

# The Elephant in the Room: Litigating the Fix After *Arch Coal* and *Dairy Farmers*

**Darren S. Tucker**

Parties to proposed mergers are seeking with increasing frequency to eliminate competitive concerns by restructuring their transactions or selling overlapping assets to third parties. These efforts, however, do not always eliminate the concerns of the enforcement agencies, which have challenged a number of acquisitions involving these self-help, or fix-it-first, remedies. In a setback for the enforcement agencies, the courts have been willing to consider these self-help remedies in evaluating the overall competitive effects of acquisitions, thus blocking the agencies' attempts to exclude evidence related to these fixes at trial.

The enforcement agencies have enjoyed considerably more success arguing the merit—or lack of merit—of proposed fixes. From the enactment of the Hart-Scott-Rodino (HSR) regime until the *Arch Coal* case, the agencies successfully have argued in each case that notwithstanding the proposed remedy, the overall transaction was likely to lead to a substantial lessening of competition. The *Arch Coal* decision was the first time in recent memory, and the first time ever in a case brought by the Federal Trade Commission, that a court relied on a proposed fix by a defendant as a basis for denying an enforcement agency's request for an injunction to block a merger.

The agencies also have had success in the consummated merger context. In the recent *Dairy Farmers* case, the Sixth Circuit, employing a different standard than in the unconsummated merger context, held that the defendants had failed to meet their "heavy burden" of mooted the original acquisition agreement.<sup>1</sup> As a result, the government was permitted to challenge both the original and modified acquisition agreement.

As a general matter then, the courts will consider self-help remedies both in the consummated and unconsummated merger contexts under certain circumstances. As described below, the standards for admitting a proposed fix are far more difficult to satisfy in the consummated merger context.

## Standards for Litigating the Fix in Unconsummated Transactions

Courts have consistently been willing to consider fix-it-first remedies when reviewing proposed acquisitions under Section 7 of the Clayton Act. Recent decisions have clarified the precise standards under which the admissibility of fix-it-first remedies are evaluated. The only area that remains murky is the burden of proof relating to the fix.

Case law is clear that merging parties are not obligated to litigate the precise acquisition described in their HSR filings or that is the subject of a second request investigation. The courts have not been sympathetic to the agencies' claims that consideration of a proposed fix is tanta-

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<sup>1</sup> United States v. Dairy Farmers of America, Inc. 2004-2 Trade Cas. (CCH) ¶ 74,537 (E.D. Ky. Aug. 31, 2004), available at 2004 WL 2186215, rev'd 426 F.3d 850 (6th Cir. 2005).

mount to an end-run of their authority, unfairly adds to their burden of proof at trial, and improperly considers a remedy at the same time as liability. Likewise, the courts have disagreed with the FTC's argument that it alone has authority over remedies due to its role as the ultimate arbiter of mergers it challenges through the administrative process.

In *Arch Coal*, for example, the court noted that the role of a district court in a 13(b) preliminary injunction hearing was “to review the *entire* transaction in question” and that “excluding evidence and argument regarding the [divestiture] transaction would be tantamount to turning a blind eye to the elephant in the room.”<sup>2</sup> In *Libbey*, the court held that

[P]arties to a merger agreement that is being challenged by the government can abandon that agreement and propose a new one in an effort to address the government's concerns. And when they do so under circumstances as occurred in this case, it becomes the new agreement that the Court must evaluate in deciding whether an injunction should be issued.<sup>3</sup>

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Likewise, the *Franklin Electric* court explained that the proposed fix was “relevant to the determination whether, considered as a whole, defendants' transaction will lessen future competition substantially.”<sup>4</sup>

Even cases prior to the advent of the HSR regime reached similar results.<sup>5</sup> In *Atlantic Richfield*, a case from 1969, the court stated that there was “no reason why merging companies cannot elim-

<sup>2</sup> *FTC v. Arch Coal, Inc.*, No. 04-0534 (JDB), Mem. Op. at 6–8 (D.D.C. July 7, 2004). In that case, Arch Coal sought to acquire Triton Coal Company. See *FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109 (D.D.C. 2004). Arch decided to try to resolve the FTC's concerns using a fix-it-first approach. While it was responding to a second request, Arch notified the FTC that it had signed an agreement with Kiewit to sell the Triton mine contingent on its closing with Triton. After four months of additional investigation, the FTC and six states filed complaints in federal district court seeking a preliminary injunction to block Arch's proposed acquisition of Triton. Although the complaint acknowledged the fix-it-first remedy, it alleged that the Arch-Kiewit agreement was “executory”—meaning that it could be amended or terminated by the parties at will—and in any event “does not materially change the Acquisition or its likely effect on competition.” Relying in part on the divestiture, the court ultimately held that the FTC and plaintiff states had failed to meet their burden under Section 7 of the Clayton Act.

<sup>3</sup> *FTC v. Libbey Inc.*, 211 F. Supp. 2d 34, 46 (D.D.C. 2002). In that case, Libbey sought to acquire Anchor Hocking, a wholly owned subsidiary of Newell Rubbermaid. Both Libbey and Anchor manufactured and sold glassware to food service distributors and retailers. Approximately one month after the Commission had voted to seek a preliminary injunction, and one week after the FTC had filed its complaint, Libbey and Newell amended their agreement so that Libbey would acquire only Anchor's manufacturing plants and specialty glassware business. Anchor's food services glassware business was to be retained by Newell and transferred to another of its subsidiaries, which would outsource its production needs to a third-party manufacturer. The court held that it was required to review the new transaction in determining whether a preliminary injunction should issue. The court nevertheless granted the injunction, finding that Newell's higher costs resulting from the revised agreement would lead to a substantial lessening of competition.

<sup>4</sup> *United States v. Franklin Elec. Co.*, No. 00-C-0334-C, Order at 2-3 (W.D. Wis. July 19, 2000). In that case, Franklin Electric's subsidiary, FE Petro, and Union Dominion Industries's subsidiary, The Marley Company, proposed a joint venture that would have combined the only two U.S. manufacturers of submersible turbine pumps (STPs), which are used for pumping gasoline from underground storage tanks at service stations. See *United States v. Franklin Elec. Co.*, 130 F. Supp. 2d 1025 (W.D. Wis. 2000). During the government investigation, but before the suit was filed, the defendants attempted to address the government's concerns that the joint venture was a merger to monopoly by offering a technology license and resale agreement to two independent parties. The day before the Department of Justice filed its complaint, the merging parties amended their merger agreement, making the license agreement a condition to closing. The actual licensing agreement was not signed until a few weeks after the DOJ filed its complaint. Ultimately, the court found the proposed fix insufficient to negate the adverse effects of the merger and granted a preliminary injunction.

<sup>5</sup> For other cases involving consideration of proposed remedies, see *FTC v. Atl. Richfield Co.*, 549 F.2d 289 (4th Cir. 1977); *Consolidated Gold Fields PLC v. Anglo Am. Corp.*, 698 F. Supp. 487, 502 (S.D.N.Y. 1988); *White Consol. Indus., Inc. v. Whirlpool Corp.*, 612 F. Supp. 1009 (N.D. Ohio 1985), *aff'd*, 781 F.2d 1224 (6th Cir. 1986); *Chemetron Corp. v. Crane Co.*, 1977-2 Trade Cas. (CCH) ¶ 61,717 (N.D. Ill. 1977).

inate probable anti-competitive effects by such a disposition of assets as will be made here.”<sup>6</sup> And in *Connecticut National Bank*, a decision from 1973, the court stated:

It seems clear that the evidence, which is part and parcel of the merger agreement between the defendants, is an inseparable and relevant element of the entire proof on likely competitive effects. The Court must view the proposed consolidation as a complete picture; the divestiture is an intrinsic aspect of the merger. Therefore, the Court deems it appropriate and proper to weigh the effect of the divestiture plan as a matter of plain common sense.<sup>7</sup>

As a result of several recent cases, the standards under which the courts consider the admissibility of proposed fixes in unconsummated transactions have become reasonably clear. While no case lays out a mechanical standard, the following three prong test has emerged: the proposed remedy: (1) must be a good-faith effort to address competitive concerns raised by the underlying transaction; (2) must be reasonably certain to occur; and (3) must be disclosed within a time frame that allows for agency review. As long as these standards are met, the structural form of the fix is immaterial.

**First Requirement: Good Faith Effort.** The first requirement—that the parties have acted in good faith by proposing a remedy that addresses the competitive concerns raised by the original transaction—has its genesis in the *Libbey* decision. The *Libbey* court suggested that it would be unlikely to consider a proposed remedy where the parties had intentionally attempted to avoid agency or judicial review.<sup>8</sup> This could occur, for example, where the parties had continually altered the proposed remedy. Otherwise, courts look favorably on merging parties’ efforts to cure possible anticompetitive effects.<sup>9</sup>

**Second Requirement: Reasonable Likelihood.** The second requirement is that the proposed remedy must be reasonably certain to occur. Courts have not been receptive to speculative claims that the parties will simply abandon or modify proposed fixes once the court approves the merger.<sup>10</sup> Nevertheless, each party to a divestiture should be prepared to offer evidence of its intent to consummate the remedy.

For example, in *Arch Coal*, the court noted, in a pretrial ruling, the need for “some factual development as to the nature and firmness . . . of the agreement and the commitment involved” before

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<sup>6</sup> *United States v. Atl. Richfield Co.*, 297 F. Supp. 1061, 1069 (S.D.N.Y. 1969). In that case, two large integrated oil companies, Sinclair Oil Company and Atlantic Richfield Company, sought to merge. After the merger agreement had been executed, Atlantic entered into an agreement with BP Exploration U.S.A., Inc., under which BP agreed to purchase Sinclair properties in the Northeastern United States on the first day of the month following the completion of the merger. The DOJ filed suit alleging that the merger would substantially reduce competition in the marketing of gasoline in four geographic markets, including the Northeastern states. The court found that the proposed fix was sufficient to mitigate any competitive harm in the Northeast gasoline market but enjoined the merger based on potential anticompetitive harm in the southeast gasoline market.

<sup>7</sup> *United States v. Connecticut Nat’l Bank*, 362 F. Supp. 240, 283 (D. Conn. 1973). In that case, the court allowed evidence of the proposed divestiture of six bank branches in a DOJ challenge to a merger of two national banks. The parties had already contracted to sell three of the branches, as was required under their merger agreement. The defendants “assured” the court that they would sell three other branches within a year of the merger closing. The Court allowed the merger to proceed, conditioned on the three “binding” divestitures and the three proposed sales.

<sup>8</sup> *Libbey*, 211 F. Supp. at 46 n.27.

<sup>9</sup> See, e.g., *Libbey*, 211 F. Supp. 2d at 46 n.27 (“[A] good faith effort to address the FTC’s concerns regarding the agreement . . . is consistent with the policies underlying Section 7.”); *Arch Coal*, Mem. Op. at 7 (noting that the divestiture agreement “was proposed as a good faith response to the Commission’s investigation and concerns regarding the competitive effects of the Arch-Triton merger”).

<sup>10</sup> See, e.g., *Atlantic Richfield*, 297 F. Supp. at 1068 (“The record does not lend the slightest support to such a speculation”).

ruling on the admissibility of the divestiture agreement.<sup>11</sup> Immediately after the close of evidence, the court handed down a decision rejecting the FTC's motion to preclude all evidence and argument on Arch's proposed divestiture. The court relied on the testimony of senior officers of the two acquiring companies to conclude that the divestiture "transaction will in fact occur as agreed if the Arch-Triton merger goes forward."<sup>12</sup> The court dismissed the "theoretical" risk that the parties might abandon or restructure the divestiture.

**Third Requirement: Sufficient Notice.** The third requirement—that the enforcement agency is given sufficient notice of the proposed remedy to give it the opportunity for meaningful review—does not mean that merging parties must offer remedy proposals during the merger investigation. The *Libbey* court, for example, entertained a proposed fix one week into the litigation. Likewise, the *Franklin Electric* court considered a licensing agreement signed a few weeks after the Department of Justice filed its complaint, as well as an amended merger agreement executed the day before the DOJ filed its complaint.<sup>13</sup>

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The notice requirement may be more stringent in cases brought by the FTC. Early in the litigation, the *Libbey* court, for example, expressed concern that the proposed fix had not been brought to the attention of or subject to a vote by the Commission. (No such requirement applies to the DOJ.) Only after the Commission issued a statement that it rejected the proposed fix was the court willing to consider the parties' remedy. The *Arch Coal* court, citing *Libbey*, placed particular emphasis on the fact that the Commissioners themselves had the opportunity to and in fact did review the proposed remedy. Similar concerns have not been present in cases brought by the Antitrust Division.

The point at which it is too late for a court to consider a proposed remedy necessarily will depend on the court's scheduling order, particularly the deadline for discovery and expert reports. Accordingly, practitioners should inform the FTC or DOJ of the likelihood of a self-help remedy as early as possible to avoid a charge of bad faith and to avoid a claim that the agency lacked sufficient time to develop a record regarding the fix. Likewise, enforcement officials should be prepared to alter their litigation strategy based on modifications to the transaction structure, rather than assume the court will only consider the original transaction.

**Form of the Remedy Not a Factor.** The form of the remedy has not been a subject of concern to the courts. In *Arch Coal*, *Connecticut Bank*, and *Atlantic Richfield*, the merging parties executed agreements with third parties to divest overlapping assets. In *Franklin Electric*, the parties signed a technology license and supply agreements with a new competitor. And in *Libbey*, the parties revised their acquisition agreement to allow the target company to retain certain assets. As the *Arch Coal* court found, "the Court does not find [the] structural choice to be dispositive."<sup>14</sup>

An issue that has not yet been litigated, however, is whether an acceptable fix-it-first solution could be based on self-imposed conduct restrictions, such as firewalls or non-discrimination commitments. Courts are likely to be far more skeptical of conduct restrictions because they take place over a longer period of time than structural fixes and are easier to circumvent. Accordingly,

<sup>11</sup> *FTC v. Arch Coal, Inc.*, No. 04-0534 (JDB), Pretrial Hr'g Tr. at 7 (June 15, 2004).

<sup>12</sup> *Arch Coal*, Mem. Op. at 7.

<sup>13</sup> The district court in *Dairy Farmers* considered a revised merger agreement 15 months into the litigation and at the end of the discovery period, suggesting that a similar notice requirement does not apply in the consummated merger context.

<sup>14</sup> *Arch Coal*, Mem. Op. at 4. The same is likely to be true in the consummated merger context. In *Dairy Farmers*, the acquiring party converted its ownership interest from voting securities to a non-voting preferred stock.

merging parties should avoid fixes based on self-imposed conduct restrictions if a structural fix is available.

**No Deference Given to Either Side.** Likewise, courts are unlikely to give either the enforcement agencies or private parties any special deference in assessing proposed fixes. In *Libbey*, each side argued that it was entitled to deference. The FTC argued that it had unique experience assessing and crafting remedies, while the companies contended that they had a unique business perspective. The *Libbey* court appropriately rejected both arguments.

**Disagreement as to Burden of Proof.** Although the courts are consistent in their standards for admitting evidence of a proposed fix, there is some disagreement as to how this evidence affects the overall burden of proof under Section 7. The majority view, as exemplified by *Arch Coal*, *Libbey*, *Atlantic Richfield*, and *Connecticut National Bank*, is that the government bears the burden of showing that the entire transaction—the original transaction and the proposed fix—will result in a substantial lessening of competition.<sup>15</sup> In these cases, the court viewed the fix not as an affirmative defense to the transaction but as part of the transaction itself. The minority view, followed by the *Franklin Electric* court, holds that the burden of proof is squarely on the merging parties to show that the proposed fix remedies the competitive harm. As that court put it, “defendants have the burden of proving their contention that that because of the proposed [fix] the number of competitors will not change.”<sup>16</sup>

In a recent article, former FTC Bureau of Competition Deputy Director D. Bruce Hoffman urges courts to follow an approach similar to that used by the *Franklin Electric* court.<sup>17</sup> Under his proposal, “if the Commission or the DOJ can show that the original transaction likely will have anti-competitive effects, the burden would shift to the merging parties to show that their proposed relief would fully cure those effects and restore premerger competition.”<sup>18</sup> This burden-shifting approach is needed, in his view, because of the “potential for gaming the HSR system” and the agencies’ need to conduct a thorough investigation.

The concerns appear to be unwarranted. Hoffman points to no instances where parties have sought to “game the system,” and in any event, such conduct would likely lead to the fix being held inadmissible.<sup>19</sup> As Hoffman recognizes, his second concern can be largely, if not entirely, addressed through pre-trial discovery. In addition, the agencies can issue compulsory process related to the proposed fix, as was done in *Arch Coal*.<sup>20</sup>

Hoffman’s approach also suffers from three problems. The first and most significant is that it dramatically alters the framework of Section 7 analysis. Instead of the “substantial lessening of

<sup>15</sup> Although the *Libbey* and *Atlantic Richfield* courts do not explicitly discuss the burden of proof for proposed fixes, both decisions evaluate the proposed fixes as part of the government’s prima facie case, which suggests that the burden rests with the government. See *Libbey*, 211 F. Supp. 2d at 47–50; *Atlantic Richfield*, 297 F. Supp. at 1067–69.

<sup>16</sup> *Franklin Elec.*, 130 F. Supp. 2d at 1033; see also *id.* at 1026 (“I conclude that defendants have failed to show that there will be no change in the competitive picture if the joint venture is consummated . . .”). In a pre-trial ruling, the court indicated that it would examine whether “the evidence of defendants’ proposed post-merger licensing will be [sufficient to show that it will negate any adverse effects of the merger upon the submersible turbine market.” *United States v. Franklin Elec. Co.*, No. 00-C-0334-C, Order at 2 (W.D. Wis. July 19, 2000). In neither instance did the court cite any authority for its standard.

<sup>17</sup> D. Bruce Hoffman, *Remedial Self-Help in Merger Litigation After Arch Coal*, ANTITRUST, Spring 2005, at 32, 35; see also Jaret Seiberg, *Healing and Dealing*, THE DEAL (Nov. 29, 2004) (paraphrasing Hoffman) (“A company should have the burden of showing that its proposed remedy is adequate to resolve competitive worries about the deal . . .”).

<sup>18</sup> Hoffman, *supra* note 17, at 35.

<sup>19</sup> See *Libbey*, 211 F. Supp. at 46 n.27 (suggesting that it would not consider a fix resulting from an effort “to avoid judicial and FTC review”).

<sup>20</sup> See generally 15 U.S.C. § 57b-1 (FTC civil investigative demand statute); 15 U.S.C. § 1312 (DOJ civil investigative demand statute).

competition” standard in Section 7, transactions involving fix-it-first efforts effectively would be governed by an “any lessening of competition” standard. This is because under Hoffman’s approach, the proposed fix must “fully cure” the competitive concerns and “restore premerger competition.” This is not the approach envisioned by Section 7, which permits acquisitions that reduce competition to the point where they cause a “substantial lessening of competition.”

The second (and related) problem is the use of a remedy standard to determine the merits of a transaction.<sup>21</sup> The “fully cure” and “restore premerger competition” requirements are consistent with the standards used by the agencies to evaluate proposed consent decrees.<sup>22</sup> In other words, these standards are used only *after* there has been a determination that the underlying transaction violates Section 7. Hoffman would use these standards as the means of determining whether there is a Section 7 violation. This approach will only add confusion to what are now distinct and longstanding standards.

The third problem with placing the burden on the merging parties to show that their proposed relief rebuts the government’s case is that this will discourage the use of fix-it-first remedies. Merging parties that might otherwise resort to a fix-it-first remedy might be discouraged by the greater difficulty and cost of securing a remedy that completely eliminates the competitive harm.

The policy implications of discouraging fix-it-first remedies are significant and negative. In some transactions, use of a fix-it-first remedy may be the parties’ only realistic option other than abandoning the transaction. This is because fix-it-first remedies offer a number of benefits relative to consent decrees, including speed and reduced risk of a fire sale of the divested assets. The Antitrust Division has described how the government also benefits from use of fix-it-first remedies when those remedies eliminate competitive harm otherwise arising from mergers, although the FTC may have a different view:<sup>23</sup>

Indeed, in certain circumstances, a fix-it-first remedy may restore competition to the market more quickly and effectively than would a decree. This would be particularly important, for example, where a rapid divestiture would prevent asset dissipation or ensure the resolution of competitive concerns before an upcoming bid . . . . A fix-it-first remedy restores premerger competition, removes the need for litigation, allows the Division to use its resources more efficiently, and saves society from incurring real costs. Moreover, a fix-it-first remedy may provide more flexibility in fashioning the appropriate divestiture. Because different purchasers may require different sets of assets to be competitive, a fix-it-first remedy allows the assets to be tailored to a specific proposed purchaser. A consent decree, in contrast, must identify all of the assets necessary for effective competition by any potentially acceptable purchaser.

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<sup>21</sup> The better analogy may be to the *General Dynamics* defense, under which merging parties introduce evidence to rebut the government’s prima facie case and the government must then produce additional evidence of anticompetitive effect. *United States v. Gen. Dynamics Corp.*, 415 U.S. 486 (1974). The ultimate burden of persuasion always rests with the government. *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 714–15 (D.C. Cir. 2001). A proposed fix that satisfies the three prong test is conceptually no different from a traditional *General Dynamics* defense and should follow a similar burden shifting analysis.

<sup>22</sup> See Frequently Asked Questions About Merger Consent Order Provisions, <http://www.ftc.gov/bc/mergerfaq.htm>; Statement of the Federal Trade Commission’s Bureau of Competition on Negotiating Merger Remedies, available at <http://www.ftc.gov/bc/bestpractices/bestpractices030401.htm>; U.S. DEP’T OF JUSTICE, ANTITRUST DIVISION POLICY GUIDE TO MERGER REMEDIES § II (Oct. 2004), <http://www.usdoj.gov/atr/public/guidelines/205108.htm> [hereinafter ANTITRUST DIVISION REMEDIES GUIDE].

<sup>23</sup> ANTITRUST DIVISION REMEDIES GUIDE § IV.A.; see also *Libbey*, 211 F. Supp. 2d at 46 n.27 (good faith use of a fix-it-first remedy “is consistent with the policies underlying Section 7”). The FTC “has no formal fix-it-first policy—preferring instead to have an order binding the parties.” See Deborah Platt Majoras, Chairman, FTC, Looking Forward: Merger and Other Policy Initiatives at the FTC, Remarks Before the ABA Antitrust Section Fall Forum (Nov. 18, 2004), available at <http://www.ftc.gov/speeches/majoras/041118abafallforum.pdf>.

### Standards for Litigating the Fix in Consummated Mergers

Until recently, there were no reported cases involving a government challenge to a consummated merger where the parties employed a fix-it-first remedy. *United States v. Dairy Farmers of America, Inc.*, is the only modern case to address this issue.<sup>24</sup> In that case, the Sixth Circuit held that the government has the ability to contest the original agreement, the modified agreement, or both. In so doing, the court applied a different standard than generally applied in the non-consummated merger context. In the post-consummation setting, only if the merged entity can prove that it will not resort to its original agreement can it moot a challenge to the original merger agreement. The defendant in *Dairy Farmers* was unable to make such a showing.

Dairy Farmers of America, a Kansas milk marketing organization, had acquired a 50 percent interest in Southern Belle Dairy Co., which owned a milk processing plant in Kentucky. A little over a year later, on April 24, 2003, the DOJ and the State of Kentucky brought an action under Section 7 of the Clayton Act alleging that the acquisition threatened to diminish competition in school milk markets in Kentucky and Tennessee as a result of DFA's existing ownership interest in National Dairy Holding, a competing Kentucky dairy.

On July 20, 2004, at the close of discovery, defendants moved for summary judgment, simultaneously filing a document modifying the agreement that governed the relationship between DFA and Southern Belle. Effective July 14, 2004, DFA would exchange its voting interests in Southern Belle for non-voting preferred interests.<sup>25</sup> As a result, DFA lost its right to vote on or veto any procurement or other decisions of Southern Belle, and the other owner's put option was rescinded.

Relying on the revised corporate structure, the district court held that plaintiffs had failed to raise a triable issue of material fact as to a violation of Section 7, granted the defendants' motions, and entered judgment for the defendants.<sup>26</sup> As the court explained, "because DFA is not involved in the day-to-day operations of either Southern Belle or NDH, this court finds that the incentives and opportunities for collusion are not substantially greater than they were prior to this challenged acquisition."<sup>27</sup>

The DOJ appealed the decision to the Sixth Circuit, contending that the district court had failed to consider whether DFA had violated the Clayton Act up to the time that Southern Belle's principals restructured their ownership structure. The government also argued that even under the modified ownership structure, there was a triable issue of fact as to the anticompetitive potential of the acquisition. The government's brief was noteworthy in that it did not contest the admissibility of the modified capital agreement.

The Sixth Circuit reversed and reinstated the action, finding that DFA had the burden of demonstrating that the government's claim against the original agreement was moot. The court observed that, under Supreme Court precedent, "a defendant's voluntary cessation of a challenged practice does not deprive a federal court of its power to determine the legality of the practice, unless subsequent events made it absolutely clear that the allegedly wrongful behavior could not rea-

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<sup>24</sup> 2004-2 Trade Cas. (CCH) ¶ 74,537 (E.D. Ky. Aug. 31, 2004), available at 2004 WL 2186215, rev'd 426 F.3d 850 (6th Cir. 2005).

<sup>25</sup> In early 2004, the operating agreement for NDH was restructured to ensure that NDH was operated and controlled solely by its other owner. However, DFA retained veto power over major capital expenditures and the dissolution, sale, or merger of NDH.

<sup>26</sup> The court did not expressly rule on the government's request for discovery related to the modified agreement pursuant to Federal Rule of Civil Procedure 56(f) or the government's motion to exclude evidence related to the modified agreement.

<sup>27</sup> *Dairy Farmers*, 2004 WL 2186215, at \*8.

sonably be expected to recur.”<sup>28</sup> A defendant bears a “heavy burden” to show that it will not revert to its original merger agreement.<sup>29</sup>

The Sixth Circuit held that the government’s challenge to the original agreement was not mooted because DFA presented no evidence that it would not revert to its original agreement. The Sixth Circuit also reversed the district court’s dismissal of the government’s case against the modified capital agreement, finding that there were genuine issues of material fact with respect to whether DFA had control or influence over Southern Belle. As a result, the government could challenge both the original and the revised agreement on remand.

The result in *Dairy Farmers* is essentially opposite to results in the unconsummated merger cases, in which the government typically will only be able to challenge the revised acquisition structure. This apparent inconsistency between *Dairy Farmers* and the line of cases involving unconsummated mergers can be easily reconciled, however. As the *Dairy Farmers* court points out, its holding is premised on the fact that the challenged practice had already occurred.<sup>30</sup> In unconsummated mergers, the transaction, by definition, has not yet been completed, leaving the court to speculate about the future if the transaction proceeds.

A question left unanswered by the *Dairy Farmers* decision is what evidence might satisfy the “heavy burden” standard of showing that the parties would not revert to the original merger agreement. Sworn testimony of the merging parties, although sufficient in the nonconsummated merger cases, is probably not enough to meet this test.<sup>31</sup> Additional evidence that might be enough to satisfy the *Dairy Farmers* test includes the adoption of a board resolution prohibiting the reversion to the original agreement or the repurchase of the divested assets, the amendment of senior management’s employment contracts to the same effect, the institution of a compliance program, and the formalized tasking of the company’s legal department with oversight.

## Conclusion

Evidence of a proposed fix is likely to be admitted in federal court litigation, with the enforcement agencies, and not the merging parties, likely bearing the burden of proof with regard to the proposed fix, i.e., to show that the entire transaction including the fix will lead to a substantial lessening of competition. This is particularly relevant to the development of expert reports. For example, in the *Libbey* case, the FTC’s expert witness only calculated concentration statistics for the original transaction. And in *Arch Coal*, despite knowledge of the parties’ fix-it-first remedy for months before litigation commenced, the FTC’s economic expert focused virtually all of his analysis on the original transaction, although he noted that his analysis would remain the same if the divestiture were considered.

The willingness of the courts to entertain self-help remedies, combined with *Arch Coal*’s recent victory through use of such a remedy, may encourage more merging parties to consider fix-it-first strategies when faced with agency disapproval in the HSR process. The recent revisions to the

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<sup>28</sup> *Dairy Farmers*, 426 F.3d at 857 (quoting *Friends of the Earth, Inc. v. Laidlaw Env’tl Serv. (TOC), Inc.*, 528 U.S. 167, 189 (2000)).

<sup>29</sup> *Id.*

<sup>30</sup> See *Dairy Farmers*, 426 F.3d at 857.

<sup>31</sup> Cf. *Kidder, Peabody & Co. v. Maxus Energy Corp.*, 925 F.2d 556, 563 (2d Cir. 1991) (non-binding representation by defendant that it would not repeat the conduct at issue did not render lawsuit moot). But see *United States v. San Diego County Veterinary Med. Ass’n*, 1976-2 Trade Cas. (CCH) ¶ 61,131 (S.D. Cal. 1976) (industry association’s representation to court and public announcement to refrain from future dissemination of fee schedule sufficient to moot government antitrust action).



Tunney Act, which require more rigorous district court review of proposed DOJ consent decrees, may also encourage merging parties to employ self-help remedies in DOJ investigations, rather than face the risk of a lengthy or unfavorable *Tunney* proceeding.<sup>32</sup> The recently issued *Antitrust Division Policy Guide to Merger Remedies*, which supports the use of fix-it-first remedies under certain circumstances, may serve as an added incentive in cases under review by the Antitrust Division.<sup>33</sup>

On the other hand, as the *Dairy Farmers* case illustrates, fix-it-first strategies have considerably less appeal in the context of consummated mergers. Even if a restructured deal does not independently violate Section 7, the original transaction may still be challenged. If the original transaction were found to violate the antitrust laws, a court-fashioned remedy could well go beyond the fix. ●

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<sup>32</sup> Antitrust Criminal Penalty Enhancement and Reform Act of 2004, 108 Pub. L. No. 237, 118 Stat. 668 (2004) (codified at 15 U.S.C. § 16).

<sup>33</sup> U.S. Dep't of Justice, Antitrust Division Policy Guide to Merger Remedies (Oct. 2004), available at <http://www.usdoj.gov/atr/public/guidelines/205108.htm>. The FTC has a less favorable a view toward fix-it-first remedies. See *supra* note 23.

## Bugs in the Boardroom? Congress Is Poised to Allow Wiretapping in Federal Antitrust Investigations

**Mark A. Racanelli**

On October 25, 2005, the U.S. Senate passed a bill which, if made law, has the potential to significantly change the way that federal antitrust cases are investigated and prosecuted. The bill—entitled the Antitrust Criminal Investigative Improvements Act of 2005<sup>1</sup>—proposes that the Antitrust Division of the Department of Justice be given the power to initiate wiretaps and other electronic surveillance to investigate the involvement of business executives in federal antitrust crimes. Originally co-sponsored in the Senate by Senators Michael DeWine (R-Ohio), Patrick Leahy (D-Vermont), and Herbert Kohl (D-Wisconsin), after passage in the Senate,<sup>2</sup> the bill was referred to the House of Representatives,<sup>3</sup> where it now awaits passage as part of the proposed amended Patriot Act.<sup>4</sup>

This measure is the latest in a series of steps by legislators and enforcers to strengthen the government's hand in criminal antitrust cases. Last year, Congress amended the penalty provisions of the Sherman Act, increasing the maximum term of imprisonment for an antitrust violation from three to ten years, the maximum fine for corporations from \$10 million to \$100 million and the maximum fine for individuals from \$350,000 to \$1 million.<sup>5</sup> And on November 1, 2005, the U.S. Sentencing Commission—following a recommendation by the Antitrust Division—amended the federal Sentencing Guidelines to boost the recommended jail terms and fines for convicted antitrust violators.<sup>6</sup>

Broadening the scope of the wiretap laws marks a further expansion of the power of antitrust prosecutors. Until now, antitrust offenses have not been included among the types of crimes that give prosecutors the authority to initiate wiretaps and bugs. That authority typically has been exercised by prosecutors of organized crime, racketeering, terrorism, and narcotics offenses. This new law would give prosecutors with the Antitrust Division the same power, opening the door to the appearance in antitrust investigations of bugs in boardrooms and taps on the phones of corporate executives, no matter how senior.

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<sup>1</sup> S. 443, 109th Cong., 1st Sess. §§ 1, 2 (2005).

<sup>2</sup> 250 Cong. Rec. S11,850 (daily ed. Oct. 25, 2005) (Statements of Senators DeWine and Leahy).

<sup>3</sup> 250 Cong. Rec. H9273 (daily ed. Oct. 26, 2005).

<sup>4</sup> The Patriot Act was extended without amendment until June 2006. As of the publication date of this article, the Antitrust Wiretapping Bill awaits the Senate's consideration of broader changes to the Patriot Act.

<sup>5</sup> Antitrust Criminal Penalty Enforcement and Reform Act of 2004, Pub. L. No. 108-237, 118 Stat. 665 (amending 15 U.S.C. §§ 1-3, 16).

<sup>6</sup> U.S. SENTENCING GUIDELINES MANUAL § 2R1.1 (2005). See also Scott D. Hammond, Deputy Assistant Attorney General for Criminal Enforcement, Antitrust Division, Testimony Before the U.S. Sentencing Commission Concerning Proposed 2005 Amendments to Section 2R1.1 (Apr. 12, 2005), available at <http://www.usdoj.gov/atr/public/testimony/209071.htm>. Notably, the maximum sentence recommended under the new Guidelines for the most serious antitrust offense (i.e., those involving the largest dollar volume of affected commerce) more than tripled the previous maximum under the old Guidelines. The new maximum sentencing range is 78-97 months' imprisonment; the previous maximum range was 24-30 months.

### The Existing Wiretap Law and the Proposed Amendment

The law that gives the Department of Justice the authority to use electronic surveillance is Title 18, United States Code, Sections 2510 et seq. If the federal government is investigating certain crimes specified in the statute (“predicate crimes”),<sup>7</sup> and if it can demonstrate probable cause to believe that a suspect is using a location or device to communicate about such crimes, it may make an application to a U.S. district court for an order authorizing electronic surveillance of that location or device.<sup>8</sup>

The application for the electronic surveillance, which is made under oath, must, among other things: (1) identify the law enforcement officer making the application (typically a federal agent) and the officer approving the application (usually a prosecutor); (2) provide a “full and complete statement” outlining (a) the nature of the offense, (b) the device or location that will be “intercepted” (that is, wiretapped or bugged), and (c) the nature of the conversations and the identity of the people to be intercepted; and (3) explain all other investigative procedures, short of a wiretap or bug, that have failed to yield results, that are too dangerous, or that are not reasonably likely to succeed.<sup>9</sup>

If granted, the court’s order remains in effect for a 30-day period, which can be extended if the government demonstrates that the criminal activity is ongoing and the surveillance is bearing fruit (or there is a reasonable explanation for any failure to make progress).<sup>10</sup> There is no restriction on the government’s ability to listen to intercepted communications as long as they are relevant to the investigation and not privileged. Investigators can make decisions about which conversations to record as the conversations are occurring, without having to go back to the court for approval. And the surveillance can take many forms: wiretaps on telephones, cellphones, and fax lines, hidden video cameras and audio bugs in homes, cars, or offices, and even the interception of data over the Internet.

There are scores of predicate crimes listed in the statute, and Congress has amended the law over the years to include more and more such crimes. The timing and sequence of these amendments reflect the sweep of societal concern about certain types of crimes from decade to decade, beginning with a focus on organized crime, then moving to include crimes associated with drug cartels, violent gangs, and, most recently, terrorism.<sup>11</sup> While certain white-collar crimes are included as predicates—including mail, wire, and bank fraud—prosecutors, as a practical matter, have rarely relied on wiretaps to investigate these types of crimes.

Logically, wiretaps have most often been used—and are most effective—where the government suspects ongoing criminal activity by members of tight-knit conspiracies that are difficult to investigate because of the surrounding secrecy fostered by the loyalty of the participants. Many—including the Senators who sponsored the new antitrust wiretap bill, as described below—would argue that antitrust cartels share these characteristics.

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<sup>7</sup> 18 U.S.C. § 2516(1).

<sup>8</sup> 18 U.S.C. §§ 2516, 2518.

<sup>9</sup> 18 U.S.C. §§ 2518(1)(a)–(f). To fulfill the last requirement, the application might, for instance, explain why physical surveillance of a target alone, while showing whom he or she meets with and when, will not allow law enforcement to capture any ongoing criminal conversations. The application might explain how the introduction of an undercover agent or a confidential informant would be impractical and could prove dangerous to the success of the investigation since the cartel at issue is closely knit and none of the targets would trust someone new.

<sup>10</sup> 18 U.S.C. § 2518(5).

<sup>11</sup> 18 U.S.C. §§ 2516(1)(b), (c) (e), (n), (p), and (q).

Yet antitrust crimes have not, to date, been listed among the predicate offenses that allow for the use of wiretaps and bugs.<sup>12</sup> The legislation the Senate has passed would change that by including any violation of Sections 1 or 2 of the Sherman Act as predicate offenses that could trigger the initiation of a wiretap or bug. Antitrust prosecutors, therefore, will clearly be vested with all the power permitted under the federal wiretapping laws when investigating any antitrust violation should this bill become law.

### What the Senate Was Thinking

The legislative history of the bill is not rich. Originally approved by the Senate Judiciary Committee on October 20, 2005, the full Senate passed the bill just five days later with no objection and, indeed, not even a recorded vote. The most extensive commentary—which consists of fewer than ten pages—came from the bill’s three sponsors, Senators Kohl, Leahy, and DeWine.<sup>13</sup>

All three Senators voiced their concern about the seriousness of antitrust offenses and their belief that prosecutors with the Antitrust Division have, until now, been denied a weapon given to prosecutors of such white-collar crimes as mail and wire fraud. None of the Senators, however, took note of the fact that wiretaps are rarely used to investigate these types of white collar crimes, and that there are other, significant white collar offenses—such as securities fraud—that are also not included as predicate offenses.<sup>14</sup>

What is notable is that some of the Senators’ comments indicate their view that antitrust crimes are different from some other types of white collar offenses and therefore require special law enforcement measures. Senator Kohl noted that antitrust cartels, because of their “secret nature” as “agreement[s] among competitors,” are “likely *harder* to detect than a fraudulent offering over the phone or through the mail. A properly issued wiretap, therefore, is even more necessary to detect criminal antitrust conspiracies than other white collar offenses.”<sup>15</sup> Similarly, Senator DeWine explained that the type of evidence that antitrust prosecutors must gather—relating to the workings of a criminal *conspiracy*—“is very difficult to gain without penetrating the inner workings of a conspiracy in action. . . . Without the ability to obtain wiretaps, the Antitrust Division unnecessarily faces a much heavier burden in detecting and preventing these conspiracies.”<sup>16</sup>

*Antitrust crimes have not, to date, been listed among the predicate offenses that allow for the use of wiretaps and bugs. The legislation the Senate has passed would change that by including any violation of Sections 1 or 2 of the Sherman Act as predicate offenses that could trigger the initiation of a wiretap or bug.*

<sup>12</sup> Antitrust prosecutors have sometimes argued that bid-rigging and other antitrust offenses involve “fraud” in order to take advantage of even stiffer possible sentences for fraudulent conduct under the U.S. Sentencing Guidelines. *See, e.g.,* United States v. Anderson, 326 F.3d 1319, 1331–32 (11th Cir. 2003) (court in bid-rigging case applied, at government’s urging, fraud guideline—resulting in longer sentence—as opposed to substantive antitrust guideline; court noted that fraud guideline was appropriately applied, even though government did not charge defendant substantively with fraud violation, because “the purpose of the bid rigging was to defraud the Government . . . Bid rigging was merely a means to” commit fraud). The Division has also taken the position that antitrust crimes involve fraud when seeking to extradite individuals from countries that do not recognize antitrust violations—but do recognize fraud—as criminal in nature. *See, e.g.,* Scott D. Hammond, An Update of the Antitrust Division’s Criminal Enforcement Program, Remarks Before the ABA Antitrust Section (Nov. 16, 2005), available at <http://www.usdoj.gov/atr/public/speeches/213247.htm> (citing the ruling by a British court that Ian Norris, former Chairman and CEO of Morgan Crucible, was extraditable on U.S. price-fixing charge, even though at that time price fixing was not a criminal act in Great Britain, because price-fixing “would constitute the UK offense of conspiracy to defraud.”). The position that antitrust crimes involve fraud would, theoretically, have permitted the use of wiretaps even under existing law, but to this point there is no reported instance of the Antitrust Division using wiretaps on other electronic surveillance unless there was a consensual recording.

<sup>13</sup> 250 Cong. Rec. S11850 (daily ed. Oct. 25, 2005, statements of Senators Kohl and Leahy); 250 Cong. Rec. S11914 (daily. ed. Oct. 26, 2005, statement of Senator DeWine).

<sup>14</sup> Nor does there appear to have been any substantial push from the Department of Justice to obtain this authority in antitrust cases; the legislative history does not reveal any position papers from the government in support of the legislation.

<sup>15</sup> 250 Cong. Rec. S11850 (emphasis added).

<sup>16</sup> 250 Cong. Rec. S11914.

The Senate's decision to give the Antitrust Division this new power, then, can be said to arise from the view that, almost alone among white collar crimes, antitrust cartels involve ongoing conduct that is highly and frequently coordinated between disciplined co-conspirators, and that thrives in secrecy. Not surprisingly, these are the same features that led Congress to include the predicate crimes—such as racketeering, narcotics and terrorism offenses—currently listed in the statute. It should be noted, however, that the proposed wiretap authority is not limited to price fixing, market division, or other cartel behavior prohibited by Section 1 of the Sherman Act, but also extends to Section 2 violations.

### Expansion of the Division's Surveillance Powers

With the passage of this bill, the Division's ability to conduct electronic surveillance will be significantly expanded. Previously, the Division's practice was to monitor phone calls or bug meetings only where a party to those communications—typically an undercover agent or an informant present for the conversation—*consented* to the recording.<sup>17</sup> In a highly publicized example, the Division relied on consensual recordings in its investigation of Archer Daniels Midland (ADM). The ADM case, which unfolded in the 1990s, involved a conspiracy between executives at the highest levels of ADM and their counterparts at foreign corporations to fix prices in the market for lysine, a commercial feed additive.<sup>18</sup> The government had access to a cooperator who was a high-ranking executive at ADM, and who consented to the Division's recording and videotaping of devastatingly explicit conversations that he had with other ADM officials and with competitors about lysine price fixing.

Requiring the prior consent of a participant to a conversation, however, placed real limits on the Division. For instance, if the cooperator left a meeting that was under surveillance, the recording had to stop. If the cooperator did not have personal access to certain targets, it became more difficult to record those targets. And if a problem developed with the cooperator that made him or her unusable in an investigation—as was the case in ADM, where the cooperator was later found to be secretly embezzling from the company—the Division was in danger of losing its ability to conduct electronic surveillance entirely.

This new legislation would lift these restrictions, allowing the Division to tap phones and bug locations regardless of whether anyone consents to the recording.

### The Division's Likely Use of Its New Wiretap Powers

If we take as a guide the way that mob, drug cartel, and violent gang prosecutors traditionally have used wiretaps and bugs in their investigations, how can the antitrust prosecutors be expected to exercise new wiretap powers?

As an initial matter, antitrust prosecutors will still need the help of cooperating witnesses before they will have sufficient evidence to apply for a wiretap or other electronic surveillance. Cooperating witnesses are typically former members of a criminal conspiracy who have decided to assist the government in exchange for leniency. In antitrust cases, cooperators are often employees who have either obtained leniency individually from the Antitrust Division or who work for a company that has obtained it. The Division's leniency program allows individuals and cor-

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<sup>17</sup> 18 U.S.C. § 2511(2)(c).

<sup>18</sup> Scott Hammond, *The Fly on the Wall Has Been Bugged—Catching an International Cartel in the Act*, Address Before The Jurys Ballsbridge Hotel, Dublin, Ireland (May 15, 2001), available at <http://www.usdoj.gov/atr/public/speeches/8280.htm>.

porations who believe they have criminal exposure arising from their participation in an unlawful trade agreement to receive complete immunity from criminal liability if they, among other things, provide truthful information about the conspiracy.<sup>19</sup>

Once the necessary probable cause is shown, the two most critical pieces of information that a cooperator can provide to assist a wiretap or electronic surveillance investigation are: (1) the phone numbers for phones that co-conspirators used to communicate with the cooperator about the conspiracy; and (2) the precise locations where the cooperator met, or is planning to meet, with co-conspirators to discuss the conspiracy. Armed with that information, prosecutors can cast a wide net of electronic surveillance.

For example, one might imagine that, in a price-fixing investigation, the government's cooperator could be a salesperson who swapped future pricing information with counterparts at a competitor. If those discussions took place over the phone, the government might have probable cause to place a wiretap on any phones that the salesperson's counterparts used to discuss the anticompetitive activity. Those calls could reveal that these salespeople are talking to still others—people whom the cooperator may not even know—about the crime. For instance, the salespeople might be exchanging pricing information with additional competitors or they may be reporting their activities to higher-ranking executives within their own companies. Based on those calls, the government could have a basis to seek to tap the phones of all these other parties to see what they are discussing, and with whom. In this way, the wiretaps can grow almost exponentially.

The surveillance web can grow just as quickly if the government seeks to install a hidden audio or video bug. The cooperator might have had a set location for past meetings with his or her competitors to discuss the conspiracy—an office, boardroom, car, hotel room, or a room in someone's home. Or the cooperator might have information about a future meeting among the competitors that will take place. That information may be enough for the government to seek to place a bug at the meeting spots.

With an authorization order from the court in hand, antitrust prosecutors would then be able to intercept all of these communications regardless of whether other, legitimate business—or even personal matters—are being discussed. Moreover, the government would be permitted to use evidence reaped from a wiretap even if it is relevant to a *different* crime than the crime for which the prosecutors had probable cause to begin intercepting.<sup>20</sup> If the government initiates a wiretap believing that the conspirators are discussing price fixing, for instance, but the recordings indicate that, in reality, they are conspiring to monopolize a market, the interceptions can (and likely will) still continue. While it is unlikely that the Division will bring a criminal monopolization case, that evidence can still be used in any civil case that the government decides to file.

### What Lawyers Will Have to Know

An Antitrust Division armed with these new powers will mean that antitrust counselors alerted to a client's involvement in an antitrust investigation should assume that the Division has recorded incriminating conversations of some type, whether through a phone tap or a bug. Unfortunately, prosecutors are under no obligation to reveal the existence of these recordings until after crimi-

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<sup>19</sup> U.S. Dep't of Justice, Corporate Leniency Policy (1993); U.S. Dep't of Justice, Individual Leniency Policy (1994). *See also* Scott D. Hammond, Cornerstones of an Effective Leniency Program, Address Before the ICN Workshop on Leniency Programs (Nov. 22–23, 2004), available at <http://www.usdoj.gov/atr/public/speeches/206611.htm>.

<sup>20</sup> 18 U.S.C. § 2517(5).

nal charges are filed. For lawyers advising a company about possible criminal exposure before anyone is charged, therefore, it is of utmost importance to identify the likely targets of any electronic surveillance by the Division through an internal investigation geared towards locating anyone in the company who might have had suspect communications with competitors.

If the internal investigation reveals any such individuals, attorneys should take several steps immediately. First, the targets should be debriefed to determine exactly what they did and said to advance any anticompetitive conduct. Anyone—either inside the company or at competitors—to whom those people communicated about the conduct should be identified. If the targets used a work phone to talk about these things, the phone records should be obtained—and if the phone was a work-issued cellphone, the attorneys should collect and safeguard the device itself. If a personal or home phone was used, the targets should be asked to turn over any phone records for those phones for the relevant time period. At the same time, attorneys should collect and review all documents in that targets' possession—including e-mails, calendars, travel records, and expense reports—to ensure they have captured the full scope of the what the targets were doing and with whom they were communicating.

This information will go a long way towards allowing attorneys to give informed advice about whether it makes sense to immediately approach the Division about cooperation or to wait and see whether, and what, criminal charges are filed. Each approach carries risks. Approaching the government may save the client from criminal charges, but patience might show that the Division's case against the client is not terribly strong. On the other hand, a company that waits could lose its chance to cooperate and escape criminal liability if another member of the conspiracy decides to seek leniency first. The decision will necessarily be driven by the lawyers' honest assessment of the facts and credibility of the witnesses.

If the decision is to wait, the Division will turn over any intercepted communications in discovery. Attorneys should carefully review all of those recordings, as well as the documents relating to the application for the electronic surveillance. Thoroughly understanding the recordings and the supporting documents is critical not just from a defensive perspective, but offensively as well. A careful review of the recordings may show, for instance, that the government's cooperator—upon whose information the government relied in obtaining the wiretap—was not truthful with the prosecutors about something, or that the government failed to comply with some of the many technical requirements of the wiretap.<sup>21</sup> These problems might provide a basis to suppress the fruits of the electronic surveillance.

Moreover, even if the recordings are not suppressed, the substance of the interceptions may reveal defenses available to the client. For example, the recordings might show that an employee of the client only reluctantly became involved in the conspiracy and did so only because of pressure from a cooperator working with the government who gave the employee the idea to par-

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<sup>21</sup> Some of these include the following requirements: (1) that the affidavit sworn out by the law enforcement officer seeking the wiretap included, among other things, specific details about the offense being investigated, a disclosure of all previous applications for wiretaps in the investigation, and a description of all other investigative procedures, short of a wiretap, that have proven unsuccessful in meeting the investigation's purposes (18 U.S.C. § 2518(1)); (2) that, while the wiretap was in use, the prosecutor provided to the district court updates describing any progress that was made towards the achieving the investigation's goals (18 U.S.C. § 2518(6)); and (3) that any recordings made pursuant to the wiretap, along with the wiretap application and related paperwork, were sealed immediately following the expiration of the wiretap's term. (18 U.S.C. § 2518(8)).

ticipate in the offense. This could constitute entrapment.<sup>22</sup> Or the recordings may document a claim that the company “joined” the conspiracy as a result of pressure from other co-conspirators, which could be a basis for a duress defense.<sup>23</sup> Or it may be that the recordings will help establish that the employee, while at one time a member of the conspiracy, not only withdrew from the enterprise but communicated his or her renunciation of the conspiracy and its benefits.<sup>24</sup> The development of these types of defenses is invaluable regardless of whether the client is interested in negotiating a favorable plea or going to trial.

### Conclusion

While it is unclear to what extent the Antitrust Division will use its new electronic surveillance powers should this new bill become law, it would not be surprising if the Division took steps relatively quickly to incorporate wiretaps and bugs into its criminal investigations. One can almost certainly expect that there will be bumps along the road as the prosecutors and investigators familiarize themselves with the requirements and usefulness of electronic surveillance tools. It is almost just as certain, however, that the Division will quickly hone its skills in this area, and that evidence reaped from wiretaps and bugs will be appearing in antitrust cases—and in courtrooms—soon. ●

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<sup>22</sup> See *United States v. Russell*, 411 U.S. 423, 436 (1973) (Entrapment comes into play “only when the Government’s deception actually implants the criminal design in the mind of the defendant . . .”).

<sup>23</sup> A defendant asserting that he or she joined a conspiracy as a result of duress must show that he or she submitted to force at the time the conspiracy was entered into, such that “the defendant reasonably feared immediate death or severe bodily injury which could be avoided only by committing the criminal act charged.” *United States v. Patrick*, 542 F.2d 381, 386 (7th Cir. 1976) (quoting *United States v. Stevison*, 471 F.2d 143, 147 (7th Cir. 1972)).

<sup>24</sup> See *United States v. Berger*, 224 F.3d 107, 118 (2d Cir. 2000) (To withdraw from a conspiracy, a defendant must not only resign from the conspiracy, but must also show that he or she did “not take any subsequent acts to promote the conspiracy” and did “not receive any additional benefits from the conspiracy.”).



# Minimum Service Requirements in Real Estate Brokerage: A Response to Maureen K. Ohlhausen

**Darryl W. Anderson**

In recent years, state legislatures and regulatory agencies have engaged in more aggressive supervision of the real estate market in an effort to protect consumers who undertake what for many individuals is the single largest and most important commercial transaction of their lives—the purchase of a home. The action at the state level is a response to the proliferation of real estate brokerage options. Consumers previously chose between either a full-service broker who handled every aspect of the purchase or sale of a home or no broker at all; now, however, there are a number of so-called Limited Service Brokers (LSBs) who offer à la carte brokerage services. Through an LSB, consumers can, for example, purchase for a flat fee a broker's listing capabilities, but handle the details of negotiating a deal with a potential buyer by themselves.

LSBs pose unique challenges to the consumer protection goals that have long animated much state legislation governing real estate transactions, and the recent activity at the state level is best seen as an effort to adapt pre-existing rules and regulations to these new circumstances. The states' efforts to ensure that their consumer protection laws keep pace with the rapidly evolving brokerage market have been resisted at virtually every turn, however, by federal antitrust authorities. As Maureen Ohlhausen explains in her recent article in *The Antitrust Source*, the Federal Trade Commission and/or the Department of Justice Antitrust Division have opposed state efforts in Alabama, Kentucky, Michigan, Missouri, South Dakota, and Texas either by filing suit against state agencies or, more commonly, by writing advocacy letters opposing proposed changes to state law or regulations.<sup>1</sup>

The uniform actions by the FTC and the DOJ in these areas appear to reflect a conclusion that any legislation or regulation imposing duties or obligations on brokers is anticompetitive and thus in conflict with the policies underlying the federal antitrust laws. But this one-size-fits-all view fails to account for the vastly different approaches employed by the states. The appropriate analysis of price restrictions in Kentucky, for example, that prohibited brokers from offering rebates to consumers is vastly different from the appropriate analysis of regulations like those in Alabama, Missouri, and Texas that impose certain minimum obligations on individuals who have agreed to serve as a broker for a consumer.

■ **Darryl Anderson** is a Senior Associate in the Houston office of Fulbright & Jaworski L.L.P. He has previously represented the Texas Association of Realtors before the Texas Real Estate Commission on matters relating to the adoption of minimum service requirements for brokers. The views expressed herein are his own and do not necessarily reflect the views of the Texas Association of Realtors.

<sup>1</sup> See Maureen K. Ohlhausen, Competition Issues in Real Estate Brokerage, ANTITRUST SOURCE, Nov. 2005, at <http://www.abanet.org/antitrust/source/11-05/Nov05-Ohlhausen11=29.pdf>. The federal antitrust authorities more commonly resort to advocacy letters because legislation passed by states is protected from antitrust scrutiny by virtue of the state action doctrine. “[T]he general language of the Sherman Act should not be interpreted to prohibit anticompetitive actions by the States in their governmental capacities as sovereign regulators.” *City of Columbia v. Omni Outdoor Advertising, Inc.*, 499 U.S. 365, 374 (1991) (citing *Parker v. Brown*, 317 U.S. 341 (1943)). The state action doctrine even protects actions taken by state agencies and regulators if the actions are pursuant to a “clear articulation of a state policy to authorize anticompetitive conduct,” *id.* at 372, and the state is “actively supervising” this policy. *California Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980). Thus, in one of the few lawsuits the agencies have filed on these matters, the DOJ alleged that the Kentucky Real Estate Commission acted contrary to state policy when it prohibited certain price rebates that LSBs had been offering there. See *United States v. Kentucky Real Estate Comm’n*, Civ. A. No. 3:05CV188-H (W.D. Ky. filed Mar. 31, 2005).

This article takes a closer look at the so-called “minimum service” regulations and explains why the federal agencies’ concerns with respect to these types of regulations are often misguided.

### The Nature of the Real Estate Market

States have long seen the need to regulate their real estate markets to protect consumers.<sup>2</sup> Texas, for instance, has had a statute on the books since 1939 establishing the Texas Real Estate Commission, which has as its mission “to assist and protect consumers of real estate services, thereby fostering economic growth in Texas.”<sup>3</sup> Among the principal justifications for this statute is the informational asymmetry between real estate professionals and individuals buying or selling a home.<sup>4</sup> Consumers participate in the real estate market only a limited number of times in their lifetimes; in 2004, a recent survey found that 40 percent of home-buyers were first-time purchasers.<sup>5</sup> Brokers, on the other hand, are regular, repeat participants in this market, and have extensive knowledge that most laypersons simply do not have. When a consumer enters into an agreement with a broker, the average consumer is at a distinct informational disadvantage, providing opportunities for abuse by disreputable brokers.

Moreover, brokers in every major market have created an information exchange to facilitate transactions. This exchange, known as the Multiple Listing Services (MLS), consists of a database maintained by local realtor associations that collects properties available for sale by participating realtors and makes them available for viewing by fellow participants. Through the MLS, brokers communicate information and make offers to each other, and offer to pay each other a share of the commission. A broker who lists a property on the MLS exposes the property to a much wider array of brokers for potential buyers than one who does not, and likewise a broker who is representing a buyer has a much easier job finding properties if he or she has access to the MLS database of properties for sale. The realtor organizations generally require membership to access the MLS database, and membership is open to anyone who agrees to abide by the established requirements for participation. One common requirement, which exists in Texas among other places, is the requirement that the individual broker be the exclusive agent for the represented principal. This requirement ensures that a broker who sees a property listed on the MLS can be sure that the listing broker has full and exclusive authority to negotiate with respect to the property.

*When a consumer enters into an agreement with a broker, the average consumer is at a distinct informational disadvantage, providing opportunities for abuse by disreputable brokers.*

<sup>2</sup> Fifty years ago, an article in *The Harvard Law Review* noted that “[p]ublic concern with the proper conduct of [real estate agents’] business activities is evidenced by the fact that more than thirty states and the District of Columbia have enacted statutes regulating their activities.” Recent Case, 69 HARV. L. REV. 559, 559 (1956).

<sup>3</sup> See Texas Real Estate Commission, Mission of the Texas Real Estate Commission, <http://www.trec.state.tx.us/mission.asp>.

<sup>4</sup> The Supreme Court has recognized that some restrictions may “have a net procompetitive effect” when they address informational asymmetries, especially “in a market characterized by striking disparities between the information available to the professional and the [consumer].” *California Dental Ass’n v. FTC*, 526 U.S. 756, 771 (1999). In that case, which involved dental services, the Court noted that “the quality of professional services tends to resist either calibration or monitoring by individual patients or clients, partly because of the specialized knowledge required, and partly because of the difficulty in determining whether, and the degree to which, an outcome is attributable to the quality of services (like a poor job of tooth filling) or to something else (like a very tough walnut).” *Id.* at 772. The Fifth Circuit has recognized in the real estate context that “most homeowners do not possess the necessary experience in the specialized field of effectively presenting to the public essential and enlightening information about property offered for sale” and that market imperfections “arise from the lack of knowledge . . . regarding property values and available sources and methods of financing.” *United States v. Realty Multi-List, Inc.*, 629 F.2d 1351, 1368 (5th Cir. 1980) (citation and internal quotation marks omitted).

<sup>5</sup> Paul C. Bishop et al., *The 2004 National Association of Realtors Profile of Home Buyers and Sellers 4* (2004), available at [http://www.realtor.org/Research.nsf/files/HBSHilite2004.pdf/\\$FILE/HBSHilite2004.pdf](http://www.realtor.org/Research.nsf/files/HBSHilite2004.pdf/$FILE/HBSHilite2004.pdf).

The combination of the knowledge engendered by repeated participation in the real estate market and access to the MLS listings creates a powerful informational advantage for the broker over the individual consumer. State law, therefore, regulates the means and manner by which brokers deal with consumers, whether those consumers are the brokers' clients or whether they are on the opposite side of a real estate transaction. In Texas, as in many other states, the legislature has long prohibited a licensed broker from "negotiat[ing] or attempt[ing] to negotiate the sale, exchange, or lease of real property with an owner, landlord, buyer, or tenant with knowledge that that person is a party to an outstanding written contract that grants exclusive agency to another broker in connection with the transaction."<sup>6</sup> In turn, Texas brokers are required "to negotiate the best possible transaction for the principal."<sup>7</sup> Texas law does not, however, prohibit an unlicensed individual from offering advertising-only services to consumers, such as by contracting to market a property for sale in local newspapers and the like.

### **The Potential Consumer Harm from the LSB Business Model**

The advent of the LSB poses challenges to this regulatory system. On the one hand, as Ohlhausen notes, LSBs can allow consumers to save money "by allowing them to pay only for those services they want."<sup>8</sup> No one disputes that LSBs can provide more choice to consumers to tailor their brokerage needs than exists in a market in which a customer can choose only between a full-service broker or no broker at all.

But, as with most things, there is a flip side to this coin, and the federal agencies have not given sufficient consideration to the problems that come with cafeteria-style brokerage services. The problems arise because of the informational asymmetry between the LSB and the consumer. When consumers used only full-service brokers, this problem could be addressed by imposing fiduciary-type obligations on the broker with respect to every aspect of the potential transaction. This is the case under most state regulatory systems today. This type of solution is obviously unworkable, however, when the very point of the brokerage relationship is for the parties to agree to only a limited subset of brokerage obligations, as is the case with LSBs.

Consider the home seller who decides she wants to engage an LSB to list her property on the MLS, but otherwise handle the negotiation of a sales contract herself. Once she begins negotiating with potential buyers, however, she realizes that there are a number of details she had not considered and decides it would be to her benefit to have a broker's assistance. At this point, the seller has no one to turn to. Her LSB may not even offer these services, or may offer them only at an exorbitant fee. Moreover, having already paid her LSB a fee for the listing, engaging a full-service broker at this time only results in the seller's incurring greater fees than if she had engaged a full-service broker at the outset. These problems are greatly exacerbated when, as is the case in Texas, the seller entered into an "exclusive agency" agreement with the LSB to have her property listed on the MLS in the first place. In this situation, no one other than the original LSB can provide these services to the seller, giving the LSB an opportunity for rent-seeking. In effect, the exclusive services agreement makes the LSB a monopoly brokerage provider to the particular customer, and she is subject to monopoly pricing if she seeks to purchase additional brokerage

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<sup>6</sup> TEX. OCC. CODE ANN. § 1101.652(b)(22) (Vernon 2004). A similar rule applies to lawyers, too. *See, e.g.*, Tex. Disciplinary R. 4.02.

<sup>7</sup> 22 Tex. Admin. Code § 535.2(b) (2005).

<sup>8</sup> Ohlhausen, *supra* note 1, at 3.

services after she had already entered into the limited service agreement and signed the exclusive agency agreement.

The practical impact of this unfortunate chain of events is often that the seller solicits assistance from the potential buyer's broker. Indeed, when considering a proposed regulation imposing minimum service requirements in Texas, the Texas Real Estate Commission heard testimony from buyers' brokers who had been approached for assistance by sellers who had engaged LSBs for listing of their property only. When this occurs, the broker is placed in a difficult position, not unlike that confronted by a lawyer litigating against a pro se opponent. And it goes without saying that the seller seeking this type of advice from even the most ethical broker on the other side of the transaction is soliciting advice from what might charitably be called the "second-best" source.

As this example demonstrates, the potential problem with LSBs arises from the severe informational disparity at the outset of a brokerage relationship. Consumers tempted by the low prices of LSBs may believe themselves capable of performing some brokerage-type services on their own at the outset of a relationship, only to discover as time goes by that they need a broker's assistance. Thus, while the additional choices provided by LSBs are undeniably beneficial in a world of fully informed consumers of brokerage services, in the real world in which state legislatures and regulatory agencies operate, the existence of informational asymmetries makes the LSB option a decidedly mixed blessing. Especially at the initial consummation of a brokerage relationship, the informational asymmetries create a serious potential for "buyer's remorse" on the part of the consumer of brokerage services as the consumer moves forward in the process of buying or selling a home.

### **The Procompetitive Benefits of Minimum Service Requirements**

One way that states have addressed buyer's remorse is by adopting minimum service requirements. These requirements set forth minimum services that a broker should be prepared to provide if and when consumers believe they need these services. As Ohlhausen notes, Alabama, Missouri, and Texas have implemented regulations or enacted statutes that obligate the broker to accept and present offers, assist in developing and communicating offers, and answer questions from the consumer.<sup>9</sup> Properly understood, these requirements are essentially a real estate customer's bill of rights. Some customers may not need and may never make use of these services. But those who decide, once they have embarked on the process of buying or selling a home, that they do have questions or need assistance in preparing an offer should have someone to whom they can turn other than a rent-seeking broker.

What is especially compelling about minimum service requirements is how neatly they solve the information asymmetry problem that is otherwise exacerbated by LSBs. By establishing what a customer can expect from a broker, the minimum service requirements prompt brokers and customers to negotiate at the outset what the charges will be for these services. In essence, the LSB is forced to disclose in advance what he or she will charge for each of the required minimum services. The rent-seeking opportunities that currently exist when a locked-in customer experiences buyer's remorse and seeks additional help from his or her broker are eliminated because the price for these services is included in the initial contract. Thus, an LSB can charge the same flat fee for a listing-only service, and if the customer only uses the listing service, the transaction will occur just as it did before the minimum service requirements were implemented. But the LSB will also

*What is especially compelling about minimum service requirements is how neatly they solve the information asymmetry problem that is otherwise exacerbated by LSBs.*

<sup>9</sup> See *id.* at 6; see also TEX. OCC. CODE ANN. § 1101.557(b) (Vernon Supp. 2005) (codifying minimum service requirements in Texas).

have included in the contract additional fees that will be incurred by the customer if he or she later elects to make use of the LSB to, for instance, answer questions. And by including these fees in the initial agency agreement, a customer can shop around when he or she has the maximum amount of options to minimize the costs of these additional services if they later become required.

By forcing the parties to negotiate for certain baseline services up-front, imposing minimum service requirements protects consumers from the problem of buyer's remorse. And it does so in a way that encourages vigorous competition for these additional services at a time when the consumer has maximum opportunity and options, before the customer has entered into an agreement with anyone. Indeed, with these protections in place, one should expect more consumers to make use of LSBs than do so currently. This is because those consumers who recognize their own lack of information at the outset of the relationship may fear use of a listing-only LSB currently, but may be more comfortable doing so with these protections in place and full disclosure of their potential total cost if they make use of all the services required to be available by state law.

### The Federal Agencies' Flawed Analysis of Minimum Service Requirements

In light of these benefits, it is difficult to understand the opposition to minimum service requirements by federal antitrust authorities. That opposition appears to arise from a misunderstanding of the nature of the problem, compounded by a misunderstanding of the nature of the minimum service remedy.

In particular, the federal agencies appear to focus solely on the negotiation of the initial transaction, with little consideration for what might happen later.<sup>10</sup> Ohlhausen makes this same mistake in her recent article. Nowhere does she give any consideration to the consumer with buyer's remorse. Her focus is entirely on whether the consumer has maximum choice at the outset of the relationship, and gives short shrift to the informational asymmetry that poses the very real possibility that consumers may often be making that choice with too little information to make a decision that maximizes consumer welfare.<sup>11</sup>

Indeed, Ohlhausen mischaracterizes the concern of supporters of minimum service requirements by interpreting it in terms of an *ex ante* problem of consumer information. According to Ohlhausen, "proponents of [minimum service requirements] generally claim that such restrictions are necessary to protect consumers from receiving fewer services than they *expect*."<sup>12</sup> By characterizing the problem as one of expectation at the outset of the relationship, Ohlhausen is able to dismiss minimum service requirements as excessive, and argue that a less restrictive approach would be, for instance, to "require that brokers offering fee-for-service options specifically delineate in writing those services the client will *not* receive."<sup>13</sup>

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<sup>10</sup> In their letter to the Texas Real Estate Commission, for example, the DOJ and the FTC argued that the minimum service regulation proposed in Texas "would force home-sellers who prefer to market their house and to negotiate a transaction on their own in exchange for lower brokerage fees to purchase extra services, which necessarily raises the price of brokerage." Letter from Deborah P. Majoras, Chairman, Federal Trade Commission, and R. Hewitt Pate, Assistant Attorney General, Department of Justice Antitrust Division, to Loretta R. DeHay, General Counsel, Texas Real Estate Commission at 7 (Apr. 20, 2005), available at [http://www.usdoj.gov/atr/public/press\\_releases/2005/208653a.htm](http://www.usdoj.gov/atr/public/press_releases/2005/208653a.htm). The agencies contend in the letter that any concerns about consumers' lack of information could be resolved through requirements that the brokers disclose what services they were and were not providing. *Id.* at 10.

<sup>11</sup> See *California Dental Ass'n*, 526 U.S. at 773 (noting the "significant challenges to informed decisionmaking by the customer for professional services").

<sup>12</sup> Ohlhausen, *supra* note 1, at 6 (emphasis added).

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

The problem, however, is not one of expectation *ex ante*. Rather, it is a problem related to information learned during the course of the relationship, based upon which the consumer determines he or she would like services in addition to those for which the consumer initially contracted. Under Ohlhausen's approach, and that of the federal antitrust agencies generally, this consumer is out of luck. Requiring disclosure of the services provided ahead of time simply cannot address these informational asymmetries anymore than providing an individual with an advance copy of *Gray's Anatomy* could solve the informational asymmetries between a doctor and a patient.

Moreover, Ohlhausen and the federal agencies misinterpret the minimum service remedy that states are implementing in a way that exaggerates competitive concerns. As Ohlhausen describes it, "[o]ne effect of these restrictions would be to force consumers to choose between purchasing a larger bundle of real estate services than they would otherwise desire or forgoing the help of a real estate agent altogether."<sup>14</sup> Under this view, minimum service obligations require a broker to provide services whether the customer likes it or not—the broker will answer questions, even if the customer does not have any—and so LSBs will be forced to charge higher prices than they otherwise would. But these laws are better understood, as described above, as providing a customer's bill of rights, rather than forcing services upon an unwilling customer. Customers need not make use of these rights, but they are protected if, upon learning additional information, they decide they need the minimal services covered by the regulation. Put differently, if a customer approaches his or her broker with a question, the broker must answer the question, a not unreasonable obligation for which the price has been negotiated up front should that service be required.

Moreover, as the preceding section explains, these requirements do not mean that customers will necessarily face higher brokerage prices to cover the costs of services they do not need. Ohlhausen assumes that the result of these requirements is that brokers will charge a flat fee that will be high enough to cover the provision of all of these services, which would necessarily be higher than the flat fee a broker could charge without being required to make these services available. A rational broker would not do so, however. Instead, the broker would charge the same flat fee for the services offered prior to the minimum service regulations. The difference would be that the broker would also provide in the contract for additional fees if the customer actually uses the additional services the broker is required to provide by virtue of the minimum services obligations.

Thus, the parties to the transaction can negotiate for the exact same bundle of real estate services as before minimum service requirements were imposed, but their contract must make plans for the contingency that the customer may need additional services later; the customer need not ever be required to purchase more services than needed. Importantly, however, the customer is protected by the terms of the contract from rent-seeking if the customer later determines he or she would like to make use of the additional services.

### **The Federal Agencies' Concern with Minimum Service Requirements Is Misplaced**

As the preceding sections show, the federal agencies' analysis of minimum service requirements fails to appreciate the informational asymmetries in the real estate brokerage context and as a consequence overlooks the competition-enhancing aspects of these regulations. In truth, much of their concern appears to be driven not so much by the impact of minimum service requirements

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

in and of themselves, but instead by the potential interaction of these requirements with the private regulations of MLS exchanges. Thus, Ohlhausen discusses the theoretical customer who engages a broker solely to have access to the MLS.<sup>15</sup>

Some of the opportunities for abuse that have prompted states to enact minimum service requirements would be diminished if LSBs did not enter into exclusive agency agreements with their customers. But private MLS regulations frequently require a broker to be the “exclusive agent” for the property being listed, so an LSB who wants to provide a “listing-only” service must sign up a customer to an exclusive agency agreement. States are understandably concerned about the consequences of these exclusive agreements on consumers of real estate services, who risk being taken advantage of by disreputable brokers.

Thus, to the extent the federal agencies are concerned about the ability of brokers to provide listing-only services, their concern is better directed to the private regulations of the MLS, and not to state regulators trying to protect consumers acting in the market as it exists. It should not pass unnoticed, however, that the concern for the listing-only broker rests on a misperception of the nature and purpose of the MLS. As one court has pointed out, “[t]he MLS is a cooperative facility operated by and for real estate brokers which is designed to pool resources so as to enhance the value of brokerage services to the public. Because it increases the efficiency of those services, the MLS has a significant procompetitive effect as well.”<sup>16</sup> The federal agencies and Ohlhausen rightly recognize the substantial benefits that inure to brokers’ customers as a byproduct of the MLS. It is important to note, however, that the MLS is not the real estate corollary to a common carrier, much less to an essential facility, to which all must be given access.<sup>17</sup> The MLS was created by brokers, for their benefit, and they have chosen the rules of participation in the MLS and sharing in those benefits. As courts have recognized, as long as those restrictions are reasonably necessary to the legitimate goals of providing an effective MLS, the antitrust laws interpose no objection.<sup>18</sup>

The Department of Justice has taken on some of the participation requirements imposed by local MLS services in its recent suit against the National Association of Realtors.<sup>19</sup> To the extent

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<sup>15</sup> See *id.* at 3; see also Letter from Majoras and Pate, *supra* note 10, at 3 (“Some consumers may want to sell their house without the assistance of a broker but desire the additional exposure of listing their home in the local MLS.”).

<sup>16</sup> *Supermarket of Homes, Inc. v. San Fernando Valley Bd. of Realtors*, No. CV 80-1888, 1983-2 Trade Cas. (CCH) ¶ 65,718 (C.D. Cal. Sept. 1, 1983), *reprinted at* 1983 WL 2199, at \*9.

<sup>17</sup> See *id.* (“The real issue here is whether the antitrust laws confer upon the public (and plaintiff) the right to convert an informational service compiled and maintained by brokers for their own benefit into what would amount to little more than another advertising medium. The Court concludes that the antitrust laws confer no such right.”). Moreover, the Supreme Court recently cast substantial doubt on the viability of the essential facility doctrine in antitrust law. *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 411 (2004) (noting that the Supreme Court has “never recognized such a doctrine” and finding in any event an “indispensable requirement” of such a claim to be “unavailability of access to the ‘essential facilities’”).

<sup>18</sup> See *United States v. Realty Multi-List, Inc.*, 629 F.2d 1351, 1374–75 (5th Cir. 1980) (applying this standard and concluding that certain regulations did not pass the test); *Pope v. Mississippi Real Estate Comm’n*, 695 F. Supp. 253, 269–72 (N.D. Miss. 1988) (finding MLS requirement that participant be a member of local board of realtors, which established and ran the MLS, did not violate antitrust laws). But see *Thompson v. Metropolitan Multi-List, Inc.*, 934 F.2d 1566, 1581–82 (11th Cir. 1991) (finding general requirement of membership in local board of realtors too broad under antitrust laws, but recognizing right to impose specific membership requirements with procompetitive justifications). In connection with the requirement that a broker be the exclusive agent, it is worth noting that the Fifth Circuit in *Realty Multi-List* appears to assume that the requirement of exclusive agency is a fundamental requirement for the formation of an MLS. See *Realty Multi-List*, 629 F.2d at 1355 (noting that the MLS at issue in that case was formed by members who “obligated themselves to attempt to obtain from sellers ‘exclusive’ rather than ‘open’ listings of real estate and to pool their exclusive listings”).

<sup>19</sup> See Ohlhausen, *supra* note 1, at 5–6 (describing lawsuit).

the DOJ's efforts to protect LSBs reflect a fundamental concern with access to the MLS, these types of actions are the proper forum for resolving those concerns. But certainly the states should not be limited in their ability to address proactively the problems that arise when an LSB secures an exclusive agency from a customer and then turns its back on that customer later. The minimum service requirements are an effective, procompetitive tool that should be encouraged.

### **Conclusion**

Recent state efforts to adapt their regulations protecting consumers in the real estate market have taken a variety of forms, but the federal antitrust authorities appear to treat any new regulation as an effort to hinder the competition of LSBs, while ignoring the new forms of consumer harm that can accompany the LSB business model. While restrictions on price that have been adopted by some states may deserve more searching scrutiny, the minimum service requirements implemented in Alabama, Missouri, and Texas protect consumers and simultaneously enhance competition. Of all the federal agencies, the Federal Trade Commission, with its twin missions of consumer protection and promotion of competition, should appreciate and support such a win-win solution. ●



# Four Economic Principles Underlying the FTC's Position Against Reverse Payments in Patent Settlement Agreements

**Robert Kneuper**

Antitrust challenges to settlements of patent disputes have become the latest focus in the ongoing debate concerning the proper relationship of antitrust law to intellectual property law. In recent years, the Federal Trade Commission and private plaintiffs have brought a series of actions against branded and generic drug manufacturers that settled patent disputes in the context of Hatch-Waxman regulations.<sup>1</sup> In cases, such as *Schering/Upsher-Smith*, *Hoechst/Andrx*, and *Zeneca/Barr*, the FTC and/or private plaintiffs have alleged that patent settlement agreements have caused anticompetitive delays in generic entry costing consumers hundreds of millions of dollars. The FTC has put forth a particularly strong stand against so-called “reverse payment” settlement agreements—agreements involving payments from the plaintiff patent holder to the defendant generic producer.<sup>2</sup>

Antitrust policy with regard to these types of patent settlements is currently in a state of flux. After a series of initial court decisions in favor of the plaintiffs (mostly in cases involving interim or temporary reverse payments while the patent suit continued), the courts have recently made a number of key rulings supporting the legality of patent settlement agreements with reverse payments. The Eleventh Circuit recently vacated the FTC's order in *Schering-Plough*,<sup>3</sup> which the FTC has appealed to the Supreme Court. The Second Circuit ruled against plaintiffs in the *Tamoxifen Citrate Antitrust Litigation* (involving *Zeneca* and *Barr*)—a decision that in many ways mirrored the Eleventh Circuit's decision in *Schering-Plough*.<sup>4</sup> These cases demonstrate a wide discrepancy between the views of the FTC and the courts regarding appropriate antitrust policy in this area—a discrepancy that has far-reaching consumer welfare implications.

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<sup>1</sup> The Hatch-Waxman regulations were implemented to facilitate the approval of generic drugs. Generic drugs are filed with the Food and Drug Administration as an Abbreviated New Drug Application (ANDA). Relevant patent holders are notified of ANDA filings and have up to 45 days to initiate a patent lawsuit even though the generic has not entered the market. After the initiation of the lawsuit, the patent holder is given a 30-month stay during which the generic firm is not permitted to enter the market.

<sup>2</sup> Such settlements also often include an agreement to delay generic entry until a specific date or until certain conditions are met. I use the term “reverse payment” here consistent with much of the literature discussing this issue. However, this type of patent settlement is different from the more typical situation in which potentially infringing entry has already occurred. In these more typical situations, a settlement usually involves a payment from the defendant entrant to the plaintiff patent holder. Hatch-Waxman settlement agreements, by contrast, occur prior to generic entry and thus prior to a loss of profits by the patent holder. For this reason, the use of the term “reverse payment” (i.e., a payment that is opposite of the expected direction) is probably a misnomer.

<sup>3</sup> *Schering-Plough Corp. v. FTC*, 402 F.3d 1056 (11th Cir. 2005) (*Schering* appeal). See also *Schering-Plough Corp.*, FTC Docket No. 9297, 2003 WL 22989651 (Dec. 8, 2003) (FTC *Schering* decision).

<sup>4</sup> *Tamoxifen Citrate Antitrust Litig.*, 429 F.3d 370 (2d Cir. 2005) (*Zeneca/Barr* appeal).

Economic theory has played a key, and perhaps underappreciated, role in the development of the FTC's position against reverse payments. Indeed, the FTC's opposition to reverse payments can largely be distilled to four basic economic principles. The analysis of each of these principles, and their alleged shortcomings, which follows will demonstrate that, despite the various criticisms of the FTC's position, there remain valid economic reasons for an antitrust policy that strongly discourages settlement agreements with reverse payments.<sup>5</sup>

### The Four Economic Principles

**Principle #1—The Patent Holder Has Market Power.** The first economic principle underlying the FTC's position against reverse payments in patent settlement agreements is the straightforward notion that, because the patent holder would have market power but for the entry of the generic manufacturer, the settlement agreement may be anticompetitive. This market power argument has a simple explanation—economic studies and other evidence generally show that generic entry significantly reduces prices to the benefit of consumers. Thus, a patent settlement agreement that delays generic entry delays this benefit and is anticompetitive.

This market power concern is heightened in situations in which the patent settlement agreement involves the first generic filer, who either is well ahead of others in the patent approval process or can potentially create a bottleneck that will slow entry of later generic competitors. Hatch-Waxman regulations give the first filing generic a period of 180 days of exclusivity that is triggered when the first Abbreviated New Drug Application (ANDA) filer begins marketing its product or when there is a court decision declaring the patent at issue either invalid or not infringed. Thus, an agreement delaying entry of the first generic can potentially delay entry of all other generics.<sup>6</sup>

**Principle #2—Economic Incentives Encourage Delayed Generic Entry.** The second principle is that the patent holder and the potential generic entrant have strong economic incentives to negotiate a settlement agreement that delays generic entry. The parties' incentives favor delaying entry because the patent holder's profit loss after generic entry is generally much greater than the generic firm's profit gain. This is because generic entry generally leads to significantly lower prices and lower profits available to generic entrants compared to what previously existed for the branded product. Thus, both parties can gain from a delay in generic entry as long as the patent holder compensates the generic firm at or above the level of profits lost due to the delay. Such compensation could take many forms, including a reverse payment.

Thus, a patent settlement agreement in the context of Hatch-Waxman may provide the patent holder and the generic entrant with mutually beneficial gains, assuming the generic entrant is compensated by at least the amount of profits forgone by the delay in generic entry. If not for such compensation, the generic entrant's economic incentive would instead favor pressing ahead with litigation to achieve a judgment against the branded patent holder as quickly as possible.<sup>7</sup>

*Economic theory has played a key, and perhaps underappreciated, role in the development of the FTC's position against reverse payments. Indeed, the FTC's opposition to reverse payments can largely be distilled to four basic economic principles.*

<sup>5</sup> I characterize the FTC's position against reverse payments in patent settlement agreements based on my own reading of the decisions of the FTC's Commissioners in this area, as well as the positions taken by FTC staff in their legal filings. However, the views expressed in this article are ultimately my own and do not necessarily reflect the views of the FTC, any individual Commissioner, or Commission staff.

<sup>6</sup> Later generic entrants can, of course, break any bottleneck by winning their litigation against the patent holder. However, the first filing generic generally has the most to gain financially from a quick settlement of the litigation.

<sup>7</sup> An exception to this general rule can occur in a high-growth market. If the market is growing faster than the rate of interest, the first filing generic firm entitled to the 180 days of exclusivity may actually benefit from a delay in generic entry even without a reverse payment.

**Principle #3—Patents Are Probabilistic Property Rights.** The third economic principle underlying the FTC’s position against reverse payments is that patent rights are properly viewed as probabilistic property rights; that is, there is some probability that the patent will be upheld in court, but this outcome is uncertain. Thus, the financial value of the patent to its holder depends upon both the expected profit stream and the probability that the patent will be upheld.

For some settlement agreements, it may be possible to estimate the probability (or range of probabilities) that the patent holder would have prevailed in the patent suit. The patent holder could, for example, have retained an objective fact finder to review the evidence and estimate the patent holder’s likelihood of prevailing. This probability (or range of probabilities) could then be used to estimate the likely date (or range of dates) of generic entry as a result of litigation. This date (or dates) can then be compared to the date of entry under the settlement agreement to see if the agreement likely delayed generic entry.<sup>8</sup>

However, in practice it is often difficult to measure the patent holder’s probability of winning the patent litigation.<sup>9</sup> While pleadings and other court documents may be available to antitrust enforcers (or private plaintiffs), other types of evidence may be privileged or otherwise unavailable. Even where sufficient information is available, there are other practical impediments to directly applying this approach.<sup>10</sup> For these reasons, the FTC has generally relied on the fact of the reverse payment as the most accurate barometer of an anticompetitive settlement agreement. This has led in practice to a presumption that reverse payment settlements are anticompetitive, thereby placing the burden upon the defending parties to overcome this presumption by presenting evidence supporting alternative explanations for the reverse payment.<sup>11</sup>

**Principle #4—Aggressive Antitrust Enforcement Benefits Consumers.** The fourth economic principle underlying the FTC’s position against reverse payments is that aggressive antitrust enforcement in this area benefits consumers, particularly for settlements involving “blockbuster” drugs. This is because the delay in generic competition to blockbuster drugs would likely cost consumers billions in lost savings from lower-priced drugs, whereas saved litigation expenses associated with a patent settlement for such drugs will amount only to a few million. From this perspective, the financial risk to consumers of under-enforcement is great compared to the financial risk of over-enforcement.

More generally, this idea can be illustrated by imagining two extreme worlds: one in which all Hatch-Waxman-type settlement agreements involving a reverse payment are presumptively legal,

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<sup>8</sup> This approach is consistent with a more general standard proposed by economist Carl Shapiro. Shapiro argues for a standard that balances the rights of the patentees with consumer interests, stating that “consumers have a ‘property right’ to the level of competition that would have prevailed, on average, had the two parties litigated the patent dispute to a resolution in the courts.” See Carl Shapiro, *Antitrust Limits to Patent Settlements*, 34 RAND J. ECON. 391, 10–11 (2003).

<sup>9</sup> In some cases, a probabilistic approach can be used even without knowing the likely range of probabilistic outcomes. For example, suppose that the two parties have agreed to a settlement that includes a reverse payment and generic entry at the end of the patent life. In such cases, as long as the generic firm had some chance of winning the patent case, the probabilistic model would predict an entry date under litigation before that in the settlement agreement.

<sup>10</sup> For example, one such complication involves estimating the likely economic life of the patent. If the economic life is shorter than the patent life, the economic life should be used under the probabilistic approach. However, the economic life of the patent can be unclear because of the uncertainty associated with the potential approval and entry of competing drugs. For a discussion of various other practical impediments to this approach, see FTC *Schering* decision, *supra* note 3, at 34–35.

<sup>11</sup> In its *Schering* decision, the FTC states: “If there has been a payment from the patent holder to the generic challenger, there must have been some offsetting consideration. Absent proof of other offsetting consideration, it is logical to conclude that the quid pro quo for the payment was an agreement by the generic to defer entry beyond the date that represents an otherwise reasonable litigation compromise.” FTC *Schering* decision, *supra* note 3, at 26.

versus another in which such settlements are presumptively illegal.<sup>12</sup> In the presumptively legal world, the potential harm to consumers from an antitrust perspective could be measured by totaling the consumer welfare losses associated with anticompetitive settlement agreements. By contrast, in the presumptively illegal world, the potential harm to consumers would derive from settlement agreements that were not reached due to the rule against reverse payments. In the short-term, the parties' litigation expenses could be a reasonable proxy for these losses.<sup>13</sup>

From the FTC's perspective, the presumptively legal world leads to very significant consumer welfare losses because the settling parties have an incentive to negotiate delays in generic entry until the end of the patent life. By contrast, the presumptively illegal world leads to relatively low consumer welfare losses because such losses would likely be limited to the litigation expenses incurred as a result of the inability to reach settlement agreements that did not include a reverse payment provision.<sup>14</sup>

*[A]n antitrust policy*

*detering patent*

*settlements with*

*reverse payments*

*promotes consumer*

*welfare.*

This idea can be illustrated by considering the patent settlements that were the subject of a 2002 FTC study. The study reviewed 104 New Drug Applications resulting in 75 patent lawsuits. The median net sales level of the drugs involved in the 75 lawsuits was \$190 million annually.<sup>15</sup> Assume that a presumptively legal policy existed and that all of the lawsuits settled, resulting in an average delay in generic entry of five years beyond what would have occurred had there been litigation. This outcome would result in consumer welfare losses of approximately \$32 billion or \$6.4 billion for each year of delay associated with the 75 patent lawsuits.<sup>16</sup> By contrast, the savings associated with reduced litigation expenses are \$375 million if litigation expenses of \$5 million per lawsuit are assumed. Thus, the losses from delayed entry are approximately 85 times the size of the litigation savings. From this perspective, an antitrust policy deterring patent settlements with reverse payments promotes consumer welfare.

<sup>12</sup> The appellate decisions in *Schering* and *Zeneca/Barr* are somewhat akin to the presumptively legal world, whereas the FTC's position is somewhat akin to the presumptively illegal world.

<sup>13</sup> The short- and long-term social costs associated with a strong rule against patent settlement agreements with reverse payments are unclear. In the short term, fully litigated outcomes do provide social benefits that may well exceed litigation costs. Such benefits derive from the fact that the ultimate legality of the patent is resolved and made known not only to the settling parties, but to other firms as well. In the long term, a policy that "chills" settlement agreements could lead to reduced investment in innovation. However, this effect is unclear because patent holders may also be deterred from pursuing investment efforts relating to products likely to have relatively weak patent protection relative to products likely to have relatively strong patent protection. In other words, patent holder investment decisions could potentially be more efficient under an antitrust policy that discourages patent settlement agreements with reverse payments.

<sup>14</sup> A reverse payment is only one of many options that can be used by parties attempting to settle a patent dispute. Other options include changing the generic entry date, providing a payment flowing from the generic firm to the branded firm, side licenses involving other products, other side agreements such as manufacturing, distribution, and marketing agreements, etc. From the FTC's perspective, any side transactions need to be at fair market value, and not a hidden way to make a reverse payment. The FTC's 2002 study of patent settlement agreements demonstrates that a reverse payment is not necessary to reach a patent settlement agreement in a Hatch-Waxman setting. See *GENERIC DRUG ENTRY PRIOR TO PATENT EXPIRATION: AN FTC STUDY* (July 2002), available at [http://www.ftc.gov/os/2002/07/generic\\_drugstudy.pdf](http://www.ftc.gov/os/2002/07/generic_drugstudy.pdf) [GENERIC DRUG STUDY]. The study found that 20 of the 53 paragraph IV patent suits involved a resolution that included a settlement and 11 of the 20 settlements did not involve a reverse payment. Under seven of these settlements, the brand firm licensed the generic firm to either enter the market immediately or relatively soon after the settlement agreement. Two other settlements involved supply agreements pursuant to the brand's New Drug Application. While these other types of settlement agreements are not free from potential antitrust concerns, they do demonstrate economically viable settlement options that go beyond the simple use of a reverse payment.

<sup>15</sup> See *id.* at 14.

<sup>16</sup> This calculation assumes that the annual generic share of the market is 90% and that the fall in the price as a result of generic entry is 50%. This means that the consumer welfare gain from generic entry in a \$190 million market is  $.9 \times .5 \times 190$  or \$85 million annually (assuming a perfectly inelastic demand curve). This calculation ignores the potential consumer welfare losses from generic entry as discussed in the criticisms of the FTC's position that the patent holder has market power.

## Criticisms of the Economic Principles

**Principle #1—The Patent Holder Has Market Power.** The primary criticism against this principle is that in certain instances the patent holder does not have market power, and that delayed generic entry does not lead to anticompetitive effects because consumers may actually benefit from delays in generic entry (or even no generic entry). Generic entry may not only reduce product prices to the benefit of consumers but also reduce promotional activities to the detriment of consumers. Promotion of pharmaceutical products tends to increase the demand for such products (or can change the shape of the demand curve) and some particular types of promotions, such as sampling, provide direct benefits to consumers. This means that generic entry can in some situations be output reducing and that the consumer welfare losses from reduced promotional activity due to generic entry can partially or fully offset the consumer welfare gains from the fall in price. This argument can be particularly relevant where the availability of an important drug depends heavily on promotions.

A version of this argument was made by one of the defendant's economic experts in the *Schering* case, Sumanth Addanki. Addanki argued that it was incorrect to infer market power simply from the price impact of generic entry.<sup>17</sup> The product at issue in that case was a potassium chloride supplement sold by Schering under the brand name K-Dur 20. Many other potassium chloride supplements were on the market but K-Dur 20 was the only 20 mg size supplement available and the only once-a-day supplement available. As a result of successfully marketing these additional benefits of K-Dur 20 to physicians, Schering garnered a significant share of all potassium chloride sales, as well as a substantial price premium. However, Addanki argued that any price premium on K-Dur 20 was purely the result of Schering's marketing efforts and was not a price premium associated with market power. This view was ultimately rejected by the FTC, which instead focused on two key pieces of evidence: (1) the parties' documents predicting significant consumer welfare benefits from generic entry; and (2) ex-post entry data demonstrating significant average price decreases for the brand and its corresponding generic after generic entry.<sup>18</sup>

But the question remains: How does one reconcile the potential consumer welfare losses and gains from generic entry in particular cases? Obviously, a careful consideration of the evidence and underlying data is important. For example, if no significant consumer welfare losses from generic entry are predicted in the parties' generic impact forecasts, this may raise doubts as to the credibility of an argument that such losses are great. An analysis of pricing and marketing data associated with actual generic entry can also be useful. However, translating such measures into estimates of actual consumer welfare losses can be very difficult. Overall, given the numerous studies that have shown the significant consumer welfare benefits from generic entry in general, a reasonable approach may be to presume market power under two conditions: (1) evidence indicates that generic entry provides unique and significant price benefits to consumers; and (2) there is no evidence of a substantial output reduction as a result of generic entry.<sup>19</sup> This would then place the burden upon defendants to overcome the presumption by demonstrating on a case-by-case basis that generic entry will not harm consumers overall.

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<sup>17</sup> For a summary of Addanki's arguments, see his slide presentation entitled, "Schering-Plough and the FTC's Unusable 'Direct Test' of Monopoly Power in Pharmaceutical Markets," available at [http://www.nera.com/event.asp?e\\_ID=2498](http://www.nera.com/event.asp?e_ID=2498).

<sup>18</sup> See FTC *Schering* decision, *supra* note 3, at 19–23.

<sup>19</sup> The price effect and output effect of generic entry are generally measured using sales of both the branded drug and its generic counterpart.

**Principle #2—Economic Incentives Encourage Delayed Generic Entry.** The primary criticism of this principle is that the incentive to privately negotiate a delay in generic entry through a settlement agreement may be offset by other factors, including the threat of treble damages from an antitrust suit. In other words, incentives alone are not a sufficient basis to conclude that a “bad” settlement agreement will be negotiated.<sup>20</sup> For example, assume that the parties negotiating a settlement with a reverse payment perceived a 50/50 chance of “getting caught” by antitrust authorities. In such a situation, the prospect of potential treble damages may be sufficient to fully deter the parties from negotiating a settlement agreement with a reverse payment.

This is not so much an argument against aggressive antitrust enforcement in this area but an argument against simply assuming that the strong incentives towards delaying generic entry will always lead to settlement agreements that delay generic entry. After all, the incentives to negotiate a delay depend on many factors, including the parties’ perceptions of the likelihood of antitrust enforcement as well as the penalties associated with such enforcement. However, the profit-gain incentives do inform the analysis in that they show a logical profit-maximizing rationale tying reverse payments to delayed generic entry. Indeed, few would doubt that if reverse payments were presumptively legal, the vast majority of settlements would involve generic entry dates at the end of the patent life, or alternative formulations to achieve the same result.

**Principle #3—Patents Are Probabilistic Property Rights.** While economists have generally embraced the concept of patents as probabilistic property rights, some have disagreed with the FTC’s approach of presuming delay from the fact of a reverse payment.<sup>21</sup> These economists have put forth alternative explanations for a reverse payment, including risk aversion, asymmetric information, etc. For example, in the *Schering* case, Addanki argued that risk aversion can be used to explain reverse payments. According to Addanki, “the risk averse patentee would be willing to settle for a ‘date certain’ earlier than the expected date under litigation so as to avoid the risk associated with the litigation.”<sup>22</sup> Another economic expert, Robert Willig, made similar arguments relating to asymmetric information and liquidity constraints. For example, Willig hypothesized that “a ‘cash starved’ generic may actually be able to enter earlier and more effectively if it receives some up-front support from the pioneer manufacturer.”<sup>23</sup> From this perspective, reverse payments are consistent with no delay in generic entry and contrary to the FTC’s approach of presuming delay from reverse payments.

The appellate courts in the *Schering* and *Tamoxifen* cases appear to have agreed that logical explanations exist for “reverse payments” beyond simply a payment for delay. In *Schering*, the court stated:

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<sup>20</sup> In its *Schering* decision, the FTC acknowledged that “[t]he existence of these strong incentives standing alone, obviously does not amount to proof of a law violation, but it may help to resolve conflicting inferences.” FTC *Schering* decision, *supra* note 3, at 27.

<sup>21</sup> The two recent appellate decisions in *Schering* and in *Zeneca/Barr* have bypassed the probabilistic approach in favor of simply presuming the validity of the patent. Such a standard can be interpreted in several ways. One interpretation would be that the plaintiff must first overcome the presumption of a valid patent before it can argue that a settlement agreement with a reverse payment is anticompetitive. This would presumably involve a trial on the merits of the patent in an attempt to show that the patent would likely have been found invalid. A second interpretation would be that courts are simply assuming a 100% likelihood that the patent would have been held to be valid in court. Either of these interpretations would seem to have the effect of making all patent settlements with reverse payments presumptively legal with certain limited exceptions (e.g., situations involving sham litigation).

<sup>22</sup> See Sumanth Addanki, *Schering-Plough and the Antitrust Analysis of Patent Settlement Agreements in Pharmaceutical Markets*, ANTITRUST INSIGHTS, (NERA NEWSL.), May 31, 2005, at 5, available at [http://www.nera.com/Newsletter.asp?n\\_ID=31](http://www.nera.com/Newsletter.asp?n_ID=31).

<sup>23</sup> FTC *Schering* decision, *supra* note 3, at 38.

Hatch-Waxman essentially redistributes the relative risk assessments and explains the flow of settlement funds and their magnitude. Because of the Hatch-Waxman scheme, ESI and Upsher gained considerable leverage in patent litigation: the exposure to liability amounted to litigation costs, but paled in comparison to the immense volume of generic sales and profits.<sup>24</sup>

The FTC has not rejected the notion that there are potential alternative explanations for reverse payments. But, in their enforcement actions, the FTC has stated that it has not found sufficient evidence supporting these other explanations to overcome the presumption of delay. Moreover, the FTC expressed skepticism regarding the notion that a reverse payment is a natural byproduct of the Hatch-Waxman setting, stating that “we do not have evidence before us to justify any conclusion that payments by pioneers to generics are a ‘natural by-product of the Hatch-Waxman process.’”<sup>25</sup>

From an economic perspective, these alternative explanations depend on a specific set of theoretical assumptions concerning the patent holder and the potential generic entrant. For example, from the perspective of standard bargaining theory, an argument tying a reverse payment to risk aversion holds only if the patent holder is in a more risk averse position compared with the generic. The simple fact that the patent holder may be exposed to a greater financial loss from an adverse outcome as compared with the generic does not automatically translate into greater risk aversion. A firm’s level of risk aversion depends on many factors, including the available ways in which particular firms can diversify against adverse outcomes.

Overall, in considering alternative economic explanations for reverse payments it is important to carefully consider the assumptions underlying economic models of firms’ negotiating behavior, as well as the available evidence relating to such assumptions. From the FTC’s perspective, such arguments are all too often made in a theoretical vacuum without careful consideration of the actual facts of the case.

**Principle #4—Aggressive Antitrust Enforcement Benefits Consumers.** With respect to this issue, there appears to be some concern by some economists and the courts that a rule against reverse payments will have a significant chilling effect on patent settlement agreements. For example, the *Schering* decision quotes from another ruling by Judge Richard Posner, in which he stated that “any settlement agreement can be characterized as involving ‘compensation’ to the defendant, who would not settle unless he had something to show for the settlement. If any settlement agreement is thus classified as involving a forbidden ‘reverse payment,’ we shall have no more patent settlements.”<sup>26</sup>

From the FTC’s perspective, this argument certainly raises concerns regarding a rule against any type of compensation from the branded plaintiff to the generic defendant as part of a patent settlement. But the FTC’s rule is not against any type of compensation—it applies only to settlement agreements with reverse payments or side deals and other arrangements that mask a reverse payment (i.e., not fair market-valued transactions). Many patent settlement agreements have not resulted in FTC enforcement actions despite providing some form of compensation to the generic firm. This includes licenses of the generic firm, side licensing deals, supply arrangements, etc. In addition, settlement agreements with relatively small reverse payments (e.g., under \$2 mil-

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<sup>24</sup> *Schering-Plough Corp. v. FTC*, 402 F.3d 1056, 1074 (11th Cir. 2005).

<sup>25</sup> FTC *Schering* decision, *supra* note 3, at 29.

<sup>26</sup> See *Schering* appeal 402 F.3d at 1074 (quoting *Asahi Glass Co. v. Pentech Pharm.* 289 F. Supp. 2d 986, 994 (N.D. Ill. 2003)).

lion) are still allowed under the FTC's rule as long as they are reasonably related to litigation expenses.

More generally, even if the FTC's rule against settlement agreements with reverse payments did have a significant chilling effect, this does not necessarily mean that such a policy is unsound. As stated earlier, a valid argument can be made that even if all settlement agreements with reverse payments were presumptively illegal, such a policy would likely be consumer-welfare enhancing. While patent litigation can be expensive, it may be more expensive to allow anticompetitive delays in generic entry.

### **Conclusion**

The FTC's position against reverse payments in patent settlement agreements is an important and controversial area of antitrust enforcement. The merits of the FTC's position have been debated extensively, but primarily from a legal perspective. The focus of this analysis has instead been on the economic principles underlying the FTC's position. These principles demonstrate the existence of strong economic and consumer welfare reasons for the FTC to continue to pursue an antitrust policy that strongly discourages settlement agreements with reverse payments. ●



# Hart-Scott-Rodino Treatment of Corporate Officer Stock Acquisitions Solely for Investment—A Commentary

Malcolm R. Pfunder

An officer or director of a corporation receiving voting securities of the employer through participation in an employer-sponsored executive compensation program may have to make premerger notification filings under the Hart-Scott-Rodino Act<sup>1</sup> if the value of the person's resulting holdings of the employer's stock exceeds \$56.7 million. The reason is that, under informal interpretations issued by the Premerger Notification Office of the Federal Trade Commission, officers and directors, unlike most other investors, are ineligible to claim that their acquisitions are made solely for the purpose of investment and are therefore exempt.

The enforcement agencies' categorical presumption that officers and directors are incapable of having the requisite passive investment intent when acquiring stock of the employer as executive compensation is unnecessarily broad and should be revisited.

## Background and Explanation of the Issue

The HSR Act generally requires that persons acquiring the voting securities of a corporation file a notification form with the FTC and the Antitrust Division of the U.S. Department of Justice and wait 30 days before making the acquisition whenever the value of their resulting holdings of that corporation's voting securities would exceed \$56.7 million.<sup>2</sup> HSR Act reporting requirements are imposed only where the acquiror and the corporate issuer satisfy certain statutory "size-of-person" criteria<sup>3</sup> and no exemption in the HSR Act or its implementing rules applies.

Acquirors are generally permitted to acquire up to 10 percent of the outstanding shares of a corporation without having to make HSR Act filings, so long as they acquire and hold the shares "solely for the purpose of investment."<sup>4</sup> The HSR rules, in turn, define this term to mean that "the person holding or acquiring such voting securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer."<sup>5</sup> Because the FTC

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<sup>1</sup> 15 U.S.C. § 18a.

<sup>2</sup> Additional HSR Act notifications are required if the value of the acquiring person's holdings of the company's stock would exceed \$113.4 million or \$567.0 million, or 25% of the company's stock (valued at more than \$1,134.0 million), or 50% of the company's stock (valued at more than \$56.7 million). The reason for the odd dollar figures is Congressionally mandated indexing, which changes the dollar thresholds annually.

<sup>3</sup> The statutory size-of-person tests generally require that either the acquiring person or the acquired person have either annual net sales or total assets of at least \$113.4 million, and the other person have either annual net sales or total assets of at least \$11.3 million. These size-of-person tests do not apply to acquisitions resulting in the acquiring person's holding voting securities of the company valued in excess of \$226.8 million (which are reportable without regard to the sizes of the acquiring and acquired persons). A natural person may exclude residences and personal property in determining his or her "total assets." Holdings of spouses and their minor children are aggregated for these purposes.

In these kinds of acquisitions, the employer company usually has either annual net sales or total assets (or both) of more than \$113.4 million. Thus, if the acquiring employee has either annual net sales (e.g., from entities that he or she controls) or total assets of more than \$11.3 million, the statutory size-of-person criteria are met.

<sup>4</sup> 15 U.S.C. § 18a(c)(9), 16 C.F.R. § 802.9.

<sup>5</sup> 16 C.F.R. § 801.1(i)(1).

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takes the position that corporate officers and directors are never eligible to rely on this “passive investor exemption,”<sup>6</sup> HSR Act filings may be required of officers and directors who receive shares of their employer through employer-sponsored executive compensation programs, including retirement plans. Civil penalties of up to \$11,000 per day can be assessed for non-compliance.

Typically, acquisitions by an officer or director participating in an employer-sponsored executive compensation arrangement can occur by (a) exercising an option to acquire employer-issued stock, (b) receipt of shares (including restricted shares) issued by the employer as an additional incentive or reward to the employee, or (c) purchase of shares or receipt of matching shares in the employee’s 401(k) or other employer-sponsored retirement account. The value of the executive’s resulting holdings is based on the current market price for any previously acquired shares and the greater of market price or acquisition price for any additional shares being acquired.<sup>7</sup>

*[T]he FTC takes the position that corporate officers and directors are never eligible to rely on this “passive investor exemption” . . .*

A person or entity acquiring an otherwise reportable quantity of the voting securities of a company is exempt from HSR Act filing requirements if that person acquires its shares “solely for the purpose of investment” and the person’s resulting holdings do not exceed 10 percent of the company’s total outstanding voting securities. The enforcement agencies have interpreted this exemption very narrowly, allowing shareholders claiming the exemption to vote their shares, but not otherwise allowing them to participate in or attempt to influence the basic business decisions of the issuer or any affiliate of the issuer. Informal interpretations issued by the FTC’s Premerger Notification Office specifically preclude any officer or director of the issuer, or of any affiliate of the issuer, from relying on the investment exemption, regardless of any other facts potentially relevant to the acquiring person’s actual intent.<sup>8</sup> Because officers and directors are inevitably “participating in the basic business decisions of the issuer” by reason of their employment duties, the FTC views them as factually incapable of satisfying the prerequisites for the passive investor exemption.<sup>9</sup>

<sup>6</sup> See ABA SECTION OF ANTITRUST LAW, PREMERGERNOTIFICATION PRACTICE MANUAL 21–22 (3d ed. 2003); FTC Informal Staff Opinion 9106001 (July 2, 1991), available at <http://www.ftc.gov/bc/hsc/informal/opinions/9106001.htm>.

<sup>7</sup> For HSR Act purposes, the value of voting securities held as a result of an acquisition is the “market price” of any shares previously held plus greater of the “market price” or the “acquisition price” of additional shares being acquired. “Market price” usually means the lowest closing quotation in the previous 45 calendar days, and “acquisition price” is the actual price paid for the to-be-acquired shares. 16 C.F.R. § 801.10(a), (c).

Note that the value of previously acquired securities that the acquiring person holds can result in crossing HSR Act notification thresholds by reason of increases in market value. Such increases do not by themselves trigger filing requirements because the HSR Act applies only to acquisitions, but any subsequent acquisition of additional shares (no matter how small) would require HSR Act notifications.

<sup>8</sup> There is one other exception to the filing requirements which sometimes applies to acquisitions of employer-issued voting securities by officers and directors of the company. If the value of the shares held as a result of the anticipated acquisition will not exceed \$226.8 million, and if the officer or director acquiring the shares does not control any entities and does not himself or herself have a regularly prepared personal balance sheet, then the acquiror must create a pro forma balance sheet listing all of his or her assets (other than residences and personal property). From that balance sheet may be excluded (a) any cash to be spent in making the anticipated acquisition of the employer’s stock and (b) the value of any employer-issued voting securities already held. If the acquiring person’s resulting “total assets” do not exceed \$11.3 million, the acquisition of the employer stock is not reportable. 16 C.F.R. § 801.11(e), PREMERGER NOTIFICATION PRACTICE MANUAL, *supra* note 6, at 181.

<sup>9</sup> The staff view ignores the softer language in the original Statement of Basis and Purpose (SBP) to the rules, which stated that an acquisition of stock by an officer or director of an issuer “could be . . . viewed” as inconsistent with investment purpose. 43 Fed. Reg. 33,450, 33,465 (July 31, 1978). The SBP went on to say that “the facts and circumstances of each case will be evaluated whenever any of these actions have been taken by a person claiming that voting securities are held or acquired solely for the purpose of investment.” This language suggests, at worst, an inference (albeit questionable) that an officer or director would not normally acquire shares of its employer solely for investment.

### Critique of the FTC Staff's View

As a matter of semantics, the phrase “solely for the purpose of investment” refers to the acquiror’s intended use of the stock. Does the acquiror buy or hold the stock solely for the purpose of realizing a gain in its value? Or does the acquiror buy or hold the stock intending to use that stock as a vehicle for or means of controlling, influencing, or participating in the basic business decisions of the issuer? The HSR rules, as drafted, could have been clearer that the appropriate focus is on the stockholder’s reasons for buying and holding the stock and intended use of any stock being purchased.<sup>10</sup>

The FTC staff instead reads the definition of “solely for the purpose of investment” as a gloss on the stockholder’s intended participation in management decision making, rather than on the stockholder’s use of its stock. This reading is apparently premised on an expectation that corporate executives are more likely to do anticompetitive mischief if they acquire or hold stock of their employer than if they do not.

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The FTC staff’s apparent fears of anticompetitive influence are misplaced. The HSR Act is aimed at identifying acquisitions of voting securities that may give the acquiror the ability to exercise control or influence over the actions of the issuer in order to effect some anticompetitive purpose or result. An officer’s or director’s ability to influence the issuer does not derive from any stock that may be received as compensation; rather, it derives from the person’s powers and responsibilities as an officer or a director. The Act surely has no purpose to limit the ability of officers and directors to participate directly in the formulation, determination, or direction of the basic business decisions of their own employer. Nor does the Act seek to limit the ability or inclination of officers and directors to acquire the stock of their employers. The Act itself offers no basis for an assumption that officers and directors who acquire shares of their employer are any more likely to guide the issuer toward anticompetitive activity or otherwise alter the manner in which they, in their executive capacities, formulate, determine, or direct the basic business decisions of the issuer. The origin of, and basis for, any assumption that officers and directors warrant greater scrutiny of their holdings of the stock of their own employers and of their intentions with respect to those holdings than do other investors is simply puzzling.

Indeed, officers and directors are probably *more* likely to acquire and hold their shares for investment than they are to intend those shares as a means of influencing the basic business decisions of the issuer. Employers have an obvious incentive to attract and retain qualified executives and reward them for their performance on behalf of the corporation. Officers and directors have a similar incentive to exercise their duties in a manner that enhances the performance of the corporation and rewards its owners. Those incentives often coincide to create and support executive compensation programs that induce senior officials to invest in the stock of the company and to share in any increase in the value of the enterprise. Those incentives are also wholly consistent with an assumption—indeed, with a *presumption*—that the officers and directors who acquire the employer’s stock do so as wholly passive investors, relying on their executive positions and responsibilities, and not on their stock holdings, as their means to influence the basic business decisions of the issuer, and thus enhance the performance of the corporation.

In any case, to the extent that an officer or director, or indeed any other acquiror whose holdings would exceed \$56.7 million in value, in fact has an intention to use his or her holdings to con-

<sup>10</sup> The author participated in the drafting of the original HSR Act implementing rules and the accompanying statement of basis and purpose.

control, influence, or otherwise participate in the basic business decisions of the issuer, the exemption is unavailable, and HSR Act filings would be required.

Because the HSR Act is aimed at identifying potentially problematic acquisitions of stock, the definition of “solely for the purpose of investment” in the HSR rules should be read (or if necessary should be explicitly amended to read) that the person holding or acquiring such voting securities has no intention of *using those securities as a means*<sup>11</sup> of participating in the formulation, determination, or direction of the basic business decisions of the issuer.

### Possible Remedies

There are several possible remedial approaches to this issue. The simplest and most direct would be to treat officers and directors like any other acquirors of voting securities, allowing them to claim the passive investor exemption when they in fact have no intention to use their shares as a means of controlling or influencing or participating in the basic business decisions of the issuer. This could be done administratively by issuing an informal interpretation that simply rescinds the disqualification of officers and directors in claiming the exemption. It could be done by formal interpretation, which would have the advantage both of publicizing the change and of reinforcing the need for officers and directors to examine their intentions prior to acquiring shares of their employer, even through an executive compensation plan. A change in the definition of “solely for the purpose of investment” through formal rulemaking may be unnecessary but would further assure that the application of the provision is clear.<sup>12</sup>

If the case is persuasive that officers and directors acquiring voting securities of their employers under employer-sponsored executive compensation plans are *inherently likely* to acquire and hold such shares solely for investment, an informal staff presumption of passivity and entitlement to claim the exemption would be appropriate.

If, as has been suggested in the past,<sup>13</sup> holders of 10 percent or less of the stock of any issuer are generally incapable of controlling or influencing or meaningfully participating in the basic business decisions of the issuer, the FTC and the Assistant Attorney General for Antitrust have the statutory power<sup>14</sup> to exempt all such acquisitions, regardless of the acquiror's intent, as inherently unlikely to violate the antitrust laws. ●

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<sup>11</sup> Section 7 of the Clayton Act, enforcement of which the HSR Act was intended to facilitate, exempts acquisitions of stock solely for the purpose of investment and has been interpreted as focusing on whether the acquiror intends to use the acquired stock to control or influence the issuer. *See, e.g., United States v. Tracinda Inv. Corp.*, 477 F. Supp. 1093, 1099 (C.D. Cal. 1979) (“The ultimate definitive factor the courts have looked to . . . is whether the stock was purchased for the purpose of taking over the active management and control of the acquired company.”); *Hamilton Watch Co. v. Benrus Watch Co.*, 114 F. Supp. 307, 316 (D. Conn.) (critical issue is whether “purchases were made with a purpose to obtain control”), *aff'd on other grounds*, 206 F.2d 738 (2d Cir. 1953).

<sup>12</sup> If a narrower approach were thought appropriate, the investment purpose exemption could be made available to acquisitions of securities by officers and directors pursuant to an employer-sponsored executive compensation program.

<sup>13</sup> In 1988 the FTC sought public comments on a proposed amendment to the HSR rules that would have allowed an acquiror to hold up to 10% of the outstanding voting securities of an issuer without regard to the acquiror's intent or the value of the resulting holding. 53 Fed. Reg. 36,831 (Sept. 22, 1988). No further action was taken by the Commission concerning this proposal.

<sup>14</sup> This power derives from 15 U.S.C. § 18a(d)(2)(B).

## Paper Trail: Working Papers and Recent Scholarship

**Editor's Note:** In this issue, we note a recent Green Paper issued by the Commission of the European Communities proposing and requesting comments on a variety of policy options designed to facilitate private actions for antitrust damages.

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

—WILLIAM H. PAGE AND JOHN R. WOODBURY

### Recent Papers

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**European Commission Green Paper: Damages Actions for Breach of the EC Antitrust Rules, Brussels (Dec. 19, 2005), SEC(2005) 1732, [http://europa.eu.int/comm/competition/antitrust/others/actions\\_for\\_damages/gp\\_en.pdf](http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/gp_en.pdf)**

In this Green Paper, the European Commission proposes to investigate how best to encourage private actions for antitrust damages in the courts of the EC's member states. Articles 81 and 82 of the EC Treaty are roughly comparable to Sections 1 and 2 of the Sherman Act. Because those provisions are now "directly applicable" to member states, both the Commission and the local competition authorities may bring public enforcement actions. Private actions for damages and injunctive relief are also available, at least by implication, but a commissioned study in 2004 concluded that private antitrust actions have been extremely rare in Europe, for a variety of reasons.<sup>1</sup>

The Green Paper proposes to change that. It announces at the outset that facilitating private actions for damages will improve both compensation and deterrence and thereby increase the competitiveness of the European economy. To that end, the Green Paper lists nine categories of "obstacles" to such actions, and poses fifteen questions about how best to overcome the obstacles. Each of the questions is followed by one or more "options" for legal reform. A much longer attached staff working paper<sup>2</sup> provides additional details. The Green Paper invites comments (by April 21, 2006) to help the Commission decide whether actions at the community level are necessary to facilitate actions for damages.

Although neither the Green Paper nor the staff working paper cites American authorities, both the obstacles they describe and the proposals for reform are obviously based on comparisons with the U.S. system of antitrust remedies. The staff working paper notes that "the US system of antitrust litigation offers strong incentives to bring" antitrust suits, including treble damages, cost-shifting, and class action procedures. On the other hand, the "US system is often perceived as encouraging unmeritorious or vexatious litigation," so it "should be examined carefully and lessons

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<sup>1</sup> Denis Waelbroeck et al., Study on the Conditions of Claims for Damages in Case of Infringement of EC Competition Rules (Aug. 31, 2004), [http://europa.eu.int/comm/competition/antitrust/others/actions\\_for\\_damages/comparative\\_report\\_clean\\_en.pdf](http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/comparative_report_clean_en.pdf).

<sup>2</sup> Commission Staff Working Paper, Annex to the Green Paper, Damages Actions for Breach of the EC Antitrust Rules (Dec. 19, 2005), [http://europa.eu.int/comm/competition/antitrust/others/actions\\_for\\_damages/sp.html](http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/sp.html).

drawn from it” in order “to keep excessive litigation in check and to try to achieve some form of moderation in the enforcement system.”

Thus, the Green Paper does not propose a wholesale adoption of the American model. It identifies a variety of policy options that pick and choose among American procedures and substantive rules. Interestingly, it departs from the American system significantly in proposing some procedural reforms that would be applicable only to antitrust cases.

**1. Access to Evidence.** Many member states do not authorize anything like the broad discovery available under the Federal Rules. According to the staff working paper, “Parties are . . . not obliged to produce relevant documents unless the requesting party can expressly identify the individual document he seeks.” The Green Paper asks several questions about access to evidence, including whether there should be special disclosure rules for documentary evidence in antitrust cases, whether parties should have access to documents held by competition authorities, subject to confidentiality protections, and whether there should be special measures to prevent the destruction of evidence. Under one option related to the timing of discovery, the rules would allow courts to order disclosure of documents after a party has alleged “facts” and supported them with “reasonably available evidence.”

Interestingly, the Green Paper raises one question under this heading that has nothing to do with discovery: “Should the claimant’s burden of proving the infringement be alleviated, and, if so, how?” The Green Paper proposes that this issue might be addressed by giving preclusive effect to decisions of competition authorities in private actions. The Green Paper also mentions the possibilities of reducing the burden of proof in cases of unjustified refusals to produce evidence and “shifting or lowering the burden of proof in cases of information asymmetry between claimant and defendant,” presumably after a prima facie showing.

**2. Fault.** A minority of member states’ substantive law requires proof of “fault” (negligence or intent) in addition to proof of a violation of antitrust law. The Green Paper asks whether this requirement should be dropped in actions for damages, or limited to less serious offenses.

**3. Computation of Damages.** The member states pursue a variety of approaches to the calculation and proof of damages. The Green Paper addresses the approaches best suited to claims for antitrust damages by asking whether damages should be measured by harm to the claimant or gain to the defendant, whether interest should be calculated from the date of the violation or the date of the injury, and whether there should be a mandatory or optional provision for double damages for injuries from cartels. The Green Paper also asks whether “complex economic models” or “simpler methods” should be used for proof of damages. One proposal that would go beyond the relief available in the U.S. system is to allow prejudgment interest on damages from the date of the injury or the violation.

**4. Passing-On Defense and Indirect Purchaser Standing.** Here, the Green Paper asks how best to resolve the myriad issues raised by the *Hanover Shoe* and *Illinois Brick* rules. The Green Paper asks whether the law should allow a passing-on defense, indirect purchaser standing, neither, or both, and sets out the consequences of the various combinations of rules for complexity, duplication of damages, and compensation.

**5. “Defending Consumer Interests.”** The 2004 Study found that the member states imposed numerous restrictions on the use of “collective actions.” No state provides a remedy like the American class action. The Green Paper asks whether procedures for collective actions by “consumer associations” should be adopted, and, if so, how damages might be distributed to members.

**6. Costs of Actions.** The Green Paper asks whether an unsuccessful claimant could be excused from paying costs in cases in which there is a reasonable basis for the claim.

**7. Coordination of Public and Private Enforcement.** The Green Paper focuses on a number of areas of possible conflict between public enforcement and private damage actions. The most important of these have to do with the effect of private actions on leniency programs in public cartel enforcement. The Green Paper asks whether leniency applications should be protected from discovery and whether leniency applicants should be excused from damage liability, in whole or in part.

**8. Jurisdiction and Applicable Law.** Under EU law, defendants can be sued where they are domiciled, where the actions giving rise to the claim occurred, or where the injury occurred. Under a recent proposal, the law of the country in which a tortious harm occurs governs the action. The Green Paper asks whether that choice of law rule should apply in antitrust cases or whether a different rule, such as the law of the forum, should apply. One possibility in the case of actions that affect more than one country is to allow the claimant to choose the applicable law to the case, either a single law, or a separate law for each loss.

**9. Other Issues.** In the residual category, the Green Paper asks whether courts should, as a way of reducing costs, require parties to agree on a single expert witness or permit the court to appoint one. It also asks whether the statute of limitations for private actions should be suspended during public enforcement proceedings. Finally, it asks whether standards for proof of causation should be clarified to assure that they do not “pose a significant obstacle for claimants.” ●

—WHP