

## Interview with Deborah P. Majoras, Chairman, Federal Trade Commission

**Editor's Note:** In this interview with the Antitrust Source, Deborah Platt Majoras candidly talks about her plans for the Federal Trade Commission. Chairman Majoras discusses her goals and priorities for the Bureau of Competition in both merger and non-merger enforcement, as well as her enforcement objectives in the increasingly global area of consumer protection. She also highlights the importance of the FTC's policy and advocacy programs in its overall mission of protecting consumers and competition.

Ms. Majoras was sworn in as Chairman of the Federal Trade Commission on August 16, 2004. This is her second time in public service. From 2001–2004 she was with the U.S. Department of Justice Antitrust Division, first as Deputy Assistant Attorney General and then as Principal Deputy. During her three year tenure at the Antitrust Division, she oversaw matters involving numerous industries, including software, financial networks, defense, and media and entertainment. She also served as Chair of the International Competition Network's (ICN) Merger Working Group and oversaw policy initiatives, such as the FTC/DOJ Health Care Hearings, the DOJ's Merger Review Process Initiative, and the Mergers Best Practices Project.

Ms. Majoras joined the FTC from the law firm of Jones Day, where she was a partner in the firm's antitrust section, and a member of the firm's technology issues practice. She is a member of the American Bar Association's Section of Antitrust Law, where she recently served as Vice Chair of the Section 2 Committee and as a member of the Long-Range Planning Committee. Ms. Majoras also served as a non-governmental advisor to the ICN and was named by President Bush to serve on the Antitrust Modernization Commission, a position she was required to resign when she assumed the duties of FTC Chairman.

The Antitrust Source conducted this interview on March 4, 2005.



Deborah P. Majoras

**ANTITRUST SOURCE:** You assumed the Chairmanship of the Federal Trade Commission in August, so you are about seven months into this now. We appreciate your willingness to talk to us at this relatively early stage in your tenure. Let's begin by talking about resources that you have to work with. Do you have any plans for shifting the allocation of your resources among the Bureaus of Economics, Competition, and Consumer Protection in terms of the staffing, employees, and numbers?

**MAJORAS:** No. I have no current plans to do any major reallocation of resources. I have been fortunate enough to take over the leadership of an agency that I think is functioning quite well and, from what I can tell so far, allocating resources in a way that is very effective.

**ANTITRUST SOURCE:** The proposed '06 budget for the FTC is essentially at the same level as it is for '05. Do you plan to cut any programs or to initiate any new programs based on your projected budgeting levels for '06?

**MAJORAS:** As you know, these are going to be somewhat lean times for government agencies generally, and agencies are being asked to be cautious and tighten their belts. But we are, relatively speaking, doing very well in the budget process. We work very closely with Congress, particularly on the consumer protection side. We have a lot of programs that are very important to Congress, and we cannot keep doing our work on them all if we do not have the funds. In addition, one could argue that our total budget is a rounding error compared to the overall U.S. budget. Overall, we

are doing well, and we have no plans to make cuts. Now, if we are asked by Congress to add any significant additional programs, then we will need to ask that they be funded.

**ANTITRUST SOURCE:** There have been some recent announcements of changes in leadership positions at the FTC. For example, Jeff Schmidt has come in as a Deputy Director of the Bureau of Competition, and Jeff Brennan has moved from the Health Care Unit to become Associate Director of the Bureau of Competition. Can you explain how their responsibilities will be allocated within the front office at the Bureau of Competition?

**MAJORAS:** I generally leave that to Susan Creighton, who is my very able Director of the Bureau of Competition, although she and I do talk a fair amount about the organization. Jeff Brennan will serve as a liaison between the Bureau of Competition and the regional offices on competition matters, but he also is going to have other responsibilities. He really will be functioning as Susan's third deputy. For example, we have put Jeff in charge of the initiative to produce, with the Department of Justice's Antitrust Division, a commentary on the Horizontal Merger Guidelines. Jeff Schmidt will help Susan in a wide variety of areas. In particular, he will assist her in supervising investigations, managing litigation, and preparing enforcement recommendations for the Commission. Beyond that, we are becoming quite busy in the Bureau of Competition with the recent mergers that have been announced, so I expect that Susan is delighted to have two able new folks to add to her team.

I would also like to add that Bill Blumenthal has recently been appointed General Counsel of the FTC. The General Counsel's Office handles not just a wide array of litigation matters, but also undertakes important research and policy development projects. I am delighted to have him at the helm there.

**ANTITRUST SOURCE:** What if anything can you tell us about any anticipated future staff changes in the near term at the Federal Trade Commission?

**MAJORAS:** Rosemarie Straight, our excellent Executive Director, has retired, so her deputy, Judy Bailey, is currently serving as Acting Executive Director, and we are in an active search for a replacement for Rosemarie. That position may be the most important job in the building, including mine. As far as other positions go, I was lucky enough to have almost the entire senior staff who worked for former FTC Chairman Tim Muris stay on with me during the transition and beyond.

**ANTITRUST SOURCE:** Let's turn to the FTC's merger program. Are you planning to make any changes in the second request issuance process, for example, in particular investigations?

**MAJORAS:** I would like to see second requests customized for each investigation. It is something that I worked on when I was at the Department of Justice. As you know, I have initiated a merger process reform project here at the FTC, and I have put together a large committee drawing from the merger shops in the Bureau of Competition, from the General Counsel's office, and from the Bureau of Economics. We are going to be looking at a number of things to improve the process. I am not fond of issuing essentially the same broad second request in every instance and then waiting for the negotiation process to tailor it. The negotiation process is, of course, important, because we do not know all the facts we would need to know to tailor it in the first instance. But I think in most instances, some tailoring can and should be done early.

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**ANTITRUST SOURCE:** Are there any particular steps you have in mind in terms of streamlining the process specifically or are we at the planning stage right now?

**MAJORAS:** I think we are at the planning stage. I definitely have ideas, and I am passing them along to the committee. But I want the staffers who are doing this on a daily basis to be involved in establishing what some of the best practices are, so I would rather wait until we have done a little bit more work on it before I give the specifics.

In the meantime, though, let me give you an example of the type of reforms we might consider. When I was at the Justice Department, we examined the respective incentives of the agency and the parties in a merger investigation. We asked ourselves what the two sides of any merger really want. The parties typically want some specificity on the timing, and, of course, they want it to happen as fast as possible. They also would like to have their burdens lessened. The agency wants to get information as quickly as possible and have time to review it. In light of this, one of the things that we did at DOJ was to empower the chief to enter into letter agreements and make deals. For example, at the FTC, the staff could promise the parties a meeting with the Bureau Director by a date certain if the parties promise to produce, say, the pricing data by a fixed date and finish their production by a fixed date. At DOJ, we found that those deals could be very effective because people felt that their cooperation was being rewarded. I think that using a little creativity can go a long way toward streamlining the process.

Here is another idea for streamlining the process: If it appears at the beginning that one issue might be determinative but we are not certain, we could perhaps take all the other issues and put them on the backburner and have a production made just on the determinative issue. If it turns out to be determinative and we do not need to go any further, then we have not wasted our time on other things. Methods like these and others, I think, can improve the process.

**ANTITRUST SOURCE:** How do you think the FTC and the DOJ are managing the efficiency and timeliness of the clearance process currently? Is there room for improvement?

**MAJORAS:** Yes, I think there is room for improvement. The clearance process goes up and down. Most of the time, it works very well and very effectively. I think if the merger stream continues the way it seems to be, there will be plenty of work for everyone to do, and that will help matters. But Assistant Attorney General Hew Pate and I have been working to try to improve the process, and we will continue to work at it. The competition between the agencies for work is a good sign in some ways: it shows that our agency lawyers are very, very excited about working on particular deals. But the bottom line on clearance is that both agencies are highly capable of examining deals and examining conduct cases. We need to be clearing cases efficiently, particularly when we have a merger clock, so that we can do our work for the public and not fight with each other.

**ANTITRUST SOURCE:** Has there been any effort to restart the attempts to come up with a new clearance process—sort of rules of engagement?

**MAJORAS:** No, not really. From time to time, we talk about tweaks here and there, but the basic rule—that experience in the relevant product market is the key factor in determining who gets clearance—is still in place. Incidentally, the provision in the appropriations bill that forbade us from executing the abandoned clearance agreement has been removed. However, as I said during my confirmation hearing, I will not reinstitute that particular agreement.

**ANTITRUST SOURCE:** You announced that the FTC and the DOJ are going to produce a commentary on the 1992 Horizontal Merger Guidelines sometime in 2005. Can you tell us anything more about how the commentary is being developed—what the approach is, who is doing it, the process, or anything else?

**MAJORAS:** I have put together a task force of folks from the Bureau of Competition, the Bureau of Economics, and the General Counsel's office—with Jeff Brennan at the helm—to work with the Justice Department to come up with a commentary on the Horizontal Merger Guidelines. Because we want to produce a commentary on what we really do in merger review, I think it is very important that the folks who are reviewing mergers have a lot of input and that this not be just a Chairman-imposed or Bureau-imposed project. We are looking at all the major areas of the Guidelines. We are drawing on all our years of experience with these Guidelines and on the 2004 Merger Workshop to try to enlighten folks on how we are using the Guidelines to review mergers.

**ANTITRUST SOURCE:** Do you anticipate that the commentary will address any new areas or new issues, for example, how intellectual property would fit into the analysis of a merger review?

**MAJORAS:** It is possible that it could. I do not want to say exactly what is going to be in it yet, because we have not made all of those determinations. But there is no question that reviewing mergers involving intellectual property has become a much more common exercise now than it was in 1992, when the Horizontal Merger Guidelines were issued. It might make sense to discuss how those mergers are reviewed and whether there is anything different about the review.

**ANTITRUST SOURCE:** Let's talk specifically about the timing of entry. Two years may be a lot for one industry and actually a little for another. Do you anticipate that the commentary would potentially come out with any guidance that would indicate that the agency has flexibility in the time test in the Guidelines, perhaps as it relates to specific industries?

**MAJORAS:** I do not know whether we will be that specific. There may be an explication of relevant factors that go into assessing the time period. It is possible that some industries can provide examples. Obviously, we have learned a lot about that entry question over the years. I am not certain, however, that it would be as specific as a true industry-by-industry analysis.

**ANTITRUST SOURCE:** Let's talk about the recently appointed Associate General Counsel for Energy. Will that position be involved in reviewing oil industry mergers and investigations or is it more of a policy advocacy position or is it a combination of everything?

**MAJORAS:** It really is a combination. I am delighted that John Seesel agreed to take the position. As you know, he is a long-time FTC lawyer and highly respected both inside and outside the agency. He is really tackling the position with a lot of vigor. His role is to coordinate all of our efforts in this industry, not only on the competition side but on the consumer protection side. He is advising us on merger and conduct investigations, on policy, on any legislative efforts, and any consumer education efforts. He is even involved in some of the Federal Energy Regulatory Commission advocacy work that we do on electricity. As you know, energy is a very significant area for the FTC, and we have pieces of it all around the agency. John acts as the focal point to ensure that we are staying on top of every aspect of energy policy, and that we are coordinating

it all so that our work is consistent. We have a lot of inquiries in this area from Congress and from interest groups, and he can help us make sure that we are being responsive to those who are interested, particularly with respect to gasoline prices but also with respect to winter heating costs and the like. This is a major issue for consumers, and we want to treat it as such.

**ANTITRUST SOURCE:** In the *Arch Coal* and *Oracle* cases, the courts seemed to accord a low significance to customer complaints. Verified customer complaints have long been one of the key factors in deciding whether to challenge a merger. How do you think the FTC should reconcile this sort of difference between how the courts have recently looked at that and how the agencies and others have traditionally looked at it?

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**MAJORAS:** We have to take these cases seriously. As you may remember, I have long been a proponent of court involvement in our cases because I believe it is very healthy to have neutral judges taking a look at our work and our theories. With respect to these and other cases, particularly when one loses, it is very important to try to figure out what happened. We are not planning on backing away from customer testimony, and view it as a very important part of the analysis. We have been doing some research internally to further support our own belief that it is very important. I think what we likely need to do is not take for granted that a court will understand why it is important. We must work harder at not just putting customers on the stand or submitting their declarations; we must really explain to the court why this testimony matters and is relevant to the issues at hand.

**ANTITRUST SOURCE:** Let's shift focus now to the non-merger side of the Bureau of Competition, to the anticompetitive practices part of the mission. You inherited an agenda that placed a pretty high priority on anticompetitive abuses under the *Noerr-Pennington* doctrine, in the context of standard-setting activities and in pharmaceutical industry patent settlements. Do you intend to pursue more cases in these areas?

**MAJORAS:** It is always hard to say exactly which kind of cases we are going to pursue. But we do believe that there is still a fair amount of abuse with respect to government process and the like, so I think you can expect that we will continue to pursue these types of cases. I think we need to protect the integrity of government processes. I wish there were not so much fodder, but there is, so we will continue to investigate these cases.

**ANTITRUST SOURCE:** You inherited an agenda that focused a good bit on single firm activity. Will you be looking for incidences of collusion that might not rise to the level of criminal activity but should nonetheless be investigated civilly and prosecuted either under Section 5 of the FTC Act or under Section 1 of the Sherman Act?

**MAJORAS:** Of course. Horizontal conduct should always be high on the list for an antitrust enforcer. As you know, particularly with respect to physicians, the FTC has investigated a number of agreements that violate the antitrust laws. We would like to do a better job of trying to educate physician groups, because naturally we would rather cut down on the incidence of price fixing through ventures in which there has been no efficiency-enhancing integration. It is just surprising that despite the many cases we have brought, we still seem to need to get the message out. The bottom line is that I think you will continue to see us bringing these cases.

**ANTITRUST SOURCE:** Does the FTC have any programmatic interest in clarifying the law in the area of bundled rebates or loyalty discounts or other types of vertical price restraints?

**MAJORAS:** I think we all do—all of us in the antitrust community who care so much about this discipline. This is an area in which the law is not entirely uncertain, but *LePage's* revealed that there is enough uncertainty in this area that it is difficult to counsel clients. Vertical restraints, whether price or non-price, are an area in which the antitrust bar plays such a significant role in working with clients to avoid violations in the first place. Lawyers on the outside have said over and over that they are just not sure how they are now supposed to counsel their clients on bundled rebates. In addition, I think we in the antitrust bar and in the business community—not just in the United States, but worldwide—are engaged in a serious dialogue over monopolization/dominance. *Trinko* helps a lot, but there are still debates about the sorts of cases that should be brought, and about the test that should be used to evaluate these cases. I have been in a number of rather heated discussions on this topic, and I think you will continue to see a lot of discussions on it. Naturally, the FTC would like to be right in the middle of any public dialogue, contributing to clarifying this area of the law in any way we can.

**ANTITRUST SOURCE:** That's a good segue to the international area. What is your agenda on the international front for competition?

**MAJORAS:** I think we will continue to devote significant resources to our work in the international area. In fact, I think it will get to the point where international issues will simply be integrated into our everyday work, because it is hard to have a day go by anymore when I am not somehow engaged in a matter with a global aspect or having a meeting with someone from another jurisdiction. This area has just absolutely exploded, and we will continue to participate through several different means.

With respect to multi-jurisdictional forums, we will continue to be huge supporters of, and active participants in, the International Competition Network, which both U.S. agencies helped establish. It is an organization that, I believe, has accomplished a great deal in a short period of time. The membership has grown and continues to grow, and I think there is a lot that can be accomplished in that forum. We will also continue our work in the Organization for Economic and Cooperative Development, which is another important, slightly different multi-jurisdictional forum. We will continue funding through the U.S. Agency for International Development and the like in order to participate in technical assistance programs for jurisdictions with new competition regimes. The demand for this assistance exceeds our resources. There is just so much demand for help now from all of these countries that have brand-new regimes, so both we and the European Union are engaged in a lot of this kind of work.

We have very significant bilateral relationships, of course. The European Union is the most important of these, given that they are our most important trading partner. But we have no end of countries who are interested in strengthening bilateral ties with us, as we have more and more investigations that are overlapping. We do find a great advantage to having established some relationships upfront—before we are confronted with a joint investigation—because it helps us to work together. All of that, I think, is very important on the competition side. With respect to individual cases, we cooperate with the European Union, Canada, Japan, and other countries on such a regular basis now that it is fairly routine. The problem now is that when I give speeches about it, sometimes people look at me as though they are thinking, "Well, gosh, that is sort of boring." Well,



maybe good government is boring. It has become very routine for our folks to work with other nations on joint investigations.

**ANTITRUST SOURCE:** Continuing on the international front, what is your agenda there for consumer protection?

**MAJORAS:** The international component may be becoming even more important on the consumer protection side. We are dealing with so much fraud perpetrated on the Internet, which of course is borderless, that we are working very hard to establish ties with jurisdictions around the world to work on fraud cases, identity theft cases, and a whole host of issues. It does not necessarily have to be fraud stemming from Internet and email use, but it often is. We are working hard on a piece of legislation that would give us much better tools to be able to combat cross-border fraud. We are very anxious to get that legislation passed because the fact of the matter is that, although I hate to say it, the fraudsters on the Internet are ahead of us. Unlike us, they do not have to worry about jurisdictional rules or borders or information sharing and confidentiality. They are just sitting on some offshore island defrauding U.S. consumers. We need better tools so we can catch up. Also, we have an organization similar to ICN, called the International Consumer Protection and Enforcement Network, which consists of consumer protection agencies from around the world working together on common issues like fighting spam or getting consumer redress in fraud cases. We also work on consumer protection in OECD.

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**ANTITRUST SOURCE:** How do you see guidelines and advocacy fitting in to the FTC's overall mission? By advocacy, I mean amicus briefs, business review letters, testimony at the state level or on the Hill.

**MAJORAS:** I think it is one of the most important things we do. It is often done at a relatively low cost, and yet if we can help to block an anticompetitive piece of legislation from becoming law, we can save consumers a lot of money. That is why I think you should expect to see even more advocacy coming out of the FTC, and, of course, we will do a lot of it with our friends at the Antitrust Division.

Our mission is protecting consumers. Some of that involves protecting consumers directly, and some of it involves protecting competition, which in turn benefits consumers. I have a strongly held view that part of the work we need to be doing is maintaining a strong competition culture for the United States. You might think that we should not have to be worried about maintaining that culture, since we have had it for so long. But individual interests are constantly pecking away at it. Former FTC General Counsel Bill Kovacic was always fond of saying that the FTC and the Antitrust Division are the ones who stand up for the market and not for any particular interest. You will hear me doing a lot of evangelizing, along with my colleagues here at the FTC, on this subject.

On the amicus brief side, courts are increasingly asking us to weigh in on competition issues, especially as private litigation has proliferated. Courts have wanted to strive for some consistency, so we are asked to weigh in. For example, the Solicitor General was just asked by the Supreme Court to weigh in on the *Dagher* case from the Ninth Circuit.

A lot of the advocacy work we do is behind the scenes. I gave a speech recently and talked a lot about our specific advocacy efforts, some of which we thought had been quite successful. For example, FTC staff and the Antitrust Division filed an amicus brief last year urging the West Virginia Supreme Court to reject a bar opinion that laypersons could not lawfully provide real

estate settlement services. We emphasized the lack of consumer harm from such lay services, and noted that banning them would drive up settlement costs for West Virginians.

But in addition to such advocacy efforts, we talk to Congress or to our colleagues in the federal government daily, answering questions about issues of competition or consumer policy. In that sense, it is like having clients.

**ANTITRUST SOURCE:** Do you see a need for new guidelines in any particular substantive area or industry?

**MAJORAS:** I do not see a need for something new. That is not to say that something will not pop up, of course. Guidelines are really important in areas in which we have had a record of experience. They are also important in particular areas that have special qualities, such as intellectual property, because they allow us to discuss our approaches to those particular areas. But at this moment, it is not apparent to me that there is a new area in need of guidelines.

**ANTITRUST SOURCE:** I'd like to ask a question about the Antitrust Modernization Commission. The list of topics that the commissioners are going to be focusing on is now on their Web site [[www.amc.gov](http://www.amc.gov)]. How do you plan to give input to the Modernization Commission to get the agency's views heard and understood as they study the issues?

**MAJORAS:** We already have been providing input to the Commission, and I am sure we will continue to do it. I am pleased to say that the members of the Commission are very interested in hearing the views of many of us here at the FTC, and we will continue to give them as much support as we can. As a matter of fact, we let them use our 601 New Jersey Avenue facility when they have meetings!

**ANTITRUST SOURCE:** Do you have any comments or points you'd like to add to what you've said so far at this point?

**MAJORAS:** I am often asked what I think is possibly the most important issue for the Antitrust Modernization Commission. I think that if the Modernization Commission could recommend elimination of all or virtually all exemptions and immunities from the antitrust laws, they would have accomplished a great deal. Most of those exemptions and immunities are dinosaurs. They were in put in place for particular reasons at certain times, but the markets have moved on. Markets have become far more global, and it is hard to justify most exemptions and immunities today. I think they are inconsistent with our general approach to competition and need to be eliminated. ●



## The Curious Case of *Stolt-Nielsen S.A. v. United States*

### Jim Walden and Kristopher Dawes

On February 25, 2003, Stolt-Nielsen S.A. (SNSA) announced that it and its U.S.-based subsidiary had received conditional amnesty under U.S. and European Union corporate leniency programs for antitrust matters. According to a press release, SNSA sought amnesty because an internal investigation disclosed “possible collusive behavior” in the parcel tanker industry.<sup>1</sup> While some on-line publications heralded this “surprise announcement”<sup>2</sup> in a large and lucrative industry, no one could have imagined the surprises to come.

Less than two months later, on April 8, 2003, SNSA became the first company ever to be suspended from the U.S. Department of Justice’s Corporate Leniency Program (Amnesty Program). The Antitrust Division of the Department of Justice charged that SNSA failed to (a) take “prompt and effective action” to end conspiratorial activities and (b) cooperate fully and completely.<sup>3</sup> Both are requirements of the Amnesty Program.<sup>4</sup>

After the Division revoked SNSA’s amnesty, SNSA promised to “vigorously challenge” the decision.<sup>5</sup> The Division responded with a press release of its own:

All companies that apply to the Corporate Leniency Program must meet certain requirements and make accurate representations to the Division. Corporate applicants are accepted on a conditional basis. As part of its enforcement efforts, throughout the investigation, the Division verifies the representations of the corporate leniency applicant. At any time throughout the process, the Division may expel an applicant after concluding that a company has made false representations to the Division or has otherwise not fully complied with the leniency policy requirements.<sup>6</sup>

With this pronouncement, the Division essentially said it would hold companies to their end of the bargain. In addition, Division officials publicly promised a “full accounting” of the basis for SNSA’s ejection from the Amnesty Program.<sup>7</sup>

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<sup>1</sup> Press Release, Stolt-Nielsen S.A., Stolt-Nielsen Transportation Group Granted Conditional Amnesty in Parcel Tanker and Inland Barge Investigations (Feb. 25, 2003), available at <http://www.stolt-nielsen.com/>.

<sup>2</sup> *In a Surprise Announcement, the Stolt-Nielsen Transportation Group Has Been Granted Conditional Amnesty from Prosecution and Fines* (Apr. 3, 2003), available at <http://www.purchasing.com/article/CA287718.html?text=%22stolt%2Dnielsen%22>.

<sup>3</sup> See *Stolt-Nielsen S.A. v. United States*, 352 F. Supp. 2d 553, 568 (E.D. Pa. 2005).

<sup>4</sup> U.S. Dep’t of Justice, Corporate Leniency Policy (Aug. 10, 1993), available at <http://www.usdoj.gov/atr/public/guidelines/0091.htm>.

<sup>5</sup> Press Release, Stolt-Nielsen S.A., Stolt-Nielsen S.A. Reports Withdrawal of Amnesty by Department of Justice (Mar. 22, 2004), available at <http://www.stolt-nielsen.com/>.

<sup>6</sup> Press Release, U.S. Dep’t of Justice, Justice Department Statement Regarding Antitrust Division’s Corporate Leniency Program (Mar. 22, 2004), available at [http://www.usdoj.gov/atr/public/press\\_releases/2004/202940.pdf](http://www.usdoj.gov/atr/public/press_releases/2004/202940.pdf).

<sup>7</sup> *Stolt-Nielsen Misled U.S. on Timing of Price Fixing*, BLOOMBERG, Apr. 2, 2004, available at <http://quote.bloomberg.com/apps/news?pid=10000085&sid=acF20WAQJis&refer=europe>.

■  
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With the battle lines drawn, SNSA pursued a novel strategy: it moved for an injunction in federal court to stave off any indictment of the company. While the antitrust bar waited in anticipation, January 14, 2005, brought the biggest surprise of all: the district court granted SNSA's application and enjoined the indictment of SNSA and one of its executives.<sup>8</sup>

As the dust starts to settle, some will inevitably characterize both events—the revocation of SNSA's amnesty and the decision to enjoin SNSA's indictment—as watersheds in the development of criminal enforcement policy. It is unlikely, though, that either event will have lasting legal or practical significance, except to the parties in the ongoing litigation.<sup>9</sup> As discussed below, the court's curious decision to enjoin the indictment has dim chances of surviving an appeal. Moreover, the Division's decision to oust SNSA from the Amnesty Program is not likely a portent of more ejections to come.

### SNSA's Amnesty Agreement

The Antitrust Division, like most other divisions of the Department of Justice, has standard cooperation agreements.<sup>10</sup> SNSA's amnesty agreement, like all other such agreements authored by the Division, contained corporate representations that are a condition precedent to admission into the amnesty program.<sup>11</sup> In that regard, SNSA represented that it:

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(a) "took prompt and effective action to terminate its part in the anticompetitive activity being reported upon discovery of the activity"; and

(b) "did not coerce any other party to participate in the activity, and was not the leader or the originator of the activity."<sup>12</sup>

The agreements are specifically conditioned on the Division's "verification of [these] representations," and on an applicant's full, complete and unconditional cooperation. The agreements also provide a broadly worded termination provision:

If the Antitrust Division at any time determines that [the applicant] has violated this Agreement, this Agreement shall be void, and the Antitrust Division may revoke the conditional acceptance of [the applicant] into the Corporate Leniency Program. Should the Antitrust Division revoke the conditional acceptance of [the applicant] into the Corporate Leniency Program, the Antitrust Division may thereafter initiate a criminal prosecution against [the applicant], without limitation.<sup>13</sup>

As described in the district court's opinion, the basis for SNSA's representation about "prompt and effective" termination of conspiratorial activities was supplied to the Division at a meeting on December 4, 2002.<sup>14</sup> At that meeting, SNSA sought to establish a "marker" for amnesty protection. A Division official made reference to an article that had appeared in the *Wall Street Journal*, which reported that SNSA's former general counsel had initiated a lawsuit against SNSA based on

<sup>8</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 562–63.

<sup>9</sup> The Division has not yet filed a notice of appeal.

<sup>10</sup> Department of Justice, Model Amnesty Letter, in Gary R. Spratling, *The Corporate Leniency Policy: Answers to Recurring Questions*, Presented at the ABA Section of Antitrust Law Spring Meeting (Apr. 1, 1998), available at <http://www.usdoj.gov/atr/public/speeches/1626.htm>.

<sup>11</sup> See Corporate Leniency Policy, *supra* note 4, Part A.

<sup>12</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 558.

<sup>13</sup> Model Amnesty Letter, *supra* note 10.

<sup>14</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 565.

constructive termination. In essence, the general counsel claimed that he had discovered collusive activities and brought them to the attention of senior management, who failed to take action to stop the conduct. Therefore, the general counsel said he was forced to make a choice: resign or become complicit.<sup>15</sup>

In referring to the *Wall Street Journal's* coverage, the Division official said that SNSA would be ineligible for amnesty if these facts were true because it could not show “prompt and effective termination” of collusive activities. In response to these concerns, SNSA’s outside counsel confirmed that the former general counsel had found evidence of the antitrust activities, but characterized his allegations of constructive termination (due to the company’s failure to act) as spurious.<sup>16</sup> SNSA’s counsel produced documentary evidence that SNSA had actually notified its co-conspirators of its withdrawal from the conspiracy, and claimed that SNSA had implemented “remedial steps to enhance its antitrust compliance program.”<sup>17</sup> The Division official explicitly warned SNSA’s counsel that it could not secure amnesty if the general counsel’s claims were true and the remedial steps were merely a “head fake.”<sup>18</sup>

The Division terminated SNSA’s amnesty when it determined that the representations made at the December 4 meeting were untrue. The Division’s continuing investigation revealed that two of SNSA’s high-level executives, who were not disciplined or terminated after discovery of the collusive activity, continued to participate in the conspiracy until at least November 2002, nine months after discovery by the former general counsel.<sup>19</sup>

In spite of this evidence, the court in *Stolt-Nielsen* handed the company a major victory (although possibly a temporary one) by enjoining indictment.

### Good Facts Led to Questionable Law

There are many striking aspects of the *Stolt-Nielsen* opinion, as much for what it omits as for what it says. The opinion took no issue with the Division’s evidence concerning the continuation of the conspiracy. The opinion made no mention of the “conditional” nature of the amnesty protection afforded by the agreement, including the express right to “verify” the company’s representations about “prompt and effective” termination. The opinion did not discuss the express right the Division retained to “revoke the conditional amnesty protection” and declare the agreement “void” upon breach, including the right to institute a prosecution against the company “without limitation.”

While these important provisions of the agreement certainly bear on whether the Division bargained for the right to, in good faith, unilaterally declare the agreement void, as is a common provision of the DOJ’s cooperation agreements,<sup>20</sup> the court also made glaringly inconsistent statements about the underlying facts. Importantly, the court stated that the Division “did not and does

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<sup>15</sup> James Bandler & John McKinnon, *Stolt-Nielsen Is Probed for Traffic with Iran*, WALL ST. J., Nov. 22, 2002, at A3.

<sup>16</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 565.

<sup>17</sup> *Id.* at 557. Indeed, SNSA’s counsel also apparently indicated that an SNSA executive, Richard B. Wingfield, personally advised his co-conspirators that SNSA could no longer have collusive contact. *See Stolt-Nielsen v. U.S.*, 04-CV-537 (TJS), Government’s Proposed Findings of Fact, ¶ 47(g).

<sup>18</sup> Government’s Proposed Findings of Fact, *supra* note 17, ¶ 47(k).

<sup>19</sup> *Id.*, ¶ 36.

<sup>20</sup> In other circumstances, courts—including the Third Circuit—have been very reluctant to second-guess the government’s decision to declare a cooperation agreement in breach. *See, e.g.*, *United States v. Fuentes*, No. 03-3215, 2004 WL 1179256, at \*2 (3d Cir. May 28, 2004) (“Thus, the government need not prove a defendant’s breach of a plea agreement by any measure of evidence, but must only act without unconstitutional motive and in good faith.”).

not claim that [SNSA] failed to cooperate in the investigation,”<sup>21</sup> even though the court’s findings of fact explicitly reflect that the Division did, indeed, assert SNSA’s failure to cooperate as grounds for breach.<sup>22</sup> As is clear from the record below, the Division asserted that SNSA “falsely represent[ed] the true duration of [SNSA’s] participation in the conspiracy and fail[ed] to fully disclose the roles played by some of its senior executives.”<sup>23</sup>

There is a more striking and surprising aspect to the decision: the issuance of an injunction against a federal indictment. Targets of criminal investigations have, from time to time, sought to prevent their indictment through injunctions. Those actions have generally failed. In evaluating such claims, courts typically begin with the “basic doctrine of equity jurisprudence that courts of equity should not act, and particularly should not act to restrain a criminal prosecution, when the moving party has an adequate remedy at law and will not suffer irreparable injury if denied equitable relief.”<sup>24</sup>

Because *Stolt-Nielsen* was decided by a district court in the Third Circuit, another Third Circuit case, *United States v. Kenny*,<sup>25</sup> is of particular interest. There, a defendant was originally indicted in a state criminal case, but the state voluntarily delayed trial pending a subsequently-issued federal indictment. In the federal case, the defendant was severed from the case and granted transactional immunity, after which he testified against his former co-defendants. After his testimony in the federal case, the defendant sought an injunction in federal court against the state prosecution.<sup>26</sup> The district court granted the injunction and the court of appeals reversed.<sup>27</sup> In so doing, the court of appeals held: “[T]he record fails to demonstrate that the pending state prosecution posed any threat to defendant’s rights that could not be eliminated by assertion of an appropriate defense in the state courts.”<sup>28</sup>

Based on similar reasoning, the Division argued that SNSA had an adequate remedy at law because it could raise the immunity agreement as grounds to dismiss an indictment under Rule 12(b)(1) of the Federal Rules of Criminal Procedure.<sup>29</sup> Students of the *Younger* abstention doctrine might have rated this argument a proverbial “slam dunk” in light of the Supreme Court’s clear and unequivocal holding that “the cost, anxiety, and inconvenience of having to defend against a single criminal prosecution could not by themselves be considered ‘irreparable’ in the special legal sense of that term.”<sup>30</sup>

On the issue of “adequate remedy at law,” the *Stolt-Nielsen* Court did not cite *Younger*, nor did it refer to *Kenny*. Instead, in a footnote, the Court quoted language from a 1947 Second Circuit opinion, *In re Fried*, in which a criminal defendant moved for pre-indictment suppression of evidence: “[A] wrongful indictment . . . works a grievous, irreparable injury to the person indicted’

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<sup>21</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 561.

<sup>22</sup> *Id.* at 569.

<sup>23</sup> Letter from James M. Griffin, Deputy Assistant Att’y Gen., U.S. Dep’t of Justice Antitrust Division, to J. Mark Gidley, White & Case LLP at 2 (Mar. 2, 2004) (on file with author).

<sup>24</sup> *Younger v. Harris*, 401 U.S. 37, 43–44 (1971).

<sup>25</sup> 462 F.2d 1230 (3d Cir. 1972).

<sup>26</sup> *Id.* at 1231.

<sup>27</sup> *Id.* at 1233.

<sup>28</sup> *Id.* at 1232.

<sup>29</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 560.

<sup>30</sup> *Younger*, 401 U.S. at 46.

resulting in damage to the person's reputation which, because the public remembers the accusation and suspects guilt, cannot be simply cured by a subsequent finding of not guilty."<sup>31</sup>

As a brief aside, it is difficult to imagine how SNSA could have experienced the particular "harm" identified by *In re Fried*—damage to its reputation from an unfounded accusation—since it publicly announced that it was involved in collusive activities and had received amnesty. In effect, SNSA had already publicly announced its guilt.

Putting aside the factual problems inherent in the court's finding of harm to SNSA, the court's reliance on *In re Fried* is, at least, contextually awkward. The *In re Fried* opinion is a polemic against the then-prevalent use of coercive and unconstitutional interrogation techniques. Calling these techniques "foul exploits" and "miserable behavior," the opinion promotes the "vigorous exercise" of equity powers to restrain them.<sup>32</sup>

Although the historical context makes the sweeping language of *In re Fried* understandable, the overwhelming weight of authority rejects the notion that equity jurisdiction should, in any case, be "vigorously" exercised.<sup>33</sup> Rather, courts have consistently held that such equity powers should be exercised with "caution and restraint."<sup>34</sup> Courts have also rejected the more specific suggestion in *In re Fried* that "irreparable harm" flows from the threat of indictment. Instead, courts have held that "[t]he mere threat of prosecution is not sufficient to constitute irreparable harm."<sup>35</sup>

This rule has been followed in the Third Circuit. In *Johnson v. United States*, the official liquidator of an offshore bank brought an action to recover computer tapes that were stolen by a former managing director and given to the FBI.<sup>36</sup> Although the liquidator argued that the unlawfully obtained tape might result in "widespread investigation and possible prosecution of the [bank's] clients,"<sup>37</sup> the court rejected the contention that such prosecutions constituted "irreparable harm."<sup>38</sup> Indeed, the court noted that it "must exercise 'caution and restraint'" before exercising equitable jurisdiction to restrain the criminal process.<sup>39</sup>

*Stolt-Nielsen* makes no mention of *Johnson*, nor of the hundreds of federal cases urging caution in the use of equity powers to restrain the criminal process when an adequate remedy at law is available. Instead, *Stolt-Nielsen* relied on *United States v. Meyer*,<sup>40</sup> for the proposition that due process required a pre-indictment determination concerning whether SNSA breached the amnesty agreement.

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<sup>31</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 560 n.9 (quoting *In re Fried*, 161 F.2d 453, 458–59 (2d Cir. 1947)).

<sup>32</sup> *In re Fried*, 161 F.2d at 459.

<sup>33</sup> See, e.g., *Ramsden v. United States*, 2 F.3d 322, 324 (9th Cir. 1993).

<sup>34</sup> *Id.*

<sup>35</sup> *Ramsden*, 2 F.3d at 326; see also *United States v. Search of Law Office, Residence and Storage Unit Alan Brown*, 341 F.3d 404, 415 (5th Cir. 2003) ("[W]e conclude that the irreparable harm . . . must have focused on the injury . . . from loss of the property, not simply harm from the grand jury's reliance on the illegally seized evidence in indicting [petitioner]."); *Blinder, Robinson & Co. v. United States*, 897 F.2d 1549, 1557 (10th Cir. 1990) ("We . . . hold that the mere threat of imminent indictment does not establish irreparable injury[.]"); *Matter of Search of 4801 Fyler Ave.*, 879 F.2d 385, 389 (8th Cir. 1989) ("[I]f we were to allow the mere threat of future prosecution to constitute irreparable harm these procedures would not be extraordinary, but quite ordinary. Every potential defendant could point to the same harm, thereby invoking the equitable powers of the court.").

<sup>36</sup> 971 F. Supp. 862, 863 (D.N.J. 1997).

<sup>37</sup> *Id.* at 865 n.2.

<sup>38</sup> *Id.* at 868.

<sup>39</sup> *Id.* at 866 (quoting *Ramsden*, 2 F.3d at 324).

<sup>40</sup> 157 F.3d 1067 (7th Cir. 1998).

This reliance is curious. The *Meyer* Court did not hold that due process required a pre-indictment determination. In *Meyer*, the defendant moved to dismiss a pending indictment based on a prior immunity agreement. The district court rejected that motion, and the defendant was later convicted at trial. On appeal, the defendant again claimed that the indictment should have been dismissed based on the immunity agreement. In addition, the defendant claimed that the government should have obtained a pre-indictment determination of his breach before presenting the case to the grand jury. The *Meyer* court rejected this argument, holding that “[o]n the facts of the present case, . . . [the defendant] received all of the protection demanded by due process.”<sup>41</sup> However, citing the Seventh Circuit’s decision in *United States v. Verrusio*,<sup>42</sup> the court said, “we again stress that, in cases such as these, the preferred procedure, absent exigent circumstances, would be for the government to seek relief from its obligations under the immunity agreement prior to indictment.”<sup>43</sup>

In spite of *Meyer*’s reliance on *Verrusio*, even a cursory reading reveals that *Verrusio* recognized no such requirement. In *Verrusio*, like *Meyer*, the defendant moved to dismiss a pending indictment based on a prior plea agreement.<sup>44</sup> Like *Meyer*, *Verrusio* held that due process required no pre-indictment determination about whether a breach occurred.<sup>45</sup> Instead, the court held that a post-indictment motion to dismiss was an “acceptable procedural mechanism” to resolve the issue. The court went on to say, in dicta:

It would of course be preferable for the government to notify a defendant that it intends to reindict because he has breached the plea agreement . . . Perhaps an even better procedure would be a motion by the government for relief from its obligations under the plea agreement, before it proceeds to the indictment stage.<sup>46</sup>

Thus, the *Meyer* court’s pronouncement about the “preferred procedure” was dicta, which relied on dicta from *Verrusio*—and neither case holds that due process requires the government to obtain a judicial determination concerning the breach of an immunity agreement before presenting an indictment to the grand jury.

*Stolt-Nielsen* went further: “Due process dictates that a court must decide whether there has been a breach of the agreement before it can be voided, and the decision should be made before indictment.”<sup>47</sup> As striking as this leap may be, it is more striking that the *Stolt-Nielsen* opinion failed to even mention, let alone discuss, substantial contrary authority.

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<sup>41</sup> *Id.* at 1077.

<sup>42</sup> 803 F.2d 885 (7th Cir. 1986).

<sup>43</sup> *Meyer*, 157 F.3d at 1077.

<sup>44</sup> *Verrusio*, 803 F.2d at 887.

<sup>45</sup> *Id.* at 889 (“We merely hold that, under the circumstances of this case, an evidentiary hearing on *Verrusio*’s motion to dismiss is sufficient to satisfy the demands of due process.”).

<sup>46</sup> *Id.*

<sup>47</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 555. The court in *Stolt-Nielsen* found equitable relief imperative because SNSA “gave up significant constitutional rights” when it entered into the immunity agreement. The only example given by the court is as follows: “At the same time it provided evidence against its co-conspirators, [SNSA] incriminated itself in the same illegal activities. Now the government wants to use [SNSA’s] self-incriminating evidence against it and [its executive] in prosecuting them.” To read this passage, one might believe SNSA gave up its constitutional right against self-incrimination, a right that a corporation does not possess. See *Braswell v. United States*, 487 U.S. 99, 104–08 (1988) (“[W]e have long recognized that, for purposes of the Fifth Amendment, corporations and other collective entities are treated differently from individuals . . . the Fifth Amendment privilege applies only to natural individuals . . .”).

Until *Stolt-Nielsen*, courts have generally refused to enjoin federal prosecutions.<sup>48</sup> “[I]n no case that we have been able to discover,” one circuit court wrote, “has a federal court enjoined a federal prosecutor’s investigation or presentment of an indictment.”<sup>49</sup> Indeed, courts have repeatedly rejected defendants’ attempts to enjoin federal indictments,<sup>50</sup> holding that a motion to dismiss an indictment under Rule 12(b)(1) constitutes an adequate remedy at law. Courts have reached this conclusion even where—as in *Stolt-Nielsen*—the movant sought to enforce an immunity agreement with an injunction against an indictment.<sup>51</sup>

*Stolt-Nielsen*’s failure to address these authorities, and its reliance on dicta to announce a broad new due process protection, may give it a short shelf-life. If appealed, it will not escape the Third Circuit’s attention that the announced rule also would create a glaring anomaly: it provides an avenue of appellate redress to one set of litigants (grand jury targets who file for pre-indictment injunctions) that is denied to others (defendants who file motions to dismiss under Rule 12(b)(1)), in spite of the fact that the latter is generally afforded greater protections than the former.<sup>52</sup>

Long ago, the Supreme Court held that a defendant cannot obtain interlocutory appeal from a district court’s denial of a motion to dismiss a pending indictment based on a prior immunity or plea agreement.<sup>53</sup> Predictably, this rule has been followed by every circuit to address the issue.<sup>54</sup>

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<sup>48</sup> In the few cases in which such extraordinary relief is granted, the injunctions are necessary to protect the movants’ constitutional rights. See, e.g., *PHE, Inc. v. U.S. Dep’t of Justice*, 743 F. Supp. 15, 26–27 (D.D.C. 1990) (enjoining simultaneous prosecutions designed to suppress constitutionally protected speech); *Freedberg v. U.S. Dep’t of Justice*, 703 F. Supp. 107, 112 (D.D.C. 1988) (enjoining successive federal prosecutions which would be inconsistent with the Double Jeopardy clause of the Fifth Amendment).

<sup>49</sup> *Deaver v. Seymour*, 822 F.2d 66, 69 (D.C. Cir. 1987); see also *Doe Corp. v. United States*, 714 F.2d 604, 606 (6th Cir. 1983) (finding no jurisdiction to take interlocutory appeal of denial of injunction of indictment); *Christoforu v. United States*, 842 F. Supp. 1453, 1456 (S.D. Fla. 1994) (“Prospective defendants cannot, by bringing ancillary equitable proceedings, circumvent federal criminal procedure.”) (quoting *Deaver*, 822 F.2d at 71); *Doe v. United States*, 534 F. Supp. 652, 655 (D. Kan. 1982) (“No reported case is found in which the injunctive powers of a federal court have been used to prevent federal prosecutorial functions.”).

<sup>50</sup> See *Deaver*, 822 F.2d at 68; *Doe Corp.*, 714 F.2d at 604 (noting district court’s denial of injunction); *Christoforu*, 842 F. Supp. at 1456; *Doe*, 534 F. Supp. at 655.

<sup>51</sup> See *Doe Corp.*, 714 F.2d at 604; *Doe*, 534 F. Supp. at 653.

<sup>52</sup> See *United States v. Quam*, 367 F.3d 1006, 1008 (8th Cir. 2004) (recognizing that neither “the Fifth Amendment privilege [nor] due process rights required an effective warning against self-incrimination be given to a witness before a grand jury”); *In re Grand Jury Investigation*, 182 F.3d 668, 671 (9th Cir. 1999) (noting that “the rights of grand jury witnesses are less broad than those of criminal defendants”).

<sup>53</sup> *Heike v. United States*, 217 U.S. 423, 431 (1910) (A grant of statutory immunity is not intended to “secure to a person making such a plea immunity from prosecution but to provide him with a shield against successful prosecution, available to him as a defense . . . [and does not] operate to give a right of review upon any other than final judgments.”).

<sup>54</sup> See *United States v. Ecker*, 232 F.3d 348, 350 (2d Cir. 2000) (“The law of this Circuit remains that an order denying a motion to dismiss on the ground of an allegedly breached plea agreement is not appealable prior to the entry of final judgment.”); *United States v. Green*, 139 F.3d 1002, 1004 (4th Cir. 1998) (“[T]he district court’s decision on [defendant’s] contract and due process claims is not an appealable final order.”); *United States v. Ledon*, 49 F.3d 457, 460 (8th Cir. 1995) (“[W]e must dismiss the plea agreement appeal for lack of jurisdiction.”); *United States v. Crosby*, 20 F.3d 480, 487 (D.C. Cir. 1994) (“[W]e conclude that we are without jurisdiction to review” the district court’s denial of a motion to dismiss counts in an indictment based on a prior plea agreement); *United States v. Dederich*, 825 F.2d 1317, 1321 (9th Cir. 1987) (“Indeed, the majority of courts have denied interlocutory appeals grounded in plea-bargain promises or grants of immunity.”), *overruled on other grounds* by *Midland Asphalt Corp. v. United States*, 489 U.S. 794 (1989); *United States v. Bird*, 709 F.2d 388, 392 (5th Cir. 1983) (“By refusing to hear this interlocutory appeal, of course, we subject [the defendant] to the personal strain, embarrassment and expense of a trial, notwithstanding the possibility that her claim [of immunity from prosecution] might eventually be held well-founded.”); *United States v. Eggert*, 624 F.2d 973, 975–76 (10th Cir. 1980).



Thus, an allegedly immunized defendant must wait until after a conviction to have the district court's denial of a motion to dismiss reviewed.<sup>55</sup>

Under the *Stolt-Nielsen* rule, a putative defendant can make an end-run around this rule by seeking an injunction against the indictment in the first instance, the denial of which is potentially subject to interlocutory review.<sup>56</sup> For this very reason, the *Deaver* court refused to countenance an injunction against a potential indictment:

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Were [appellant] to bring this same claim as a Rule 12(b)(1) motion, we think it likely the final judgment rule would bar any appeal of a denial of that motion until after conviction. Were we to allow [appellant] to bring a civil challenge, with its attendant rights of appeal, before a prosecution even begins, we would thereby undermine the final judgment rule.<sup>57</sup>

Putting aside the many other curiosities in *Stolt-Nielsen*, the Third Circuit will likely pause before putting its imprimatur on this anomaly.<sup>58</sup>

### Omen or Outlier?

The Division's decision to suspend SNSA from the Amnesty Program sent shock waves through the antitrust bar. One publication announced the Division's decision to suspend SNSA's amnesty with the headline "DOJ In Leniency Shock."<sup>59</sup> Commentators quickly predicted that the Division's decision would cause "some uncertainty for the advisors of companies or individuals . . . if there are questions about the timeliness or quality of their cooperation."<sup>60</sup> Such concern in the immediate aftermath of the *Stolt-Nielsen* decision may well prove unwarranted, given the Division's interest in a continuing—and even increasing—flow of amnesty applications.

Before the Amnesty Program was revised in 1993, transparency in the amnesty process was practically nonexistent. Because corporations could not accurately predict whether their applica-

<sup>55</sup> See *Ecker*, 232 F.3d at 350 ("The law of this Circuit remains that an order denying a motion to dismiss on the ground of an allegedly breached plea agreement is not appealable prior to the entry of final judgment."); *Green*, 139 F.3d at 1004 (noting that defendant can "subsequently raise these [plea agreement] issues if he is convicted"); *Ledon*, 49 F.3d at 459–60 ("[T]he order denying the motion to dismiss for breach of the plea agreement is not final or appealable."); *Crosby*, 20 F.3d at 487 (holding that review of defendant's plea agreement violation claim is prohibited until after conviction and sentencing); *Dederich*, 825 F.2d at 1321 ("The guarantee afforded by the immunity can be adequately protected by appeal after conviction."); *Bird*, 709 F.2d at 392 ("[Defendant's] plea that the agreement bars her prosecution can be fully vindicated, if appropriate, in an appeal from any conviction the government obtains in her case."); *Eggert*, 624 F.2d at 975 ("[Defendant's plea agreement claim] can be fully reviewed by this court on direct appeal in the event of a conviction.")

<sup>56</sup> See *Blalock v. United States*, 844 F.2d 1546, 1548 (11th Cir. 1988) (affirming district court's denial of motion to enjoin grand jury's investigation); *Deaver*, 822 F.2d at 68 (noting that "the denial of [appellant's] application for a preliminary injunction [to prevent independent counsel from obtaining an indictment] is an interlocutory order appealable under 28 U.S.C. § 1292(a)(1)"); but see *Doe Corp.*, 714 F.2d at 605 (treating a denial of a civil motion to enjoin indictment as a criminal pretrial order which is not subject to interlocutory appeal).

<sup>57</sup> *Deaver*, 822 F.2d at 71.

<sup>58</sup> See *United States v. Johns*, 858 F.2d 154, 160 (3d Cir. 1988) (noting "the long-standing principle that disfavors piecemeal appeals" in refusing to recognize a new exception to the final judgment rule).

<sup>59</sup> See *DOJ in Leniency Shock*, GLOBAL COMPETITION REV., Mar. 26, 2004, available at <http://www.globalcompetitionreview.com/> (subscription required).

<sup>60</sup> See D. Martin Low, Cartel Enforcement, Immunity and Jurisdiction: Some Recent Canadian Developments, Address Before International Bar Ass'n, Communications and Competition Law Conference 8 (May 17–18, 2004), available at [http://www.mcmillanbinch.com/Upload/Publication/Cartel%20Enforcement%20Immunity%20and%20Jurisdiction\\_Some%20Recent%20Canadian%20Developments\\_Low\\_0504.pdf](http://www.mcmillanbinch.com/Upload/Publication/Cartel%20Enforcement%20Immunity%20and%20Jurisdiction_Some%20Recent%20Canadian%20Developments_Low_0504.pdf).

tions would be granted, the Division received approximately one amnesty application per year.<sup>61</sup> Since its revision in 1993, the Amnesty Program has been one of the Division's most potent tools in prosecuting criminal antitrust violations.<sup>62</sup> The Division currently receives amnesty applications at a rate of approximately two per month. Since 1997, the program has generated nearly \$2 billion in criminal fines, as well as scores of convictions.<sup>63</sup> The Division therefore has a strong interest in encouraging corporations to seek amnesty by making the amnesty process transparent.

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To ensure transparency, the 1993 revisions to the Program provided that amnesty would be granted automatically to any corporation that satisfied the enumerated requirements. The Division has characterized the surrender of prosecutorial discretion in these circumstances as "the ultimate sacrifice for transparency,"<sup>64</sup> which provides companies with a high degree of certainty about the program and its benefits.

The Amnesty Program took time to catch on with an antitrust bar skeptical of the program's benefits. The Division sought to encourage participation in the Amnesty Program by engaging in a number of activities designed to alleviate concerns about the fairness of the program's administration. Such activities included the publication of a number of papers, the drafting of a model conditional amnesty letter, and speeches before various legal associations and the media.<sup>65</sup> This enthusiastic and extended effort on the part of the Division illustrates the Amnesty Program's value to the Division.

Because amnesty applications are so highly valued by the Division, the decision to grant or deny amnesty is made at the highest levels. The Division's Corporate Leniency Policy states that the final decision on an amnesty application will be made by the Assistant Attorney General.<sup>66</sup> Because the Division has entrusted one high-level decision-maker with the authority to approve amnesty applications, corporate applicants are assured of greater consistency in the evaluation of amnesty applications.

Division officials are well aware that both the Division and the antitrust bar have an interest in predictability in the enforcement of amnesty agreements. From the Division's perspective, the Amnesty Program will cease to be a valuable tool in the prosecution of antitrust conspiracies unless it challenges amnesty applicants that fail to make a good-faith effort to comply with the terms of the agreement. Failure to police will mean encouragement to continue collusive activities. Nevertheless, practitioners are well aware that the Division's interpretation of the rules has been generous. Even Division officials admit they have "had to swallow hard on a number of amnesty applicants that they would have preferred to prosecute."<sup>67</sup> However, if the Division completely abdicated its responsibility to enforce the promises made in the amnesty agreement, the Division

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<sup>61</sup> Scott D. Hammond, An Overview of Recent Developments in the Antitrust Division's Criminal Enforcement Program, Address Before the American Bar Association Midwinter Leadership Meeting 8–9 (Jan. 10, 2005), available at <http://www.usdoj.gov/atr/public/speeches/207226.htm>.

<sup>62</sup> See *id.* (discussing benefits of revised program).

<sup>63</sup> *Id.* at 9.

<sup>64</sup> See Scott D. Hammond, Cornerstones of an Effective Leniency Program, Address Before the ICN Workshop on Leniency Programs 20 (Nov. 22–23, 2004), available at <http://www.usdoj.gov/atr/public/speeches/206611.pdf>.

<sup>65</sup> *Id.* at 19–20.

<sup>66</sup> See Corporate Leniency Policy, *supra* note 4, at 4–5.

<sup>67</sup> Hammond, *supra* note 64.

would forgo the benefit of the program (prosecuting the most culpable antitrust violators) while enduring the cost (granting amnesty to culpable corporations).

From the point of view of potential applicants, enforcement of the terms of the amnesty agreement is critical to the fair application of the Program. When a conspirator secures the “amnesty chair,” it deprives another conspirator of the benefits of amnesty. Many companies endure prosecution and hefty fines (not to mention jail time for senior executives) for being second in line. If the Division turned a blind eye to flagrant violations of the Amnesty Program, the program would be pervaded with a real sense of unfairness, and deserving applicants would be foreclosed from attaining the benefits of the Program. Thus, the Division’s actions in *Stolt-Nielsen* should be welcome news to companies seeking amnesty in good faith.

The unusual facts in *Stolt-Nielsen* also reinforce its place as an outlier. As noted above, SNSA did not apply for amnesty on a completely clean slate. The Division’s interest in SNSA, and the parcel tanker industry as a whole, was triggered by an article in the *Wall Street Journal*.<sup>68</sup> The article described a lawsuit by SNSA’s former general counsel, alleging that he was forced to resign because he would not support various illegal activities, including “price fixing and other collusive conduct.”<sup>69</sup> The Division warned SNSA at the outset of the amnesty discussions that the corporation would be ineligible for the Amnesty Program if the conduct continued after the general counsel’s discovery. SNSA represented that the conduct stopped because of the company’s remedial actions.<sup>70</sup>

SNSA’s “remedial actions” certainly appear to have been a “head fake.” SNSA apparently failed to suspend or terminate the culpable employees, allowing them to continue their collusive activities.<sup>71</sup> These were not low-level employees in distant places, whom the company had little hope of controlling, but high-level executives and the very targets of the company’s internal investigation.<sup>72</sup> Moreover, the continuation of criminal activities was protracted.<sup>73</sup> It would have contravened clearly articulated policies issued by two Deputy Attorney Generals if the Division had ignored these clear signs that the company failed to take meaningful action to terminate the conduct.<sup>74</sup>

### Lesson in Remediation

The lesson of *Stolt-Nielsen* is clear: when a company discovers collusive activity, it must take decisive action to ensure termination of its involvement in that activity. Obviously, culpable employees are the direct source of the criminal activity. However, these same employees are the source of the company’s cooperation, allowing them to “perfect” the company’s “marker” for amnesty protection. Indeed, it is common for the government to request interviews with these individuals

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<sup>68</sup> Bandler & McKinnon, *supra* note 15, at A3.

<sup>69</sup> *Id.* Other allegations included the illegal conduct of business with Iran.

<sup>70</sup> *Stolt-Nielsen*, 352 F. Supp. 2d at 557.

<sup>71</sup> Government’s Proposed Findings of Fact, *supra* note 17, ¶¶ 27–36.

<sup>72</sup> *Id.* ¶¶ 5, 8, 19, 20.

<sup>73</sup> *See id.* ¶ 36 (noting that the conspiracy allegedly ran from 1998 through November 2002).

<sup>74</sup> *See* Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003) (citing a corporation’s remedial actions as one consideration when determining whether to charge a corporation), *available at* [http://www.usdoj.gov/dag/cftf/business\\_organizations.pdf](http://www.usdoj.gov/dag/cftf/business_organizations.pdf); Memorandum from Eric Holder, Deputy Attorney General, to All Component Heads and United States Attorneys (June 16, 1999) (same), *available at* <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html>.

before action is taken to terminate their employment. Thus, it is often impossible to take immediate action to terminate the employees. In these circumstances, what can a company do to prevent further transgressions?

Most importantly, the company must give clear, unequivocal instructions about contact with competitors. With *rare* exception, the rules should proscribe competitor contact. With *no* exception, the rules must prohibit any employee who was suspected of collusive activity from having any competitor contact, and these employees should be reassigned to roles that make the prohibition enforceable. With *no* exception, the rules should forbid sharing competitive intelligence with, or receiving it from, competitors.

If some employees must have contact with competitors for legitimate business reasons, any meeting or contact should be preceded by notice to the company's legal department. The company should adopt clear policies about procedures for such meetings, including the preparation of an agenda, which should be reviewed by the legal department, and the mandatory attendance of company counsel during any competitor contact. All informal and social contact with competitors must be prohibited, and the prohibition must be clearly conveyed to the business units.

To make these prohibitions meaningful, the company must conduct some regular surveillance. While distasteful to many corporate executives and general counsel, the least-intrusive surveillance program could have disclosed the continuing competitor contact at SNSA: monitoring the company's e-mail system. The Information Technology divisions at most companies can monitor employees' communications with specified e-mail addresses, and in the aftermath of an antitrust problem, that system should be used to monitor employees' contact with competitors. If ABC Company is a competitor with which employees were conspiring, the IT systems can send an alert whenever an employee corresponds with an employee of ABC Company. IT need not review the e-mail itself; rather, those e-mails can be escalated to the legal or compliance departments, which can determine whether the contact is permitted or prohibited. This simple technique could have easily revealed the continuing problem at SNSA because some of the continuing contact was via the company's e-mail system.

In addition to specific rules for potential violators and surveillance to make the rules meaningful, the company should immediately implement general ethics policies, including an anonymous hotline to report criminal or unethical activity, and a specific antitrust compliance program, with mandatory participation by all employees. If the company has such programs, they should be enhanced to ensure effectiveness. The company must invest sufficient resources to train employees and make the rules widely known and comprehensible. Certifications for these training sessions should be maintained for each employee in attendance, and the programs should be followed by periodic refresher courses (including on-line training).

Best practices also demand that a senior-level compliance officer (with reporting lines to the chief executive officer, the general counsel, and the audit committee of the board of directors) should oversee the compliance and ethics programs. That officer should be given sufficient resources, and managers at all levels of the company should be given compliance responsibilities. Performance of compliance duties and adherence to the program's requirements should be an aspect of evaluation and compensation for all employees. Audits of the program's effectiveness should occur on a regular basis.

Although all these steps are necessary, they are not enough to create a complete record of the company's efforts to terminate and remediate illegal conduct. Senior management is responsible for ensuring that a company's culture is guided by ethics and integrity, and it must set an appropriate course. Senior management must have "zero tolerance" for ethical lapses, and that mes-

*Senior management is responsible for ensuring that a company's culture is guided by ethics and integrity, and it must set an appropriate course.*

sage must be clearly and repeatedly conveyed to the business. This “tone from the top” is a critical element of the overall success of the company’s ethics and compliance programs.

While these many steps cost the company resources, especially in the short term, the long-term benefits far outweigh the costs. However, even all of these efforts may not constrain a rogue employee from continuing to violate the law. If that happens, a company can have complete confidence that, if all of these efforts were undertaken in good faith, its amnesty will not be in peril. *Stolt-Nielsen* teaches that remediation must be taken seriously. ●

# The New “Non-Corporate Interest” Rules Under the Hart-Scott-Rodino Act—A Detailed Look at How They Will Work

**Malcolm R. Pfunder**

The following discussion may test the patience and endurance of even the most avid Hart-Scott-Rodino buffs.<sup>1</sup> Final HSR rules that are effective as of April 7, 2005, make some significant changes in premerger notification and waiting period obligations relating to the formations of partnerships, LLCs and other unincorporated entities, and to the acquisitions and transfers of “interests” in such entities.<sup>2</sup> The rules received a fair amount of attention and commentary when they were originally announced, but the proposals turned out to be relatively uncontroversial, as only seven comments were filed in the rulemaking proceeding.

The newly promulgated rules may be harder to understand and to apply than they look. They will raise a variety of practical questions in their application—not because they are not well thought out, but because application of otherwise familiar HSR principles and analysis to acquisitions of “interests” in unincorporated entities may not come easily.

This article explores two broad scenarios in detail: formations of incorporated and unincorporated entities under previous and newly promulgated HSR rules, and acquisitions of “non-corporate interests” that “confer control” of the underlying entity under the new rules.<sup>3</sup> Rule 801.1(f)(1)(ii) defines the term “non-corporate interest” to mean an interest in any unincorporated entity which gives the holder the right to any profits of the entity or the right to any assets of the entity in the event of dissolution of that entity and after payment of the entity’s debts. Current rules

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<sup>1</sup> The Hart-Scott-Rodino Act, 15 U.S.C. § 18a, requires parties to certain mergers and acquisitions of assets or voting securities valued at more than \$50 million (as adjusted annually for indexing) to file notification with the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice, and thereafter to wait for a period of time—generally thirty days—before completing a reportable transaction, provided that certain size-of-person tests are met. *See infra* note 7.

As a result of statutory amendments to the HSR Act in 2001 and rules promulgated by the FTC earlier this year, all of the dollar-denominated reporting thresholds in the Act and most of those in the HSR rules have been adjusted upward. 70 Fed. Reg. 4987, 5020 (Jan. 31, 2005). During calendar year 2005, for example, the \$50 million threshold as adjusted by the requirement of annual indexing is \$53.1 million. To avoid having to amend the rules annually, the Commission has amended the HSR rules to insert the phrase “(as adjusted)” throughout the rules, to indicate where the original thresholds are subject to this annual adjustment. *See* Malcolm R. Pfunder, *Indexing Comes to the HSR Act*, ANTITRUST SOURCE (Jan. 2005), [http://www.abanet.org/antitrust/source/01-05/02\\_Jan05\\_pfunder.pdf](http://www.abanet.org/antitrust/source/01-05/02_Jan05_pfunder.pdf).

<sup>2</sup> The proposed rules were issued on March 30, 2004, and published in the *Federal Register* at 69 Fed. Reg. 18,685 (Apr. 8, 2004). Final rules were published at 70 Fed. Reg. 11,501 (Mar. 8, 2005), and are effective for transactions closing on or after April 7, 2005. <http://www.ftc.gov/os/2005/02/050223premergerfrn.pdf>. The current rules are (and the new rules will be) codified at 16 C.F.R. Parts 801–803.

<sup>3</sup> Specific examples of unincorporated entities named in the rules include general partnerships, limited partnerships, limited liability partnerships, limited liability companies (LLCs), cooperatives and business trusts but exclude trusts described in existing Rules 801.1(c)(3)–(5). While an unincorporated entity may be wholly owned (and formation of such an entity is always exempt), the following discussion assumes that any such entity will have at least two persons with interests in the entity’s profits and/or its assets in dissolution. It is also assumed throughout the discussion that any other exemptions under the HSR Act or rules will be separately considered and applied.

define “control” of an unincorporated entity as having a right to 50 percent or more of the entity’s profits or a right to 50 percent or more of the entity’s assets in the event of dissolution.<sup>4</sup>

### Formations of Unincorporated Entities

**Reportable Formations of New Entities Under Present HSR Rules.** HSR rules have, to date, treated formations of three different kinds of entities in three different ways. Until now, the formation of a partnership simply was never reportable, and contributions of assets to a partnership in connection with its formation were never reportable, by the partnership, or by the contributing partner, or by any of the other partners.<sup>5</sup> That much is easy.

Formations of LLCs have been reportable only under a specific, and somewhat unusual set of facts. While the HSR rules themselves do not address formations of LLCs, so-called “Formal Interpretation 15” lays out filing tests and procedures relating to LLC formations.<sup>6</sup> Under Formal Interpretation 15, formation of an LLC has been reportable only if (a) two or more pre-existing businesses that are not under common control are contributed to the LLC by different persons, and (b) at least one of the forming members will “control” the new LLC, and (c) contributions of non-exempt assets by the other forming members are valued collectively at more than \$50 million, and (d) the HSR Act’s size-of-person tests are met by the controlling member and the members contributing non-exempt assets.<sup>7</sup> This convoluted scenario just doesn’t arise very often, and the practical effect is that to date most LLCs have been formed without HSR filing obligations.

Formations of “joint venture or other corporations” by multiple forming shareholders have been reportable under Rule 801.40 since the HSR Act first went into effect in 1978. Formation of a corporation results in the forming shareholders’ acquisitions of voting securities of the newly formed corporation. Each such acquisition is reportable by the ultimate parent of the forming shareholder if (a) a special three-way size-of-person test is satisfied,<sup>8</sup> (b) the value of the voting securities of the new corporation being acquired by that shareholder exceeds \$50 million (as adjusted), and (c) the acquiring shareholder and the new corporation meet the traditional statutory two-party size-of-person test. Filings are made only by acquiring persons that satisfy these tests; there is no “acquired person” filing.<sup>9</sup> A single waiting period begins when all acquiring persons required to file do so.<sup>10</sup> The new corporation’s “acquisitions” from its contributing shareholders in connection

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<sup>4</sup> Rule 801.1(b)(1)(ii). Existing Rule 801.1(b)(2) also purports to define an unincorporated entity as controlled by a person having the contractual power presently to designate 50% or more of the individuals exercising functions similar to those of corporate directors. However, the FTC staff has long taken the position that unincorporated entities do not have individuals who exercise functions similar to those of corporate directors, thereby effectively reading this provision out of the rules. The new rules formally repeal this provision for unincorporated entities, leaving it in place for corporations and trusts.

<sup>5</sup> By contrast, sales to an unincorporated entity (or corporation) at the time of its formation, by a person who does not acquire an interest in the unincorporated entity (or become a shareholder in the corporation), are and remain subject to normal HSR Act treatment.

<sup>6</sup> 64 Fed. Reg. 5808 (Febr. 5, 1999).

<sup>7</sup> Under these tests, the ultimate parent of either the acquiring or the acquired person must have annual net sales or total assets of at least \$100 million (as adjusted), and the other must have annual net sales or total assets of at least \$10 million (as adjusted). (The \$10 million test for an acquired person ignores annual net sales if the person is not engaged in manufacturing.) Under the 2001 amendments to the HSR Act, size-of-person tests are inapplicable to transactions valued at more than \$200 million (as adjusted). Subsequent references to size-of-person or “SOP” tests in this article should be read to include their inapplicability to transactions of this size.

<sup>8</sup> Rule 801.40(c).

<sup>9</sup> Rules 801.40(a), (b), and 802.41.

<sup>10</sup> Rule 803.10(a)(2).



with its formation are not separately reportable.<sup>11</sup> All of this does not happen all that often either, but it happens.

**Reportable Formations Under the Newly Promulgated Rules.** The new rules are intended generally to make the reporting obligations arising from formations of unincorporated entities more nearly parallel to the obligations applicable to formations of corporations by multiple shareholders. The new rules do not alter the existing Rule 801.40 regime relating to formations of such corporations.

Formations of unincorporated entities are reportable under new Rule 801.50 where (a) at least one of the forming parties will “control” the new entity,<sup>12</sup> (b) the value of that controlling party’s interest exceeds \$50 million (as adjusted), and (c) a special size-of-person test<sup>13</sup> applicable to this scenario is satisfied.<sup>14</sup> Sounds simple enough. But it isn’t.

**Formation Transactions Are Treated Differently from Other Acquisitions.** The HSR Act treatment of transactions arising from the formation of a corporation or an unincorporated entity by multiple forming parties is different from that of conventional acquisitions of assets or voting securities, in the following respects:

- Special size-of-person tests apply, and the existing tests for formation of a corporation under Rule 801.40 are somewhat different from the new tests that apply to formation of an unincorporated entity in Rule 801.50.<sup>15</sup>
- Even though the newly formed entity “acquires” the assets that are contributed to it by its forming shareholders or partner/members in connection with its formation, the new entity has no filing obligation as an acquiring person.<sup>16</sup>
- Similarly, forming parties that contribute assets in connection with formation of a new entity have no filing obligation as acquired persons as a result of such contributions.<sup>17</sup>

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<sup>11</sup> Rules 803.10(a) and 802.41.

<sup>12</sup> Since “control” of an unincorporated entity arises where a person is entitled to 50% or more of the entity’s profits, or its assets in dissolution, an unincorporated entity can have multiple “controlling” partners or members if two parties each have a right to exactly 50% of the entity’s profits or assets in dissolution, or if one party has a right to at least 50% of the entity’s profits and a different party has a right to at least 50% of its assets in the event of dissolution.

<sup>13</sup> Here, too, if the value of the interest acquired by the controlling partner/member (valued under Rule 801.10(d)) is greater than \$200 million (as adjusted), neither the statutory size-of-person tests nor the special size-of-person tests under Rule 801.50(b) apply.

<sup>14</sup> The current reporting requirements in Formal Interpretation 15 for formations of LLCs will be repealed when the newly promulgated rules become effective.

<sup>15</sup> This is really as hard as it gets: Existing Rule 801.40 makes acquisitions of voting securities of newly formed corporations potentially reportable if either (a) the acquiring person has annual net sales or total assets of at least \$100 million (as adjusted) and the new corporation will have total assets of at least \$10 million (as adjusted) and at least one other acquiring person has annual net sales or total assets of at least \$10 million (as adjusted), or (b) the acquiring person has sales or assets of at least \$10 million (as adjusted) and the joint venture will have total assets of at least \$100 million (as adjusted) and at least one other acquiring person has sales or assets of at least \$10 million (as adjusted). Rule 801.50(b) makes acquisitions of controlling interests in newly formed unincorporated entities potentially reportable if either (a) the acquiring person has annual net sales or total assets of at least \$100 million (as adjusted) and the new entity will have total assets of at least \$10 million (as adjusted), or (b) the acquiring person has sales or assets of at least \$10 million (as adjusted) and the new entity will have total assets of at least \$100 million (as adjusted). The requirements differ in that for formations of unincorporated entities, only controlling interests are reportable and the sizes of the non-controlling interest holders are irrelevant.

<sup>16</sup> Rules 801.40(a) and 802.41. Acquisitions by the new entity from persons that do not take back voting or non-voting securities or non-corporate interests in return are subject to normal HSR Act analysis and reporting obligations. Such persons are not “forming” parties or shareholders, and the acquisitions from them are not “contributions” made “in connection with” the formation. *See supra* note 5.

<sup>17</sup> Rule 801.50(a) extends to formations of unincorporated entities this principle from the existing rules for formations of corporations.

- Even though the newly formed entity issues voting securities or non-corporate interests to the forming parties, the new entity has no filing obligation as an acquired person.<sup>18</sup>
- Contributions that the forming parties have agreed to make to the newly formed entity at any time, and any amounts of credit that the forming parties have agreed to extend or obligations that the forming parties have agreed to guarantee at any time, have to be included in determining the total assets of the new entity.<sup>19</sup>
- If two or more forming parties are required to file notification in connection with formation of a new entity,<sup>20</sup> a single waiting period begins once all such parties have filed their notifications.<sup>21</sup>
- The “intraperson exemption,” Rule 802.30, is generally inapplicable to acquisitions in connection with formation of a new entity, although there is an exception under certain circumstances.<sup>22</sup>
- Unless the acquisition price is specified, valuation of the voting securities or non-corporate interests acquired by the forming parties in connection with formation of a new entity is essentially the total value of the contributions to the new entity at the time of formation, allocated across all the voting securities or non-corporate interests that the forming parties receive as consideration for their contributions.
- “Formation” of an unincorporated entity does not arise unless the parties intend to form a new entity. Thus, mutual contractual undertakings that might be viewed as creating joint venture or partner-like relationships are not subject to the HSR Act unless the parties intend to create a partnership or joint venture or some other kind of separate legal entity to perform or implement those undertakings.<sup>23</sup>

### Acquisitions of Non-Corporate Interests in Existing Entities

***Use of Non-Corporate Interests to Define Control of an Unincorporated Entity.*** Rules in effect since 1987 state that any person having a right to 50 percent or more of the profits of an unincorporated entity, or to 50 percent or more of its assets in the event of dissolution, “controls” that entity and is deemed to hold 100 percent of the unincorporated entity’s assets and must include the annual net sales of the entity in computing its own annual net sales.<sup>24</sup> This rule affects what

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<sup>18</sup> Rule 802.41 extends to formations of unincorporated entities this principle from the existing rules for formations of corporations.

<sup>19</sup> Rule 801.40(d) is made applicable to formations of unincorporated entities by Rule 801.50(c).

<sup>20</sup> This could occur in the formation of a corporation if two shareholders each acquire more than \$50 million (as adjusted) worth of the stock of the corporation. Two or more forming persons may control a newly formed unincorporated entity and may therefore be required to file in connection with its formation. See *supra* note 12.

<sup>21</sup> The final rules amend existing Rule 803.10(a)(2) to apply to formations of unincorporated entities under Rule 801.50 (it already applies to formations of corporations under Rule 801.40) in the specific situation where two (or more) forming parties acquire control of a new unincorporated entity.

<sup>22</sup> Rule 802.30(c) exempts assets and voting securities contributed to a new corporation by the controlling shareholder or to a new unincorporated entity by a controlling party in connection with the formation. This is an exception to the parenthetical phrase in Rule 802.30(a) that otherwise precludes application of the intraperson exemption to formation transactions.

<sup>23</sup> Of course, formation of a corporation involves no comparable ambiguity, because specific legal procedures are required to create the new entity and to issue its voting securities.

<sup>24</sup> See *supra* text accompanying note 4.

you count for the size-of-person and size-of-transaction test under Rule 801.11,<sup>25</sup> but it does not tell you when or whether an acquisition has occurred. Because the HSR Act applies only to acquisitions, the “control” rule does not by itself define when filing obligations arise.

**Acquisitions Become Potentially Reportable if They Confer Control.** To date the HSR rules have not viewed partnership or other non-corporate interests as either assets or voting securities when they are acquired, and such interests could be created, acquired, or transferred without any HSR Act implications unless, as a result of a transaction, a person would hold all of such interests. Where one person obtains a right to all the profits of the entity and to all of its assets in dissolution, that person is deemed to be acquiring all of the assets of the partnership, and HSR filings are required if size-of-person and size-of-transaction tests are met. Otherwise, “acquisitions” of partnership and other non-corporate interests have been non-reportable.

Under the new rules, an “acquisition” resulting in a right to 50 percent or more of the profits of an existing unincorporated entity (or to 50 percent or more of its assets in dissolution) is said to “confer control” of that entity. Such transactions are reportable under the HSR Act if (a) the value of the non-corporate interests held by the acquiring person as a result of the transaction exceeds \$200 million (as adjusted) or (b) the value of such interests exceeds \$50 million (as adjusted) and the normal size-of-person tests are met. Like voting securities acquisitions, potentially reportable acquisitions of non-corporate interests may occur on a clean slate, or a transaction may increase the minority interests of an existing interest holder so that they reach or exceed 50 percent.<sup>26</sup>

**When Does an “Acquisition” of Non-Corporate Interests Occur?** In many situations, there will be no doubt when such a transaction occurs. For example, an agreement may be negotiated under which existing partnership interests are explicitly transferred, or an agreement may specify that, in return for a contribution to an existing partnership, the contributor will simultaneously acquire a stated percentage interest, with the other partners’ shares being comparably diluted. Under the new rules, these kinds of transactions are analyzed similarly to transactions involving voting securities of corporations.<sup>27</sup>

But application of the new rules can be potentially confusing when partners’ entitlements to partnership profits (or assets in dissolution) shift by reason of some event that does not look like a transaction. For example, it is not uncommon for investment vehicles to be created by persons that agree to share different levels of profit differently. One partner might be entitled, say, to 100 percent of the first \$2 million of profits, the other partner to 100 percent of the next \$2 million of

*Application of the new rules can be potentially confusing when partners’ entitlements to partnership profits (or assets in dissolution) shift by reason of some event that does not look like a transaction.*

<sup>25</sup> If a person controls an unincorporated entity, that person holds all of the entity’s assets and must include the annual net sales of the entity in determining its own annual net sales. If a person holds a non-controlling interest in an unincorporated entity, none of the entity’s annual net sales are attributable to the person, and the person includes the value of the non-controlling interest in the person’s total assets only to the extent that that non-controlling interest is reflected on the person’s most recent regularly prepared balance sheet. Whether a person preparing a pro forma balance sheet under Rule 801.11(e) would include a non-controlling interest in an unincorporated entity depends upon the accounting procedures normally used by that person.

<sup>26</sup> A parallel change in Rule 801.4 makes potentially reportable a secondary acquisition of voting securities resulting from a primary acquisition of non-corporate interests that confers control of the holder of the voting securities. Note that a reportable secondary acquisition of non-corporate interests cannot occur because, by definition, a secondary acquisition is an indirect acquisition of a minority interest. Acquisitions of minority non-corporate interests are not reportable under the new rules. (There is an odd exception where a person already holding a minority interest in a partnership makes a secondary acquisition of additional non-corporate interests that, when combined with the previous holdings, confers control of the entity.)

<sup>27</sup> The new rules do not reach acquisitions of non-corporate interests that do not “confer” or shift control of the entity, unlike voting securities acquisitions which may be reportable if the resulting holdings are valued in excess of \$50 million (as adjusted), even if the acquiring shareholder does not control the issuer.

profits, and the two partners to equal shares thereafter. Under this arrangement, the first partner would control the partnership until it had earned \$2 million; the second partner would control the partnership after it had earned \$2 million and until it had earned \$4 million; and both partners would control the partnership thereafter.

Would these apparent shifts of control result in potentially reportable acquisitions of non-corporate interests under the new rules? Would the second partner “acquire” a controlling interest in the partnership from the first partner when the partnership passes the \$2 million profit mark? Would the first partner re-acquire control (which it then shares with the second partner) after the partnership earns an additional \$2 million of profits?

The new rules themselves do not answer these questions explicitly. The specific rule that defines the reporting obligation purports to apply only to “an acquisition of non-corporate interests which results in an acquiring person controlling the entity” but remains ambiguously circular.<sup>28</sup> However, the accompanying statement of basis and purpose explains that whenever the right to profits and/or the right to assets upon dissolution is not fixed, the Commission will determine in the following manner whether a controlling interest has been acquired.

If the right to profits is variable and the right to assets upon dissolution is fixed, the right to 50 percent or more of the assets upon dissolution will be deemed to confer control, and the right to profits is ignored.<sup>29</sup> Conversely, if the right to assets in dissolution is variable and the right to profits is fixed, the right to 50 percent or more of the profits will be deemed to confer control, and the right to assets is ignored. Where both the right to profits and the right to assets upon dissolution are variable, “control will be determined by applying the formula for determining rights to assets upon dissolution to the total assets of the unincorporated entity at the time of the acquisition, as if the entity were being dissolved at that time.”<sup>30</sup>

In order for there to be a filing requirement when an acquisition “confers control,” the controlling person must acquire a right either to profits or to assets in dissolution.<sup>31</sup> Note also that an acquisition may “confer control” even if somebody else already has (and retains) control. Here is an example: a 25 percent partner buys out the interest of another 25 percent partner, resulting in two equal 50 percent partners. The acquisition by the 25 percent buying partner is potentially

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<sup>28</sup> Rule 801.2(f)(1)(i).

<sup>29</sup> Thus, in the above example, because the rights to profits are variable, acquisition of an interest in this partnership would confer control on the acquiring person only if as a result of that acquisition the acquiror received a right to 50% or more of the assets of the partnership in dissolution. This would be true in either a formation transaction or a subsequent acquisition, and it would not matter how much profit the partnership had earned or what the partners’ respective rights to profits were at the time of the acquisition.

<sup>30</sup> One could imagine opportunities for shenanigans in structuring ostensibly nonreportable arrangements conferring contingent or conditional rights to profits or assets, where the contingencies or conditions are essentially a sham. Rule 801.90 presumably would apply to any transaction or device entered into for the purpose of avoiding compliance with the HSR Act.

<sup>31</sup> Contrast this example. Suppose that a partnership having two equal partners receives assets from a third party valued at \$60 million, and the third party takes back a 30% interest in the partnership as consideration. Because the partnership was already in existence, the transaction is not a “formation” and Rule 801.50 does not apply. *See* Rule 801.2(f)(2). If the share of each of the original partners is reduced to 35%, control has shifted from each of the original 50% partners to the partnership itself. However, the partnership is not viewed as having “acquired” control of itself, because the partnership did not obtain a right to its own profits or to its own assets in dissolution. Thus no filing is required because no acquisition of a controlling non-corporate interest has occurred. However, the partnership must file for acquisition of the \$60 million asset that it received from the third party, and each of the original controlling partners must file as an acquiring person in that transaction.

reportable because it confers control on that partner, even though there is already another controlling (50 percent) partner.<sup>32</sup>

Another example: one person acquires a right to 60 percent of a partnership's assets in the event of dissolution; a different person already has a right to 60 percent of the partnership's profits. The person acquiring the right to assets in dissolution has a potential reporting obligation because acquisition of that interest confers control on that person, even though another person already controls the partnership and will continue to do so.

**Acquisitions of Non-Corporate Interests from Current Holders of such Interests.** If a person acquires a non-corporate interest from a current partner/member, that transaction is reportable only if the acquisition confers control of the unincorporated entity on the acquiring person. If a filing is required, the *acquired* person that must also file is the pre-acquisition ultimate parent of the entity.<sup>33</sup> That may or may not be the partner/member from whom the interest was acquired. It might instead be the entity itself (if no one controlled it prior to the acquisition).<sup>34</sup>

**Acquisitions by Existing Partnerships from Their Own Partners.** If instead of acquiring a non-corporate interest from an existing holder, a person transfers assets to an existing partnership or other unincorporated entity and takes back a newly created interest in that entity, the person acquiring the non-corporate interest may or may not have a filing obligation, depending upon whether the acquisition confers control of the entity.<sup>35</sup>

But because this is not a formation transaction governed by Rule 801.50, the entity may also have a separate filing obligation with respect to its acquisition of the contributed assets from the new partner/member. Of course, a contribution of cash is not reportable by the recipient,<sup>36</sup> and there are a number of other kinds of assets that may be acquired without filing (e.g., real estate assets covered by Rule 802.2). But if no exemption applies,<sup>37</sup> the entity and the partner/member from which it acquires the contributed assets may have a separate filing obligation.

To state it differently, a contribution of assets to an existing unincorporated entity may give rise to two distinct sets of reporting obligations. First, if the contributor acquires control of the entity, that contributor may have to file for its acquisition of the controlling interest, depending upon the value of the interest that is held as a result of the acquisition. Second, if the contributed assets are large enough, the unincorporated entity (or its ultimate parent, which may be the person that acquires control of the entity as a result of the contribution) may have a reporting obligation for its acquisition of assets, depending upon the value of the assets contributed.

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<sup>32</sup> Conversely, a transaction as a result of which a partner acquires a right to 50% or more of the partnership's assets in dissolution does not "confer control" if that same partner already had a right to 50% or more of the partnership's profits. (Alternatively, the intraperson exemption may be viewed as applying to such a transaction.)

<sup>33</sup> Rule 801.2(f)(1)(i).

<sup>34</sup> In an odd case, it might be a different partner/member. Suppose, for example, that partners A, B, and C each have a right to one-third of the partnership's assets and D has a right to all of the partnership's assets in the event of dissolution. If A acquired B's right to partnership profits, the acquisition would confer control on A, who would have a potential reporting obligation. If a filing is required, the acquired person would be the pre-acquisition ultimate parent of the partnership, namely D.

<sup>35</sup> See discussion *supra* at text accompanying note 26. Acquisitions by existing unincorporated entities and acquisitions of interests in existing unincorporated entities are not viewed as "formations" of a new entity and are not covered by new Rule 801.50. This contrasts with to-be-withdrawn Formal Interpretation 15, which deems a new LLC to be formed whenever assets are contributed to an existing LLC and the members' entitlements to the profits and assets of the LLC are altered.

<sup>36</sup> Rule 801.21(a).

<sup>37</sup> See especially the discussion of amended Rule 802.4, *infra* at text accompanying note 42.

## The Intraperson Exemption Enlarged

Here, however, the new rules may provide relief. Rule 802.30(c) expands the existing “intraperson exemption” applicable to transactions *other than* the formation of a corporation or unincorporated entity. Where an acquiring person and at least one acquired person are the same person (i.e., their ultimate parents are literally the same), the acquisition is exempt. “Control” for this purpose includes holding 50 percent or more of the stock of a corporation, or having a right to either 50 percent of an unincorporated entity’s profits or 50 percent of its assets in dissolution; it does not include control of a corporation through a contractual power presently to designate half or more of its directors.

*Assets held by an existing corporation may be transferred to or from an existing partnership, where the corporation and partnership are already under common control.*

Thus, for example, assets held by an existing corporation may be transferred to or from an existing partnership, where the corporation and partnership are already under common control. This is a considerable expansion of the present rule, which exempts acquisitions only where the acquiring and acquired persons are the same person *by reason of holdings of voting securities*. Since unincorporated entities do not issue voting securities, transfers to or from partnerships or LLCs have to date been unable to utilize the intraperson exemption.

But the intraperson exemption can be tricky to apply. Here is an example right out of the new rules (following Rule 802.30(a)):

A and B each have the right to 50% of the profits of [existing] partnership X. A contributes assets to X valued in excess of \$50 million [as adjusted]. B contributes cash to X. [Presumably the partners’ respective rights to profits and assets remain unchanged.] Because B is an acquiring person but not an acquired person, its acquisition of the assets contributed to X by A is not exempt under §802.30(a). However, A is both an acquiring and acquired person, and its acquisition of the assets it is contributing to X is exempt under §802.30(a).

Let’s take the same example more slowly. When A contributes a potentially reportable quantity of assets to the partnership that A already controls (by its 50 percent interest), this is a classic application of the intraperson exemption. A is the acquiring person because it controls the partnership; it is the acquired person because it transfers the assets. Because it is both the acquiring and the acquired person *with respect to the transfer of these assets*, it is entitled to the exemption. The partnership’s acquisition of A’s contributed assets is therefore not reportable by A. However, with respect to that same transfer of A’s assets, B is also an acquiring person, because B also controls the partnership (by reason of its 50 percent interest). B is not an acquired person, because the assets being acquired by the partnership are not B’s assets. Therefore, B does not get the exemption and has to file notification for the partnership’s acquisition of A’s assets. At the same time, B’s transfer of cash results in a separate acquisition by the partnership (and therefore by each of its controlling partners), but an acquisition of cash is non-reportable by reason of Section 801.21(a), and the application of the intraperson exemption is therefore not required. Note that no acquisitions of any non-corporate interests occur in this example.

Complicate this example slightly by supposing that A and B each make separate asset transfers to the fifty-fifty partnership, each of which is valued in excess of, say, \$55 million. A controls the partnership and has to file for the acquisition of B’s assets. B is exempt from filing *for that acquisition*, because B is both an acquiring person (through its control of the partnership) and an acquired person (as transferor of the assets) and therefore claims the intraperson exemption. B’s acquisition of the assets of A must be separately analyzed and is reportable by B (because it controls the partnership and is not eligible for the intraperson exemption *in that acquisition*) but not by A (because of the intraperson exemption). Again, no non-corporate interests are acquired.



*The moral of this story is that nearly every transaction between an existing non-corporate entity and one of its partner/members has two sides to it—an acquisition of non-corporate interests by the partner/member and an acquisition of assets by the non-corporate entity.*

To illustrate the nuances of the intraperson exemption further, alter this same example in one simple respect. In return for their respective asset transfers valued in excess of \$55 million, A's right to partnership profits and to assets in dissolution is increased from 50 percent to 52 percent, and B's interest is correspondingly reduced to 48 percent. In other words, in return for transfers of assets by A and B, A increases its controlling interest in the partnership, and B's interest is reduced so that it is no longer controlling.<sup>38</sup> The partnership's acquisition of A's assets remains intraperson exempt for A, which both controls the partnership and transferred the assets. The partnership's acquisition of B's assets remains reportable by A. The partnership's acquisition of A's assets is not separately reportable by B, because as a result of the acquisition B no longer controls the partnership and thus is not viewed as acquiring either A's assets or B's own assets that were transferred to the partnership.

Finally, take one more similar example. Suppose that A has a 48 percent interest and B a 52 percent interest in a partnership. A and B then each transfer assets to the partnership valued in excess of \$55 million. But A's assets are more valuable, so its share of the partnership is increased to 52 percent, and B's is correspondingly reduced to 48 percent. Thus, the partnership has acquired assets from each of its partners, and as a result of those acquisitions, control of the partnership has shifted from B to A. Here is the result: A files for its acquisition of a controlling interest in the partnership. (The intraperson exemption does not apply because A is not an acquired person in that transaction because it did not control the partnership prior to the transaction.) Neither the partnership nor its now controlling partner, A, files for acquisition of the additional assets transferred by A (intraperson exemption applies). The partnership's separate acquisition of assets from B is also reportable, so the partnership's controlling partner, A, will file as the acquiring person and B, as the transferor of its assets to the partnership, will file as the acquired person.

The moral of this story is that nearly every transaction between an existing non-corporate entity and one of its partner/members has two sides to it—an acquisition of non-corporate interests by the partner/member and an acquisition of assets by the non-corporate entity. Any such transaction must always be analyzed in both directions for potential reportability. The intraperson exemption will often, but not always, come into play. And simultaneous transactions between an unincorporated entity and several of its partner/members can require a complicated series of analytical steps.

### **Valuation of Potentially Reportable Acquisitions of Non-Corporate Interests**

When an acquisition of a non-corporate interest confers control of an unincorporated entity upon an acquiring person, reportability of that acquisition must be determined. The new rules state that a person that acquires control of an unincorporated entity is viewed as holding all of the assets of that entity.<sup>39</sup> However, the new rules require the acquiring person to determine the value of the controlling non-corporate interests that it holds as a result of the acquisition, rather than the value of the unincorporated entity's underlying assets. Roughly speaking, the value of the non-corporate

<sup>38</sup> Recall that where a person transfers more than \$50 million (as adjusted) of assets to an existing unincorporated entity and takes back a non-controlling interest in the entity, the intraperson exemption will not apply, and the acquisition of the assets by the entity will be reportable by the entity (or its ultimate parent, if it has one) as the acquiring person, and by the new minority partner/member (as an acquired person transferring its assets). The contributor's acquisition of the minority interest in the entity is, of course, non-reportable.

<sup>39</sup> Rule 801.2(f)(1)(i).



rate interests held (and the relevant value under the statutory size-of-transaction test) will normally reflect only the acquiring person's proportionate share of the total assets or value of the enterprise.

New Rule 801.10(d) is quite similar to existing Rules 801.10(a)(2) and 801.13(a), which determine the value of voting securities of a corporation held as a result of an acquisition. Under Rule 801.10(d), if the acquisition price of the non-corporate interests now being acquired is determined, then the acquiring person adds that acquisition price to the fair market value of any additional non-corporate interests in the same entity that it already holds. If the acquisition price of the to-be-acquired interests is not determined, then the acquiring person uses the fair market value of all the non-corporate interests that will be held as a result of the acquisition.<sup>40</sup>

The result, again roughly speaking, is that a person that will hold a 60 percent interest in an unincorporated entity as a result of an acquisition will value that 60 percent interest. This contrasts with present rules, under which no filing is required for an acquisition that confers control of an unincorporated entity, but an acquiror that will hold 100 percent of the interests in such an entity is deemed to be acquiring 100 percent of the assets of that entity, even if the acquiror already held an interest in that entity, and even if that interest was a majority interest.

Because of the dual tests for control of an unincorporated entity, valuation can have some odd twists. How does one value a right to, say, 60 percent of a partnership's profits? To the extent that the parties agree on an "acquisition price" for a 60 percent interest, the question is answered, even though the rationale may not be evident. But where the acquisition price is not determined, acquiring persons may be faced with some difficult theoretical questions.<sup>41</sup> Similarly difficult issues can also arise under the present rules but will likely be exacerbated by application to a potentially larger number and variety of unincorporated entities.

*Valuation issues are likely to raise a whole range of new and ephemeral questions.*

Valuation issues are likely to raise a whole range of new and ephemeral questions. Is the value of a right to half the profits of a partnership equal to the value of half the partnership's assets? Is the value of a right to half the profits of a partnership equal to a right to half the assets of the partnership in dissolution?

And what if a person were to acquire a right to 60 percent of the profits of a partnership, but someone else had a right to 60 percent of the partnership's assets in the event of dissolution? One might plausibly claim that a right to majority of profits is worth somewhat less if one does not also have a right to a majority of assets in dissolution. But how much less? What are the relevant valuation criteria and considerations? Because it is contingent, any right to a partnership's assets in the event of dissolution would appear normally to be worth less than a comparable right to the present profits of the partnership. But how much less? One could imagine a circumstance where dissolution of a highly profitable partnership might seem so remotely contingent as to render a right to a majority of the partnership's assets of limited value. Conversely, one might imagine a situation where a struggling partnership's profit potential is nearly non-existent, while the rights to its assets (e.g., intellectual property rights) in dissolution could be significant.

<sup>40</sup> This valuation rule is also used when valuing acquisition of a controlling interest in the formation of an unincorporated entity.

<sup>41</sup> Consider, for example, the situation where a one-third partner buys out the interests of one of the other one-third partners for \$20 million. Rule 801.10(d) says that the newly acquired one-third interest is valued at its acquisition price of (\$20 million), and the acquiror's initial one-third interest must be separately valued at fair market. But is that FMV by itself (i.e., a minority interest) or in combination (i.e., half of a majority interest)? Is valuation based on the value of the partnership's assets, or its enterprise value? The new rules do not provide any guidance on those issues. (Nor do the present rules provide guidance for similar issues arising with respect to voting securities acquisitions.)

Fortunately, there are not likely to be very many transactions in which control of a partnership is conferred solely by acquisition of a right to a majority of its assets in dissolution. Most partnerships are likely to divide rights to profits and to assets in dissolution in the same way, so that what is acquired is essentially a percentage equity interest in the enterprise.

### Other Newly Promulgated Rules

*The existing exemption in Rule 802.4 is expanded in two ways that are likely to be helpful in acquisitions of non-corporate interests that confer control of an unincorporated entity.*

The existing exemption in Rule 802.4 is expanded in two ways that are likely to be helpful in acquisitions of non-corporate interests that confer control of an unincorporated entity. Present Rule 802.4 was part of a package of rules promulgated several years ago that exempted acquisitions of certain types of real estate assets. That rule presently exempts acquisitions of voting securities of corporations that hold assets that would be exempt if acquired directly under the related real estate and certain other exemption rules, so long as the issuer does not hold more than \$50 million (as adjusted) worth of other “non-exempt” assets. Amended Rule 802.4 would expand this exemption to acquisitions that confer control of unincorporated entities and would expand the kinds of “non-exempt assets” that don’t count against the \$50 million (as adjusted) trigger to include any assets that can be acquired under any exemptions in the HSR Act and rules.<sup>42</sup>

Another new exemption allows conversion of an unincorporated entity into a new entity provided no new assets are contributed to the new entity as a result of the conversion and either (i) as a result of the conversion the acquiring person does not increase its percentage entitlement to profits or assets in dissolution or (ii) the acquiring person controlled the original entity.<sup>43</sup>

There are a number of other proposed rules that become effective with the non-corporate interest rules. A number of these have little or nothing to do with non-corporate interests and simply clean up existing small glitches in the rules.<sup>44</sup>

### What the New Rules Don’t Reach

While the new rules will require notification in a variety of situations that the current rules do not reach, there nevertheless remain a significant number of common scenarios involving formations

<sup>42</sup> In this example, note the interplay between the intraperson exemption and amended Rule 802.4 in a formation transaction under the new rules. A and B form a 50/50 partnership, which is controlled by each of them. A contributes \$60 million worth of assets and B contributes \$40 million in cash. A has acquired control of the partnership. The value of A’s interest is the acquisition price of \$60 million. Thus, A’s acquisition would be reportable, unless an exemption applies. Rule 802.4 provides such an exemption if the new partnership will hold less than \$50 million worth (as adjusted) of “non-exempt assets.” Rule 802.30(c) (the intraperson exemption) says that for purposes of applying Rule 802.4 to a formation transaction, A’s \$60 million worth of contributed assets are “exempt assets”. The cash contributed by B is also exempt, under § 801.21(a). Thus the new partnership has non-exempt assets of less than \$50 million (as adjusted) (in fact it has none at all), and A’s acquisition of its controlling interest is therefore exempt under Rule 802.4. B has also acquired control of the partnership, but its acquisition is also non-reportable, because B’s acquisition price of \$40 million does not meet the minimum filing threshold under the HSR Act.

<sup>43</sup> Rule 802.10(b).

<sup>44</sup> Rule 801.2(d)(iii) states that any combination of corporations and unincorporated entities into an upstream holding company is potentially reportable, and all parties that lose their separate identities in such a transaction are treated as both acquiring and acquired persons. Dual-listing arrangements were originally proposed to be covered by this rule but have been deleted from the final rule.

Rule 802.2 is amended to revoke the exemption previously applicable to acquisitions of timberland, timber tract operations, and logging.

Rule 802.65 creates a new exemption for financing transactions in which one party contributes only cash and receives a preferential right to 50% or more of an unincorporated entity’s profits that drops below 50% (or disappears altogether) once the financing party has received its preferential return.

Rule 802.80 makes the new reporting requirements inapplicable to unincorporated entities that were under investigation and supplied information or documentary material under compulsory process prior to the effective date of the rules.

of unincorporated entities and acquisitions of interests in existing unincorporated entities that remain non-reportable under the new rules. Here are some examples.

*It would not be surprising if it takes a while for the new rules to be widely understood and for full compliance with them to be achieved.*

- All formations of unincorporated entities in which none of the forming parties controls the new partnership. (In order for this to occur, there must always be at least three forming parties.)
- All formations of unincorporated entities in which no forming party (including its affiliates) acquires non-corporate interests valued at more than \$50 million (as adjusted) as consideration for its initial contribution of assets or voting securities to the new entity. (Any number of otherwise unaffiliated forming parties may acquire non-corporate interests valued at less than \$50 million.)
- All formations of unincorporated entities in which one forming party contributes more than \$50 million (as adjusted) worth of assets (e.g., technology) or voting securities, that party alone controls the new entity, and the other forming parties contribute any amounts of cash or other exempt assets, but do not collectively contribute more than \$50 million worth of non-exempt assets.
- All acquisitions of non-corporate interests in existing entities by minority partner/members that remain minority owners after their acquisitions.
- All acquisitions of non-corporate interests in existing entities by controlling parties that continue to control the entities after their acquisitions.
- All acquisitions of minority interests in existing non-corporate entities by new partner/members.
- All contributions of non-exempt assets to existing unincorporated entities, where the contributed assets are valued at less than \$50 million (as adjusted) (unless Rule 801.13(b), relating to multiple post-formation acquisitions from the same acquired person, applies).

### Conclusion

One of the major uncertainties relating to these new rules arises because it is not known how frequently transactions of these types occur and because the degree of formality or informality that characterizes them is not well understood. The rules explicitly will not reach inadvertent formations of unincorporated entities; a formation is not reportable unless the parties intend to form a new legal entity. However, it is less clear that transactions conferring control of an unincorporated entity must similarly reflect an intentional acquisition or a transfer of an equity interest in the entity. Moreover, while people may be somewhat used to thinking about whether mergers or acquisitions of assets or voting securities may be reportable, transactions that shift entitlement to an unincorporated entity's profits or to its assets in dissolution may be less familiar contexts in which to consider possible reporting obligations. It would not be surprising if it takes a while for the new rules to be widely understood and for full compliance with them to be achieved.

Those of us who practice in the HSR area have only just begun to consider the implications of these new rules. The journey is likely to be interesting. ●

# Empirical Facts and Innovation Markets: Analysis of the Pharmaceutical Industry

**Rosa M. Abrantes-Metz, Christopher P. Adams and Albert D. Metz**

Over the last ten years, the Federal Trade Commission has analyzed the effects of a number of mergers in industries where innovation is an important dimension of competition. It brought an action or required a divestiture in a number of these mergers because of potential anticompetitive effects.<sup>1</sup> Consequently, a debate has ensued over whether the agency's market analysis should be limited to potential competition for actual goods or should also include actual competition for potential goods.

In a recent article, Ilene Knable Gotts and Richard T. Rapp analyzed ten mergers and found that no drugs had yet entered the U.S. market in four of the cases, one drug had entered the U.S. market in two of the cases, and two or more drugs had entered the U.S. market in the four remaining cases.<sup>2</sup> Gotts and Rapp argue that these results support their view that agency decision making would be improved by limiting enforcement to mergers involving potential competition for actual goods: "Proper enforcement involving future goods can only happen when the good is far enough along in the development process to allow it to be identified as a source of potential competition, along with its close substitutes, in a forecast relevant goods market."<sup>3</sup>

In contrast, FTC Commissioners Harbour and Thompson argued in the *Genzyme* case that the merger was problematic because it reduced actual competition for potential goods.<sup>4</sup> As Commissioner Thompson explained in his dissent.

The basic facts of this matter are clear and for the most part uncontested. The *Genzyme/Novazyme* merger constitutes a consummated merger to monopoly in the research and development of a highly specialized drug, and entry of a new market participant is not likely to replace the innovation competition eliminated by the merger. The presumption of anticompetitive effects from this merger to monopoly has not been rebutted and is therefore sufficient to indicate that a Commission challenge is warranted.<sup>5</sup>

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or their clients. All errors  
are our own.

<sup>1</sup> See Amgen Inc., FTC Docket No. C-4056 (Sept. 3, 2002) (consent order), available at <http://www.ftc.gov/os/caselist/c4056.htm>; FTC Press Release, FTC Seeks to Block Cytoc Corp.'s Acquisition of Digene Corp. (June 24, 2002), available at [http://www.ftc.gov/opa/2002/06/cytc\\_digene.htm](http://www.ftc.gov/opa/2002/06/cytc_digene.htm); Glaxo Wellcome plc, FTC Docket No. C-3990 (Jan. 26, 2001) (consent order), available at <http://www.ftc.gov/os/caselist/c3990.htm>; Pfizer Inc., FTC Docket No. C-3957 (July 27, 2000) (consent order), available at <http://www.ftc.gov/os/caselist/c3957.htm>; CIBA-Geigy Ltd., FTC Docket No. C-3725 (Mar. 24, 1997) (consent order), available at <http://www.ftc.gov/os/caselist/c3725.htm>; Baxter Int'l, FTC Docket No. C-3726 (Mar. 24, 1997) (consent order), available at <http://www.ftc.gov/os/caselist/c3726.htm>; Am. Home Prods. Corp., FTC Docket No. C-3557 (Feb. 14, 1995) (consent order); Glaxo plc, FTC Docket No. C-3586 (June 14, 1995) (consent order); Hoechst AG, FTC Docket No. C-3269 (Dec. 5, 1995) (consent order); Upjohn Co., FTC Docket No. C-3638 (Feb. 8, 1996) (consent order).

<sup>2</sup> Ilene Knable Gotts & Richard T. Rapp, *Antitrust Treatment of Mergers Involving Future Goods*, ANTITRUST, Fall 2004, at 100.

<sup>3</sup> *Id.* at 102.

<sup>4</sup> See David A. Balto & Scott A. Sher, *Refining the Innovation Focus: The FTC's Genzyme Decision*, ANTITRUST, Spring 2004, at 28.

<sup>5</sup> Dissenting Statement of Commissioner Mozelle W. Thompson, *Genzyme Corporation's Acquisition of Novazyme Pharmaceuticals Inc.*, File No. 021-0026 (Jan. 13, 2004), available at <http://www.ftc.gov/os/2004/01/thompsongenzymestmt.pdf>.

According to Commissioner Harbour, “[t]he creation of innovation monopolies in such an industry eliminates the all important race-to-innovate aspect of innovation competition, [and] diminishes important diversity in research approaches . . . .”<sup>6</sup>

This article summarizes the empirical analysis of new drug development in the pharmaceutical industry that we presented in a recent FTC Bureau of Economics Working Paper.<sup>7</sup> This article does not enter into the innovation market analysis debate, but instead provides empirical facts in the context of arguments that have been made on both sides of the debate.<sup>8</sup>

### Stages of the Drug Development Process

The drug development process from initial discovery to FDA approval and release to the market consists of a number of distinct stages. After initial discovery, drugs are analyzed and tested in the laboratory. Pharmaceutical firms and other researchers analyze the likely efficacy of the drug using genetic analysis and “animal models,” among other things. Information from these tests is subsequently provided to the FDA (or another similar regulatory agency) when the drug company applies to begin a series of tests in humans.

Phase I of the human clinical trials involves a small number of healthy patients. These Phase I trials are aimed at proving that the drug is relatively safe. After Phase I, the drug moves into Phase II, where trials are conducted on a few hundred patients with the disease in question. Phase II trials are also focused on safety, but with some additional analysis of the drug’s efficacy. Phase III trials are much larger, with upwards of 3000 patients involved, and are aimed at determining the effectiveness of the drug. While overlap sometimes occurs between these phases of the human clinical trials, drug tests generally progress sequentially from Phase I through to Phase III.

Once the trials are completed, the data is sent to the FDA for analysis. After review, the FDA can approve the drug for a particular disease indication. Once approved, the drug can be marketed for that indication.<sup>9</sup>

### Merger Enforcement

**Potential Competition for Actual Goods.** Gotts and Rapp argue that the agencies should concentrate merger enforcement on those cases where “potential competitors can be considered in goods (or, where applicable, service) markets that are reasonably likely to exist within a foresee-

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<sup>6</sup> Statement of Commissioner Pamela Jones Harbour, Genzyme Corporations’s Acquisition of Novazyme Pharmaceuticals Inc., File No. 021-0026 (Jan. 13, 2004), available at <http://www.ftc.gov/os/2004/01/harbourgenzymestmt.pdf>.

<sup>7</sup> ABRANTES-METZ ET AL., PHARMACEUTICAL DEVELOPMENT PHASES: A DURATION ANALYSIS (Bureau of Economics, Federal Trade Commission Working Paper No. 274, Oct. 2004), available at <http://www.ftc.gov/be/workpapers/wp274.pdf>.

<sup>8</sup> Others have used the empirical facts drawn from the authors’ work in analyzing mergers in the pharmaceutical industry. Then Federal Trade Commission Chairman Timothy Muris cited the authors’ work in his defense of the FTC’s decision not to prosecute the *Genzyme* case. Chairman Muris wrote a statement supporting the Commission’s position to close the case, while Commissioner Thompson wrote a dissenting statement, and Commissioner Harbour wrote a statement expressing some concerns about the decision. See FTC Press Release, FTC Closes Its Investigation of Genzyme Corporation’s 2001 Acquisition of Novazyme Pharmaceuticals, Inc. (Jan. 13, 2004), available at <http://www.ftc.gov/opa/2004/01/genzyme.htm>. Gotts and Rapp cite the authors’ work in describing the background for recommending that antitrust enforcement be limited to cases where the identities of sellers can be predicted and their capacities approximated. See Gotts & Rapp, *supra* note 2, at n.25.

<sup>9</sup> A number of firms also do Phase IV trials, but it is our understanding that these generally are not needed for marketing approval. For a more detailed discussion of the development process, see ABRANTES-METZ ET AL., *supra* note 7.

able time frame.”<sup>10</sup> The question, of course, remains, what is “reasonably likely” and when is “foreseeable?”

In the *Genzyme* case, neither firm had a product that was even as far along the development process as human clinical trials.<sup>11</sup> In contrast, in the *Glaxo Wellcome/SmithKline Beecham* merger, the FTC cited concerns in the market for topical antiviral cold sore (herpes) drugs.<sup>12</sup> SmithKline Beecham owned Denavir, which was the only drug approved by the FDA for treating such infections, while Glaxo Wellcome owned Zovirex, which was approved in Europe and a year away from approval in the United States. According to the FTC, “[t]he merger, as proposed, would eliminate the only potential entrant into the market—Glaxo’s Zovirex—as the combined Glaxo SmithKline would likely not bring Zovirex to market to compete against its own product, Denavir.”<sup>13</sup> The examples of *Genzyme* and *Glaxo Wellcome/SmithKline Beecham* seem to occupy opposite ends of the spectrum. In *Genzyme* the probability of bringing either of the drugs in development to market seemed very small and the time to market very long.<sup>14</sup> Meanwhile, in the *Glaxo Wellcome/SmithKline Beecham* merger, the likelihood of entry was high and the time to market was short.<sup>15</sup>

But what is the probability that a drug will ever get to market? How does the probability change as the drug moves through the development process? How does the probability of getting to market vary across drugs? In our work, we present “crude” probabilities that are calculated by simply observing the number of drugs that successfully reach the market divided by the total number of drugs that go into development.<sup>16</sup> We also present simulation results from a type of regression analysis called a duration model. This model enables us to determine how different features of the drug determine the drug’s success rate. For example, the model helps to determine whether the high crude success rate of a cancer drug is due to the drug’s indication or due to some other characteristic like the drug’s route of administration.

Overall, it seems that only about 1 in 4000 drugs proposed in preclinical testing actually ever makes it to market.<sup>17</sup> Once the drug gets to Phase I, the probability of success seems to increase substantially.<sup>18</sup> In our data, we find that about 26 percent of Phase I drugs are launched on the market. For drugs that reach Phase II, the probability that the drug will get to market increases

*But what is the probability that a drug will ever get to market? How does the probability change as the drug moves through the development process? How does the probability of getting to market vary across drugs?*

<sup>10</sup> Gotts & Rapp, *supra* note 2.

<sup>11</sup> Balto & Sher, *supra* note 4.

<sup>12</sup> FTC Press Release, Resolving Competitive Concerns, FTC Agreement Clears \$182 Billion Merger of SmithKline Beecham and Glaxo Wellcome (Dec. 18, 2000), available at <http://www.ftc.gov/opa/2000/12/skb.htm>.

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

<sup>14</sup> Based on the FDA’s analysis and the analysis presented in our paper, one in four thousand drugs in preclinical testing make it to market. See DEP’T OF HEALTH AND HUMAN SERVICES, FOOD AND DRUG ADMIN., FDA AND THE DRUG DEVELOPMENT PROCESS: HOW THE AGENCY ENSURES THAT DRUGS ARE SAFE AND EFFECTIVE (FDA Publication No. FS 02-5, Feb. 2002), available at <http://www.fda.gov/opacom/factsheets/justthefacts/17drgdev.html> [hereinafter FDA REPORT]. Other works cited below and our work suggest that it takes between 13.5 and 8.5 years for a drug to go from preclinical testing to market.

<sup>15</sup> Below we discuss evidence on the probability of success and time to market for drugs in the FDA approval process.

<sup>16</sup> To be precise, it is the total number of drugs that go into human clinical trials and for which we observe the drug exit (either successfully to the next phase or as a failure).

<sup>17</sup> This is based on the FDA’s statement that 1 in 1000 drugs make it to human clinical trials and our result that one in four drugs make it from human clinical trials to market. FDA REPORT, *supra* note 14.

<sup>18</sup> This sample includes drugs that first entered human clinical trials between 1989 and 2002 and for which the data base includes information on when the drug began at least one of the phases of the human clinical trials. For a more detailed description of the data used in this analysis and the duration model that we estimate, see ABRANTES-METZ ET AL., *supra* note 7.



somewhat to 33 percent. For drugs that reach Phase III, the probability of success is 57 percent. Unfortunately, we were not able to determine the probability of success for drugs that entered the FDA approval process after completing Phase III trials.

While these averages provide a solid foundation for understanding the probability of entry from the different stages of a drug's development, there is substantial variation in these probabilities across different types of drugs. For instance, in our sample, we find that biological drugs, such as those at issue in *Genzyme*, have a 42 percent probability of getting from Phase I to market and a 70 percent probability of getting from Phase III to market.<sup>19</sup> We find that AIDS drugs have a 50 percent probability of getting from Phase I to market, with a 94 percent probability of getting from Phase III to market. At the other end of the spectrum, we find that drugs for Alzheimer's have only a 16 percent probability of getting from Phase I to market and a 33 percent probability of getting from Phase III to market.

How much of this variation is due to differences between diseases and how much is due to differences in the drug's chemistry or its molecule's size? In our sample, we find that a cancer drug has a 42 percent probability of getting from Phase I to market and a 66 percent probability of getting from Phase III to market. Both of these probabilities are much higher than the average and suggest that cancer drugs have a greater chance of getting to market. Our regression analysis shows, however, that this difference is due to other characteristics of the drug, such as the drug's chemistry or route of administration. The value of the regression analysis is that it is able to separate out how different characteristics of the drug contribute to the drug's success rate. For this reason, we find that all else being equal, drugs indicated for cancer actually possess a decreased probability of getting to market. The regression analysis thus suggests that cancer is a particularly difficult disease for which to find a successful treatment. This fact seems to be masked by the tendency of cancer drugs to have other characteristics more typically associated with higher success rates.

What is a drug's time to market from the different stages of development and how does time to market vary across drugs? Other research suggests that it takes about 13.5 years for a drug to go from discovery to approval.<sup>20</sup> Our research presents both the average durations through each phase of the human clinical trials and simulation results from the regression analysis. Once a drug gets to Phase I, we find that it takes an average of 8.5 years to be launched on to the market. For drugs in Phase II, it takes about 6.5 years. It takes an average of 3.75 years for a drug to go from the beginning of Phase III trials to market launch. We do not present any data on the average length of time from the start of regulatory approval (the time following the completion of Phase III trials) to market. Recent work analyzing FDA approval times, however, finds that these times have fallen from an average of 24.2 months in 1991 to 14.2 months in 2002.<sup>21</sup> This decrease in approval times is also found in our work and appears to stem from the introduction of the Prescription Drug

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<sup>19</sup> Biological drugs are drugs based on chemistry that is naturally occurring in the body, such as proteins. The drugs at issue in *Genzyme* and in *Amgen/Immunex* were biologicals.

<sup>20</sup> David Dranove & David Meltzer, *Do Important Drugs Reach the Market Sooner?*, 25 RAND J. ECON. 402 (1994); Joseph A. DiMasi et al., *The Price of Innovation: New Estimates of Drug Development Costs*, 22 J. HEALTH ECON. 151 (2003) (estimating that the time from discovery to marketing approval is a little over twelve years).

<sup>21</sup> For a detailed discussion of the acts and the effect the acts have had on the approval process, see ERNST R. BERNDT ET AL., *ASSESSING THE IMPACTS OF THE PRESCRIPTION DRUG USER FEE ACT (PDUFA) ON THE FDA APPROVAL PROCESS* (National Bureau of Econ. Research Working Paper 10822, Oct. 2004), available at <http://www.nber.org/books/frontiers8/w10822.pdf>.



User Fee Act (PDUFA) in 1992.<sup>22</sup> PDUFA enables the FDA to collect user fees associated with drug approval applications, with the understanding that these fees will be used to increase expenditure on staff and equipment to reduce review and approval times.

As with success rate, we find substantial variation in times to market across drugs with different characteristics. For example, thrombosis drugs take about 9.5 years to go from Phase I to market and 5 years to go from Phase III to market. Yet AIDS drugs take approximately 5.5 years to go from Phase I to market and less than 2 years to go from the start of Phase III to market. The FDA has allowed AIDS drugs to go through an accelerated approval process, resulting in a very short time from the start of Phase III to market.<sup>23</sup> This means that AIDS drugs are able to apply for marketing approval prior to completing Phase III clinical trials.<sup>24</sup>

We find little variation in times to market for drugs with different materials of origin. For example, biological drugs take slightly less than 8 years to go from Phase I to market while chemical drugs take slightly more than 8 years to go from Phase I to market. There also seems to be little difference in time to market for drugs with different routes of administration. We do find, however, that topical drugs move through the earlier phases more quickly than average, but then slow down in Phase III, with an average of 4.5 years from the beginning of Phase III to market. Also, our regression analysis suggests that an indication for Parkinson's diseases is likely to increase a drug's time to market, all else equal, while an indication for AIDS or hypertension will reduce a drug's time to market.

There are two important caveats. First, there is no average drug, and even within categories there can be variation in both success rates and time to market. Still, we argue that it is important to understand the empirical facts of pharmaceutical development to put facts and arguments into context. The second caveat is that our analysis is based on observed data, which are affected by the strategic decisions of the pharmaceutical firms themselves. Pharmaceutical firms are constantly assessing the likely cost and benefits of developing different drugs. When we observe that a drug ends development in Phase II, we are unable to determine whether that "failure" is due to some adverse event, like a serious illness among patients, or due to a change in expected profits caused by entry of a similar drug (for example).<sup>25</sup>

Assuming that anything greater than a one in two chance is "reasonably likely" and anything less than three years is "foreseeable," these results suggest that on average, only drugs in Phase III or beyond will satisfy the Gotts and Rapp criteria. However, enough variation exists to suggest there exist exceptions. For example, AIDS drugs in Phase II can be satisfy the criteria while Alzheimer's drugs cannot until they have finished Phase III trials and are under regulatory review. If "reasonably likely" is anything greater than a four in five chance of success, then most drugs would need to be under review to qualify. A notable exception again would be AIDS drugs, where

*We argue that it is important to understand the empirical facts of pharmaceutical development to put facts and arguments into context.*

<sup>22</sup> 21 U.S.C. § 379.

<sup>23</sup> See Dep't of Health and Human Services, Food and Drug Admin., Expanded Access and Expedited Approval of New Therapies Related to HIV/AIDS (Jan. 1996), available at <http://www.fda.gov/oashi/aids/expanded.html>.

<sup>24</sup> Michelle Meadows, *The FDA's Drug Review Process: Ensuring Drugs Are Safe and Effective*, FDA CONSUMER (July–Aug. 2003), available at [http://www.fda.gov/fdac/features/2002/402\\_drug.html](http://www.fda.gov/fdac/features/2002/402_drug.html).

<sup>25</sup> One survey of firms finds that 34% of trials are abandoned for "economic" reasons, 38% for "efficacy," 20% for "safety," and 9% for "other." See Joseph A. DiMasi, *Risks in New Drug Development: Approval Success Rates for Investigational Drugs*, 69 CLINICAL PHARMACOLOGY AND THERAPEUTICS 297 (May 2001), available at [http://www2.us.elsevierhealth.com/scripts/om.dll/serve?action=get-media&id=a115446&trueID=pdf\\_115446&location=jcp010695&type=pdf&name=x.pdf](http://www2.us.elsevierhealth.com/scripts/om.dll/serve?action=get-media&id=a115446&trueID=pdf_115446&location=jcp010695&type=pdf&name=x.pdf).

*We find evidence that firms with a large number of drugs in development have higher success rates and shorter times to market. This seems to be particularly true for drugs in Phase III of the development process.*

drugs in Phase III would satisfy the criteria. If “foreseeable” is less than five years, then some drugs in Phase II may satisfy the Gotts and Rapp criteria.

**Actual Competition for Potential Goods.** An important issue in *Genzyme* was whether the merger would lead to a reduction in “research competition.” Commissioner Thompson stated that the merger would reduce the number of active programs researching a cure for Pompe disease from two to one.<sup>26</sup> In particular, there was concern that there would no longer be a “race to market” in Pompe disease.<sup>27</sup> The effect of a reduction in the number of pharmaceutical firms on research and development seems to be an open question in economics. According to an FTC Staff Report, “economic theory and empirical investigations have not established a general causal relationship between innovation and competition.”<sup>28</sup>

When firms competing in research and development merge, the merger could reduce the incentive to be first to market, but it could also bring together scientists working on different approaches and improve the productivity of the research programs. If the first effect dominates, then we might expect mergers to reduce spending on research and development. One recent study analyzing the financial effects of mergers in the pharmaceutical industry finds some decrease in research and development spending for smaller firms that merge, but no change in research and development spending for larger firms that merge.<sup>29</sup> If the second effect dominates, it would be because there are “spillovers” in research and development, with larger research and development programs having greater success. Another study finds some empirical evidence that there are indeed “spillovers” in research and development programs in the pharmaceutical industry. The study finds that larger firms seem to have more productive research efforts.<sup>30</sup>

Our analysis also suggests that larger firms are more productive. We find evidence that firms with a large number of drugs in development have higher success rates and shorter times to market. This seems to be particularly true for drugs in Phase III of the development process. Using our sample, we compare the success rates of the drugs originated by the top ten pharmaceutical firms by revenue against the all other drugs. We find that the probability that a drug from a large firm successfully gets from Phase III to market is 69 percent compared to 54 percent for all other drugs. However, the success rate from Phase I to market is almost identical, at 25 percent and 26 percent, respectively. With respect to the duration of time from Phase I to market, we find drugs from the large pharmaceutical firms take about 7 years, while other drugs take approximately 8 years. These differences are consistent with our regression results, suggesting that larger firms are more productive.

<sup>26</sup> Dissenting Statement of Commissioner Mozelle W. Thompson, *supra* note 5.

<sup>27</sup> For a detailed discussion of the case see Balto & Sher, *supra* note 4.

<sup>28</sup> 1 FEDERAL TRADE COMM’N, ANTICIPATING THE 21ST CENTURY: COMPETITION POLICY IN THE NEW HIGH-TECH, GLOBAL MARKET PLACE ch. 7, at 16 (1996), available at [http://www.ftc.gov/opp/global/report/gc\\_v1.pdf](http://www.ftc.gov/opp/global/report/gc_v1.pdf). But see FEDERAL TRADE COMM’N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY (Oct. 2003) (“Competition can stimulate innovation. Competition among firms can spur the invention of new or better products or more efficient processes. Firms may race to be the first to market an innovative technology.”), available at <http://www.ftc.gov/os/2003/10/innovationrptsummary.pdf>.

<sup>29</sup> PATRICIA M. DANZON ET AL., MERGERS AND ACQUISITIONS IN THE PHARMACEUTICAL AND BIOTECH INDUSTRIES (National Bureau of Econ. Research Working Paper 10536, June 2004), available at <http://www.nber.org/papers/w10536.pdf>.

<sup>30</sup> Iain Cockburn & Rebecca Henderson, *Scale, Scope and Spillovers: The Determinants of Research Productivity in the Drug Industry*, 26 RAND J. ECON. 32 (1996).

An important caveat is that our method of measuring firm size may not be independent. In particular, we measure firm size as of 2001, and all of the drugs that are with the large firm are assumed to have always been with the large firm. This is a problem because a number of mergers occurred during this period, and so the positive relationship between success and firm size may mean that firms merge to improve their drug development pipelines. If firms are merging to purchase drugs that will improve their pipelines, then it may be that successful drugs *cause* large firms rather than the other way around.<sup>31</sup> ●

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<sup>31</sup> See DANZON ET AL., *supra* note 29, for a more detailed discussion of the motivation behind pharmaceutical mergers.

# The True Reagan Antitrust Legacy: The End of Intra-brand Competition

**Mark E. Roszkowski**

In the Summer 2004 issue of ANTITRUST, the departing Editorial Chair, Deborah A. Garza, paid tribute to the antitrust achievements of former President Ronald Reagan.<sup>1</sup> She praised the Reagan administration for “changing the course of federal antitrust enforcement to comport with economic learning and real world facts.”<sup>2</sup> Such an assessment of Reagan’s antitrust legacy calls for a more searching inquiry into the real consequences for antitrust law of the “Chicago School” antitrust theories that were incorporated into law by the Reagan administration and its judicial appointees. Such an inquiry reveals that the Reagan antitrust “revolution” has been a failure, rendering the law unable to prevent, control, or remedy many serious anticompetitive practices.

Although Chicago School theory has had an adverse impact in many areas of antitrust,<sup>3</sup> its most significant effect has been in vertical restraints law, as developed in four major cases: *Continental T.V., Inc. v. GTE Sylvania Inc.*<sup>4</sup>; *Monsanto Co. v. Spray-Rite Service Corp.*<sup>5</sup>; *Business Electronics Corp. v. Sharp Electronics Corp.*<sup>6</sup>; and *State Oil Company v. Khan*.<sup>7</sup> As I have demonstrated at length in other forums,<sup>8</sup> and will summarize below, these cases have virtually eliminated scrutiny of vertical restraints, thus providing no antitrust protection for intra-brand competition. They also have undermined fundamental Sherman Act principles governing horizontal restraints, such as price fixing and classic group boycotts.

The cases listed above need little introduction to readers of this publication. They are the revered pillars of the modern antitrust edifice created by uncritical judicial acceptance of Chicago School theorizing. In fact, as outlined below, the reasoning supporting these cases is seriously flawed, resulting in a profound debilitating effect on antitrust enforcement under Section 1.

<sup>1</sup> Deborah A. Garza, *Editor's Note*, ANTITRUST, Summer 2004, at 6.

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

<sup>3</sup> One notable example is the attempted monopolization doctrine under Section 2 of the Sherman Act, as announced in *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447 (1993). For discussion of the manifold problems created by the doctrine’s “dangerous probability of success” requirement, see Mark E. Roszkowski & Ralph Brubaker, *Attempted Monopolization: Reuniting a Doctrine Divorced from Its Criminal Law Roots and the Policy of the Sherman Act*, 73 MARQ. L. REV. 355 (1990).

<sup>4</sup> 433 U.S. 36 (1977).

<sup>5</sup> 465 U.S. 752 (1984).

<sup>6</sup> 485 U.S. 717 (1988).

<sup>7</sup> 522 U.S. 3 (1997).

<sup>8</sup> See Mark E. Roszkowski, *The Sad Legacy of GTE Sylvania and its “Rule of Reason”*: *The Dealer Termination Cases and the Demise of Section 1 of the Sherman Act*, 22 CONN. L. REV. 129 (1989) [hereinafter Roszkowski, *Sylvania*]; Mark E. Roszkowski, *Vertical Maximum Price Fixing: In Defense of Albrecht*, 23 LOY. U. CHI. L.J. 209 (1992) [hereinafter Roszkowski, *Albrecht*]; and Mark E. Roszkowski, *State Oil Company v. Khan and the Rule of Reason: The End of Intra-brand Competition?*, 66 ANTITRUST L.J. 613 (1998) [hereinafter Roszkowski, *State Oil*].

### *GTE Sylvania*

In *GTE Sylvania*, the Court held that the legality of a location clause in a franchise agreement was to be governed by a rule of reason standard. In so doing, the Court overruled *United States v. Arnold, Schwinn & Co.*,<sup>9</sup> which announced a per se standard for vertical nonprice restrictions imposed in conjunction with a sale of goods, and a rule of reason standard for those created in agency and consignment arrangements.<sup>10</sup> In *GTE Sylvania*, the Court justified its rule of reason standard on the basis that although vertical restrictions may stifle intrabrand competition, they may also promote interbrand competition by possibly creating “certain efficiencies” in a manufacturer’s product distribution, enabling it to compete more efficiently with other manufacturers.<sup>11</sup>

The *GTE Sylvania* holding is seriously flawed. Not only is its sole justification (stifling intrabrand competition may promote interbrand competition) likely wrong in fact,<sup>12</sup> its free floating “rule of reason” standard—involving as it does a balancing of actual harm to intrabrand competition against possible or arguable benefits to interbrand competition—is both unprecedented<sup>13</sup> and is incapable of meaningful judicial application.<sup>14</sup> As I have demonstrated in another forum, none of the arguments supporting vertical market division survive serious scrutiny,<sup>15</sup> resulting in their failure to satisfy a traditional, searching “harms, benefits, alternatives”<sup>16</sup> application of the rule of reason.<sup>17</sup> Nevertheless, under the intrabrand-interbrand balancing test endorsed by *GTE Sylvania*—which accepts the pro-vertical restraints arguments as gospel and therefore attaches no weight to the elimination of intrabrand competition—courts have effectively fashioned a rule of per se legality for most vertical restraints. This fact is well illustrated by an exchange between Robert Pitofsky, then Chairman of the Federal Trade Commission, and Kevin J. O’Connor, then Chair of

<sup>9</sup> 388 U.S. 365 (1967).

<sup>10</sup> *Id.* at 380–81.

<sup>11</sup> *GTE Sylvania, Inc.*, 433 U.S. at 54–55.

<sup>12</sup> As Robert Steiner has argued, there is typically “no basis for a sweeping generalization that the net welfare effect of stifling intrabrand competition and stimulating interbrand competition will be favorable.” Robert L. Steiner, *Sylvania Economics—A Critique*, 60 *ANTITRUST L.J.* 41, 45 (1991). Steiner concludes:

The strength of interbrand competition among manufacturers governs their margins. But even the most vigorous sort of interbrand competition among manufacturers does not discipline retailers’ margins when intrabrand competition is free—much less when it is restrained. Generally, it is the onset of intrabrand competition that *first* forces down the margins and prices of well-known brands. *Then*, interbrand competition—primarily within stores rather than between them—depresses the prices of competing goods.

*Id.* at 44 (emphasis added).

<sup>13</sup> See Roszkowski, *Sylvania*, *supra* note 8, at 153–56. Prior to *Sylvania*, courts had consistently rejected its approach because, as Justice Marshall long ago noted, courts are unable “to weigh, in any meaningful sense, destruction of competition in one sector of the economy against promotion of competition in another.” *United States v. Topco Assocs.*, 405 U.S. 596, 609–10 (1972). Economists are no better at such balancing. See Roszkowski, *Sylvania*, *supra* note 8, at 147–49.

<sup>14</sup> See Roszkowski, *Sylvania*, *supra* note 8, at 156–60.

<sup>15</sup> *Id.* at 144–51. These arguments include achieving economies of scale, preventing free riding, historical success, preventing vertical integration, and promoting dealer goodwill.

<sup>16</sup> In applying the rule of reason, Professor Areeda has suggested that virtually all courts apply a three-part analysis:

- (1) What harm to competition results or may result from the collaborators’ activities? (2) What is the object they are trying to achieve and is it a legitimate and significant one? That is, what are the nature and magnitude of the “redeeming virtues” of the challenged collaboration?
- (3) Are there other and better ways by which the collaborators can achieve their legitimate objectives with fewer harms to competition? That is, are there “less restrictive alternatives” to the challenged restraint?

PHILLIP E. AREEDA, *THE “RULE OF REASON” IN ANTITRUST ANALYSIS: GENERAL ISSUES 2* (1981); see also PHILLIP E. AREEDA, *ANTITRUST LAW* ¶ 1502 (1986).

<sup>17</sup> See Roszkowski, *Sylvania*, *supra* note 8, at 160–68.

the NAAG Multistate Antitrust Task Force at the ABA Antitrust Law Section's 1997 Spring Meeting. After noting the value of per se rules in avoiding expense and delay, and in promoting certainty, Chairman Pitofsky stated:

Maximum resale price maintenance is a different matter. Once the Court said that it was legal to allocate territorial zones to your distributors . . . the distributors had much discretion over price and they could raise price if they chose to, and the manufacturer couldn't do anything about it if maximum resale price maintenance is per se illegal.<sup>18</sup>

. . . the Supreme Court

Later in the program, Mr. O'Connor responded:

. . . has, as a result of

Now, Bob said something that I thought was somewhat revealing. He said that exclusive territories in effect are legal. Well, they're not always legal. They're subject to the rule of reason. I know he knows that. But it is significant that there's an assumption in the profession that if a restraint is in the rule of reason category, it's rarely going to be challenged, and in fact exclusive territories are rarely challenged. . . . [T]he point is, when you put something in the rule of reason category, you're not going to see much litigation in the area, and when you do see it, it's going to be very difficult and costly to resolve.<sup>19</sup>

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Even with its toothless rule of reason standard, *GTE Sylvania* would not be the debilitating decision it has become had it been confined to its holding: nonprice vertical restraints are governed by the rule of reason. Unfortunately, the decision has spawned a series of additional cases that has undermined antitrust enforcement in two additional areas discussed below: dealer terminations and vertical maximum price fixing.

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### The Dealer Termination Cases

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*GTE Sylvania* has had perhaps its most profound impact in an area only tangentially related to the *GTE Sylvania* facts: termination by a common supplier of one retail or wholesale dealer at the request of another dealer or group of dealers, usually because of price cutting by the terminated dealer. Professor Sullivan long ago noted the important distinction between the exclusive franchise and dealer-induced agreements to terminate competitors: "The first commitment forecloses *potential* intrabrand competition only; the second stamps out existing competition at the behest of a firm which is suffering under it."<sup>20</sup> Despite this obvious difference, the Supreme Court, through its decisions in *Monsanto Co. v. Spray-Rite Service Corp.*<sup>21</sup> and *Business Electronics Corp. v. Sharp Electronics Corp.*,<sup>22</sup> has, as a result of an uncritical infusion of *GTE Sylvania* reasoning, virtually eliminated any judicial scrutiny of what has predictably become perhaps the most common and effective form of resale price maintenance.

In *Monsanto*, the Court initially discussed the principles governing dealer termination cases. The first is the distinction between concerted and independent conduct. The former is proscribed under Section 1; the latter is permitted under the *Colgate* doctrine,<sup>23</sup> under which "the manufacturer can announce its resale prices in advance and refuse to deal with those who fail to comply.

<sup>18</sup> Roundtable Conference with Enforcement Officials, 65 ANTITRUST L.J. 929, 955-56 (1997).

<sup>19</sup> *Id.* at 957-58.

<sup>20</sup> LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 427 (1977) (emphasis added).

<sup>21</sup> 465 U.S. 752 (1984).

<sup>22</sup> 485 U.S. 717 (1988).

<sup>23</sup> *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919).

And a distributor is free to acquiesce in the manufacturer's demand in order to avoid termination."<sup>24</sup> That is, "[a] manufacturer . . . generally has a right to deal, or refuse to deal, with whom-ever it likes, as long as it does so independently."<sup>25</sup> The second is the distinction between agree-ments to fix resale prices, long per se illegal,<sup>26</sup> and those imposing nonprice restraints, governed by *GTE Sylvania*'s rule of reason standard.

The Court stated that manufacturers and their distributors have "legitimate reasons to exchange information about the prices and the reception of their products in the market"<sup>27</sup> and that the "man-ufacturer's strongly felt concern about resale prices does not necessarily mean that it has done more than the *Colgate* doctrine allows."<sup>28</sup> Permitting inference of conspiracy merely from the existence of complaints or in response to complaints "could deter or penalize perfectly legitimate conduct"<sup>29</sup> and "would . . . inhibit management's exercise of its independent business judg-ment."<sup>30</sup> Accordingly, the Court held that "something more than evidence of complaints is need-ed. There must be some evidence that tends to exclude the possibility that the manufacturer and nonterminated distributors were acting independently."<sup>31</sup>

In *Business Electronics*, the Court erected another procedural barrier to plaintiff recovery in deal-er termination cases, holding that an agreement between a manufacturer and a dealer to terminate another dealer was a per se violation of Section 1 only if the agreement required the surviving deal-er to set prices at a particular level.<sup>32</sup> Both cases suffer from two fundamental flaws: (1) a mis-characterization of a horizontal restraint as vertical; and (2) a usurpation of the jury function. *Business Electronics* introduces another error—a wholly unprecedented definition of price fixing.

**Mischaracterization of Horizontal as Vertical.** The most fundamental error of both *Monsanto* and *Business Electronics* is their failure to recognize that the restraints involved were horizontal price restraints, not nonprice vertical restraints. The dealer termination cases almost all fit the text-book definition of a classic horizontal group boycott, conduct that has always been per se illegal under the Sherman Act.<sup>33</sup> In the classic group boycott, a competitor or group of competitors at one functional level (for example, the complaining *Monsanto* distributors) desire for whatever reason (usually discount pricing) to eliminate a competitor at their level (for example, *Spray-Rite*). To achieve this purpose, the conspirators coercively exert pressure at a functional level above or below them in order to induce a supplier (for example, *Monsanto*) or customer of the boycott vic-tim not to deal with him.

Before the debilitating impact of *GTE Sylvania*, the Court had no trouble recognizing the deal-er termination fact pattern for what it is: "a classic conspiracy in restraint of trade."<sup>34</sup> Now, through

<sup>24</sup> *Monsanto*, 465 U.S. at 761.

<sup>25</sup> *Id.*

<sup>26</sup> *See* *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 404–09 (1911).

<sup>27</sup> *Monsanto*, 465 U.S. at 762–63.

<sup>28</sup> *Id.* at 763.

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

<sup>30</sup> *Id.* at 764.

<sup>31</sup> *Id.*

<sup>32</sup> 485 U.S. 717, 726 (1988).

<sup>33</sup> *See, e.g.*, *E. States Retail Lumber Dealers' Ass'n v. United States*, 234 U.S. 600 (1914); *Fashion Originators' Guild of Am., Inc. v. FTC*, 312 U.S. 457 (1941).

<sup>34</sup> *United States v. Gen. Motors Corp.*, 384 U.S. 127, 140 (1966).

*The dealer termination cases almost all fit the textbook definition of a classic horizontal group boycott, conduct that has always been per se illegal under the Sherman Act.*



the *GTE Sylvania* lens, these cases—none of which involves the legality of any vertical restriction imposed by the manufacturer—become vertical restraints simply because the act implementing the restraint (the supplier terminating the price cutter) comes from above. Of course, action by an actor above or below the boycott victim is exactly how the classic group boycott works. Regarding the irrelevance of vertical restraints analysis in this setting, Justice Stevens noted in his dissent in *Business Electronics*:

In its opinion the majority assumes, without analysis, that the question presented by this case concerns the legality of a “vertical nonprice restraint.” As I shall demonstrate, the restraint that results when one or more dealers threaten to boycott a manufacturer unless it terminates its relationship with a price-cutting retailer is more properly viewed as a “horizontal restraint.” Moreover, an agreement to terminate a dealer because of its price cutting is most certainly not a “nonprice restraint.” The distinction between “vertical nonprice restraints” and “vertical price restraints,” on which the majority focuses its attention, is therefore quite irrelevant to the outcome of this case. Of much greater importance is the distinction between “naked restraints” and “ancillary restraints” . . .<sup>35</sup>

**Abrogation of the Jury Function.** Before *Monsanto*, courts were split concerning the amount of evidence necessary to support a jury inference of conspiracy in a dealer termination case. In *Monsanto*, the Court adopted the Third Circuit’s majority opinion in *Edward J. Sweeney & Son, Inc. v. Texaco, Inc.*<sup>36</sup> In *Sweeney*, Judge Sloviter, in dissent, highlighted the two errors of the *Sweeney* majority, and thus *Monsanto*: (1) its unduly restrictive test for proof of conspiracy, and (2) its abrogation of the jury function.

On the first issue, Judge Sloviter noted that the case law is “replete” with price-motivated dealer terminations, and that

[U]ntil now, there has not been any serious question in this circuit that the competitors’ complaints to the supplier about the discounter’s market behavior and the supplier’s action in response thereto are sufficient to constitute the “combination” necessary to bring the matter within the scope of section 1 of the Sherman Act.<sup>37</sup>

Judge Sloviter then noted that the majority’s contrary holding was unsupported by any authority and that other courts had taken a more realistic view of the effect of reactions by suppliers to dealer price complaints.<sup>38</sup> In her view, case law long had “established that action which on the surface appears to be unilateral behavior can be considered to be part of a combination when viewed in light of the surrounding circumstances.”<sup>39</sup>

On the second issue, Judge Sloviter, after reviewing the evidence, concluded that a jury could well find a conspiracy between Texaco and the complaining dealers but that the court had usurped the jury’s fact finding function noting

The pertinent issue, of course, is not what the majority deems to be the reasonable inferences that can be drawn from the testimony but what the jury believes to be the reasonable inferences that can be drawn from the testimony . . .

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<sup>35</sup> *Business Electronics*, 485 U.S. at 736 (Stevens, J., dissenting).

<sup>36</sup> 637 F.2d 105 (3d Cir. 1980).

<sup>37</sup> *Id.* at 124 (Sloviter, J., dissenting) (footnote omitted).

<sup>38</sup> *Id.* at 124–25.

<sup>39</sup> *Id.* at 125.

Although the majority purports to take cognizance of the difficulty of proving an antitrust conspiracy by direct evidence, the effect of its decision will be to require nothing less than direct evidence of a causal connection between Sweeney's competitors' complaints and Texaco's actions.<sup>40</sup>

*Business Electronics* provides a classic illustration of this effect of the *Monsanto/Sweeney* rule. At trial, after hearing several days of testimony, the jury concluded that Sharp's defense that it had terminated Business Electronics for poor sales performance was "pretextual."<sup>41</sup> Although the accuracy of this conclusion was unchallenged, Justice Stevens noted that

Nevertheless, the rule the majority fashions today is based largely on its concern that in other cases juries will be unable to tell the difference between truthful and pretextual defenses. Thus, it opines that "even a manufacturer that agrees with one dealer to terminate another for failure to provide contractually-obligated services, exposes itself to the highly plausible claim that its real motivation was to terminate a price cutter." But such a "plausible" concern in a hypothetical case that is so different from this one should not be given greater weight than facts that can be established by hard evidence. If a dealer has, in fact, failed to provide contractually obligated services, and if the manufacturer has, in fact, terminated the dealer for that reason, both of those objective facts should be provable by admissible evidence. Both in its disposition of this case and in its attempt to justify a new approach to agreements to eliminate price competition, the majority exhibits little confidence in the judicial process as a means of ascertaining the truth.<sup>42</sup>

**Definition of Price Fixing.** In addition to the errors outlined above, *Business Electronics* introduces yet another error into modern antitrust jurisprudence—its holding that the illegality of a price-fixing arrangement depends upon the conspirators' agreement to set prices at a particular level. This holding is unprecedented in antitrust law and directly undermines perhaps the most important of all Sherman Act cases, *United States v. Socony-Vacuum Oil Co.*,<sup>43</sup> which holds that price fixing is illegal per se and includes any conduct that has the purpose and effect of restraining price movement and the free interplay of market forces. As noted by the Court in *Socony-Vacuum*:

[A]ny combination which tampers with price structures is engaged in an unlawful activity. . . . [It is not] important that the prices paid by the combination were not fixed in the sense that they were uniform and inflexible. Price-fixing . . . has no such limited meaning. An agreement to pay or charge rigid, uniform prices would be an illegal agreement under the Sherman Act. But so would agreements to raise or lower prices whatever machinery for price-fixing was used . . . . Under the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se*.<sup>44</sup>

It is clear that the coercive dealer terminations involved in *Monsanto* and its ilk constitute horizontal price fixing in the classic sense. The sole purpose of the arrangement is to eliminate price competition of a competitor of one or more of the conspirators, who are then able to charge a higher price. Clearly, this is concerted "tamper[ing] with price structure" and "interfer[ing] with the setting of price by market forces." Yet the combination of *GTE Sylvania*, *Monsanto*, and *Business Electronics* virtually insulates this conduct from antitrust scrutiny.

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<sup>40</sup> *Id.* at 126–128.

<sup>41</sup> *Business Electronics*, 485 U.S. at 751 (Stevens, J., dissenting) (footnotes and internal citations omitted).

<sup>42</sup> *Id.* at 751–52 (Stevens, J., dissenting) (footnotes and internal citations omitted).

<sup>43</sup> 310 U.S. 150 (1940).

<sup>44</sup> *Id.* at 221–23.

## Vertical Maximum Price Fixing

*Schwinn* excepted, no pre-*Sylvania* antitrust case is more reviled than *Albrecht v. Herald Co.*,<sup>45</sup> which holds that vertical maximum price fixing is illegal per se. Judge Posner spoke of its “wobbly, moth-eaten foundations”<sup>46</sup> in his successful invitation to the Supreme Court to overrule *Albrecht* in *State Oil Co. v. Khan*.<sup>47</sup> As I have demonstrated at length on two other occasions,<sup>48</sup> the only thing wobbly and moth-eaten in the maximum vertical price fixing area is the voluminous Chicago School criticism of the *Albrecht* holding.<sup>49</sup>

*Albrecht* is one of only three maximum vertical price-fixing cases decided by the Supreme Court before *State Oil: Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*<sup>50</sup>; *Altbrecht*; and *Atlantic Richfield Co. (ARCO) v. USA Petroleum Co.*<sup>51</sup> *Kiefer-Stewart* was an attempt by liquor suppliers to control downstream liquor prices charged by an alleged wholesaler cartel after Office of Price Administration (OPA) price controls were lifted. *Albrecht* was an attempt by a newspaper to control price gouging by newspaper distributors it had established in exclusive territories. *ARCO* involved an attempt by an oil company to destroy independent retail competition by maintaining its dealers’ prices at artificially low levels.

Both *Kiefer-Stewart* and *Albrecht* were treated by the Court as straightforward price-fixing cases governed by *Socony-Vacuum Oil Co.*<sup>52</sup> Despite this fact, *Albrecht* was for decades criticized, and ultimately overruled based on three grounds: (1) control of successive monopoly, (2) the specter of vertical integration; and (3) the “*Schwinn*” connection. As summarized below, none of these arguments withstand scrutiny.

**Control of Successive Monopoly.** Virtually all *Albrecht* criticism is based upon the “control of successive monopoly” economic paradigm. Under this paradigm, monopoly exists at two stages of a product’s distribution (for example, manufacturing and distribution), resulting in higher prices and lower output than if only the manufacturing stage is monopolized. Critics assert that *Albrecht*’s maximum price-fixing rule is wrong because it eliminates an important tool for control of successive monopoly.<sup>53</sup> Although this theory may be defensible as a matter of economic theory, it is irrelevant as a basis for rejecting the *Albrecht* rule. Simply stated, neither *Albrecht*, nor any of the other three Supreme Court vertical maximum price-fixing cases involves successive monopoly or, indeed, any monopoly.<sup>54</sup> In fact, “[m]aximum vertical price fixing as condemned by *Albrecht* inevitably involves a supplier’s exercise of power over its downstream dealers.”<sup>55</sup> In this setting,

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<sup>45</sup> 390 U.S. 145 (1968).

<sup>46</sup> *Khan v. State Oil Co.*, 93 F.3d 1358, 1363 (7th Cir. 1996).

<sup>47</sup> 522 U.S. 3 (1997).

<sup>48</sup> See Roszkowski, *Albrecht*, *supra* note 8; Roszkowski, *State Oil*, *supra* note 8.

<sup>49</sup> See Roszkowski, *State Oil*, *supra* note 8, at 614 n.6.

<sup>50</sup> 340 U.S. 211 (1951).

<sup>51</sup> 495 U.S. 328 (1990).

<sup>52</sup> 310 U.S. 150 (1940).

<sup>53</sup> See Roszkowski, *Albrecht*, *supra* note 8, at 214 n.38.

<sup>54</sup> For additional discussion of this issue, see Roszkowski, *State Oil*, *supra* note 8, at 622–24.

<sup>55</sup> Brief for Service Station Dealers of America, at 7, *State Oil v. Khan*, 522 U.S. 3 (1997) (No. 96-871). Judge Posner admits this fact in the court of appeals opinion in *State Oil*, noting that a supplier without such power “cannot squeeze his dealers’ margins below a competitive level; the attempt to do so would just drive the dealers into the arms of a competing supplier.” *Khan v. State Oil Co.*, 93 F.3d 1358, 1362 (7th Cir. 1996). What Judge Posner fails to note is the more common option for the squeezed supplier, going out of business altogether.

vertical maximum price fixing facilitates imposition of a price-cost squeeze on dealers with significant potential for anticompetitive effect.<sup>56</sup>

**Specter of Vertical Integration.** Another argument used to attack *Albrecht* (and also to justify eliminating antitrust scrutiny of any vertical restraint, price or nonprice) is the specter of vertical integration. Here, this argument asserts that if suppliers are unable to use maximum price fixing to control downstream price gouging, “it creates perverse incentives for manufacturers to integrate vertically into distribution to the detriment of dealers.”<sup>57</sup> This argument is indeed surprising given the voluminous Chicago School commentary on vertical integration, either by new entry or merger, which is virtually uniform in its praise of (or at least lack of antitrust concern for) the practice.<sup>58</sup> The Chicago School approach to vertical integration is of course consistent with its modern vertical restraints law, which elevates supplier over small dealer interest and permits suppliers to direct downstream competition by controlling the retail dealer’s prices, territories, locations, and customers. It is clear that the “specter of vertical integration” argument is used here only to support an otherwise weak argument for rejecting *Albrecht*.

**The Schwinn Connection.** Certainly the flimsiest anti-*Albrecht* argument is the *Schwinn* connection, which asserts that: (1) *Albrecht* is based upon *United States v. Arnold, Schwinn & Co.*,<sup>59</sup> which held that nonprice vertical restrictions imposed in conjunction with a sale of goods are per se illegal; (2) *GTE Sylvania* overruled *Schwinn*; and (3) therefore *Albrecht* is no longer good law because it is based on the assumption that the exclusive territories granted by the newspaper were per se illegal under *Schwinn*. The only problem with this argument, which figures prominently in *Albrecht* criticism and *State Oil*, is that *Albrecht* is not based on *Schwinn*. In *Albrecht*, the Supreme Court was reviewing the Eighth Circuit Court of Appeals’ decision, which affirmed the district court’s judgment for the newspaper. The court of appeals’ decision was rendered on October 20, 1966, almost eight months before *Schwinn* was decided on June 12, 1967. Nonprice vertical restraints law at the time of the *Albrecht* lower court decisions was governed by *White Motor Co. v. United States*,<sup>60</sup> which (for lack of information about competitive impact) declined to announce a special standard for such restraints. Thus, nonprice vertical restraints law was at the time governed by the rule of reason, the same standard that now applies (at least in name) under *GTE Sylvania*.

The applicable nonprice vertical restraint standard was, in any event, irrelevant in the lower courts because the legality of the exclusive franchises was not at issue. Rather, the sole basis of the court of appeals holding was that no “combination” had been created, rendering the newspaper’s action “completely unilateral,”<sup>61</sup> and therefore outside the scope of Section 1.

The Supreme Court disagreed, applying *United States v. Parke, Davis & Co.*<sup>62</sup> to find the existence of a combination.<sup>63</sup> Then, citing, inter alia, *United States v. Trenton Potteries Co.*<sup>64</sup> and

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<sup>56</sup> For discussion of these effects, see Roszkowski, *State Oil*, supra note 8, at 630–32 and authorities cited therein.

<sup>57</sup> Brief for Business Roundtable at 13, *State Oil v. Khan*, 522 U.S. 3 (1997) (No. 96-871).

<sup>58</sup> See Roszkowski, *Albrecht*, supra note 8, at 235 n.147.

<sup>59</sup> 388 U.S. 365 (1967).

<sup>60</sup> 372 U.S. 253 (1963).

<sup>61</sup> *Albrecht v. Herald Co.*, 367 F.2d 517, 523 (8th Cir. 1966).

<sup>62</sup> 362 U.S. 29 (1960).

<sup>63</sup> *Albrecht*, 390 U.S. at 150.

<sup>64</sup> 273 U.S. 392 (1927).

*United States v. Socony-Vacuum Oil Co.*,<sup>65</sup> the Court applied “the long accepted rule in Section 1 cases that resale price fixing is a per se violation of the law whether done by agreement or combination.”<sup>66</sup> The irrelevance of the *Schwinn* issue is made abundantly clear both by the Court in *Albrecht* (“neither the existence of exclusive territories nor the economic power they might place in the hands of the dealers was at issue before the jury”),<sup>67</sup> and by Justice Douglas in concurrence.<sup>68</sup> In sum, *Schwinn* has nothing to do with the *Albrecht* holding, and by overruling *Albrecht* in *State Oil* to recognize its first-ever exception to the per se rule against price fixing, the Court has undermined its most fundamental and important Sherman Act holding, *Socony-Vacuum*.

*Albrecht* critics also prefer to ignore another question presented by the *Albrecht* case: why did the distributors have the power to gouge their customers? The answer: because the supplier established them in exclusive territories. Thus, the presumptive illegality of the exclusive territories is apparent from the fact that price fixing is necessary to police them. This fact was clearly articulated by Justice White in *Albrecht*,<sup>69</sup> and has been echoed by other critics.<sup>70</sup> This fact is ignored by *Albrecht* critics because it undermines the legacy of *GTE Sylvania*, which finds such restraints procompetitive or competitively innocuous.

## Conclusion

A detailed examination of the antitrust regime created by *GTE Sylvania* and its progeny reveals a bankrupt shell that refuses to recognize and protect any of the myriad values traditionally associated with antitrust law.<sup>71</sup> All of the pillars of Chicago School vertical restraints law introduce unprecedented and wholly unsupported holdings into the law:

- *GTE Sylvania*—proven injury to competition in one market can be justified by purported benefits to competition in another market.
- *Monsanto*—proof of an antitrust conspiracy requires proof that excludes the possibility that the defendants were acting independently.

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<sup>65</sup> 310 U.S. 150 (1940).

<sup>66</sup> *Albrecht*, 390 U.S. at 151.

<sup>67</sup> *Id.* at 153.

<sup>68</sup> “Under our decisions the legality of exclusive territorial franchises in the newspaper distribution business would have to be tried as a factual issue; and that was not done here.” *Id.* at 155–56 (Douglas, J., concurring).

<sup>69</sup> Justice White stated that the exclusive territories could not be presumed valid and that “[t]he assertion that illegal price fixing is justified because it blunts the pernicious consequences of another distribution practice is unpersuasive,” and noted that if the economic effect of the exclusive territories established by the newspaper “was such that the public could be protected only by otherwise illegal price fixing itself injurious to the public, the entire scheme must fall under § 1 of the Sherman Act.” *Albrecht*, 390 U.S. at 153–54.

<sup>70</sup> As succinctly stated by Professor Harry First: “If the manufacturer is concerned about distributors exploiting the monopoly power which flows from assigned exclusive territories, the problem should be cured by looking at the extent of the territorial restraint rather than by permitting the imposition of an additional restraint.” Brief of the Association of the Bar of the City of New York, at 16 (dissenting statement of Harry First), *State Oil v. Khan*, 522 U.S. 3 (1997) (No. 96-871).

<sup>71</sup> As Professor Sullivan has noted:

If antitrust law is, then, to remain a system of law, not a system of applied economics, it must be responsive to values other than allocative efficiency . . . . And it must be open to influences other than economics. . . . Among the non-economic goals of antitrust, all quite tenable as policy objectives, are a preference for decentralization of economic power, reduction of the range within which private discretion may be exercised in matters materially affecting the welfare of others, enhancement of the opportunity for more people to exercise independently entrepreneurial impulses, and, most blatantly, a social preference for the small rather than the large . . . .

LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 11 (1977); see also Eleanor M. Fox, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140, 1152–54 (1981) (antitrust laws designed to protect “competition as process,” reflected in distrust of private power, concern for consumers, and concern for entrepreneurs).

- *Business Electronics*—a price fixing agreement requires specific agreement on prices or price levels.
- *State Oil*—price fixing is not a per se violation of the Sherman Act.

As Justice Stevens noted in his dissent in *Business Electronics*, the “most troubling” consequence of current vertical restraints law is its “failure to attach any weight to the value of intrabrand competition.”<sup>72</sup> Though pre-*GTE Sylvania* case law, common sense, and many commentators<sup>73</sup> find significant value in intrabrand competition, its elimination is now justified by theoretical and likely nonexistent<sup>74</sup> purported benefits to interbrand competition.

The antitrust world created by *GTE Sylvania* is indeed a strange place in which horizontal price restraints become vertical nonprice restraints, concerted conduct becomes unilateral, and the facts of individual cases do not matter. Perhaps it is time to recognize that those who developed Sherman Act jurisprudence during its first eighty-seven years might have gotten it right, and that a return to pre-*Sylvania* values is necessary to restore the Sherman Act to its rightful place as the “Magna Carta of free enterprise.”<sup>75</sup> ●

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<sup>72</sup> *Business Electronics*, 485 U.S. at 748 (Stevens, J., dissenting).

<sup>73</sup> See Roszkowski, *State Oil*, *supra* note 8, at 634–36.

<sup>74</sup> See *supra* note 12.

<sup>75</sup> *United States v. Topco Assocs.*, 405 U.S. 596, 610 (1972).

# Coordinated Effects Analysis: The *Arch Coal* Decision

An ABA Section of Antitrust Law Brown Bag Program (October 27, 2004)

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**Editor's Note:** In August 2004, the U.S. District Court denied the FTC's request for a preliminary injunction to prevent Arch Coal from acquiring the Triton Coal Company, in *FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109 (D.D.C. 2004), appeal dismissed per curiam, No. 04-5291, 2004 WL 2066879 (D.C. Cir. Sept. 15, 2004). The court's opinion raises a slew of questions about the way in which the enforcement agencies (and outside parties) analyze mergers. Some of these questions relate to market definition and market share measurement in exhaustible resource industries. But other questions relate to the agencies' reliance on using a coordinated effects analysis to challenge a merger. The court opinion clearly found that the FTC's coordinated effects case in Arch Coal missed the mark for injunctive relief. What (if anything) does this decision imply about future agency reliance on a coordinated effects theory or for the construction of such a theory? Still other questions pertain to the agencies' traditional reliance on customer testimony as credible evidence supporting an agency claim of anticompetitive effects. The court dismissed such customer testimony in Arch Coal, raising issues about how this type of evidence might be used in the future.

In October 2004, the ABA Section of Antitrust Law Fuel and Energy, Economics, and Mergers and Acquisitions Committees jointly sponsored a brown bag program on the implications of the Arch Coal decision for antitrust enforcement—for market definition and for a theory of anticompetitive effects. Three distinguished and well-known economists were invited to opine on those implications. The insights offered by the three panelists are both thoughtful and provocative.

—JOHN WOODBURY

**JOLA STERBENZ:** We've invited our distinguished economists to share their views on the recent district court decision in *FTC v. Arch Coal* declining the FTC's request for a preliminary injunction against Arch's acquisition of Triton Coal's mining assets in the Southern Powder River Basin (SPRB). The decision was a significant blow to the FTC's merger enforcement efforts, especially in cases where the agency pursues a theory of coordinated interaction, which it relied on in this case.



The SPRB, which is situated in southern Wyoming, is a prolific area of high-quality, environmentally friendly coal, which has been increasingly used by US coal-fired generators. This is a relatively concentrated region. At the time of the merger proposal, Arch and Triton were the third and fifth largest producers of SPRB coal, in addition to Peabody, RAG, and Kennecott. The FTC argued that the merger would facilitate coordination on output decisions among the remaining coal producers. More specifically, the FTC posited that, after the merger, the major SPRB producers would be able to keep their production levels lagging slightly behind expected customer demand, which would create upward pressure on prices. The district court declined to issue the injunction, concluding that the agency failed to show the likelihood of such output coordination.

Before I turn the discussion over to our panelists, let me describe the major issues raised by the court's determination. I propose to use this list as a springboard for our discussion. One of those issues is the viability of the production-lagging-demand theory of output restriction that the FTC pursued in this case. The court's order implied that there is something novel about this theory. But is that correct? Does each and every output restriction case depend on evidence of an actual reduction in output?

Relatedly, the court seemed to imply that there was something novel about this coordinated output restriction theory in a sense that the agency didn't offer any evidence of pricing coordination in addition to the evidence of the alleged output restriction. But is such pricing coordination evidence even necessary, given that an output restriction will likely be followed by a price increase?

An even more interesting question is raised by the part of the decision devoted to the kind of evidence that the government would have to present to support a tacit coordination case. In this case, the FTC relied on what I will call historical evidence, as well as "documentary" evidence. The historical evidence consisted primarily of a 2000 SPRB coal price spike, which was preceded by public announcements by the major SPRB producers regarding the need to increase SPRB coal prices, either through output reduction or mine closings. The agency corroborated this evidence with internal company documents that apparently indicated that the industry was ripe for collusion. But the court was not too persuaded by this evidence. First, it concluded that the prior output reductions and mine closings could be explained by legitimate business reasons. It also pointed to possible independent reasons for the price spike, such as bad weather or low utility stockpiles. Ultimately, what the court found to be fatal to the agency's case was the fact that the FTC did not offer evidence of how this alleged output coordination could be done. In the court's view, the agency merely demonstrated that the producers were eager and willing to collude. However, it did not show how this collusion could actually work and how deviations from the common scheme could be detected and punished. The issue for us today is, thus, what were the shortcomings of the FTC's evidentiary case, if any?

Then there is the issue of the weight that should be given by a court or the antitrust enforcers to customer complaints. The FTC relied on heavy customer opposition to the Arch/Triton merger. The complaining customers were large sophisticated electric power generators (both utility and nonutility). Some of them testified before the court, and some presented economic studies in support of their agency affidavits. Nonetheless, the court essentially disregarded their testimony, concluding that, at the end of the day, the customers had no way of knowing whether this particular merger would increase prices. Given traditional reliance by the FTC and the DOJ on strong customer opposition in merger cases, that brings into question the continued viability of such reliance on customer testimony—that is, of course, unless a customer is able to present evidence demonstrating that, in fact, a given market will not behave competitively after the merger. The related question is whether a customer would ever be able, or willing, to put forth this kind of evidence.

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—JOLA STERBENZ

And finally, there is the issue of the proper measure of market shares in the natural resources industry. In this case, the FTC measured market shares based on actual productive capacity of the mines as well as loadout capacity. The court, however, agreed with Arch that a better measure was to rely on future reserves that are controlled by the producers, which had the effect of slightly lowering relevant market shares. The issue for us to explore is which approach is better and why.

**ELIZABETH BAILEY:** The way we're going to proceed is first, we'll hear from each of our presenters. Then, before we open it up to questions, we'll give the presenters an opportunity to respond to each other. Then we'll open it up to questions. Andrew?

**ANDREW DICK:** I will discuss several issues raised by the *Arch Coal* decision, and I will try to place my remarks into the broader perspective of the FTC's and DOJ's renewed interest in coordinated effects merger analysis.

Following the adoption of the 1992 Horizontal Merger Guidelines, coordinated effects analysis languished as an active instrument of merger review and enforcement. Over the last decade, mergers were much more likely to be reviewed (or challenged) on the basis of unilateral effects concerns. More often than not, when a merger complaint included a coordinated effects allegation, it had the flavor, if not the reality, of being an afterthought. When coordinated effects theories were advanced in merger challenges, the agencies usually built their case in fairly simple terms, on three legs: a structural presumption, the checklist of market factors associated with Richard Posner and George Stigler, and evidence about premerger conduct, such as a history of attempted collusion or facilitating practices. Both the theoretical underpinnings and the empirical foundations of this three-legged approach have received substantial criticism of late from antitrust practitioners and industrial organization economists.

Under recent leadership—Tim Muris at the FTC and Hew Pate and Charles James at the DOJ—the agencies have sought to reinvigorate coordinated effects merger analysis by bolstering its theoretical foundations and applying new approaches to analyzing evidence. Agency officials have spoken publicly about their renewed interest in pursuing coordinated effects theories, and these officials have outlined some of the new thinking that is being applied by agency staffs. In summer 2003, the DOJ successfully blocked UPM-Kymmene Oyj's proposed acquisition of Bemis MACtac using a coordinated effects theory. Several speeches by DOJ officials explained the agency's thinking behind that merger challenge. And while it ultimately cleared the Carnival/Princess and Royal Caribbean/Princess transactions in late 2002, the FTC issued a lengthy closing statement articulating some of its new thinking on coordinated effects analysis and empirical methods.

While acknowledging the lingering influence of the three-legged approach that I just mentioned—the structural presumption, the checklist, and premerger conduct—the agencies' approach now places greater emphasis on articulating and empirically demonstrating the specific mechanisms by which a particular merger would make coordination easier to arrange or sustain. While some commentators have described this approach as "new," in fact, it simply harkens back to the Guidelines' recognition that successful coordination requires reaching an agreement, monitoring compliance, and (when necessary) punishing deviations. What makes the current approach "new" is that the agencies have acknowledged the need to articulate and demonstrate the mechanisms by which they believe a merger would facilitate reaching and enforcing an anti-competitive agreement.

In its challenge to the Arch Coal merger, however, the FTC largely reverted to the traditional three-legged approach. The court rejected the FTC's arguments and evidence on each of the three legs as being either inadequate or inconclusive. In light of this, and given the FTC's failure to clearly articulate and convincingly demonstrate the mechanisms by which the merger would have made coordination easier, the court was left with no basis on which to block the merger. The clearest indication of the shortcomings associated with the FTC's approach lies in the court's statement that the FTC's theory was "novel." The FTC's case theory was underdeveloped analytically and was supported insufficiently by the evidence offered to the court, but it did *not* present novel economics.

I will start by describing the three legs of argument and evidence that the FTC advanced, and I will then discuss why the court effectively rejected each leg. Next, I will draw some broader lessons about coordinated effects cases from each of these discussions.

*. . . when the structural presumption is at best weak, the agency must identify the mechanism by which a seemingly small change in market structure could make coordination easier to reach or sustain.*

The first leg of the FTC's challenge was its attempt to establish a structural presumption. The FTC alleged that the merger would combine two of the four leading producers in what the agency asserted was the relevant market, would substantially increase concentration, and would result in a highly concentrated market. I believe that Michael Salinger and Greg Werden will discuss in more detail the dispute between the litigants over market definition and measurement, and so I will not dwell on that issue. While the issue was important, it was not decisive to the outcome of the case. In the defendants' preferred market, the delta would have been just 49 points. Even under the FTC's preferred market definition, the delta would have been only 224 points. The court believed that both of these changes in concentration fell well below levels typically associated with merger challenges. The court also noted that because the transaction involved a partial divestiture to a third party not currently in the market, the merger would not actually reduce the number of competitors. The need to litigate the divestiture "fix" further weakened the FTC's ability to develop a strong structural presumption.

In the end, the court held that the FTC had barely satisfied its prima facie case burden, and it concluded that the structural case was "not strong." Based on this, the court lowered the bar for the defendants to rebut the FTC's prima facie case. The lesson that I take away from the court's view of the FTC's first argument is that when the structural presumption is at best weak, the agency must identify the mechanism by which a seemingly small change in market structure could make coordination easier to reach or sustain.

—ANDREW DICK

The second leg of the FTC's challenge relied on the familiar Stigler-Posner checklist of factors thought to be conducive to coordination. The FTC's complaint cited several checklist factors when characterizing the premerger market, including: a small number of competitors, barriers to entry, product homogeneity, inelastic demand, close geographic proximity, and substantial competitor information. The court disputed the FTC's claims about several of these characteristics, believing that the factors either were not present or that the evidence was inconclusive. Facing what it regarded as ambiguity in the factual record, the court lacked any basis on which to balance the plus and minus factors on the FTC's checklist. The agency's silence on the balancing issue highlights one of the primary weaknesses of the checklist approach, which is that there is no rigorous method to weigh the various factors when they come into conflict. Equally important, the FTC did not explain whether or how the merger would have *changed* any of the checklist factors. Specifically, the agency did not articulate how the merger would have given rise to a market whose characteristics were more conducive to coordinated interaction. As a result, the FTC failed to establish the second leg of its merger challenge.

The lesson that I take away from the court's view of the FTC's second argument, therefore, is that reliance on the checklist remains both problematic and insufficient as a basis for merger chal-

lenges. The checklist is problematic because if the evidence is mixed across various factors—as it often is in the real world—then we are left without an objective basis to weigh conflicting evidence. Moreover, the checklist is insufficient because, standing alone, it is silent as to the mechanisms by which a merger would change any of the checklist factors in such a way as to make coordination more likely post-merger.

The third leg upon which the FTC based its challenge was evidence about premerger conduct. The FTC alleged that major coal producers frequently and publicly communicated their pricing and production intentions to each other. The FTC asserted that these public announcements amounted to signaling between competitors that could facilitate coordination. The court rejected the FTC's interpretation, however, for two reasons. First, the government's expert witness offered no opinion as to the state of pre-merger competition, which undercut the FTC's allegation that firms already had been attempting to coordinate. Second, while the court described some of the public statements by company executives as "indicative of possible producer coordination to limit production" and cautioned that these statements "warrant close scrutiny," the court ultimately concluded that there were independent, legitimate business reasons supported by credible evidence to explain the premerger conduct. The court also went on to note that the FTC had not shown that competitors had responded to or acted upon Arch's public pronouncements about cutting production.

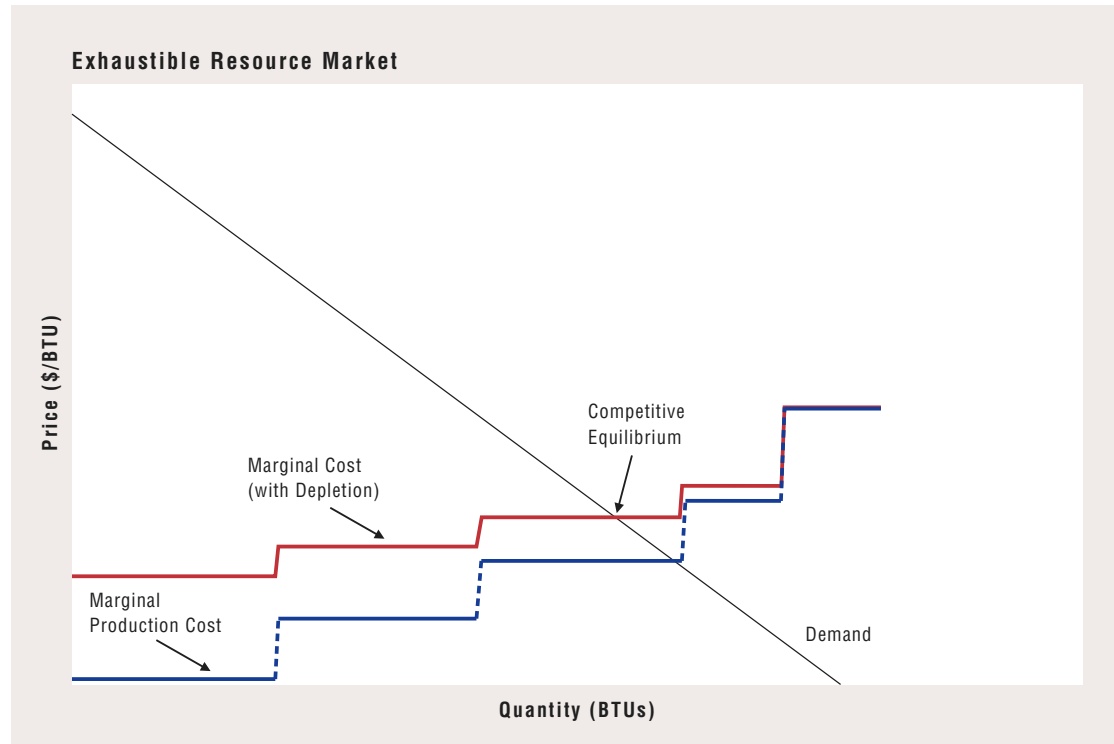
The FTC's failure to draw a tight link between competitor communications and pre-merger competition removed the third and final leg of its merger challenge. The lesson that I take away from this is that the agency must provide the court with a basis to reject alternative and competitively innocuous explanations for conduct that the government seeks to characterize as anticompetitive. Related to this, to the extent that it seeks to characterize premerger conduct as evidence of attempted but unsuccessful coordination, the agency needs to identify the mechanism by which the bad conduct would be more likely to prevail post-merger.

Having failed to be persuaded by the FTC's traditional lines of argument, the court found itself without a basis to block the merger. The court clearly was searching for an explanation from the FTC about how the merger would facilitate reaching and enforcing an agreement. The court voiced its confusion, or frustration, by describing the FTC's proposed theory of output restriction as "novel." The FTC's theory was predicated on an output restriction in which the major coal producers would limit extraction so that increases in supply would lag behind increases in demand, thus creating upward pressure on price. As I mentioned earlier, the theory does not present novel economics. I think the court's difficulty in embracing the theory, however, stemmed from the FTC's failure to clearly articulate and persuasively demonstrate the mechanisms by which the merger would have facilitated the coordinated output restriction.

In summary, the FTC's approach in *Arch Coal* shifted the agency back towards its traditional approach of alleging a coordinated effects case: the structural presumption, the checklist factors, and the emphasis on developing evidence of pre-merger conduct. The court indicated its willingness to consider the FTC's approach and the evidence that it mustered on each of the three legs. But having found factual weaknesses or ambiguities on each leg, and without the benefit of the FTC offering and supporting a clear statement of the mechanisms by which coordination would have been facilitated, the court was left without a basis on which to assess whether coordination would in fact become more likely post-merger.

**MICHAEL SALINGER:** Andrew did an excellent job of summarizing the case so I'm going to focus my comments on a small number of the economic issues that were particularly knotty. First, in an exhaustible resources market, how should we measure market share? Should it be output or

reserves or something else? Second, how should we deal with variations in the quality of the resource, in this case coal? And then third, what beyond the structural evidence should we consider in a coordinated effects analysis? I will use a simple supply and demand analysis as it relates to exhaustible resources to answer these questions.



Here's my supply and demand graph. Let me start with a technical detail. Notice that on the horizontal axis, quantity is measured in BTUs (rather than tons) and price on the vertical axis is measured in dollars per BTU (rather than dollars per ton). That choice reflects the assumption that even though utilities literally buy tons of coal, what they care about are the BTUs. If so, they compare bids at least to a first approximation on a price per BTU basis. This point about how quantity should be measured is important because the measure of quantity determines how price is defined, which in turn determines which suppliers are low cost suppliers and which are high cost.

The implication of this being an exhaustible resource is shown in the cost curves. With an exhaustible natural resource, you should expect that there will be variation—indeed, perhaps substantial variation—in production cost. That's the lower of the upward-sloping schedules on the slide, labeled Marginal Production Cost. I've put steps into these schedules to suggest that we have different mines that have different costs associated with them. In an exhaustible resources market, the production cost is not the only cost that you need to worry about. There is also an opportunity cost (or scarcity rent) to the coal, and that cost is inversely related to the production costs. The difference between the production cost and the marginal cost including the depletion, which is the higher of the two lines, is bigger for the low production cost firms. But the effect of the depletion cost doesn't completely offset the low production cost. The low-production cost firms are also the low total marginal cost firms.

In a competitive market, the marginal cost curve is the supply curve; and the equilibrium in a competitive market is the intersection between the supply curve and the demand curve. Now I need to make two more points about natural or exhaustible resource markets to answer the ques-

tions that I've set out to answer. First, monopoly power cannot lead to permanently higher prices. The difference between monopoly in an exhaustible resource industry and competition is that with monopoly, you have higher prices today and for some period. But then, as a consequence, the resource gets used more slowly and more of it is available in the future. Prices in the future are then going to be lower than they otherwise would be. The importance for antitrust analysis is that if we are going to be concerned with price increases in these kinds of industries, those have to be price increases in the short and intermediate run. We can't be concerned with price increases into the indefinite future.

The second point is that the low cost producers on this slide would like the price to be higher. What stops it from being higher? It is the producers in the middle—in this case, the producer represented by the third highest step is the marginal supplier, and that supplier's cost determines the current price. The next supplier on the supply curve also limits how large a price increase would be feasible if the marginal supplier were to allow the price to go up, but not all suppliers or all potential suppliers are constraining the current price and can be expected to constrain the price in the intermediate run. The very high cost suppliers (e.g., those on the highest step) might become a force in the market at some point in the future, but they aren't now.

With these analytic preliminaries out of the way, I can answer the question that I set out to answer. First, "How do you measure market share?" Do you use reserves, do you use current output, or do you use one of the various capacity measures that the FTC put forward? The problem with reserves is that they include high cost reserves. And, if so, they do not constrain the price within the timeframe that is relevant for antitrust analysis. Current output does have potential drawbacks. A current supply source that is going to be exhausted imminently might represent a constraint now, but not for very long. In this case, the mine that was closest to running out of reserves was seven and a half years away from running out of reserves. I would not count that as being imminent for the time frame that has to be relevant for this kind of market. So production would have been pretty good.

The use of production would miss the implications of that fourth step on the attached chart—that supply source that can't profitably produce today but could constrain the exercise of market power if the price were to go up. It wasn't clear to me that the alternatives proposed by the FTC handled that problem. In any event, the alternatives proposed by the FTC gave pretty much the same answer as production. So the issue really was: "Do you use reserves or do you use one of the others?" I would go for "one of the others."

Second, does 8800 BTU coal, the high heat content coal, constitute a separate relevant market? What you want in the market is those low cost sources of supply. Presumably the cost of mining coal is driven by the cost of digging it out of the ground, which presumably does not depend much on heat content. If BTUs were the only factor determining cost/BTU, then the high BTU content coal would be the low cost coal. But BTU content is not the only determinant of cost per BTU. Production cost per ton varies across mines. Mines have different locations which give rise to differences in transportation costs. As a result, the heat content per ton isn't a perfect sorter of the low cost vs. the high cost suppliers. On top of that, even if the heat content per ton is the primary determinant of cost per BTU, 8800 BTUs per ton might not be the right cutoff for determining what is in the market. I think the court was probably right to reject the 8800 BTU coal as being a relevant market.

To summarize my points so far, I would take the relevant market as being the production of all the coal in the SPRB. As Andrew pointed out, even with that market definition, the structural change here was quite modest. The increase in the Herfindahl was only about 200, which is sim-

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—MICHAEL SALINGER



ilar to taking an industry with ten equally sized firms and shrinking it to nine equally sized firms. That normally wouldn't be viewed as much of a problem.

Much has been said about the court's unfortunate assertion that the FTC's theory was novel. But given the weak structural case, the FTC had to come up with something else. A bid-rigging scheme wasn't going to work because the buyers were large and sophisticated; and they designed their bidding schemes to make collusion on the bids difficult. That presumably is why the FTC came up with its theory about the coordination on capacity. There's nothing novel about that economic theory, but it was completely appropriate for the court to evaluate the risk of that threat critically.

Now let me turn to whether coordinated effects were particularly likely as a result of this merger. The decision contains an analysis of whether or not Triton was a disruptive supplier. The court concluded that rather than being a disruptive supplier, Triton bid to be the supplier of last resort. It went on to conclude that the likelihood of coordinated effects was not greatly affected by this merger. I question the court's inference from its analysis of Triton's bidding behavior. Remember from the graph that the suppliers of last resort constrain the price. If the low cost suppliers could get the supplier of last resort to submit higher bids, the price would go up. That theory, it seems to me, would be a better way of articulating the concern that the suppliers expressed about having this merger go through.

I do think there is some risk that this merger will turn out to be anticompetitive. Whether the court should have blocked the merger really turns on its relative tolerance for false acquittals and false convictions. It was, in my judgment, a close call.

**GREG WERDEN:** Judge Bates's opinion may signal a more searching analysis of coordinated effects theories than has been characteristic of prior court decisions, and if so, I find that neither surprising nor unwelcome. On the other hand, I think he was wrong, as has already been said, to label the FTC's coordinated effects theory "novel," and I think the D.C. Circuit said as much in its order denying the FTC's emergency motion for injunction pending appeal.

The FTC stressed coordination on capacity and output, and I think capacity was really more the story than output. With briefs not made public, so I've never seen them, the defendants appear to have convinced Judge Bates that this sort of theory was out of line with the FTC's prior litigated merger cases. But when I look at those cases, I come away with the view that the FTC may not have had any theories in these cases, but if they did, they surely didn't have any specific theories. Certainly, these decisions didn't say that some theories were okay and other theories weren't. So I don't take anything away from these cases that suggests that some coordinated effects theories are better than others, and there is no basis in these decisions for saying the FTC's theory was novel. What would be novel, given these decisions, is to have a specific theory, but having a specific theory is a good thing.

As a matter of economics, the FTC's theory makes sense to me, and a lot more sense than a theory of pricing coordination. It's bound to be easier in this market to reach an understanding on the terms of coordination, to monitor that agreement, and to police that agreement when it's about capacities and output than when it's about price. A lot of the opinion talks about how hard it is to coordinate on price, but that wasn't the FTC's theory.

It also seems to me, somewhat contrary to what Andrew was saying, that the FTC did articulate a theory about why the acquisition mattered. The theory was that the transaction would take some capacity away from fringe players and give it to the "big three," which would coordinate their activities. This is a straightforward story about why it is more in the interests of the "big three" to coordinate after the acquisition, and about why the remaining competitors have less ability to

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undermine that coordination. So there was a mechanism for how the acquisition mattered even if the number of competitors didn't change. If Andrew is saying that the FTC didn't have any such mechanism, I disagree. If he's saying that the FTC didn't put together all of the pieces of the puzzle, then he may be right.

I also can't agree with Judge Bates that punishment for cheating on coordinated capacities would be ineffective because it would not be detected until well after the fact, if ever. Maybe that is true on price, but not on capacity. It is easy to observe capacity expansions immediately, and cheating can be punished before the first sale of additional output from the expanded capacity. In contrast to most pricing coordination theories, the punishment mechanism in this theory may work especially well. Theoretical work supports the efficacy of this sort of punishment mechanism: If defection from coordination can be punished before it generates any profit, it is easy to enforce coordination in repeated game models.

Although the FTC's theory wasn't novel, or in any way suspect for the reasons suggested by Judge Bates, it did become novel given the findings he made. In his market and with the Buckskin Mine going to Peter Kiewit, the transaction didn't change the number of competitors. I'm fairly confident that there's no precedent for finding a substantially enhanced risk of coordinated effects under a theory that does not involve a change in the number of competitors, so that makes the case novel. But that's not fatal. The FTC did have a theory for why the asset transfer mattered, and that theory made sense economically. Whether it was enough is a different question, and the court did not explicitly decide the question of whether it was enough because the court didn't quite understand that was the question posed. To an extent, however, the question was decided implicitly: The court found that the best measure of share—by no means a perfect measure according to the court, but the best one—indicated the transaction was within the Horizontal Merger Guidelines' safe harbor. And the court found that the North Rochelle Mine, which Arch Coal was acquiring, was a weak competitor, in part because of its high cost. Given these findings, it seemed to the court, not unreasonably, that the transaction just didn't have much effect.

On the subject of assigning market shares, I differ with Mike. A key principle adhered to by both sides is that, if shares are going to be indicative of market power, they have to be based on something real, like control over scarce assets. The FTC advocated such a measure of share—one based on productive capacity at a bottleneck stage of production (as I describe in *Assigning Market Shares*, 70 ANTITRUST L.J. 67, 81–85 (2002)). A coal mine's capacity can be measured in several ways, and the FTC felt the most appropriate measure was "loadout" capacity, which is the current maximum deliverable quantity.

When I studied this industry a long time ago, for reports the Department of Justice was required to prepare for Congress, I concluded that uncommitted reserves were the best basis for assigning shares, and in this case, the defense advocated a reserve-based measure of market share. The FTC disfavored reserves in large part because the mines periodically acquire additional blocks of reserves from the federal government, and different mines find themselves in different positions in this cycle. This may have profound effects on reserve-based shares, but there ought to have been a way to take this cycle into account. In addition, as the court suggested, there ought to have been a way to take into account the fact that some of the reserves were committed to long-term contracts.

Some of the facts I found most important a quarter of a century ago are no longer true in this industry. Back then, a new contract would be large relative to the size of a mine, but that is not at all true now. And the contracts were actually entered into substantially before initial delivery, so it was not necessary to have a mine to compete in this industry; all that was needed was a reserve

base. That's not true now, and with these important changes in circumstances, loadout capacity has become a more sensible measure, but it still may only be relevant for some relatively short-term period of time, and how long is not clear. The court made a finding, with which I'm sure the FTC disagrees, that loadout capacity can be expanded easily and cheaply. The court was unclear about how quickly, and that's important. If it takes years, then maybe loadout capacity is still the relevant measure. If it takes months, then maybe it's not. One thing we know is that loadout capacity has been expanded quite a bit in recent years, and it's expected to be expanded in the future because this is a growing market.

I have one final point on the appropriate share measure. Mike seems to be saying that reserve-based shares are almost never appropriate for natural resource industries, and if that's really his point, I just can't agree. If we assume that loadout capacity can be increased cheaply in a very short amount of time, then it's not an important constraint on the ability of the fringe to undermine the coordination of the big three. Something else has to be that constraint, and I think that has to be reserves. And if you look at the industry a quarter century ago, when I did look at it, a mine was not required in order to compete, so obviously loadout capacity couldn't have been the right basis for assigning shares. In addition, Mike says that it is wrong to include high-cost reserves. Well then, don't include them; use a "right-cost" reserve measure. That may be hard to do, and in many cases there won't be any practical way to do it, but in theory, in many cases, I think it would be the right approach.

Finally, as to the customer testimony, the court made an interesting holding that I think a lot of people misread. The court found that no customer said that the acquisition would lead to increased coordination, and the court held that any such testimony could not have been credited. I understand the court to have said that the latter testimony would have been inadmissible—that customers were not permitted to offer expert opinions about competitive effects relating to price or capacity coordination. I think that's right, and I think all economists ought to stand up for the proposition that lay people must not testify about these subjects. In the *Oracle* and *First Data* cases, the Antitrust Division filed motions to exclude the testimony of industry experts on issues like this. So by and large I agree with what I understand the court to have said relating to customer testimony about likely competitive effects.

But I do take issue with what the court made of customer testimony that bids were "competitive." This is the word that the witnesses apparently used, and the court found it indicative of the market performing competitively. My experience is that lay people don't use economic terminology the way economists use it, and it's terribly wrong to assume they do. I don't think I would have read any of the customer testimony to offer the opinion that the market was currently performing competitively, contrary to what the FTC was arguing. If a customer witness had said: "I did a competitive analysis, and I found that this market is performing competitively," that testimony should have been excluded because the witness was not qualified to offer that kind of opinion testimony.

I think the court was inconsistent in its treatment of customer testimony. If it was going to say: "I can't listen to testimony from customers that the merger would have anticompetitive effects," then it similarly should not have listened to customer testimony that the market currently was performing competitively. One way or another, the court had to be wrong. I think the court misread the testimony that the market was competitive, and it was right to say that testimony that the acquisition would lead to enhanced coordination would have been inadmissible. Thus, I think one of the most criticized parts of the decision is actually one of the most important and correct parts of the decision. I do not see how the Federal Rules of Evidence permit testimony from witnesses with experience as buyers but no specialized knowledge of economics or any other discipline that

would qualify them to opine about increased risk of coordination. That is not something they have any basis for knowing about. They do have a basis to say they're worried that it might happen; they did say it; and the court credited it. But the court also concluded that this testimony didn't get the FTC very far, and I think the court was right about that.

**ELIZABETH BAILEY:** Before we open up the discussion for questions why don't we give our panelists an opportunity to respond to each other? Andrew, do you want to start?

**ANDREW DICK:** I will comment briefly on two points raised by Greg and by Michael. I agree with Greg that the FTC did state that its theory was output restriction. I did not mean to imply that the agency was completely silent on that. But I do think that the FTC fell well short in terms of clearly articulating and persuasively demonstrating the mechanisms by which the coordinated output restriction would come to pass. The tenor of recent policy statements is that both agencies will not just state a theory but also will provide detailed support on how their theory of effects would be operationalized by firms. It's on those latter steps where I believe the FTC fell short.

As to Michael's comments, I agree that there are some important economic differences associated with exhaustible resource markets. However, I do not believe that these differences were paramount to the antitrust analysis in this case. First, as Michael noted, because an exhaustible resource has a fixed available stock, prices cannot be permanently higher when supply is monopolized or cartelized. While this is correct, the agencies place much greater weight on the near-term effects of a merger than on its long-run effects. The fact that a higher post-merger price could not have been sustained forever, given the fixed stock of reserves, therefore, was likely not a decisive factor in the court's rejection of the FTC's theory. Parenthetically, I believe that the focus on near-term effects is economically rational. The farther out in the future we project, the greater is the uncertainty that we face about whether a substitute resource might be developed, new reserves might be discovered, or a regulatory change might reduce effective reserves.

My second comment goes to the question of measuring market shares and concentration. Michael noted that high-cost reserves usually would not constrain the market-clearing price. While this is correct, it is true not only in an exhaustible resource market but also in other industries where firms may face a supply curve that eventually slopes upward as a capacity constraint is neared. Michael suggests that a more informative measure of share in an exhaustible resource market may be current production. While I agree that we do not want to use a measure of total reserves inclusive of supply that would likely be uneconomical to mine at any foreseeable price, I think that uncommitted reserves of all actively producing mines would be closer to the measure we seek than current mine production.

**MICHAEL SALINGER:** I'll stick to the assertion that in a natural resource industry, an upward-sloping supply curve is a more important feature than in the typical manufacturing industry where, at least in the long run, constant returns to scale is a reasonable approximation.

On reserves versus production, my main point was that the market definition should exclude the high-cost sources of supply. In suggesting that production was the right measure of share in this case, or at least was better than reserves, I was conjecturing—and, not having worked on the case, I don't know this to be a fact—that production would do a more effective job of getting rid of the high cost sources of supply. If it is indeed feasible to exclude the high cost reserves, I don't have an opinion about reserves versus production.

**GREG WERDEN:** I don't want to get into all the complications, but the analysis in this case depended on the fact that there wasn't just a market for BTUs, as Mike suggests. The interaction between the 8800 and the 8400 coal was a lot more complicated than that. The customers were heterogeneous with respect to their locations, their sunk investments in the generating technology designed to use particular types of coal, and their abilities to blend Powder River coals with other coals. I think there was a strong correlation between heat content and the cost of production, but it did not go the way than Mike suggested. The 8800 coal was cheaper to produce than the 8400 coal, I believe. The two types of coal were located in different places, with different seam thicknesses and overburden ratios.

I also want to address Andrew's discussion of my point about the FTC having a theory. I'm not saying the FTC had a theory just because coordination on capacity was mentioned. I'm saying the FTC had a theory because it explained how coordinating on capacity would pay a lot better after the deal than before it, as a result of the fact that productive assets were being taken away from the fringe and given to the "big three." The FTC had a quantitative analysis of the difference in profitability of coordination by the "big three" before versus after, which the FTC's expert said was the basis of his opinion that the acquisition was anticompetitive. Andrew may think that the FTC needed more, and I might agree, but they had the analysis I just described, for which I'm not sure Andrew is giving them credit.

Mike makes an interesting point about the acquired mine being the supplier of last resort and therefore being particularly important to competitive effects theory, but I think the facts are more complicated than he may have let on. According to some of the testimony and some of the court's findings, the acquired mine may not have been the supplier of last resort; rather, it may have been higher up on the supply curve than even that, which would make a difference. However, I don't have any opinion about what the facts actually are.

**ELIZABETH BAILEY:** I'm going to take the opportunity to ask the first question, because one of the things that I find interesting is that there is such a large number of examples of industries in which firms have colluded successfully, including electrical equipment, folding boxes, diamonds, OPEC, graphite electrodes, and fine arts auctions. It strikes me that this is a really diverse group of industries along a host of dimensions. So the question I have for the panelists is: as economists, how confident are we of both our empirical and theoretical abilities to predict which industries and which market structures are ripe for collusion? And relatedly, do you think we are more or less confident in our abilities to predict a coordinated price increase as opposed to a unilateral price increase?

**GREG WERDEN:** My impression is that antitrust lawyers have a lot of faith in coordinated effects theories and they have doubts about unilateral effects theories. I find both the faith and the doubt baffling. As an expert witness, I would be worried about having sufficient confidence in a coordinated effects theory to feel comfortable on the witness stand. Economics only lets us make very general statements, and that would bother me. This is not true of unilateral effects. We can make sophisticated predictions based on particular models. We also can quantify the things that matter in these models, and make quantitative predictions.

Moreover, our vague notions about when coordination is likely and when it is not likely are not totally borne out by the data. We see successful coordination among large numbers of firms on occasion, and we find successful coordination in other situations in which our theories say it ought to be hard. One reason firms may have been able to coordinate in these instances is they didn't

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coordinate on price. Customer allocation is a common form of coordination and often the best theory in a coordinated effects merger case. The checklist that Andrew talked about is mostly about the wrong things in lots of cases; it's mostly about how hard it is to do things firms are never going to do. Instead, they would do the easy thing—the customer allocation, which we actually find in many cartel cases.

**MICHAEL SALINGER:** I don't think we should have much faith in our ability to predict with precision when coordinated effects will arise. Nor do I think we should have as much faith as some people suggest in our ability to predict unilateral effects. I think we've made a big mistake in dismissing structural evidence. "Dismissing" is too strong for how that evidence is treated; but, often, structural evidence is the best evidence you have to say that coordinated effects are likely or unlikely. If you think you can go beyond that and say "well, yes, I know in this case we're going to have coordinated effects or not," the science isn't there; and I don't think it's going to be there in my lifetime.

**ANDREW DICK:** I agree with some but not all of Greg's comment. A lot of the criticism of coordinated effects is based on a straw man version of the checklist. As Greg and Liz correctly pointed out, collusion is believed to have occurred in a wide variety of industries and these industries do not appear to adhere closely to the checklist factors. This may be because firms have found ways to coordinate that overcome the checklist obstacles or perhaps it is because the checklist tells us relatively little about the ability of firms to coordinate. In reality, though, the checklist should be regarded as nothing more than a set of highly stylized facts that can offer guideposts for how we organize and analyze the facts presented in a particular market. The checklist cannot be a substitute for developing and testing hypotheses about how coordination might occur in a particular market and whether or how a merger could make that occurrence more likely. Thus, it is unsurprising that its predictive track-record is somewhat checkered when it comes to analyzing coordination in particular settings.

In that vein, I want to circle back to something that Greg said earlier. The reason that I did not give the FTC much credit for stating its theory of the case was that the agency seemed to do little more than say that the merger would increase the firms' intent and incentive to coordinate. That is true of any concentrating merger, to the extent that the now-larger merged firm has a greater incentive to internalize the benefits of a coordinated output reduction. The FTC's theory, at least as it was articulated and developed, did not speak persuasively to the issue of whether firms would have a greater *ability* post-merger to implement coordination.

**GREG WERDEN:** The FTC's theory did speak to the profitability of coordination.

**ANDREW DICK:** I disagree as to whether the FTC's evidence spoke directly to profitability. A firm with a larger market share may have a bigger incentive to see coordination succeed, and this incentive could make the firm more industrious or creative at finding ways to reach and enforce a collusive agreement. But it does not follow necessarily that coordination is in fact more likely to occur.

**GREG WERDEN:** I think you make some good points, and the FTC's story, at least this part of it, perhaps was not enough. But to simplify and exaggerate, the FTC was saying that, before the acquisition, it didn't make sense for just these three firms to coordinate their output because they would have been eaten alive by the remaining competitors, but after the acquisition, it would make

sense. Three can coordinate; five can't; therefore, the acquisition is anticompetitive. Maybe you need more than that, but that's certainly the germ of coordinated effects theory.

**ELIZABETH BAILEY:** Let's open this to other questions.

**QUESTIONER NO. 1:** Leaving aside lots of qualifications and nuances that have been discussed today, I think many of us have the sense that what the judge did say was that coordinated effects needs essentially to be proven almost to the point of having evidence that there is agreement among the parties or there practically is agreement. He also faulted the FTC for not providing expert testimony to demonstrate why coordination would have been likely. If each of you three were on the stand as the expert in this case or a similar case, what kind of evidence would you put forward to demonstrate likelihood? What wasn't put forward here that might have been? And obviously you might have to speculate about what evidence might have been if you'd asked the right questions.

**GREG WERDEN:** Let me argue with the hypothesis a little bit. The court found that the best measure of market share indicated that the change in the Herfindahl was 49 and that there was no change in the number of competitors. Under these circumstances, I would have been shocked and amazed if the court then found the acquisition was anticompetitive. That the court didn't make that finding, therefore, cannot be interpreted to have imposed a particularly heavy burden on the FTC in general, but rather only when the change in the Herfindahl was 49. I don't think the FTC would have brought the case if they thought the change in Herfindahl was 49. The statistics were released late last year and supplemented this year, so you can look and see what the change in the Herfindahls were in the actual cases, and you are not going to see any cases at 49. In terms of how one could come up with a probability, an actual number, I don't think there is any way. I think economists have to admit they can't do that.

**ANDREW DICK:** I would respond to the question by noting that the court's opinion identified a germ of a theory, which was that the target firm might have been bidding as if it were a marginal firm. In a coordinated effects setting, that can be a synonym for a maverick firm that is indifferent or on the margin between going along and not going along with coordination. To develop that theory, one would need to find evidence that the target firm actually was the marginal or price-setting bidder. Another way to develop the theory, harkening back to the FTC's allegations about signaling, would involve finding evidence that the target alone did not send or accept signals in the past. As a result, the maverick's actions would have been less predictable, and the merger could have been a mechanism by which this impediment to coordination might have been removed.

**GREG WERDEN:** Although it would not apply in all coordinated effects cases, of course.

**ANDREW DICK:** Correct.

**MICHAEL SALINGER:** I think I'm agreeing with what Andrew said. I would have focused on the bidding rather than the capacity expansion. When Arch bids in a particular instance, it's making some probabilistic assessment of how the price it bids relates to its chances of getting the business, which in turn represents some belief about what others are going to bid. I would try to understand how its acquisition of this mine would have changed that calculation. That's the coordinated effect

that you're worried about, not that they get together in a smoke-filled room and allocate customers. It's the tacit coordination that comes from recognizing they're in a small numbers game.

**GREG WERDEN:** I think the FTC was basically right in saying that the way the companies would coordinate is by focusing on capacity and production. This is a market in which firms have increased their capacity and production, and they can be expected to do so in the future. A plausible theory of coordination is slower and smaller increases in capacity and production than otherwise would have occurred, rather than an actual decrease in output. So there is a real theory there but no good way based on economic theory to make a specific prediction.

**QUESTIONER NO. 2:** What does this decision predict for the agencies' reliance on customer testimony in contesting a merger?

**GREG WERDEN:** I think the future role for customer testimony is no different than it was in the past. Customer testimony is vitally important in merger cases to get at issues like market power and market definition. Customers know about demand, and we need to know about that, but there are lots of things they can't tell us. The thing I take away from *Arch Coal* is that customers should only be listened to when they're telling us about things what they know.

Although there is difficulty in understanding what Judge Walker is saying in the *Oracle* case [*United States v. Oracle Corp.*, 331 F. Supp. 2d 1098 (N.D. Cal. 2004)], a reasonable interpretation is that he concluded that the customers didn't tell him what their demands were. Judge Walker could have been thinking that the customers did not know what they would do in a world different from the world they were living in. The customers knew exactly what to do in the current world, and they were doing it, but they had not investigated all of the possible options, because it wasn't sensible to investigate all the possible options. But if the world changes, the customers may have to get more information and reevaluate their decisions, and they may come to different conclusions. I think what Judge Walker may be saying is that the customers had not gone out and gotten that information yet, so they could not tell us what they would do after this merger. You don't have to read the testimony that way, but if you do, and I think there is a good reason to read it that way, then there isn't much of a lesson for the future except that complicated facts make it difficult to win a merger case. ●



## Paper Trail: Working Papers and Recent Scholarship

**Editors' Note:** In this edition we note a recent paper by one of the editors that considers why courts have certified the Microsoft indirect purchaser cases as class actions far more frequently than have courts in other indirect purchaser cases. The paper touches on, but does not explore, the possible effect of the Class Action Fairness Act on indirect purchaser litigation, a topic that we would like to address in future issues. Send suggestions for papers to review on this topic—or any others—to: [page@law.ufl.edu](mailto:page@law.ufl.edu) or [jwoodbury@crai.com](mailto:jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

### Recent Papers

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**William H. Page, Class Certification in the *Microsoft* Indirect Purchaser Litigation,**  
[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=671048](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671048)

In a 1999 article,<sup>1</sup> I surveyed class certification decisions in cases that indirect purchasers had filed under state “*Illinois Brick*<sup>2</sup> repealer” statutes and similar state laws. I found that most of the courts up to that time had denied certification on the ground that the individual issues of “impact” and damages predominated over the common issues of liability. Even though the states’ laws authorized indirect purchaser suits, these courts were skeptical of claims that plaintiffs, relying on the tax incidence model of passing on, could prove an overcharge to indirect purchasers by common proof. Their skepticism was based on many of the same factors the Supreme Court had cited in *Illinois Brick* as reasons for denying indirect purchasers the right to sue at all. A minority of courts, however, routinely granted certification, applying what I called a “sanguine” approach to the problems of proving passing on.

I concluded that the most important determinant of whether an indirect purchaser class would be certified was whether it had been filed in a skeptical jurisdiction or a sanguine jurisdiction. In addition, however, I observed that some putative indirect purchaser classes were less likely to be certified even under a more lenient standard: those that consisted of large numbers of consumers who made frequent, undocumented purchases from many sellers; those in which the overcharge to direct purchasers varied significantly; those in which the direct purchasers had market power on the buying or selling side; those in which the monopolized product was heterogeneous; and those in which intermediate purchasers added value to the monopolized product or incorporated it into other products. I argued that these findings suggested that indirect purchaser suits were not effective in providing real compensation to the vast majority of indirect purchasers of price-fixed products. The costs and practical limitations of class action litigation—factors largely independent of the merits of the claims—make it impossible to calculate and distribute damages to millions of indirect purchasers who suffer small individual harms.

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<sup>1</sup> William H. Page, *The Limits of State Indirect Purchaser Suits: Class Certification in the Shadow of Illinois Brick*, 67 ANTITRUST L.J. 1 (1999).

<sup>2</sup> *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977).

In the recent *Microsoft* follow-on litigation, however, state courts have certified indirect purchaser classes much more frequently than have the courts in the pre-1999 cases. Of the fourteen opinions on certification in the *Microsoft* cases, three (two in Michigan and one in Maine) denied certification, while eleven granted it. In the present paper, I explore possible explanations for this disparity in the rate of certification and consider whether the experience in these cases helps us decide whether indirect purchaser class actions are in the consumer interest. I once again survey the results in all of the class certification decisions in indirect purchaser cases to date.<sup>3</sup> I discovered that, while the numbers are still relatively small, indirect purchaser classes are being certified significantly more frequently since my 1999 study, and that much of that change is attributable to the *Microsoft* cases. Slightly more than a third of indirect purchaser cases (in which written opinions were issued) were certified through 1998; since then, about two thirds have been certified—half of the non-*Microsoft* cases and almost 80 percent of the *Microsoft* cases.

Like the earlier cases, a *Microsoft* indirect purchaser case's chances of certification depended in large part—but not exclusively—on whether it was filed in a sanguine or skeptical jurisdiction. The rate of certification in the *Microsoft* cases has been higher primarily because they were filed in sanguine jurisdictions more frequently than were earlier cases. Courts in previously sanguine states all continued to follow the sanguine approach in their *Microsoft* cases; courts in states with no track record in indirect purchaser litigation all adopted the sanguine view in their *Microsoft* cases. In addition, however, courts in two previously skeptical states, Florida and Minnesota, adopted versions of the sanguine view in their *Microsoft* cases. Only two of the previously skeptical states, Michigan and Maine, continued to follow that approach.

The paper places these cases in context by discussing their relationship to the government *Microsoft* case. I note that the government case offered little support for an overcharge claim: it held that Microsoft had illegally maintained its monopoly by exclusionary practices it adopted during and after 1995; it did not hold that Microsoft acquired its monopoly unlawfully. Nor did it hold that Microsoft was charging a monopoly price, even though it had the power to do so; indeed, many of the holdings suggest that Microsoft was at least temporarily charging low prices. Recognizing the limited support that the government case provided, the indirect purchaser plaintiffs alleged that Microsoft acquired its monopoly by illegal conduct that began in the 1980s, long before the browser wars that were a focus of the government case. Some of the classes alleged that this illegality extended to the Microsoft Office application software, which was not at issue in the government litigation.

Sanguine courts differed from skeptical courts primarily in their treatment of the expert testimony offered to support plaintiffs' proposals for common or classwide proof that direct purchasers passed on an overcharge to end users. Most of the plaintiffs offered similar presentations by the same expert, who outlined the statistical methods that he planned to use to prove the overcharge and the rate of pass-through. First, assuming that there would be evidence that Microsoft engaged in illegal actions in operating-system markets prior to the damage period, the expert suggested that an overcharge would be "embedded" in prices at every level of distribution. To prove the overcharge, the expert identified three yardstick methods. To prove how much of this overcharge the intermediate purchasers passed on to end users, he proposed estimating the relationship between Microsoft's prices to its customers and the prices paid by end users using basic economic principles (including the tax incidence model of passing on), standard statistical methods,

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<sup>3</sup> My focus is on cases involving single states. I separately discuss three federal cases in 2004 that certified multiple classes under state law.

and data that “should be readily available.” He did not, however, actually implement the methods using data from the states in which the classes were located.

Microsoft challenged these assertions through its own experts, claiming that the plaintiffs’ proposed methodologies did not take account of numerous demand, cost, and competitive factors in different locations and at different times that would affect whether and to what extent any overcharge was passed on. In general, however, the sanguine courts accepted the plaintiffs’ proposed methodologies, refusing to resolve what they viewed as a “battle of experts.” In contrast, the skeptical courts rejected the proposed methodologies because they failed to “bridge the gap between theory and reality.” The Michigan court noted that because the class was large, the products were complex, and the intermediate level was not perfectly competitive, there would likely be widely varying rates of passing on.

The Minnesota case, *Gordon v. Microsoft*,<sup>4</sup> was unique in granting certification while distinguishing prior cases in that jurisdiction that had denied certification on skeptical grounds. In one of the prior cases, the court noted, there were many defendants and a multitude of different transactions; in another, there were many defendants and many different drugs at issue; in a third, the products at issue gained value through repackaging at intermediate levels; in a fourth, buyers had no records of the amount of the product they bought or the price they paid; and in a fifth, the expert could not show that anyone had ever used his methods. In *Gordon*, in contrast, there was a single seller of two primary products; there were relatively infrequent transactions for each class member, and there were likely to be records of those transactions; and the expert had proposed using widely adopted methods of proving damages. The court reviewed the plaintiffs’ expert’s proposed methods, and Microsoft’s objections, and found the methods sufficient, declining to resolve the battle of experts at the certification stage.

Although I conclude in the paper that the main reason for the overwhelming certification of the *Microsoft* cases was that they were filed in sanguine jurisdictions, I do suggest that some of the cases, in choosing a sanguine approach, may have overestimated the relevance of the judgment in favor of the government in *United States v. Microsoft*. Several courts, for example, had referred to the findings in the government case that Microsoft had injured consumers. Yet none of the passages mentioned by the courts found that consumer injury consisted of an illegal overcharge. I also note that the government case rested on a theory that operating-system markets were characterized by network effects; consequently, even if there had been no illegal conduct in the market, it is entirely possible that the tendency of users and developers to choose the most popular operating system would have caused the market to tip toward a single dominant standard.

In the final section of the paper, I consider whether the experience in the *Microsoft* indirect purchaser cases helps to resolve whether indirect purchaser litigation is in the consumer interest. All of the cases settled, so we cannot tell if the sanguine courts’ deferential approach to certification was warranted. In the abstract, a lenient standard makes erroneous grants of certification more likely, while a strict standard makes erroneous denials more likely. Sanguine courts estimate that the costs of an erroneous denial are greater for two main reasons: first, a denial essentially ends the action where the putative class members’ stakes are small, while a grant is only provisional; and second, an erroneous denial thwarts the substantive law’s policy, while an erroneous grant only defers to a later time the proper disposition of the action. Consequently, these courts suggest that a lenient certification standard is appropriate.

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<sup>4</sup> *Gordon v. Microsoft Corp.*, No. 00-5994, 2001 WL 366432 (D. Minn. Mar. 30, 2001).

Scholars have recently argued, however, that this reasoning ignores the fact that certification places enormous pressures on the defendant to settle even an unmeritorious suit.<sup>5</sup> They also note that class actions involving small individual claims fail to provide significant compensation to the plaintiffs, and that deterrence can be provided by other means, such as public enforcement. These objections are consistent with the experience in the Microsoft indirect purchaser litigation—all of the cases settled without an adjudication on the merits, and the settlement funds have not provided much compensation to individual class members, who have not filed many claims. The cases might, however, be justified on a deterrence rationale, particularly because the direct purchasers—Compaq, Gateway, Dell, for instance—have not sued Microsoft for an overcharge. This is an important consideration, because, in general, direct purchasers sue in addition to indirect purchasers, raising serious concerns about duplicative recoveries. But *Microsoft* is also different from other overcharge cases in another respect: it was essentially about exclusionary practices that harmed rivals more directly than purchasers. All of these rivals—Netscape (AOL) and Sun Microsystems, for example—have sued and settled for substantial amounts. Thus, one may well question whether the indirect purchaser suits were necessary to provide adequate deterrence. ●

—WHP

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<sup>5</sup> See, e.g., Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1268 (2002).