supreme Court decisions that bar indirect purchasers' rights to seek damages for federal antitrust violations and prohibit a pass-through defense to direct purchaser suits.[41] Delrahim's principal deputy assistant attorney general (Finch) said that the Antitrust Division is considering arguing that the decisions should be overruled, either by Congress or the Supreme Court. Finch supported the position by pointing to confusion created by the Court's rule and the states' "*Illinois Brick* repealers." Before Finch's speech, Delrahim also indicated that the Antitrust Division is looking into the possibility of recovering damages for taxpayers in price-fixing cases.[42] That approach would be consistent with Finch's remarks because the federal government is frequently an indirect purchaser and it is unclear whether it would be able to bring claims under state law.

### Economic Liberty

Former Acting Chairman Ohlhausen recently focused significant attention on economic liberty, which refers to the elimination or reform of burdensome licensing restrictions that needlessly raise barriers to entry. She emphasized this in several speeches over the past year, specifically addressing occupational licensing reform.[43] Additionally, the FTC established an Economic Liberty Task Force that is working with the states to reform licensing requirements and fees to reduce these barriers and costs.[44] Whether Chairman Simons will similarly pursue this focus is unknown, but the policy demonstrated the agency's willingness to promote consumer welfare by using its authority beyond just enforcing the antitrust statutes.

### International Antitrust Enforcement

The Trump administration's antitrust agencies are also becoming increasingly active on the international scene. The revised International Guidelines were published in 2017,[45] updating and expanding the previous Guidelines published in 1995. Negotiations for the competition chapter of NAFTA were completed in October 2017, providing increased procedural fairness in competition law enforcement.[46]

The DOJ in particular has publicly emphasized international antitrust enforcement. The Foreign Commerce Section has been renamed the International Section, and their budget and staff have been increased. Delrahim has focused upon the importance of international cooperation among agencies.[47] He has also advocated for adherence to principles of due process and non-discrimination in antitrust enforcement, i.e., not favoring domestic companies over foreign companies or unfairly disadvantaging foreign companies.[48] In addition, Delrahim's international affairs deputy, Roger Alford, has discussed the importance of adhering to principles of international comity, especially with regard to extraterritorial remedies.[49]

It remains to be seen, however, whether divergence between the United States and international enforcement will occur in the future. There are two possible areas of divergence. One area is abuse of dominance, where the EC has found that large technology companies like Google are liable for what the FTC has previously found is procompetitive behavior.[50] It is also possible that efforts by foreign agencies to change the rules regarding the licensing of Standard Essential Patents (SEPs), in light of the current administration's new position, may create divergence in the future.

### Antitrust-IP Policy

The new administration's antitrust enforcement at the intersection of intellectual property rights is another area of recent activity. Regarding SEPs, the administration is concerned that implementers will "hold out" and use SEPs without a license, which the DOJ has claimed reduces incentives for innovators to invest in foundational and essential technology.[51]

This is a departure from the Obama administration, which was concerned about SEP holders like Qualcomm increasing the costs of implementers like Apple, which the FTC and DOJ claimed would increase the costs of consumer products and lead to reduced incentives to invest in devices that implemented SEPs. The new administration has signaled lukewarm support for the FTC's pending suit against Qualcomm. In addition, in a speech by Delrahim, it has signaled a potential investigation of the IEEE patent policy,[52] expressing concern that the DOJ's earlier Business Review Letter approving the new policy had been interpreted in ways "totally inconsistent with modern antitrust law."[53] Notably, the new administration's policy position on SEPs also appears to be contrary to the positions of several agencies in other jurisdictions, such as the European Commission and certain agencies in Asian jurisdictions.

Thus, it is at least possible that the rule developed by the Obama administration against obtaining injunctions on SEPs may be abandoned by the administration. Such a shift, however, may have limited impact given the decisions by the Federal Circuit that limit the ability of SEP holders to seek injunctions when they have made a FRAND commitment and have a history of licensing their patents.[54]

## Criminal Enforcement

The DOJ's views on criminal enforcement are aligned with a traditional Republican focus. Aggregate fine levels are expected to decline in the short term as the auto parts cases wind down, but that does not reflect any policy to reduce criminal antitrust enforcement. In fact, after the European Commission handled those cases, its fine levels similarly declined.

Another indicator that aggressive criminal enforcement will remain a priority under the new administration is the DOJ's position of criminalizing no-poach agreements.[55] While this is not a new position, it is a display of willingness to enforce the law aggressively. Further evidence of a possible expansion of the scope of criminal liability comes from the fact that Delrahim suggested that a patent transfer to Native American Tribes may be subject to criminal liability where the transfer was an attempt to take advantage of sovereign immunity.[56]

## Conclusion

Looking at the first year of activity at the antitrust agencies under the Trump administration, it is hard to come up with support for the narrative that Republican antitrust enforcement is more lax or permissive than it is under Democratic administrations. Instead, the actions of the current leadership and the pronouncements of the incoming leadership at both the FTC and the DOJ's Antitrust Division show a desire to vigorously enforce antitrust laws. Not only has merger enforcement continued actively following the Obama administration, but the agencies are also focusing on many other antitrust concerns.

A notable difference between Obama and Trump antitrust appears to be the Trump administration's recognition that antitrust is law enforcement rather than regulation. Consistent with an approach that disfavors government intervention, the Trump administration seems to be backing off from efforts by the Obama administration (and agencies in other jurisdictions) to police standard-setting organizations' contracts and shift the bargaining power in SEPs from innovators to implementers.

It appears antitrust enforcement during this administration will continue to be active, but more focused, and remedies sought will tend to be structural, rather than behavioral or involving continued oversight of business conduct by the antitrust agencies. The administration's position on behavioral remedies could have the following practical implications: sellers in vertical deals may be more likely to insist on hell-or-high-water protection, commitments to make divestitures, and/or higher reverse break fees, as well as commitments to litigate. Further, buyers should document and quantify with specifics the efficiencies from vertical integration that would be lost if the merger were to be blocked.

The Trump administration's antitrust enforcement appears to take a more hands-off approach to regulating business conduct, while still adhering to, and enforcing, evidence-based, economically sound antitrust law. ■

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[1] Complaint, United States v. AT&T, 1:17-cv-02511 (D.D.C. filed Nov. 20, 2017), ECF No. 1.

[2] Simons made an interesting comment in a questionnaire submitted to the Senate Commerce Committee, noting "significant concerns" that merger enforcement has been too permissive, and also noting that the FTC needs to assess whether merger enforcement has gotten too lax. *See* Joseph Simons, Nominee, Fed. Trade Comm'n, Initial Questionnaire (Jan. 31, 2018), https://www.commerce.senate.gov/public/_cache/files/6c4149af-3023-4825-90f1-3c38e279fd0d/6A0CCF409AF89DC8D5C0A84CE8730012.confidential---simons---committee-questionnaire-redacted.pdf.

[3] Makan Delrahim, Assistant Att'y Gen., Antitrust Div., Dep't of Justice, Antitrust and Deregulation, Remarks as Prepared for Delivery at American Bar Association Antitrust Section Fall Forum at 1 (Nov. 16, 2017), https://www.justice.gov/opa/speech/file/1012086/download [hereinafter Delrahim Fall Forum Remarks].

[4] *See* Maureen K. Ohlhausen, Acting Chairman, Fed. Trade Comm'n, Competition Policy at the FTC in the New Administration at 1 (Sept. 11, 2017), https://www.ftc.gov/system/files/documents/public_statements/1253063/ohlhausen_-_competition_policy_at_the_ftc_in_the_new_administration_gw_9-11-17.pdf [hereinafter Ohlhausen, New Administration].

[5] Delrahim Fall Forum Remarks, *supra* note 3, at 1.

[6] *Id.*

[7] Joseph Simons, Nominee, Fed. Trade Comm'n, Prepared Statement (Feb. 14, 2018).

[8] 15 U.S.C. § 2.

[9] Christine S. Wilson, Nominee, Fed. Trade Comm'n, Majority QFRs (Feb. 14, 2018).

[10] *See* John D. Harkrider, *Antitrust Enforcement During the Bush Administration—An Economic Estimation*, Antitrust, Summer 2008, at 44; Deborah L. Feinstein, *Recent Trends in U.S. Merger Enforcement: Down But Not Out*, Antitrust, Summer 2007, at 74; *see also* Fed. Trade Comm'n & Dep't of Justice, Hart-Scott-Rodino Annual Report (2016), https://www.ftc.gov/system/files/documents/reports/federal-trade-commission-bureau-competition-department-justice-antitrust-division-hart-scott-rodino/p110014_fy_2016_hsr_report_final_october_2017.pdf.

[11] *See* Andrea Hamilton et al., *The LATEST: FTC "Second Requests" to Be Narrower in Scope Under Ohlhausen's Leadership*, Antitrust Alert, McDermott Will & Emery (Feb. 17, 2017), https://www.antitrustalert.com/2017/02/articles/mergers-acquisitions/the-latest-ftc-second-requests-to-be-narrower-in-scope-under-ohlhausens-leadership/; Kirk Victor, *Lots of Changes Ahead at FTC Regardless of Trump's Pick for Chairman*, FTCWatch (Feb. 3, 2017), https://www.mlexwatch.com/articles/2648/lots-of-changes-ahead-at-ftc-regardless-of-trump-s-pick-for-chairman.

[12] *See* Dep't of Justice, Request for Additional Information and Documentary Material Issued to Weebyewe Corporation (Model Second Request) (Nov. 28, 2016), https://www.justice.gov/atr/file/706636/download; Fed. Trade Comm'n, Model Request for Additional Information and Documentary Material (Second Request) (Aug. 2015), https://www.ftc.gov/system/files/attachments/merger-review/guide3.pdf; *cf.* Dep't of Justice, Request for Additional Information and Documentary Material Issued to Weebyewe Corporation (Model Second Request) (Mar. 2012), https://www.justice.gov/sites/default/files/atr/legacy/2012/06/01/220239.pdf; Fed. Trade Comm'n, Model Request for Additional Information and Documentary Material (Second Request) (June 2010), https://www.ftc.gov/sites/default/files/attachments/merger-review/guide3.pdf.

[13] *See* Maureen K. Ohlhausen, Acting Chairman, Fed. Trade Comm'n, Antitrust

Policy for a New Administration (Jan. 24, 2017), https://www.ftc.gov/system/files/documents/public_statements/1051993/antitrust_policy_for_a_new_administration.pdf.

[14] United States v. Comcast Corp., 1:11-cv-00106, Competitive Impact Statement (D.D.C. filed Jan. 18, 2011), ECF No. 4, http://www.justice.gov/atr/cases/f266100/266158.pdf.

[15] *See* U.S. Dep't of Justice, Antitrust Div., Antitrust Division Policy Guide to Merger Remedies 2 (2011), https://www.justice.gov/sites/default/files/atr/legacy/2011/06/17/272350.pdf.

[16] *See* Derek Thompson, *Why the Trump Administration Is Suing to Block the AT&T-Time Warner Merger,* Atlantic (Nov. 20, 2017), https://www.theatlantic.com/business/archive/2017/11/trump-att-time-warner/546443/ ("The main reason this lawsuit seems suspicious, though, is that it would appear quite out of character for the Trump administration, which has hailed the need for deregulation.").

[17] *See* Delrahim Fall Forum Remarks, *supra* note 3.

[18] *Id.* at 1.

[19] *Id.* at 5.

[20] *Id.* at 8.

[21] *See* Bruce Hoffman, Acting Dir., Bureau of Competition, Fed. Trade Comm'n, Vertical Merger Enforcement at the FTC, Remarks at Credit Suisse 2018 Washington Perspectives Conf. (Jan. 10, 2018), https://www.ftc.gov/system/files/documents/public_statements/1304213/hoffman_vertical_merger_speech_final.pdf.

[22] *See* Charles McConnell, *US DOJ Official: Asset Carve-Outs Are "Inherently Suspect,"* Global Competition Rev. (Feb. 2, 2018), https://globalcompetitionreview.com/article/1153335/us-doj-official-asset-carve-outs-are-"inherently-suspect".

[23] *See* Andrea Zach, *Taking a Hard Look at the Asset Package*, Competition Matters (Nov. 9, 2016), https://www.ftc.gov/news-events/blogs/competition-matters/2016/11/taking-hard-look-asset-package.

[24] *See* FTC Press Release, Parties Agree to Divestiture of Senior Living Facilities Referral Service Caring.com as a Condition of Red Venture's Acquiring Bankrate (Nov. 3, 2017), https://www.ftc.gov/news-events/press-releases/2017/11/parties-agree-divestiture-senior-living-facilities-referral-service.

[25] Makan Delrahim, Assistant Att'y Gen., Antitrust Div., Dep't of Justice, Improving the Antitrust Consensus, Remarks Delivered at N.Y. State Bar Ass'n (Jan. 25, 2018), https://www.justice.gov/opa/speech/remarks-assistant-attorney-general-makan-delrahim-delivered-new-york-state-bar ("[T]he Division believes that by contracting with settling parties to apply a preponderance standard to contempt proceedings, it will significantly increase the efficacy and efficiency of decree enforcement . . . The goal of fee shifting is to encourage speedy resolution of decree violation investigations, and to compensate taxpayers for the costs associated with investigation and enforcement necessitated by the violation."); United States v. Entercom Commc'ns Corp., 1:17-cv-02268-JEB (D.D.C. filed Jan. 31, 2018) (final judgment), ECF No. 13, https://www.justice.gov/atr/case-document/file/1030176/download ("The United States retains and reserves all rights available to it under applicable law to enforce the provisions of this Final Judgment . . . Any civil contempt action, any motion to show cause, or any similar action brought by the United States regarding an alleged violation of this order shall be evaluated under a preponderance of the evidence standard."); United States v. Parker-Hannifin Corp., 1:17-cv-01354-JEJ (D. Del. filed Dec. 18, 2017) (final judgment), ECF No. 29, https://www.justice.gov/opa/press-release/file/1018596/download ("Unless this Court grants an extension, this Final Judgment shall expire ten (10) years from the date of its entry, except that after five (5) years from the date of its entry, this Final Judgment may be terminated upon notice by the United States to the Court and defendants.").

[26] Tronox Ltd., FTC Docket No. 9377 (Dec. 5, 2017), https://www.ftc.gov/system/files/documents/cases/docket_no_9377_tronox_cristal_part_3_administrative_complaint_redacted_public_version_12072017.pdf.

[27] *See* Bruce Hoffman, Acting Dir., Bureau of Competition, Fed. Trade Comm'n, It Only Takes Two to Tango: Reflections on Six Months at the FTC, Remarks at GCR Live 7th Annual Antitrust Law Leaders Forum (Feb. 2, 2018), https://www.ftc.gov/system/files/documents/public_statements/1318363/hoffman_gcr_live_feb_2018_final.pdf ("I also want to underscore that we will treat with the utmost seriousness any attempt to impede our investigations or enforcement actions-mergers or conduct-by tampering with evidence, including threatening or retaliating against witnesses.").

[28] Complaint, United States v. AT&T, 1:17-cv-02511 (D.D.C. filed Nov. 20, 2017), ECF No. 1.

[29] Complaint, United States v. Parker-Hannifin Corp., 1:17-cv-01354-UNA (D. Del. filed Sept. 26, 2017), ECF No. 1.

[30] *See, e.g.*, Tara Lachapelle, *Opinion, Sprint, T-Mobile: Three Big Takeaways*, Bloomberg, Apr. 29, 2018, https://www.bloomberg.com/gadfly/articles/2018-04-29/sprint-t-mobile-merger-takeaways.

[31] DraftKings Inc., FTC Docket No. 9375 (June 19, 2017), https://www.ftc.gov/system/files/documents/cases/docket_no_9375_draftkings_fanduel_part_3_complaint_final_redacted_public_version.pdf.

[32] Sanford Health, FTC Docket No. 9376 (June 21, 2017), https://www.ftc.gov/system/files/documents/cases/d9376sanfordmiddakotacomplaint.pdf.

[33] Otto Bock HealthCare North Am., Inc., FTC Docket No. 9378 (Dec. 20, 2017), https://www.ftc.gov/system/files/documents/cases/otto_bock_part_3_complaint_redacted_public_version.pdf.

[34] Tronox Ltd., FTC Docket No. 9377 (Dec. 5, 2017), https://www.ftc.gov/system/files/documents/cases/docket_no_9377_tronox_cristal_part_3_administrative_complaint_redacted_public_version_12072017.pdf.

[35] *See* Press Release, Fed. Trade Comm'n, FTC Challenges Proposed Acquisition of Conagra's Wesson Cooking Oil Brand by Crisco Owner, J.M. Smucker Co. (Mar. 5, 2018), https://www.ftc.gov/news-events/press-releases/2018/03/ftc-challenges-proposed-acquisition-conagras-wesson-cooking-oil?utm_source=govdelivery.

[36] *See* Complaint for Injunctive and Other Equitable Relief ¶ 49, FTC v. Shire ViroPharma Inc., 1:17-cv-00131-UNA (D. Del. Feb. 7, 2017), https://www.ftc.gov/system/files/documents/cases/170216viropharma_unredacted_sealed_complaint_.pdf.

[37] California Motor Transp. Co. v. Trucking Unlimited, 404 U.S. 508 (1972).

[38] Prof'l Real Estate Inv., Inc. v. Columbia Pictures Indus., Inc., 508 U.S. 49 (1993).

[39] Illinois Brick Co. v. Illinois, 431 U.S. 720 (1977).

[40] Hanover Shoe, Inc. v. United Shoe Mach. Corp., 392 U.S. 481 (1968).

[41] *See* Andrew Finch, Principal Deputy Assistant Att'y Gen., Antitrust Div., Dep't of Justice, Trump Antitrust Policy After One Year, Remarks Delivered at the Heritage Found. (Jan. 23, 2018), https://www.justice.gov/opa/speech/file/1028906/download ("We are looking at whether or not it might be worthwhile to revisit those rules and suggest the same to the Supreme Court."); *see also* Charles McConnell, *DOJ Looks at Overturning* Illinois Brick, Global Competition Rev. (Jan. 24, 2018) ("Stephen Weissman, who served under the Obama administration as deputy director of the Federal Trade Commission's bureau of competition, called the decision to review Illinois Brick "interesting [and] odd" and not typical of a Republican DOJ.").

[42] *See* Charles McConnell, *DOJ Looks to Recover Damages for Price-Fixing*, Global Competition Rev. (Jan. 22, 2018).

[43] *See, e.g.*, Ohlhausen, New Administration, *supra* note 4; Maureen K. Ohlhausen, Acting Chairman, Fed. Trade Comm'n, Death by a Thousand Haircuts: Economic Liberty and Occupational Licensure Reform, Keynote at Heritage Foundation (July 26, 2017), https://www.ftc.gov/public-statements/2017/07/death-thousand-haircuts-economic-liberty-occupational-licensure-reform; Maureen K. Ohlhausen, Acting Chairman, Fed. Trade Comm'n, Advancing Economic Liberty, Remarks at the George Mason Law Review's 20th Annual Antitrust Symposium (Feb. 23, 2017), https://www.ftc.gov/public-statements/2017/02/advancing-economic-liberty.

[44] *See Economic Liberty*, Fed. Trade Comm'n, https://www.ftc.gov/policy/advocacy/economic-liberty.

[45] U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Guidelines for International Enforcement and Cooperation (2017), https://www.ftc.gov/system/files/documents/public_statements/1049863/international_guidelines_2017.pdf.

[46] *See* Press Release, Office of U.S. Trade Rep., USTR Lighthizer Welcomes Start of NAFTA Round 4, Announces New Developments (Oct. 2017),

https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/october/ustr-lighthizer-welcomes-start.

[47] Makan Delrahim, Assistant Att'y Gen., Antitrust Div., Dep't of Justice, International Antitrust Policy: Economic Liberty and the Rule of Law, Remarks as Prepared for Delivery at Antitrust in Developing Countries: Competition Policy in a Politicized World, NYU School of Law and Concurrences (Oct. 27, 2017), https://www.justice.gov/opa/speech/file/1007231/download.

[48] *Id.*

[49] *See* Roger P. Alford, Deputy Assistant Att'y Gen. for International Affairs, Antitrust Div., U.S. Dep't of Justice, Antitrust Enforcement in an Interconnected World, Remarks at the American Chamber of Commerce in South Korea (Jan. 29, 2018), https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-roger-p-alford-delivers-remarks-american-chamber.

[50] *See* Case AT.39740—Google Search (Shopping), Comm'n Decision (June 27, 2017), http://ec.europa.eu/competition/antitrust/cases/dec_docs/39740/39740_14996_3.pdf. *But see* Fed. Trade Comm'n, Statement Regarding Google's Search Practices, FTC File No. 111-0163 (Jan. 3, 2013).

[51] *See* Makan Delrahim, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Competition, Intellectual Property, and Economic Prosperity, Remarks at the U.S. Embassy in Beijing (Feb. 1, 2018), https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-us-embassy-beijing; Makan Delrahim, Assistant Att'y Gen., Antitrust Div., Dep't of Justice, Take It to the Limit: Respecting Innovation Incentives in the Application of Antitrust Law, Remarks as Prepared for Delivery at USC Gould School of Law (Nov. 10, 2017), https://www.justice.gov/opa/speech/file/1010746/download ("[W]e as enforcers have strayed too far in the direction of accommodating the concerns of technology implementers who participate in standard setting bodies and perhaps risk undermining incentives for IP creators, who are entitled to an appropriate reward for developing break-through technologies.").

[52] IEEE-SA Standards Board Bylaws (Dec. 2017), https://standards.ieee.org/develop/policies/bylaws/sb_bylaws.pdf.

[53] *See* Charles McConnell, *Delrahim Hints at IEEE Probe*, Global Competition Rev. (Jan. 23, 2018), https://globalcompetitionreview.com/article/usa/1152963/delrahim-hints-at-ieee-probe.

[54] Commonwealth Sci. & Indus. Research Org. v. Cisco Sys., Inc., 809 F.3d 1295 (Fed. Cir. 2015); Apple Inc. v. Motorola, Inc., 757 F.3d 1286 (Fed. Cir. 2014).

[55] *See* Finch, *supra* note 41 ("[T]he Division expects to initiate multiple no-poach enforcement actions in the coming months.").

[56] *See* Charles McConnell, *Delrahim: Patent Transfer May Have Been a Crime*, Global Competition Rev. (Jan. 19, 2018), https://globalcompetitionreview.com/article/1152913/delrahim-patent-transfer-may-have-been-a-crime.

# Welcome to the Wild, Wild West: *Actavis* Five Years Later

BY LISA JOSE FALES, PAUL FEINSTEIN, AND ZAK VARSHOVI

FIVE YEARS AGO, THE U.S. SUPREME Court altered the antitrust analysis that applies to settlements of pharmaceutical patent litigation. In its landmark 2013 decision in *FTC v. Actavis*, the Supreme Court held that such a settlement is subject to antitrust scrutiny under the rule of reason if it contains a "reverse payment"—that is a "large and unjustified" payment flowing from the patentee brand company to the alleged generic infringer.[1] In so doing, the Court left the task of structuring the rule of reason in this context to the lower courts—a task for which Chief Justice Roberts famously wished "good luck to the district courts."[2]

Five years later, uncertainty shrouds the post-*Actavis* landscape as the decision has sown a disorderly mishmash of lower court opinions.[3] Three aspects of *Actavis* have consumed courts' attention: what constitutes a "large and unjustified" reverse payment; how to structure the rule of reason framework; and the role of the patent in antitrust injury.[4] Though some limited consensus has emerged regarding these issues, the overall status was perhaps best described by defense counsel in *Apotex, Inc. v. Cephalon, Inc.*, the second case to go to trial since *Actavis*: "The truth of the matter is . . . you can read [*Actavis*] over again, you can read the subsequent cases, it's the wild, wild west."[5]

## What Is a "Large and Unjustified" Payment Under *Actavis*?

The lion's share of uncertainty post-*Actavis* has centered on what qualifies as a "large" and "unjustified" payment. In fact, nearly every decision since *Actavis* has analyzed some aspect of the issue—from what it means for a payment to be "large and unjustified," to even what constitutes a "payment" in the first place. Though some consensus has emerged regarding the latter, the former still engenders discord. Subsequent decisions, for example, have emphasized that whether a payment was "large and unjustified" "requires viewing the payment in the context of the facts of the case, which may include business considerations that are less tangible or quantifiable."[6]

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## What Is a "Payment"?

A threshold question tackled by courts in the immediate aftermath of *Actavis* was what form an alleged reverse "payment" must take. Although some district courts initially limited *Actavis*' application to cash payments only,[7] the reversal of those decisions has paved a consensus to the contrary. That is, antitrust scrutiny attaches to cash and non-cash payments alike.[8] Non-cash reverse payments that are now subject to antitrust scrutiny under *Actavis* include, among others, so-called No-AG agreements (short for No-Authorized Generics, it is an agreement by the brand not to launch an authorized generic version of the drug during the generic's 180-day exclusivity period),[9] other business arrangements like product development and co-promotion agreements,[10] and settlements of other litigation.[11]

## What Is a "Large" Payment?

The Court in *Actavis* did not expressly define what constitutes a "large" payment. As a result, the decisions since *Actavis* generally make clear that what is "large" is a circumstance and fact-driven inquiry devoid of bright lines.[12]

To date, the guidepost that has received the most analysis is the brand company's saved litigation costs. This is a product of *Actavis* itself. As the Court made clear, "The likelihood of a reverse payment bringing about anticompetitive effects depends upon its size, *its scale in relation to the payor's anticipated future litigation costs*, its independence from other services for which it might represent payment, and the lack of any other convincing justification."[13] Though specifically identified as a factor by the Court, the weight of post-*Actavis* decisions has tilted heavily against an analysis that is simply a comparison to saved litigation costs. Indeed, the majority of decisions that analyze "large" hold that saved litigation costs are not dispositive and must be accompanied by additional considerations.[14]

In *Aggrenox*, the district court reasoned that "[e]ven if the payments exceed avoided litigation costs, the *Actavis* factors . . . still matter."[15] Similarly, in *Opana*, the court stated in no uncertain terms: "A 'large' payment is anything more than the value of the avoided litigation costs *plus* any other services provided from the generic to the brand manufacturer."[16] Even more, the court in *K-Dur* held on summary judgment that a large payment exists if "the brand-name company paid the generic company consideration of some kind" in the settlement and that consideration "exceeded the estimated cost of litigation *and* the costs of other services and products."[17] Thus, courts are generally in agreement on the lower bound of what is large. As the court in *Aggrenox* aptly put: "payments smaller than avoided litigation costs," are presumptively valid payments under *Actavis*, and "represent a *de facto* safe harbor," and "payments exceeding avoided litigation costs are not automatically deemed unlawful for that reason alone."[18]

Given the open-ended nature of the inquiry, the issue of what goes into the "large" analysis has been hotly disputed in two of the three post-*Actavis* cases put before a jury—*Modafinil* and *Solodyn*.[19] Each offers a helpful window into "how in the heck a trial judge (and a jury) is supposed to apply the *Actavis* decision to an actual case."[20]

In *Modafinil*, the court first instructed the jury that "[w]hether a payment is large depends on the specific facts and circumstances of this case."[21] Then, consistent with its analysis at summary judgment,[22] the court instructed the following: "[f]irst, you must ask whether the payment exceeds the patent holder's . . . anticipated future litigation costs," and "[s]econd, you must consider whether the payment was significant enough to induce a generic challenger . . . to abandon its patent claim and stay off the market."[23] To illuminate the second question, the court added: "you may consider . . . whether the payment comes close to or exceeds the expected profit to be earned by [the generic] if it had prevailed in the patent litigation."[24]

*Modafinil* is also noteworthy because the defendant was permitted to offer evidence comparing the alleged size of the reverse payment to the brand's profits for the patented product. Such a comparison finds support in *Actavis* itself. For example, the Court in *Actavis* recognized the relevance of a patent's value when it said that it is inappropriate to measure whether a reverse payment is legal based "*solely* against the length of the patent's term or its earning potential," and that "traditional antitrust factors" must be considered.[25] Though such evidence regarding the size of the payment relative to the brand company's potential earnings under its patent does not "immunize" a reverse payment agreement "from antitrust attack,"[26] it does appear to be relevant to whether the payment is "large."

More recently, the court in *Solodyn* agreed that a comparison between the alleged size of the reverse payment and the brand's profits is relevant to the "large" inquiry. The plaintiffs in that case—based in part on what happened in *Modafinil*—filed a motion in limine seeking to exclude certain arguments and evidence regarding "large," including comparisons between the amount of the alleged reverse payment to the brand's "sales or profits" from Solodyn, or to the "potential profits" the brand "stood to lose" upon generic entry.[27] The court declined the invitation to "narrow the evidence at trial as to whether the payment from [the brand] to the [the generic] . . . was 'large.'"[28] Instead, the court made clear that "whether a reverse payment was 'large and unjustified' *requires* viewing the payment in its factual context, which may include certain business realities," and such evidence was introduced to the jury.[29]

## What Is an "Unjustified" Payment Under *Actavis*?

*Actavis* arguably provides more detail regarding what payments are likely considered "unjustified." The Court offered several examples of payments that escape antitrust scrutiny. They include: (1) payments that are "no more than rough approximation" of avoided litigation expenses; (2) payments that "reflect compensation for other services that the generic has promised to perform—such as distributing the patented item or helping to develop a market for that item;" (3) payments that reflect "traditional settlement considerations;" or (4) payments that offer "any other convincing justification."[30] And, importantly, as the Third Circuit has held, the preceding list "do[es] not exclude other possible legitimate explanations from also justifying reverse payment settlement agreements."[31] The sum of post-*Actavis* decisions on this point make clear that whether a payment is unjustified is an open-ended inquiry that may be assessed separately or shoehorned into the "amorphous" rule of reason and battled over in the burden-shifting framework.[32] As a consequence, *Actavis* offers litigants flexibility in proffering justifications for the payment. The permissibility of particular justifications has been largely case-specific.

Recently, the Third Circuit shed light on the meaning of "unjustified" in the context of determining whether a challenged settlement posed the potential anticompetitive harm identified by the Supreme Court in *Actavis* (such that the rule of reason analysis applied).[33] Specifically, the court in *Wellbutrin* stated that a No-AG agreement included in the challenged settlement "could [] be said to be unjustified in the sense of being unexplained."[34] The No-AG at issue could be unexplained, according to the court, because it (1) "was not tied to the merits of the litigation" and (2) its duration was "fixed at 180 days, regardless of who prevailed in the case."[35] The court, however, noted that it was making no "comment on whether a no-AG promise could be justified in the sense of being a sound exercise of business judgment and consonant with good public policy."[36]

*Solodyn* is another recent example of note demonstrating the breadth of the "unjustified" inquiry. There, the court declined to exclude the defendant's expert, who opined on the commercial reasonableness of a joint product development agreement executed contemporaneously to the patent litigation settlement.[37] The court credited the defendant's argument

that "whether [the joint product development agreement] was commercially reasonable is relevant to whether the reverse payment was justified."[38] That holds true, the court reasoned, because "antitrust litigation often requires an elaborate inquiry into the reasonableness of a challenged business practice."[39] And, as stated in its denial of the motion in limine, answering the "large and unjustified" question "requires viewing the payment in the context of the facts of the case, which may include business considerations that are less tangible or quantifiable."[40]

The court in *Solodyn* also wrestled with another common explanation to justify a reverse payment: "fair value" for services. Such a justification can be relevant where, in addition to resolving patent litigation, the parties enter into contemporaneous business agreements. Examples of such arrangements that have been challenged as reverse payments include product distribution agreements, pharmaceutical ingredient supply agreements, product development collaborations, and intellectual property licenses.[41] A "fair value" exchange for those services is considered a "traditional settlement consideration" under *Actavis* because "there is not the same concern that a patentee is using its monopoly profits to avoid the risk of patent invalidation or a finding of non-infringement."[42]

Although fair payment for goods and services may not be a "silver bullet against antitrust scrutiny," evidence that such payments are for fair value can justify a payment under *Actavis*.[43] Conversely, evidence that such payments exceed fair value can rebut a defendant's explanation used to justify the payment.[44] But, not surprisingly, what is considered "fair value" is disputed. The court's decision in *Solodyn* on this point is instructive. There, the court rejected plaintiffs' "narrow definition" that fair value "requires 'arms-length, objective, market based measurement' of the services [the generic] promised to perform."[45] The court made clear that other "acceptable methods" exist for calculating fair value and remained unconvinced that a focus on "the brand's perspective of future earnings [under the joint development agreement] is irrelevant to the question of fair value."[46]

Other courts have similarly considered a broad range of evidence in assessing "fair value" for services, including, for example, the economic value to the brand, the brand's need for the services/products it is buying from the generic, and the typicality of the transaction.[47]

## The Rule of Reason

After concluding that antitrust scrutiny attaches to reverse payment settlement agreements, the Supreme Court concluded that such agreements are subject to the rule of reason. In so doing, the Court specifically rejected the "quick look" approach, which, the Court reasoned, is "appropriate only where 'an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets.'"[48] Reverse payment settlements, according to the Court, don't fit that mold. But thereafter the Court's guidance screeched to a halt. The Court concluded that "the structuring of the present rule-of-reason antitrust litigation" is best left to the lower courts. Not surprisingly, lower courts have struggled with and differed on this task.[49]

**[C]ourts have generally adopted one of two overlapping approaches. The first . . . assigns plaintiffs an initial or threshold burden of showing a large and unjustified reverse payment before weighing under the rule of reason analysis alleged anticompetitive effects against alleged procompetitive justifications for the settlement agreement. . . . As for the second approach, other courts have blended the required showing of a large and unjustified reverse payment into the rule of reason.**

To date, courts have generally adopted one of two overlapping approaches. The first—which has been adopted by most courts—assigns plaintiffs an initial or threshold burden of showing a large and unjustified reverse payment before weighing under the rule of reason analysis alleged anticompetitive effects against alleged procompetitive justifications for the settlement agreement.[50] The district court in *Lidoderm* outlined the underpinnings for such an approach: "Most district courts read *Actavis* to hold that it is the 'large and unjustified reverse payment' that creates the anticompetitive concerns, and only after finding such a payment in the settlement may courts engage in the traditional rule of reason analysis."[51] Two recent courts of appeals decisions apply the first approach. The First Circuit in *Loestrin* noted in the context of the appropriate pleading standard, that "plaintiffs must allege facts sufficient to support the legal conclusion that the settlement at issue involves a large and unjustified reverse payment under *Actavis*."[52] Citing to this language, the Third Circuit in *Lipitor* made clear that "if plaintiffs do so, they may proceed to prove their allegations under the traditional antitrust rule-of-reason analysis."[53] Thus, arguably a consensus exists in the First and Third Circuit that plaintiffs must establish a "large and unjustified" reverse payment as a precursor to the rule of reason analysis.

As for the second approach, other courts have blended the required showing of a large and unjustified reverse payment into the rule of reason. For instance, one district court decision, *K-Dur*, expressed "concern[]" that requiring a plaintiff to make a preliminary showing establishing a "large" payment amounts to the "quick look" test *Actavis* rejects.[54] As a result, the court adopted the detailed rule of reason framework articulated by the California Supreme Court in *Cipro*.[55]

Mirroring *Cipro*, *K-Dur* baked in the large and unjustified analysis within the following rule of reason analysis: plaintiffs must first prove an agreement limiting the generic's market entry and that the brand compensated the generic, then defendants must produce evidence showing "the value of litigation costs, products, or services the settlement covered," then plaintiffs must prove that the compensation exceeds "the reasonable value of litigation costs, products, and/or services," and finally the defendant may put forth procompetitive justifications to which the plaintiff can rebut.[56] However, because *K-Dur* preceded the Third Circuit's decision in *Lipitor* (discussed above), it's an open question whether the district court's analysis on this point still holds.

Nevertheless, *Solodyn* offers another example of courts blending "large and unjustified" into the rule of reason. There, the court held that "allegations of a large and unjustified payment are required for plaintiffs to satisfy their initial burden of alleging anticompetitive effects under Section 1."[57] That is proper, the court reasoned, because *Actavis* states "a reverse payment, *where large and unjustified*, can bring with it the risk of significant anticompetitive effects."[58] And, because *Actavis* focuses on "whether a reverse payment could have an anticompetitive effect or whether it was reasonable compensation for litigation costs or the value of services," plaintiffs "must bear this initial burden."[59]

## Antitrust Injury

The Supreme Court in *Actavis* did not address the critical element of antitrust injury[60]—an issue which has proven to be central in the post-*Actavis* landscape. To prove antitrust injury in this context, the plaintiff must show that "the harm they say they experienced . . . was caused by the settlement they are complaining about."[61] In the post-*Actavis* case law, this has typically come to mean that private plaintiffs have the burden of proving that but-for the challenged agreement, generic entry would have occurred earlier.[62] This has proved to be a real, if unforeseen, hurdle as plaintiffs have failed to meet this burden in several cases.[63] To be sure, however, in two instances, district courts have found that the plaintiff proffered sufficient evidence regarding the possible invalidity of the brand's patent to withstand summary judgment.[64]

A notable consideration in the antitrust injury analysis in post-*Actavis* cases is the role of the patent. In *Actavis*, the Court opined that "it is normally not necessary to litigate patent validity to answer the antitrust question,"[65] but the post-*Actavis* landscape is not necessarily as the Court may have envisioned. As Chief Justice Roberts correctly predicted in dissent: "if the patent holder is acting within the scope of a valid patent and therefore permitted to do precisely what the antitrust suit claims is unlawful . . . the defendant (patent holder) will want to use the validity of his patent as a defense—in other words, he'll want to say 'I can do this because I have a valid patent that lets me do this.'"[66] In short, the "turducken task" of "deciding a patent case within an antitrust case about the settlement of the patent case"[67] has worked its way into the application of *Actavis* by the lower courts.[68]

In particular, courts generally concur that patent validity and/or non-infringement is part of the causation analysis necessary to prove antitrust injury,[69] though some courts disagree.[70] This stems from plaintiffs' reliance on two causation theories which directly implicate patent validity and/or non-infringement: (1) that the generic would have prevailed in the underlying patent litigation,[71] and (2) that the generic would have launched at-risk lawfully.[72] A launch "at-risk" takes place before the questions of infringement and validity are resolved, either through litigation or a license.

The relevance of the patent to the first causation theory is self-explanatory. As for the second, most courts agree that to argue that the generic would have launched at risk, the plaintiff must make some evidentiary showing that the generic "would have" or "could have" succeeded in the underlying patent litigation.[73] Put another way, most courts have emphasized that alleging a launch at risk is not enough, it must be a *lawful* launch at risk.[74] *Wellbutrin* underscored this point because it "is beyond fair dispute" that "a regulatory or legislative bar can break the chain of causation in an antitrust case."[75] Moreover, in that decision, the Third Circuit rejected the plaintiff's causation theories "[b]ecause both of the scenarios . . . fail[ed] to show that [the generic] would have been able to launch its 150 mg version of Wellbutrin XL without running afoul of the [the brand's] patent."[76]

Similarly, the First Circuit in *Nexium* found fatal that "the plaintiffs did not present such evidence that the brand-name's patents would have been declared invalid or that an at-risk launch would not have infringed the patents," because "without such evidence, the 'patent served as an independent regulatory bar to [a generic's] launch.'"[77]

Some courts have sought to apply this requirement in earlier stages of the litigation. Two district courts, for example, have held that to survive summary judgment, plaintiffs must come forward with "some evidence" that the generic "could have" prevailed in the patent litigation.[78] On a motion to dismiss, at least one district court has rejected the argument that plaintiffs "must plead that [the brand's] patents would ultimately have been invalidated or found uninfringed."[79] This opinion, however, was issued before the circuit court decisions in *Nexium* and *Wellbutrin*.

## Conclusion

Now five years removed from *Actavis*, the questions emanating from the case still outnumber the answers. Despite this murkiness, several takeaways have emerged from the post-*Actavis* landscape. First, whether a payment is "large" depends on the circumstances of the case and will almost always require more than a rote comparison to saved litigation costs. Second, whether a payment is "justified" is a flexible, fact-specific, and open-ended inquiry. Third, courts are likely to require plaintiffs to prove a "large and unjustified" payment, either as a part of the plaintiff's initial burden in the rule of

reason analysis or as a showing prior to engaging in a rule of reason analysis. And, fourth, despite judicial aversion to "turducken tasks," the patent will likely play a role in the antitrust injury analysis. Beyond that, however, the post-*Actavis* landscape remains the "wild, wild west." ■

[1] 570 U.S. 136, 141, 158 (2013).

[2] *Id.* at 160, 173.

[3] In 2015, the authors analyzed *Actavis*' progeny in the two years following the Court's decision. That analysis encompassed 15 district court opinions, one appellate opinion, and one jury trial. Lisa Jose Fales & Paul Feinstein, *Two Years and Counting Since* Actavis*: Developments in the Law*, ANTITRUST, Fall 2015, at 31–36.

[4] This is not to say that these three issues are the only ones inviting attention from the lower courts. Recently, market power—and specifically, whether the relevant market is limited to the brand and generic version of a drug—has been a focus of several decisions. *See, e.g.*, Mylan Pharm. Inc. v. Warner Chilcott Pub. Ltd. Co. (*Doryx*), 838 F.3d 421, 437–38 (3d Cir. 2016); *In re* Solodyn (Minocycline Hydrochloride) Antitrust Litig. (*Solodyn*), No. 14-md-02503, 2018 WL 563144, at *4–13 (D. Mass. Jan. 25, 2018); United Food & Commercial Workers Local 1776 & Participating Employers Health & Welfare Fund v. Teikoku Pharma USA (*Lidoderm*), No. 14-MD-02521-WHO, 2017 WL 5068533, at *14 (N.D. Cal. Nov. 3, 2017); *In re* Aggrenox Antitrust Litig. (*Aggrenox*), 94 F. Supp. 3d 224, 246 (D. Conn. 2015).

[5] Apotex, Inc. v. Cephalon, Inc. (*Modafinil*), 2:06-cv-02768-MSG, Trial Tr., Day 3, 146 (June 14, 2017).

[6] *See Solodyn*, 2018 WL 734655, at *4; *see also Modafinil*, 2:06-cv-02768-MSG, ECF #1259, Final Jury Instructions, Instr. 9 (July 6, 2017) ("Whether a payment is large depends on the specific facts and circumstances of this case.").

[7] *In re* Lamictal Direct Purchaser Antitrust Litig. (*Lamictal*), 18 F. Supp. 3d 560, 567–68 (D.N.J. 2014), *vacated and remanded*, King Drug Co. of Florence v. Smithkline Beecham Corp., 791 F.3d 388 (3d Cir. 2015); *In re* Loestrin Antitrust Litig. (*Loestrin*), 45 F. Supp. 3d 180, 190–93 (D.R.I. 2014), *vacated and remanded*, 814 F.3d 538 (1st Cir. 2016).

[8] In 2016, the First Circuit spoke twice on the issue. First, in *Loestrin*, the court concluded that "the district court erred in determining that non-monetary reverse payments do not fall under *Actavis*'s scope." 814 F.3d at 549. And, in *Nexium*, the court reiterated that "improper reverse payments may take the form of 'non-monetary' advantages. The language and logic of *Actavis* dictated that outcome." 842 F.3d 34, 41 (1st Cir. 2016). *See also Lamictal*, 791 F.3d at 403–05. And not only do the First Circuit and Third Circuit agree, the district court decisions outside those circuits have also held *Actavis* applies to non-cash payments. *See In re* Actos End Payor Antitrust Litig., No. 13–cv–9244(RA), 2015 WL 5610752, at *13 (S.D.N.Y. Sept. 22, 2015), *rev'd on other grounds*; *Lidoderm*, 74 F. Supp. 3d at 1069–70 (N.D. Cal. 2014) (same). *Cf. In re* Opana ER Antitrust Litig. (*Opana*), 162 F. Supp. 3d 704, 717 (N.D. Ill. 2016).

[9] *See, e.g.*, *Lamitcal*, 791 F.3d at 411; *Opana*, 162 F.3d at 717. Since we last wrote, the Third Circuit has reversed the District Court for the District of New Jersey in *Effexor*, which had dismissed plaintiffs claim for a No-AG as reverse settlement payment. *In re* Lipitor Antitrust Litig. (*Lipitor*), 868 F.3d 231, 274 (3d Cir. 2017). And, on remand from the First Circuit, the District Court for the District of Rhode Island, in *Loestrin*, concluded that because the no-AG exceeded $40 million dollars to the generic, the plaintiffs "plausibly allege[d] that a no-AG agreement is both very valuable to a generic manufacturer (and thus may induce it to stay out of the market) and amounts to a sacrifice by a brand manufacturer, rendering the potential anticompetitive effect plain." 261 F. Supp. 3d 307, 333 (D.R.I. 2017).

[10] *See, e.g.*, *Solodyn*, 2018 WL 563144, *3; *Opana*, 162 F.3d at 716–17; *Modafinil*, 88 F. Supp. 3d at 409.

[11] *See, e.g.*, *Lipitor*, 46 F. Supp. 3d 523, 549 (D.N.J. 2014), *rev'd on other grounds*; *Nexium*, 42 F. Supp. 3d 231, 293 (D. Mass. 2014).

[12] *See, e.g.*, *In re* K-Dur Antitrust Litig. (*K-Dur*), No. 01-cv-1652-SRC, 2016 WL 755623, at *12 (D.N.J. Feb. 25, 2016); *Aggrenox*, 94 F. Supp. 3d at 244; *Modafinil*, 88 F. Supp. 3d at 416–17; *In re* Effexor XR Antitrust Litig., No. CIV.A. 11-5479 PGS, 2014 WL 4988410, at *23 (D.N.J. Oct. 6, 2014), *rev'd on other grounds*, *Lipitor*, 868 F.3d 231 (3d Cir. 2017).

[13] *Actavis*, 570 U.S. at 159.

[14] *See, e.g.*, *Aggrenox*, 94 F. Supp. 3d at 243 ("Even if the payments exceed avoided litigation costs, the *Actavis* factors . . . still matter."); *Modafinil*, 88 F. Supp. 3d at 417 (holding "a reverse payment is sufficiently large (1) if it exceeds saved litigation costs *and* (2) a reasonable jury could find that the payment was significant enough to induce a generic challenger to abandon its patent claim.") (emphasis added); *K-Dur*, 2016 WL 755623, at *12 (implying that largeness requires that, among other things, that consideration "exceeded the estimated cost of litigation *and* the costs of other services and products.") (emphasis added).

[15] *Aggrenox*, 94 F. Supp. 3d at 243.

[16] 162 F. Supp. 3d at 718 (emphasis added).

[17] 2016 WL 755623, at *12. Note that some courts, like the Third Circuit in *Lipitor*, consider litigation costs relevant only to whether a payment is justified. 868 F.3d at 256 ("The alleged reverse payment here was also 'unjustified.' As noted earlier, avoiding litigation costs, providing payment for services, or other consideration may justify a large reverse payment.").

[18] 94 F. Supp. 3d at 243.

[19] In the only other case to go to trial since *Actavis*, the plaintiffs in *Nexium* alleged a payment of up to $690 million, so the precise meaning of "large" was not extensively argued. *Nexium*, 842 F.3d 34, 50 (1st Cir. 2016). That said, in its instructions to the jury, the court did not narrowly limit the meaning of "large." As the court explained: "whether a payment is 'large' depends upon the specific circumstances of a particular case." The court did, however, draw a lower bound: "It's got to be at least more than [the brand's] reasonably estimated save-litigation costs." *Nexium*, 12-md-02409-WGY, Jury Charge, Trial Tr. at 35–36 (D. Mass.).

[20] *See In re* AndroGel Antitrust Litig. (No. II), No. 1:09-MD-2084, 2013 U.S. Dist. LEXIS 174273, at *10 (N.D. Ga. Oct. 23, 2013) ("As much as I would love some guidance from the Eleventh Circuit on how in the heck a trial judge (and a jury) is supposed to apply the *Actavis* decision to an actual case, I doubt that the Eleventh Circuit is going to jump into that briar patch until it has to.").

[21] *See Modafinil*, 2:06-cv-02768-MSG, ECF #1259, Final Jury Instructions, Instr. 9 (July 6, 2017).

[22] *Modafinil*, 88 F. Supp. 3d at 417.

[23] 2:06-cv-02768-MSG, ECF #1259, Final Jury Instructions, Instr. 9, Trial Tr. at 31–32 (July 6, 2017).

[24] *Id.*

[25] *Actavis*, 570 U.S. 136, 148–49 (emphasis added).

[26] *Id.* at 147.

[27] *Solodyn*, 14-md-02503, Pls. Mot. at 1.

[28] *See* ECF #1089, Order: "Court's Rulings on various motions in limine" (Mar. 8, 2018) (quoting *Actavis*, 570 U.S. at 158).

[29] ECF #1089, Order: "Court's Rulings on various motions in limine" (Mar. 8, 2018). (emphasis added); *see also* Barba v. Shire, 2016 WL 3964606, at *4–5 (approving defense expert's analysis comparing the alleged payment to the brand name manufacturer's monthly income from the drug and explaining that the analysis is "not necessarily linked to a determination of *largeness*," but is instead "linked to the *overall* issue of whether the payment is anticompetitive." The weight of this case is limited, however, because it settled prior to the district judge's ruling on the magistrate's Report and Recommendations.

[30] *Actavis*, 570 U.S. at 156.

[31] *Lipitor*, 868 F.3d at 251.

[32] *Actavis*, 570 U.S. at 160 (Roberts, C.J., dissenting).

[33] *In re* Wellbutrin XL Antitrust Litig., 868 F.3d 132, 162 (3d Cir. 2017).

[34] *Id.*

[35] *Id.* at 163.

[36] *Id.* at 163 n.49.

[37] *Solodyn*, 2018 WL 734655, *5.

[38] *Id.* at *4.

[39] *Id.*

[40] *Id.*

[41] *See, e.g.*, *Nexium*, 42 F. Supp. 3d at 261–62.

[42] 570 U.S. at 156.

[43] *See Nexium*, 42 F. Supp. 3d at 263–64 ("The *Actavis* opinion makes it clear that evidence of a fair value exchange can 'redeem[ ]' an otherwise suspicious reverse payment."); *see also K-Dur*, 2016 WL 755623, at *15.

[44] *See Modafinil*, 88 F. Supp. 3d at 419 (agreeing with *Nexium* that "establishing fair market value is just one of many possible defenses available to a Defendant seeking to demonstrate procompetitive justifications for a reverse payment.") (quoting *Nexium*, 42 F. Supp. 3d at 263–64).

[45] *Solodyn*, 2018 WL 734655, at *4, *6.

[46] *Id.* at *6.

[47] *See, e.g.*, *K-Dur*, 2016 WL 755623, at *15–16; *Modafinil*, 88 F. Supp. 3d at 419–21.

[48] *Actavis*, 570 U.S. at 159.

[49] *Compare K-Dur*, 2016 WL 755623, at *13, with *Lidoderm*, 2015 WL 5458570, at *7.

[50] *See, e.g.*, *Lipitor*, 868 F.3d at 253; *Loestrin*, 261 F. Supp. 3d at 338. Relatedly, most courts, in conducting the rule of reason analysis, have maintained that the analysis should focus on the settlement agreement as a whole. *See, e.g.*, *Opana*, 162 F. Supp. 3d at 718.

[51] *Lidoderm*, 74 F. Supp. 3d at 105.

[52] *Loestrin*, 814 F.3d at 552 (1st Cir. 2016). *See also Loestrin*, 261 F. Supp. 3d at 338 ("Plaintiffs have satisfied their burden to allege facts that ["the sum total of the Watson Agreement constituted a large and unjustified payment"] [and] have the reasonable expectation of proving their prima facie case under the rule of reason.").

[53] *Lipitor*, 868 F.3d 231, 252; *see also Lamictal*, 791 F.3d at 412 (holding that under rule of reason analysis the plaintiff is burdened to show pay for delay—"a payment that prevents the risk of competition"—and, if shown, the defendant must show that "legitimate justifications" accompany the challenged conduct (e.g., a payment no more than saved litigation costs, fair value exchange for services) to which the plaintiff can rebut); *Lipitor*, 868 F.3d at 253 ("Because the complaint in [*Lamictal*] plausibly alleged a large and unjustified reverse payment, the plaintiffs there could proceed to prove their claim through 'the traditional rule-of-reason approach.'").

[54] 2016 WL 755623, at *12.

[55] *In re Cipro Cases I & II*, 348 P.3d 845, 863 (2015).

[56] *See K-Dur*, 2016 WL 755623, at *13 (adopting *Cipro*). Before *K-Dur* adopted *Cipro*, however, the court recognized that *Actavis* "gave lower courts further guidance on the application of the rule of reason to reverse payment settlement cases." *K-Dur*, 2016 WL 755623, at *11. That guidance included the following: "antitrust considerations only arise if a 'reverse payment' has occurred, and that the reverse payment in question must be 'large and unexplained.'" *Id.* (quoting *Actavis*, 570 U.S. at 156–59). Thus, the court's criticism of threshold burdens seems puzzling if, as it recognizes, antitrust scrutiny under *Actavis* is not triggered absent a large and unexplained reverse payment.

[57] 2015 WL 5458570, at *7.

[58] *Id.* (quoting *Actavis*, 570 U.S. at 158).

[59] *Solodyn*, 2015 WL 5458570, at *7. *See also Modafinil*, 88 F. Supp. 3d at 416; *Aggrenox*, 2015 WL 1311352, at *9.

[60] Subsequent decisions suggest that this was at least partly due to the fact that the FTC was the plaintiff in *Actavis*, as opposed to a private entity. *See, e.g.*, *Nexium*, 842 F.3d at 60 ("Private plaintiffs and the FTC as government enforcer stand in different shoes . . . . The Supreme Court has consistently held private plaintiffs to this standard of proving both antitrust violation and antitrust injury."); *In re* Wellbutrin XL Antitrust Litig., 133 F. Supp. 3d at 764 ("*Actavis*, however, was brought by the FTC. The FTC faces a different standard of causation in bringing agency antitrust actions such as *Actavis*: the FTC must establish only that the defendant's action is 'likely to cause injury.' Because the FTC Act's causation requirement is broader and more relaxed than the Clayton Act's, no showing of proximate cause is required.") (internal citations omitted).

[61] *Wellbutrin*, 868 F.3d at 164–65.

[62] *See, e.g.*, *Wellbutrin*, *id.* at 151–52 ("[T]o establish an antitrust claim for anticompetitive litigation, the Appellants had to show not only that GSK's litigation was a sham, but also that it caused an antitrust injury by delaying generic competition.").

[63] *See, e.g.*, *Nexium*, 842 F.3d at 65 (affirming district court's grant of summary judgment; and jury verdict in favor of defendants on causation); *Wellbutrin*, 133 F. Supp. 3d at 762 (granting defendants summary judgment).

[64] *Solodyn*, 2018 WL 563144, at *18 ("Plaintiffs have provided 'some evidence' of the invalidity of [the brand's] patent, sufficient to raise a genuine dispute of material fact on this causation theory and overcome Defendants' motion for summary judgment."); *Lidoderm*, 2017 WL 5068533, at *5–12 (finding that plaintiffs met "some evidence" standard for two of their causation theories).

[65] *Actavis*, 570 U.S. at 157.

[66] *Id.* at 171 (Roberts, C.J., dissenting).

[67] FTC v. Watson Pharm., Inc., 677 F.3d 1298, 1315 (11th Cir. 2012), *rev'd and remanded*, *Actavis*, 570 U.S. 136 (2013).

[68] A turducken, a traditional meal in the southern United States but enjoyed everywhere, consists of a deboned duck stuffed in a deboned chicken that is then stuffed in a deboned turkey. *See* Amanda Hesser, *Turducken*, N.Y. Times: Cooking, https://cooking.nytimes.com/recipes/548-turducken.

[69] *See, e.g.*, *Nexium*, 842 F.3d at 63; *Modafinil*, 255 F. Supp. 3d 604, 614 (E.D. Pa. 2017); *Solodyn*, 2018 WL 563144, at *13 (D. Mass. Jan. 25, 2018); *Lidoderm*, 2017 WL 5068533, at *2 (N.D. Cal. Nov. 3, 2017).

[70] For example, the court in *Aggrenox* held that "the salient question is not whether the fully-litigated patent would ultimately be found valid or invalid—that may never be known—but whether the settlement included a large and unjustified reverse payment leading to the inference of profit-sharing to avoid the risk of competition." 94 F. Supp. 3d at 241. *See also Opana*, 162 F. Supp. 3d at 720.

[71] *See, e.g.*, *Wellbutrin*, 868 F.3d at 166; *Nexium*, 842 F.3d at 62; *Modafinil*, 255 F. Supp. 3d at 614; *Solodyn*, 2018 WL 563144, at *13.

[72] *See, e.g.*, *Nexium*, 842 F.3d at 62; *Lidoderm*, 2017 WL 5068533, at *4.

[73] *See Wellbutrin*, 868 F.3d at 165; *Nexium*, 842 F.3d at 62; *Lidoderm*, 2017 WL 5068533, at *4–5; *Solodyn*, 2018 WL 563144, at *13.

[74] *See Wellbutrin*, 868 F.3d at 165 ("It is not enough for the Appellants to show that Anchen wanted to launch its drug; they must also show that the launch would have been legal."); *Solodyn*, 2018 WL 563144, at *13 ("To succeed on an at-risk launch theory, Plaintiffs must show that Impax could have launched at-risk lawfully, i.e., without infringing any lawful patent held by Medicis.").

[75] *Wellbutrin*, 868 F.3d at 165.

[76] *Id.*

[77] 842 F.3d at 63.

[78] *Solodyn*, 2018 WL 563144, at *14 (quoting *Lidoderm*, 2017 WL 5068533, at *4).

[79] *Opana*, 162 F. Supp. 3d at 720; *id.* ("Plaintiffs need not plead (or prove) the weakness of the Endo patents, because the patent's ultimate validity is not at issue."). That court grounded its holding in *Actavis*' refrain that "it is normally not necessary to litigate patent validity" because "[a]n unexplained large reverse payment itself would normally suggest that the patentee has serious doubts about the patent's survival." *Id.* The court, in *Aggrenox*, similarly held that "the salient question is not whether the fully-litigated patent would ultimately be found valid or invalid—that may never be known—but whether the settlement included a large and unjustified reverse payment leading to the inference of profit-sharing to avoid the risk of competition." 94 F. Supp. 3d at 241.

# *Doryx*, *Namenda*, and Coercion: Understanding and Un-Tying Product-Hopping Litigation

BY JACK E. PACE III AND KEVIN C. ADAM

WHAT IS MORE DANGEROUS TO competition, pharmaceutical "product hopping" or attempts to prevent it? This article will not answer that question because the answer depends on the product involved, the test the court applies to evaluate the defendant's conduct, and other factors. And that uncertainty is precisely the problem.

"Product hopping" is the pejorative term, adopted here for the sake of simplicity, for a pharmaceutical manufacturer's launch of a new version of a product and, in some cases, subsequent discontinuation of the older version. Courts evaluating antitrust challenges to product hopping have faced a variety of facts, but all the courts' decisions share a common thread: they each required the plaintiff to prove customer "coercion" by the defendant—a concept familiar to antitrust practitioners who have been involved with product tying arrangements. But the courts do not appear to have evaluated, in the first instance, whether the competitive effects of tying are sufficiently similar to the effects of product hopping to justify using the same test. And the use of an ambiguous coercion test in the product-hopping context risks creating inconsistent results and uncertainty for drug manufacturers, which is troubling because product-hopping litigation involves not only the launch of new products (an area that antitrust law promotes and the FDA protects) but also health care (an area Congress protects, or at least regulates heavily).

In the discussion below, we attempt to synthesize the case law on antitrust challenges to product hopping, take a closer look at the coercion requirement and whether it makes sense in the context of product hopping, and offer a few proposals to bring greater certainty to courts, clients, and practitioners involved in these cases.

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## "Product Hopping" and the Regulatory Landscape

Replacing one product with another is not obviously anticompetitive and very likely could be procompettive. So to understand why product hopping might be seen to violate the antitrust laws requires understanding a few things about the laws governing the marketing of pharmaceuticals in the United States, particularly the 1984 Drug Price Competition and Patent Term Restoration Act (Hatch-Waxman Act) and the state laws on drug substitution in pharmacies.

***Hatch-Waxman Act.*** The Hatch-Waxman Act permits a generic drug manufacturer seeking Food and Drug Administration (FDA) approval to launch a generic version of an approved drug to submit an Abbreviated New Drug Application (ANDA) and attempt to demonstrate that its generic drug is "bioequivalent" to the reference-listed drug.[1] Under the Act, if the generic drug is bioequivalent, then the generic manufacturer may obtain approval to market the drug without conducting the lengthy and expensive clinical trials that the brand manufacturer was required to conduct for its New Drug Application (NDA). ANDA filers typically seek permission to refer to products as "AB-rated" or "pharmaceutically equivalent" to a reference brand drug—that is, the generic version contains the same active ingredient and is the same strength, route of administration, and dosage form.[2]

The Hatch-Waxman Act does not prohibit pharmaceutical product hopping but instead may, when coupled with other regulations, require brand manufacturers to inform the FDA if and when they plan to withdraw a product from the market.[3] Congress has amended the Act several times during the last 35 years and never included any language prohibiting product hopping or otherwise limiting new-product introductions or old-product discontinuations.

The absence of product-hopping restrictions in Hatch-Waxman seems deliberate. For example, in 2009, Congress enacted product-hopping limits in the context of biologics—but not pharmaceuticals—when it included limits on

exclusivity for minor product reformulations in the Biologics Price Competition and Innovation Act of 2009 (BPCIA), which functions like the Hatch-Waxman Act for biologic products.[4] The district court in one prominent product-hopping case, *Doryx*, acknowledged Congress's decision not to legislate in this area, writing that "Congress certainly could have created barriers to brand-name drug changes that could delay generic entry, but, perhaps understanding the adverse effects this could have on innovation, it did not."[5]

***State Substitution Laws.*** Most states have enacted laws dictating when a generic version of a drug may, or must, be substituted for a brand drug by the pharmacist.[6] Many of these state substitution laws allow for the automatic substitution of generics as long as they are AB-rated to the prescribed brand drug.[7]

Plaintiffs in product-hopping cases often allege that replacing an old version of a brand drug with a new one is contrary to the "spirit" of the laws described above.[8] Plaintiffs contend that a "minor" modification to an existing drug could mean that the new product is no longer AB-rated to the old version, and thus generic versions of the old product might not be automatically substituted in the pharmacy when the new product is prescribed. But this concern does not apply in every state, as several states allow automatic pharmacy substitution between drugs that are not AB-rated to one another.[9] Moreover, to date, no plaintiff in a product-hopping case has offered a clear framework for determining when a product change is so "minor" as to violate the "spirit" of state substitution laws or the Hatch-Waxman Act.

***The Alleged "Price Disconnect."*** Some plaintiffs in product-hopping cases have argued that a "price disconnect" makes health care different than other markets and therefore in need of different antitrust rules. Plaintiffs argue that physicians are indifferent to the prices of the medicine they prescribe and therefore are too willing to prescribe a new version of a brand drug even when a cheaper generic version is available.[10]

But the behaviors of health care industry participants appear to paint a different picture. In today's prescription drug market, everyone in the distribution chain—from wholesalers and retailers to pharmacy benefit managers (PBMs), insurers, doctors, and patients—is price sensitive and works to ensure the lowest price possible for drugs. For example, PBMs negotiate aggressively with brand drug manufacturers for substantial rebates in exchange for favorable placement on the PBMs' formularies, which are lists of drugs that insurance companies are willing to cover and the copay level for each drug.[11] Losing favorable placement on a formulary to a competing product can devastate a manufacturer's bottom line, so price competition for formulary placement through rebates to PBMs is fierce. Large health insurers also focus on drug prices, contracting with PBMs to negotiate rebates, implementing the heavily negotiated formularies for their health plans, and employing a number of other controls to reduce costs.

Similarly, retail chains and pharmacies obtain greater margins on the sale of generic drugs than on brand drugs and thus are incentivized to encourage substitution of brand prescriptions with generic alternatives whenever possible, often by contacting doctors directly to modify existing prescriptions.[12] Doctors are also well aware of the relative price of brand drugs compared to other brands in the therapeutic category and the available generic alternatives.[13] Indeed, when a patient's insurance plan does not cover a drug, requires a patient to first try a different drug (i.e., step edit), calls for additional permissions from his or her doctor (i.e., prior authorization), or requires a high patient copay, it is the doctor who gets the call from the pharmacy to modify the patient's prescription. And with the growth of e-prescribing, doctors often know what drugs are covered by a patient's insurance program and the patient's copay obligation with just a click of a tablet.[14] Finally, patients today are more aware than ever of drug prices, what drugs their insurance companies will cover, their premiums, and how their copays may vary from drug to drug.

As in any regulated market, Congress and the courts adjudicating pharmaceutical antitrust claims are left to balance the need to prevent anticompetitive conduct with the need to preserve the incentive for manufacturers to invest in new treatments. In doing so, however, courts must confront what the D.C. Circuit called the "challenge for an antitrust court," which is to "stat[e] a general rule for distinguishing between exclusionary acts, which reduce social welfare, and competitive acts, which increase it."[15]

## Reconciling the "Product-Hopping" Case Law

In recent years, plaintiffs have filed several antitrust challenges based on the theory of product hopping, alleging defendants sought to stifle generic competition by introducing new versions of brand drugs and, in some instances, discontinuing older versions.[16] Only two such cases, however, have reached the federal courts of appeals: *New York v. Actavis, PLC* (*Namenda*)[17] and *Mylan Pharmaceuticals, Inc. v. Warner Chilcott* (*Doryx*).[18] The Second Circuit in *Namenda* ruled for the plaintiff, affirming a preliminary injunction that required the brand manufacturer to continue selling an old version of its drug until one month after generics were permitted to enter the market. The Third Circuit in *Doryx* ruled for the defendant, affirming the dismissal of the plaintiffs' claims on summary judgment because the defendant's introduction of new versions, and later discontinuation of older versions, did not prevent generic manufacturers from entering the market and competing. Despite the different outcomes, the decisions can be reconciled given the cases' procedural posture and the particular facts in *Namenda*.

***Namenda.*** In 2014, the New York Attorney General's Antitrust Bureau sued Forest Laboratories (owned at the time by Actavis) seeking to enjoin Forest from following through on its announced plan to launch a new, once-daily version of its Namenda Alzheimer's medication, Namenda XR (extend-

ed release), and transition away from the older, twice-daily version, Namenda IR (immediate release). In December 2014, following expedited discovery, Judge Robert Sweet of the Southern District of New York granted the Bureau's request for a preliminary injunction, thereby preserving the status quo by requiring Forest to continue selling Namenda IR until July 2015, one month after the FDA approved the first generic version of Namenda IR to be sold.[19]

Forest appealed the injunction, arguing that its proposed transition to once-daily Namenda XR was neither anticompetitive nor exclusionary under Section 2 of the Sherman Act. The Second Circuit affirmed the district court's ruling.[20] The Second Circuit relied on *Berkey Photo, Inc. v. Eastman Kodak Co.*[21] in holding that while neither product withdrawal nor product improvement alone is anticompetitive, the combination of a product transition with additional conduct that "coerces" consumers to switch to the new product may be.[22]

***Doryx.*** Unlike *Namenda*, which involved a lawsuit to prevent an alleged product hop before it happened, *Doryx* was an action for damages over past alleged product hops.[23] Plaintiff Mylan, a competitor generic manufacturer, argued that Warner Chilcott's reformulations of its acne drug Doryx delayed generic competition by making it difficult for competing manufacturers to "keep pace with" new versions of Doryx.[24] The alleged product hopping included a change from capsules to tablets, the introduction of new dosage strengths, and the addition of a scoring line to allow for breaking of the tablet—along with the discontinuation of older versions of Doryx. In April 2015, Judge Paul Diamond of the Eastern District of Pennsylvania granted summary judgment in favor of defendant Warner Chilcott, concluding that:

> Defendants did not exclude competition when they reformulated Doryx, introduced new versions of Doryx into the marketplace, marketed the new versions of Doryx, and withdrew old versions. . . . Mylan remains able to reach consumers through, *inter alia*, advertising, promotion, cost competition, or superior product development. Mylan instead seeks to take advantage of generic substitution laws and thus increase its profits. Defendants have no duty to facilitate Mylan's business plan by keeping older versions of branded Doryx on the market.[25]

Judge Diamond also pointed out the risk of deterring innovation by policing the introduction of new drugs, noting that "Mylan's theory also risks slowing or even stopping pharmaceutical innovation. The prospect of costly and uncertain litigation every time a company reformulates a brand-name drug would likely increase costs and discourage manufacturers from seeking to improve existing drugs."[26]

Mylan appealed, and in September 2016 the Third Circuit affirmed, concluding that "Mylan's claims fail under a straightforward application of the *Microsoft Corp.* framework"—which was used in *United States v. Microsoft* to evaluate the government's rule of reason claim and which rquired the plaintiffs to first establish that conduct is anticompetitive before the burden shifted to the defendant to justify that conduct—"because Mylan has failed to produce evidence that Defendants' conduct was anticompetitive."[27] The Third Circuit distinguished *Namenda* by highlighting that "there were no patent cliffs on the horizon, and the evidence demonstrates that there were plenty of other competitors already in the oral tetracycline market."[28] The Third Circuit also noted, much like the Second Circuit in *Namenda*, that certain "insignificant design or formula changes, *combined with other coercive conduct*, could present a closer call with respect to establishing liability in future cases."[29]

***The Takeaway.*** Though at first glance *Namenda* and *Doryx* may appear to be in conflict, even "irreconcilable,"[30] the two decisions are consistent, reflecting the application of the same legal framework to unique sets of facts. Both cases employed the burden-shifting framework outlined in *United States v. Microsoft Corp.*,[31] first requiring plaintiffs to establish that the defendants' alleged conduct was exclusionary, and then, if necessary, requiring the defendants to offer procompetitive benefits to be weighed against the potential anticompetitive effects. Both cases also held that discontinuing a pharmaceutical product in favor of a new product, without more, is not anticompetitive. *Namenda* and *Doryx* confirmed that the courts should apply the antitrust laws to alleged product hopping only when that conduct is combined with some other "coercive" conduct designed to "force" patients to the new product against their will—an inquiry that necessarily requires an assessment of other reasonable alternatives available for those patients. Additionally, *Doryx* confirms that when the case involves an alleged product hop that already occurred, which was not the case in *Namenda*, the appropriate liability question is whether the brand manufacturer's conduct somehow "foreclosed" or "prevented" a competitor from being able to market a generic version,[32] and not simply whether the competitor failed to get the benefit of automatic substitution under certain state laws.

## The Role of "Coercion" in Product-Hopping Cases

***The Coercion Requirement.*** Every court evaluating a product-hopping antitrust claim has required the plaintiffs to show that the defendants' conduct "coerced" customers. The opinions make clear that simply replacing one product with another—short of additional, "coercive" conduct—is not sufficient for a finding of antitrust liability. Indeed, even the Second Circuit in *Namenda*, ruling in an emergency preliminary injunction setting on a limited record, required that the plaintiff show that the defendant's alleged product-hopping "coerce consumers":

> Certainly, neither product withdrawal nor product improvement alone is anticompetitive. But under *Berkey Photo*, when a monopolist *combines* product withdrawal with some other conduct, the overall effect of which it to coerce consumers rather than persuade them on the merits, *id.* at 287, and to impede competition, *id.* at 274–75, its actions are anticompetitive under the Sherman Act.[33]

The Second Circuit reviewed past cases "evaluating a monopolist's product redesign" and noted that every decision in those cases was "in accord" with the Second Circuit's "emphasis on consumer coercion."[34] *Allied Orthopedic* (Ninth Circuit) (challenge to new version of pulse oximetry sensors and monitors), *In re Suboxone (Buprenorphine Hydrochloride and Naloxone) Antitrust Litigation* (E.D. Pa.) (new version of Suboxone opioid addition treatment), *Abbott v. Teva* (D. Del.) (new version of TriCor cholesterol medication), *Mylan v. Warner Chilcott* (new version of Doryx acne treatment), and *Walgreen v. AstraZeneca* (new version of Prilosec heartburn medication) all required the plaintiffs to prove that the defendant's discontinuation of one product in favor of a new product "forced" or "coerced" customers to the new product.[35]

Though the harm allegedly caused by "coercion" of customers is outside the traditional concerns of antitrust because it essentially is marketing to increase demand and does not restrict supply,[36] coercion is alleged to be a concern of the antitrust laws because it can eliminate or reduce consumer choice.[37] But eliminating or reducing choice alone is not an antitrust violation, as various types of legitimate competition—such as driving competitors out of business with better quality products or lower prices—may reduce the number of choices available to consumers. So what is the basis for the courts' reliance on "coercion" in the product-hopping context?

The answer appears to be courts' familiarity with coercion from cases evaluating tying arrangements. Several courts evaluating antitrust challenges to product-hopping cite the language regarding "coercion" or "forcing" customers from tying cases and then follow a similar approach.[38] But concerns about coercion in the tying context do not necessarily squarely apply in the product-hopping context.

***Coercion's Heritage in Tying Cases.*** Early tying cases used terms like "coercion" and "forcing" to describe a seller's attempt to leverage its power in one product market into power in a second market.[39] But the leveraging theory used in these early decisions was criticized and ultimately rejected in favor of the approach taken in *Jefferson Parish*.[40] There, the Supreme Court held that the harm caused by tying was not that the seller would gain power in a new market, but instead that "the economic effect . . . condemned by the rule against tying . . . is that [the tying seller] has foreclosed competition on the merits in a product market distinct from the market for the tying item."[41]

The theme of protecting "competition on the merits" continued into the Supreme Court's tying decision in *Eastman Kodak Co. v. Image Technical Services, Inc.*, but with an emphasis on deception.[42] There, the plaintiffs, who competed with Kodak in servicing Kodak equipment, challenged Kodak's refusal to sell them Kodak parts. The plaintiffs characterized Kodak's refusal as a tying arrangement, i.e., that Kodak "unlawfully tied the sale of service for Kodak machines to the sale of parts."[43] The Court confirmed that it would evaluate the plaintiffs' tying claim by measuring the extent of any alleged coercion, or "forcing," of customers to the other product, quoting *Jefferson Parish*:

> The essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer e*ither did not want at all, or might have preferred to purchase elsewhere on different terms*. When such "*forcing*" is present, competition on the merits in the market for the tied item is restrained and the Sherman Act is violated.[44]

The Court adopted the lower court's conclusion that Kodak's "[c]ustomers were *forced to switch* to Kodak service even though they preferred ISO service."[45]

Importantly, in explaining why Kodak's conduct was anticompetitive, the Court highlighted that Kodak's customers potentially were deceived into making purchases that the Court believed were undesirable.[46] The Court rejected Kodak's argument that tying of Kodak equipment with service could be seen as net-procompetitive because Kodak failed to show that customers actually were aware of the "total cost of the 'package'" that Kodak argued reflected a net, "overall competitive price."[47] Concluding that the information necessary for a Kodak customer to make an informed decision "is difficult—some of it impossible—to acquire at the time of purchase,"[48] the Court was comfortable second-guessing customers' purchases as "forced unwanted purchases."[49]

## Limitations of Finding Coercion in a Product-Hopping Case

Based on the way in which the coercion test has been interpreted by courts in tying cases, the test does not seem appropriate in the context of product hopping.

In the tying context, the Supreme Court has explained that coercion can harm competition when it "force[s] unwanted purchases" upon customers unable to make informed purchasing decisions.[50] But product-hopping arguably does not involve concealing any relevant information. The manufacturer's switch—be it a "hard switch" or "soft switch"[51]—is public and even publicized, as is all the relevant information about the drugs and their costs. Thus, to the extent that coercion from forcing unwanted purchases arises from a lack of relevant information that concern is lessened in the product-hopping context. A manufacturer replacing an older pharmaceutical product with a new version not only markets the new version aggressively but also typically advertises that the old version is being replaced.[52] The manufacturer also may be required to inform the FDA of the withdrawal of the old version of the drug, which leads to additional public reporting of the manufacturer's switch from old to new.[53] And many pharmaceutical manufacturers discuss, even tout, their plans to transition to new products in presentations to investors and analysts.[54]

But several courts nonetheless have found that product hopping was "coercive," or at least that the plaintiffs plausibly alleged coercion sufficient to survive a motion to dis-

miss.[55] But what does that tell us about the effects on competition? Not much, it turns out. So far, of the two product-hopping cases to reach the federal courts of appeal, the Second Circuit in *Namenda* is the only one that found coercion,[56] and arguably that finding has limited applicability to other cases.[57]

Specifically, the finding of coercion in *Namenda* was limited to the unique product market for the sale of Alzheimer's treatments at issue in that case. The court made clear that "[d]etermining whether Defendants' actions are unlawfully anticompetitive" depended in part on the "peculiar characteristics of treatment for Alzheimer's disease."[58] At least for purposes of a preliminary injunction to preserve the status quo, the court found that the uniqueness of Namenda compared to other Alzheimer's treatments would have made the withdrawal of the old version potentially coercive because it could "*force*[] patients to switch" to Namenda XR (the new version), "the only other memantine drug on the market."[59] Because defendants did not appeal the issue of relevant market—another unique aspect of the litigation—the Second Circuit accepted the district court's findings regarding the product market and concluded that "other available Alzheimer's drugs, all CIs [acetylcholinesterase inhibitors], are not substitutes for Namenda because they perform different medical functions and are not designed to treat moderate-to-severe Alzheimer's disease."[60] The Second Circuit also accepted the district court's findings, which the defendants contested, that the unique features of the Alzheimer's disease population also meant that elderly patients who tried the new version allegedly would "be very unlikely to switch back" to the old version, even if generic versions of the old version were available.[61] Thus, the court held that the defendants' potential conduct could amount to coercion and therefore was anticompetitive.[62]

*Namenda*'s product-market-dependent finding of coercion is unlike other product-hopping cases, which typically have involved products in crowded markets in which interchangeable brands compete for prescriptions.[63] So where a product-hopping challenge does not involve the unique market conditions involved in *Namenda*, coercion will be much more difficult to prove.

## A Better Approach

If coercion is not the right test of product hopping, then what is? In the wake of *Namenda* and *Doryx*, there has been no shortage of discussion on how courts should evaluate product-hopping claims. Practitioners, judges, academics, and even former FTC officials have proposed "guidelines," "tests," or "safe harbors" for courts to consider.[64] But, to date, no court has adopted clear guidance indicating when and in what circumstances a pharmaceutical manufacturer may replace a product with a new product without potentially incurring antitrust liability. Instead, courts have attempted to answer on a case-by-case basis questions, such as whether a new product represents a mere "tweak" of an old product or the next Moon landing, whether the brand manufacturer actually "foreclosed" or "prevented" generic competition, and whether customers were (or would be) "coerced" to buy the new product based on the lack of therapeutic substitutes.

Requiring judges and juries to answer these questions is likely to lead to inconsistent rulings and create uncertainty that could threaten innovation. Indeed, courts have acknowledged that they are not qualified to evaluate the potential benefits of new products.[65] Specifically, while judges and juries may regularly evaluate the competitive effects of conduct retrospectively, it is another issue altogether for them to assess how a new pharmaceutical product may perform in the market, how patients and doctors may use that product, and whether that new product will end up being "innovative enough" in the future to avoid antitrust exposure in the present. The Supreme Court has made clear that "[n]ew products and new brands are essential to a dynamic economy."[66] Similarly, in *Microsoft*, the court noted that "[a]ntitrust scholars have long recognized the undesirability of having courts oversee product design," where "any dampening of technological innovation would be at cross-purposes with antitrust law."[67] This suggests that any legal test that attempts to measure, and potentially punish, innovation should be as accurate and restrained as possible.

The test should give clear guidance to courts, pharmaceutical manufacturers, and litigants, while at the same time preventing the supposed harm (i.e., disrupting "competition on the merits" through deception) caused by customer "coercion." The proposal on a product-hopping standard that comes closest to effectuating these goals is one offered by Judge Douglas Ginsburg of the D.C. Circuit Court of Appeals and Professor Joshua Wright, former FTC Commissioner, in a 2015 comment to proposed "product switching" rules in Canada.[68] In that comment, they argued that "a competition law sanction on product switching" is appropriate only in the face of "clear and convincing objective evidence that [the new product] represents a sham innovation with zero or negative consumer benefits."[69] This rule is consistent with the Supreme Court's concern about the potential anticompetitive harm of coercion, as it would prohibit deception by a brand manufacturer engaging in "sham innovation." The standard also finds support in the case law; for example, requiring clear and convincing evidence that conduct is fraudulent or sham is commonplace in *Walker Process* fraud antitrust cases.[70] Finally, requiring clear and convincing, objective evidence of "sham innovation" arguably would result in more-consistent case law than an assessment of "coercion," which may vary from case to case, and therefore threatens to discourage innovation in the pharmaceutical industry.

## Practical Guidance

Though product-hopping law is still developing, one can identify a few guidelines to minimize the risk of antitrust exposure for manufacturers deciding whether to invest in new versions of products and transition away from older versions:

- **Tell the truth.** The antitrust issue with coercion in tying cases was the market distortion caused by customers deceived into making "unwanted purchases." Even under the Ginsburg-Wright approach, "sham innovation" could give rise to antitrust liability. Thus, carefully scrutinize representations about your new and old versions of the drug.
- **Write it down.** Document the benefits of your innovation. Too often the obvious benefits of a new version of a pharmaceutical product (greater dosing flexibility, improved coating, and others) are assumed to be self-evident in internal company documents. But that allows others to fill the void, years later in litigation, by second-guessing the benefits of the new product. Thus, where possible, memorialize the benefits of the new product in marketing plans and other documents.
- **Try to avoid "some other conduct."**[71] *Namenda* and every other decision in a product-hopping case make clear that replacing one product with another is not anticompetitive unless "combine[d]" with additional conduct deemed coercive. In *TriCor*, the additional conduct allegedly included removing the National Drug Data File codes that showed pharmacists that the old version of TriCor existed.[72] In *Suboxone*, the additional conduct allegedly included misrepresentations to doctors about the safety of the old product—to encourage them to stop prescribing it.[73]
- **Patents.** In the rare situation in which the old version of your product is not protected by patents, you have great flexibility to control the timing of your replacement of the old product with the new and improved version. Without patent protection, the old version of the product would have been open to generic competition well before the new version was launched, and therefore a plaintiff could not reasonably argue that you launched the new version to avoid generic competition. ■

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[1] The FDA has defined bioequivalence as "the absence of a significant difference in the rate and extent to which the active ingredient or active moiety in pharmaceutical equivalents or pharmaceutical alternatives becomes available at the site of drug action when administered at the same molar dose under similar conditions in an appropriately designed study." U.S. Food & Drug Admin., Center for Drug Evaluation and Research, Guidance for Industry: Bioavailability and Bioequivalence Studies for Orally Administered Drug Products—General Considerations (2003); *see also* 21 U.S.C. § 355(j)(2)(A)(iv).

[2] *See, e.g.*, Benjamin M. Miller, *Product Hopping: Monopolization or Innovation*, 22 B.U. J. Sci. & Tech. L. 89, 98–99 (2016) (providing overview of requirements); *see also* U.S. Dep't of Health & Human Servs., FDA, Approved Drug Products with Therapeutic Equivalence Evaluations vii–x (35th ed. 2015), http://1.usa.gov/1PzbMxF (the "Orange Book"). Generic versions of pharmaceuticals nonetheless are the same as the reference brand products, though bioavailability may be anywhere between 80 and 125% of the brand. *See* C. Andrade, *Bioequivalence of Generic Drugs: A Simple Explanation for a US Food and Drug Administration Requirement*, 76 J. Clin. Psychiatry 742 (2015).

[3] *See, e.g.*, 21 C.F.R. § 314.81. After the manufacturer notifies the FDA of a product withdrawal, the fact of the withdrawal is reported publicly in the Federal Registrar, and the FDA may require the manufacturers to make additional public announcements if the drug is being withdrawn from the market for safety reasons. *See* 21 C.F.R. §§ 314.153 (b), 314.161, 314.162.

[4] Darren S. Tucker & Gregory F. Wells, *Emerging Competition Issues Involving Follow-on Biologics*, Antitrust, Fall 2014, at 100, 105 ("The BPCIA's legislative history indicates that Congress was aware of product hopping considerations and attempted to address one potential avenue for product hopping."); 42 U.S.C. § 262(k)(7)(C).

[5] Mylan Pharm., Inc. v. Warner Chilcott Pub. Ltd. Co., No. 12-3824, 2015 U.S. Dist. LEXIS 50026, at *43–44 (E.D. Pa. Apr. 16, 2015) ("[T]he Act is silent on product hopping. . . . Congress certainly could have created barriers to brand-name drug changes that could delay generic entry, but, perhaps understanding the adverse effects this could have on innovation, it did not. Courts should not seek to substitute their 'legislative judgment' for that of Congress.").

[6] *See* Jesse C. Vivian, *Generic-Substitution Laws*, US Pharmacist (June 19, 2008), https://www.uspharmacist.com/article/generic-substitution-laws.

[7] Joanna Shepherd, *Deterring Innovation:* New York v. Actavis *and the Duty to Subsidize Competitors' Market Entry*, 17 Minn. J.L. Sci. & Tech. 663, 686–88 (2016).

[8] New York v. Actavis, PLC, 2014 U.S. Dist. LEXIS 172918, at *122 (S.D.N.Y. Dec. 11, 2014) ("The hard switch violates the spirit of the Hatch-Waxman Act and the public policy underlying it.").

[9] *See* Vivian, *supra* note 6.

[10] Michael A. Carrier & Steve D. Shadowen, *Product Hopping: A New Framework*, 92 Notre Dame L. Rev. 167, 179–80 (2016).

[11] *See* Shepherd, *supra* note 7, at 688; *see also* Haiden Huskamp et al., *The Effect of Incentive-Based Formularies on Prescription-Drug Utilization and Spending*, 349 N. Engl. J. Med. 2224, 2230 (2003); Thomas S. Rector, *Effect of Tiered Prescription Copayments on the Use of Preferred Brand Medications*, 41 Med. Care 398, 398–99 (2003) ("Health plans are increasingly using more open drug formularies that offer differential prescription copayments as an incentive to enrollees to use brands that plans prefer.").

[12] *See, e.g.*, Adam J. Fein, *Surprise? CMS Computes and Publishes Pharmacy Prescription Profit Margins*, Drug Channels (Dec. 11, 2012), http://www.drugchannels.net/2012/12/surprise-cms-computes-and-publishes.html (noting pharmacies incentivized to dispense generic drugs where "[g]ross margins on brand prescriptions average about 10%, while gross margins on generic prescriptions average about 50%.").

[13] Chuck Farkas & Tim van Biesen, *The New Cost-Conscious Doctor: Changing America's Health Care Landscape*, Bain & Company: Insights (Mar. 4, 2011), http://www.bain.com/publications/articles/the-new-cost-conscious-doctor.aspx (noting physicians understand generic equivalents and generic therapeutic alternatives cost patients and health plans less than brand name drugs) ("Increasingly aware and concerned about the growing cost of healthcare, for the first time a majority of physicians show an increased willingness to consider the cost implications of the products they use. They recognize a pressing need to adjust their clinical practices to accommodate healthcare cost considerations."); *see also* Linda L. Barret, *Physicians' Attitudes and Practices Regarding Generic Drugs*, AARP (Mar. 2005), https://www.aarp.org/health/conditions-treatments/info-2005/physicians_attitudes_and_practices_regarding_gener.html.

[14] *See, e.g.*, Michael A. Fisher et al., *Effect of Electronic Prescribing with Formulary Decision Support on Medication Use and Cost*, 168 Arch. Intern. Med. 2433, 2433–34 (2008) (concluding "[c]linicians using e-prescribing with FDS were significantly more likely to prescribe tier 1 medications, and the potential financial savings were substantial."). The reliance on e-prescribing to minimize patient and insurer costs has increased considerably since 2008.

[15] United States v. Microsoft Corp., 253 F.3d 34, 58 (D.D.C. 2001).

[16] *See, e.g.*, Abbott Labs v. Teva Pharm USA, Inc., 432 F. Supp. 2d 408 (D. Del. 2006) (*TriCor*); Walgreen Co v. AstraZeneca Pharm LP, 534 F. Supp. 2d 146

(D.D.C. 2008) (*Prilosec*); *In re* Suboxone (Buprenorphine Hydrochloride and Naloxone) Antitrust Litig., 64 F. Supp. 3d 665 (E.D. Pa. 2014) (*Suboxone*); Sergeants Benevolent Ass'n Health & Welfare Fund v. Actavis, PLC, No. 15-cv-6549 (CM), 2016 U.S. Dist. LEXIS 128349 (S.D.N.Y. Sep. 13, 2016); *In re* Asacol Antitrust Litig., Civil Action No. 15-cv-12730-DJC, 2017 U.S. Dist. LEXIS 186009 (D. Mass. Nov. 9, 2017).

[17] New York v. Actavis, PLC (*Namenda*), 787 F.3d 638, 643 (2d Cir. 2015).

[18] 838 F.3d 421 (3d Cir. 2016).

[19] *Actavis*, 2014 U.S. Dist. LEXIS 172918, at *2.

[20] *Namenda*, 787 F.3d at 663.

[21] 603 F.2d 263 (2d Cir 1979).

[22] *Namenda*, 787 F.3d at 654.

[23] Mylan Pharm. Inc. v. Warner Chilcott Pub. Ltd. Co. (*Doryx*), 838 F.3d 421, 438 (3d Cir. 2016).

[24] Complaint ¶ 71, Mylan Pharm., Inc. v. Warner Chilcott Pub. Ltd. Co., No. 12-3824, Doc. No. 1 (E.D. Pa. July 6, 2012).

[25] *Mylan*, 2015 U.S. Dist. LEXIS 50026, at *34, 40 (citing Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 415 (2004)); *see also id.* at *48–49 ("Although Mylan had numerous opportunities to market generic Doryx, it waited until the sales of branded Doryx were so great that huge generic sales—buoyed by regulatory compulsion—were assured. Defendants' efforts to deny Mylan this regulatory windfall were hardly predatory. On the contrary, these efforts have compelled pharmaceutical giant Mylan to compete against much smaller Warner Chilcott and Mayne on the merits and price of its products.").

[26] *Id.* at *43; *see also id.* at *48 ("Mylan's reading of the Sherman Act would not only require federal courts to serve as FDA adjuncts, it would strongly discourage pharmaceutical development and innovation. Finally, giving generics a regulatory "preferred place" would not necessarily reduce drug prices.").

[27] *Doryx*, 838 F.3d at 441–42.

[28] *Id.* at 440.

[29] *Id.* (emphasis added).

[30] Lindsey M. Edwards, Namenda *and* Doryx, Intellectual Property Comm. Newsl. 22 (ABA Section of Antitrust Law) (July 2017) ("The Second Circuit and Third Circuit opinions appear to be irreconcilable in several ways."). Several aspects of the Second Circuit's *Namenda* decision, however, do appear inconsistent with precedent, including from the U.S. Supreme Court. First, the Second Circuit adopted the trial court's finding that "competition through state drug substitution laws is the only cost-efficient means of competing available to generic manufacturers." *Namenda*, 787 F.3d at 655 (emphasis added). That finding ignores significant evidence, recognized by the *Doryx* court, that generic drug manufacturers, who often sell brand drugs as well, have many efficient ways of marketing their products and competing with brands. *Mylan*, 2015 U.S. Dist. LEXIS 50026, at *35–37. State substitution laws simply are not the only efficient means of competition available to generic manufacturers. Second, the *Namenda* court held that the Sherman Act "requires [brand manufacturers] to allow generic competitors a fair opportunity to compete using state substitution laws." *Namenda*, 787 F.3d at 658. Such a finding is contrary to Supreme Court precedent confirming that the Sherman Act does not impose a duty to help one's rivals. *See* Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 415 (2004). Last, the *Namenda* court agreed with the surprising proposition that a court can step in and require not only that a patent holder practice its patent (forcing a manufacturer to sell a patented drug), but also that the defendant manufacture and sell a product it does not want to make and sell—something unheard of outside of wartime. *See* United States v. Microsoft Corp., 110 F. Supp. 295 (D. Mass. 1953); *see also* Joshua D. Wright & Judge Douglas H. Ginsburg, Comment of U.S. Federal Trade Commissioner Joshua D. Wright and Judge Douglas H. Ginsburg on the Canadian Competition Bureau's Draft Updated Intellectual Property Enforcement Guidelines (Aug. 2015), https://www.ftc.gov/public-statements/2015/08/comment-commissioner-joshua-d-wright-judge-douglas-h-ginsburg-canadian.

[31] 253 F.3d 34 (D.D.C. 2001).

[32] *Doryx*, 838 F.3d at 438; *Mylan*, 2015 U.S. Dist. LEXIS 50026, at *38–40.

[33] *Id.* at 654–55 (emphasis added).

[34] *Id.* at 653 n.23.

[35] *Id.*

[36] Mark R. Patterson, *Coercion, Deception, and Other Demand-Increasing Practices in Antitrust Law*, 66 Antitrust L.J. 1, 4–5 (1997).

[37] *See, e.g.*, *Suboxone*, 64 F. Supp. 3d at 682 ("The key question is whether the defendant combined the introduction of a new product with some other wrongful conduct, such that the comprehensive effect is likely to stymie competition, prevent consumer choice and reduce the market's ambit.").

[38] *See* Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 287 n.39 (2d Cir. 1979) ("If a monopolist's products gain acceptance in the market, therefore, it is of no importance that a judge or jury may later regard them as inferior, so long as that success was not based on any form of coercion. . . . In such a case the technological desirability of the product change might bear on the question of monopolistic intent.") (citing Response of Carolina, Inc. v. Leasco Response, Inc., 537 F.2d 1307, 1330 (5th Cir. 1976)).

[39] *See* Times Picayune Pub. Co. v. United States, 345 U.S. 594, 605, 608, 614 (1953) (describing tying as means to "coerce" and "force" customers) (citing United States v. Griffith, 334 U.S. 100, 106–08 (1948) ("If monopoly power can be used to beget monopoly, the [Sherman] Act becomes a feeble instrument indeed.")); Northern Pac. Ry. Co. v. United States, 356 U.S. 1, 6 (1958) (describing tying as "forcing" and citing *Griffith*); *see also* Patterson, *supra* note 36, at 8–12.

[40] Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2 (1984); Patterson, *supra* note 36, at 9–11.

[41] *Id.* at 21.

[42] 504 U.S. 451 (1992).

[43] *Id.* at 458–59.

[44] *Id.* at 464 n.9 (emphasis added) (quoting *Jefferson Parish*, 466 U.S. at 12).

[45] *Id.* at 458.

[46] *Id.* at 472.

[47] *Id.* at 473–74.

[48] *Id.*

[49] *Id.* at 479 n.29.

[50] *See supra* notes 40–46 and accompanying text.

[51] *Compare Actavis*, 2014 U.S. Dist. LEXIS 172918, at *26–27 ("A branded manufacturer may use various tactics to encourage physicians and patients to switch to its new follow-on drug. Typically, the company will aggressively promote the follow-on drug and remove marketing effort behind the original drug, what has been termed a 'soft switch.'"), *with id.* at *46–48 (describing "hard switch" allegations).

[52] *Actavis*, 2014 U.S. Dist. LEXIS 172918, at *49.

[53] *See supra* note 3.

[54] *Actavis*, 2014 U.S. Dist. LEXIS 172918, at *49.

[55] *See In re* Asacol Antitrust Litig., 15-cv-12730-DJC, 2016 U.S. Dist. LEXIS 94605 (D. Mass. July 20, 2016); Sergeants Benevolent Ass'n Health & Welfare Fund v. Actavis, PLC, No. 15-cv-6549 (CM), 2016 U.S. Dist. LEXIS 128349, at *1 (S.D.N.Y. Sept. 13, 2016); *Suboxone*, 64 F. Supp. 3d at 672.

[56] In the other case, *Doryx*, the Third Circuit affirmed the grant of summary judgment for the defendant on the grounds that the plaintiffs failed to raise a triable issue regarding coercion and that, in any event, the relevant product market for the sale of acne medication was so broad that the defendant lacked the monopoly power necessary to commit actionable coercion. 838 F.3d at 437 ("In sum, given the high degree of interchangeability and cross-elasticity demonstrated in the record, we agree with the District Court that the relevant market consisted of Doryx and other oral tetracyclines prescribed to treat acne."); *see also id.* at 440 ("[T]he *Namenda* Court itself also persuasively distinguished this case, citing it as an example of a situation in which there was no evidence of consumer coercion because

generics 'had already entered the market at the time of defendants' product reformulation.'").

[57] We describe the coercion in *Namenda* as only potential coercion because the injunction affirmed by the Second Circuit prevented the alleged product-hop from ever occurring. As the New York Attorney General confirmed in voluntarily dropping its damages claim, no customers ever were affected by the alleged potential coercion in the sale of Namenda. *See* New York v. Actavis plc, No. 1:14-cv-07473 (S.D.N.Y. Nov. 30, 2015) (ECF No. 96-1) ("The injunction prevented Allergan from removing Namenda IR from the market, or limiting the distribution of Namenda IR, and during the Injunction term and afterwards Allergan has continued to manufacture and supply Namenda IR, thus permitting patient access at all times to Namenda IR.").

[58] *Id.* at 643.

[59] *Id.* at 654 (emphasis added).

[60] Id. at 646.

[61] *Id.* at 649.

[62] *Id.* at 654.

[63] *See, e.g.*, *Mylan*, 2015 U.S. Dist. LEXIS 50026, at *25 ("The record abounds with uncontradicted evidence—some of it Mylan's—confirming and reconfirming the interchangeability of Doryx with other oral tetracyclines."); *In re* Solodyn (Minocycline Hydrochloride) Antitrust Litig., 14-md-02503-DJC, 2015 U.S. Dist. LEXIS 125999 (D. Mass. Aug. 14, 2015).

[64] *See generally* Edwards, *supra* note 30; Douglas H. Ginsburg et al., *Product Hopping and the Limits of Antitrust: The Danger of Micromanaging Innovation*, Competition Policy Int'l Antitrust Bull. (Dec. 2015), https://ssrn.com/abstract=2703597; Carrier & Shadowen, *supra* note 10; Shepherd, *supra* note 7; Miller, *supra* note 2.

[65] *See, e.g.*, Allied Orthopedic Appliances, Inc. v. Tyco Health Care Grp. LP, 592 F.3d 991, 1000 (9th Cir. 2010) ("To weigh the benefits of an improved product design against the resulting injuries to competitors is not just unwise, it is unadministrable. There are no criteria that courts can use to calculate the 'right' amount of innovation, which would maximize social gains and minimize competitive injury."); United States v. Microsoft Corp., 147 F.3d 935, 948, (D.C. Cir. 1998) ("Antitrust scholars have long recognized the undesirability of having courts oversee product design, and any dampening of technological innovation would be at cross-purposes with antitrust law."); *Berkey Photo, Inc.*, 603 F.2d at 287 ("[N]o one can determine with any reasonable assurance whether one product is 'superior.'").

[66] Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 891 (2007); Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 480 (1974) (noting patent laws promote progress of science and arts and that "[t]he productive effort thereby fostered 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."); Princo Corp. v. Int'l Trade Com'n, 616 F.3d 1318, 1335 (Fed. Cir. 2010) ("Where the venture is producing a new product . . . there is patently a potential for a productive contribution to the economy.") (citing Addamax Corp. v. Open Software Found., Inc., 152 F.3d 48, 52 (1st Cir. 1998)).

[67] *Microsoft*, 253 F.3d at 395.

[68] Wright & Ginsburg, *supra* note 30.

[69] *Id.*; *see also* Ginsburg et al., *supra* note 64.

[70] Walker Process Equip., Inc. v. Food Mach. & Chem. Corp., 382 U.S. 172 (1965).

[71] *See supra* note 37 and accompanying text.

[72] *See* Abbott Labs v. Teva Pharm. USA, Inc., 432 F. Supp. 2d 408, 422, 423–24 (D. Del. 2006).

[73] *Suboxone*, 64 F. Supp. 3d at 672 ("This switch was allegedly accompanied by Reckitt falsely disparaging the tablet through fabricated safety concerns and ultimately removing Suboxone tablets from the market just as generic Suboxone tablets were able to begin competing.").

COMMENT

# Pivoting Toward Schumpeter: Makan Delrahim and the Recasting of U.S. Antitrust Towards Innovation, Competitiveness, and Growth

BY DAVID J. TEECE

ASSISTANT ATTORNEY GENERAL Makan Delrahim, head of the U.S. Department of Justice's Antitrust Division and a patent lawyer, has signaled a subtle but important shift in antitrust policy in the United States, particularly where intellectual property and competition policy issues interact or appear to collide. He has carefully noted that competition law and intellectual property law share the common purpose of promoting innovation and enhancing consumer welfare. However, if he is to be believed, we are henceforth not going to be waylaid by economic theory alone. He has recently noted that when competition law is "thoughtfully applied," and "when informed by economic experience" (i.e., not just by theory), "these complementary bodies of law yield exciting results: a strong dynamic economy with rich and varied choices for consumers."[1]

This article will examine some of Delrahim's recent speeches to determine whether his instincts are Schumpeterian[2] and what a tilt away from static competition and towards dynamic competition might look like. By Schumpeterian, I do not refer to Schumpeter's quixotic approach to bigness: sometimes claiming large firms and monopoly power assist innovation, and sometimes not.[3] I instead refer to Schumpeter's view that, whatever is the preferred firm and industrial structure to support innovation, in the end, it is innovation that most powerfully drives competition. Moreover, innovation is about "new combinations."[4] Schumpeter was not explicit about what this meant for antitrust and technology policy. However, he noted that, with respect to innovation-led competition versus static competition, the former is "much more effective than the other as a bombardment is in comparison with forcing a door."[5] He saw innovation as "the powerful lever that in the long run expands output and brings down prices."[6]

For 30 years or more, a small group of economists has been calling for a pivot in antitrust in favor of (Schumpeterian) dynamic competition over static competition. We may soon witness such a pivot, led by Makan Delrahim. Global competition, with new players employing effective industrial policies, now requires it.

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## Competitiveness, Industrial Policy and Technology Policy

At a 1988 conference that began to explore the relationship between antitrust, industrial policy, and technology policy, Thomas Jorde and I, echoing Schumpeter, called for a change in antitrust thinking. We proclaimed that

> the kind of competition embedded in standard microeconomic analysis may not be the kind of competition that really matters if enhancing economic welfare is the goal of antitrust. Rather, it is dynamic competition propelled by the introduction of new products and new processes that really counts. If the antitrust laws were more concerned with promoting dynamic rather than static competition, which we believe they should, we expect that they would look somewhat different from the laws we have today.[7]

At the conference, Phillip Areeda declared that "for 100 years, the Sherman Act has been at the core of American industrial policy. Whether antitrust law can meet the challenge of that office for the next century" depended, according to Areeda, "on (1) its receptivity to the principle of efficiency, growth, and innovation; (2) its ability to implement its principles in practice; and (3) the availability of supplemental mechanisms to insulate an occasional arrangement

from the usual antitrust tribunals."[8] Areeda's identification of innovation and growth as antitrust issues was noteworthy. This message, however, was ignored until quite recently.

As Gregory Sidak and I noted recently, "The conference was designed to alert the law and economics community to a set of emerging issues on antitrust and innovation. In hindsight, we believe that the conference was a watershed event. A slow and reluctant awakening to antitrust and innovation issues is now well underway."[9] Unfortunately, the positive developments have tended more toward "slow" than "well underway."

There have undoubtedly been minor efforts at the margin to bring innovation issues into sharper focus. For instance, Michael Katz and Howard Shelanski in 2005 signaled a shifting of the intellectual winds. They argued that "the challenge has been taken up," but there is little evidence that it has, at least not in a robust fashion.[10] In 2003, Robert Crandall and Cliff Winston of the Brookings Institute showed some skepticism with respect to the claimed benefit of current antitrust efficacy, noting that they "find little empirical evidence that past interventions have provided much direct benefit to consumers."[11] Even such a heraldic challenge did not stir the mainstream antitrust community to come forth with evidence to contradict them. Since Schumpeter taught us that innovation was key to consumer benefits, the Crandall and Winston assessment would not surprise a Schumpeterian. As noted earlier, Schumpeter was clear that sooner or later innovation brings down prices more assuredly than anything else, but this is not the orientation of current enforcement action.

Given strong economic evidence that innovation drives productivity, sharpens competition, and creates new products,[12] a serious consumer-oriented antitrust policy, with an intermediate to long-term orientation, must necessarily focus primarily on supporting and advancing innovation. There are good reasons for antitrust policy to keep a consumer welfare focus, but there is no good reason to look at just short-term consumer benefits. Surely, the long-term matters too.[13] After all, our social discount rates are single-digit.

The reality is that current (and historical) market shares are of little moment when it comes to analyzing dynamic competition. Innovations by businesses are the fundamental drivers of competition, and market concentration has little to do with the strength of innovation. Current market shares and market positions are often at best only a very weak proxy for competitive position. Rather, innovation, market structure, and firm size are jointly determined.[14] Moreover, relationships vary across industries, and the nature of the technology itself also impacts sectoral patterns of innovation.[15] Additionally, the technological opportunity and the appropriability regime impacts the intensity of innovation, market concentration, and entry.[16] This is well recognized in the strategic management and innovation literatures, but it has yet to bleed over to the antitrust literature, other than through occasional remarks such as those from Katz and Shelanski.[17] Makan Delrahim has declared his position in the past, for instance in his Separate Statement to the Antitrust Modernization Commission 2007 report:

> Although the benefits of static efficiency are very important, they are incremental gains. In contrast, the other type of efficiency, dynamic efficiency, results when an entirely new technology is developed and made available to consumers. Dynamic efficiency has much more dramatic effects on consumer well-being, and therefore is an appropriate focus of attention for policymakers.[18]

The issue I put forward for consideration here is whether a focus on (long-run) dynamics rather than (short-run) static competition ought now to be the focus of antitrust. I then review Makan Delrahim's speeches to ascertain if, explicitly or implicitly, that is the direction of travel he is seeking to establish. To crystallize the issue, I will describe both static competition and dynamic competition in turn. In doing so, I recognize that these styles of competition sometimes do not have bright lines separating them. Certainly, Schumpeter did not provide any crisp delineation.

## Dynamic vs. Static Competition in Antitrust Jurisprudence

***General.*** Antitrust agencies routinely claim to favor both innovation and competition. However, they have unnecessarily seen the tension between short-term (static) competitive analysis, with its emphasis on achieving low prices in the here and now, and the dynamic issues raised by intellectual property (and associated royalty payments). Royalties, in the short run, raise prices of licensed goods relative to the prices that would prevail absent payments. However, payments to licensors support innovation by helping innovators achieve the economic returns necessary to draw forth the critical investment dollars needed to support R&D and continuing innovation.

Schumpeter spoke of "creative destruction"; today we talk of "disruption" to markets and incumbents, which is the elixir of competition. Notwithstanding this well-accepted perspective, our antitrust agencies, and sometimes the courts, have not just been IP unfriendly—they have been innovation unfriendly, and have done little to promote technology-driven "disruption," or economic competitiveness writ large.[19]

One U.S. example from the past in which antitrust authorities and the courts did not pay sufficient attention to relevant innovation issues was the breakup of AT&T in 1982. There was virtually no consideration given in the modified final judgment to the survival of a robust Bell Labs, arguably western civilization's greatest scientific and commercial research laboratory. This failure resulted in unnecessary collateral damage to an otherwise beneficial divestiture.

This is not an isolated example. In 2015, the DOJ gave a favorable business review letter to the IEEE approving the organization's controversial changes to its Intellectual Property Rights (IPR) policy, essentially inviting collusion by implementers against inventors involved in the standard-setting

process at IEEE. In 2016, the FTC required semiconductor maker NXP to divest its radio frequency power business (and technology) as a condition for its acquisition of Freescale Semiconductor. This resulted in a sale to Jianguang Asset Management Co., which had financial support from the Chinese government. While possibly sensible from a short-term consumer prospective, the action resulted in critical technologies migrating to China, leading to a loss in U.S. economic welfare, and likely in long-run consumer welfare, too.

By contrast it is hard to find circumstances where the DOJ or the FTC had taken up the cudgel for innovators and patent owners. This failure has serious longer-term negative implications for U.S. producers as well as for consumers.

A "neo-Schumpeterian" framework for antitrust analysis that favors dynamic competition over static competition would put less weight on market concentration in the assessment of market power and more weight on assessing technological opportunity, potential competition, and appropriate enterprise-level capabilities.[20] It would also accept the importance of intellectual property protection to vigorous innovation, particularly where enabling technologies are important to competition and economic welfare.

***Mergers.*** The one area where the agencies have already begun to give some attention to innovation is with respect to mergers. The 2010 Merger Guidelines note that "the agencies may consider whether a merger is likely to diminish innovation competition . . . . [T]he curtailment of innovation could take the form of reduced incentive to continue with an existing product-development effort or reduced incentive to initiate development of new products."[21] Neither the DOJ nor the FTC has made much of the considerable benefits to innovation from mergers when they help in the commercialization of innovation by lining up complementary innovations and/or complementary assets.[22] A more nuanced approach to innovation and competition would see issues going both ways. That does not seem to be recognized in either the U.S. or Europe.

The European Commission recently broadened its analysis to examine whether a merger could reduce innovation. In Dow/Dupont, it explored whether post-merger, the parties would have fewer incentives to maintain R&D spending and develop new pesticides, with respect not only to current products but also to new products not yet in the new product development pipeline. The Commission cleared the merger subject to Dupont's commitment to divest its global R&D organization, which seems like a problematic move. The European Commission rejected the notion that its implicit theory of harm was speculative, referring to economic studies that conclude that any merger "tends to reduce overall innovation."[23]

The EU's chief competition economist Tommaso Valetti reportedly[24] laid out his views of competition and innovation by referencing, but not developing, a capability theory of innovation, noting that in agrochemicals, "only a few have the capability to do innovation at every stage and in every segment."[25] While it is encouraging that Mr. Valetti would highlight capabilities, there is no capability theory that he seems to develop or even mention. He noted the lack of relevant research on innovation and competition in the field of industrial organization, but said nothing of the much larger literature in innovation studies, much of it inspired by Schumpeter, which looks at not only value creation but also value capture.[26] He concluded that there is a need for further research "on the nature of future competition between the merging companies on the basis of their R&D activities and innovation capabilities." This research would be jump-started if industrial organization economists would review and incorporate the very extensive literature on innovation in the fields of innovation studies, strategic management, and entrepreneurship.

In addition, European Competition Commissioner Margrethe Vestager has noted that "protecting innovation is important to a merger policy" and that "when we look at high-tech mergers, we don't just look at whether they raise prices. We also assess whether they could be bad for innovation."[27]

Whether it is mergers or intellectual property, or whether it is Europe or the United States, or the courts or the competition agencies, there appears to be a slip between the cup and the lip inasmuch as the agencies do not seem to understand the drivers of national or firm-level innovation. As two prominent American scholars have noted, "Antitrust has long acknowledged the importance of innovation but has struggled to incorporate it within the contours of its analysis."[28] That struggle has its roots in the inability of antitrust economists to take the study of innovation seriously, for to do so would involve abandoning a good deal of their own intellectual capital, as Thomas Kuhn pointed out 50 years ago.[29] In short, the dynamic competition paradigm is itself disruptive to mainstream (incumbent) antitrust scholarship.

Indeed, the existing industrial organization literature is hung up on the rather tired market power-innovation nexus, frequently misframed as the Schumpeter-Arrow debate. As Sidney Winter points out, there are many rich frameworks available in the innovation studies scholarly literature.[30] Nor is the issue simply firm-level incentives to innovate. As noted, technological opportunity, appropriability, organizational structure, culture, and capabilities—all topics largely outside the paradigm for competition economists—matter a great deal. In particular, the proper analysis of issues, such as cannibalization and the closeness of competitors, which some competition agencies are now focusing on, require a difficult analysis of firm-level dynamic capabilities.

***Patents.*** With respect to patents, the assumption of market power from patents, even patent portfolios, needs to be severely challenged. Antitrust economists often fail to understand that a patent is not issued with an automatic right to an injunction stapled to it. Text books, and much economic theory, frequently (implicitly) assume that a patent covers technology essential to competition in a market and also

comes with the automatic right to exclude. The exclusion, of course, requires a court or analagous body to issue an injunction against an infringer. In reality, the former condition rarely holds, and injunctions are often very difficult to secure.

Antitrust scholars too often worry about patent thickets but rarely if ever about patents that might be unnecessarily curtailed or weakened because of the actions of the Patent Trial and Appeal Board (PTAB). They worry about the impact of royalties on prices today, but rarely about a whittled-down panoply of consumer choice and benefits in the future that results when innovators are shortchanged. In short, static competition issues too often have trumped concerns about dynamic competition at the antitrust agencies and in the courts.

Mr. Delrahim's speeches are promising in that, while relating primarily to antitrust patent issues, they indicate the presence of an authentic champion of high powered innovation-driven competition at the DOJ's Antitrust Division. If so, he will need to work hard with staff to break free of the "static model" that the economics profession injects into antitrust analysis.

## The Delrahim Speeches

Mr. Delrahim has recently given several major speeches on antitrust issues. On November 10, 2017, he gave a speech entitled *Take It to the Limit: Respecting Innovation Incentives in the Application of Antitrust Law* at USC Gould School of Law.[31] In that speech, Mr. Delrahim gave what I believe to be a salutary reappraisal of antitrust issues regarding standards development and patents. On February 1, 2018, he gave a speech entitled *Competition, Intellectual Property, and Economic Prosperity* in Beijing.[32] On March 18, 2018, he gave a speech entitled *The 'New Madison' Approach to Antitrust and Intellectual Property Law* at University of Pennsylvania Law School.[33] This article examines these three recent speeches from an economic and public policy perspective. I begin with the second, as it is the most general. All three are tantalizing, and suggest a pivot in the direction of recognizing innovation as the key driver of competition.

***The China Speech: The Primacy of Dynamic Competition.*** In Beijing, Mr. Delrahim noted that

> experience and economic research have taught us that intellectual property rights are the key to unlocking the innovation that drives our economy. Intellectual property laws provide incentives for investment in research and development and these are the processes through which new products and services are ultimately offered to consumers, improving their lives, and stimulating the economy along the way. . . . The key component of promoting innovation and spurring advances in science and technology is enforcing intellectual property rules. Protecting the inventions that result from research and development is essential to any pro-growth and competitive economic agenda.[34]

In summary, Mr. Delrahim emphasized:

> China has had a long history of invention as well, and as it continues to shift toward a market-based economy, one of the most important decisions it will make is to protect and reward innovation. With an eye to promoting dynamic competition, I humbly submit that competition law enforcers around the world must give careful consideration to the interests that drive innovation, including by allowing innovators to reap the full rewards of their investment in research and development.[35]

Thus, the focus of sound analysis must be less on short-term pricing and more on the innovation and growth that delivers value to consumers over the longer term. Mr. Delrahim went on to say, "We must also approach remedies for violation of antitrust law with caution. I am generally skeptical of behavioral remedies, and even more so when it comes to mandating licensing requirements that could skew incentives away from technological advancement."[36] He was clear that his emphasis on humility when it comes to competition law enforcement in the IP context

> should not be taken to imply that there are no circumstances in which the exercise of patent rights should attract antitrust scrutiny. While I support the thoughtful and deliberate application of the competition laws to the exercise of IP rights, I do not believe in wholesale exemptions from those laws. In the United States, patent holders are not immune from the antitrust laws . . . .[37]

Mr. Delrahim went on to discuss the growth of Chinese dedicated IP courts and the role that their development played in protecting IP owners. He noted:

> It is probably not a coincidence that these reforms have occurred at the same time that Chinese companies have transformed from net implementers of IP rights to important innovators and holders of IP rights. Almost daily, I see news reports evidencing the furious pace of innovation that is underway here.[38]

He further noted:

> This exciting new environment means that now, more than ever, the promotion and protection of patent rights is critical . . . . As China continues its transformation to an innovation economy, I believe that progress can be amplified—and its prosperity increased—through policies that promote and protect IP rights, including thoughtful competition law enforcement and effective adjudication of IP related disputes."[39]

***The USC Speech: Hold-out Is a More Serious Problem Than Hold-Up.*** The issue of standards-essential patents (SEPs), commitments to make licenses to such patents available on "fair, reasonable, and non-discriminatory" (FRAND) terms, and the proper treatment of these issues under the antitrust law have attracted both voluminous literature and a wealth of case law in recent years. In his USC speech, Mr. Delrahim said, and Schumpeterian scholars would agree, that "fresh thinking about the implications of SSOs (standards-setting organizations) and the proper role of antitrust law is long overdue."[40]

Mr. Delrahim acknowledges that, in addition to concerns about "patent hold-up," in which the owner of an SEP seeks

to charge standards implementers excessive royalties for their use of its patented technology, there are concerns about what has been termed "patent hold-out." Sometimes referred to as "reverse hold-up," hold-out occurs when implementers seek to pay insufficiently low royalties or no royalties for their use of standardized technology.[41] Mr. Delrahim (in my view, correctly) noted:

> Too often lost in the debate over the hold-up problem is recognition of a more serious risk: the hold-out problem. . . . The hold-out problem arises when implementers threaten to under-invest in the implementation of a standard or threaten not to take a license at all until their royalty demands are met.[42]

It is important to note that patents are not self-enforcing and that patent holders, unlike suppliers of tangible inputs into the production process, cannot physically withhold their patented technology from implementers who do not pay for it. Instead, they have little choice but to resort to costly, time-consuming, and risky patent infringement litigation to enforce their rights. I agree with Mr. Delrahim that the potential for hold-out is significant. Indeed, unauthorized and unpaid use of patented technology is rampant in many industries, and such widespread infringement can adversely affect patent holders' abilities to receive adequate compensation for their contributions.[43] I welcome Mr. Delrahim's acknowledgment that hold-out may be "a more serious risk" than hold-up—a position that, until now, has generally not been acknowledged by the competition authorities.

Mr. Delrahim said, "I view the collective hold-out problem as a more serious impediment to innovation,"[44] though he did not define what he meant by "collective hold-out" or give an example. He acknowledged that "the hold-up and hold-out problems are not symmetric,"[45] correctly pointing out that "innovators make an investment before they know whether that investment will ever pay off," while "the implementer has some buffer against the risk of hold-up because at least some of its investments occur after royalty rates for new technology could have been determined."[46]

I have previously noted[47] that so-called *ex ante* licensing—by which is typically meant licensing that occurs *after* the technology developer has made the sunk-cost investment to develop its technology (at least to the point where it can be considered for incorporation into the standard), but *before* implementers make their investments in developing and making standards-compliant products, and in some cases before the technology has been chosen for incorporation into the standard—is better thought of as "interim" licensing, because it occurs after one party has made its investment but before the other party has. I applaud Mr. Delrahim's acknowledgment of this fundamental temporal asymmetry and its public policy implications.

He also acknowledged that "[u]nfortunately, in recent years, competition policy has focused too heavily on the so-called unilateral hold-up problem, often ignoring what fuels dynamic innovation and efficiency . . . . Every incremental shift in bargaining leverage toward implementers of new technologies acting in concert can undermine incentives to innovate."[48]

There is a large, well-established empirical literature in economics on the private versus social rates of return to innovation,[49] which demonstrates that even successful innovators capture only a small fraction of the social benefits arising from their innovations. Firms contemplating investing in R&D run the risk that they will encounter "dry holes" or will be beaten to the finish line by others; *ex ante*, the rewards from successful innovation have to compensate for the risks associated with unsuccessful innovation. Anything that reduces the returns to innovation can significantly reduce the incentives to innovate.

Since innovation is a key driver of economic development and growth, misguided efforts to curtail hold-up run the risk of encouraging hold-out and thus derailing economic growth. Given the importance of standards in encouraging interoperability and compatibility among the offerings of various firms and facilitating competition, I believe that the competition authorities should tread warily before intervening. Mr. Delrahim's USC speech reflects a long-overdue reappraisal of the issues associated with patents and standards.

Mr. Delrahim also proposed that "antitrust law should not police FRAND commitments to S[S]Os."[50] FRAND commitments made to SSOs are contractual, and implementers are third-party beneficiaries of such commitments. Accordingly, implementers can and do use the legal process to enforce contractual FRAND commitments. I see no reason to believe that the courts are either unable or unwilling to enforce such commitments, nor that the courts systematically misinterpret them, and thus see little need for antitrust intervention in what is fundamentally a contractual matter.

I note that implementers have made no comparable contractual commitments to take licenses, to *pay* royalties to those whose technology they use to make standards-compliant products. This asymmetry is another reason why I believe that the antitrust authorities should tread warily in this area.

Mr. Delrahim concluded that "the Antitrust Division will, therefore, be skeptical of rules that SSOs impose that appear designed specifically to shift bargaining leverage from IP creators to implementers."[51] I concur with such a policy. I believe that had Mr. Delrahim's views been in place at the time of the 2015 DOJ IEEE business review letter, it is unlikely that the DOJ would have approved the new IEEE IPR policy.[52]

***The Pennsylvania (Madison) Speech: Antitrust and Intellectual Property.*** In his University of Pennsylvania (*Madison*) speech, Mr. Delrahim contrasted the approaches to patents taken by Thomas Jefferson and James Madison.[53] He advocated for what he termed a "New Madison" approach to patent protection. He says:

> The New Madison approach . . . has four basic premises that are aimed at ensuring that patent holders have adequate incentives to innovate and create exciting new technologies

> and that licensees have appropriate incentives to implement those technologies. [The four premises are (1)] that hold-up is fundamentally not an *antitrust* problem, and therefore antitrust law should not be used as a tool to police FRAND commitments that patent-holders make to standard setting organizations, [(2) that] standard setting organizations should not become vehicles for concerted actions by market participants to skew conditions for patented technologies' incorporation into a standard in favor of implementers because this can reduce incentives to innovate and encourage patent hold-out, [(3) that] because a key feature of patent rights is the right to exclude, standard setting organizations and courts should have a very high burden before they adopt rules that severely restrict that right or—even worse—amount to a de facto compulsory licensing scheme, [and (4) that] consistent with the fundamental right to exclude, from the perspective of the antitrust laws, a unilateral and unconditional refusal to license a patent should be considered *per se* legal.[54]

Mr. Delrahim notes that "[s]tating that a patent holder can derive higher licensing fees through hold-up simply reflects basic commercial reality. Condemning this practice, in isolation, as an antitrust violation, while ignoring equal incentives of implementers to 'hold out,' risks creating 'false positive' errors of over-enforcement that would discourage valuable innovation."[55]

He further argues:

> Advocates of using antitrust law to reduce the supposed risk of patent hold-up fail to identify actual harm to the competitive process that warrants intervention. If an inventor participates in a standard-setting process and wins support for including a patented technology in a standard, that decision does not magically transform a lawful patent right into an unlawful monopoly. To be sure, that decision gives the patent holder some bargaining power in claiming a piece of the surplus created by standardization. And, it would require the patent holder to live up to commitments as they would have bargained for it, enforceable by contract laws. But standard-setting decisions are intended to be recognition that technology is superior to its alternatives. A favorable SSO decision, like a patent itself, is a reward for an innovator's meritorious contribution whose wide-ranging benefits can ripple throughout the economy, contributing to dynamic competition.[56]

I agree, and I note that Mr. Delrahim's reference to the patent holder's "claiming a piece of the surplus created by standardization," while fully consistent with the cooperative nature of standards-setting and the fact that, in cooperative conduct, the gains from trade are to be divided between the participants, is inconsistent with some language in recent court decisions. These decisions have found that the patent holder should not obtain any of the gains from standardization but that its rewards should be limited to a royalty measured by the *ex ante* value of the now-standardized technology.[57]

Perhaps Mr. Delrahim's most trenchant observation is:

> It is therefore unsurprising that proponents of using antitrust law to police FRAND commitments principally rely on models devoid of economic or empirical evidence that hold-up is a real phenomenon, much less one that harms competition. Since hold-up theories gained traction in the early 2000s, it is striking that they remain an empirical enigma in the academic literature.[58]

I agree. The lack of empirical support for the proposition that hold-up is anything more than a theoretical possibility is striking.[59]

## Other Topics

***Patent Royalties as Transfer Payments.*** It is worth noting that, while technology implementers treat royalty payments as a private cost, from a societal perspective it is better to think of royalty payments as *transfer payments* (while they are, admittedly, compensatory payment for the use of real, albeit intangible, resources) from implementers to patent holders.[60] When royalties are paid, in the short run, the implementer has less money, but the patent holder has more money. Royalties are a private cost to implementers, but not a societal cost.[61] This implies that royalty payments should not be seen as real resource costs,[62] while the R&D effort to develop standardized technology clearly does involve real resource costs. In particular, this implies that SSOs, when acting pursuant to the interests of implementers (who tend to be the majority of SSO participants), have a societally inefficient incentive to avoid incorporating royalty-bearing technology into standards. Mr. Delrahim does not address this issue. This is another reason to be wary of antitrust intervention on the side of collective buyer-side action by SSO implementer members. As Mr. Delrahim put it, "Antitrust enforcers should scrutinize concerted action within SSOs that causes competitive harm to the dynamic innovation process."[63] In my view, this issue has received inadequate attention in the existing literature.

***Availability of Injunctive Relief.*** Another topic that is currently being hotly debated is whether SEP holders who have made FRAND commitments should be allowed to seek and/or obtain injunctive relief against unlicensed implementers (or whether the fact that the patent holder has agreed to accept royalty payments means that the patent holder will not suffer "irreparable harm" if an injunction is not issued). Mr. Delrahim correctly noted that "patents are a form of property, and the right to exclude is one of the most fundamental bargaining rights a property owner possesses. Rules that deprive a patent holder from exercising this right—whether imposed by an SSO or by a court—undermine the incentive to innovate and worsen the problem of hold-out."[64] He argued (I believe correctly), "We should not transform commitments to license on FRAND terms into a compulsory licensing scheme," though we acknowledge that the courts will have to determine what FRAND licensing terms are should the parties be unable to reach an agreement. Again, I wish that Mr. Delrahim's position had been adopted by the DOJ at the time it approved the change in the IEEE's IPR policy, which explicitly provided that a patent holder that had made a FRAND commitment should not be allowed even to

seek (much less receive) injunctive relief against unlicensed infringers.

***Miscellaneous.*** Other questions raised include (a) what the appropriate royalty base and/or damages base is for SEPs, and in particular whether the royalty/damages base should be the "smallest saleable patent-practicing unit" (SSPPU), a recent court-developed doctrine[65]; and (b) whether and to what extent courts need to consider issues such as "patent thickets" and/or "royalty stacking" in determining patent infringement damages. With respect to the former, Mr. Delrahim said that "its use as a requirement by a concerted agreement of implementers as the exclusive determinant of patent royalties may very well warrant antitrust scrutiny."[66]

## Conclusion

Favoring innovation-driven competition involves more than simply looking at the incentive impact of mergers. Antitrust policy needs to pivot to a deeper understanding of innovation processes and competition over the long run. The singular focus on short-term price impacts infects too many aspects of our national policy; public capital markets, in particular, tend to be short term. Antitrust should not be augmenting the bias. It must escape its deleterious penchant to favor the present, especially if this means penalizing the future. The focus on consumer benefits has in practice become a focus on short-term (measurable) consumer benefits, not the present value of present and future benefits. By sleight of hand, the absence of a robust approach to innovation, and operating inside the relics of the structuralist paradigm, antitrust practice has become very short-term in orientation, without any declaration to that effect. A loss of long-run economic and consumers' welfare naturally follows.

Just because it is hard to measure long-term benefits is no excuse to ignore them. A better proxy when addressing Sherman Act Section 2 issues is to ask whether the behavior and/or the transaction in question likely enhances firm-level capabilities, especially a firm's innovative and dynamic capabilities. It is these capabilities that "provide the powerful lever that in the long run expands output and brings prices down," to quote Schumpeter again.

The Chicago school's focus on consumer benefits was remiss in ignoring innovation (by porting in simple static economic models) and in not pointing out that a long-run view matters most. Stating the goal that way would have forced scholars to focus on innovation, which is largely absent from the neoclassical microeconomic view of the supply side which undergirded the Chicago school advice. In this regard, the post-Chicago perspective was no better, and in some ways, worse.

It is time for a Schumpeterian perspective to gain serious traction, especially given the global challenge that the United States and Europe now face. Makan Delrahim is possibly leading the antitrust community in new and exciting directions. At a minimum, he is torpedoing antitrust theories that don't have empirical evidence to support them. He is the guardian of innovation as a crtical driver of competition. By prioritizing innovation, he also puts high-powered competition first, and America first, because the United States remains, by a modest (though declining) margin, the world's greatest innovator. Nation states have a chance of doing better and holding their own in global competition if their antitrust agencies change gears and become champions of innovation-enabled competition. This implies a review of a whole raft of public policy issues, of which IP is just one. Education, science, technology, and technology policy and industrial policy, along with trade policy, are implicated as well.

As Areeda reminded us 30 years ago, the U.S. antitrust laws are an important part of U.S. industrial policy.[67] It is time for this to be explicitly recognized.[68] If antitrust is to remain relevant in a world where other nation-states have robust industrial policies, and these infect their antitrust policies, the U.S. needs greater policy coherence among antitrust, industrial policy, and technology policy. The dynamic-competition paradigm is both the easiest and the best intellectual paradigm for the competition agencies and the courts to employ to unshackle antitrust from its neoclassical straightjacket. Doing so will allow it to prioritize primary (i.e., dynamic) competition over its weaker sibling, which is secondary (i.e., static) competition, thereby enhancing not just consumer welfare, but economic welfare, too.

Innovation and growth, criteria that Areeda indicated antitrust must embrace, are naturally brought into focus with the prioritization of dynamic competition. Makan Delrahim is carrying the torch in this direction. His initial focus has been on the patent-antitrust interface, but his intellectual paradigm (and his respect for innovation as the primary driver of competition and the need to support investment in R&D and related activities) can take him further. If he is able to go further, he will preserve a place for antitrust through the rest of this century. Should he fail, national imperatives at home and abroad will otherwise confine antitrust to a diminishing role in a broader gestalt of technology and industrial policies that will disrupt antitrust policy as we currently know it. ■

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1 Makan Delrahim, Assistant Atty Gen., Antitrust Div., U.S. Dep't of Justice, Competition, Intellectual Property, and Economic Prosperity, Remarks Before the US Embassy in Beijing (Feb. 1, 2018) [hereinafter Delrahim, Competition], https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-us-embassy-beijing.

2 The three Delrahim speeches I have reviewed took place between November 2017 and March 2018.

3 *See, e.g.*, Franco Malerba & Luigi Orsengio, *Schumpeterian Patterns of Innovation*, 19 Cambridge J. Econ. 47 (1995).

4 Schumpeter may have borrowed the concept from Adam Smith, who prominently featured the idea in the *Wealth of Nations*, where he emphasized that an aspect of an ever deeper division of labor was the emergence of a separate industry, which today we would think of as being concerned with R&D and innovation. Smith spoke of "philosophers or men of speculation, whose trade it is, not to do anything, but to observe everything. And who, upon that

account, are often capable of combining together the most distant and dissimilar objects." (1 Adam Smith, Wealth of Nations 9 (Oxford Univ. Press, Glasgow ed. 1976)).

5 Joseph A. Schumpeter, Socialism, Capitalism and Democracy (1942).

6 *See id.*

7 *See, e.g.*, Thomas M. Jorde & David J. Teece, *Introduction*, Antitrust, Innovation, and Competitiveness 5 (Thomas M. Jorde & David J. Teece eds., 1992).

8 Phillip Areeda, *Antitrust Law as Industrial Policy*, *in* Antitrust, Innovation, and Competiveness, *supra* note 7, at 29.

9 J. Gregory Sidak & David J. Teece, *Dynamic Competition in Antitrust Law*, 5 J. Competition L. & Econ. 581 (2009).

10 Michael L. Katz & Howard A. Shelanski, *"Schumpeterian" Competition and Antitrust Policy in High Tech Markets*, 14 Competition 47 (2005).

11 Robert Crandall & Cliff Winston. *Does Antitrust Policy Improve Consumer Welfare? Assessing the Evidence*, 17 J. Econ. Persp., Fall 2003, at 3.

12 For a survey of the literature, see Bronwyn H. Hall, *Innovation and Productivity* (NBER Working Paper No. w17178, 2011), https://ssrn.com/abstract=1879040.

13 A longer-term focus implicitly enables innovation and capability-strengthening issues to be taken into account. It favors a de facto economic welfare perspective, not just a short-term consumer gains orientation.

14 Wesley M. Cohen & Richard C. Levin, *Empirical Studies of Innovation and Market Structure*, *in* 2 Handbook of Industrial Organization 1059 (Richard Schmalensee & Robert Willig eds., 1989).

15 Keith Pavitt, *Sectoral Patterns of Innovation: Towards a Taxonomy and a Theory*, 13 Research Pol'y 343 (1984).

16 Sidney J. Winter, *Schumpeterian Competition in Alternative Technological Regimes*, 5 J. Econ. Behav. & Org. 287 (1984).

17 The reason might be that many antitrust scholars are quite closed-minded and fearful of their own capital being cannibalized when it comes to accepting economic concepts outside the neoclassical microeconomic framework. This tends to trap many antitrust scholars into focusing on a narrow set of incentive and "anti-cannibalism" issues associated with current market position, and little else.

18 Antitrust Modernization Commission, Report & Recommendations 406 (2007) (Separate Statement of Commissioner Delrahim).

19 The antitrust laws were also leveraged by RCA's competitors to force it to share its patents with domestic rivals for free, incenting it to license to foreign companies for whatever it could get. This boosted the prospects of the Japanese electronics industry, but arguably cost jobs and prosperity for millions of Americans.

20 *See supra* note 9, at 619.

21 *See* U.S. Dep't of Justice & Fed. Trade Comm'n Horizontal Merger Guidelines Section 6.4 (2010) (discussing "Innovation and Product Variety"). That section notes that "the Agencies may consider whether a merger is likely to diminish innovation competition by encouraging the merged firm to curtail its innovative efforts below the level that would prevail in the absence of the merger." It also acknowledges that "the Agencies also consider whether the merger is likely to enable innovation that would not otherwise take place, by bringing together complementary capabilities that cannot be otherwise combined for some merger-specific reason."

22 David J. Teece, *Profiting from Innovation in the Digital Economy: Enabling Technologies, Standards, and Licensing Models in the Wireless World*, Research Pol'y (forthcoming 2018) [hereinafter Teece, *Profiting from Innovation*].

23 Giulio Federico, Gregor Langus & Tommaso Valletti, *A Simple Model of Mergers and Innovation* (CESifo Working Paper Series No. 6539, June 29, 2017), https://ssrn.com/abstract=3005163.

24 Asher Schechter, *Mergers Are Bad for Innovation*, Promarket, http://promarket.org/mergers-bad-innovation/ (Sept. 29, 2017).

25 *See id.*

26 A good introduction to this field is Jan Fagerberg & Bart Verspagen, *Innovation Studies—The Emerging Structure of a New Scientific Field*, 38 Research Pol'y (2009).

27 Margrethe Vestager, Comm'r, European Comm'n, Competition: The Mother of Invention, Remarks Before the Ministry of Economic Affairs, European Competition and Consumer Day in Amsterdam, Netherlands (Apr. 18, 2016), https://ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/competition-mother-invention_en; *see also* Andrea Lofaro et al., *An Innovation in Merger Assessment?: The European Commission's Novel Theory of Harm in the Dow/Dupont Merger*, Antitrust, Fall 2017, at 100.

28 Richard J. Gilbert & Hillary Greene, *Merging Innovation into Antitrust Agency Enforcement of the Clayton Act*, 83 Geo. Wash. L. Rev. 1919 (2015).

29 Thomas Kuhn, The Structure of Scientific Revolutions (1970).

30 Sidney G. Winter, *The Logic of Appropriability: From Schumpeter to Arrow to Teece*, 35 Research Pol'y 1100 (2006).

31 Makan Delrahim, *Take It to the Limit: Respecting Innovation Incentives in the Application of Antitrust Law*, Remarks as Prepared for Delivery at USC Gould School of Law (Nov. 10, 2017) [hereinafter Delrahim, *Limit*], https://www.justice.gov/opa/speech/file/1010746/download.

32 Delrahim, Competition, *supra* note 1.

33 Delrahim, The "New Madison" Approach to Antitrust and Intellectual Property Law, Remarks as Prepared for Delivery at University of Pennsylvania Law School (Mar. 16, 2018) [hereinafter Delrahim, Madison], https://www.justice.gov/opa/speech/file/1044316/download.

34 Delrahim, Competition, *supra* note 1.

35 *Id.*

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.*

40 Delrahim, *Limit*, *supra* note 31, at 14.

41 David J. Teece, *The 'Tragedy of the Anticommons' Fallacy: A Law and Economics Analysis of Patent Thickets and FRAND Licensing*, 32 Berkeley Tech. & L.J. No. 4 (forthcoming 2018) [hereinafter Teece, *Anticommons Fallacy*].

42 Delrahim, *Limit*, *supra* note 31, at 5.

43 Firms are reluctant to pay royalties if they see their rivals apparently getting away with not paying, even if they know that the other firm may ultimately face liability for patent infringement. Since patent infringement litigation is costly and time consuming, this adversely affects patent holders' abilities to license their technologies.

44 Delrahim, *Limit*, *supra* note 31, at 5.

45 *Id.*

46 *Id.*

47 David J. Teece & Edward Sherry, *Licensing and Standards Setting: The Multiple Meanings of "Ex Ante" Negotiations and Implications for Public Policy* (Tusher Center for the Management of Intellectual Capital, Haas School of Business, University of California, Berkeley, May 21, 2015), http://businessinnovation.berkeley.edu/wp-content/uploads/businessinnovation-archive/documents/Tusher-Center-Working-Paper-10.pdf.

48 Delrahim, *Limit*, *supra* note 31, at 6.

49 This is summarized in Teece, *Anticommons Fallacy*, *supra* note 40 and Teece, *Profiting from Innovation*, *supra* note 22.

50 Delrahim, *Limit*, *supra* note 31, at 7.

51 *Id.* at 11.

52 David J. Teece, *Are the IEEE Proposed Changes to IPR Policy Innovation Friendly?* (Tusher Center for the Management of Intellectual Capital, Working Papers, Feb. 2, 2015), http://businessinnovation.berkeley.edu/intellectual-capital/working-papers/.

53 Delrahim, Madison, *supra* note 33, at 5.

[54] *Id.*

[55] *Id.* at 8.

[56] *Id.*

[57] *See, e.g.*, Ericsson Inc. v. D-Link Sys., Inc., 773 F.3d 1201, 1232 (Fed Cir. 2014). (In the SEP context/FRAND licensing, "The patentee's royalty must be premised on the value of the patented feature, not any value added by the standard's adoption of the patented technology. These steps are necessary to ensure that the royalty award is based on the incremental value that the patented invention adds to the product, not any value added by the standard's adoption of that technology.").

[58] Delrahim, Madison, *supra* note 33, at 9.

[59] Alexander Galetovic & Stephen Haber, *The Fallacies of Patent-Holdup Theory*, 13 J. Competition L. & Econ. 1 (2017); Anne Layne-Farrar, Patent Holdup and Royalty Stacking Theory and Evidence: Where Do We Stand After 15 Years of History, Paper Prepared for OECD Directorate for Financial and Enterprise Affairs Competition Committee (Dec. 17–18, 2014), https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP/WD%282014%2984&doclanguage=en ("Despite the 15-years proponents of the theories have had to amass evidence, the empirical studies conducted thus far have not shown that holdup or royalty stacking is a common problem in practice.").

[60] David J. Teece and & Edward F. Sherry, *Standards Setting and Antitrust*, 87 Minn. L. Rev. 1931 (2003).

[61] That said, the obligation to pay royalties can affect real resource uses by deterring some customers from buying royalty-bearing products that they would have bought absent the royalties, leading to a degree of dead-weight loss. *See id.*

[62] Even in a static model, royalties are pure transfers, except for any dead weight loss, which is likely small. In a dynamic model, royalties, of course, are the very stuff that helps fuel R&D and innovation.

[63] Delrahim, *Limit*, *supra* note 31, at 9.

[64] For example, the new IEEE IPR policy says that it is not acceptable for the owner of an SEP to even seek (much less enforce) injunctive relief against those making standards-compliant products without a license, unless the other firm refuses to participate in the legal process. *See* IEEE IPR Policy, Section 6.2, standards.ieee.org/develop/policies/bylaws/sect6-7.html.

[65] For a recent analysis, see David Kappos & Paul R. Michel, *The Smallest Salable Patent-Practicing Unit: Origins and Development*, 32 Berkeley Tech. & L.J. No. 4 (2018).

[66] Delrahim, *Limit*, *supra* note 31, at 11.

[67] Areeda, *supra* note 8.

[68] In conversations with antitrust scholars, I have heard comments that taking industrial policy questions into account when crafting competition policy is tantamount to the second coming of the bubonic plague. It might in fact be precisely the opposite, which is what Areeda had suggested.

# The EC Communication on SEPs: Convergence, Divergence, or Silence?

BY IAN SIMMONS, BENJAMIN HENDRICKS, AND PHILIPPE NOGUES

ON NOVEMBER 29, 2017, THE European Commission (EC) released a communication entitled, "Setting out the EU approach to Standard Essential Patents."[1] The EC Communication outlines a strategy to "creat[e] a fair and balanced system for Standard Essential Patents."[2] This article analyzes what the EC Communication says—and, more importantly, does not say—discusses how the EC Communication fits in with recent developments in competition law related to SEPs in the United States, and offers practical guidance to those involved in standard setting.

## Standard-Setting Background

Standards are "consistent protocols that can be universally understood and adopted" that "fuel compatibility and interoperability and simplif[y] product development."[3] Some ubiquitous standards include mobile network standards, such as 3G or 4G (and soon 5G), which allow any cell phone to connect to the same network, WiFi standards that allow any computer to connect to wireless Internet, or Bluetooth standards that allow wireless products to connect to various devices. But not all standards are high-tech: 19th century railroads strived to create standards for track gauges so a train could move between tracks made by different manufacturers in different regions of the country with ease.[4]

Once standards are adopted, numerous competitors can build products that use the standards and allow consumers to take advantage of "interoperability" even though consumers use products created by different firms (e.g., Google phones can communicate with Samsung phones and computer accessories manufactured by a range of suppliers can all plug into the same USB port). The benefits of standardization and interoperability are expected to increase exponentially with the advent of "the Internet of things" (IOT). This is because more and more consumer products—from cars to refrigerators—will connect to WiFi, mobile, or other networks to share information. The EC estimates that upwards of 40 percent of the benefits from the IOT comes from "interoperability enabled by standards."

But standards and standard setting can implicate competition concerns. Indeed, Standard Development Organizations (SDOs) consist of groups of competitors that agree on a single technological protocol for an industry. These types of agreements raise fundamental competition questions.[5] The selection of a standard may confer market power on a firm that owns patents that cover technology needed to practice a standard.[6] A patent that is essential to practicing a standard is called a "Standard Essential Patent" or SEP.

Typically, prior to adopting a standard, SDOs require firms to disclose the existence of potential SEPs and promise to license them on fair, reasonable, and non-discriminatory (FRAND) terms.[7] The FRAND commitment is designed to protect industry members against the risk of an SEP owner abusing the market power conferred via the standard while still allowing SEP owners to collect a reasonable royalty for the invention.[8] If a potential SEP owner refuses to make the FRAND commitment, the SDO may elect to choose a different standard that does not incorporate the relevant technology or abandon efforts to create a single standard entirely.

The potential for a firm to use SEPs to exercise market power over the standardized industry has piqued the interest of competition authorities. Most enforcers have focused on patent hold-up, which is "[t]he tactic of withholding a license unless and until a manufacturer agrees to pay an unduly high royalty rate for an SEP."[9] More recently, especially in the United States, competition authorities have also voiced concern about "hold-out," which is when the licensee (or a group of licensees) refuses to pay a reasonable royalty, using FRAND as a shield against a patent infringement suit to drive royalties down.[10] Antitrust authorities have not yet settled on a consistent competition analysis for standard setting and the licensing of SEPs, and a heated debate has emerged about the role competition laws have to play in standard-setting processes, the licensing of SEPs, and setting royalty rates compliant with the FRAND promise.

## The EC Communication

In an attempt to strike a balance between ensuring that "licensing programs" are "fair and reasonable" while also rec-

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**Faced with diverging views from within the EC and from various external stakeholders, the Commission avoided choosing sides, saying that there is no one-size-fits-all definition of FRAND.**

ognizing the need to "reward patent holders so they continue to invest in R&D," the EC Communication avoided declarations on the thorniest intersections of competition laws and SEPs.[11] Thus, the EC Communication is not likely to change the current landscape of FRAND litigation and licensing in Europe or the United States.[12] Nevertheless, it has been welcomed by licensors and licensees of SEPs (companies often embody both roles simultaneously), which have indicated that the Communication "is a victory for all European consumers and innovative businesses—especially Europe's car industry and the hundreds of SMEs active in the growing IoT sector."[13]

***The Creation of the EC Communication.*** The adoption of the Communication is part of the EC's wider Digital Single Market initiative, and it comes after considerable internal work and consultations, as well as intense lobbying.

Within the EC, a task force composed of members spanning different Directorates-General, or DGs, met regularly over several months to discuss issues related to licensing and the EC's Digital Single Market initiative. This group was set up in 2014, after DG Grow launched its public consultation on patents and standards.[14] The purpose of the consultation was to allow interested stakeholders to share their views on how the current framework governing standardization and SEPs was performing and how to ensure that standard setting remains effective in a fast-changing economic and technological environment. These consultations confirmed that the FRAND concept is important, but DG Grow indicated that it had doubts as to whether FRAND could be further refined because it was generally defined through bilateral negotiations.[15]

Following these consultations, FRAND licensing issues were hotly debated, in particular among DG Competition, DG Grow, and DG Connect. For DG Competition, these discussions took place shortly after its FRAND-related decisions in the *Samsung*[16] and *Motorola*[17] cases, which clarified that an SEP owner seeking an injunction for infringement of the SEPs could violate competition laws when that SEP holder has otherwise committed to license the SEP on FRAND terms and the (allegedly infringing) licensee has said it would be willing to enter a license on FRAND terms. While Commissioner Margrethe Vestager of DG Competition offered additional guidance going beyond its case law on the practical implications of FRAND—specifically that FRAND required the SEP holder to license SEPs to all willing licensees—other DGs refused to take a clear position.[18]

Both SEP holders and licensees lobbied intensely for the positions most favorable to their businesses (perhaps most notably whether the royalty of an SEP may be based on the value of the end device or whether the smallest saleable patent practicing unit (SSPPU) was the proper royalty base). These lobbying efforts extended beyond the Commission to members of the European Parliament and of the European Council.

Faced with diverging views from within the EC and from various external stakeholders, the Commission avoided choosing sides, saying that there is no one-size-fits-all definition of FRAND.

***EC Communication Summary.*** In its Communication, the EC focuses on four areas "where the SEP licensing environment could be improved." Each is discussed below, followed by a discussion of the significant areas left untouched by the EC Communication.

**Increasing Transparency and SEP Exposure.** The EC Communication laments the "lack of transparency" in SEP licensing and argues that this makes licensing for start-ups and small- and medium-sized entities more difficult. Transparency issues cause problems when licensees have difficulty identifying the SEPs they need to license to practice a standard and then verifying that these SEPs' "fair value" to facilitate licensing negotiations. These issues are especially pronounced when it is not clear whether the declared-SEP is truly essential to the standard. To this end, the EC Communication encourages SDOs to (1) "provide detailed [patent] information in their databases"; (2) develop "an information tool to assist in licensing negotiations"; (3) require more precise SEP-declarations with sufficient information "to assess patent exposure"; and (4) impose greater scrutiny on SEPs to ensure they are truly essential. Notably, each of these suggestions imposes *upfront costs on SEP owners* and thus departs from the policies and procedures currently followed by most (if not all) SDOs worldwide. But increased transparency should reduce hold-up *and* hold-out during negotiations because each side will have a more symmetric view of the value of the SEPs.

**General Principles for FRAND Licensing.** SEP owners promise to license SEPs on FRAND terms. But FRAND is famously (or infamously) undefined and is in the eye of the beholder. The EC Communication does little to change this. Instead, it establishes a "set of key signposts on the FRAND concept." These "key signposts" are: (1) FRAND "creates legitimate expectations on the part of third parties that the proprietor of the SEP will in fact grant licences on such terms"; (2) FRAND forbids SEP owners from "discriminat[ing] between implementers that are 'similarly situated'"; (3) FRAND requires parties to engage in "good faith negotiations" for SEP licensing but recognizes that there is "no one-size-fits-all" solution and what "can be considered fair and reasonable *differs* from sector to sector and over time"; (4) a FRAND-compliant royalty must be related to the "economic value of the patented technology" and may not

include value resulting from the "success of the product which is unrelated to the patented technology"; (5) FRAND allows SEP owners to charge royalties sufficient to "ensure continued incentives for SEP holders" to continue to invent; (6) FRAND takes a "reasonable aggregate rate for the standard" into account; and (7) FRAND allows SEP owners to use portfolio-wide and global licenses. Taken together, these "signposts" offer little clarity on what an SEP owner is promising when it commits to FRAND terms. The EC Communication implicitly recognizes this by calling for "an expert group" to study FRAND licensing and continue to "deepen" expertise in the area.

**A Predictable Enforcement Environment for SEPs.** The EC Communication lays out a number of principles for the enforcement of SEPs, noting that "SEPs show a higher degree of litigation than other patents." Again, attempting to strike a balance between the interests of SEP owners and licensees, the EC Communication affirms that the ability "to enforce is one of the key aspects of intellectual property rights," but recognizes that the FRAND commitment can limit this right. Most notably, the EC Communication affirms that "SEP holders may not seek injunctions against users willing to enter into a license on FRAND terms," but suggests that licensees should pay a "security" that is "at a level that discourages patent hold-out strategies." Further, the EC Communication appears to embrace alternative dispute resolution, noting that a "willingness of the parties to submit to binding third-party FRAND determination" is itself an "indication of FRAND behaviour." Finally, the EC Communication cautions Patent Assertion Entities that they are "subject to the same rules as any other SEP holder."

**Guidance for Open Source Standards.** Finally, the Communication focuses on the importance of integrating open source projects and standard development processes within the Information and Communication Technology (ICT) sector. The EC believes this integration will speed up the standardization process and increase the use of standards in the field of ICT (especially for small and medium firms), leading to the wider dissemination and use of open source software implementations if standards can provide interoperability. The press release accompanying the Communication acknowledges that FRAND terms and royalty free licenses are not necessarily incompatible in open source contexts.[19]

***Unresolved Issues.*** The EC chose not to wade into a number of complex issues that have plagued competition enforcers, SEP owners, SEP licensees, and SDOs, likely leaving these issues to the interpretation of the courts, and ceding an opportunity to lead global SEP and competition policy. Some of the most prominent questions left unanswered are:

**At What Level in the Distribution Chain are SEP-Owners Required to License?** The EC Communication is unequivocal that SEP licenses "should be made available to any potential user of the standard." But what does this mean in practice? Does this require an SEP owner to license to any willing licensee, no matter whether it manufactures components or end-products? Or, can an SEP owner license to end-product manufacturers only (leaving component manufacturers unlicensed)?[20] Moreover, the EC Communication asserts that SEP owners can discriminate among potential licensees that are *not* "similarly situated," without defining "similarly situated."[21] Thus, while the EC Communication hints that SEP owners must license to all willing licensees regardless of their position in the supply chain, the fact that the EC Communication did not explicitly affirm this means this debate is likely to continue.

And this is not a hypothetical debate. This is one of the key questions the U.S. FTC is litigating in its case against Qualcomm, having alleged that "Qualcomm refuses to license FRAND-encumbered cellular SEPs to competing suppliers of baseband processors" even though Qualcomm does license its SEPs to end-product manufacturers.[22] Qualcomm, on the other hand, argues that this structure respects FRAND licensing, stating that it "grants exhaustive licenses to its patented technologies . . . at the handset [i.e., end-product] level."[23] While Qualcomm's motion to dismiss was denied,[24] the question is still an open one.

**How to Calculate a FRAND Royalty?** While the EC Communication gave "signposts" for determining FRAND-compliant royalties, the EC Communication stopped short of mapping how to calculate FRAND-compliant royalties. The most precise guidance offered in the EC Communication is the observation that a FRAND-compliant royalty must be related to the patent itself and may not include value resulting from the "success of the product which is unrelated to the patented technology" and that parties should take a "reasonable aggregate rate for the standard" into account.[25]

That a FRAND-compliant royalty cannot incorporate value from the "success of the product which is unrelated to the patented technology" alludes to the idea that a FRAND-compliant royalty should capture only the *ex ante* value of the patents (i.e., the value of the patents *before* they were incorporated into a standard). But it is unclear whether the EC is really advocating for an *ex ante* valuation of SEPs. More specifically, the idea of a "reasonable aggregate rate" may conflict with the *ex ante* value idea because the *ex ante* approach would likely require a "bottom-up" approach to value the individual patent on a standalone basis, whereas the "aggregate rate" approach implies a need first to establish a reasonable FRAND-rate for *all* SEPs based on the products incorporating the standard and then determining the proper proportion of the aggregate rate to assign to each relevant SEP (a "top-down" approach). This tension has also reared its head in U.S. courts, which have not taken a consistent approach to calculating FRAND rates.[26]

In a related but separate question, the EC Communication did not discuss whether FRAND imposes limits on what can be used as the royalty base to which the rate is applied. Under U.S. patent law, courts setting a "reasonable" royalty

typically use the SSPPU,[27] but some SEP owners may calculate the royalty based on the sale price of the (often far more expensive) consumer product, not the component that practices the patent. This question is becoming increasingly more relevant as cars, appliances, and other high-priced consumer products begin to use standards to connect to the IOT. The closest the EC Communication comes to resolving this issue is asserting that a FRAND royalty should not include value resulting from the "success of the product which is unrelated to the patented technology,"[28] which can be very difficult to parse.

**The Extent to Which Competition Laws Should Govern SEP Licensing Practices.** Finally, the biggest open question from the EC Communication is whether, and to what extent, competition laws should be used to enforce FRAND or SEP licensing more generally. Indeed, the EC Communication barely mentions competition law.[29] The EC Communication mentions "hold-up" and "hold-out" exactly one time each, but does not discuss how each implicates competition laws. The EC Communication also does not refer to the market power that can flow from an SEP portfolio. The EC Communication does not take any position on how competition law weighs on SEPs, leaving significant questions unanswered, including: (1) Can a refusal to license a SEP constitute an antitrust violation? (2) Does unilateral patent hold-up or hold-out create antitrust liability? (3) Is the EC concerned with potential cartel-like behavior within SDOs? (4) Can SEP owners tie licenses for SEPs with other commitments, such as product purchase agreements or licenses with non-SEPs? The EC chose not to address any of these issues, perhaps waiting for further guidance from courts adjudicating specific practices. The EC Communication's only stance on the application of competition laws to SEPs is its apparent endorsement of *Huawei v. ZTE*,[30] which applied EU competition law (Article 102 TFEU) to forbid an SEP owner from seeking an injunction against a *willing licensee* of an SEP.

Interestingly, the EC Communication also does not mention a role for contract law to enforce FRAND commitments, even though reliance on private contract law is the preferred route for enforcing FRAND by those skeptical of applying competition laws to SEP licensing.[31] The EC Communication's silence on these issues was likely intended to preserve maximum flexibility for itself (and the courts of EU member states) for future issues regarding SEP licensing.

**Contrasting the EC Communication with the DOJ Speech.** Only a few weeks prior to the release of the EC Communication, Makan Delrahim, Assistant Attorney General for the Antitrust Division of the Department of Justice, gave a speech setting out a new policy for the DOJ with regard to SEPs.[32] In contrast to the balance sought by the EC Communication between the rights of SEP owners and licensees, Delrahim argued that the rights of SEP owners should be emphasized over SEP licensees. The DOJ speech asserted that "competition policy has focused too heavily" on the danger of patent "hold-up" by SEP-owners, and that hold-up is based on a "shady empirical foundation." On the other side of the ledger, the DOJ speech argued that "[t]he [h]old-*[o]ut* [p]roblem [p]oses a [m]ore [s]erious [t]hreat to [i]nnovation than the [h]old-[u]p [p]roblem."[33] The DOJ speech posited that "enforcers have strayed too far in the direction of accommodating the concerns of technology *implementers*" and risk undermining incentives for SEP owners, who the DOJ fears are not being sufficiently rewarded in proportion to their investment in the underlying technologies they own.

The DOJ speech also focused on risks from "cartel-like behavior"[34] by SEP licensees, who may band together in violation of Section 1 of the Sherman Act to extract an agreement for an unreasonably *low* royalty.[35] The DOJ speech's concern with collective action within SDOs is in stark contrast to the EC Communication, which does not address the dangers of "cartel-like" behavior within SDOs, and *encourages* some forms of collective action within SDOs to make SEP licensing more transparent and efficient. Specifically, the EC Communication "encourages stakeholders to pursue sectoral discussions with a view of establishing common licensing practices." The EC Communication also encourages the "creation of industry licensing platforms and patent pools." While the EC would clearly not condone a cartel maintained within an SDO, its encouragement of coordination among stakeholders contrasts with Delrahim's concern that coordination could lead to "cartel-like behavior" and that coordination among horizontal competitors in the standard-setting context merits "careful[] scrutin[y]."[36]

The EC Communication and DOJ speech also part company with regard to injunctive relief for SEPs. As discussed above, the EC Communication finds that SEP owners cannot seek to enjoin a willing licensee from practicing an SEP. In 2015 the DOJ recognized that a ban on injunctions for SEPs by an SDO was "consistent with the direction of U.S. law."[37] In contrast, the DOJ speech argues that "[a] patent holder cannot violate the antitrust laws by properly exercising the rights patents confer, such as seeking an injunction or refusing to license such a patent."[38] While U.S. courts have not established a "per se rule that injunctions are unavailable for SEPs," prior to the DOJ speech U.S. courts typically found that "money damages are adequate to fully compensate" an SEP owner. Thus, the DOJ speech's position that injunctions for SEPs do not violate competition laws can fairly be read as a break from prior U.S. policy, and the position laid out in the EC Communication.

Finally, whereas the EC Communication seeks to create "[a] predictable enforcement environment for SEPs," the DOJ speech has likely accomplished the opposite. For example, in 2015 the DOJ released a Business Review Letter endorsing a number of policy changes by the Institute of Electrical and Electronics Engineers (IEEE), including prohibiting injunctions for SEPs and encouraging royalty rates based on the SSPPU. Recent reports indicate that the DOJ may now be investigating conduct within the IEEE, stating

that "some interpretations of that letter that we have learned seem to be totally inconsistent with modern antitrust law."[39] Whether the DOJ's Business Review Letter to the IEEE still reflects DOJ policy is unclear, thus creating additional uncertainty in the United States.

In many ways, the EC Communication and the DOJ speech advocate competing views of SEP competition policy, with the EC Communication balancing SEP policy between licensors and licensees, while the DOJ speech argues that policies regarding SEPs need to be corrected in favor of SEP owners. Nonetheless, both the EC Communication and the DOJ speech should be viewed as starting places for SEP competition guidance and not a culmination of these debates. The EC Communication sets out only general principles and offers broad guidance, leaving significant space for SDOs, SDO members, and European courts to fill in the spaces. Similarly, the ultimate effect of the DOJ speech—especially to the extent that it breaks with DOJ policy during the Obama administration—may be that U.S. courts must devise a consistent SEP policy since the DOJ has not embraced a consistent policy across political administrations.

## Practical Guidance for Stakeholders

Because the primary goal of the EC Communication was to strike a balance among stakeholders in standard setting, it cannot be viewed as a safe harbor for any single stakeholder. Nonetheless, some guidance can be teased out of the EC Communication for SDOs, SEP owners, and SEP licensees.

**SDOs.** SDOs should take a more active role in encouraging efficiency and transparency in the standard-setting process. This includes increasing disclosure requirements for putative SEP owners, easing the burdens of potential licensees to research SEPs, and exploring ways to encourage patent pools or other mechanisms to make it easier for licensees to practice a standard. That said, in light of the DOJ speech, before making any reforms discussed in the EC Communication, SDOs should act cautiously and seek antitrust counsel to ensure they insulate themselves from accusations of facilitating cartel-like behavior within their walls. SDOs should make sure that both licensees *and* SEP owners are supportive of policy initiatives to avoid scrutiny from the DOJ, even if the change is in line with the EC Communication's suggestions.

**SEP Owners.** SEP owners should work with SDOs to increase transparency of SEPs without imposing significant costs on participation in the standard-setting process. SEP owners should also enact licensing policies consistent with the FRAND commitment, such that the SEP owner cannot be accused of abusing market power flowing from SEPs. While nothing prevents an SEP owner from seeking significant royalty payments from licensees, the SEP owner should be ready to justify its position based on the share of its SEPs' contribution to a reasonable aggregate royalty or based on a valuation of the patent *prior* to the enactment of the standard. SEP owners may even consider publicly announcing FRAND rates for SEP portfolios like Ericsson did with regard to its 5G SEP portfolio.[40] Finally, SEP owners should consider asking licensees to submit to binding arbitration should the licensing negotiation break down, or at least be prepared to accept binding arbitration as a last resort at the request of the licensee.

**SEP Licensees.** SEP licensees should work with SDOs to ensure that they have sufficient information with regard to SEPs to facilitate fair negotiations with SEP owners. But in light of the DOJ speech, SEP licensees should be cautious in their communications with fellow SDO members to ensure no communications raise the specter of cartel-like behavior. SEP licensees should be especially wary of discussing specifics regarding what constitutes a "reasonable" royalty with other licensees.

An SEP licensee should also establish a policy regarding its licensing practices that ensure it is in a position to offer a "concrete" counter-offer that protects it from being labeled an "unwilling" licensee and/or in engaging in patent hold-out. An SEP licensee also needs to consider the terms on which it would accept binding arbitration in the event of a failed negotiation. Further, should SEP policies in Europe and the United States diverge, SEP licensees may consider seeking separate SEP licenses for each jurisdiction such that they can take advantage of EC policies that are more friendly to licensees without attracting scrutiny from the DOJ, which is shifting its focus to patent hold-out.

## Conclusion

Ultimately, the EC Communication is not likely to change how competition laws govern SEPs as the EC's attempt to a strike a balance among standard-setting stakeholders resulted in a plain-vanilla recitation of uncontroversial principles. The national courts of the Member States in the EU and federal courts in the United States will likely remain the main actors in bringing more clarity to the FRAND concept, as illustrated by the recent judgments of Justice Birss in the *Unwired Planet v. Huawei* case, which handed down the first UK court decision determining the value of a FRAND royalty rate and whether the licensee (Huawei) should be subject to an injunction in the UK.[41] The EC Communication's biggest legacy may be whether its attempt to find common ground can become a starting place for a consistent policy of how competition law governs SEPs globally or whether it is overshadowed by competition authorities willing to take more concrete steps like the positions outlined in the DOJ speech. ■

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[1] European Commission, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, Setting Out the EU Approach to Standard Essential Patents, COM(2017) 712 (Released Nov. 29, 2017) [hereinafter EC Communication], https://ec.europa.eu/docsroom/documents/26583.

[2] Press Release, European Comm'n, Intellectual Property: Protecting Europe's

know-how and innovation leadership (Nov. 29, 2017), http://europa.eu/rapid/press-release_IP-17-4942_en.htm.

[3] *What Are Standards?*, IEEE, https://standards.ieee.org/develop/overview.html (last visited Mar. 13, 2018).

[4] *See* Douglas J. Puffert, *The Standardization of Track Gauge on North American Railways*, 1830–1890, 60 J. Econ. Hist. 933 (2000).

[5] Microsoft Corp. v. Motorola, Inc., 795 F.3d 1024, 1030–31 (9th Cir. 2015) (*Microsoft II*) ("The development of standards . . . creates an opportunity for companies to engage in anti-competitive behavior.").

[6] *See* Apple Inc. v. Samsung Elecs. Co. Ltd., No. 11-CV-01846, 2012 WL 1672493, at *6 (N.D. Cal. May 14, 2012) (Koh, J.) (citing Broadcom v. Qualcomm, Inc., 501 F.3d 297, 314 (3d Cir. 2007)); *see also* Rambus Inc. v. FTC, 522 F.3d 456, 463 (D.C. Cir. 2008) (finding patent holder's SEPs for computer memory technologies "g[a]ve it monopoly power in each of those markets").

[7] *See* ETSI, Rules of Procedure Annex 6 (Nov. 29, 2017), http://www.etsi.org/images/files/IPR/etsi-ipr-policy.pdf.

[8] *See* Research in Motion Ltd. v. Motorola, Inc., 644 F. Supp. 2d 788, 794 (N.D. Tex. 2008); *id.* at 791 ("'FRAND commitments' are intended to prevent owners of essential patents from acquiring too much of the market power that would otherwise be inherent in owning an essential patent.").

[9] *Microsoft II*, 795 F.3d at 1031; *see also* Dennis Carlton & Allan Shampine, *An Economic Interpretation of FRAND*, 9 J. Competition L. & Econ. 531 (2013).

[10] Makan Delrahim, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Take It to the Limit: Respecting Innovation in the Application of Antitrust Laws (Nov. 10, 2017) [hereinafter DOJ speech], https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-usc-gould-school-laws-center. Notably, there is little evidence of patent holdout in case law. *See* A. Douglas Melamed & Carl Shapiro, *How Antitrust Law Can Make FRAND Commitments More Effective*, Yale L.J. (forthcoming).

[11] The communication emphasizes a need for "balance" between SEP owners and SEP licensees no fewer than six times. *See, e.g.*, EC Communication, *supra* note 1, at 2 ("There is therefore a need for a clear, balanced and reasonable policy for Standard Essential Patents in the EU."); *id.* at 9 ("A balanced and predictable enforcement environment has particularly positive effects . . . ."); *id.* at 13 ("[A] balanced IPR framework is needed that supports a sustainable and efficient standardization ecosystem and SEP licensing environment.").

[12] Under EU law, a Communication is an administrative document with no legally binding effect and merely summarizes current Commission views on a topical issue, here SEPs.

[13] *See* Press Release, Fair Standards Alliance, Fair Standards Alliance Welcomes European Commission's Forward-looking Standard Essential Patents (SEP) Guidelines (Nov. 29, 2017), http://www.fair-standards.org/2017/11/29/press-release-fair-standards-alliance-welcomes-european-commissions-forward-looking-standard-essential-patent-sep-guidelines/.

[14] *See* European Comm'n, Public Consultation on Patents and Standards: A Modern Framework for Standardisation Involving Intellectual Property Rights (Oct. 14, 2014) (updated Aug. 26, 2016), http://ec.europa.eu/growth/content/public-consultation-patents-and-standards-modern-framework-standardisation-involving_en.

[15] *See* European Comm'n, Public Consultation on Patents and Standards—A Modern Framework for Standardisation Involving Intellectual Property Rights, Summary Report (Oct. 27, 2015), http://ec.europa.eu/DocsRoom/documents/14482/attachments/1/translations/en/renditions/native.

[16] *See* Case AT.39939—Samsung—Enforcement of UMTS Standard Essential Patents, http://ec.europa.eu/competition/antitrust/cases/dec_docs/39939/39939_1501_5.pdf.

[17] *See* Case AT.39985—Motorola—Enforcement of GPRS Standard Essential Patents, http://ec.europa.eu/competition/antitrust/cases/dec_docs/39985/39985_928_16.pdf.

[18] *See* Margrethe Vestager, DG Competition Comm'r, 19th IBA Conference Opening Remarks (Sept. 11, 2015), https://ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/intellectual-property-and-competition_en.

[19] Press Release, *supra* note 2.

[20] The doctrine of patent exhaustion states that "when a patentee sells one of its products . . . the patentee can no longer control that item through the patent laws." Impression Prods., Inc. v. Lexmark Int'l, Inc., 137 S. Ct. 1523, 1529 (2017). Thus, "The purchaser and all subsequent owners are free to use or resell the product just like any other time of personal property, without fear of an infringement suit." *Id.*

[21] EC Communication, *supra* note 1, at 7.

[22] Complaint at 59, FTC v. Qualcomm, Inc., No. 5:17-cv-00220 (Jan. 17, 2017), ECF No. 1. Authors Ian Simmons and Benjamin Hendricks submitted an amicus brief on behalf of Samsung Electronics Co. in *FTC v. Qualcomm, Inc.*

[23] Motion to Dismiss at 5, FTC v. Qualcomm, Inc., No. 5:17-cv-00220 (Apr. 3, 2017), ECF No. 69.

[24] Order Denying Motion to Dismiss, FTC v. Qualcomm, Inc., No. 5:17-cv-00220 (June 26, 2017), ECF No. 133.

[25] EC Communication, *supra* note 1, at 6–7.

[26] *See* TCL Comm. Tech. Holdings, Ltd. v. Telefonaktiebolaget LM Ericsson, 2017 WL 6611635 (C.D. Cal. Dec. 21, 2017); Microsoft Corp. v. Motorola, Inc., 2013 U.S. Dist. LEXIS 60233 (W.D. Wash. Apr. 25, 2013); *In re* Innovatio IP Ventures, 2013 WL 5593609 (E.D. Ill. Oct. 3, 2013).

[27] *See generally* Ericsson, Inc. v. D-Link Sys., Inc., 773 F.3d 1201, 1201 (Fed. Cir. 2014); Laser Dynamics, Inc. v. Quanta Computer, Inc., 694 F.3d 51 (Fed. Cir. 2012).

[28] EC Communication, *supra* note 1, at 6–7.

[29] The only reference to competition laws in the EC Communication is a note that the communication "does not bind the Commission" with regard to competition laws and a caveat that transparency initiatives and patent pools containing SEPs must be made in accordance with EC competition laws. EC Communication, *supra* note 1, at 3, 7.

[30] Case C-170/13, Huawei Tech. Co. Ltd. v. ZTE Corp. (CJ 2015).

[31] *See* Douglas Ginsburg, Koren Wong-Ervin & Joshua Wright, *The Troubling Use of Antitrust to Regulate FRAND Licensing*, CPI Antitrust Chron. (Oct. 2015).

[32] DOJ Speech, *supra* note 10, at 1.

[33] *Id.* at 3 (emphasis added).

[34] Mr. Delrahim stated that "enforcers should carefully examine and recognize the risk that SSO participants might engage in a form of buyer's cartel, what economists call a monopsony effect. When implementers act together within a standard-setting organization as the gatekeeper to sales or products including a new technology, they have both the motive and means to impose anticompetitive licensing terms. At the extreme, they can shut down a potential new technology in favor of the status quo, all to the detriment of consumers."

[35] It is unclear whether licensee-side collusion could effectively coerce a SEP owner, which could use the threat of patent infringement cases to combat hold-out tactics. Indeed, both in the U.S. and the EU there is no documented instance of collective hold-out by putative licensees. *See* Melamed & Shapiro, *supra* note 10.

[36] DOJ speech, *supra* note 10, at 10, 13.

[37] U.S. Dep't of Justice, Antitrust Div., Response to Institute of Electrical and Electronics Engineers, Inc., IEEE Business Review Letter at 11 (Feb. 2, 2015), https://www.justice.gov/atr/response-institute-electrical-and-electronics-engineers-incorporated; *see* Apple Inc. v. Motorola, Inc., 757 F.3d 1286, 1331–32 (Fed. Cir. 2014); *see also* Decision and Order, Fed. Trade Comm'n, Motorola Mobility LLC et al., No. C-4410 (July 23, 2013) (forbidding "covered injunctive relief" for SEPs).

[38] DOJ speech, *supra* note 10, at 8.

[39] Charles McConnell, *Delrahim Hints at IEEE Probe*, Global Competition Rev. (Jan. 23, 2018).

[40] Press Release, Ericsson, Ericsson's FRAND Licensing Terms for 5G/NR in 3GPP Release (Mar. 3, 2017), https://www.ericsson.com/assets/local/networked-society/innovation/patents–licensing/frand-licensing-terms-for-5g-nr-in-3gpp-release-15.pdf.

[41] *See* Unwired Planet Int'l Ltd v. Huawei Technologies Co. Ltd., [2017] EWHC 711 (Pat), https://www.judiciary.gov.uk/wp-content/uploads/2017/04/unwired-planet-v-huawei-20170405.pdf.

# Comparative Analysis of Court-Determined FRAND Royalty Rates

BY FEI DENG, GREGORY K. LEONARD, AND MARIO A. LOPEZ

STARTING WITH THE *MICROSOFT v. Motorola* decision in 2013, litigation over licensing practices involving standard-essential patents (SEPs), and particularly the appropriate "fair, reasonable and non-discriminatory" (FRAND) royalty rates for portfolios of such patents, has taken off.[1] In *Microsoft v. Motorola* (U.S., 2013), *In re Innovatio* (U.S., 2013), and *Realtek v. LSI* (U.S., 2014), FRAND rates were determined for portfolios of 802.11 Wi-Fi SEPs (in the first two cases by judges and in the latter case by a jury).[2] In *Huawei v. InterDigital* (China, 2013), *Unwired Planet v. Huawei* (UK, 2017), and *TCL v. Ericsson* (U.S., 2017), FRAND rates were determined for cellular (2G, 3G, and 4G) SEPs (in each case by judges).[3]

These litigations have taken place in various jurisdictions around the world, which raises the possibility of inconsistency across jurisdictions, either in the FRAND rates themselves or in the methodologies used to determine the rates. Inconsistency could be particularly problematic given that some of these litigations have set FRAND rates that would apply globally (e.g., *TCL*). We review and compare the two most recent cellular cases, *Unwired Planet* and *TCL*, to determine the extent to which the decisions are consistent with each other.[4]

In patent infringement litigation in the United States, one form of damages that a patent owner may seek is a "reasonable royalty." The reasonable royalty is meant to be limited to the "incremental value of the invention" and, in the case of an SEP, the reasonable royalty should exclude "the value of the standard as a whole or any increased value the patented feature gains from its inclusion in the standard."[5] Three approaches commonly used to determine the reasonable royalty in patent litigation in the United States are (1) benchmarking of the royalty based on "comparable" licenses ("comparable license approach"), (2) calculation of the incremental economic benefit of the patented technology versus a non-infringing alternative ("bottom-up approach"), and (3) explicit "apportionment" of an appropriately defined profit to the patented technology, taking into account the contributions of factors other than the patented technology at issue ("top-down approach"). Versions of these approaches have also provided the basis for experts opining on FRAND royalty determination in SEP litigation.

*Fei Deng, Gregory Leonard, and Mario Lopez are economists and partners at Edgeworth Economics LLC. They have consulted for or testified on behalf of the following entities in FRAND-related litigation: Samsung (Deng, Leonard, Lopez), TCL (Deng, Leonard, Lopez), Oppo (Lopez), Vivo (Lopez), Cisco (Leonard, Lopez), Realtek (Leonard, Lopez), Intel/D-Link/Netgear (Leonard, Lopez), and Motorola (Leonard). Fei Deng is an editor of* The Antitrust Source. *Gregory Leonard is a Senior Editor of* The Antitrust Law Journal. *The authors thank Nethra Venkatesh, Jessie Jiang, and Michael O'Donnell for excellent research assistance.*

## Summary of the Two Decisions

In *Unwired Planet*, the court began with a set of Ericsson patent licenses on the basis that *Unwired Planet* had acquired the SEP portfolio at issue from Ericsson.[6] After analyzing and "unpacking" each of these licenses to assess the "one-way" royalty rate that Ericsson charged the counter-party, the court chose one specific license (the counter-party was not named), and Ericsson's one-way rate from that license, as a starting point.[7] To adjust for differences in size between the Ericsson and Unwired Planet portfolios, the court multiplied the Ericsson one-way rate from the chosen comparable license by the ratio of Unwired Planet's portfolio strength to Ericsson's portfolio strength.[8] As a "cross-check," the court calculated the "aggregate royalty burden" (ARB) for all SEPs that would be implied by the Ericsson and Unwired Planet one-way rates.[9] The ARB is a key element of a top-down approach.

In *TCL*, the court relied on both a top-down analysis and comparable licenses. In its top-down analysis, the court determined an ARB for all SEPs for a given standard, then apportioned the ARB to the Ericsson SEP portfolio based on Ericsson's share of total SEP value of that standard. In its comparable license analysis, the court determined that the appropriate comparable licensees were those with global businesses and then unpacked the licenses to determine the one-way rate that Ericsson was charging each counter-party. The court compared the range of rates from the top-down and comparable license approaches and settled upon a FRAND royalty rate from the range of these rates.[10]

An important question is the extent of consistency between these two decisions. We start by comparing the outcomes, i.e., the determined rates, and subsequently compare the methodologies used and the inputs to those methodologies.

The royalty that the UK *Unwired Planet* court determined for the six Unwired Planet LTE SEPs was 0.062 percent. In

addition, as an intermediate step in the analysis, the *Unwired Planet* court concluded that the FRAND rate for Ericsson's LTE SEP portfolio was 0.80 percent for a "major market."[11] In contrast, the *TCL* court found the FRAND rate for Ericsson's LTE SEP portfolio (after the divestiture of the SEPs to Unwired Planet) in the United States to be 0.45 percent.[12] The difference between the two decisions in their conclusions regarding the FRAND rate for Ericsson's portfolio is substantial. We analyze the methodologies of the two decisions to identify the reasons for this difference.

**Although both courts relied on Ericsson licenses as comparables, they ultimately arrived at substantially different FRAND royalty rates for Ericsson's SEP portfolio. . . . [T]he *Unwired Planet* court found a rate for Ericsson's LTE portfolio that is almost double that found by the *TCL* court.**

## Comparison of the Comparable License Approaches in the Two Decisions

Although both courts relied on Ericsson licenses as comparables, they ultimately arrived at substantially different FRAND royalty rates for Ericsson's SEP portfolio. As noted above, the *Unwired Planet* court found a rate for Ericsson's LTE portfolio that is almost double that found by the *TCL* court.[13] It is therefore instructive to consider what can be gleaned from the decisions as to why the two courts may have differed in their comparable license analyses.

A first consideration is the list of licenses that were available for analysis to each court and the specific licenses the respective courts chose to examine. A comparable license analysis typically begins by identifying those licenses that were signed under economic circumstances that are sufficiently comparable to the situation being studied or for which reasonable adjustments could be made to account for any significant differences. Moreover, in a FRAND case, the nondiscriminatory component of FRAND would appear to limit consideration to licenses with counter-parties that are "similarly situated" to the prospective counter-party in question.

Although both decisions focus on licenses with major handset manufacturers, the courts may not have considered the same set of licenses.[14] For example, the *TCL* decision discusses a 2015 Ericsson license with Apple, but this license may not have been considered in *Unwired Planet*.[15] The TCL court specifically addressed the question of whether Apple and Samsung (the world's two largest handset manufacturers) were similarly situated to TCL, which was substantially smaller than those two companies.[16] The court found that such firms should be included in the FRAND analysis for TCL because excluding them "would have the effect of insulating them, and further contributing to their dominant positions, by imposing a barrier in the form of higher rates for those not at the top end of the market."[17]

Both courts also concentrated on more recent licenses, with the *Unwired Planet* court specifically noting evidence of a decline in rates over time due to a number of FRAND decisions worldwide that reduced the threat of injunction faced by implementers.[18]

Apart from the respective sets of licenses that were analyzed, the specific assumptions and methodologies may also have differed between the two courts. While both courts appeared to have adopted a similar framework for unpacking the licenses at a high level, both decisions redacted much of the information necessary to compare details of the assumptions made on a license-by-license basis. The major factors considered by the courts were:

- **Unpacking one-way rates from cross-license agreements.** Because Ericsson also sells cellular networking equipment (e.g., cellular base stations), most of the license agreements involving Ericsson were cross-licenses. Under a cross-license, one party typically makes payments to the other, and those payments are net of any cross-licensing value the paying party receives under the license. In both *TCL* and *Unwired Planet*, Ericsson's one-way rates were unpacked using various measures of the relative SEP portfolio strengths of the parties to the respective licenses.[19]
- **Sales forecast estimates.** In *TCL*, Ericsson's expert relied upon Ericsson's internal projections (referred to as its "Business Case"), which the court viewed skeptically, while TCL's expert relied upon both the Ericsson Business Case projections, as well as sales data from a third-party vendor, International Data Corporation (IDC).[20] The court favored the IDC data, noting that such "independent third-party data serves as a valuable check on a party's internal and unvalidated projections."[21] In *Unwired Planet*, the court did not specifically address the types of sales forecasts used to calculate the effective royalty rates, and appears to have relied on the projections used by the experts in the case.
- **Other provisions.** A license may include other provisions that may need to be taken into account if they had a material effect on the net payments made under the license. Examples of such provisions are the exchange of patents, licensing of other patent rights (e.g., patents to other standards, non-SEP or implementation patents, etc.), or other business arrangements.
- **Unpacking of rates for major and minor markets.** Many of Ericsson's licenses covered worldwide sales. In principle, its worldwide royalty rate for a given counter-party should reflect its average portfolio strength across jurisdictions, weighted by the counter-party's sales in those jurisdictions. Ericsson's portfolio strength varies substantially across jurisdictions. The *TCL* court unpacked the Ericsson licenses into U.S. rates, European rates, and rest-of-world rates. Notably, it placed a lower bound on Ericsson's portfolio strength in each jurisdiction based on Ericsson's

portfolio strength in China, where TCL manufactured its products. We note, however, that patent rights covering products manufactured, but not sold, in a country are generally less valuable than patent rights covering products sold in a country because a manufacturer could, in principle, choose to manufacture in a different country. The *Unwired Planet* court appears to have made a similar unpacking adjustment to calculate Ericsson's rate in "major markets," which was then used to calculate Unwired Planet's rate in such a market.[22] The court then made a downward adjustment to obtain Unwired Planet's rate in the rest of the world. As in *TCL*, the *Unwired Planet* court used China as a lower bound for the rest-of-world rates, though it relied on an ad hoc 50 percent adjustment to the major market rate rather than an adjustment based directly on portfolio strength.[23]

## Comparison of the Top-Down Approaches in the Two Decisions

In its top-down approach, the TCL court began by determining the appropriate aggregate royalty burden for the standard as a whole, and then apportioned that ARB to the Ericsson SEP portfolio. Thus, the FRAND rate for Ericsson's LTE SEP portfolio can be expressed as:

> Ericsson FRAND LTE Rate = ARB x Ericsson's Share of the Value of All LTE SEPs.

In assessing the ARB, the *TCL* court cited statements regarding ARB levels that Ericsson and other SEP holders made at around the time the standards were set. The court noted that Ericsson had long endorsed the concept of a maximum ARB, that these statements held special importance in a FRAND context because the statements were made prior to or around the time the standards were set and, at the time, Ericsson was both a licensee and a licensor for handsets, and therefore had an incentive to "strike a reasonable balance" with respect to how FRAND rates should be set.[24] Moreover, the court found that "Ericsson's statements were thus not a hope or prediction, but a pledge to the market that if the market adopted Ericsson's championed standard, the total aggregate royalties would be calculated" based on its 6 to 8 percent ARB.[25] Based on these statements, the *TCL* court adopted 5 percent as the ARB for 2G and 3G, and a range of 6 to 10 percent as the ARB for LTE.

The *TCL* court then turned to determining Ericsson's appropriate share of the ARB, noting that the ARB should be apportioned across SEP holders according to the relative values of their respective portfolios.[26] It is widely accepted among economists that patent values vary widely, and the court acknowledged that "many [SEPs] are relatively trivial, while some are key features of the standard."[27] TCL had presented a technical analysis of Ericsson's patents that attempted to measure the "contribution" and "importance" of Ericsson's SEPs to the standard. While the court found certain flaws in the technical analysis, it nevertheless concluded that the technical analysis provided "some value" in showing that "Ericsson's patent portfolio is certainly not as strong or essential as it has claimed."[28]

TCL's economics expert also presented a forward citation analysis of Ericsson's portfolio as a secondary approach.[29] However, although a number of empirical economic studies have shown a relationship between patent value and forward citations,[30] and other courts have endorsed this form of analysis,[31] the TCL court chose not to rely on forward citation analysis to calculate Ericsson's share of the ARB. The TCL court effectively concluded, based on the evidence, that the relative strength of the Ericsson SEP portfolio was reasonably approximated by its share of the total number of all SEPs, which is equivalent to concluding that the average Ericsson SEP had value equal to the average SEP.

The *TCL* court made certain adjustments, such as accounting for patents that would expire over the license term as well as new SEPs that would issue during that period. As discussed above, the *TCL* court also accounted for variation in Ericsson's portfolio strength across jurisdictions, adopting TCL's expert's estimate of Ericsson's regional portfolio strength ratios in arriving at separate FRAND rates for different regions.[32]

Although the *Unwired Planet* court rejected the Ericsson statements on which the TCL court based its range for the ARB, calling them "self-serving," it nevertheless relied upon the ARB as a check against its FRAND rate determinations.[33] As discussed above, the *Unwired Planet* court did not perform a full top-down analysis, but instead calculated the ARB that is implied by the Unwired Planet one-way rate and its relative portfolio strength. Specifically, rearranging the equation above,

> ARB = UP LTE FRAND Rate / UP's Share of the Value of All LTE SEPs.

The *Unwired Planet* court's calculation yielded an ARB of 8.8 percent.[34] This is within the range that the *TCL* court determined for the ARB (6 to 10 percent).

## Conclusion

The *Unwired Planet* and *TCL* decisions found different rates for Ericsson's LTE SEP portfolio primarily because they reached different conclusions from their respective comparable license analyses. While the details of these analyses are not entirely clear, the two analyses likely differed in the licenses considered most comparable and the sales forecasts used to unpack the Ericsson one-way rates.

The two decisions also differed substantially in their respective implied assessments of Ericsson's portfolio strength. From the *Unwired Planet* court's calculations, the implied Ericsson share of all LTE SEP value was 9.1 percent. The *TCL* court, on the other hand, concluded that Ericsson's share of all LTE SEP value was only about half as large.[35]

Interestingly, these two factors roughly canceled out so that the two decisions were in rough agreement as to the ARB

for all LTE SEPs. The ARBs determined in the two decisions are also consistent with statements made by Ericsson, Nokia, NTT Docomo, NEC, and Sony—some of which had both significant SEP portfolios and handset businesses—at around the time of LTE adoption advocating a single-digit ARB for LTE handsets.[36] This suggests that future FRAND rate litigation in the cellular space may focus more on the measurement of relative portfolio strength and less on the level of the ARB. ■

[1] In some contexts (e.g., 802.11), the term "RAND" ("reasonable and non-discriminatory") is used instead of FRAND. As economists, we view the two terms as having the same meaning. We use FRAND throughout this article for ease of exposition.

[2] Microsoft Corp. v. Motorola, Inc., No. C10-1823JLR, 2013 WL 2111217 (W.D. Wash. Apr. 25, 2013); *In re* Innovatio IP Ventures, LLC Patent Litig., No. 11 C 9308, 2013 WL 5593609 (N.D. Ill. Oct. 3, 2013); Realtek Semiconductor Corp. v. LSI Corp., No. C-12-3451-RMN, 2014 WL 10936481 (N.D. Cal. Feb. 26, 2014).

[3] Unwired Planet Int'l Ltd. v. Huawei Techs. Co., [2017] EWHC (Pat) 711; TCL Commc'n Tech. Holdings, Ltd. v. Telefonaktiebolaget LM Ericsson, Nos. SACV 14-341 JVS(DFMx) and CV 15-2370 JVS (DFMx), 2017 WL 6611635 (C.D. Cal. Dec. 21, 2017), ECF No. 1802; InterDigital v. Huawei, Civil Judgment Record No. 305 (2013), Final, Civil Division III, Higher People's Court of Guangdong Province.

[4] In both *Unwired Planet* and *TCL*, FRAND rates were determined for the 2G, 3G, and LTE portfolios as well as for both handsets and infrastructure. For simplicity, we focus on the FRAND rates for LTE handset SEPs.

[5] Ericsson, Inc. v. D-Link Sys., Inc., 773 F.3d 1201, 1235 (Fed. Cir. 2014).

[6] The *Unwired Planet* court also considered other agreements entered into directly by Unwired Planet with Lenovo and Samsung, but ultimately concluded that the Lenovo license "is not a useful comparable from the point of view of setting a FRAND rate today" and that the Samsung license "does not represent useful evidence of the market value of the Unwired Planet patent portfolio." *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 389, 409.

[7] A license agreement may involve each party licensing the other (a "cross-license"). Instead of specifying "one-way" royalty payments (or royalty rates) that would be applicable to each party, cross-licenses often specify only the "balancing" royalty payment (or royalty rate) that is the difference between the two one-way payments. Thus, what has been termed an "unpacking" analysis is required to determine the one-way royalty payments (or rates) from a typical cross-license that specifies only the balancing payment (or rate). For more detail, *see infra* note 22.

[8] For example, for LTE, the court determined that Ericsson's one-way royalty rate from the chosen license was 0.80%. The court then determined that Unwired Planet's LTE SEP portfolio was 7.69% of the value of Ericsson's LTE Portfolio, arriving at an adjusted royalty rate of 0.062% for Unwired Planet's LTE portfolio. *Unwired Planet*, [2017] EWHC (Pat) 711 ¶ 475.

[9] *Id.* ¶ 476.

[10] For example, for LTE the *TCL* court first analyzed the range of rates from both the top-down and comparable licenses approaches (which ranged from 0.28% to 0.84%) and then narrowed down the range by eliminating the highest and lowest rates. It then selected a data point near the middle of this range, 0.45%, as the final FRAND rate for the United States. *TCL*, *supra* note 3, at *51.

[11] *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 464, 476. Note that the heavily redacted *Unwired Planet* decision does not explicitly identify the rates as Major Market rates, but it is implied by the adjustments made by the court. *See id.* ¶¶ 478, 807. Also, although the *Unwired Planet* decision does not explicitly say so, the court's calculations imply that it was evaluating the Ericsson portfolio after divestiture of the patents to Unwired Planet. *See also id.* ¶ 228 ("From now on I intend to put most weight on figures derived from the [post-divestiture] portfolio.").

[12] *TCL*, *supra* note 3, at *51.

[13] In *TCL*, although the royalty rate rates from the top-down approach influenced the final rate of 0.45% in the U.S., the derived rates from many of Ericsson's licenses were also near 0.45%: three of the eight were below 0.45%, while two others were slightly above 0.45% (one at 0.50% and the other at 0.53%). *Id.*

[14] The *TCL* court focused on licenses with Apple (2015), Samsung (2014), Huawei (2016), LG (2014), HTC (2014), and ZTE (2011 with a 2015 Amendment), though it is likely that other licenses were produced in the matter. *Id.* at *41–48. The *Unwired Planet* court listed other licenses, such as Huawei (2009), RIM (unspecified date), Apple (2008), Sony (2012), and an unnamed licensee. *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 382–468. The *TCL* decision specifically excluded certain Ericsson licenses with regional manufacturers. *TCL*, *supra* note 3, at *32 ("Local kings [regional manufacturers] are not similarly situated to global firms for two reasons. First, their sales largely occur in one country, while a single country will generally account for a relatively small percentage of the global firm's sales . . . . Second, local kings receive a different license from Ericsson. A local king only needs license to Ericsson's SEPs in one jurisdiction, and Ericsson is bound to limit its offer to a rate that reflects the SEP strength of its portfolio in that jurisdiction. . . . Thus, a license between Ericsson and a local king does not reflect the rate that a global firm like TCL would have to pay.").

[15] The *Unwired Planet* decision does not name the parties to the licenses it analyzed and, given the date of the Ericsson-Apple license, it is possible that it was executed after the close of discovery.

[16] The *Unwired Planet* court also rejected the idea that the FRAND rate should vary with licensee size, stating that "it would not be FRAND, for example, for a small new entrant to the market to have to pay a higher royalty rate than an established large entity." *Unwired Planet*, [2017] EWHC (Pat) 711 ¶ 175.

[17] *TCL*, *supra* note 3, at *30. The court further noted that "ETSI contemplates facilitating competition in the market, particularly from emerging firms" and that "permitting Ericsson to define similarly situated very narrowly by picking and choosing criteria with no relation to its SEPs or the FRAND commitment would effectively allow Ericsson to read the non-discrimination prong out of the FRAND commitment." *Id.*

[18] Huawei's expert pointed to decisions in jurisdictions, such as the United States, China, Japan, and the EU. The court accepted that there was "some evidence of a decline in some rates over time and I am sure that at least part of the explanation is the emergence by 2013 of decisions in which courts were prepared to set FRAND rates, which in turn strengthened the bargaining position of licensees by reducing the power of the threat of an injunction." The court rejected the proposed ad hoc 50% adjustment to the rates in early licenses. *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 431–432; *see also id.* ¶ 175.

[19] That is, the balancing payment made by the counter-party is equal to Ericsson's one-way royalty rate multiplied by the counter-party's sales, less the counter-party's one-way royalty rate multiplied by Ericsson's sales. Mathematically, if the balancing payment and the parties' sales are known, there is one equation and two unknowns—i.e., the royalty rates. However, under FRAND, the counter-party's one-way royalty rate would be expected to be proportional to Ericsson's one-way royalty rate, with the factor of proportionality equal to the relative strengths of the parties' SEP portfolios. This provides a second equation that allows calculation of Ericsson's one-way royalty rate.

In *Unwired Planet*, the parties to the litigation appeared to have considered portfolio strength measures based on quality-adjusted patent counts, where the quality adjustment was based on the number of a party's technical "contributions" to the standard-setting organization. *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 187–195. The *Unwired Planet* court noted that such contribution measures do not necessarily reflect patented technologies and that just because "Ericsson advanced arguments on this [contributions] basis during negotiations does not mean it is accepted as a method by the counterparty." *Id.* ¶ 185. In *TCL*, TCL's expert relied on the estimated number of SEPs based on a technical assessment of whether the SEPs were essential and related to handsets. Ericsson's expert relied upon technical contributions to the standard-setting organization. As in *Unwired Planet*, the *TCL* court rejected this measure because "standard contribution

counting counts contributions, not patents," and because such contributions "can be made for ideas that are unpatented . . . [or] patented by someone else." The *TCL* decision in particular noted the incentive to manipulate this measure, pointing to Ericsson's internal documents, which showed "that it has inflated its counts by 'hijacking' the contributions of other companies as well as requiring subsidiaries to vote for Ericsson's proposals." *TCL*, *supra* note 3, at *41.

[20] The *TCL* court noted that the "IDC data is based on actual handset sales, which makes it much more reliable." The court further noted that, in many cases, "Ericsson's business cases dramatically underestimated the licensee's revenue when compared to IDC data." *Id.* at *39–40.

[21] *Id.*; *see also id.* at *39.

[22] The redacted decision does not specifically detail the court's unpacking methodology. However, the court uses the Ericsson royalty rate to calculate Unwired Planet's adjusted royalty rate in a major market. For example, the court took the 0.80% Ericsson rate for LTE and adjusted it downward to calculate the rate for Unwired Planet as the benchmark rate in major markets, which implies that the 0.80% rate was also for a major market. *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 464, 591.

[23] *Id.* ¶¶ 582–584.

[24] *TCL*, *supra* note 3, at *11.

[25] *Id.* at *13.

[26] *Id.* at *8.

[27] *Id.* at *21.

[28] *Id.* at *24.

[29] A patent receives a forward citation when it is cited by a later patent.

[30] *See generally* Dietmar Harhoff et al., *Citations, Family Size, Opposition and the Value of Patent Rights*, 32 Research Pol'y 1343 (2003); Dietmar Harhoff et al., *Citation Frequency and the Value of Patented Inventions*, 81 Rev. Econ. Stat. 511 (1999); Adam Jaffe & Manuel Trajtenberg, Patents, Citations and Innovations: A Window on the Knowledge Economy (2002); Mark Schankerman, *How Valuable Is Patent Protection? Estimates by Technology Field*, 29 RAND J. Econ. 77 (1998); Manuel Trajtenberg, *A Penny for Your Quotes: Patent Citations and the Value of Innovations*, 21 RAND J. Econ. 172 (1990).

[31] *See, e.g.*, Better Mouse Co. v. Steelseries ApS, No. 2:14-cv-198-RSP, ECF No. 308 (E.D. Tex. Jan. 5, 2016); Comcast Cable Commc'ns, LLC v. Sprint Commc'ns Co., No. 12-859, ECF No. 334 (E.D. Pa. Nov. 21, 2016).

[32] *TCL*, *supra* note 3, at *24–26.

[33] The court also claimed that Ericsson's statements did "not take into account what implementers and SEP holders have actually been content to agree in the intervening years," and "have little value in arriving at a benchmark rate today." *Unwired Planet*, [2017] EWHC (Pat) 711 ¶¶ 269–270. This stands in contrast to the *TCL* court, which viewed Ericsson's statements as a "pledge to the market," and that were "designed to entice manufacturers to invest in LTE" over alternative standards at the time. *TCL*, *supra* note 3, at *11, *13. From this perspective, effective royalty rates for Ericsson above the level implied by Ericsson's ARB "pledge" would constitute hold-up.

[34] *Unwired Planet*, [2017] EWHC (Pat) 711 ¶ 807.

[35] The Ericsson share of 9.1% implied by the *Unwired Planet* decision is calculated by dividing the 0.70% Unwired Planet LTE share by the 7.69% relative strength of Unwired Planet's portfolio as compared to Ericsson's portfolio. *Id.* ¶ 807. The Ericsson share implied by the *TCL* decision is obtained by dividing the *TCL* court's U.S. rate of 0.45%, which was based on both a comparable license analysis and a top-down analysis, by an ARB of 10%, which is the upper end of the range that the *TCL* court considered.

[36] *TCL*, *supra* note 3, at *11–12; *see also* Press Release, Ericsson, Wireless Industry Leaders Commit to Framework for LTE Technology IPR Licensing, (Apr. 14, 2008), http://www.ericsson.com/en/press-releases/2008/4/wireless-industry-leaders-commit-to-framework-for-lte-technology-ipr-licensing. As noted above, the *TCL* court specifically cited these statements as support for its ARB range, while the *Unwired Planet* court declined to rely on these statements, despite finding an ARB consistent with them.

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## WEDNESDAY, OCTOBER 17, 2018

7:30–9:30pm **REGISTRATION**

8:00–9:30pm **WELCOME RECEPTION**

## THURSDAY, OCTOBER 18, 2018

7:30am–5:30pm **REGISTRATION**

8:00–8:10am **WELCOME AND INTRODUCTION**

8:10–9:00am **PLENARY SESSION**

### Understanding Competition Law Systems and the Role of Core Concepts of Antitrust

A sound grounding in the key institutional, legal, and economic concepts employed to review and analyze competition issues is essential to understanding the U.S. antitrust laws as well as other systems in the world. This session reviews the foundations of the U.S. competition system and summarizes the basic conceptual underpinnings of the U.S. antitrust laws, especially the importance of collusion, exclusion, and market power, as well as efficiencies.

9:00–10:00am **PLENARY SESSION**

### Legal and Economic Analysis of Horizontal Restraints: Part I

This session will provide a brief history of the origins and evolution of the rule of reason and then address the economic and legal analysis of activities involving horizontal competitors that can give rise to antitrust claims, including joint ventures, contractual agreements. or other forms of joint action.

10:15am–12:00pm **PLENARY SESSION**

### Legal and Economic Analysis of Horizontal Restraints: Part II

To understand the operation of today's framework for evaluating concerted conduct by competitors, it is necessary to appreciate how courts structure their analysis using inferences, presumptions, and burdens of pleading, production, and proof. Using case examples, this session will examine that analysis, including the meaning of "rule of reason balancing."

1:15–2:15pm **View from the FTC**

This panel brings together attorneys from the FTC to discuss key trends and issues related to the FTC's recent enforcement decisions, including health care mergers, pay for delay, technology, and other recent conduct litigation and consent decrees.

**CONCURRENT SESSIONS: ATTENDEES SELECT ONE WHEN REGISTERING**

2:15–3:45pm

### Cartel Investigations

This panel will address the details of how to handle a government cartel investigation in the U.S., focusing primarily upon criminal cartel conduct. The panel will also weave in compliance tips to avoid such investigations.

### Conditional Pricing

Pricing policies often are a source of antitrust disputes. This panel will review developments and provide practical advice.

### Planning for Mergers & JVs

In order to promote a successful merger or joint venture transaction, coordination and planning on antitrust issues is essential. The experienced merger practitioners participating in this session will address key issues in transaction planning.

**CONCURRENT SESSIONS: ATTENDEES SELECT ONE WHEN REGISTERING**

4:00–5:30pm

### Distribution and Robinson-Patman Issues

Vertical restraints usually fall under the rule of reason, yet advising clients remains as challenging as ever in light of conflicting federal decisions and inconsistent state laws. This panel will discuss how to advise clients on price differentials and non-price vertical restraints in the Internet era, as well as trends in the law and recent agency and court decisions in this area.

### International Cartel Investigations

This session deals with myriad issues and challenges that arise in representing clients in international cartel matters. After reviewing the variances in cartel enforcement across the world, including differing and evolving views on criminalization, the panel will address:

- Coordination issues (waivers, information sharing, extradition, etc.)
- Coordinating leniency/cooperation
- Settlement issues, fines and sentencing
- Extradition

### Making Effective Agency Presentations

The ability to make effective presentations to the enforcement agencies is among the most highly valued of the antitrust practitioner's skills. This panel will discuss key issues including:

- Understanding the agency decision making process
- Practical do's and don'ts
- How to deal with staff logjams
- When and how to involve the client
- Role of economists

6:30–9:30pm **RECEPTION & DINNER**

## FRIDAY, OCTOBER 18, 2018

7:30am–5:30pm **REGISTRATION**

8:00–9:00am **PLENARY SESSION**

### The Law and Economics of Cartel Formation

What are the boundaries of criminal liability under U.S. antitrust law and what legal and economic techniques can be applied to establish the existence of unlawful cartel activities? This session will examine insights from the economic and legal literature on factors that can facilitate or frustrate coordination, as well as the legal standards for establishing "agreement" under the Sherman Act.

9:00–9:45am **PLENARY SESSION**

### Origins and Evolution of Merger Analysis

This session will examine the evolution of U.S. merger analysis, including the influence of early Supreme Court decisions, the introduction of the Horizontal Merger Guidelines, and the influence of the Hart-Scott-Rodino Pre-Merger Notification system on the role of government agencies in developing standards for merger review.

10:00–11:30 am **PLENARY SESSION**

**Modern Competitive Effects Analysis and the Horizontal Merger Guidelines**
This session continues to address the legal and economic principles applied in U.S. merger reviews with a focus on the Horizontal Merger Guidelines and the Guidelines' consideration of competitive effects and efficiencies and other factors.

11:30 am–12:30 pm **View from the Department of Justice**
This panel brings together attorneys from the Antitrust Division to discuss key trends and issues related to DOJ's recent criminal, merger and civil non-merger enforcement initiatives

1:30–2:15 pm **Winning and Retaining Antitrust Clients**
Two experienced in-house counsel offer their perspectives on what lawyers and their firms can do to attract and retain antitrust clients in an increasingly cost-sensitive and competitive environment. They will discuss the attributes and qualities that clients look for when seeking representation for antitrust counseling, government investigations, mergers and litigation, and also talk about what attorneys do that will put them on the "don't hire" list.

**CONCURRENT SESSIONS: ATTENDEES SELECT ONE WHEN REGISTERING**

2:15–3:45 pm

**Advising the Allegedly Dominant Firm**
For firms with arguably dominant market positions, distinguishing between efficiency-enhancing, aggressive procompetitive conduct and exclusionary anticompetitive strategies is often a challenging task—with potentially significant legal consequences. This session will focus on counseling the high-risk client with respect to single-firm strategies that are frequently the subject of investigations or litigation.

**Expert Witnesses**
This session will review key issues in selecting and using experts in antitrust litigation and offer practical suggestions on:
- Selection of an expert
- Discovery and other deposition issues
- *Daubert* motions
- Direct and cross examination

**Merger Review Beyond the DOJ/FTC: The Global Dimension**
Multi-jurisdictional merger review is a fact of life in our global economy. This panel will consider issues arising from multi-national merger clearance.

**CONCURRENT SESSIONS: ATTENDEES SELECT ONE WHEN REGISTERING**

4:00–5:30 pm

**Advanced Merger Economics**
All substantial merger investigations are highly dependent on contemporary economic analysis. Antitrust agencies around the world are becoming more adept at conducting sophisticated economic analysis, although not all agencies can be relied upon to apply the analysis consistently or evenly. Therefore, it is incumbent on practitioners to be conversant in current theories and how they are used by the antitrust authorities in reviewing transactions. This panel will review the state of the art economic analyses.

**Antitrust Compliance Programs**
In recent years, there has been renewed focus on the adequacy and effectiveness of antitrust compliance programs. This panel will consider issues relating to compliance programs and offer practical insights on how to maximize effectiveness.

**Class Certification**
Certification is often the make-or-break moment in an antitrust class action. This session will examine class certification requirements, and offer practical guidance on:
- Class definition issues
- Selection of and challenges to class representatives
- Discovery issues
- Working with economic experts
- Class certification arguments

6:30–9:30 PM **COCKTAIL RECEPTION & DINNER**

## SATURDAY, OCTOBER 20, 2018

7:30 am–1:30 pm **REGISTRATION**

8:00–8:45 am **PLENARY SESSION**

**The Law and Economics of Exclusion by Dominant Firms**
This session will identify and examine the legal and economic principles that provide the foundation for our consideration of foreclosure and exclusion claims, especially claims of monopolization. Emphasis will be placed on the integration of economic teachings into the legal standards used to judge the conduct of dominant firms.

8:45–9:45 am **PLENARY SESSION**

**Exclusionary Distribution Strategies**
Building on the previous session as well as earlier sessions on collusion, this one will examine various examples of distribution-related conduct, such as vertical intra and interbrand restraints and vertical mergers, to illustrate how common core economic concepts have influenced the law regarding a wide-range of vertical conduct based on its tendency to facilitate horizontal competitive harms through coordination and/or the exclusion of rival firms, both through contract and merger.

10:00–11:00 am **PLENARY SESSION**

**An Advanced Introduction to Comparative Perspectives: Focus on the U.S. and EU**
An appreciation of comparative perspectives is increasingly important for the "antitrust master," and the number of jurisdictions adopting and enforcing competition laws continues to increase. This session will focus primarily on a comparison of the U.S. to the EU, focusing in particular on institutional characteristics as well as the treatment of mergers, abuse of dominance, and cartels. Other jurisdictions, such as the UK, may also be referenced.

**CONCURRENT SESSIONS: ATTENDEES SELECT ONE WHEN REGISTERING**

11:00 am–12:30 pm

**Consent Decrees and Remedies**
The session will explore the procedural and substantive issues that arise with resolving antitrust concerns either through a consent decree or a contested remedy. The issues will include:
- What do the agencies require?
- Do the FTC and DOJ apply the same standards?
- Divestiture buyer issues
- Behavioral remedies
- Disgorgement
- What if effective prospective relief is not feasible?

**Counseling on Competitor Collaboration**
Competitors often deal with each other in various situations, some of which are plainly anticompetitive and some of which may be permissible. In seeking to draw a line between the two, this session will address typical situations involving competitors such as:
- Joint ventures
- Group buying
- Trade associations
- Benchmarking and information exchanges
- Joint research and development
- Licensing competitors
- Supply and distribution agreements involving competitors

**Pleading and Proving Conspiracy**
In *Twombly*, the Supreme Court gave trial courts more latitude to dismiss a lawsuit on the pleadings. This panel will examine both how to plead an anticompetitive agreement and how to defeat a claim on the pleadings in this new era of jurisprudence. Panelists will discuss:
- Motions to dismiss
- Plus factors
- Discovery issues
- Role of economic evidence

12:30–1:30 pm **LUNCH AND WRAP UP**

# Non-Horizontal Merger Enforcement? Of Course They Can

BY J. ROBERT ROBERTSON

Small, independent, decentralized business of the kind that built up our country, of the kind that made our country great, first, is fast disappearing, and second, is being made dependent upon monster concentration.

95 Cong. Rec. 11,486 (1949)
(remarks of Rep. Emanuel Celler)

HAVING SPENT DECADES IMMERSED in antitrust merger law, whether from within the government or in private practice, it was no shock to me when the Department of Justice recently filed its complaint against AT&T.[1] Nevertheless, the main question asked by reporters and others was, "Can they do this"? The assumption made by all was that, under the law, it was not possible to challenge anything but a traditional horizontal merger. To each person's apparent surprise, my answer was, "Of course they can." The legislative history and the law are clear that either the Federal Trade Commission or the Department of Justice can challenge any kind of merger or acquisition. Whether it is horizontal, vertical, or conglomerate makes no difference, and below I explore these concepts in detail.

The questioners' surprise was not entirely misplaced: we have the detailed Horizontal Merger Guidelines[2] but only some limited agency guidance on non-horizontal mergers,[3] and there is no question that for decades, the agencies have taken few non-horizontal mergers to court. Importantly, however, Congress clearly intended that the antitrust agencies *could* challenge these kinds of mergers. In fact, in amending Clayton Act, Section 7 in 1949–1950, Congress was worried about non-horizontal combinations at least as much as horizontal ones.

*J. Robert Robertson is formerly the Chief Trial Counsel at the Bureau of Competition of the Federal Trade Commission, and is a partner at DLA Piper in Chicago. While at the FTC, the author was lead trial counsel for the agency on many matters, including* Chicago Bridge & Iron, Polypore International, CCC Holdings, Whole Foods *(on remand) and, after leaving the agency, for the defendants in* Laboratory Corp. of America, Advocate Healthcare, *and* H&R Block. *This article expresses the author's views and not those of any other party.*

Congress's stated reason for revising Section 7 was not well received by the academics. In the 1970s and '80s, Robert Bork and Richard Posner (and many of their followers) were some of the first professors to argue that the new Section 7 should be limited to horizontal merger enforcement—for the reason that there were either no good standards for non-horizontal mergers or that they simply should not be challenged as a matter of policy.[4] Those early arguments have, over time, become a common understanding within the antitrust bar, even though they are contrary to the legislative history of the Clayton Act, Section 7.

There is also no reason to invent a new non-horizontal merger standard of proof for presumptions, burden-shifting, and the like, in non-horizontal mergers. There is ample, settled law and economics that can be used in non-horizontal cases. Indeed, in the AT&T/Time Warner case, the DOJ simply followed the basic burden-shifting framework found in both merger and non-merger antitrust cases: once the government puts forward evidence, either structural or direct, of likely anticompetitive effects, the burden shifts to the defendants to show that the government's predictions are not accurate and that the merger is indeed not harmful to competition. Then, these countervailing effects are balanced, with the understanding that the government need only show the reasonable likelihood of net anticompetitive effects.[5] This is a simple, established model for horizontal merger cases as well as for non-merger cases. There is no reason that this model cannot be used for non-horizontal mergers as well, and indeed this is just what Congress intended.

## Congressional Intent to Stop "Monster Consolidation,"[6] and the Academic Backlash

After World War II, Congress was deeply concerned about large businesses destroying the fabric of the American economic system—i.e., small, independent businesses. The chief concern was that large companies would become so powerful that the government would need to become even more powerful to control them. The result would be a collapse of the economic framework of the capitalist system. For example, in support of the expansion of Section 7 in 1949, Rep. Sidney Yates argued:

> Ever since Karl Marx, Communists have based their belief in the collapse of capitalism upon their prediction that concentration of wealth and power would be carried so far in capitalist countries as to deprive most people of protection from monopoly and to leave them without interest in the survival of private enterprise.[7]

Yates's comments were echoed by many others in Congress, and the fundamental principle that large, conglomerate and vertical mergers were extremely harmful to the well-being of the country was thoroughly spelled out in the legislative history.[8] For example, Rep. Hale Boggs called the "conglomerate acquisition" "one of the most detrimental movements to a free enterprise economy."[9]

Senator Estes Kefauver emphasized: "The increased concentration of economic power is dooming free enterprise. The

present trend of great corporations to increase their economic power is the antithesis of meritorious competitive development."[10] Kefauver was convinced that the Clayton Act needed to be amended to reign in these large, conglomerate or vertical mergers because, if the alleged trend towards fewer larger corporations continued, "[i]t either results in a Fascist state or the nationalization of industries and thereafter a Socialist or Communist state."[11]

Many in Congress also expressed their concern that local ownership of small businesses was being threatened by large conglomerate corporations. "Under local ownership, there are strong social and civic ties that bind the community together. Under outside ownership, these ties are weakened and broken."[12] As Kefauver put it, "The control of American business is steadily being transferred, I am sorry to have to say, from local communities to a few large cities in which central managers decide the policies and the fate of the far-flung enterprises they control."[13] Thus, many in Congress blamed large mergers and increased concentration for ruining local competition and the decentralized fabric of the U.S. economy.

In its report, the House emphasized that the amendment of Section 7 was directed towards "the broad economic problem of high and increasing concentration with which this legislation is concerned."[14] And to be absolutely clear that the amended Section 7 applied to vertical and conglomerate mergers, the House Report explained that the former provision in the 1914 version of Section 7 that had required a lessening of competition "between the acquiring and the acquired firm has been eliminated."[15] Thus, as the House Report stated, "[T]he bill applies to all types of mergers and acquisitions, vertical and conglomerate as well as horizontal, which have the specified effects of substantially lessening competition * * * or tending to create a monopoly."[16]

Besides the fear of socialism or communism, the House saw other issues in conglomerate and vertical mergers. One example cited was downstream foreclosure, such as a vertical merger by a raw material producer of a downstream fabrication plant, which could lessen competition in a fabrication market, "even though there did not exist any competition between the acquiring (raw material) and the acquired (fabricating) firms."[17] And long before courts took on such issues in any detail, Congress appeared to understand that buyer power was as much of a problem for competition as downstream selling power because, if there were such power, "[s]uppliers are often compelled to accept what huge companies choose to pay."[18] As for any assumption that large mergers always are most often efficient and somehow good, Congress rejected that premise.[19] For example, Rep. Emanuel Celler emphasized that "[b]igness does not mean efficiency, a better product, or lower prices."[20]

Support for Congress' fear of large corporate acquisitions and mergers came from many sources, including economic data showing a trend that most of the corporate assets in the United States were becoming controlled by fewer and fewer large corporations,[21] and by the Federal Trade Commission's 1948 Report on the Merger Movement, detailing the history of this trend. The FTC Report concluded that "there are few greater dangers to small business than the continued growth of the conglomerate corporation."[22] The FTC Report sounded the alarm that "there is present in most conglomerate acquisitions a simple drive to obtain greater economic power. With the economic power which it secures through its operations in many diverse fields, the giant conglomerate corporation may attain an almost impregnable economic position."[23] Through its data and economic analysis, the FTC urged that "if nothing is done to check the growth in concentration, either the giant corporations will ultimately take over the country, or the Government will be impelled to step in and impose some form of direct regulation in the public interest. In either event, collectivism will have triumphed over free enterprise . . . ."[24]

In the end, the Celler-Kefauver Act of 1950 revised Section 7 of the Clayton Act and deliberately included all kinds of mergers and acquisitions within its ambit. The Senate Report stated that the Act's purpose "is to limit future increases in the level of economic concentration resulting from corporate mergers and acquisitions" and "thereby aid in preserving small business as an important competitive factor in the American economy."[25] The House Report also made it clear that the scope of the revised Section 7 was broad and applied to "vertical and conglomerate as well as horizontal" mergers.[26]

More than a decade later, then Professor Robert Bork criticized the revision of Section 7 as bad policy. Not only did he believe that very few horizontal mergers should be challenged, and certainly not through coordinated effects theory, which he rejected,[27] but when he examined non-horizontal mergers, he rejected almost any theory that might challenge them. For example, absent below-cost pricing, "antitrust should never object to the verticality of any merger," and "there is no threat to competition in any conglomerate merger."[28] In short, "[p]roperly drawn and applied horizontal rules are all that we need."[29]

Ignoring the data used by Congress, and the legislative history, Bork's excuse for recommending that courts abstain from stopping conglomerate mergers was because, in his view, they was "no threat to competition" because "some conglomerate mergers surely do create efficiencies."[30] It should be noted, that despite Bork's core argument that efficiencies should preclude any challenge to a non-horizontal merger, and to most horizontal mergers as well, the efficiencies defense has not been very successful in any litigated case.[31]

In short, the history of the amendments to Section 7 leaves us with unambiguous Congressional intent and clear law that proscribes any merger or acquisition that creates the incipiency towards a likely, significant reduction of competition in any product and geographic market—whether that transaction is horizontal or non-horizontal.

## It's Clear That Section 7 Includes All Mergers

After the Celler-Kefauver Act became law, it took a number of years before any significant cases addressed its history. Under the pre-amended Section 7, the Supreme Court set the stage for non-horizontal mergers with *du Pont*, which was a

vertical case.[32] As the Court pointed out, for decades, "The Government did not invoke § 7 against vertical acquisitions," and yet the Court found that even the original Section 7 allowed a challenge to a vertical acquisition if it "tend[ed] to create a monopoly."[33] The importance of this case for this discussion is that in *du Pont*, the Court specifically held that "although du Pont and General Motors are not competitors, a violation of the section has occurred," and it ordered the divestiture of du Pont's ownership of General Motors' stock.[34] The Court added that the antitrust agencies' failure to challenge vertical acquisitions was irrelevant to Congress's intent to include "vertical acquisitions . . . within the purview of the Act."[35] The Court also recognized that in Congress's recent amendment to Section 7, it had made "it clear that the bill applies to all types of mergers and acquisitions, vertical and conglomerate as well as horizontal."[36]

Following up on *du Pont* was the district court case of *Bethlehem Steel*. In the late 1950s, Bethlehem Steel attempted to merge with Youngstown Steel and claimed that they did not compete effectively for downstream customers. Thus, the merger should have been cleared. Yet, the DOJ refused clearance, and the case was then tried in the Southern District of New York. Judge Edward Weinfeld enjoined the transaction on multiple theories, including horizontal, vertical, and conglomerate (potential competition) grounds.[37] The court justified its injunction against the non-horizontal aspects of the merger based on the legislative history of the amended Section 7, which, under a "fair reading," left "no doubt as to its major objectives," including a concern about non-horizontal mergers.[38] Interestingly, Judge Weinfeld had no problem applying potential competition, vertical buyer power, and foreclosure theories (while rejecting any claims of efficiencies) to enjoin the merger.[39] In this sense, the opinion in *Bethlehem Steel* was ahead of its time.[40]

Four years later, in 1962, the U.S. Supreme Court finally got its chance to weigh in on the meaning of the amended Section 7 with *Brown Shoe*.[41] Beginning with the district court's opinion, which focused on Congress's intent to "tighten[] the screws upon acquisitions," the Supreme Court detailed the history of the Celler-Kefauver Act in great detail.[42] However, after nearly a dozen pages of dense history of the Act, Chief Justice Warren gave us one of the most mis-cited quotes in antitrust: "It is competition, not competitors, which the Act protects."[43] What follows that sentence, however, is the main point:

> But we cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally owned business. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision.[44]

Upon that solid grounding in legislative history, as well as the plain language of Section 7, the Court found that the Act "was intended to apply to all mergers—horizontal, vertical or conglomerate."[45]

Although *Brown Shoe* is a long and sometimes confusing opinion, it remains the governing law today.[46] *Brown Shoe* ended up being both a horizontal and a non-horizontal case. The horizontal aspects are well known, but the vertical aspects are less so. For the vertical side, in which the merging shoe companies would become vertically integrated into manufacturing, the Court used the legislative history to buttress its conclusion that Brown's vertical integration gave it the power to expand its "avowed policy of forcing its own shoes upon its retail subsidiaries" and "may foreclose competition . . . without producing any countervailing competitive, economic, or social advantages."[47]

The theory of vertical harm was this: "tying a customer to a supplier . . . by foreclosing the competitors of either party from a segment of the market otherwise open to them . . . may act as a 'clog on competition.'"[48] As in *Bethlehem Steel*, the Court also recognized the harm from buyer power, which could "disrupt and injure" competition on the upstream supply side.[49] In short, *Brown Shoe* determined that Section 7 applied to *any* merger or acquisition agreement that resulted in a reasonable probability of substantially lessening competition or of tending to create a monopoly.[50] That holding did not depend upon the form of the transaction, whether vertical, horizontal, conglomerate, or other.

Shortly after *Brown Shoe*, the FTC had the opportunity to address another attempt by merging parties to argue that Section 7 did not apply outside of the context of a horizontal merger. In *Procter & Gamble* (*Clorox*), the FTC responded sharply to the argument by holding: "Under Section 7, as amended, any acquisition whether it be vertical, conglomerate or horizontal is unlawful if the effect may be substantially to lessen competition or to tend to create a monopoly in any line of commerce."[51]

In *Clorox*, Procter, a large retailer of goods for grocery stores, was attempting to buy Clorox, a large producer of bleach. The FTC focused on both a potential competition theory (whether Procter was a probable entrant into the bleach market) and whether the merger would expand Procter's ability to obtain "favored treatment" for "shelf space" or "certain advantages in the display or marketing of its products which are not available to a single-product producer, such as the pre-merger Clorox."[52] After a remand for additional evidence (and a change of Commissioners), the FTC enjoined the transaction, but the Sixth Circuit reversed the FTC's order in 1966.[53] In 1967, the Supreme Court reversed the decision of the Sixth Circuit and instructed it to affirm the FTC's decision against Procter.[54]

Although one can explain the Supreme Court's *Clorox* decision solely on the basis of a potential competition theory, the reasoning and holding of the Court has more relevance to any discussion of non-horizontal mergers. The Court declared emphatically that "[a]ll mergers are within the reach of [Section] 7, and all must be tested by the same standard, whether they are classified as horizontal, vertical, conglomerate, or other."[55] Agreeing with the FTC that a large con-

glomerate could change the competitive position of Clorox and thus harm competition, it explained: "The anticompetitive effects with which this product-extension merger is fraught can easily be seen." Aside from potential competition, the Court pointed out the anticompetitive effects of the "substitution of the powerful acquiring firm for the smaller, but already dominant, firm" would raise "entry barriers" and "dissuad[e] the smaller firms from aggressively competing."[56] The Court then added that "[p]ossible economies cannot be used as a defense to illegality. Congress was aware that some mergers may also result in economies but it struck the balance in favor of protecting competition."[57]

Justice Harlan agreed with the majority's result but gave a more economically based argument in support of affirming the FTC. Citing the same legislative history as in *Brown Shoe*, he concluded that if a company obtains an "increased power over price" as a result of a merger, it "should be attackable under [Section] 7," and that the FTC could thus "properly find a conglomerate or product-extension merger illegal under [Section] 7 because it substantially increases pricing power in the relevant market" and raises barriers to entry.[58] When one considers the actual legislative concerns expressed during the revision of Section 7, Harlan's logic is sensible.

Whereas there are other cases on both sides of these issues,[59] *du Pont*, *Bethlehem Steel*, *Brown Shoe*, and *Clorox* give a broad view of the scope of Section 7. They all answer the fundamental question as to what kind of mergers or acquisitions fall within the ambit of Section 7: They all do. And all pose the same issue: whether the merged entity obtained market power as a result of the merger so that the likelihood is that competition will be harmed substantially.

## Yes, Non-Horizontal Merger Challenges Happen Today

The history of non-horizontal merger challenges has continued at the agencies although most recent cases were settled or did not go forward in the face of a threatened complaint. For example, "Since 2000, the FTC and DOJ have challenged 22 vertical mergers—about one per year."[60] A typical example is the Department of Justice's challenge to United Technologies Corporation's acquisition of Goodrich, in which the parties agreed to a divestiture remedy to reduce the vertical effects of the merged company's position as the sole supplier of electronic control systems to its only competitor.[61] The FTC's structural remedy in Broadcom's acquisition of Brocade follows the same pattern, and the resulting order was designed to prevent the vertical effects of Broadcom's supply of fibre channel switches to Cisco, which competed directly with Brocade.[62] And when Comcast attempted to acquire Time Warner Cable, the Department of Justice stood by its conclusion that the merger would "make Comcast an unavoidable gatekeeper for Internet-based services that rely on a broadband connection to reach consumers."[63] The parties abandoned the transaction. Thus, it is incorrect for anyone to say that the agencies have ignored non-horizontal mergers.

## Standards of Proof Should Be the Same in All Merger Cases

The common thread found in all merger cases is a likelihood of substantial harm to competition in a relevant market. It should not matter how one classifies the case—as horizontal, vertical, conglomerate, product extension, potential competition, foreclosure, raising rivals' costs,[64] etc. Horizontal mergers have their economic models, and so do vertical ones.[65] But there is no reason, in my view, to jettison the basic framework of burden shifting for non-horizontal mergers.

The basic burden-shifting structure in a merger case was not created by the courts only for Section 7. It had previously existed in non-merger Sherman Act cases for years, and continues to be used in such cases.[66] For decades, the basic order of proof has been the same for all rule of reason cases, with the exception that in a merger case the proof need only show a "reasonable probability" of anticompetitive effects, so that a harmful merger can be stopped in its "incipiency."[67]

The classic burden-shifting framework is nearly identical in merger and non-merger cases.[68] The burden-shifting framework in a non-merger case starts with the plaintiff's defining a relevant market and offering proof that the challenged conduct is likely to be anticompetitive within that market.[69] Once the plaintiff makes out its prima facie case, either through direct evidence of likely anticompetitive effects[70] or through market share statistics, the burden shifts to the defendant to show that the restraint at issue "actually has a procompetitive effect on balance, while the plaintiff can dispute this claim or show that the restraint in question is not reasonably necessary to achieve the procompetitive objective."[71] For merger cases, the defendant's burden is deliberately similar: Once the plaintiff establishes its prima facie case, "the burden shifts to the defendants to rebut the presumption with evidence that 'shows that the market-share statistics [give] an inaccurate account of the [merger's] probable effects on competition' in the relevant market.'"[72]

In the first stage of the burden-shifting framework, the plaintiff in any merger or Section 1 Sherman Act case can satisfy its prima facie case by showing that the merged entity has substantial market share in that market or the ability to foreclose more than 30–40 percent of the relevant market.[73] If the market is already concentrated, and if the merger will increase the merged party's market share by an appreciable amount as a result of the merger, it would follow that the prima facie case has been met. It should not matter whether the increase in market share arose from the acquired party directly or whether it arose from an increase in market power resulting from the merger.

Even without a strong structural case (based on market shares and changes of shares as a result of a merger), a plaintiff can still satisfy its initial burden by offering direct evidence of likely foreclosure or other harm to competition (likely tying, bundling, supracompetitive price increases, foreclosure of competition, and use of market power against buyers or sellers, etc.).[74] For example, the European Commission has

focused its own Non-Horizontal Merger Guidelines on proof of such anticompetitive effects. Those Guidelines make sense, and are entirely consistent with the theories found in *Brown Shoe* and in most current non-horizontal concepts of competitive harm.[75] Such direct evidence of likely effects is often the most compelling. In my experience, the best evidence of likely effects is not an economic model, but the parties' and their customers' documents that often detail potential price increases or other direct evidence of anticompetitive effects.

To rebut the plaintiff's initial case in any merger or conduct case, a defendant can use classic arguments, such as a flawed market definition, low barriers to entry, likely entry, procompetitive justifications, and efficiencies. In my experience, attacking the plaintiff's market definitions has been the most effective form of defense. Other defenses can be as effective. However, defendants nearly always find it exceedingly difficult to prove reasonably verifiable, within market, merger-specific efficiencies as a defense.[76] And, although the burden-shifting structure is the same in a merger case as it is in a Section 1 conduct case, in a merger case the defendants do not need to show that the transaction is actually procompetitive, as is necessary in a Section 1 case. But this is not really a difference. Few defendants have any chance of winning a merger case if they do not try to persuade the court that the merger has at least some pro-competitive effect. That is especially important when one considers that, in a merger case, the government's burden to show likely, incipient harm is so low.

This well-established burden-shifting framework can also be used in any non-horizontal merger case. For example, if a vertical merger allows an acquirer to purchase a large supplier, which would, for the first time, give the acquirer the ability to foreclose a competitor or raise a competitor's cost so that the acquirer can raise prices, that would appear to satisfy a plaintiff's prima facie case. If, for another example, a conglomerate merger allowed an acquirer to increase its market power against its suppliers upstream or control segments of retail downstream (such as control over shelf space), that would also appear to satisfy the kind of competitive harm Congress wanted Section 7 to stop.

A simple case could be based upon a defendant's newfound ability (or predicted ability), as a result of a merger, to raise prices, enhance coordination between competitors, tie or bundle products together, or raise barriers to entry through exclusionary conduct. If, for example, the dominant water and electric companies combined and, in order for a customer to get a single bill, required customers to rent a water regulator box and sign a multi-year exclusive contract, would this fall within a prima facie case? If the power to do so harmed competition in either market, and the power to do so was created by the merger, the answer should be "yes." This proof would be even more convincing if a new entrant would need to compete as a combined water and electric company to defeat the anticompetitive effects of the merger.

Another hypothetical example would be a vertical merger that gave the merged company a new ability to raise the costs of its competitors in a concentrated market, diverting customers to the merged company. The result may likely be higher market prices for the competitive products, or, due to the shift in market share to the merged entity, an increased likelihood of coordinated effects. These types of scenarios are just examples of prima facie cases that defendants could rebut.

## Conclusion

The classification of a merger as either horizontal or non-horizontal should not determine whether the merger is likely to be anticompetitive, and it is clear that Congress intended the governing principle to be whether, through a merger or acquisition, the acquirer obtains additional market power to harm competition substantially. If it does, and there are no countervailing procompetitive justifications for the transaction, it should be enjoined. The unequivocal legislative history and binding Supreme Court precedent make clear that non-horizontal merger enforcement should be treated no differently. ■

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1 United States v. AT&T, No. 1:17-cv-02511 (D.D.C. Nov. 20, 2017). I take no position on the merits of this case or whether either side will prevail. This article is just about the theory. Success at trial, for either side, is always far more difficult than it appears, as this case shows. See discussion of *AT&T infra*.

2 U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines 5.3 (2010), http://www.justice.gov/atr/public/guidelines/hmg-2010.html. I do not suggest that the agencies actually follow these guidelines in court or that they are, in fact, as formulaic in practice as they appear in print.

3 *See, e.g.*, U.S. Dep't of Justice, Non-Horizontal Merger Guidelines (1984), https://www.justice.gov/atr/non-horizontal-merger-guidelines.

4 *See, e.g.*, Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself 221–22 (Basic Books ed. 1978); Richard A. Posner, *Conglomerate Mergers and Antitrust Policy: An Introduction*, 44 St. John's L. Rev. 529, 530 (1969), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?referer=https://www.bing.com/&httpsredir=1&article=2900&context=journal_articles. *Cf.* Donald F. Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 Harv. L. Rev. 1313, 1358 (1965) ("[T]here is some economic case for a rule prohibiting a disproportionately large firm from acquiring a member of a loose oligopoly market.").

5 Joint Statement on the Burden of Proof at Trial, *AT&T* (Mar. 13, 2018), https://www.justice.gov/atr/case-document/file/1043756/download. Defendants rejected the burden-shifting framework.

6 95 Cong. Rec. 11,486 (1949) (remarks of Rep. Emanuel Celler).

7 95 Cong. Rec. 11,494 (1949) (remarks of Rep. Sidney R. Yates).

8 *See, e.g.*, *Section 7 of the Clayton Act: A Legislative History*, 52 Colum. L. Rev. 766–81 (1952); the legislative history is also detailed in *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962).

9 95 Cong. Rec. 11,496 (1949) (remarks of Rep. Hale Boggs).

10 96 Cong. Rec. 16,452 (1950) (remarks of Rep. C. Estes Kefauver).

11 *Id.*; *see also* H.R. Rep. No. 1191, 81st Cong., 1st Sess., at 13 (1949) (Larger corporations would lead to larger unions and "statism" necessary to regulate them.).

12 95 Cong. Rec. 11,495 (1949) (remarks of Rep. Joseph R. Bryson).

13 96 Cong. Rec. 16,452 (1950) (remarks of Rep. C. Estes Kefauver).

14 H.R. Rep. No. 1191, 81st Cong., 1st Sess., at 3 (1949).

15 *Id.* at 11.

16 *Id.*

[17] *Id.*

[18] 95 Cong. Rec. 11,486 (1949) (remarks of Rep. Emanuel Celler).

[19] "The possibility of lower costs was brushed aside in the legislative deliberations . . . ." Derek C. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 Harv. L. Rev. 226, 318 (1960).

[20] 95 Cong. Rec. 11,486 (1949). Rep. Celler also stressed the difficulty "for small business to compete against the financial, purchasing, and advertising power of the mammoth corporations." *Id.*

[21] *Corporate Mergers and Acquisitions: Hearing on H.R. 2734 Before the Subcomm. of the Comm. on the Judiciary U.S. Senate*, 81st Cong., 1st Sess. 241 (1949) (statement of Willford I. King, Chairman, Committee for Constitutional Government), https://babel.hathitrust.org/cgi/pt?id=umn.31951d02092346b;view=2up;seq=238. For an excellent critique of the use of data (and antitrust policy) to support this populist position then and now, see Carl Shapiro, *Antitrust in a Time of Populism*, Int'l J. Indus. Org. (forhcoming), http://faculty.haas.berkeley.edu/shapiro/antitrustpopulism.pdf.

[22] U.S. Fed. Trade Comm'n, Report on the Merger Movement: A Summary Report 59 (U.S.G.P.O. 1948) (citing Fed. Trade Comm'n, The Present Trend of Corporate Mergers and Acquisitions 13 (U.S.G.P.O. 1947).

[23] *Id.* at 59.

[24] *Id.* at 68.

[25] S. Rep. No. 1775, 81st Cong., 2d Sess., at 3 (1950).

[26] H.R. Rep. No. 1191, 81st Cong., 1st Sess., at 11 (1949).

[27] Bork, *supra* note 4, at 221–22. By 2001, Richard Posner stated that "Conglomerate mergers . . . that do not involve potential competition are no longer an object of antitrust concern." Richard A. Posner, Antitrust Law 131 (2d ed. 2001). This conclusion was repeated by the Antitrust Modernization Commission, which declared that conglomerate mergers "generally do not raise antitrust issues." Antitrust Modernization Commission, Report and Recommendations 58 (Apr. 2007), https://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

[28] Bork, *supra* note 4, at 245–46.

[29] *Id.* at 245.

[30] *Id.* at 246, 248–49.

[31] *See, e.g.*, FTC v. Sysco Corp., 113 F. Supp. 3d 1, 82 (D.D.C. 2015) ("The court is not aware of any case, and Defendants have cited none, where the merging parties have successfully rebutted the government's *prima facie* case on the strength of the efficiencies.").

[32] United States v. E. I. du Pont de Nemours & Co., 353 U.S. 586, 590 (1957). The case was brought in 1949, and thus was governed by the pre-amended Section 7.

[33] *Id.*

[34] *Id.* at 592.

[35] *Id.* at 590.

[36] *Id.* (citation omitted).

[37] United States v. Bethlehem Steel Corp, 168 F. Supp. 576, 611 (S.D.N.Y. 1958).

[38] *Id.* at 583.

[39] *Id.* at 583, 599, 613, 618 (addressing probable entrants; "Section 7 is intended to protect buyers as well as competing sellers"; the merger was a "threat to independent wire rope fabricators"; "A merger may have a different impact in different markets but if the proscribed effect is visited on one or more relevant markets then it matters not what the claimed benefits may be elsewhere.").

[40] *See* British Oxygen Co., 86 F.T.C. 1241, 1975 WL 173325, at *95 (Dec. 8, 1975) (noting that indeed Bethlehem later became a direct competitor of Youngstown when it opened a plant in Chicago).

[41] United States v. Brown Shoe Co., 370 U.S. 294 (1962).

[42] United States v. Brown Shoe Co., 179 F. Supp. 721, 741 (E.D. Mo. 1959); *see also Brown Shoe*, 370 U.S. at 311–24.

[43] *Brown Shoe*, 370 U.S. at 344.

[44] *Id.*

[45] *Id.* at 317, 317 n.31; *see also* 314 n.21 (citation omitted) (noting that the Court had held in *du Pont* that even the earlier Act included non-horizontal acquisitions as well).

[46] *See* United States v. H&R Block, Inc., 833 F. Supp. 2d 36 (D. D.C. 2011) (citing *Brown Shoe* more than a dozen times); FTC v. H.J. Heinz Co., 246 F.3d 708, 713 (D.C. Cir. 2001) (relying on *Brown Shoe*).

[47] *Brown Shoe*, 370 U.S. at 334.

[48] *Id.* at 324 (citation omitted).

[49] *Id.* at 324 n.40.

[50] *Id.* at 316–22. This complete test was best summarized by the Appellant Brief of the United States, Brown Shoe Co. v. United States, No. 4, 1961 WL 101890, *45 (U.S. Nov. 15, 1961). Although *Philadelphia National Bank* was a horizontal case, it also relied on *Brown Shoe*, as well as general Section 1 case law, as support for its holding. United States v. Phila. Nat'l Bank, 374 U.S. 321, 363–66 (1963).

[51] The Procter & Gamble Co., 63 F.T.C. 1465, at *7 (1963) (quoting *Scott Paper Co.*, 57 F.T.C. 1415, at *21 (1960)).

[52] *Id.* at *67.

[53] Procter & Gamble Co. v. FTC, 358 F.2d 74 (6th Cir. 1966), *rev'd and remanded*, 386 U.S. 568 (1967).

[54] 386 U.S. at 581.

[55] *Id.* at 577.

[56] *Id.* at 578.

[57] *Id.* at 580 (citing *Brown Shoe*, 370 U.S. at 344).

[58] *Id.* at 597, 604 (Harlan, J., concurring).

[59] *See generally* 1 ABA Section of Antitrust Law, Antitrust Law Developments 399–405 (8th ed. 2017). A more traditional approach can also be found in *Ford Motor Company v. United States*, 405 U.S. 562 (1972) (detailing the legislative history of the Celler-Kefauver Act and ordering divestiture in a vertical merger.).

[60] *See* D. Bruce Hoffman, Acting Director, Bureau of Competition, Fed. Trade Comm'n, Vertical Merger Enforcement at the FTC, Remarks Before Credit Suisse 2018 Washington Perspectives Conf. (Jan. 10, 2018), https://www.ftc.gov/system/files/documents/public_statements/1304213/hoffman_vertical_merger_speech_final.pdf.

[61] United States v. United Technologies Corp., No. 1:12-cv-01230 (D.D.C. July 26, 2012), http://www.justice.gov/atr/case/us-v-united-technologies-corp-and-goodrich-corp.

[62] Broadcom Ltd., FTC Docket C-4622 (Aug. 17, 2017)), https://www.ftc.gov/enforcement/cases-proceedings/171-0027/broadcom-limitedbrocade-communications-systems.

[63] *See* Press Release, U.S. Dep't of Justice, Comcast Corporation Abandons Proposed Acquisition of Time Warner Cable After Justice Department and the Federal Communications Commission Informed Parties of Concerns (Apr. 24, 2015), https://www.justice.gov/opa/pr/comcast-corporation-abandons-proposed-acquisition-time-warner-cable-after-justice-department.

[64] *See* J. Thomas Rosch, Comm'r, Fed. Trade Comm'n, Remarks Before the University of Hong Kong, Terra Incognita: Vertical and Conglomerate Merger and Interlocking Directorate Law Enforcement in the United States (Sept. 11, 2009) (explaining the similarities in existing U.S. law and the law in Europe), www.ftc.gov/sites/default/files/documents/public_statements/terra-incognita-vertical-and-conglomerate-merger-and-interlocking-directorate-law-enforcement-united/090911roschspeechunivhongkong.pdf.

[65] *See, e.g.*, Thomas Krattenmaker & Steven Salop, *Antitrust Analysis of Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 Yale L.J. 209 (1986); Serge Moresi & Steven Salop, *vGUPPI: Scoring Unilateral Pricing Incentives in Vertical Mergers*, 79 Antitrust L.J. 185 (2013); Janusz A. Ordover, Garth Saloner & Steven C. Salop, *Equilibrium Vertical Foreclosure*, 80 Am. Econ. Rev. 127 (1990); Michael H. Riordan & Steven Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 Antitrust L.J. 513 (1995).

[66] *See, e.g.*, FTC v. Motion Picture Advert. Serv. Co., 344 U.S. 392, 395 (1953) (non-merger case); Am. Tobacco Co. v. United States, 328 U.S. 781, 814 (1946); ZF Meritor LLC v. Eaton Corp., No. 06-623-SLR (D. Del. 2009) (jury instructions in a vertical exclusion case with the burden-shifting presumption can be found at http://apps.americanbar.org/antitrust/at-committees/at-trial/pdf/jury-instructions/zf_meritor-juryinstructions.pdf [hereinafter ZF

Meritor Jury Instructions]. *Philadelphia National Bank* adopted the burden shifting in non-merger cases for merger cases. 374 U.S. at 365. This history is also detailed in J. Robert Robertson, *Editor's Note:* Philadelphia National Bank *at 50*, 80 ANTITRUST L.J. 189 et seq. (2015).

[67] *Heinz*, 246 F.3d at 713, 719 (citing *Brown Shoe*, 370 U.S. at 323, and legislative history for the proposition that Section 7 does not demand certainty but rather proscribes mergers with a "reasonable probability" of anticompetitive effects); *H&R Block, Inc.*, 833 F. Supp. 2d at 49.

[68] *Compare* United States v. Baker Hughes Inc., 908 F.2d 981, 982–83 (D.C. Cir. 1990), FTC v. Penn St. Hershey Med. Ctr., 838 F.3d 327, 337–38 (3d Cir. 2016), and St. Alphonsus Med. Ctr.-Nampa Inc. v. St. Luke's Health Sys., Ltd., 778 F.3d 775, 785 (9th Cir. 2015) *with* non-merger cases, e.g., ZF Meritor Jury Instructions, *supra* note 66, and Agnew v. NCAA, 683 F.3d 328, 335–36 (7th Cir. 2012).

[69] *Brown Shoe*, 370 U.S. at 324; FTC v. Swedish Match, 131 F. Supp. 2d 151, 156 (D.D.C. 2000).

[70] *See, e.g.*, Ash Grove Cement Co. v. FTC, 577 F.2d 1368, 1378 (9th Cir. 1978) (vertical case using the same framework); Impax Labs., Inc., FTC Docket No. 9373 (May 18, 2018), http://www.ftc.gov/system/files/documents/cases/d09373initialdecisionpublic.pdf (pay-for-delay case, citing cases).

[71] *Agnew*, 683 F.3d at 335–36.

[72] FTC v. CCC Holdings Inc., 605 F. Supp. 2d 26, 35 (D.D.C. 2009) (citations omitted).

[73] "Traditionally a foreclosure percentage of at least 40% has been a threshold for liability in exclusive dealing cases," unless the defendant is a monopolist, in which case it could be less. McWane, Inc. v. FTC, 783 F.3d 814, 837 (11th Cir. 2015). I realize that the Horizontal Merger Guidelines put an additional gloss on the statistics of a prima facie case, but courts still use the market share percentage as a backstop. *See* FTC v. ProMedica Health Sys., Inc., No. 3:11 CV 47, 2011 WL 1219281, at *56 (N.D. Ohio Mar. 29, 2011), and cases cited therein.

[74] *See, e.g.*, *Brown Shoe*, 370 U.S. at 324; Polypore Int'l, Inc. v. FTC, 686 F.3d 1208, 1215 (11th Cir. 2012) (defendant raised prices following the acquisition); FTC v. Whole Foods Mkt., Inc., 548 F.3d 1028, 1040 (D.C. Cir. 2008) (Brown, J.) (use of direct evidence); Yankee Entm't & Sports Network, LLC v. Cablevision Sys. Corp., 224 F. Supp. 2d 657, 673 (S.D.N.Y. 2002) (explaining foreclosure theory).

[75] Guidelines on the Assessment of Non-Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings § 5, 2008 O.J. (C 265) 6 (2008); Jeffrey Church, Dep't of Econ., Univ. of Calgary, *The Impact of Vertical and Conglomerate Mergers on Competition* xix (Sept. 2004) (explaining why it is important to stop "the acquiring conglomerate with the opportunity to engage in (i) tying, (ii) bundling, or (iii) foreclosure."), http://www.appliedantitrust.com/12_nonhorizontal_mergers/7_europe/church_impact_vertical9_2004.pdf.

[76] *H&R Block*, 833 F. Supp. 2d at 89; *Heinz*, 246 F.3d at 721; *Sysco*, 113 F. Supp. 3d at 82.

## Postscript: AT&T—A New Beginning?

As this article was being sent to press, Judge Richard Leon delivered his 172-page *AT&T* decision.[77] Judge Leon warns us that "the temptation by some to view this decision as being something more than a resolution of this specific case should be resisted by one and all!"[78] He is correct. Instead of accepting the common thinking that non-horizontal merger law is dead, Judge Leon used the same general, burden-shifting approach that this article discusses.[79] Thus, the outcome of *AT&T* was not the result of a mistaken or novel view of the law. It was, like most cases, driven by the evidence.

In *AT&T*, the government attempted to show that the merger would "enable Turner to charge AT&T's rival distributors—and ultimately consumers—higher prices," increase the risk of coordinated conduct between AT&T and Comcast, and prevent "AT&T's rival distributors from using HBO as a promotional tool to attract and retain customers."[80] The court rejected all of these claims, not as a matter of law but due to a lack of proof.

Certain key issues guided Judge Leon towards this result. First, the court rejected the defendants' argument that vertical mergers should be per se or presumptively lawful, as proposed by Robert Bork.[81] Instead, the court assumed that "vertical mergers" can indeed be unlawful and then followed traditional merger law to determine whether the government had established its case through the evidence.[82] It found that it had not.[83] Second, the court accepted AT&T's commitment to continue arbitrating its disputes, which reinforces the history of courts' accepting real fixes to asserted competitive issues in a merger.[84] It even accepted the defendants' efficiencies argument, based on the evidence, although it was "not necessary" for the "final judgment."[85] Finally, the court followed traditional analysis in examining the government's unilateral and coordination theories and then rejected them based on a lack of evidence.[86]

In short, the court's findings were factual, not legal. Although *AT&T* was an "epic battle" and an unusual case because it was a non-horizontal merger, Judge Leon's opinion demonstrates that non-horizontal cases can be brought under the same law as horizontal mergers. He even said he was "skeptical . . . both as a matter of law and logic" of the argument that traditional law should not be applied in all merger cases.[87] That, of course, was the point of this article, and like Judge Leon, I hope that others will not look merely at the outcome in *AT&T* and believe that it was "something more than a resolution of this specific case" rather than the result of a trial fought over the evidence.[88] ■

—J.R.R.

[77] *AT&T*, *supra* note 1, slip op. (June 12, 2018).

[78] *Id.* at 171.

[79] *Id.* at 53–54 and n.17, 56.

[80] *Id.* at 60.

[81] *Id.* at 59 n.20.

[82] *Id.*

[83] *Id.* at 59, 105 (accepting defendants' expert's analysis that prices would not increase).

[84] *Id.* at 149 n.51.

[85] *Id.* at 54 n.17.

[86] *Id.* at 152–59 (describing the lack of evidence and an apparent concession by the government's expert that coordination was not likely).

[87] *Id.* at 54 and n.17.

[88] *Id.* at 171.

# Connecting the Dots: Tracing the DOJ's Inclusion of Indirect Commerce in Auto Parts Criminal Penalties

BY MICHELLE BURTIS, DANIEL K. OAKES, AND MARY BETH SAVIO

AFTER AN UNPRECEDENTED RUN spanning at least seven years, the U.S. Department of Justice's international criminal investigations into collusion in the auto parts industry appear to have largely concluded. What began with dawn raids of several auto parts manufacturers in Detroit in February 2010 and led to plea agreements pertaining to a handful of auto parts, quickly expanded into "the largest criminal investigation the Antitrust Division has ever pursued, both in terms of its scope and the potential volume of commerce affected by the alleged illegal conduct."[1] All told, the DOJ charged 48 companies and 65 executives with price fixing, bid rigging, and other anticompetitive conduct that involved more than 50 different automotive parts.[2] Of that group, 46 companies—the majority being Japanese component parts manufacturers—entered plea agreements and all together agreed to pay more than $2.9 billion in criminal fines.

The auto parts investigations are important not just because they set a new high-water mark for DOJ enforcement efforts, but also because they form a large set of plea agreements that may be compared to each other to analyze the DOJ's criminal fining policy. Indeed, from "amnesty plus" to "penalty plus" to obstruction of justice to inability to pay, the various auto parts plea agreements display an example of nearly everything in the DOJ's policy toolkit.[3] The set of agreements make a dataset worthy of examination, particularly with regard to whether the sentencing outcomes are consistent, both across the various investigations and with the DOJ's stated policies.

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While there are many potential topics for examination, we focus our attention here on one of the main drivers of criminal antitrust fines: the volume of commerce (VOC) considered by the DOJ to have been affected by the conspiracy and used as a basis in the determination of the fine. Though the DOJ is frequently criticized for a general lack of transparency in calculating affected VOC,[4] the auto parts cases viewed together shed additional light on the DOJ's methodology of accounting for a controversial type of "indirect" sales potentially affected by conspiratorial agreements. As far as we are aware, these cases are the first to explicitly detail the DOJ's treatment of such indirect sales. However, the DOJ's methodology is not intuitive and so far has not been explained or rooted in any clearly articulated policy statement.

## The Need for Transparency in Leniency-based Criminal Cartel Enforcement.

The DOJ has led enforcement agencies around the world in bringing cartel activity—self-concealing and difficult to detect by its very nature—to light by instituting leniency programs that provide incentives for self-reporting and cooperation. These programs are based upon the pillars of transparency and predictability in enforcement. Corporations considering whether to self-report violations or cooperate with DOJ investigations must weigh the costs and benefits of doing so almost entirely *ex ante*. Without a high degree of predictability in the treatment to be received from enforcement agencies and the ultimate sentencing outcome, a potential cooperator cannot adequately assess the significant consequences attached to its choices. Uncertainty would tend to decrease the willingness of corporations and culpable individuals to cooperate, and would limit the effectiveness of the leniency program. Indeed, the DOJ has often reiterated the importance of transparency in every aspect of its policy and practice, from investigation and charging decisions to plea negotiation.[5]

Transparency and guidance are arguably most necessary regarding the calculation of criminal cartel fines. At least conceptually, cartel fines levied by the DOJ (in both the negotiated and the charged contexts) should be predictable because they are based on the formulaic approach set forth in the U.S. Sentencing Commission Guidelines (USSG).[6] However, while the USSG approach is clearly outlined, the inputs into those formulas are not described in the same detail and, historically, the DOJ has not fully explained how it determines those inputs.

## Role of Volume of Commerce in the Operation of the Sentencing Guidelines

The initial input driving the calculation of criminal antitrust fines is the VOC "attributable to the defendant." Under USSG § 2R1.1, the "base fine" is calculated as "20 percent of the volume of affected commerce."[7] It is notable that, for

the sake of simplicity and to reduce the burden on the court, the USSG uniformly imposes the assumption of a 10 percent overcharge resulting from the conduct.[8] (Note however that the USSG commentary also makes room to account for circumstances where the actual overcharge substantially differs.) After the base fine is calculated, it is then increased by minimum and maximum multipliers (determined by the USSG "culpability score") to create a range.[9] Finally, after selecting the appropriate level within the range at which to peg the fine, the DOJ may seek upward and/or downward departures based on mitigating or aggravating factors.[10] For example, cooperating companies that provide "substantial assistance in the investigation or prosecution of another organization" can obtain reductions of the overall fine.

Though the steps laid out in the USSG are simple enough to follow, there remains a significant gap in guidance regarding the fining process. Despite its obvious importance in driving the magnitude of the ultimate fine, the USSG provides no substantive guidance in defining what is (and what is not) to be included in the calculation of VOC. The relevant section of the USSG states only that the VOC "attributable to an individual participant in a conspiracy is the volume of commerce done by him or his principal in goods or services that were affected by the violation."[11] And because the vast majority of U.S. criminal enforcement actions have resulted in negotiated plea agreements, case law interpreting the USSG definition is scant and the outcomes are conflicting.[12] The case law that does exist focuses primarily on whether commerce that did not experience the price effect intended by the conspiracy is properly excluded in the calculation of "affected" sales. As one court has noted, "Sales that were entirely unaffected did not harm consumers and therefore should not be counted for sentencing because they would not reflect the scale or scope of the offense."[13]

## Direct vs. Indirect Commerce

In this context, one of the most important recurring issues is the treatment of sales potentially affected by collusion that were not made directly by a conspirator to purchasers in the United States. "Direct" sales—sales to purchasers in the U.S. of domestically-produced products and foreign-produced imported products ("domestic" and "direct import" sales, respectively)—are the paradigmatic form of affected VOC under the Sherman Act. Inclusion of conspiracy-affected direct sales in the VOC is uncontroversial.

However, as further discussed below, the DOJ's treatment of "indirect" sales is more questionable. "Indirect" sales could encompass, for example, a foreign defendant's sales of products to a buyer located outside of the United States which are later incorporated as inputs to other products destined to be sold in the U.S.

Indirect sales of this type have two notable characteristics. First, sales of the price-fixed products are made by foreign companies to foreign companies. Second, to the extent any domestic sales are affected by the conspiracy, U.S. consumers are not impacted by an overcharge on the price-fixed part itself, but rather by an overcharge on the purchase price of a product incorporating the price-fixed product as an input. For example, domestic sales would be impacted where the overcharge on a foreign-produced and sold auto part was passed through to U.S. consumers by the increased price of a domestically-sold automobile.

At one time, cartel fines were largely based solely on direct commerce.[14] But for at least two decades, the DOJ has also sought to account for affected foreign, indirect commerce by incorporating additional fining penalties based on the rationale that "the amount of U.S. commerce affected by a defendant in an international cartel understates the seriousness of the defendant's role in the offense and, therefore, the impact of the defendant's conduct on American businesses and consumers."[15] Early DOJ guidance suggested that indirect commerce could be accounted for in one of two ways: (1) adjusting the baseline volume of commerce under the USSG to account for worldwide sales affected by the violation; or (2) treating sales outside of the United States as an aggravating factor requiring an upward adjustment in the Sentencing Guidelines calculation. In practice, the DOJ appears to have settled largely on the latter.[16]

But while the DOJ's intention to account for indirect sales has been clear, it has not provided an overarching framework to address many pertinent questions, such as: how it assesses the impact of foreign sales on U.S. commerce; when it will seek to account for such sales in a fine; how it will set the magnitude of the fine given such sales; and how it will avoid the double-counting of commerce as international cartel enforcement continues to rise.

## Treatment of Indirect Commerce in the Auto Parts Cases

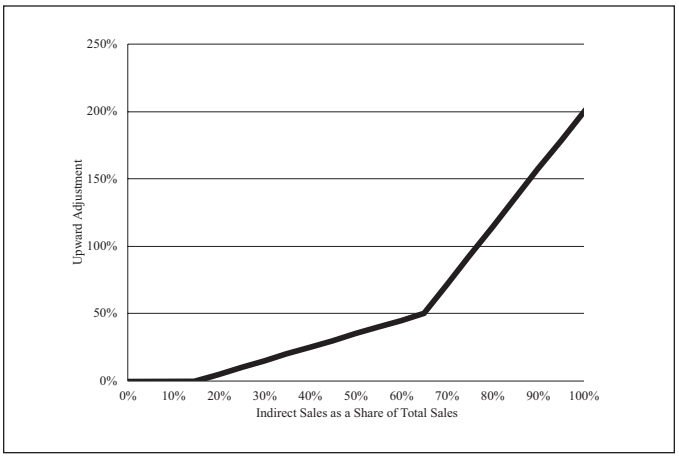
Despite this lack of guidance and other questions about its propriety,[17] indirect sales played a prominent role in criminal fine determinations in the auto parts cases. Indeed, of the 33 defendants analyzed in this article,[18] 19 defendants—nearly half of all pleading companies—experienced an increased fine because of indirect commerce penalties. That indirect commerce would so often impact conspiracies involving component parts sold predominantly by Japanese manufacturers to automakers worldwide is not entirely surprising given the global nature of automobile supply and sales channels. What is of greater interest, of course, is the DOJ's methodology in calculating the upward adjustment in fines, which accounted in several cases for significant portions of the total fines of the affected defendants.

In general, the DOJ's upward adjustment depends on the amount of indirect sales relative to the defendant's direct sales (including both domestic and direct import sales). Specifically, the DOJ method stiches together the treatment of indirect sales within three different ranges. In the first range, if indirect sales account for 15 percent or less of total sales (where total sales include both direct and indirect sales),

**Table 1. Illustration of DOJ's Treatment of Indirect Sales**

| | USSG Minimum Fine | Indirect Sales and Percentage of Total Sales | Calculation of Upward Adjustment | Total Fine |
|---|---|---|---|---|
| Firm 1 | $16.80 | $10 (14%) | 0% | $16.80 |
| Firm 2 | $16.80 | $40 (40%) | 40% – 15% = 25% | $21.00 |
| Firm 3 | $16.80 | $180 (75%) | 50% + 4.2856 * (75% – 65%) = 93% | $32.40 |

**Graph 1. Graphical Illustration of DOJ's Treatment of Indirect Sales**

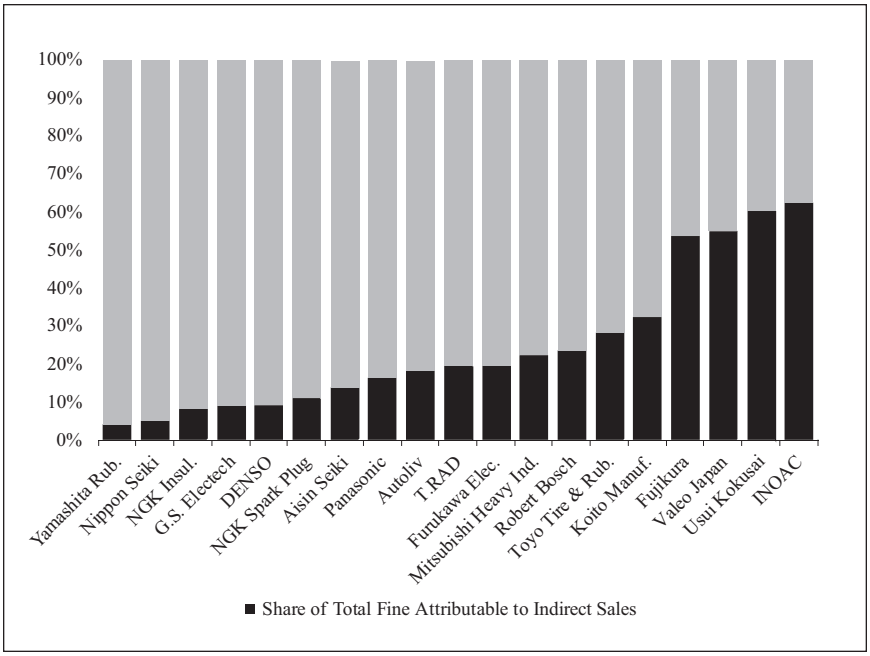



no upward adjustment is applied and indirect sales do not affect the DOJ's fine calculation at all. In the second range, if indirect sales are between 15 percent and 65 percent of total sales, the Guidelines' fine is adjusted upward by that percentage less 15 percentage points.[19] In the third range, if indirect sales account for more than 65 percent of total sales, the upward adjustment to the fine begins to increase significantly, and is calculated with the following formula:

50% + 4.2857 * (Percentage of Indirect Sales – 65%).[20]

To illustrate, Table 1 shows how the DOJ's methodology would account for varying levels of indirect sales. The Table assumes three hypothetical firms, all with total conspiracy-affected direct sales equal to $60 million, and minimum and maximum culpability multipliers under the USSG of 1.4 and 2.8, respectively, resulting in a fine in the range between a minimum of $16.8 million and a maximum of $33.6 million.[21] In particular, Table 1 shows the method by which the DOJ would adjust the minimum fine (and by implication also the maximum fine or any fine in between) for different levels of indirect sales. When indirect sales are relatively low (less than 15 percent of total sales), the DOJ methodology produces no upward adjustment in the fine. When indirect sales are somewhat higher at 40 percent of total sales, the upward adjustment increases the fine (based on the low end of the USSG range) by 25 percent to $21.0 million. Finally, when indirect sales account for a substantial percentage of total sales, here assumed to be 75 percent, the upward adjustment is 93 percent, increasing the total fine to $32.4 million.

**Graph 2. Share of Total Criminal Fine Attributable to Indirect Sales by Auto Parts Defendant**




A graphical illustration of the DOJ's methodology is shown in Graph 1. The line on the graph shows the relationship between the percentage of indirect sales and the corresponding percentage upward adjustment. As described above, when indirect sales are a relatively low percentage of total sales, there is no upward adjustment (shown by the segment of the line that is horizontal at a level of zero). But as indirect sales grow relative to total sales, the upward adjustment increases (the two upward sloping line segments). The slope of the line is steeper when indirect sales account for a larger portion of total sales, indicating that the upward adjustment increases more quickly at those levels. Also notice that, as the percentage of indirect sales approaches 100 percent of total sales, an

upward adjustment equal to 200 percent of the unadjusted base fine results. That is, there is an upper bound, equal to 200 percent, to the upward adjustment of the fine for indirect sales.

Across the auto parts cases, indirect sales contributed to the overall fines in varying degrees. Graph 2 below shows, for each of the 19 defendants for which indirect commerce caused an upward adjustment in its fine, the share of the total fine that was attributable to indirect sales. This number ranged from 4 percent and 62 percent of the total fine.

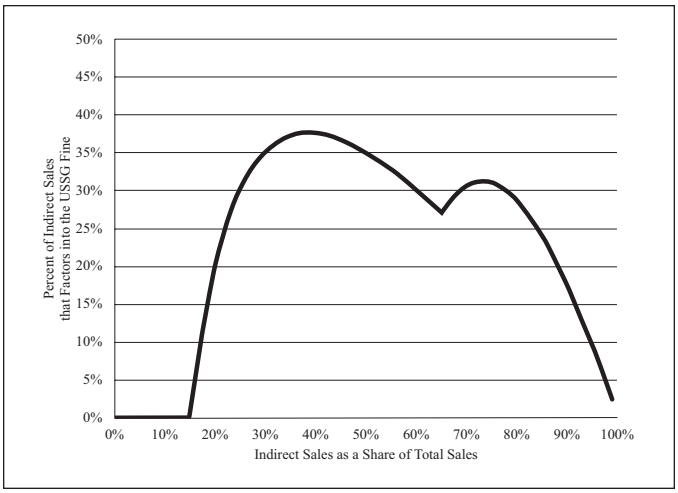
## Implications of DOJ Methodology

There are several notable features of the DOJ methodology, three of which we note here. Of particular interest are the handful of defendants whose indirect commerce was greater than 65 percent of the total sales, thus yielding the largest upward adjustments. INOAC Corp. had direct sales of only $4.5 million, the second lowest of all pleading auto parts defendants. However, its indirect sales were $51.0 million, accounting for more than 90 percent of total sales.[22] The resulting upward adjustment to its fine was 165 percent, increasing the fine from within a range of $1.3 million to $2.5 million (the minimum and maximum of the USSG range) to $3.4 million, before accounting for any subsequent downward adjustment.[23] This substantial increase illustrates that the DOJ's treatment of indirect commerce can drive a defendant's ultimate fine even *higher than* the top of the unadjusted USSG range before accounting for any downward adjustment—in INOAC's case roughly 33 percent higher. Three other defendants experienced upward adjustments above 100 percent based on high indirect sales: Fujikura Ltd. (with an upward adjustment of 115 percent), Valeo Japan Co. Ltd. (121 percent), and Usui Kokusai Sangyo Kaisha, Ltd. (Usui) (151 percent).[24]

Second, for indirect commerce, the formula systematically generates a relatively lower impact on the fine than the impact the same amount of direct commerce would have. This is due to two main reasons: (1) the treatment of indirect commerce as a muted upward adjustment as opposed to being included dollar-for-dollar in the baseline VOC, and (2) the total impact of indirect commerce on the fine being effectually capped at 200 percent of direct commerce. To illustrate, consider the fine of INOAC, discussed above. Had the DOJ considered all of INOAC's $56.0 million total sales as baseline VOC, the resulting fine would have been nearly $11 million,[25] instead of the actual fine of $2.4 million.

Third, compared to the dollar-for-dollar effect of direct sales, the largest effect of indirect sales on the fine is at most 38 cents on the dollar. That is, a defendant who is attempting to estimate a potential fine could consider the sum of direct sales and 38 percent of indirect sales as VOC in the USSG fine calculation. That effect, however, is not constant—it changes as the ratio of indirect sales to total sales varies. Graph 3 below illustrates the relationship. The DOJ methodology produces a somewhat unusual (and unexplained) result: the impact on the fine of a dollar of indirect commerce first rises, then falls, and then rises and falls again as the indirect sales increases as a percentage of total sales. The maximum amount, 38 percent, occurs when indirect sales account for approximately 40 percent of total sales.

**Graph 3. Relationship Between Percentage of Indirect Sales and Percentage of Indirect Sales that Factors into USSG Fine Calculation**




The DOJ's decision to account for indirect sales as a muted upward adjustment to the VOC (rather than as part of VOC) might reflect the fact that cost changes, including overcharges, may not be passed through fully (or even at all) in higher prices to indirect purchasers, and that determining the extent of any pass-through can be highly complex. Those realities are reflected in both the law and in economic theory. Since *Illinois Brick*,[26] indirect purchasers have been prevented from bringing federal civil antitrust claims at least in part as a result of such considerations. Moreover, those legal limitations are complemented by economic theory that recognizes prices may be "rigid," or "sticky," and in certain circumstances would not respond to changes in economic variables, such as a potential overcharge to a component part.[27] Such rigidity implies that component part cost changes may not affect the final price, which indicates a lack of pass-through of alleged overcharges. A lack of pass-through seems especially likely in industries like the auto parts industry, where the value of many of the individual components used in an automobile constitute only a very small percentage of the value of an entire automobile. If the overcharge was not passed through to American consumers or businesses, there would be no "impact of the defendant's conduct on American businesses and consumers" and no reason to adjust the fine.

## Additional Transparency Is Necessary

Given the DOJ's stated commitment to enforcement transparency, it is noteworthy that the DOJ's indirect commerce methodology was not revealed in a speech or other policy statement. Rather, as far as we are able to tell, practitioners

were left to piece together the DOJ's methodology from disparate plea agreements, sentencing memoranda, and hearing transcripts from enforcement actions spanning years.

In fact, the formula used for cases with the largest percentages of indirect commerce only first surfaced in the sentencing memorandum for INOAC filed in January 2016—in the relatively late days of the auto parts investigation. Given the unusually large upward adjustment imposed in that case, the DOJ may have felt compelled to more fully specify its sentencing process to the court than it had in prior cases. Importantly, the DOJ justified the use of its fining formula by simply stating that the method had been used for sentencing determinations in prior auto parts cases.[28] But the cases cited by the DOJ in INOAC either involved lower levels of indirect sales (where the high-end formula would be inapplicable) or failed to detail the methodology used. In other words, the DOJ support for the validity of its formula was simply its prior use of the (previously unspecified) formula.

Consistency is, of course, crucial to achieving fairness in the sentencing of similarly situated defendants. However, given that negotiation plays a defining role in the outcome of most criminal enforcement actions, the lack of transparency allows the DOJ to set and justify its own precedent simply by convincing an early-in corporation to agree to such an approach, one which will have follow-on effects for all other companies investigated. Moreover, it appears that the treatment of indirect commerce in the auto parts cases has differed from the treatment in other investigations.[29] In subsequent cartel investigations, such as the capacitors investigation, the DOJ has continued to account for indirect sales in the calculation of fines.[30] However, based on the available public information, it is unknown whether the methodology is the same as that used in the auto parts actions.

While it is commendable that this methodology has been made public at all, additional guidance is needed. The mathematical precision of the calculation suggests the formula was designed with a particular purpose in mind. But the DOJ has not yet explained how or why it settled on the particulars of its methodology, justified its inflection points or limits, or provided a legal or economic policy supporting it.

## Can Indirect Commerce Be Anchored by . . . Indirect Commerce?

Practitioners searching for clues on the DOJ's indirect commerce enforcement policy run into additional issues that generate confusion. In particular, the lack of clarity in plea-related documents appears to further blur the already fuzzy lines between what constitutes direct and indirect commerce.

For example, the plea-related documents of Usui raise a question about whether the DOJ has expanded its enforcement to cases where there is no direct commerce at all that can anchor the criminal plea in the Sherman Act. Usui experienced a large 151 percent upward adjustment to its fine because its affected indirect sales accounted for 89 percent of its total affected sales.

The Information filed on November 8, 2016 states that Usui and its co-conspirators sold steel tubes "in the United States for installation in vehicles and engines manufactured and sold in the United States."[31] This seems to imply straightforward, direct U.S.-to-U.S. affected sales, by at least some co-conspirators. However, the sentencing memorandum filed on December 19, 2016 says nothing about Usui's involvement in this type of direct sales.

Instead, the affected VOC for purposes of USSG § 2R1.1(d)(1) includes only parts "sold to [the foreign OEM] *in Japan* for export to the United States and installation in vehicles and engines manufactured and sold in the United States."[32] The sale and delivery of parts in Japan (even if destined for transfer by the foreign OEM to its U.S. subsidiary for later incorporation) would itself seem to constitute *indirect* commerce, not direct commerce. Yet those sales were accounted for in the volume of commerce, and then in addition, from that basis, the government added a significant upward adjustment for a much larger volume of sales to OEMs in Japan whose automobiles were later imported into and sold in the United States. It may be too early to tell whether this case signals a shift in DOJ enforcement. At a minimum, the lack of clarity in describing the language has the potential to send imprecise signals.

## Conclusion

Given the potentially significant effect of indirect commerce on a defendant's sentencing, the recent disclosure of the DOJ's fining methodology in the auto parts cases is an important revelation. However, many other questions arise:

- Why did the DOJ settle on this methodology?
- Will the DOJ use the same methodology going forward, either with respect to future component cartel investigations or more broadly?
- At what point does the effect of "indirect" sales become too attenuated to affect a plea agreement, and is there room for defendant companies to marshal evidence to show lack of price effect during plea negotiations?
- Are definitions of "direct" sales (including "domestic" and "direct import" sales) malleable enough to include what have traditionally been "indirect" sales made in another country, as the Usui case suggests?

One thing seems clear: the auto parts plea agreements suggest that the DOJ will continue including indirect sales in cartel fines, at least until that practice is tested in court. While disclosure of the DOJ's fining methodology is a key step, further transparency is necessary going forward. Companies and practitioners should not be left to retrospectively "connect the dots" of outcomes in prior investigations to divine the DOJ's enforcement policy. ■

[1] U.S. Dep't of Justice, Criminal Program Update 2012 (Spring 2012), https://www.justice.gov/atr/criminal-program-update-2012.

[2] Press Release, U.S. Dep't of Justice, Antitrust Div., Kiekert AG to Plead Guilty to Bid Rigging Involving Auto Parts (Mar. 7, 2017), https://www.justice.gov/opa/pr/kiekert-ag-plead-guilty-bid-rigging-involving-auto-parts.

[3] The tail end of the investigation has even produced a relative rarity: a criminal trial. In November 2017, Tokai Kogyo Co., Ltd. and Green Tokai Company Co. Ltd., were found not guilty of violating Section 1 of the Sherman Act after a three-week jury trial. *See* United States v. Tokai Kogyo Co. Ltd., 1:16-cr-00063-TSB, Verdict Form, ECF No. 234 (S.D. Ohio Nov. 29, 2017).

[4] *See, e.g.*, Melissa H. Maxman & Elizabeth L. Holdefer, *Volume of Commerce and Criminal Sentences for Antitrust Violations—Alternative Interpretations in the Air Cargo Fuel Surcharge Cases*, Antitrust Source (Aug. 2011), https://www.americanbar.org/content/dam/aba/publishing/antitrust_source/aug11_maxman_7_26f.authcheckdam.pdf; James H. Mutchnik, Christopher T. Casamassima & Brenton A. Rogers, *The Volume of Commerce Enigma*, Antitrust Source (June 2008), http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/Jun08_Mutchnik6_26f.pdf; Laura S. Shores, *The Starting Point: Negotiating "Volume of Commerce" with the Antitrust Division*, ABA Cartel & Crim. Prac. Committee Newsl. (Feb. 2012). https://www.americanbar.org/content/dam/aba/publications/antitrust_law/at307000_newsletter_201202.authcheckdam.pdf.

[5] Scott Hammond, Deputy Assistant Att'y Gen., U.S. Dep't of Justice, Antitrust Div., The U.S. Model of Negotiated Plea Agreements: A Good Deal with Benefits for All (Oct. 17, 2006), https://www.justice.gov/atr/speech/us-model-negotiated-plea-agreements-good-deal-benefits-all.

[6] Scott Hammond, Deputy Assistant Att'y Gen., U.S. Dep't of Justice, Antitrust Div., Antitrust Sentencing in the Post-*Booker* Era: Risks Remain High for Non-Cooperating Defendants (Mar. 30, 2005), https://www.justice.gov/atr/speech/antitrust-sentencing-post-booker-era-risks-remain-high-non-cooperating-defendants.

[7] USSG § 2R1.1. The DOJ recently discussed its justification for the calculation of the base fine. Letter to the U.S. Sentencing Commission from the U.S. Dep't of Justice, Criminal Division (July 29, 2014), https://www.justice.gov/sites/default/files/criminal/legacy/2014/08/01/2014annual-letter-final-072814.pdf. For additional commentary on the USSG approach, see Michelle M. Burtis & Bruce H. Kobayashi, *Regarding the Optimality of Cartel Fines*, ABA Cartel & Criminal Practice Comm. Newsl. (Spring 2017); Julia Schiller, Ian Simmons & Angela Thaler Wilks, *Towards Convergence: The Volume of Affected Commerce under the U.S. Sentencing Guidelines and Impact Analysis under the Clayton Act*, 18 Geo. Mason L. Rev. 987 (2011).

[8] *See* Burtis et al., *supra* note 7.

[9] USSG §§ 8C2.5 (calculating culpability score on based on aggravating or mitigating factors, such as size of the corporation, involvement or knowledge of high-level executives, engagement in obstruction of justice, prior similar violations, and cooperation and acceptance of responsibility); 8C2.6; 8C2.7.

[10] *See* USSG §§ 8C4.1–8C4.11.

[11] USSG § 2R1.1(b)(2).

[12] *Compare* United States v. Hayter Oil Co., 51 F.3d 1265 (6th Cir. 1995) (finding that VOC "includes all sales of the specific types of goods or services which were made by the defendant or his principal during the period of the conspiracy, without regard to whether individual sales were made at the target price") *with* United States v. SKW Metals & Alloys, Inc., 195 F.3d 83 (2d Cir. 1999) (finding that an unsuccessful conspiracy that fails to affect a market price "has affected no sales within the meaning of the Guidelines") *and* United States v. Andreas, 216 F.3d 645 (7th Cir. 2000) (creating a rebuttable presumption that all sales are affected by the conspiracy).

[13] *Andreas*, 216 F.3d at 678.

[14] Brief for the United States and the Federal Trade Commission as Amici Curiae at 8–10, Statoil ASA v. HeereMac V.O.F., 534 U.S. 1127 (2002) (No. 00-1842) ("[I]n all but two of the dozens of international cartel cases prosecuted . . . fines obtained by the government were based solely on domestic commerce."), http://www.usdoj.gov/atr/cases/f9800/9844.pdf.

[15] Gary R. Spratling, Deputy Assistant Att'y Gen., U.S. Dep't of Justice, Antitrust Div., Negotiating the Waters of International Cartel Prosecutions: Antitrust Division Policies Relating to Plea Agreements in International Cases 15–16 (Mar. 4, 1999), https://www.justice.gov/atr/file/518591/download.

[16] Scott D. Hammond, Deputy Assistant Att'y Gen., U.S. Dep't of Justice, Antitrust Div., Charting New Waters in International Cartel Prosecutions (Mar. 2, 2006) ("In practice, the Division has used foreign sales only as an aggravating factor requiring an increase in the fine. Moreover, the Division has since announced that it will consider only a defendant's domestic sales in calculating a defendant's volume of affected commerce under USSG §§2R1.1(d)(1) and 8C2.4(a)–(b).") (citations omitted), https://www.justice.gov/atr/file/518446/download.

[17] We note that there are significant concerns about whether the DOJ has legal authority to include indirect sales in its fine calculations at all. While the full implications are beyond the scope of this article, the Foreign Trade Antitrust Improvements Act (FTAIA), 15 U.S.C. § 6a, removes from the scope of the Sherman Act such foreign-to-foreign sales, and only brings back into the scope of the Sherman Act sales that meet certain criteria. The DOJ has asserted that the FTAIA does not apply to criminal sentencing. *See, e.g.*, Letter from DOJ to Hon. Susan Illston, No. 3:07-md-01827, ECF No. 2146 (N.D. Cal. Nov. 15, 2010). But no court has agreed with that assertion. *See* Motorola Mobility LLC v. AU Optronics Corp., 775 F.3d 816, 825 (7th Cir. 2015) ("If price fixing by the component manufacturers had the requisite statutory effect on cellphone prices in the United States, the Act would not block the Department of Justice from seeking criminal or injunctive remedies."). Moreover, establishing the requisite "direct, substantial, and reasonably foreseeable" effect on domestic commerce may be complex. Even if it can be shown that overcharges were passed through to U.S. buyers, this does not equate to a distortion of competition or the competitive process in the U.S., which is a prerequisite for establishing a legal claim under the second prong of the FTAIA's test regarding domestic effects. *See, e.g.*, Leon B. Greenfield, Steven F. Cherry, Perry A. Lange & Jacquelyn L. Stanley, *Foreign Component Cartels and the U.S. Antitrust Laws: A First Principle Approach*, Antitrust, Spring 2015, at 18; *see also* Maureen K. Ohlhausen, *The Elusive Role of Competition in the Standard-Setting Antitrust Debate*, 20 Stan. Tech. L. Rev. 93 (2017).

[18] The analyses in this article omit defendants whose fines were determined differently than other defendants due to the defendant's inability to pay or because the defendant was found to be more culpable than other defendants: Bridgestone Corp., Hitachi Automotive Systems Ltd. (shock absorbers), Alpha Corp., Mitsuba Corp., and Nishikawa Rubber Co. Ltd. The analyses in this article also omit defendants for whom publicly-available information is incomplete, including: Aisan Industry Co. Ltd., Hitachi Metals, Ltd., Toyoda Gosei Co. Ltd., Continental Automotive Electronics LLC, Corning International Kabushiki Kaisha, Maruyasu Industries Co., Ltd., Omron Automotive Electronics Co. Ltd., Sanden Corp., and Yamada Manufacturing Co., Ltd.

[19] For example, in the Yamashita sentencing memorandum, the DOJ explained that because indirect sales accounted for approximately 19.3% of total sales, the lower end of the fine range, $11.48 million was adjusted upward by 4.3% to $12 million. United States v. Yamashita Rubber Co. Ltd., No. 3:13-cr-00439, Sentencing Mem., ECF No. 21 (N.D. Ohio May 1, 2015). *See, e.g.*, United States v. Toyo Tire & Rubber Co., Ltd., No. 3:13-cr-00529, Sentencing Mem., ECF No. 38 (N.D. Ohio May 21, 2015).

[20] United States v. INOAC Corp., No. 2:15-cr-00052, Sentencing Mem., ECF No. 40 (E.D. Ky. Feb. 6, 2017) [hereinafter INOAC Sentencing Mem.]; United States v. Usui Kokusai Sangyo Kaisha, Ltd., No. 1:16-cr-00106, Sentencing Mem., ECF No. 12 (S.D. Ohio Dec. 19, 2016).

[21] For all three firms, the base fine is 20% of the volume of commerce ($60 million) or $12 million, and using the 1.4 and 2.8 multipliers for culpability, the range of fines, before indirect sales are taken into account and before any other adjustments, is $16.8 million to $33.6 million.

[22] *See* INOAC Sentencing Memo, *supra* note 20, at 6. The ultimate fine was reduced by 30% to $2.4 million based on INOAC's substantial assistance provided to the government. *Id.*

[23] *Id.* As noted above, the DOJ may seek a downward adjustment to a defendant's fine based on mitigating factors. For example, cooperating companies that provide substantial assistance in the investigation of another organization that has committed an offense can obtain reductions in their overall fine.

[24] *See* United States v. Fujikura Ltd., No. 2:12-cr-20254, Sentencing Mem., ECF No. 13 (E.D. Mich. Apr. 13, 2015); United States v. Valeo Japan Co.

Ltd., No. 2:13-cr-20713, Sentencing Hearing Tr., ECF No. 11 (E.D. Mich. Dec. 9, 2013); United States v. Usui Kokusai Sangyo Kaisha, Ltd., No. 1:16-cr-00106, Sentencing Mem., ECF No. 12 (S.D. Ohio Dec. 19, 2016) [hereinafter Usui Sentencing Mem.].

[25] Both of these values account for a 30% downward adjustment for cooperation that was factored into INOAC's fine calculation. For example, the $11.0 million in this example is calculated as $56.0 million VOC * 20% * 1.4 minimum multiplier * (1 – 30% downward departure for cooperation) = $11.0 million.

[26] Illinois Brick Co. v. Illinois, 431 U.S. 720 (1977). The DOJ has recently raised the possibility that it could seek to overturn *Illinois Brick* in order to seek recovery of damages for taxpayers in price-fixing cases. *See* Charles McConnell, *DOJ Looks at Overturning* Illinois Brick, GCR (Jan. 24, 2018).

[27] *See, e.g.*, Dennis W. Carlton, *The Theory and the Facts of How Markets Clear: Is Industrial Organization Valuable for Understanding Macroeconomics?*, *in* Handbook of Industrial Organization 916 (Richard Schmalensee & Robert D. Willing, eds., 2d ed. 1990) ("The previous examples show that the relationship of price changes to cost changes varies with the shape of the demand curve and therefore it is not possible to make any general statements about the variance of price in relation to the variance of cost based upon whether a market is competitive or monopolized. Moreover, since we know that oligopolies run the spectrum from almost competitive industries to almost monopolized industries, the simple theories do not allow any differential predictions of price flexibility for (large cost changes) that depend solely on the degree of competitiveness of the market.")

[28] *See* INOAC Sentencing Mem., *supra* note 20, at 5 (citing Fujikura, Valeo, Yamashita, Toyo Tire, and Bridgestone as examples where upward adjustment used to account for indirect sales); *id.* at 6 (citing Fujikura and Valeo as prior cases applying the high-end indirect sales formula).

[29] Explanations from DOJ officials regarding the methodology used in the air cargo investigation appear to differ from the method used in the auto parts investigations. *See* Mutchnik, *supra* note 4, at 6; Scott D. Hammond, Sentencing Issues in Today's Global Economy, Speech Before the ABA Section of Antitrust Law (Mar. 26, 2008).

[30] *See, e.g.*, United States v. Elna, No. 4:16-cr-00365, Second Supp. Sentencing Mem. at 9–10, ECF No. 49 (N.D. Cal. ) ("The government has used consistent principles to determine what should be included in the calculation of volume of affected commerce, using sales of standalone capacitors to the United States as a starting point. The consistent approach taken by the government extends to the upward adjustment within the guidelines fine range that represents the value of electrolytic capacitors sold outside the United States, but incorporated into personal desktop and laptop computers sold in the United States under five major U.S. brands (Dell, HP, Apple, IBM, and Gateway)."); United States v. Rubycon Corp., No. 4:16-cr-00367-JD, Sentencing Mem. at 13, ECF No. 5 (N.D. Cal. Sept. 7, 2016) ("Specifically, an upward adjustment of $4.6 million is warranted to account for the value of electrolytic capacitors sold outside the United States, but incorporated into personal desktop and laptop computers sold in the United States under major U.S. brands.").

[31] United States v. Usui Kokusai Sangyo Kaisha, Ltd., No. 16-cr-00106, Information, ECF No. 2 (S.D. Ohio Nov. 8, 2016).

[32] Usui Sentencing Mem., supra note 24, at 4 (emphasis added). *See also* Plea and Sentencing Mem. of Defendant Usui Kokusai Sangyo Kaisha, Ltd., No. 16-cr-00106-SJD, ECF No. 24 (S.D. Ohio Apr. 4, 2017) (stating that products at issue sold to "automobile manufacturers in Japan . . . . Defendant Usui-Japan did not manufacture [products] in the U.S. and . . . did not sell [products] to automobile manufacturers in the United States.").

# Search, Advertising, and Online Distribution: Practical Guidance and Open Questions Under FTC Standards

BY AARON BURSTEIN

SEARCH ENGINES AND ONLINE distribution platforms have transformed how consumers shop as well as how companies advertise and deliver their products. While these technologies greatly expand consumers' choices in the commercial arena and afford businesses access to new markets and customers, an intense debate is swirling around the hidden algorithms that businesses use to generate search results and place advertisements. This debate is likely to continue for a long time, but the Federal Trade Commission has recently taken some modest but significant steps illustrating the importance of squaring the use of search advertising with existing consumer protection standards.

Two sides of search-driven marketing warrant close attention: (1) the contents of search ads, which are typically provided by advertisers themselves, and (2) search engines' decisions about what results to display and how to display them. Companies that use search ads to compete for online traffic should be aware that the small amount of text in a typical search engine ad can be misleading on its own and can open the door to a more thoroughly deceptive online presence—as demonstrated by the FTC's recent enforcement action against Reservation Counter.[1]

Similarly, where the provision of search capabilities is concerned, the FTC's recent case against Victory Media[2] has breathed life into its long-standing guidance on search advertising by making the alleged failure to disclose payment for inclusion in search results part of the grounds for an enforcement action. These actions demonstrate that, while current and recent members of the FTC have expressed different views about how extensively the FTC should wade into companies' use of data and algorithms to advertise to consumers, there should be no doubt that the FTC will take action against search-related practices that, in its view, deceive consumers.

The disparate industries at issue in these two actions—travel in *Reservation Counter*, and post-secondary education in *Victory Media*—also show that companies across the economy should pay attention to the FTC's search-related standards.

This article begins with overviews of the economic significance of online distribution platforms and search engines, how they relate to one another, and the FTC's guidance on search advertising. It then discusses the FTC's actions against Reservation Counter and Victory Media, and how those actions point to the need for companies to take a holistic look at their use of search in connection with online distribution. Although the enforcement actions discussed in this article address specific companies' alleged practices, they also highlight more general questions that companies should consider in connection with any search capabilities they offer and their overall online distribution operations. The article concludes by identifying issues that the FTC's guidance and enforcement actions leave unaddressed and provides guidance on what companies should ask themselves in connection with purchasing search ads and providing search capabilities.

## Understanding the Close Connection Between Search and Online Distribution

To appreciate the broader significance of the FTC's actions against Reservation Counter and Victory Media, it is helpful to keep two general online distribution models in mind. One model is direct distribution, in which the provider of the good or service sells directly to consumers through a website or app. To take an example from the hotel industry, which is at the center of the *Reservation Counter* action, many hotel brands maintain websites and apps through which they allow consumers to search for and book rooms with a specific location.

A second general model of online distribution uses dedicated distribution platforms that offer products or services from different providers. To refer again to the hotel industry, online travel agencies (OTAs), such as Expedia and Priceline, allow consumers to search among different hotels and book rooms through the OTA platform. There are variations on this model. Of particular relevance to the *Reservation Counter* case is the OTA affiliate model, in which independent third parties contract with OTAs for inventory and conduct their own marketing campaigns in an effort to get consumers to book rooms through their services. Reservation Counter itself is an OTA affiliate, and its use of search advertising was a central element of the FTC's action against the company.

These distribution models differ significantly in how consumers use them and how payments flow among the various participants. However, they share a dependence on search results and search advertising. Consider a consumer who searches for "Milwaukee hotels" on a general search engine.

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Depending on a variety of factors, the consumer may see, among other things, search results from specific hotels in Milwaukee, results from an OTA like Expedia, results from an OTA affiliate, and search ads for any of the same. The consumer's first click from this point can make the difference between booking directly, through an OTA, or through an OTA affiliate. Unsurprisingly, search ads—which are often displayed prominently above "organic" or "natural" search results, that is, results determined through relevance to a search query—are an important force in affecting the paths that consumers take. Their importance is evident in the amount of money spent on search advertising—approximately $35 billion,[3] which is sizable in comparison with the total amount of nationwide retail electronic commerce ($294 billion in 2015[4]).

Despite the seismic shifts that the entry of online distribution channels have brought to the ways that consumers shop, one thing has remained the same when they purchase tangible goods: the goods that ultimately reach the consumer are the same as they would purchase in a physical store. That is, a pair of a particular type of sneakers purchased at Foot Locker, at the Adidas store, or from Zappos would be exactly the same.

Matters are somewhat less clear where the "product" for sale is actually a service. For some services, the very process of acquiring the service is part of the experience of using the service itself. This is especially true in the lodging industry, where there are strongly established expectations that the hotel (or other service provider) is in control of the service from beginning to end. However, an entity that is involved in distributing but not delivering a service may have the opportunity to rewrite some aspects of the experience in ways that clash with consumers' expectations. At worst, distributors can use search engines and style their online presence in a way that misleads consumers to believe that they are dealing directly with the company that ultimately provides a good or service, degrading the search and sale experience as well as the ultimate service itself. This was the case in the FTC action against Reservation Counter, as discussed below.

## Search Advertising: Broad Guidance but Little Enforcement Against Search Engines

Because search advertising and search results occupy a central position in *Reservation Counter* and *Victory Media*, it is helpful to begin by taking stock of relevant search guidance from the FTC. The nexus between search and advertising has long been of concern to the FTC, and the agency's guidance on search advertising provides some durable and fundamental principles. The existing guidance is directed to search engines, rather than advertisers. Though limited in that way, the FTC's search advertising guidance applies across the many different contexts in which companies offer search capabilities, including general-purpose search engines, vertical search engines, and online distribution platforms that incorporate search functionality.

***2002 Search Engine Guidance.*** In response to a nongovernmental group's complaint and request for investigation of several search engines, the FTC in 2002 issued staff guidance on search engine advertising (2002 Search Engine Guidance).[5] The 2002 Search Engine Guidance asks and answers a basic question about search: what do consumers take away from the content and ordering of search results? The FTC staff's answer to this question is simple. Based on standard industry practice at the time, consumers reasonably expect that search results are "based on relevancy to the search query, as determined by algorithms or other objective criteria" that are "based on a set of impartial factors."[6]

With this broad principle in the background, the FTC focused its initial guidance on two general search engine practices.

*Paid placement* practices include the still widespread practice of displaying ads above or next to organic search results. By 2002, the FTC understood that advertisers' and search engines' financial incentives could blur the line between organic results and ads. The 2002 Search Engine Guidance recommends clearly and conspicuously labeling ads to distinguish them from results chosen based on "objective criteria," including any results from sites that "have paid to be ranked higher than they would be ranked by relevancy, or other objective criteria."[7]

*Paid inclusion* practices include the listing of sites that have paid a search engine to appear in the results and also may involve the intermingling of paid with non-paid sites.[8] FTC staff advised that search engines should make clear and conspicuous disclosures about the presence of such advertising. The starkest example of paid inclusion is a service in which *all* sites pay to be included—a practice upon which FTC staff commented: "[C]ertainly, if all Web sites included in a search guide or a search engine's database have paid to be included, so that the search engine is essentially an advertising medium, that fact should be disclosed adequately to avoid deception."[9] As discussed further below, paid inclusion was an issue in *Victory Media*. Specifically, the company allegedly represented that its search tool searched "military friendly" schools, while the tool was limited to schools that paid to be included.

***Closing Statement on Google's Search Practices.*** In January 2013, the FTC announced that it was closing its antitrust-focused investigation of Google's alleged "search bias," that is to say, the accusation that Google "unfairly promoted its own vertical properties through changes in its search results page," with the effect of pushing organic results "farther down the search results page."[10] Although the closing statement focuses on the antitrust issues that were the subject of the FTC's investigation, it also affirms the 2002 Search Engine Guidance's notion that the main purpose of organic search results is to provide information that is relevant to the search query.[11]

***2013 Search Engine Guidance.*** Later in 2013, the FTC returned to the consumer protection side of search and adver-

tising. Noting a "decline in compliance" with the 2002 Search Engine Guidance, FTC staff sent letters to several general purpose search engines and 17 vertical search engines.[12] Like the 2002 Guidance, the 2013 Search Engine Guidance asserts that "consumers ordinarily expect that natural search results are included and ranked based on relevance to a search query, not based on payment from a third party."[13] The FTC sought to future-proof this view, asserting that "[r]egardless of the precise form search may take in the future, the long-standing principle of making advertising distinguishable from natural search results will remain applicable."[14] As an example, the 2013 Guidance describes a social network's recommendations for restaurants based on a user's contacts and states that any such recommendations "included or prioritized based in whole or in part on payments from a third party" should be clearly distinguished as advertising.[15] This principle holds irrespective of whether a search engine is general or vertical.[16]

The FTC's search engine guidance is sweeping. Read literally, the 2013 Search Engine Guidance advises that any search result placement or inclusion based "in whole or in part" on a third-party payment qualifies as advertising. There is no qualitative or quantitative threshold, nor does the 2013 Search Engine Guidance offer any distinction based on the nature of the payment from a third party. In particular, the 2013 Search Engine Guidance does not require the payment to be for the purpose of advertising. This is important because it is common in online distribution arrangements for money to flow in the form of commissions or fees from the seller to the distribution platform, and there is some evidence that some companies use revenue earned from partners as a factor in determining the order of search results.

## Case Study: Search and Online Distribution in the Travel Industry

As sweeping as the FTC's guidance is, its scope is not infinite. In particular, the guidance does not address advertisers' use of search engines' capabilities. If there was any doubt that the small amount of text available to advertisers in typical search ads can be part of a deceptive practice, the *Reservation Counter* action should remove that doubt. *Reservation Counter* makes clear that advertisers should ensure that their search ads are not deceptive, either on their own or as part of the broader impression that their advertising campaigns create.

In recent years, OTAs, such as Expedia and Priceline, have become a fixture in the marketplace and account for a significant portion of hotel bookings to non-business travelers. In many instances, it is clear to consumers that they are using an intermediary—like an OTA—to conduct a transaction. Still, when a room is booked through the OTA, the OTA handles only the booking while delivery of the service is up to a hotel. OTAs typically receive a commission for each booking they facilitate, creating an incentive to vie for as many bookings as possible.[17]

This arrangement can create risks for hotels and consumers when the presence or role of a third party is unclear. In addition to handling bookings themselves, OTAs contract with "affiliates" that sell hotel room inventory. Hotels do not enter into direct relationships with affiliates, and affiliates can be as small as a single person operating from her laptop computer in a college dorm room. Like many companies across the economy, some OTA affiliates reach consumers through search advertising. However, when search ads obscure the role that the OTA affiliate plays or if the OTA affiliate purports to be the hotel itself, rather than a third party, there is a problem—for the hotel and consumers. The FTC's recent action against Reservation Counter[18] and its corporate parents tackled exactly this issue.

As an OTA affiliate, Reservation Counter "obtain[s] hotel room inventory primarily through affiliate network programs sponsored by first-tier online travel agencies . . . such as Expedia, Priceline, and Orbitz, but they advertise and market the available hotel rooms through their own advertisements, websites, and call centers."[19] The FTC alleged, however, that Reservation Counter's search ad text, landing page representations, and call center practices "create[d] the impression that consumers [were] booking hotel rooms directly through the advertised hotel, and thus, that reservations made through Defendants [were] subject to the same terms and policies as those applicable to consumers who book hotel rooms directly with the hotel."[20]

***Search Ad Text.*** According to the FTC's complaint, the company's deceptive online presence began with search ads. For instance, a search for "Hilton Birmingham Atlanta" on Yahoo's search engine would return text-based ads with the headlines "Hilton Birmingham Alabama—Hilton Reservation Counter.com" and "Hilton Birmingham Al—8 Perimeter Park South, Birmingham" in "large bold lettering."[21] The effect of this ad text on consumers, in the FTC's view, was to "convey[] the impression that clicking on the advertisement will take consumers to websites owned and operated by or directly for the advertised Hilton hotel located in the Birmingham, Alabama area."[22]

Furthermore, the complaint highlighted that the second line of Reservation Counter's ads displayed website links ("URLs") that included the name of the hotel in the search query alongside Reservation Counter's (or its affiliate, Reservation Desk's) domain name, e.g., Reservation Counter.com/Hilton. This juxtaposition, according to the FTC, "convey[ed] the impression that the reference to "Reservation Counter" or "Reservation-Desk" refers to the centralized booking center operated by or for the Hilton hotel chain."[23]

***Landing Page Representations.*** The FTC further alleged that the links in Reservation Counter's search ads led to web pages "dedicated specifically and exclusively to the advertised property," i.e., the hotel name and location that were in the search query.[24] These pages prominently displayed the name and images of the hotel, as well as facilities to search for and reserve a room, and to obtain rate information.[25] Although the defendant-operated sites displayed the name "Reservation Counter," the FTC alleged that the

**The FTC's action against Reservation Counter makes it clear that the agency may take action against companies that use search ads to grab the attention of consumers and create the misimpression that they are more than a middle man.**

size, placement, and other aspects of this display was "insufficient to dispel the net impression" conveyed by its search ads and landing pages, namely that the site was operated by the hotel named in the search.[26]

***Call Center Practices.*** In addition, the defendant's landing pages allegedly displayed a phone number for "Reservations" below the name and address of the hotel, which in the FTC's view, created the impression that calling the number would put the consumer into contact with the hotel itself.[27] Instead, the number was staffed by call centers operated by Reservation Counter, whose agents allegedly were instructed to answer calls with phrases such as "Thank you for calling Reservation Counter" and were not trained or instructed to tell consumers that they were not affiliated with the hotel.[28] The complaint also asserts that, although Reservation Counter's training materials instructed call center staff not to affirmatively represent that they worked for the hotel, the materials' instructions led to "vague and ambiguous" disclosures that did not "dispel the net misimpression that the caller has reached the reservation center at the advertised hotel or acting on behalf of that hotel."[29]

Why did any of these representations matter to the FTC? After all, the FTC's complaint does not allege that Reservation Counter failed to reserve the rooms that consumers booked through its site.[30] The complaint alleges that Reservation Counter's involvement changed the terms of hotel room reservations in some important ways, without adequately disclosing those changes. Some of the common terms and policies that typically apply to direct booking apparently did not apply to reservations made through the defendants' service. For example, consumers were charged in full at the time they reserved their rooms (rather than after their stays), were subject to more restrictive change and cancellation policies, did not earn rewards or loyalty points, and may have missed special rates that otherwise would have been available to them (e.g., discount rates for weddings or conferences).[31]

The *Reservation Counter* order directly addresses the practices that were alleged in the complaint. Specifically, Reservation Counter is prohibited from making any misrepresentation that consumers who book through its service are booking directly through the hotel or that the company is, or is working directly for, an advertised hotel.[32] This type of provision is typical in FTC advertising cases. However, the order goes on to list specific elements that could lead to such misrepresentations, including the "actual or display URL" used in advertisements and placing a call center "in immediate proximity" to an advertised hotel photo or logo. The calling out of these specific elements aligns with the complaint, which details how, in the FTC's view, individual elements of Reservation Counter's ads, websites, and call center operations were misleading on their own and also worked together to create the misimpression that consumers interacted directly with hotels.[33]

Overall, the FTC's complaint outlines a set of alleged practices that work together to create the impression that consumers were dealing directly with the hotel named in their search queries. This action demonstrates that the FTC will step in when an online distributor changes terms of a transaction in ways that consumers expect based on previous experience, even if the product or service that is ultimately delivered to consumers is the one that was advertised.

## Case Study: The FTC's Search Engine Guidance in Action

The FTC's action against Victory Media demonstrates that entities that offer search capabilities also need to pay attention to the potential for creating misrepresentations about consumers' choices. In particular, the FTC's action against Victory Media provides a look at how the paid inclusion elements of the FTC's search engine guidance look in an enforcement action.

Victory Media focuses on helping "'military transitioners and veterans explore different employment, education and entrepreneurship opportunities'" through a variety of online and print publications.[34] The search-related aspects[35] of the FTC's action concern an online search tool—Matchmaker—that Victory Media provided to allow consumers to search for post-secondary schools based on a variety of criteria, including name, location, and area of study.[36] According to the FTC, Victory Media created a "military-friendly" designation for schools based on publicly available data and the results of a survey that it sent to schools, which assessed how schools met military students' interests and educational needs.

During the time period covered by the complaint, the FTC alleged, all schools listed in Matchmaker paid to be included.[37] Some of the included schools were "military-friendly"; others were not.[38] However, Victory Media ran a variety of ads in which it allegedly claimed that Matchmaker would allow consumers to search military-friendly schools.[39] In other words, "several schools not designated by the respondent as 'military friendly' [were] included in the Matchmaker search results."[40]

The charging language in the FTC's complaint combines two issues. First, the Matchmaker complaint charges that Victory Media included schools that it had not designated as military-friendly,[41] in apparent contrast with the claims in ads about Matchmaker. Second, the FTC charged Victory Media with failure to disclose that it was essentially a paid inclusion

search engine.[42] The second element of this charge fits squarely with the concept of "paid inclusion" that dates back to the FTC's 2002 Search Engine Guidance.

The *Victory Media* order addresses the allegedly undisclosed paid inclusion practice by prohibiting the company from misrepresenting "in connection with paid promotional content regarding post-secondary schools . . . the scope of the search conducted by any search tool, including, but not limited to whether any such tool searches only through schools Respondent or others have designated as military friendly."[43] In other words, the order does not prohibit a search tool that includes paid content, nor does it require a disclosure about the scope of a search in the absence of a paid promotion. It is the combination of those two conditions that falls within the scope of this order provision. Thus, the *Victory Media* order's search provision is relatively clear-cut and reflects the underlying allegation that all schools listed in the search tool paid to be included.[44]

## Implications for Search Engines and Advertisers

***Advertisers.*** The FTC's action against Reservation Counter makes it clear that the agency may take action against companies that use search ads to grab the attention of consumers and create the misimpression that they are more than a middle man. When combined with other misrepresentations and practices that diminish the quality of the product or service—such as leaving consumers with unexpectedly inflexible room reservations—the risks (potentially including enforcement by state attorneys general) of such practices are obvious.

More generally, companies must examine their own representations carefully to navigate this landscape. As the online commercial ecosystem becomes more complex, companies should start thinking about how practices that are now emerging will be viewed under fundamental consumer protection standards. It is not sufficient for advertisers to rely on search engines to clearly identify ads. Advertisers themselves need to ensure that the text of the ads that they submit does not create misleading impressions on their own or as part of a broader misrepresentation.

In addition, advertisers should look at their campaigns holistically. Multiple aspects of a company's online presence can contribute to a broader claim or representation that a company ends up making. How do these elements tie together to make broader claims? Do a distribution platform's terms differ from those of more established channels in ways that depart from consumers' expectations? These questions are particularly critical in instances in which those terms are important to a service or overall experience, as the FTC's action against Reservation Counter demonstrates.

***Search Engines.*** The Victory Media action should also give pause to companies that use payments to influence the scope or ordering of their search results. Leading a consumer to believe that search results are organic and prioritized based on consumer preferences, if they in fact are based on some form of payment, may be deceptive to consumers and harm the broader marketplace by punishing sellers who choose not to pay.

As more companies—even if they are not primarily search engines or distribution platforms—incorporate search features into their services, they will face challenges in determining when they must disclose relationships that affect search results and how to make those disclosures. The FTC's search engine guidance provides a useful lens through which to view such issues. In particular, the two-part taxonomy of paid placement and paid inclusion has continuing applicability. However, applying the guidance's principles to new issues that loom not too far ahead requires careful thought.

Some of the questions that arise implicate the paid placement dimension of the FTC's search engine guidance. As discussed above, the straightforward scenario involves payments from an advertiser to a search engine to obtain a search ranking that is higher than it would be in organic search results. (At least one platform introduced such a model.[45]) But consider a more subtle example, such as a vertical search engine that uses commissions as a factor in determining the ranking of search results. Such payments are not for the express purpose of advertising. However, to the extent that payments to distribution platforms affect organic search results—long regarded by the FTC as based on objective criteria of "relevance"—they may conflict with consumers' reasonable understanding of the results they see. More complex still is the question of when a search engine's use of commissions—or, more generally, revenue earned from its business partners—moves from being a factor in the search engine's determination of relevance to a form of advertising. And, if all results in a given search engine take this factor into account, what is an effective way to disclose this fact to consumers?

Other questions fall along the paid inclusion dimension of the FTC's search engine guidance. The most detailed statement of paid inclusion guidance—from 2002—indicates that intermingling of paid and non-paid sites, payment for prioritized review of sites or links, and payment for deeper or more thorough review as a site relative to non-paid sites are all forms of paid inclusion. What does effective disclosure look like in these instances? Is it sufficient to state that payments may affect some search rankings? Or are more specific disclosures—perhaps indicating which results are affected by payments, or quantifying the effect of payments—necessary?

Of course, paid inclusion and paid placement models are not mutually exclusive, and companies that provide search capabilities may move between them or incorporate elements of both. The FTC's existing guidance does not address the full range of business models or fact patterns that could arise in uses of search in connection with advertising. However, it is worth keeping in mind the FTC's view that consumers expect default search results to reflect their relevance based on objective criteria (other than payments by the advertiser), its broad definition of what constitutes advertising in connection with search, and its consistent return to fundamental principles of clear and conspicuous disclosures to identify advertising.

## Conclusion

Search engines and online distribution platforms have brought rapid changes in business models and a wide variety of benefits to the economy. But companies that offer these services—or use them for advertising—are subject to the same standards of deception as the FTC enforces across most of the economy, whether offering hotel reservations, job searches, or other services. While larger questions about transparency in algorithms and the economic power of online platforms are likely to persist, the FTC has sent a strong message that its consumer protection authority has a role to play now. ■

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[1] *See generally* Complaint, FTC v. Reservation Counter, LLC, 2:17-cv-01304 (D. Utah Dec. 21, 2017) [hereinafter Reservation Counter Complaint].

[2] *See generally* Complaint, Victory Media, FTC Docket No. C-4640 (Jan. 11, 2018) [hereinafter Victory Media Complaint].

[3] Interactive Advertising Bureau, IAB Internet Advertising Revenue Report 2, 11 (Apr. 2017), https://www.iab.com/wp-content/uploads/2016/04/IAB_Internet_Advertising_Revenue_Report_FY_2016.pdf.

[4] Department of Commerce, New Insights on Retail E-Commerce 1 (July 2017), http://www.esa.doc.gov/sites/default/files/new-insights-retail-e-commerce.pdf.

[5] Letter to Gary Ruskin, FTC Staff Letter, at 1 (June 27, 2002) [hereinafter 2002 Search Engine Guidance]. As noted in the 2002 Search Engine Guidance, FTC staff declined to recommend action against the search engines named in the complaint but sent them warning letters "outlining the need for clear and conspicuous disclosures of paid placement, and in some instances paid inclusion." *Id.* at 1.

[6] *Id.* at 2.

[7] *Id.* at 2.

[8] *Id.* at 3.

[9] *Id.*

[10] Statement of Federal Trade Commission at 1, Google Inc., FTC File No. 111-0163 (Jan. 3, 2013), https://www.ftc.gov/system/files/documents/public_statements/295971/130103googlesearchstmtofcomm.pdf.

[11] *Id.* ("These organic results—together with advertising, links to Google products, and other information judged to be relevant to the user's query—are returned to the user as the Google search results page.").

[12] Letter to Search Engines, FTC Staff Letter, at 1 (June 24, 2013) [hereinafter 2013 Search Engine Warning Letter]. *See also* Press Release, Fed. Trade Comm'n, FTC Consumer Protection Staff Updates Agency's Guidance to Search Engine Industry on the Need to Distinguish Between Advertisements and Search Results (June 25, 2013), https://www.ftc.gov/news-events/press-releases/2013/06/ftc-consumer-protection-staff-updates-agencys-guidance-search (stating that the 2013 Search Engine Warning letter was sent to 17 recipients).

[13] Search Engine Warning Letter, *supra* note 12, at 1.

[14] *Id.* at 4.

[15] *Id.*

[16] *See id.* at 2 ("Sometimes the results returned as part of a specialized search are based at least in part on payments from a third party. If that is the case, it is also a form of advertising and should be identified as such to consumers.").

[17] *See* Benjamin Edelman, Impact of OTA Bias and Consolidation on Consumers 4 (July 12, 2017), http://www.benedelman.org/publications/ota-bias-12jul2017.pdf (stating that hotels typically pay OTAs commission of approximately 25%).

[18] The complaint also names Reservation Counter's corporate parents, Travelpass Group, LLC, and Partner Fusion, Inc. The stipulated final order that resolved the FTC's allegations is binding on all three entities. For the sake of simplicity in presentation, however, the discussion in this article refers only to Reservation Counter.

[19] Reservation Counter Complaint, *supra* note 1, ¶ 11. The FTC's complaint contains no allegations concerning conduct by Expedia, Priceline, or other "first-tier" OTAs.

[20] *Id.* ¶ 20.

[21] *Id.* ¶¶ 22–24.

[22] *Id.* ¶ 23.

[23] *Id.* ¶ 25.

[24] *Id.* ¶ 26.

[25] *Id.* ¶¶ 26–30.

[26] *Id.* ¶ 31.

[27] *Id.* ¶ 27.

[28] *Id.* ¶¶ 43–45.

[29] *Id.* ¶ 52.

[30] However, consumer and business education materials published by the FTC and a hotel industry trade group indicate that some third-party booking sites apparently do fail to make reservations. *See* FTC Consumer Blog, *Did You Book that Night at the Hotel's Site?* (July 14, 2015), https://www.consumer.ftc.gov/blog/2015/07/did-you-book-night-hotels-site; FTC Business Blog, *Business Travelers: Check It Out Before You Check In* (July 14, 2015), https://www.ftc.gov/news-events/blogs/business-blog/2015/07/business-travelers-check-it-out-you-check; American Hotel & Lodging Ass'n, Stop Online Booking Scams, https://www.ahla.com/stopping-online-booking-scams ("They [the third-party site] took my money. The hotel had no record of my hotel reservation. I had to pay the hotel directly when I arrived because the third-party site never transmitted my reservation to the hotel.") (quoting consumer complaint on unnamed consumer review site).

[31] Reservation Counter Complaint, *supra* note 1, ¶ 20.

[32] Stipulated Order for Permanent Injunction and Judgment § I, FTC v. Reservation Counter, LLC, 2:17-cv-01304 (D. Utah Dec. 21, 2017) [hereinafter Reservation Counter Order].

[33] The Reservation Counter Order also requires Reservation Counter to develop and implement written policies designed to prevent call center personnel from misrepresenting that they are a hotel or acting for a hotel. *Id.* § IV. In addition, the order bars the company from misrepresenting any material aspect of and "travel-related good or service" that it advertises or provides. *Id.* § III.

[34] Victory Media Complaint, *supra* note 2, ¶ 3 (quoting Victory Media's website).

[35] The Victory Media Complaint contains two counts relating to misrepresentations about endorsements and recommendations, id. ¶¶ 22–26, which are not discussed in this article.

[36] *Id.* ¶¶ 8–9.

[37] *Id.* ¶ 11 ("Beginning in mid-2015, Respondent has included schools as possible search results for its Matchmaker tool only if the schools paid Respondent to be included, and regardless of whether Respondent has designated them as 'military-friendly' under Respondent's criteria.").

[38] *Id.*

[39] *Id.* ¶¶ 9–10.

[40] Analysis to Aid Public Comment, Victory Media, Inc., FTC Docket No. C-4640, 82 Fed. Reg. 50,129, 50,130 (Oct. 30, 2017).

[41] Victory Media Complaint, *supra* note 2, ¶¶ 20–21.

[42] Id. ¶¶ 24–25.

[43] Consent Order, Victory Media, Inc., at § I.A, FTC Docket No. C-4640 (Jan. 11, 2018).

[44] *See* Victory Media Complaint, *supra* note 2, ¶¶ 20–21.

[45] *See* Dennis Schaal, *First Look at Expedia Accelerator Program for Improving Hotel Placement*, Skift (Mar. 3, 2016), https://skift.com/2016/03/03/first-look-at-expedias-hotel-accelerator-program-for-improving-hotel-placement/ ("Expedia's new Accelerator program offers a way for hotel properties to move their way up from page three to the first page of listings on Expedia.com—all they might have to do is pay Expedia an additional 10 percent commission on top of their typical payments.").

# Social Media and Antitrust: A Discovery Primer

BY NATHANIEL C. GIDDINGS AND AARON PATTON

AS OUR ECONOMY HAS SHIFTED TO the online marketplace, so too have the communications that can give rise to antitrust liability.[1] Recent cases suggest that at least some communications evincing unlawful antitrust violations have migrated to social networking sites (SNS), such as Facebook and Snapchat.[2] Indeed, the DOJ recently obtained a guilty plea and a $1.9 million criminal fine from "[a]n e-commerce company and its top executive" for conspiring through SNS and encrypted messaging applications, including Facebook, Skype, and WhatsApp.[3] While these communications are generally discoverable,[4] preserving and producing (or acquiring) material from SNS can be a difficult and time-consuming process in which there are certain pitfalls (and costs) that attorneys should be mindful of when addressing this type of discovery.

## Obtaining Social Media Evidence

***First Order Pitfalls: Thinking About Ethical Rules and Federal and State Law.*** Material on SNS that may be reasonably calculated to lead to admissible evidence include private bilateral or direct message communications (e.g., Facebook or Twitter "DMs"), private group communications (e.g., a "closed," "private," or "secret" Facebook group), or a private profile (e.g., a Facebook profile that restricts access to some or all content on the profile).[5] While it would certainly be easiest to attempt to acquire this non-public material by "friending" the individual or through a "friend" of the sought-after individual, counsel must consider the applicable rules of professional conduct before undertaking such an action.[6] This is true regardless of whether the individual is employed by a company that has a policy that purports to "own" its employees' social media content[7] or whether the lawyer directly attempts to access this material or hires another individual to do it by proxy.[8] While a case-by-case analysis would be necessary, proceeding through formal discovery channels should help avoid any ethical concerns when seeking these communications.

**State Privacy Laws May Apply.** Attorneys must also consider any applicable state privacy laws that may limit their ability to collect SNS material. According to the Sedona Conference, "Many states have enacted legislation that specifically prohibit an employer from seeking such information from an employee, and an employer's attempt to solicit an employee's usernames and passwords to facilitate a social media capture may violate those states' privacy statutes."[9] As with the ethical rules, proceeding through the formal discovery process may alleviate these concerns.

**Federal Law Limits the Types of Material a Private Litigant Can Acquire Directly from Providers of SNS.** The Stored Communications Act (SCA) governs the sharing of "stored wire and electronic communications and transactional records" in the possession of "Internet service providers."[10] Courts have generally concluded that providers of SNS are "Internet service providers" under the SCA, and, as a result, private litigants are unlikely to be able to acquire electronic communications (e.g., posts on a private Facebook wall) from the provider itself.[11] For instance, in *Crispin v. Christian Audigier*, the U.S. District Court for the District of New Jersey, citing to the SCA, quashed a subpoena directed to Facebook that sought the contents of private communications occurring on that site.[12]

However, courts have held that private litigants can acquire "transactional" records from the providers of SNS. Transactional information includes, for instance, "record information regarding the characteristics of the message that is generated in the course of the communication"[13] and "identifying information associated with the subscriber as well as the usage information of each account for certain time periods."[14] This information may be useful to a private litigant attempting to understand the scope (i.e., burden) of preserving, acquiring, or producing this material before undertaking the steps necessary to do so.

***My Case Involves Potentially Relevant Material on SNS—What Should I Do?***

**Preserve the Potentially Relevant SNS Material.** Although private litigants are unlikely to acquire electronic communications directly from providers of SNS, courts have held that the contents of the communications occurring on (and stored by) the provider can be acquired through party or non-party discovery directed to individuals and entities other than the provider.[15] This being the case, "as soon as a party is on notice of actual or reasonably anticipated litigation, counsel should implement a litigation hold that accounts for potentially relevant social media evidence that is in the possession, custody or control of his or her client."[16] This litigation hold

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should include the contents of any communications, any backups, and the associated metadata for both.[17]

An employer should also take steps to preserve its employees' social media accounts material (e.g., through a litigation hold) and ask its current and former employees whether they are willing to provide access to their personal social media accounts.[18] While no court has held that a company has "control" over its employees' social media accounts,[19] at least one court has compelled a company to search for and produce documents from its employees' personal email accounts.[20] Similar rationales could be applied to employees' personal social media accounts, and, as such, whether a court would hold that a company has "control" over its employees' social media postings will likely depend on the specific facts of the case.[21]

**Serve a Discovery Request for this Material on the Parties.** As with any other discovery, a private litigant must first attempt to obtain material on SNS from parties to the litigation.[22] While this does not mean that the party necessarily needs to "exhaust" party discovery by, for instance, moving to compel the party for the discovery, before pursuing third party discovery,[23] a private litigant should take reasonable steps to acquire this information from an opposing party in the first instance.

**Respond to the Discovery Request.** A private litigant has several decisions to make when confronted with a discovery request seeking "all" of its (or its employees') communications occurring on SNS.

First, courts addressing the discoverability of social media evidence from a party opponent generally conclude that this SNS material is in the party's "control" (and therefore discoverable) when it is the party's own content.[24] For example, in *Heyman v. Nevada*, the U.S. District Court for Nevada "instructed Defendant's counsel to review Defendant's social media content and produce any relevant, nonprivileged content contained therein."[25] The same would be true for a social media site managed by the party. In *Arteria Property PTY Ltd. v. Universal Funding V.T.O., Inc.*, for instance, the U.S. District Court for New Jersey imposed sanctions on a company that destroyed its website "as it existed during the time that the dispute between the parties first arose" because the defendant had "the *ultimate* authority, and thus control, to add, delete, or modify the website's content."[26] The foregoing is true regardless of whether the party has itself stored the material.[27]

Second, regardless of whether a party ultimately decides to produce material on SNS, it should disclose the existence of this material,[28] and if the party responding to the request is taking the position that this material is beyond its possession, custody, or control, it should explicitly state as much in its responses and objections.[29]

**Serve a Subpoena for this Material on a Third Party.** If a litigant is unable to secure the production of this material from the opposing party, it should consider whether the information may be obtained through a subpoena to a third party.

While it is not possible to get the electronic communications directly from the provider of the SNS, courts have routinely held that the SCA's protections do *not* extend to individuals using an SNS or administering a "group" using the site's facilities.[30] In *Nucci v. Target Corp.*, the plaintiff petitioned the Florida District Court of Appeals "for certiorari relief to quash a December 12, 2013 order compelling discovery of photographs from her Facebook account."[31] In support of her petition, the plaintiff argued, in part, that the SCA shielded her Facebook account from discovery. The court rejected this argument and denied the petition:

> [W]e reject the claim that the Stored Communications Act has any application to this case. Generally, the "SCA prevents 'providers' of communication services from divulging private communications to certain entities and/or individuals." ***The act does not apply to individuals who use the communications services provided.***[32]

Courts have also generally rejected arguments from third parties that discovery of communications occurring on SNS would violate their privacy rights.[33] This is especially true where there is a protective order in place that limits the use of the allegedly "private" information.[34]

Finally, a third party can always assert a burden objection. One potential way to overcome this objection—and ensure that this material is collected in a way that minimizes the risk that it is later excluded (as discussed below)—is to offer to pay for the professional collection of the material.[35]

***How to Collect & Review Material from SNS.*** Once it has been determined that SNS material *will* be produced, the next question is how it should be collected for production.

Because courts have been reluctant to admit mere screenshots of webpages or social media sites under Federal Rule of Evidence 901,[36] it is advisable to engage a certified forensic examiner to collect the material on SNS so that all relevant metadata—including information identifying the parties to the communications—is maintained and the forensic examiner can submit a declaration regarding the collection methodology. For example, in *Commonwealth v. Banas*, the Appeals Court of Massachusetts found that the trial court properly excluded a printout of a picture from Facebook because "evidence that a message was from an individual's Web page was not sufficient to authenticate that the individual wrote the message."[37] Engaging a certified forensic examiner to collect the material in question can help avoid this pitfall when this material is sought to be introduced.

Because providers of SNS do not generally include litigation discovery tools as part of their platforms (at least not yet), preserving and collecting material on SNS also requires special purpose software.[38] Software tools, like X1 Social Discovery, are preservation and collection applications created, developed, and maintained by outside companies that work within the rules and policies of each SNS's Application Programming Interface (API) and Software Developer Kit (SDK).[39] Therefore, what can be collected will generally be

what is publicly available and what can be accessed given the user's account permissions.

When using a software tool to collect this material, counsel can either conduct a "Credentialed User," an "Examiner," or a "Web Crawl" collection.[40] A "Credentialed User" collection is used to collect non-public information using account credentials of a user with permission to access the data. Similarly, to collect non-public data from a private group (e.g., posts and membership rosters), a forensic examiner would either need a group member's credentials or its own account added to a group's membership by another member or administrator of the group.[41]

An "Examiner" collection is used to collect public information (e.g., public tweets, posts, comments, images, etc.). This collection method works by having the forensic examiner create a "shell" or "examiner account" and then create a targeted index of a user's or group's publicly available data.[42]

Finally, a Web Crawl collection works by "crawling" through a website's URL, deeper and deeper, capturing web content while taking snapshots of the pages with their web-enabled content fully rendered and collecting and hashing all of the web elements for authentication.

***Limitations to Collection of Material from SNS.*** While these specialized software tools are the best means of collecting this material, they can also be limited in three important ways: by the SNS, by the software itself, and by the user.

SNS providers, such as Facebook and Twitter, have unfathomable and continually growing amounts of data to store and present.[43] This means it is impractical (and likely impossible) for platforms to present all of their user data for public use or even allow access to it all through their User Interface (UI). As a result, SNS make choices about how much data to present through their web and mobile UIs, how far into the past UI-based searches can reach, how search results are presented in the UI, and what privacy settings make data inaccessible to users and applications without proper permissions. These limitations can constrain the amount of material that can be collected, even with forensic experts and professional collection software.

One available workaround to these API limitations is to use the search functionality in a platform's UI and then collect those search results with specialized software. While UI searching may not seem as powerful as many forensic and discovery options, the data set queried by the UI goes much farther into the past than external tools are allowed to reach. The result is that searching within the site's UI can better locate a greater number of potentially relevant posts, including older posts, than could otherwise be collected.

These API limitations also mean that counsel collecting material from SNS should, at a bare minimum, run targeted searches in the SNS' UI to determine whether the software tool collected all potentially relevant posts.[44]

There may also be limitations within the software itself.[45] Popular posts, shares, and tweets on SNS accrete data as more and more users react to the post (e.g., comments, likes, shares, retweets, etc.). The SNS do not always present every reaction to every item. For instance, a particularly long thread on Facebook will contain some of the replies and a hyperlink instructing a user to "Click to View More Replies." These pointers to additional content linked to a post are called "layers," and while a platform such as Facebook can store and display every layer of every comment and reply back to the beginning of a post, tools like X1 Social Discovery may not be able to reach every layer of every post.

**SNS providers, such as Facebook and Twitter, have unfathomable and continually growing amounts of data to store and present. This means it is impractical (and likely impossible) for platforms to present all of their user data for public use or even allow access to it all through their User Interface.**

Attorneys should, therefore, consider and agree with opposing counsel on any limitations on the number of layers that can be collected from SNS. For instance, X1 Social Discovery allows examiners to set the number of layers it indexes and collects, with a limit of ten layers.[46] While ten layers is usually sufficient for Credentialed account collections, in large groups or the accounts of particularly active users (e.g., celebrities), there can be substantially more than ten layers. Since the tools cannot expand layers beyond the tenth for indexing, the collected data will contain indications of uncollected data.

There is also the possibility that material on SNS has been altered, edited, or deleted. While counsel facing a potential destruction issue could attempt to determine the scope of the problem through testimony or screenshots, counsel could also undertake a "rescan" with the social media collection software. The rescan works the same as the initial collection. However, this option requires an initial collection, before any changes or deletions, as the baseline against which to compare.[47] If data is deleted or altered before an initial scan, even when there are references to deleted content, evidentiary options could be limited.[48]

***Consider the Costs and Benefits of Each Collection Method.*** There is a trade-off between an Examiner or Credentialed User collection on the one hand and a Web Crawl collection on the other. The former collection methods capture more metadata than the Web Crawl method, and they are usually faster than a Web Crawl.[49] Whereas a Credentialed Facebook collection's metadata would contain up to 75 fields (including Captions, Number of Comments, Likes, and Geo Location), a Web Crawl collects up to 23 metadata fields—

not including the previous field examples. The difference in the total number and actual fields captured is a function of collecting actual posts from SNS versus posts that are collected as webpages.[50] It is also worth noting that Web Crawls usually result in larger collections,[51] and they are usually slower to finish because they "crawl" through a link's layers, opening and rendering web pages and layers for capture and hashing. The advantage of a Web Crawl is that it accesses and collects more "layers" of information than an Examiner or Credentialed User collection.[52]

Counsel should consider these differences before deciding on a collection method. However, it may not be immediately apparent which option is necessary, meaning that the collecting party may need to attempt different collection iterations to find the "best available" option.

***Consider Options for Export and Review.*** Reviewing and using material collected from SNS is like all things in today's discovery: imperfect. While tools like X1 Social Discovery can export common review platform load files (.DAT), natives (MHTML, HTML), images (PNG), and text (embedded in .DAT), working with the export is another trade-off.[53] For example, while tools like Relativity have a viewer that can render MHTML and HTML files collected from Facebook or Twitter, if the Relativity platform is locked away from accessing the web, then the web-enabled content (OLEs, etc.) that references Internet locations will not load or render. The result in the review platform viewer is a broken-looking webpage that is not ideal for use as evidence or for review. The alternative is to review the PNG image files, but these are not ideal either. The PNG will be a single-image screen capture of a page with all of its web content enabled. That sounds ideal because the PNG will look just like a post would appear in the UI, but if the post has many comments or replies, the resulting PNG image will shrink the web page to fit all the content into a single image. The result for larger posts or threads is a very large image file with very small content that can only be viewed by using the zoom feature in the viewer.

## Conclusion

Social media is here to stay, and it can be among the most revealing evidence in a case. Attorneys should be prepared to answer questions about their clients' preservation, collection, and production of material from SNS when and if litigation occurs and should closely monitor this ever evolving area of discovery practice. ■

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1 *See* Jeffrey S. Tennenbaum & A.J. Zottola, *The Legal Aspects of Online Social Networks: an Overview for Associations*, N.Y. Soc'y of Ass'n Executives (Dec. 2009), https://www.nysaenet.org/resources1/inviewnewsletter/pastissues/2009/december2009/inview122009_article4 ("Social networking sites and related media can make it easy for members to let their guard down and share information that could lead to a violation of the antitrust laws. An association should, therefore, ensure that it applies and enforces its existing antitrust policies with respect to social networking sites.").

2 *See, e.g.*, Julia Verlaine & Gavin Finch, *Biggest Banks Said to Overhaul FX Trading After Scandals*, Bloomberg (Sept. 16, 2014), https://www.bloomberg.com/news/articles/2014-09-15/biggest-banks-said-to-overhaul-fx-trading-after-scandals; Aoife White & Gaspard Sebag, *FX Traders' Facebook Chats Said to Be Sought in EU Probe*, Bloomberg (Oct. 27, 2014), https://www.bloomberg.com/news/articles/2014-10-27/fx-traders-facebook-chats-said-to-be-sought-in-eu-probe.

3 Press Release, U.S. Dep't of Justice, E-Commerce Company and Top Executive to Plead Guilty to Price-Fixing Conspiracy for Customized Promotional Products (Aug. 7, 2017), https://www.justice.gov/opa/pr/e-commerce-company-and-top-executive-agree-plead-guilty-price-fixing-conspiracy-customized.

4 *See generally* Johnson v. PPI Tech. Servs., L.P., No. 11-2773, 2013 WL 4508128, at *1 (E.D. La. Aug. 22, 2013) ("Courts have recognized that social networking site ('SNS') content may be subject to discovery under Federal Rule of Civil Procedure 34.") (citations omitted); *see also* Forman v. Henkin, 30 N.Y. 3d 656 (N.Y. 2018).

5 *See Facebook Help: What Audiences Can I Choose from When I Share?*, Facebook, https://www.facebook.com/help/211513702214269?helpref=faq_content.

6 *See* Model Rules of Prof'l Conduct 4.2; 4.4; *see also* N.Y. City Bar Formal Opinion 2010-2.

7 *See* Steven C. Bennett, *Civil Discovery of Social Networking Information*, 39 Sw. L. Rev. 413, 418–19 (2010) ("[M]any companies expressly inform their employees that any and all documents and information created, stored or exchanged from or by the employer's computer and communications systems belong to the employer. As a result (arguably), such companies could be held to 'control' all such information, even if created for personal use, and even if physically stored on a third party's servers.") (footnotes omitted).

8 *See* Model Rules of Prof'l Conduct 8.4(a) (It is professional misconduct to "knowingly assist or induce another," or "through the acts of another," to violate the Rules of Professional Conduct.).

9 *The Sedona Conference Commentary on Rule 34 and Rule 45 "Possession, Custody, or Control,"* 17 Sedona Conf. J. 467, 524–25 (2016).

10 18 U.S.C. §§ 2701–2712.

11 *See generally* Levine v. Culligan of Fla., Inc., No. 50-2011-CA-010339, 2013 WL 1100404, at * 3 (Fla. Cir. Ct. Jan. 29, 2013) ("[C]ourts seem to be in agreement that the [SCA] prohibits records from being subpoenaed directly from Facebook and other social networking sites.") (citing cases).

12 Crispin v. Christian Audigier, Inc., 717 F. Supp. 2d 965, 991 (C.D. Cal. 2010).

13 *In re* Zynga Privacy Litig., 750 F.3d 1098, 1104–06 (9th Cir. 2014).

14 Chevron Corp. v. Donziger, No. 12-MC-80237 CRB (NC), 2013 WL 4536808, at *6 (N.D. Cal. Aug. 22, 2013).

15 *See* Nehad v. Browder, No. 15-CV-1386, 2016 WL 1428069, at *9 (S.D. Cal. Apr. 11, 2016) ("[The SCA does not, however prevent . . . requesting the . . . records through other means, such as by serving a request for production of such documents through Rule 34") (citing Mintz v. Mark Bartelstein & Assocs., 885 F. Supp. 2d 987, 994 (C.D. Cal. 2012)); *see also* Flagg v. City of Detroit, 252 F.R.D. 346, 366 (E.D. Mich. 2008).

16 Matthew K. Curtin, *The Duty to Preserve Social Media Evidence*, 35 Quinnipiac L. Rev. 791, 797 (2017).

17 Sara Anne Hook & Cori Faklaris, *Oh, Snap! The State of Electronic Discovery Amid the Rise of Snapchat, Whatsapp, Kik, and Other Mobile Messaging Apps*, Fed. Law, May 2016, at 64, 70.

18 *See* Exp.-Imp. Bank of U.S. v. Asia Pulp & Paper Co., 233 F.R.D. 338, 341 (S.D.N.Y. 2005).

19 *The Sedona Conference Commentary*, *supra* note 9, at 524 ("While some have attempted to argue that under the Practical Ability Standard, corpora-

tions may have the 'practical ability' to obtain data from social media sites they do not own or control merely by asking their employees to preserve/produce it, no court has specifically held this to be true.").

[20] Helmert v. Butterball, LLC, No. 4:08CV00342 JLH, 2010 WL 2179180, at *9 (E.D. Ark. May 27, 2010); *see also* Chevron Corp. v. Salazar, 275 F.R.D. 437, 448 (S.D.N.Y. 2011) ("[E]mployers have control over their employees and can be required to produce documents in their employees' possession.") (internal citations omitted); Mendez v. Land Inv'rs, Corp., No. 2:12-CV-158-FTM-29, 2013 WL 607908, at *3 (M.D. Fla. Feb. 19, 2013); Bleecker v. Standard Fire Ins. Co., 130 F. Supp. 2d 726, 739 (E.D.N.C. 2000) (citing Charles A. Wright & Arthur R. Miller, Federal Practice and Procedure § 2210 (2d ed. 1994)). However, other courts have reached the opposite conclusion. *See In re* Lululemon Athletica Inc. 220 Litig., C.A. No. 9039-VCP, 2015 WL 1957196, at *4–7 (Del. Ch. Apr. 30, 2015).

[21] For example, a company policy that states that an employee's activity on the company's network belongs to the employer may lead a court to conclude that the company has "control" over its employees' SNS material. *See* Bennett, *supra* note 7, at 419.

[22] *See* Bada Co. v. Montgomery Ward & Co., 32 F.R.D. 208, 209–10 (S.D. Cal. 1963); Countryman v. Cmty. Link Fed. Credit Union, No. 1:11-CV-136, 2012 WL 1143572, at *5 (N.D. Ind. Apr. 3, 2012).

[23] *See In re* Mushroom Direct Purchaser Antitrust Litig., No. 06-0620, 2012 WL 298480, at *4 (E.D. Pa. Jan. 31, 2012); *see also* Davis v. City of Springfield, Ill., No. 04-3168, 2009 WL 910204, at *4 (C.D. Ill. Apr. 1, 2009), *aff'd*, No. 04-3168, 2009 WL 1161619 (C.D. Ill. Apr. 28, 2009); Columbus Drywall & Insulation, Inc. v. Masco Corp., No. 2:06-MC-0034, 2006 WL 2871834, at *2 (S.D. Ohio Aug. 7, 2006).

[24] *See generally The Sedona Conference® Primer on Social Media*, 14 Sedona Conf. J. 191, 224 (2013) ("A user typically has 'control' of his or her own social media content—to the extent he or she can still access it—because the user typically has the 'legal right, authority, or practical ability to obtain the materials sought on demand.'").

[25] Heyman v. Nevada *ex rel.* Bd. of Regents of Nevada Sys. of Higher Educ., No. 2: 15-CV-01228-RFB-GWF, 2017 WL 6614093, at *1 (D. Nev. Dec. 27, 2017); *see also* Impson v. Dixie Elec. Membership Corp., No. CV 14-632-JWD-RLB, 2015 WL 9413122, at *4 (M.D. La. Dec. 22, 2015).

[26] Arteria Prop. Pty Ltd. v. Universal Funding V.T.O., Inc., No. Civ. A. 05 4896 (PGS), 2008 WL 4513696, at *1, 5 (D.N.J. Oct. 1, 2008).

[27] *See* Alex v. KHG of San Antonio, L.L.C., No. SA-13-CA-728-OLG, 2014 WL 12489735, at *5 (W.D. Tex. Aug. 6, 2014).

[28] Fed. R. Civ. P. 26(a)(1)(A)(ii).

[29] *See* Silvestri v. Gen. Motors Corp., 271 F.3d 583, 591 (4th Cir. 2001) ("If a party cannot fulfill this duty to preserve because he does not own or control the evidence, he still has an obligation to give the opposing party notice of access to the evidence or of the possible destruction of the evidence if the party anticipates litigation involving that evidence.") (citing Andersen v. Schwartz, 687 N.Y.S. 2d 232, 234–35 (N.Y. Sup. Ct. 1999)).

[30] In the case of a bilateral communications, this will be the third party communicating with the party employee, and in the case of a "secret" or "private" social networking group, this will be the administrator or leader of that group.

[31] 162 So. 3d 146, 148 (Fla. Dist. Ct. App. 2015).

[32] *Id.* at 155 (emphasis added) (citations omitted); *accord* Levine v. Culligan of Florida, Inc., No. 50-2011-CA-010339, 2013 WL 1100404, at * 3 (Fla. Cir. Ct. Jan. 29, 2013) ("[C]ourts seem to be in agreement that the [SCA] prohibits records from being subpoenaed directly from Facebook and other social networking sites.") (citing Crispin v. Christian Audigier, Inc., 717 F. Supp. 2d 965 (C.D. Cal. 2010)).

[33] *See Nucci*, 162 So. 3d at 153–54 ("We agree with those cases concluding that, generally, the photographs posted on a social networking site are neither privileged nor protected by any right of privacy, regardless of any privacy settings that the user may have established."); *see also* Roasio v. Clark Cnty. Sch. Dist., No. 2:13–CV–362, 2013 WL 3679375, at *5–6 (D. Nev. July 3, 2013); Appler v. Mead Johnson & Co., LLC, No. 3:14-CV-166-RLY-WGH, 2015 WL 5615038, at *5 (S.D. Ind. Sept. 24, 2015); Mailhoit v. Home Depot U.S.A., Inc., 285 F.R.D. 566, 570 (C.D. Cal. 2012); Tompkins v. Detroit Metro. Airport, 278 F.R.D. 387, 388 (E.D. Mich. 2012); Davenport v. State Farm Mut. Auto. Ins. Co., No. 3:11-CV-632-J-JBT, 2012 WL 555759, at *1 (M.D. Fla. Feb. 21, 2012); E.E.O.C. v. Simply Storage Mgmt., LLC, 270 F.R.D. 430, 434 (S.D. Ind. 2010).

[34] *See* Albany Molecular Research, Inc. v. Schloemer, 274 F.R.D. 22, 26–27 (D.D.C. 2011)

[35] *See* Mirra v. Jordan, No. 13-CV-5519 (AT)(KNF), 2015 WL 8526550, at *2 (S.D.N.Y. Dec. 7, 2015); *but see* Apex Colors, Inc. v. Chemworld Int'l Ltd., Inc., No. 2:14-CV-273-PRC, 2017 WL 2274683, at *13 (N.D. Ind. May 25, 2017), order clarified, No. 2:14-CV-273-PRC, 2017 WL 4684608 (N.D. Ind. Oct. 19, 2017).

[36] *See* Specht v. Google Inc., 747 F.3d 929, 932 (7th Cir. 2014); Fitzer v. Am. Inst. of Baking, No. CV 209-169, 2016 WL 4223612, at *6 (S.D. Ga. Aug. 9, 2016).

[37] Com. v. Banas, 85 Mass. App. Ct. 1108, 5 N.E.3d 3 (2014).

[38] *How Can I Download My Information from Facebook?*, Facebook, https://www.facebook.com/help/212802592074644 (Steps to Download my Data); *see also General Account Settings*, Facebook, https://www.facebook.com/dyi?x=AdloyGBw2qPsPrxo (Link to Download my Data); *Accessing Your Facebook Data*, Facebook, https://www.facebook.com/help/405183566203254 (Data points included in Download my Data). For instance, while Facebook offers an option for individual users to "download" their own data, and the data points included are robust, the platform does not allow users to download others' data nor is the resulting archive formatted for use in litigation.

[39] *Application Programming Interface*, Wikipedia, https://en.wikipedia.org/wiki/Application_programming_interface ("[A]n application programming interface (API) is a set of subroutine definitions, protocols, and tools for building application software [. . . .] A good API makes it easier to develop a computer program by providing all the building blocks, which are then put together by the programmer."); *Software Development Kit*, Wikipedia, https://en.wikipedia.org/wiki/Software_development_kit ("A software development kit (SDK or devkit) is typically a set of software development tools that allows the creation of applications for a certain software package, software framework, hardware platform, computer system, video game console, operating system, or similar development platform. To enrich applications with advanced functionalities, advertisements, push notifications and more, most app developers implement specific software development kits."). In fact, X1 Social Discovery states in their product description, and in bold font, that "X1 Social Discovery cannot be used to bypass or violate the privacy or security settings of any social network." *Poduct Description*, X1 Social Discovery, http://help.x1sd.com/productdescription.

[40] *Main Features of X1 Social Discovery*, X1 Social Discovery, http://help.x1sd.com/features (providing definitions for Credentialed User and Examiner collections).

[41] It is worth noting that X1 Social Discovery does not collect data from "private" or "secret" Facebook profiles or groups unless proper authorization is provided. This limitation is intentional and is in line with its policy to not to "bypass or violate the privacy or security settings of any social network." *Product Description*, X1 Social Discovery, http://help.x1sd.com/product_description.

[42] *Id.*

[43] Pamela Vagata & Kevin Wilfong, *Scaling the Facebook Data Warehouse to 300 PB*, Facebook (Apr. 10, 2014), https://code.facebook.com/posts/229861827208629/scaling-the-facebook-data-warehouse-to-300-pb/ ("Our warehouse stores upwards of 300 PB [petabytes] of Hive data, with an incoming daily rate of about 600 TB [terabytes]."); *see also* Mazdak Hashemi, *The Infrastructure Behind Twitter: Scale*, Twitter (Jan. 19, 2017), https://blog.twitter.com/engineering/en_us/topics/infrastructure/2017/the-infrastructure-behind-twitter-scale.html ("We have multiple clusters storing over 500 PB . . . .").

[44] *See* William A. Gross Constr. Assocs. v. Am. Mfrs. Mut. Ins. Co., 256 F.R.D. 134, 136 (S.D.N.Y. 2009) ("Electronic discovery requires cooperation between opposing counsel and transparency in all aspects of preservation

and production of ESI. Moreover, where counsel are using keyword searches for retrieval of ESI, they at a minimum must carefully craft the appropriate keywords, with input from the ESI's custodians as to the words and abbreviations they use, and the proposed methodology must be quality control tested to assure accuracy in retrieval and elimination of 'false positives.' It is time that the Bar—even those lawyers who did not come of age in the computer era—understand this.").

45 *Create a Web Capture or Crawl Collection*, X1 Social Discovery, http://help.x1sd.com/create-a-web-crawl-collection ("A layer consists of all the links directly related to that page.").

46 *Id.* ("You can set a limit as to how many Layers down, from the top-level domain, X1 Social Discovery will crawl and index by selecting the Layers checkbox and entering a value. The maximum number of Layers is currently capped at 10 and defaulted to 5.")

47 *Add and Configure Facebook Public Information/Examiner Account*, X1 Social Discovery, http://help.x1sd.com/add-and-configure-public-information-account-facebook$RSO.

48 *Report and Unavailable Group or Event*, Facebook, https://www.facebook.com/help/contact/157461604368161/?ref=u2u.

49 *See Facebook Metadata Fields*, X1 Social Discovery, http://help.x1sd.com/facebook-metadata-fields (Full list of metadata fields).

50 *See Web Capture Metadata Fields*, X1 Social Discovery, http://help.x1sd.com/web-capture-metadata-fields (Web capture has up to 23 metadata fields).

51 The collection of 10 layers for a large group could result in over 100 gigabytes of SNS material, and it could take over two weeks to collect.

52 *Main Features of X1 Social Discovery*, X1 Social Discovery, http://help.x1sd.com/features ("A Credentialed Facebook Account has the ability to index a user's Posts, User Information. Private Messages—Limit of 5000 per Conversation, Photos, Posts from selected Friends and Friends of Friends (depending on FB Privacy Settings) and ability for users to view (on a map) the location where posts are made where Geo Location information is available.").

53 *MHTML*, Wikipedia, https://en.wikipedia.org/wiki/MHTML (*.MHT and *.MHTML file extension); *HTML*, Wikipedia, https://en.wikipedia.org/wiki/HTML (*.HTML file extension); *Portable Network Graphics*, Wikipedia, https://en.wikipedia.org/wiki/Portable_Network_Graphics (*.PNG file extension); Craig Ball, *A Load (File) off My Mind*, Ball in Your Court (July 17, 2013), https://ballinyourcourt.wordpress.com/2013/07/17/a-load-file-off-my-mind/ (*.DAT file extension).

INTERNATIONAL DEVELOPMENTS

# A Long Way from Formalism: Has Price Abuse Law in The European Union Come of Age?

BY ALEX POTTER AND NATHAN WILKINS

IN DECEMBER 2017, ADVOCATE GENERAL Wahl wrote an Opinion to the EU Court of Justice (CJ) in the *MEO* case, in which he concluded:

> [T]he rule has progressively developed that, where the conduct of an undertaking is examined by reference to Article 102 TFEU, the existence of a restriction of competition cannot be presumed. In order to conclude that there is such a restriction, it is necessary in every case to examine the actual or potential effects of the measure complained of, having regard to all of the circumstances of the case.[1]

AG Wahl was heralding the entrenchment of effects-based analysis in EU abuse of dominance law. As intuitive as his opinion appears, such a claim would have been hard to make even four months earlier. In reaching his view, Wahl relied particularly on the CJ's September 2017 judgment in *Intel*—another case in which he had served as Advocate General—which reinterpreted the approach to loyalty rebates that had prevailed in the European Union since 1979.[2]

Prior to these developments, EU law on abuse of dominance had a well-earned reputation for basing assumptions about the effect of pricing conduct on broad, form-based categorizations. Similarly, selective price cutting could readily be construed as abusive price discrimination. The abiding impression from several decades of the Court's judgments was that many types of price competition were hazardous when practiced by firms in a dominant position.

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The *Intel* judgment is ground-breaking in several respects. It can be seen, however, as the latest point on a course the CJ has been charting—not always in a straight line—since at least 2010. Concepts developed in judgments about predatory pricing and margin squeeze have been adopted in judgments about price discrimination and, finally, against some resistance, flowed into judgments about loyalty rebates. Steered by two interventions of the CJ's Grand Chamber, the expanded panel of judges that convenes to deliver important developments in the law, there would appear to have been a clear determination by the Court to modernize the EU competition law rules that apply to the pricing conduct of dominant firms.

The outcome is arguably an overarching theory of harm relating to exclusionary pricing abuse that is more coherent and firmly grounded in meaningful effects analysis. Four key conclusions can be proposed.

First, there are no more hard presumptions that certain types of above cost pricing conduct are abusive—an analysis of actual or potential effects will in practice always need to be undertaken.

Second, while there is no requirement to prove that a particular effect has actually arisen in the market, the analysis must review in a meaningful way whether pricing conduct has the capacity to exclude—or foreclose—competitors. Foreclosure must be judged to be likely or probable. This requires a deeper analysis than observing that a detrimental effect may tend to arise from a particular pricing mechanic simply due to its form.

Third, for the most part only foreclosure of competitors who are as efficient as the dominant firm counts towards a finding of abuse—less efficient competitors receive no protection unless warranted by an extreme market structure.

Fourth, dominant firms are allowed to negotiate prices just like everyone else—there is no overriding requirement on them to offer a uniform price to all trading partners in an equivalent position. Absent an attempt to discourage cross-border trade within the European Union, price discrimination is not an abuse unless it involves pricing below cost or leads to the clear possibility of a competitive disadvantage for a dominant firm's customers or suppliers. Again, this competitive disadvantage cannot be presumed.

There remain important issues to be explored. While an effects-based framework has been established, thus far there is little clarity on how it will be applied. Most notably, use of the "as efficient competitor" (AEC) test—whereby an examination is made of a dominant company's costs to determine whether its pricing conduct would drive an equally efficient competitor from the market—appears not to be mandatory for the assessment of rebates. However, the CJ has acknowledged it to be a useful tool and confirmed that if a dominant company deploys such evidence in its defense then it must be taken seriously.

What types of market structure could cause the courts, or initially the EU enforcement authorities, to conclude that less

efficient competitors should be shielded from above cost price competition by a dominant firm? How much, or how little, of any given market need be foreclosed for an anticompetitive effect to be established? The approach to be taken in the *Intel* case by the EU General Court, to which the case has now been returned for re-hearing following the CJ's ruling, may do much to set the tone for how confident dominant firms will feel in exploring their new-found flexibility in this area.

It also appears to remain the case that evidence of a strategy or plan on the part of the dominant firm to drive a competitor out of the market will lead to a finding of illegality, at least where that competitor is equally efficient. This notion sits uneasily with the CJ's oft-repeated declaration that abuse is an objective concept. Moreover, distinguishing between a (legal) intention to win business from a competitor and an (abusive) intention to drive a competitor out of the market may in some cases rest on fine judgments and, one suspects, be disproportionately influenced by unwitting turns of phrase in business documents.

Clarity in this area would be enhanced if front line competition law enforcers in the European Union were prepared to publish more about pricing practices that they consider *not* to be abusive.[3] For the time being, the European Commission remains suspicious of rebates that are awarded for exclusivity or are conditional on other loyalty-inducing requirements.[4] Dominant companies should still expect close scrutiny when they choose to offer them.

Nevertheless, EU law seems to have moved decisively away from formalism and towards a more unified theory of pricing abuse underpinned by effects analysis. The Commission can therefore expect to be held by the Court to a more rigorous standard and a more searching review of its analysis. To get to this stage has been a journey worth making.

## Formalism Takes Root

Article 102 of the Treaty on the Functioning of the European Union (TFEU) sets out EU law's prohibition on abuse of a dominant position.[5] The second paragraph describes certain types of conduct that can fall foul of the prohibition. Those most relevant to pricing conduct are: sub-paragraph (a), which refers to "directly or indirectly imposing unfair purchase or selling prices" and sub-paragraph (c), which lists "applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage."[6]

The CJ has been clear, however, that these are only examples.[7] A wide range of pricing conduct has in practice been found to amount to an abuse of dominance.

***Loyalty Defined.*** Decisions on exclusionary pricing practices under Article 102 TFEU inevitably cite the CJ's 1979 judgment in *Hoffmann-La Roche* as a key authority.[8] This case established the principle that a dominant company could not tie customers to obtain "all or most" of their requirements exclusively from itself, even if it did so at their request. The same applied to granting fidelity—or loyalty—rebates that were conditional on a customer obtaining all or most of its requirements from the dominant firm.[9] Anticompetitive foreclosure effects could be assumed from such a rebate, and no further analysis was required.

In its 1983 ruling in *Michelin I*, the Court addressed discounts that were conditional on a customer meeting a progressive scale of target volumes. These were not loyalty rebates as there was no requirement for exclusivity or obtaining a specific proportion of supplies from the dominant company. Nor were they "mere" volume rebates that could be presumed to be non-problematic. The CJ therefore held that it was necessary to consider "all the circumstances, particularly the criteria and rules for the grant of the discount," to determine whether the discount "tends to" have anticompetitive effects.[10] The Court ruled that a discount based on volumes sold over a "relatively long reference period" (in this case, one year) had the "inherent effect" of putting pressure on the buyer to achieve the targets.[11]

Volume-based discounts—and Michelin—were again in the firing line in 2003 when the EU Court of First Instance (CFI, subsequently renamed the General Court) delivered its *Michelin II* judgment.[12] The CFI held that a rebate scheme structured to be quantity-based would not avoid illegality if it otherwise had loyalty-inducing effects. The Court therefore applied the approach in *Michelin I* of considering "all the circumstances" with a particular focus on the rebate rules.

The CFI acknowledged that a quantity rebate would not be problematic if the discounts were granted on individual invoices according to the size of the order. Schemes where the discount applied only to quantities above a threshold (sometimes known as "top slice" rebates) would be less loyalty-enhancing than retrospective (or "roll-back") rebates, which applied to all volumes purchased from the dominant supplier in a given period. The main rebate scheme here was a roll-back rebate with a reference period of a year. This failed the test.

Such a rebate could nevertheless be acceptable if based on an economically justified countervailing benefit. Accordingly, a dominant company would be allowed to pass on cost savings caused by increased order levels. The burden of proof to show these benefits, however, rested on the dominant company. Michelin's attempts in this regard were branded "too general," and dismissed.

In 2007, the CJ took essentially the same approach in *British Airways* to a scheme of target rebates based on the percentage growth in sales of British Airways tickets achieved by travel agents. The Court determined that its review of all the circumstances required identification of whether the discount was "capable" of making market entry "very difficult or impossible for competitors" or making it "more difficult or impossible" for counterparties to choose different sources of supplies or purchases.[13] However, the Court pointed only to the significantly higher levels of British Airways ticket sales compared to those of its rivals as sufficient to endorse the

conclusion that competitors were unable to match these discount levels. British Airways' argument that rival airlines were financially capable of offering a competitive response was deemed inadmissible.

***Discriminatory Tendencies.*** In *Hoffmann-La Roche*, the CJ had also reached the conclusion that the loyalty rebates involved price discrimination, or "applying dissimilar conditions to equivalent transactions," because customers received differential discounts for the same level of sales. There was, however, no mention of the additional requirement of Article 102(c) TFEU that trading parties be placed at a competitive disadvantage as a result.[14]

In *British Airways*, the CJ introduced some discipline to the analysis by underlining that a finding of abuse under Article 102(c) TFEU requires both that the behavior is discriminatory and that it places a counterparty at a competitive disadvantage. It was found to be sufficient, however, that the conduct "tends to" distort the competitive position of the dominant company's suppliers or customers. There was no requirement for proof of an actual, quantifiable deterioration in an individual trading partner's competitive position, and the Court assumed an effect without any analysis of the impact on travel agents' costs or profits.

***Pricing Below Cost.*** In 1991, the CJ defined the abuse of predatory pricing in its *AKZO* judgment. The Court held that setting prices below average variable costs (which vary depending on quantities produced) inevitably involved an abuse, as each sale generated a loss. Prices below average total costs (the sum of fixed and variable costs) would also be regarded as abusive if they were part of a "plan for eliminating a competitor." Such prices, noted the Court, could drive competitors "which are perhaps as efficient as the dominant undertaking" from the market—foreshadowing a theme that would not return to the CJ's attention for many years.[15]

***Pricing Above Cost.*** Over this period, the EU courts also took several decisions which condemned selective price cutting above cost that targeted a competitor's customers.[16] While the conduct amounted to a form of price discrimination, the courts' analysis did not include application of Article 102(c) TFEU—the harm identified was exclusion of the dominant company's competitors rather than its business partners. Despite potential aggravating circumstances in these cases, there was also no clear limitation on the Court's willingness to censure above-cost price cutting.

In the resulting uncertainty, dominant companies were at risk if they sought to retaliate against a competitor with selective price cutting, even where this did not involve predatory pricing or loyalty rebates.

## A Change of Tack

In consequence, in past decades EU price abuse law gained the reputation of censuring rebates due to broad, form-based categorizations.[17] Exclusivity and loyalty rebates were abusive. Pure quantity discounts were not. Other types of rebates were said to require a review of "all the circumstances." This review, however, looked at the theoretical effects suggested by the form of the rebate and paid limited attention to whether such effects were likely in practice, or indeed to whether it was a proper aim of competition law to protect less efficient competitors from above cost price competition by a dominant supplier. In practice, dominant companies were on notice that any type of conditional, roll-back rebate was subject to a near presumption of illegality. Other types of price reduction were also laden with risk unless applied uniformly to all customers. Overall, price competition by a dominant firm in the European Union seemed inherently dangerous.

***Efficient Priorities.*** In 2005, the European Commission responded to the debate by introducing a discussion paper on the application of Article 102 TFEU to exclusionary abuses. Then Competition Commissioner Neelie Kroes stated that dominant companies should be allowed to compete effectively, and described the task of setting this policy objective in a consistent legal and economic framework to be an ambitious project.[18]

This initiative eventually led to the issue in December 2008 of the Commission's prioritization guidance for Article 102 TFEU (Guidance Paper).[19] The Guidance Paper established a more effects-based approach to determining which exclusionary abuse cases the Commission would pursue. The Commission explained that the AEC test could be used for identifying when certain conduct—including exclusivity and loyalty rebates—would lead to anticompetitive foreclosure. However, the Guidance Paper expressly did not purport to reflect the law—it was guidance on case prioritization.

***Margin Squeeze Leads the Way.*** Notwithstanding this, the CJ quickly showed signs of embracing the new approach. In its 2010 *Deutsche Telekom* judgment, a case involving the abuse of margin squeeze in the telecommunications industry, the Court ruled that Article 102 TFEU prohibited a dominant company from adopting pricing practices which had an exclusionary effect on its "equally efficient actual or potential competitors."[20] It then endorsed use of the AEC test as a first step in determining whether an abusive margin squeeze had occurred, referring to the *AKZO* judgment for support. This would amount to an abuse if it was "capable" of causing foreclosure.

The CJ followed the same approach in 2011 in *Telia-Sonera*, also involving margin squeeze, with two important additions.[21] First, it commented on some potential limits to the usefulness of the AEC test. The Court confirmed the principle that the test contributed to legal certainty because it allowed a dominant company to gauge the legality of its pricing conduct by reference to its own costs, rather than by reference to a competitor's costs which often would not be known. However, the Court added that a competitor's costs might be relevant in some circumstances—particularly where the dominant company's cost structure was not ascertainable, where the relevant costs of the dominant company related to use of infrastructure whose cost had already been written off, or where the level of costs was "specifically attributable

to the competitively advantageous situation in which its dominant position places it."[22]

Second, the Court explored the likelihood that a margin squeeze would result in an anticompetitive effect. Where an AEC was compelled to sell at a loss to compete with the dominant company, a potentially exclusionary effect was probable. However, it was also possible for an anticompetitive effect to arise if an AEC avoided making a loss but had to sell at an artificially reduced level of profitability. This would be the case if it was likely, due to, for example, reduced profitability, that "it would be at least more difficult for the operators concerned to trade on the market concerned."[23] The bar seemed to be set relatively low.

Use of the AEC had therefore been established in this area of price abuse law, but with a warning that it would not always provide a clear defense. In some situations—certain of which appeared more relevant to where dominance was linked to being an operator of legacy infrastructure—application of the AEC would need to be qualified.

## The Grand Chamber Steps In: *Post Danmark I*

In March 2012, the CJ convened its Grand Chamber to deliver a ruling in the first *Post Danmark* case that seemed intended to impose a more coherent analytical structure on the assessment of exclusionary pricing abuses.[24] As signaled by its expanded composition, the Court was in the mood to establish a new course.

***"Primary Line" Price Discrimination Clarified.*** In addressing the main question under review, the CJ drew a line under previous cases that censured dominant companies for profitably but selectively cutting their prices to compete with rivals. Dubbed "primary line" discrimination in Advocate General Mengozzi's Opinion to the Court, this (non-rebate) pricing conduct affected the dominant company's competitors (as opposed to "secondary line" discrimination under Article 102(c) TFEU, where the theory of harm was to place customers or suppliers at a competitive disadvantage in their markets).[25]

In *Post Danmark I*, the CJ imported the cost benchmarks for predatory pricing that it had first deployed in the *AKZO* judgment to a case about primary line price discrimination. The conduct in question involved targeted price cuts to certain customers which either fell between the average total cost and the average incremental cost thresholds for predatory pricing[26] or were above Post Danmark's average total cost altogether.

The Court started by setting out a broad principle that price discrimination was not in itself anticompetitive:

> [T]he fact that the practice of a dominant undertaking may . . . be described as "price discrimination," that is to say, charging different customers or different classes of customers different prices for goods or services whose costs are the same or, conversely, charging a single price to customers for whom supply costs differ, cannot of itself suggest that there exists an exclusionary abuse.[27]

The Court then dismissed the selective price cuts that remained above average total cost, finding "[i]n those circumstances, it cannot be considered that such prices have anticompetitive effects." For the rest, the CJ stated—having previously noted that there was no evidence of a plan by Post Danmark to eliminate a competitor—that charging prices at a level between average total cost and average incremental cost could not on its own amount to an exclusionary abuse. It was necessary to consider whether the conduct produced "an actual or likely exclusionary effect, to the detriment of competition."[28] In other words, theoretical "tendencies" would not suffice.

The CJ seemed to be seeking to harmonize different strands of price abuse law in a manner that would enable dominant firms to predict with greater certainty whether selective price retaliation would be viewed as illegal.

***The "As Efficient Competitor" Goes Mainstream.*** Arguably the more important aspect of the Grand Chamber's judgment was that it could also be viewed as taking the AEC concept applied by the Court in the margin squeeze cases and establishing it as a central concept for the application of abuse of dominance law more generally. For the first time, the Court declared what to economists had long appeared self-evident: dominant companies should not be condemned for price competition that forecloses *inefficient* competitors:

> Nor does [Article 102 TFEU] seek to ensure that competitors less efficient than the undertaking with the dominant position should remain on the market. . . . Thus, not every exclusionary effect is necessarily detrimental to competition. . . . Competition on the merits may, by definition, lead to the departure from the market or the marginalisation of competitors that are less efficient and so less attractive to consumers from the point of view of, among other things, price, choice, quality or innovation. . . . Thus, Article [102 TFEU] prohibits a dominant undertaking from, among other things, adopting pricing practices that have an exclusionary effect on competitors considered to be as efficient as it is itself and strengthening its dominant position by using methods other than those that are part of competition on the merits.[29]

Following *Post Danmark I*, this notion could no longer be viewed as a limited concept. It seemed to have been proposed as a defining principle for exclusionary abuse under Article 102 TFEU.

## Familiar Headwinds: *Tomra* and *Post Danmark II*

It was perhaps ironic, then, that the CJ's next two pronouncements on rebates—the first issued less than a month after *Post Danmark I*—expressly rejected any requirement to make use of the AEC test.

In April 2012, the CJ delivered its ruling in *Tomra*—which denied that it was necessary to show pricing below cost, or "negative prices"—to find that a retroactive rebate scheme was abusive. Instead, the Court confirmed that a focus on various aspects of the rebate mechanism itself, similar to those discussed in *British Airways*, was sufficient.[30] Price abuse law as it applied to rebates was apparently unaf-

fected by the notions of efficiency that had been described just 23 days earlier.

A second judgment relating to Post Danmark in October 2015 sent more mixed messages.[31] It is tempting to think of the CJ's second chamber which ruled in this case as feeling torn between the Grand Chamber's outing in *Post Danmark I* and the Court's established body of case law on rebates. In the event, the Court seemed to land somewhere in between. While it chose largely to follow the orthodoxy of the previous rebates cases, the Court also made enough comments about the AEC test to suggest that this was a judgment necessitated by a relatively specific set of circumstances.

***Almost All the Circumstances.*** The pricing conduct before the CJ in *Post Danmark II* was once again a volume-based rebate. Due to its retroactive nature over a series of orders, the rebate could not benefit from the presumption of legality for quantity rebates, and nor was it a loyalty rebate presumed to be illegal, but instead a rebate that once again required an assessment of all the circumstances.

The Court ruled that it was necessary to assess the structure and terms of the rebate, the extent of the dominant position, and the conditions of competition on the market. Nothing explicit here about the efficiency of competitors or any broader principle set out in *Post Danmark I*. Instead, the Court's observations about these circumstances stressed Post Danmark's high market share, the fact that it enjoyed a statutory monopoly for a large proportion of the market, and the likely foreclosing effect arising from a retroactive rebate offered by a firm with such a high share. The closer a customer was to a threshold for the next discount level, the less likely it was to purchase from competitors of the dominant supplier. This was all very reminiscent of *British Airways* and *Tomra*, which were cited with approval in this part of the judgment. The review of all the circumstances was in practice based largely on market share and the form of the rebate.

***Not Always, But Sometimes.*** As regards the AEC test, the CJ noted that the concept had previously been applied by the Court in cases about predatory pricing, margin squeeze, and selective price cuts. Rebates were, however, different: it was "not possible to infer" that Article 102 TFEU required use of the AEC to find a rebate scheme abusive. Nevertheless, immediately after reaching this conclusion the Court stressed that there was no reason either to exclude use of the AEC. The CJ then declared that the AEC test "must thus be regarded as one tool amongst others for the purposes of assessing whether there is an abuse of a dominant position in the context of a rebate scheme."[32]

Interspersed with these conclusions was commentary about the market structure which may explain the CJ's reluctance to embrace the AEC test in all cases. On the facts before the Court, Post Danmark enjoyed a market share of 95 percent and a statutory monopoly which covered 70 percent of the relevant market. In these circumstances, said the Court, the AEC test could be of no relevance because the emergence of an AEC was "practically impossible." Moreover, in a market such as this—with the added protection of high barriers to entry—even competition from a less efficient firm would be beneficial.[33]

This possible qualification to AEC analysis had originally been noted by the European Commission in its Guidance Paper, where it stated that "in certain circumstances a less efficient competitor may also exert a constraint which should be taken into account when considering whether particular price-based conduct leads to anti-competitive foreclosure."[34] A plausible characterization of *Post Danmark II*, therefore, is of the Court being unwilling to apply the AEC to the facts at hand, but going out of its way to indicate that the AEC would have a role to play outside of such extreme circumstances.

***Not Purely Hypothetical.*** Finally, the CJ addressed how likely and how serious an anticompetitive effect should be to amount to an abuse. As regards likelihood, the CJEU referred to the several different formulations of the standard required—"must not be purely hypothetical;" "may potentially exclude competitors;" "is capable of restricting competition;" "likely" to have an anticompetitive effect; "produces an actual or likely exclusionary effect" (this last example from *Post Danmark I*)—and implied that these all meant the same thing. In conclusion, the Court ruled that an anticompetitive effect must be "probable."[35] There was, however, no need to show that an anticompetitive effect was of a serious or appreciable nature.

## Loyalty Revisited: *Intel* in the Court of Justice

Against this backdrop, the progress of the case against Intel came to be watched with increasing interest. Facing a European Commission fine of €1.06 billion for conduct that included rebates which were said to be conditional on exclusivity, Intel took its fight to the EU courts. The Commission had decided, relying on *Hoffmann-La Roche*, that there was no legal requirement to conduct an effects analysis for exclusivity rebates, as these were illegal simply due to their form. Nevertheless, the Commission had also conducted a lengthy effects analysis, and found that the rebates failed the AEC test—equally efficient competitors would, it said, have been forced to offer their products below a viable measure of Intel's costs to match the rebates Intel had offered.

In June 2014, the General Court dismissed Intel's appeal.[36] In doing so, it refused to review Intel's objections to the Commission's AEC analysis, holding that it was not necessary to consider effects and, even if it were, there was no obligation to apply the AEC test. The court also expressly declined to apply the ruling in *Post Danmark I* to exclusivity rebates.

In response to Intel's further appeal, the CJ once again assembled its Grand Chamber to make its point.

***Different Streams Converge.*** The first signs that the General Court had misjudged the tides came from AG Wahl. In a 75-page Opinion to the CJ, Wahl took issue with most aspects of the General Court's ruling. In his view, there were

only two types of rebates: those based solely on volume, which were presumed to be lawful, and the rest, which required a review of all the circumstances before they could be condemned as abusive. Criticizing the view that exclusivity rebates were a category apart from other pricing abuses, to which the principles in *Post Danmark I* and the margin squeeze cases did not apply, Wahl said:

> To my mind, dismissing the relevance of that case-law is problematic: it results in an unwarranted distinction between different types of pricing practices. Indeed, loyalty rebates, margin squeeze practices as well as predatory pricing possess the common feature constituting "price based exclusion.". . .
>
> It goes without saying that it is of the utmost importance that legal tests applied to one category of conduct are coherent with those applied to comparable practices. Sound and coherent legal categorisation benefits not only undertakings in terms of increased legal certainty, but also assists competition authorities in the enforcement of competition law. Arbitrary categorisation does not.[37]

The Grand Chamber adopted a more statesmanlike tone, but nonetheless agreed.

The CJ chose to address the issue simply by citing the key finding of *Post Danmark I* verbatim.[38] Thus, Article 102 TFEU did not seek to ensure that less efficient businesses stayed on the market. Legitimate competition on the merits may by definition lead to the exit of less efficient competitors. Article 102 TFEU therefore prohibited a dominant firm from, amongst other things, adopting pricing practices that had an exclusionary effect on competitors who were as efficient as itself.[39] *Post Danmark II* was not mentioned at all.

There was now no further room for ambiguity. The theory of harm underpinning different types of pricing abuse had been unified.

***A Presumption Recharacterized.*** This left the delicate question of what to make of the CJ's seminal judgment on exclusivity and loyalty rebates in *Hoffmann-La Roche*. Here, the CJ deployed some careful footwork. It acknowledged that a presumption of abuse did indeed exist for exclusivity requirements, whether they were absolute or in return for a rebate. The same applied to loyalty rebates that were conditional on a customer obtaining all or most of its requirements from the dominant firm. However,

> that case-law must be further clarified in the case where the undertaking concerned submits, during the administrative procedure, on the basis of supporting evidence, that this conduct was not capable of restricting competition and, in particular, of producing the alleged foreclosure effects.
>
> In that case, the Commission is not only required to analyse, first, the extent of the undertaking's dominant position on the relevant market and, secondly, the share of the market covered by the challenged practice, as well as the conditions and arrangements for granting the rebates in question, their duration and their amount; it is also required to assess the possible existence of a strategy aiming to exclude competitors that are at least as efficient as the dominant undertaking from the market . . . .[40]

Given that the Commission had carried out an analysis of whether the rebate scheme was capable of foreclosure, said the CJ, the General Court was required to review Intel's challenge to that analysis. Moreover, because the AEC test played a key role in the Commission's conclusion that the rebate scheme was capable of foreclosing equally efficient competitors, the General Court should have considered Intel's objections to the Commission's application of the test. The case was therefore sent back to the General Court for reassessment.

***Where to Now for Rebates?*** How best to sum up the state of the law following these judicial maneuvers? First, the CJ has not overruled the presumption that exclusivity or loyalty rebates are abusive. However, this presumption now appears to be easily nullified—assuming the dominant company brings evidence during the investigation that its rebates are not capable of leading to foreclosure, the Commission must then look closely at effects. Underpinning this is the Court's starting point that Art 102 TFEU permits pricing conduct by a dominant firm that can drive less efficient competitors from the market. The presumption should, therefore, have become one in name only.

The strategy pursued by the dominant company remains one of the relevant factors, although its relevance has been limited to strategy to exclude "at least as efficient" competitors. This seems to be a conscious restricting of the relevance of intention.

As for the AEC test, the Court avoids any commentary on whether or when it must be deployed. Rather, the CJ confines itself to finding that because the AEC test was an important part of the Commission's assessment of foreclosure, the General Court must consider Intel's criticism of this aspect of the Commission's analysis. It therefore appears to remain the formal position that use of the AEC test is not mandatory for rebates. However, given the Court's opening comments on the purpose of Article 102 TFEU, there also seems to be little scope left to ignore the AEC test when it is raised, with accompanying evidence, by a dominant company. We can evidently conclude that the market structure at issue in *Intel*—where the dominant company was held to have a market share of 70 percent or more—was not one where the AEC test was rendered irrelevant as in *Post Danmark II*, given that the Commission considered the test at length.

Finally, on the issue of likelihood, the CJ reverted back to the language of "capability." AG Wahl had been characteristically forthright about what this meant, stating that the assessment of capability was to determine whether "in all likelihood" there would be an anticompetitive foreclosure effect. He continued:

> [L]ikelihood must be considerably more than a mere possibility that certain behaviour may restrict competition. . . . Contrariwise, the fact that an exclusionary effect appears more likely than not is simply not enough.
>
> …To assume the existence of an abuse on the basis that, on balance, anticompetitive foreclosure seems more likely than

> not risks capturing not only isolated instances of practices, but a non-negligible number of practices that may, in reality, be pro-competitive. The cost of error of such an approach would be unacceptably high due to over-inclusion.[41]

The CJ chose not to comment on Wahl's views or to elaborate any further itself. However, following both *Post Danmark* judgments, the standard appears to be that a foreclosure effect must be likely or probable (or to have actually been shown to have occurred in the market). Wahl's Opinion will provide fertile ground for future debate about whether that standard is met in individual cases.[42]

## Price Discrimination Repositioned: *MEO*

In the case of *MEO*, the CJ directed its attention afresh to the appropriate treatment of differential pricing or "secondary line" price discrimination under Article 102(c) TFEU (as opposed to the "primary line" discrimination that was at issue in *Post Danmark I*).

The litigation arose following a decision by the Portuguese Competition Authority to reject a complaint made by MEO, a pay-TV operator, against GDA, a collecting society that managed the rights of artists and performers and collected royalties on their behalf. GDA had applied a different royalty tariff to MEO than it had applied to MEO's competitor. MEO alleged an abuse of dominance by GDA, based partly on discrimination, and subsequently challenged the Portuguese Authority's rejection of this complaint.

In his Opinion to the Court, AG Wahl noted: "Contrary to what a superficial analysis might suggest, point (c) of the second paragraph of Article 102 TFEU does not compel monopoly holders or dominant undertakings to apply uniform tariffs to their trading partners."[43]

The CJ's ruling in April 2018 followed this philosophy. It started with the approach set out in *British Airways*—there must be discrimination and that discrimination must "tend to" hinder the competitive position of some of the dominant company's business partners, without it being necessary to show an actual, quantifiable deterioration for individual partners. The Court added, however, that it was necessary to examine all the relevant circumstances to determine whether the price discrimination had produced or was "capable of" producing a competitive disadvantage.[44]

In particular, the Court confirmed that "the mere presence of an immediate disadvantage affecting operators who were charged more, compared with the tariffs applied to their competitors for an equivalent service, does not, however, mean that competition is distorted or is capable of being distorted."[45]

The CJ then set out guidance for the types of circumstances that may be relevant.[46] It considered three points in particular to be of importance in the case before it. First, it noted the negotiating power of the dominant company's customers and apparent lack of control the dominant company had over the royalties charged to MEO, which were set by arbitration. Second, the Court held that where the effect of the differential prices on the costs or profits of a trading partner was "not significant," this may in some cases allow the deduction that the price differentiation was not capable of having an effect on its competitive position. Finally, the Court was influenced by the apparent lack of any motive on the dominant company's part to exclude one of its trading partners from a downstream market, noting that the dominant company itself had no presence on that market.

In conclusion, the CJ stated that to find an abuse, the analysis of all relevant circumstances must lead to the conclusion that the price discrimination "has an effect" on the costs, profits, or other relevant interests of one or more trading partners of the dominant firm.

It is likely to remain the case that discrimination by a dominant firm which penalizes cross-border trade will be illegal.[47] Beyond that, however, the combination of *MEO* and *Post Danmark I* should banish the notion that price discrimination by a dominant company is inherently anticompetitive.

There will be a strong interest in understanding the proportion of costs at which competition law enforcers will start to consider that a dominant company's input could have a relevant impact on its trading partners. At first sight, the CJ's cautious comments about costs not being significant do not allow for a lot of freedom. The Court, however, was reacting to the facts before it. In certain industries, at least where individual suppliers represent a small proportion of a customer's costs, dominant firms should be freed from the uneasy feeling that they operate in a pricing straightjacket in Europe.

If adopted in practice, this would be a welcome outcome. ■

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1 Case C-525/16, MEO—Serviços de Comunicações e Multimédia SA v. Autoridade da Concorrência, Opinion of Advocate General Wahl (Dec. 20, 2017), ECLI:EU:C:2017:1020, at 70.

2 Case C-413/14 P, Intel Corp. Inc. v. Comm'n, ECLI:EU:C:2017:632 (CJ Sept. 6, 2017).

3 A welcome example of this is the UK Competition and Markets Authority's "no grounds for action" decision issued on August 10, 2017, relating to rebates offered by Unilever: *Single-Wrapped Impulse Ice Cream: Suspected Anti-Competitive Conduct*, www.gov.uk/cma-cases/consumable-goods-suspected-anti-competitive-conduct.

4 *See, e.g.*, Press Release, European Comm'n, Commission Fines Qualcomm €997 Million for Abuse of Dominant Market Position (Jan. 24, 2018) (IP/18/421); Margrethe Vestager, Competition Commissioner, A Market that Works for Consumers, Speech to the Studienvereinigung Kartellrecht International EU Competition Law Forum, Brussels (Mar. 12, 2018), https://ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/market-works-consumers_en.

5 This provision was previously contained in Article 86 of the Treaty of Rome and then Article 82 of the EC Treaty. For simplicity, we refer to Article 102 TFEU throughout.

6 Article 102(d) TFEU also lists "making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the

subject of such contracts." This has been the basis of cases relating to bundling discounts, which we do not address here.

[7] See, e.g., Case C-95/04 P, British Airways plc v. Comm'n, 2007 E.C.R. I-2331, ECLI:EU:C:2007:166, at 57.

[8] Case 85/76, Hoffmann-La Roche & Co. AG v. Comm'n, 1979 E.C.R. 461, ECLI:EU:C:1979:36.

[9] *Id.* at 89–90. The Court noted the possibility that exclusivity or fidelity rebates may be justified in exceptional circumstances where the anticompetitive effects were outweighed by efficiencies, a theme to which later judgments would return.

[10] Case 322/81, NV Nederlandsche Banden-Industrie Michelin v. Comm'n, 1983 E.C.R. 3461, ECLI:EU:C:1983:313, at 72, 73.

[11] *Id.* at 81.

[12] Case T-203/01, Manufacture Française des Pneumatiques Michelin v. Comm'n, 2003 E.C.R. II-4071, ECLI:EU:T:2003:250.

[13] Case C-95/04 P, British Airways plc v. Comm'n, 2007 E.C.R. I-2331, ECLI:EU:C:2007:166, at 68.

[14] In its earlier *Suiker Unie* judgment, the first to address exclusivity rebates, the CJ had simply noted that customers competed with other buyers from the dominant firm: Joined Cases 40 to 48, 50, 54 to 56, 111, 113 and 114/73, Coöperatieve Vereniging 'Suiker Unie' UA and Others v. Comm'n, 1975 E.C.R. 1663, ECLI:EU:C:1975:174, at 525.

[15] Case C-62/86, AKZO Chemie BV v. Comm'n, 1991 E.C.R. I-3359, ECLI:EU:C:1991:286, at 71, 72.

[16] *See* Case T-228/97, Irish Sugar plc v. Comm'n, 1999 E.C.R. II-2969, ECLI:EU:T:1999:246 and Joined Cases C-395/96 P and C-396/96 P, Compagnie Maritime Belge Transports SA and Others v. Comm'n, 2000 E.C.R. I-1365, ECLI:EU:C:2000:132.

[17] *See, e.g.*, Gianluca Fella, *The Antitrust Assessment of Loyalty Discounts and Rebates*, 4 J. Competition L. & Econ. 375 (2008), https://academic.oup.com/jcle/article/4/2/375/902415; Denis Waelbroeck, Michelin II*: A Per Se Rule Against Rebates by Dominant Companies?*, 1 J. Competition L. & Econ. 149 (2005), https://academic.oup.com/jcle/article/1/1/149/848943.

[18] Press Release, European Comm'n, Competition: Commission Publishes Discussion Paper on Abuse of Dominance (Dec. 19, 2005) (IP/05/1626).

[19] European Comm'n, DG Competition, *Communication from the Commission—Guidance on the Commission's Enforcement Priorities in Applying Article 82 of the EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings*, 2009 O.J. (C 45) 7 (Dec. 3, 2008) [hereinafter *EC Guidance*].

[20] Case C-280/08 P, Deutsche Telekom v. Comm'n, 2010 E.C.R. I-9555, ECLI:EU:C:2010:603.

[21] Case C-52/09, Konkurrensverket v. TeliaSonera Sverige AB, 2011 E.C.R. I-0527, ECLI:EU:C:2011:83.

[22] *Id.* at 44–45.

[23] *Id.* at 74.

[24] Case C-209/10, Post Danmark A/S v Konkurrencerådet, ECLI:EU:C:2012:172 (CJ Mar. 27, 2012).

[25] Case C-209/10, Post Danmark A/S v Konkurrencerådet, Opinion of Advocate General Mengozzi (May 24, 2011), ECLI:EU:C:2011:342, at 46.

[26] The average variable cost benchmark from *Akzo* was reformulated as the similar concept of average incremental costs.

[27] Case C-209/10, Post Danmark A/S v Konkurrencerådet, ECLI:EU:C:2012:172 (CJ Mar. 27, 2012), at 30.

[28] *Id.* at 36, 44.

[29] *Id.* at 21–25.

[30] Case C-549/10 P, Tomra Systems ASA and Others v. Comm'n, ECLI:EU:C:2012:221 (CJ Apr. 19, 2012).

[31] Case C-23/14, Post Danmark A/S v. Konkurrencerådet, ECLI:EU:C:2015:651 (CJ Oct. 6, 2015).

[32] *Id.* at 55–58, 61.

[33] *Id.* at 59, 60.

[34] *EC Guidance*, *supra* note 19, at 24.

[35] Case C-23/14, Post Danmark A/S v. Konkurrencerådet, ECLI:EU:C:2015:651 (CJ Oct. 6, 2015), at 65–74.

[36] Case T-286/09, Intel Corp. Inc. v Comm'n, ECLI:EU:T:2014:547 (Gen. Ct. June 12, 2014).

[37] Case C-413/14 P, Intel Corp. Inc. v. Comm'n, Opinion of Advocate General Wahl (Oct. 20, 2016), ECLI:EU:C:2016:788, at 102–03.

[38] Case C-413/14 P, Intel Corp. Inc. v. Comm'n, ECLI:EU:C:2017:632 (CJ Sept. 6, 2017), at 133–36, 139.

[39] *Id.* at 133–36.

[40] *Id.* at 138–39.

[41] Case C-413/14 P, Intel Corp. Inc. v. Comm'n, Opinion of Advocate General Wahl (Oct. 20, 2016), ECLI:EU:C:2016:788, at 117, 119.

[42] Support has been expressed for Wahl's view by a fellow AG in Case C-123/16 P, Orange Polska S.A. v Comm'n, Opinion of Advocate General Wathelet (Feb. 21, 2018), ECLI:EU:C:2018:87, at 98.

[43] Case C-525/16, MEO—Serviços de Comunicações e Multimédia SA v. Autoridade da Concorrência, Opinion of Advocate General Wahl (Dec. 20, 2017), ECLI:EU:C:2017:1020, at 67.

[44] Case C-525/16, MEO—Serviços de Comunicações e Multimédia SA v. Autoridade da Concorrência, ECLI:EU:C:2018:270 (CJ Apr. 19, 2018).

[45] *Id.* at 26.

[46] *Id.* at 31. The Court listed as relevant factors the dominant position, the dominant company's negotiating power as regards the relevant tariffs, the conditions and arrangements for charging the tariffs, their duration, and amount. The Court also listed, referring to *Intel*, the possible existence of a strategy to exclude a dominant company's business partner which is at least as efficient as its competitors from the downstream market. This apparent application of the AEC test to a business partner active on a different market than the dominant firm raises some questions of practicality (the dominant firm may well not be able to assess the relative efficiency of its customers) and is not the most obvious scenario for application of this principle.

[47] *See* Case C-18/93, Corsica Ferries, 1994 E.C.R. I-1783, ECLI:EU:C:1994:195, Case T-228/97, Irish Sugar plc v. Comm'n, 1999 E.C.R. II-2969, ECLI:EU:T:1999:246 and Case C-163/99, Portugal v. Comm'n, 2001 E.C.R. I-2613, ECLI:EU:C:2001:189.

INTERNATIONAL DEVELOPMENTS

# The *Coty* Debate: Can the Luxury Sector Re-fragment the Democratic Web?

BY STEPHEN KINSELLA AND POLA KAROLCZYK

MARKETPLACE BANS HAVE SPARKED off considerable debate in the European Union in the past decade, reflecting mounting tension between brand owners and online retailers, and, on a larger scale, also between the online and offline economy. After numerous conflicting judgments from various national courts, the debate finally reached the European Court of Justice (CJ) in *Coty Germany GmbH v. Parfümerie Akzente GmbH*.[1] The long-awaited judgment was expected to provide an answer to the question whether and in what circumstances marketplace bans can be viewed as a restriction of competition. However, to the disappointment of some, the CJ decided to err on the side of caution and issued a very narrow judgment addressing only one of the many scenarios in which marketplace bans occur, i.e., a scenario in which a retailer imposes a partial and insubstantial ban on online sales of luxury goods.

In this article, we put the *Coty* judgment in the context of the existing case law of the EU courts and Commission Regulation (EU) No. 330/210,[2] (explaining the application of Article 101(3) to categories of vertical agreements and concerted practices) (Vertical Block Exemption) and we contrast it with the current reality of e-commerce. The purpose of this exercise is to answer two questions which still linger after the *Coty* ruling, namely: (1) can the *Coty* ruling be extended to scenarios other than the one directly addressed by the CJ; and (2) what does the Coty judgment mean in practice for companies involved in or affected by online sales.

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## Origins of the *Coty* Dispute

The *Coty* dispute originated in Germany. Coty Germany, a supplier of cosmetics, was seeking an order from the German courts prohibiting one of its distributors, Parfümerie Akzente, from distributing products bearing the "Coty Prestige" brand via the marketplace "amazon.de." Parfümerie Akzente had refused to approve amendments to the distribution agreement between the two parties, which stated that internet sales of Coty Prestige goods were to be conducted through an "electronic shop window" of the authorized store, in order to preserve the luxury image of the goods. A footnote to the amendments stated that "the authorized retailer is prohibited from collaborating with third parties if such collaboration is directed at the operation of the website and is effected in a manner that is discernible to the public." In other words, the supplier was effectively imposing a ban on the use of third-party e-commerce platforms.

On July 31, 2014, the Landgericht Frankfurt am Main, the German court of first instance, dismissed Coty's application on the ground that the contractual clause was contrary to Article 101(1) TFEU,[3] and to paragraph 1 of the *Gesetz gegen Wettbewerbsbeschränkungen* (Law against restrictions of competition). First, relying on the judgment in *Pierre Fabre Dermo-Cosmetique*,[4] the court stated that a selective distribution system, which by definition restricts competition, could not be justified by the objective of preserving a prestige brand image.[5] Second, the court went on to rule that the marketplace ban clause was a hard core restriction of competition under Article 4(c) of the Vertical Block Exemption (a restriction on passive sales), and as a result the agreement as a whole could not benefit from the safe harbor for vertical agreements. Furthermore, the court stated that no individual exemption could apply because it was not shown that any claimed efficiency gains entailed by excluding internet sales via third-party marketplaces would offset the exclusion's disadvantages to competition. It was finally stated that there would have been other, equally appropriate means of maintaining Coty Prestige's luxury brand image, which would be less restrictive of competition—such as the application of specific quality criteria for third-party marketplaces.

Upon Coty Germany's appeal to the *Oberlandesgericht Frankfurt am Main* (Higher Regional Court, Frankfurt am Main), that court of appeal stayed the proceedings and referred a number of questions to the CJ under the preliminary ruling procedure (a procedure designed to obtain rulings on points of legal interpretation of EU law):

> (1) Do selective distribution systems that have as their aim the distribution of luxury goods and primarily serve to ensure a "luxury image" for the goods constitute an aspect of competition that is compatible with Article 101(1) TFEU?

(2) If the first question is answered in the affirmative:

Does it constitute an aspect of competition that is compatible with Article 101(1) TFEU if the members of a selective distribution system operating at the retail level of trade are prohibited generally from engaging third-party undertakings discernible to the public to handle internet sales, irrespective of whether the manufacturer's legitimate quality standards are contravened in the specific case?

(3) Is Article 4(b) of Regulation [No 330/2010] to be interpreted as meaning that a prohibition of engaging third-party undertakings discernible to the public to handle internet sales that is imposed on the members of a selective distribution system operating at the retail level of trade constitutes a restriction of the retailer's customer group "by object"?

(4) Is Article 4(c) of Regulation [No 330/2010] to be interpreted as meaning that a prohibition of engaging third-party undertakings discernible to the public to handle internet sales that is imposed on the members of a selective distribution system operating at the retail level of trade constitutes a restriction of passive sales to end users "by object"?

On July 26, 2017, Advocate General Wahl (AG) delivered his opinion in the case, and on December 6, 2017, the CJ delivered its final judgment responding to the questions of the court of appeal in Germany. While the legal aspects of the case are now in principle resolved, the German appeals court will still have to apply the *Coty* judgment to the specific facts in the case.

Under the preliminary ruling procedure, the CJ's role is to give an interpretation of European Union law or to rule on its validity. However, applying the law to the factual situation underlying the main proceedings is the task of the national court.[6] In other words, the German national court is not bound by the statements of facts made by the CJ in the *Coty* judgment (which are numerous—see, for example, paragraphs 54, 56, and 67) and could reach a different conclusion on certain facts addressed by the CJ.[7] The same applies to any other national court which might consider these issues in the future.

## Conclusions of the Advocate General and Court

The AG opinion significantly disagreed with the German first instance court.[8] Moreover, although AG opinions are only advisory, it was (as is often the case) largely followed by the CJ in the final judgment, though there are certain notable differences, which we discuss below. Most importantly, it appears that the AG had envisaged a judgment which could apply beyond the luxury sector,[9] while the CJ sought to answer more pointed questions focusing squarely on luxury products. This apparent difference in the AG's and CJ's approach is important because it demonstrates that the CJ intentionally chose to avoid a judgment which would have a wider application.

In response to the first question (which is formulated in the same manner in the AG opinion and in the CJ judgment), both the AG and the CJ concluded that selective distribution systems such as the one found in the contract between Coty Germany and Parfümerie Akzente were potentially compatible with Article 101(1) TFEU, if they were mainly intended to preserve the "luxury image" of the products and provided that "the *Metro* criteria are satisfied." *Metro*[10] provided that selective distribution systems could be justified, as long as resellers are chosen on the basis of objective, qualitative criteria, determined uniformly for all, and applied in a non-discriminatory manner. The criteria also demand that the nature of the product in question, and its image, require selective distribution in order to preserve the quality of the product and to ensure that it is correctly used, and that any restrictions do not go beyond what is necessary to ensure that this happens.

The wording of the second question, and therefore the response to it, differs in the opinion and in the judgment. Following the referring German Court, the AG focused on the question: "Does it constitute an aspect of competition that is compatible with Article 101(1) TFEU if the members of a selective distribution system . . . are prohibited generally from engaging third-party undertakings discernible to the public to handle internet sales . . . ?" In response the AG argued that, in order to determine the lawfulness of a contractual clause prohibiting authorized distributors from using online third-party platforms, the referring court should go on to examine whether the contractual clause is "dependent on the nature of the product, whether it is determined in a uniform fashion and applied without distinction and whether it goes beyond what is necessary."[11] It is important however to note that, while the AG focused largely on luxury goods, he did make some observations that could be capable of wider application (see paragraphs 87 and 91–92, where the AG refers to "prestige image" and "quality" and "prestige" products).

Unlike the AG, the CJ rephrased the second question asked by the German Court to confine it to luxury goods: "By its second question, the referring court asks, *in essence*, whether Article 101(1) TFEU must be interpreted as precluding a contractual clause, such as that at issue in the main proceedings, which prohibits authorised distributors in a selective distribution system *for luxury goods* . . . ."[12] With regard to this question, the CJ found that Article 101(1) TFEU does not preclude a contractual clause which prohibits authorized distributors of luxury goods from using, in a discernible manner, third-party platforms for internet sales of such goods, provided that the *Metro* conditions are met.

With regard to the third and fourth questions, the AG addressed the situation of members of a selective distribution system in general rather than those for luxury goods: "Is Article 4(b) [and 4(c)] of Regulation No 330/2010 to be

interpreted as meaning that a prohibition of engaging third-party undertakings discernible to the public to handle internet sales that is imposed on *the members of a selective distribution system* . . . constitutes a restriction of the retailer's customer group [and a restriction of passive sales to end users] 'by object'?"[13] In response, the AG advised that in terms of practical impact the prohibition on third-party platforms did not preclude all online sales (unlike in *Pierre Fabre*), and online platforms could not be considered "a significant distribution channel."[14] Also, the AG argued that it could not be said that users of third-party platforms constituted a "definable customer base."[15] As such, the advice of the AG in relation to the third and fourth questions was that a selective distribution system prohibiting distributors from making use "in a discernible manner of third-party platforms for internet sales" should not be considered to constitute a customer restriction within the meaning of Article 4(b) of the Vertical Block Exemption. Nor should it be considered to constitute a restriction of passive sales within the meaning of Article 4(c) of the Vertical Block Exemption.

In contrast with the AG, the CJ rephrased the third and the fourth question to once again shift the focus to luxury products: "By its third and fourth questions . . . the referring court asks, *in essence*, whether Article 4 of Regulation No 330/2010 must be interpreted as meaning that . . . the prohibition imposed on the members of a selective distribution system *for luxury goods* . . . constitutes a restriction of their customers, within the meaning of Article 4(b) of that regulation, or a restriction of passive sales to end users, within the meaning of Article 4(c) of that regulation."[16] With regard to Article 4(b) of the Vertical Block Exemption, the CJ argued that this provision could be applied to the clause in question only if the marketplace ban on online sales of luxury goods affected a specific and identifiable group of customers. However, the CJ considered that customers using online platforms do not constitute a specific customer group to whom distributors would be prevented to sell under the clause. Therefore, the clause in question does not restrict the customer to which a distributor of luxury goods can sell within the meaning of Article 4(b) of the Vertical Block Exemption.

With regard to Article 4(c) of the Vertical Block Exemption, the CJ merely made several statements of fact but offered no compelling legal interpretation of this provision (see paragraphs 65–69 of the judgment). Despite this omission, the CJ concluded that the clause in question does not restrict passive sales of luxury goods within the meaning of Article 4(c) of the Vertical Block Exemption. Consequently, Coty's selective distribution system could theoretically benefit from the Vertical Block Exemption.

It is particularly striking that neither the opinion nor the CJ judgment deal with the paragraph of the Guidelines on Vertical Restraints,[17] that one would have expected to be at the heart of this case. Paragraph 54 of the Vertical Guidelines provides that a supplier may require quality standards for the use of the internet site to resell its goods (just as a supplier may require quality standards for a brick and mortar shop).[18] The last sentence of paragraph 54 (often referred to as the "logo clause") states: "For instance, where the distributor's website is hosted by a third party platform, the supplier may require that customers do not visit the distributor's website through a site carrying the name or logo of the third party platform." Manufacturers have in recent times increasingly relied on the "logo clause" to restrict their distributors from selling on any online marketplace, simply because marketplaces display their logo on the website. However, the final sentence of paragraph 54, although it begins "for instance," potentially goes beyond the proposition in the preceding sentence of paragraph 54 that it is intended to illustrate, which is that restrictions may be imposed online that are equivalent to those permitted in the brick and mortar world. Given the unclear wording of the "logo clause" and its impact on practice, the AG's and CJ's guidance in this regard would have been of particular value for companies involved in or affected by online sales.

Also, both the AG opinion and the CJ judgment demonstrate a rather limited understanding of the current state of e-commerce. In the AG's and CJ's view, online marketplaces are not an important distribution channel[19] and distributors rely mainly on their own online shops.[20] This conclusion, however, directly contradicts the findings of the Commission's Final Report on the E-Commerce Sector Inquiry,[21] which found that in several countries distributors heavily rely on online marketplaces (In Germany 62 percent of retailers use marketplaces, in the United Kingdom 43 percent, and in Poland 36 percent.[22]) Further, while it may be relatively easy to launch a very simple web store, scaling an online business and increasing visibility remains extremely difficult even for the most seasoned e-commerce experts. Online marketplaces allow distributors to become visible and sell their products to a large customer base and in multiple Member States.[23] Finally, the majority of small and mid-size distributors cannot afford the expenses involved with effective advertising on search platforms. Many of them may not be able to pay large sums to ensure that their website appears amongst consumers' top search results.[24] In other words, online stores can hardly be viewed as substitutes for online marketplaces in the same way as local grocery stores with limited inventory cannot seriously challenge hypermarkets.

The national court can always come to its own assessment of factual matters. However the rulings on the law provided by the CJ are distorted by these factual misconceptions which led it to view the marketplace ban as amounting in context to a relatively minor restriction of online sales, which is not capable of limiting competition. Given this, the *Coty* judgment should be read as addressing only those situations involving luxury goods, where a marketplace ban imposed on online sales is partial and insubstantial. However, *Coty* does not provide for a general test to be applied to all marketplace bans regardless of market circumstances.

## Is the *Coty* Judgment About Luxury?

The publication of the CJ judgment inevitably led to a debate on whether the judgment should be confined to luxury goods or whether it could possibly be extended to other categories of goods.

Notably, and rather surprisingly, the European Commission's Competition Directorate-General (DG COMP) decided to provide its written interpretation of the CJ judgment.[25] In the Competition Policy Brief published on April 4, 2018, DG COMP asserted:

> The Coty judgment does not exclude that marketplace bans in selective distribution agreements for other product categories such as "high-quality" or "high technology" products could also comply with Article 101(1) TFEU, if the Metro-criteria are fulfilled. . . . Some of the Court's considerations in this regard appear to be equally applicable to those other product categories.[26]

In our view, DG COMP's position is, however, difficult to justify. As explained above, it is crystal clear that the CJ intended to limit its judgment only to luxury products and exclude other product categories from its scope.

First, according to the header of the judgment, its subject is explicitly confined to "Selective distribution of luxury products." In this respect the judgment differs from the opinion of the AG, which uses the broader header "Selective distribution." Also, numerous paragraphs of the judgment confirm its narrow focus.[27]

Second, as explained above, the CJ proceeds to answer different questions to those that have been asked by the referring court. The German court had asked questions about "members of a selective distribution system." However, the CJ quite deliberately rephrased these questions (see paragraphs 37 and 62), saying that they are "in essence" about "a selective distribution system for *luxury goods*."

Third, the CJ differentiates "luxury" products from "branded" and "quality" products. For example, at paragraph 32 of the judgment, the CJ states that *Coty* has to be distinguished from *Pierre Fabre*[28] because the goods considered in *Pierre Fabre* were "*cosmetic and body hygiene goods*," which the CJ says are not luxury goods. The DG COMP Brief makes an attempt to dismiss this distinction and argues that the differentiation made by the CJ in paragraph 32 of the *Coty* judgment is "is of limited relevance"[29] because a clear delineation between luxury goods and cosmetic and body hygiene goods "will in many cases neither be possible, nor necessary as high-quality and high-technology products similarly qualify for selective distribution compliant with Article 101(1) TFEU as long as the Metro-criteria are fulfilled."[30] It is surprising to witness DG COMP so bluntly disagreeing with the EU's highest court on a point where a distinction had been so deliberately made. The assertion in the DG COMP Brief is also misleading because the quality of the goods has always been a relevant factor and non-luxury goods, due to their different nature, are less likely to necessitate potential restrictions on online sales (i.e., they do not possess the aura of luxury which would justify the special protection). In other words, with regard to non-luxury goods, it is significantly less certain that the *Metro* criteria would be fulfilled.

Finally, the CJ very deliberately preserves the effect of *Pierre Fabre* for non-luxury goods. Under *Pierre Fabre*, the nature of the product in question is relevant for the application of Article 101(1) TFEU.[31] In other words, the nature of the product is one of the factors which may justify (or not) the use of a restrictive clause. In *Pierre Fabre*, the prestigious nature of the product was still insufficient to justify the absolute ban on online sales. The same principle is confirmed in *Coty*, where the nature of the products (luxury goods) remains relevant for the application of Article 101(1) TFEU and is capable of justifying a *partial* (and, in the CJ's view, *insubstantial*) ban on online sales.

In sum, in *Coty* the CJ took pains to confine its judgment to certain very limited circumstances (partial and *insubstantial* ban on online sales of luxury goods). At the same time, the CJ also narrowed *Pierre Fabre* to certain very limited circumstances (absolute ban on online sales of non-luxury goods). This means that any alternative scenario involving a partial but *substantial* ban on online sales (of both non-luxury and luxury goods) remains unaddressed and untested before the CJ.

This untested scenario could still be qualified as a restriction by object of Article 101 TFEU or a restriction of passive sales under Article 4(c) of the Vertical Block Exemption. The *Coty* judgment does not preclude such legal outcomes. In this context, the DG COMP Brief, which could encourage companies to apply the *Coty* judgment beyond its clearly defined scope for luxury goods, represents at best an indication of enforcement policy (or administrative convenience) rather than the law as clarified by *Pierre Fabre* and *Coty*.

## Do We Need to Extend *Coty* to Non-Luxury Scenarios for the Sake of Legal Certainty?

The main function of the block exemptions under EU competition law is to create a legal safe harbor for certain categories of agreements, which can safely be presumed to be legal. Where a distribution agreement is not covered by the Vertical Block Exemption it must be analyzed individually for possible exemption under Article 101(3) TFEU.

The DG COMP Brief argues that the broad interpretation of the *Coty* judgment (i.e., beyond the category of luxury goods) is justified by the need to apply the Vertical Block Exemption in a uniform manner to all categories of products and the need to provide companies with legal certainty.[32] In our view, however, this justification is not well founded.

It is true that the Vertical Block Exemption applies in principle to all categories of products. In this respect, however, the Vertical Block Exemption is no different from Article 101 TFEU, which also applies to all categories of products. Still, the general wording of Article 101 TFEU did not stop the courts from carving out special rules for distinct groups of goods. In particular, the nature of the product was includ-

ed in the *Metro* test, under which it can be decided whether restrictions affecting a given product deserve to fall outside the prohibition of Article 101(1) TFEU. The *Metro* test requires that the nature and image of the product in question justifies the use of a selective distribution system. Therefore, if we were to assume that the nature of the product matters for the application of Article 101(1) TFEU but has no significance when we come to the Vertical Block Exemption, we would end up with inconsistent sets of norms applicable to the same distribution agreement.

Moreover, the argument of administrative convenience that legal certainty under the Vertical Block Exemption requires ignoring the nature of the product can be tested by going to the opposite extreme. Does every single product, however basic, merit selective distribution, block exemption, and a blanket ban on certain sales channels? If that were the case, it would be clear that the Vertical Block Exemption is too broad and is ultra vires the powers devolved to the Commission.[33]

We should recall that the Vertical Block Exemption was meant to create a safe harbor only for vertical agreements falling under the 30 percent market share, which itself requires an analysis of product market, competing products etc. Even this "safe harbor" is, however, subject to a number of caveats.

First of all, it is rarely easy to determine with certainty the product and geographic markets affected by a vertical agreement. Often it will be necessary to consider the potential effect of an agreement by reference to various alternative relevant markets. A supplier might satisfy the 30 percent threshold by reference to one market analysis, but a narrower market definition may mean that the threshold is exceeded. In those cases, the benefit of the Vertical Block Exemption will remain uncertain and a more detailed assessment of the applicability of Article 101(1) and (3) TFEU will be necessary.

Second, the Commission or the competition authority of a Member State may by decision withdraw the benefit of the Vertical Block Exemption if it finds in a particular case that an agreement, whether in isolation or in conjunction with other similar agreements, has certain effects which are incompatible with the Article 101(3) TFEU exemption criteria. Indeed, the AG specifically noted the possibility of withdrawal in paragraph 16 of his opinion. In other words, the benefit of the Vertical Block Exemption can be lifted at any time even in cases where the 30 percent market share threshold is not exceeded.

Finally, the benefit of the Vertical Block Exemption is limited to vertical agreements for which it can be assumed with sufficient certainty that they satisfy the conditions of Article 101(3) TFEU (see Recital 5 of the Vertical Block Exemption). The fact that an agreement contains a restriction "by object," and thus falls under Article 101(1) TFEU, does not preclude the parties from demonstrating that the conditions set out in Article 101(3) TFEU are satisfied. However, practice shows that restrictions by object are unlikely to fulfil the four conditions set out in Article 101(3) TFEU and therefore, should not qualify for a block exemption. Hence, it is unjustified to extend the Vertical Block Exemption to a restriction which is likely to restrict Article 101(1) TFEU by object (for example, a clause in a selective distribution agreement which substantially restricts online sales via certain platforms without any reference to objective criteria that they might satisfy).

As it follows from the discussion above, the Vertical Block Exemption could not ever have been expected to offer comprehensive legal certainty but merely a presumption of legality.[34] By artificially stretching the application of the *Coty* judgment beyond the category of luxury goods, the DG COMP Brief does not provide more clarity and legal certainty to market participants but simply misleads them as to the actual meaning of this judgment.

### What the *Coty* Judgment Means in Practice for Companies Involved or Affected by Online Sales

The Higher Regional Court in Frankfurt will have to decide whether the particular restrictions imposed were lawful. Interestingly, the German court of first instance saw the marketplace ban imposed by Coty Germany on Parfümerie Akzente as a substantial limitation of online sales. The appeals court in Germany will, therefore, have to reconcile this view with the opposing one of the CJ.

We also note that the judgment by the appeals court in Germany will be issued during the ongoing sector inquiry by the Bundeskartellamt into the online advertising sector. As signaled by the Bundeskartellamt, the competitive environment in this market is difficult. Also, this agency's opposition to marketplace bans is well-known. The findings of this sector inquiry might well, therefore, contradict the CJ's conclusion in paragraph 67 of the judgment that visibility of online sellers is not restricted by marketplace bans because authorized distributors can "advertise via the internet on third-party platforms and . . . use online search engines" with the result that "customers are usually able to find the online offer of authorised distributors by using such engines." The *Google Shopping* decision questions whether expensive advertising is genuinely a viable alternative.[35]

It will also be interesting to see how the German appeals court will deal with the luxury theme of the *Coty* judgment. In this context, it is worth recalling another case considered by the Higher Regional Court of Frankfurt, namely *Deuter Sport GmbH v. an authorised dealer*. In *Deuter*, concerning online distribution of quality backpacks, the Higher Regional Court of Frankfurt drew a very clear distinction between luxury and branded goods. In particular, the court rejected Deuter's argument that the accumulation of similar product images and prices on price comparison websites suggests the mass availability of the product, which, in turn, could damage the high quality image of the product.[36] In the court's view, this argument would only be valid if the brand had a luxury image evoking an impression of exclusivity.[37] Accord-

ing to the court, the Deuter brand did stand for high product quality but could not be considered luxury. Given this, it was not evident that the image of its product was affected simply because the potential buyer could see on price comparison websites that different models of the product were offered by numerous retailers.[38]

Of course, the *Coty* judgment is likely to have an impact beyond Germany, and we may see some discrepancies at a national level in the interpretation of the notion of "luxury" products or in the assessment of the actual effect of marketplace bans on distributors' visibility on the internet. One thing is clear, though: brand owners will need to demonstrate on a case-by-case basis that the nature of their products deserves the same level of protection as luxury goods in the *Coty* case. It remains to be seen where this line will be drawn by each national court and enforcement agency.

Finally, the role of online marketplaces for distribution of goods is likely to become more prominent in the near future. As the importance of marketplaces increases, any restrictions imposed on their access can be expected to be kept under regular review by competition authorities across the EU. ■

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1 Case C-230/16, Coty Germany GmbH v. Parfümerie Akzente GmbH (*Coty*) (CJ 2017) (not yet reported).

2 Comm'n Regulation (EU) No. 33012010, 2010 O.J. (L 120) 1–7.

3 Consolidated Version of the Treaty on the Functioning of the European Union, 2012 O.J. (C 326) 47 (TFEU).

4 Case C-439/09, Pierre Fabre Dermo-Cosmetique, 2011 E.C.R. I-9419.

5 Opinion of AG Wahl, *Coty*, ¶ 27.

6 *See* Eur. Comm'n, Information note on references from national courts for a preliminary ruling, 2009 O.J. (C 297) 1–6.

7 For example, the German national court could consider marketplaces as an important distribution channel, which, in the context of the German market, would be justified. The German court could also conclude that distributors have insufficient access to the internet when confronted with marketplace bans or that their ability to advertise their offer is limited due to significant costs of advertising on the internet.

8 For a detailed analysis of the opinion of AG Wahl in the *Coty* case, see Stephen Kinsella, *Luxury: A State of Mind?*, MLex (Oct. 31, 2017), https://mlexmarketinsight.com/insights-center/ab-extras/ab-extra-luxury-a-state-of-mind.

9 For example, in paragraph 92 of the opinion of AG Wahl in the *Coty* case, the AG found that "both so-called luxury products and so-called quality products" could, subject to the satisfaction of the "*Metro* criteria," justify the use of a distribution system which is compatible with Article 101(1) TFEU.

10 Case 26/76, Metro SB-Großmärkte GmbH & Co. KG v. Comm'n, 1977 E.C.R. 1875.

11 Opinion of AG Wahl, *Coty*, ¶ 122.

12 *Coty*, ¶ 37.

13 Opinion of AG Wahl, *Coty*, ¶ 29.

14 *Id.* ¶ 149.

15 *Id.* ¶ 150.

16 *Coty*, ¶ 62.

17 Guidelines on Vertical Restraints, 2010 O.J. (C 130), 1–46 [hereinafter Vertical Guidelines].

18 Paragraph 54 of the Vertical Guidelines states: "Under the Block Exemption the supplier may require quality standards for the use of the internet site to resell his goods, just as the supplier may require quality standards for a shop or for selling by catalogue or for advertising and promotion in general."

19 Opinion of AG Wahl, *Coty*, ¶ 149.

20 *Coty*, ¶ 54.

21 Eur. Comm'n, Final Report from the Commission to the Council and the European Parliament on the E-commerce Sector Inquiry, 2017 COM (2017) 229 final (May 10, 2017) ¶ 39(ii) [hereinafter Final Report].

22 *Id.* ¶ 39(ii).

23 *Id.* ¶ 14. Through marketplaces, small- and mid-size sellers can reach around 169 million potential buyers worldwide and access the kind of support with marketing, traffic, delivery, translation, technology development, and payments that had previously been out of reach for firms of their size. *See* http://inside-ebay.eu/en/inside-ebay#inside-ebay.

24 And, as the Commission demonstrated in Case AT.39740—*Google Search* (*Shopping*), Comm'n Decision (June 27, 2017), ec.europa.eu/competition/antitrust/cases/dec_docs/39740/39740_14996_3.pdf, companies not appearing on the first two search result pages are not really able to attract consumers' attention. In addition, the Commission also found that purchasing rankings using AdWords was not an economically viable solution long-term due to the relatively high cost of AdWords.

25 DG COMP Brief, EU Competition Rules and Marketplace Bans: Where Do We Stand After the Coty Judgment? (2018), http://ec.europa.eu/competition/publications/cpb/2018/kdak18001enn.pdf. In the disclaimer provided in this policy brief, DG COMP explains: "Competition policy briefs are written by the staff of the Competition Directorate-General and provide background to policy discussions. They represent the author's view on the matter and do not bind the Commission in any way." However, despite this explanation, the author of the brief is not disclosed and in some paragraphs the brief refers directly to "DG Competition's view." See, for example, DG COMP Brief, *supra*, at 4.

26 *Id.* at 3.

27 *See Coty*, ¶¶ 28–29, 43, 51, 58, 62, 69.

28 Where the Court held, at paragraph 46, that "the aim of maintaining a [prestige] image is not a legitimate aim for restricting competition and cannot therefore justify a finding that a contractual clause pursuing such an aim does not fall within Article 101(1) TFEU."

29 *See* DG COMP Brief, *supra* note 25, at 2 (emphasis added).

30 *See id.*

31 According to paragraph 47 of the *Pierre Fabre* judgment, a ban on the use of the internet amounts to a restriction by object where, following an individual and specific examination of the content and objective of a clause and the legal and economic context of which it forms a part, it is apparent that, having regard to the properties of the products at issue, that clause is not objectively justified. *See Pierre Fabre*, 2011 E.C.R. I-9419, ¶ 47: "In the light of the foregoing considerations, the answer to the first part of the question referred for a preliminary ruling is that Article 101(1) TFEU must be interpreted as meaning that, in the context of a selective distribution system, a contractual clause requiring sales of cosmetics and personal care products to be made in a physical space where a qualified pharmacist must be present, resulting in a ban on the use of the internet for those sales, amounts to a restriction by object within the meaning of that provision where, following an individual and specific examination of the content and objective of that contractual clause and the legal and economic context of which it forms a part, it is apparent that, having regard to the properties of the products at issue, that clause is not objectively justified."

32 *See* DG COMP Brief, *supra* note 25, at 4.

33 The legal basis of the Vertical Block Exemption is Council Regulation No. 19/65/EEC, 1965 O.J. 36, 0533–0535 (on the application of Article 85(3) of the Treaty to certain categories of agreements and concerted practices), as amended by Council Regulation No. 1215/1999, 1999 O.J. (L 148) 1–4 (on the application of Article 81(3) of the Treaty to certain categories of agreements and concerted practices). Under these regulations, the Commission's power to decide which agreements will be covered by the block exemption is limited by Article 101(3) TFEU. For example, recital 8 of Regulation 19/65/EEC states that "there can be no exemption if the conditions

set out in Article 101(3) are not satisfied." In other words, the Vertical Block Exemption would be too broad if it exempted agreements which normally would not be exempted under Article 101(3) TFEU.

[34] *See, e.g.*, Vertical Guidelines, *supra* note 17, ¶ 23: "Provided that they do not contain hardcore restrictions of competition, which are restrictions of competition by object, the Block Exemption Regulation creates a presumption of legality for vertical agreements depending on the market share of the supplier and the buyer." *See also id*. ¶ 74: "The presumption of legality conferred by the Block Exemption Regulation may be withdrawn where a vertical agreement, considered either in isolation or in conjunction with similar agreements enforced by competing suppliers or buyers, comes within the scope of Article 101(1) and does not fulfil all the conditions of Article 101(3)."

[35] Case AT.39740—Google Search (Shopping), Comm'n Decision (June 27, 2017).

[36] *See* Andrzej Kmiecik, *Germany: Higher Regional Court of Frankfurt Rules on Restrictions on the Use of Online Platforms and Price Comparison Websites in the Selective Distribution System of Deuter*, MONDAQ (Apr. 5, 2016), http://www.mondaq.com/germany/x/479238/Antitrust+Competition/Higher+Regional+Court+Of+Frankfurt+Rules+On+Restrictions+On+The+Use+Of+Online+Platforms+And+Price+Comparison+Websites+In+The+Selective+Distribution+System+Of+Deuter.

[37] *Id.*

[38] *Id.*

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# AGENDA | **Merger Practice** Workshop

San Francisco, CA | October 26, 2018

**Program Co-Chairs:** Leslie C. Overton & Scott A. Sher

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7:45 am–5:00 pm
**REGISTRATION**

8:15–8:30 am
**WELCOME REMARKS AND INTRODUCTION TO THE WORKSHOP**

8:30–9:45 am
**DEMONSTRATION I:**
**ANTITRUST COUNSELING, PRE- AND POST- SIGNING**

**Scene 1:** Initial meeting with Buyer's U.S. antitrust counsel to discuss deal structure, the industry, U.S. and non-U.S. merger notification processes, and potential foreign investment roadblocks (CFIUS)

**Scene 2:** Initial meeting with Seller's US antitrust counsel to discuss risks and risk allocation, the US and non-US merger notification processes, and how to avoid the appearance of "gun-jumping"

**Scene 3:** Meeting between the Parties' counsel to discuss the 30-day HSR waiting period, Item 4 documents, and strategy for advocacy in the initial 30-day waiting period

10:00–11:15 am
**DEMONSTRATION II: INITIAL HSR WAITING PERIOD**

**Scene 1:** Internal Agency meeting to discuss HSR filing and Item 4 documents and whether to pursue an investigation

**Scene 2:** Initial meeting with Agency staff to defend the transaction and present efficiencies

**Scene 3:** Internal Agency meeting to discuss transaction, and whether to issue a Second Request; confer with State Antitrust Chief

11:15 am–Noon
**DEBRIEF DISCUSSION OF MORNING SESSIONS: BEST PRACTICES AND COMMON PITFALLS**
Panel discussion of morning sessions

Noon–12:30 pm
**LUNCH**

12:30–2:00 pm
**DEMONSTRATION III:**
**COMPLIANCE WITH SECOND REQUEST AND CHINESE COMPETITION AUTHORITY INVESTIGATION**

**Scene 1:** Meeting between the parties to discuss Second Request compliance, advocacy strategy for Second Request, engagement of economists, and Chinese competition counsel

**Scene 2:** Meeting between the parties and expert economist to discuss development of economic evidence and role of customers and documentary evidence

**Scene 3:** Meeting among the parties, U.S. antitrust counsel, and Chinese competition counsel to discuss differences between U.S. and China review timing, processes and remedies

2:00–3:30 pm
**DEMONSTRATION IV:**
**SUBSTANTIVE ADVOCACY: LITIGATION AND REMEDY**

**Scene 1:** Meeting with Agency and State Antitrust Chief to address competitive concerns and hot documents

**Scene 2:** Internal Agency meeting among staff, managers, and Front Office to make staff's recommendation on whether to challenge the deal; discuss ongoing Chinese merger investigation; confer with State Antitrust Chief

**Scene 3:** Substantive meeting with Front Office and State Antitrust Chief to address competitive concerns and present remedy package to try to save the deal

3:45–5:00 pm
**VOTING, FINAL SCENE, AND WORKSHOP WRAP-UP**

**Voting:** Audience votes whether to block or approve deal

**Final Scene:** Agency Front Office meets with staff to share final decision and rationale

5:00–6:00 pm
**COCKTAIL RECEPTION**

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