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*Dynamically Developing Law & Policy in California and Beyond*


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*in California and Beyond*

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# *Dynamically Developing Law & Policy in California and Beyond*


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# competition

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**CHAIR'S COLUMN**

Thomas Dahdouh
Federal Trade Commission
San Francisco, CA

## Welcome to the Antitrust, UCL and Privacy Section!

The Section has some big news: Our section name has changed! We have now added "privacy" to the name—our formal name now is the "**Antitrust, UCL and Privacy**" Section. As many of you well know, the practice of privacy law is growing by leaps and bounds. We are increasingly hearing of new federal and state actions and investigations by federal, state and local entities arising out of issues surrounding privacy. Earlier this year, the Executive Committee and the State Bar realized that no Section currently explicitly covered privacy law. We felt that Privacy Law fit best within our Section—and the State Bar's Board of Trustees agreed with us. In July, the Board of Trustees formally voted to change our Section name to incorporate privacy. We are very excited about this change: it will permit our Section to continue doing all the great educational work in antitrust and consumer protection law, while at the same time adding many new programs devoted to privacy . This will give our Section members even more value-added! To help the Executive Committee and the State Bar in this transition, we have assembled a stellar team of privacy law specialists into a Privacy Law Subcommittee that will be spearheading this transition. The members are: **Lori Chang, Greenberg Traurig, LLP; Jonathan Levine, Pritzker Levine LLP; Michael H. Rubin, Wilson Sonsini Goodrich & Rosati; Bryson Santaguida, Google Inc.; Tina Wolfson, Ahdoot & Wolfson, PC; Evan M. Wooten, Mayer Brown LLP; and Lauren Foster Wu, Genomic Health, Inc.** The Subcommittee will be co-chaired by Executive Committee members **Dominique Alepin, Mayer Brown LLP, and Jill M. Manning, Steyer Lowenthal Boodrookas Alvarez & Smith LLP**. Please contact them if you have any ideas!

Over the coming months, you can look forward to new offerings from our Section on privacy including e-briefs, webinars, panels and conferences. We are particularly interested in publishing more articles sounding in privacy. Over the past few years, *Competition* has offered many different articles on privacy, but, with our name change now, we are hoping to have regular privacy law articles. Please consider contributing!

At the October 10th state bar meeting in Anaheim, I will be passing on the torch of Section leadership to **Paul Riehle** of the **Sedgwick LLC** firm in San Francisco. Paul has been an outstanding member of the Executive Committee for five years now and I know he will make a great Chair. Please join me in congratulating Paul on a well-deserved accolade!

**EDITOR'S NOTE**

Heather S. Tewksbury
Wilmer Cutler Pickering Hale & Dorr LLP
Palo Alto, CA

## Dynamically Developing Law & Policy—In California & Beyond.

We start off this issue of *Competition* with a mini-symposium on the recent *In re Cipro Cases I & II*. Starting with an analysis by **Jordan Elias** where he argues that *Cipro* does what *Actavis* did not by laying out an authoritative foundation for a rule of reason with "bite." **Dylan Carson** and **Avril Love** also address *Cipro* by considering one of the chief challenges created by the decision with respect to the necessity, but the likely inability, of state courts to determine patent validity. **Steven Perry** and **Sean Howell** take a different approach to their analysis by examining the reach of *Edwards v. Arthur Andersen LLP* in light of *Cipro*.

We next have an analysis by **Kenneth Field** and **Douglas Litvack** of health care mergers in the era of payment reform. In keeping with our health care theme, **David Gringer** examines the impact of the Supreme Court's newly formulated "active market participant" test for state licensing boards in the wake of the *North Carolina State Board of Dental Examiners* case. Rounding out this area is an insightful article by **James Mulcahy** and **Filemon Carrillo** about the *Colgate* doctrine and how it may apply to the disposable contact lens antitrust litigation.

Jumping from health care to technology is an article by **Ryan McCauley**, who takes on the Second Circuit's decision in the Apple e-books case. And **Alexandra McDonald**, **Jason McDonell**, and **Caroline Mitchell** provide an overview of the legal landscape regulating mobile app development and explain how the law and the regulators are working to bring order to the "wild west" of this new world.

**David Meyer** takes us back to the future with his article that marks the 800th anniversary of the Magna Carta and presents the observation that the Supreme Court has referred to the Magna Carta in more than 200 opinions and has regularly invoked it in deciding antitrust cases. Bringing us back to the fundamental realization of the importance of the antitrust laws is **Peter Huston** observing that federal antitrust cases have grown increasingly complex, and that exposure to antitrust concepts likely makes certain courts more efficient, and possibly better, at deciding these cases. His article provides a nice platform for **Joshua Stokes** and **Jordan Ludwig's** circuit-by-circuit analysis of the standards for pleading an antitrust conspiracy under *Twombly* and their conclusion that these standards remain in flux. **Lee Berger** and **Sophie Sung** complete this robust discussion on history and procedure with an analysis of the extraterritorial reach of the antitrust laws.

The issue concludes with a piece I drafted with my colleagues Ryan Tansey and Alicia Berenyi where we discuss antitrust compliance programs and the Antitrust Division's recent steps toward incentivizing corporate compliance.

I would like to thank our authors and editors for all of their efforts in creating a fascinating edition of *Competition*. And on behalf of the Executive Committee, we would especially like to thank our Section Chair, **Tom Dahdouh**, for his incredible leadership over the past year!

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# PUTTING *CIPRO* MEAT ON *ACTAVIS* BONES: A CASE STUDY IN FILLING IN THE LEGAL GAPS

*By Jordan Elias*[1]

Justice Cardozo summed up the essential challenge of deciding cases with a single sentence: "There are gaps to be filled."[2] Gap-filling best describes the judicial function that a unanimous California Supreme Court performed this year in its major antitrust decision in the *Cipro* reverse payment litigation.[3] Confronting spaces in the law left by the U.S. Supreme Court in its own recent reverse payment decision—*FTC v. Actavis, Inc.*[4]—the California court elaborated at length on why reverse payment agreements must be treated as suspect under the rule of reason and how a reverse payment trial under the Cartwright Act[5] must be structured.

The California Supreme Court's *Cipro* decision is binding authority as to Cartwright Act claims in state and federal courts and, in my view, should also be persuasive authority for courts interpreting and applying *Actavis*. As one federal judge remarked, *Cipro* contains "one of the most thorough and thoughtful discussions of *Actavis* yet"; it explains "that 'the period of exclusion attributable to a patent is not its full life, but its expected life had enforcement been sought,' and that '[t]his expected life represents the baseline against which the competitive effects of any agreement must be measured.'"[6]

The authoritative guidance and reasoning in the *Cipro* decision should inform the prosecution, management and resolution of reverse payment claims, under California law and otherwise, for years to come.[7] Where *Actavis* left questions, *Cipro* supplied answers grounded in existing antitrust principles and economic analysis, from the high court of the most populous state. And to the extent *Cipro* has a lasting effect on the contours of future reverse payment cases, and on antitrust law in general, it will be because the California Justices refused to dodge the issues that have made reverse payments such a conundrum.

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1 The author is of counsel to Lieff Cabraser Heimann & Bernstein, LLP and one of the attorneys representing the indirect purchaser class in the California *Cipro* litigation. The views expressed in this article are the author's and do not necessarily reflect those of Lieff Cabraser or the *Cipro* plaintiffs.

2 Benjamin N. Cardozo, The Nature of the Judicial Process 14 (1921).

3 *In re Cipro Cases I & II*, 61 Cal. 4th 116 (2015) reh'g denied (July 8, 2015)("Cipro"). The *Cipro* case arises from Bayer Corporation's payment of $398.1 million to Barr Laboratories for Barr's agreement to drop its counterclaims that Bayer's patent on the blockbuster antibiotic was invalid and unenforceable. Bayer settled the California antitrust claims against it for $74 million in 2014, leaving Barr and its financial backers, alleged co-conspirators, as defendants.

4 133 S. Ct. 2223 (2013).

5 Cal. Bus. & Prof. Code § 16720 *et seq*.

6 *In re Aggrenox Antitrust Litig.*, No. 3:14-md-2516, 2015 WL 4459607, at *9-10 (D. Conn. July 21, 2015) (quoting *Cipro*, 61 Cal. 4th at 149).

7 Most of these claims now proceed in federal court as a result of the Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4 ("CAFA"), codified at various provisions of the U.S. Judiciary Code (28 U.S.C.). The California *Cipro* case, a relic of pre-CAFA times, was remanded in 2001 from federal multidistrict litigation to San Diego Superior Court. *See In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 166 F. Supp. 2d 740 (E.D.N.Y. 2001).

Few if any business developments over the past generation have produced as much consternation among antitrust practitioners and commentators as reverse payments. These are payments with which a brand manufacturer of a valuable prescription drug, whose patent comes under attack in the brand's own suit for infringement, settles with the defendant generic manufacturer. The settlement payment is known as "reverse" because the *plaintiff* in the patent infringement suit (the brand) is making it, and to a defendant with no counterclaim for damages. In exchange for dropping its legal challenge to the drug patent, the generic receives a chunk of the brand's profit stream over the life of the patent monopoly. Sometimes this payment can even surpass what the generic would have earned from selling the drug in a competitive market, giving the generic an incentive to accept the deal even if it is certain it can strike down the patent. Thus, where there was once a chance the patent would be declared void, with generic competition thereafter flooding the market to reduce prices, a reverse payment barricades the asserted patent monopoly and ensures high prescription drug prices for consumers and insurers alike, often for several years.

What made reverse payments—also known as "pay-for-delay" settlements—so perplexing as a matter of jurisprudence? The main factors, it is now apparent, were their novelty and courts' reluctance to engage with patent law issues.[8] No other factors can explain why the pre-*Actavis* case law spanned the full range of antitrust standards in less than a decade. Pharmaceutical companies argued—for a time, with growing success—that the underlying patent must be presumed valid and there can be no violation if the payment excludes no more competition than the patent already excludes. They also raised the specter of the settled patent suit having to be reopened and tried within the confines of an antitrust suit. From 2003 to 2012, a line of federal cases constructed an immunity making that unappealing prospect unnecessary.[9]

But neither the U.S. Supreme Court analyzing the Sherman Act, nor the California Supreme Court analyzing the Cartwright Act, accepted these formalistic arguments or the speculative claims that subjecting reverse payments to scrutiny would dampen innovation or

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8 *See Caldera Pharms., Inc. v. Regents of Univ. of Calif.*, 205 Cal.App.4th 338, 344 (2012) ("The appearance of a patent in state court is more than likely to unsettle lawyers and judges. . . . Even federal judges can be uneasy. . . . [¶] [T]his trepidation is unreasonably exaggerated.") (citation omitted).

9 In adopting the now-repudiated "scope-of-the-patent" rule of immunity, the Eleventh Circuit opinion reversed in *Actavis* held that it would be improvident to undertake such a "turducken" task. *FTC v. Watson Pharms., Inc.*, 677 F.3d 1298, 1315 (11th Cir. 2012). Federal appeals courts went from treating reverse payments as *per se* unlawful (*In re Cardizem CD Antitrust Litig.*, 332 F.3d 896 (6th Cir. 2003)), to recognizing a defendant-friendly rule of reason (*Valley Drug Co. v. Geneva Pharms., Inc.*, 344 F.3d 1294 (11th Cir. 2003); *Schering-Plough Corp. v. FTC*, 402 F.3d 1056 (11th Cir. 2005)), before veering to the scope-of-the-patent test (*In re Tamoxifen Citrate Antitrust Litig.*, 466 F.3d 187 (2d Cir. 2006); *In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 544 F.3d 1323 (Fed. Cir. 2008); *Watson*, 677 F.3d 1298). Finally, in *In re K-Dur Antitrust Litig.*, 686 F.3d 197 (3d Cir. 2012), the Third Circuit pushed back with a pro-consumer opinion supporting a quick-look antitrust rule. Against this disarray *Actavis* established the unique rule of reason on which the California Supreme Court expounded in *Cipro*.

burden settlement of patent cases.[10] Both courts instead held that the antitrust laws prohibit a payment to avoid even "the risk of competition,"[11] or, in the California court's reframing, to gain "freedom from the possibility of competition."[12] This is the key antitrust insight: the inherent uncertainty about how a fact finder would have decided the patent suit militates not against, but in favor of a subsequent antitrust suit over the payment that neutralized the simple threat of market entry. This insight, in turn, gives rise to a rule of reason with "bite" that should go a long way toward deterring this form of collusion among firms. Experience shows that drug patent cases under the Hatch-Waxman Act are perfectly capable of settling on procompetitive terms—for example, through licenses that account for the risk of invalidation by allowing generic entry before the patent is scheduled to expire.[13]

In *Actavis,* the U.S. Supreme Court "le[ft] to the lower courts the structuring" and operation of the rule of reason in the reverse payment setting.[14] The California Supreme Court, for its part, held that although *Actavis* "is not dispositive" on issues of California law,[15] "the rule we adopt is in harmony with *Actavis,* which offered only broad outlines and explicitly left to other courts the task of developing a framework for analyzing the anticompetitive effects of reverse payment patent settlements."[16]

What characterizes the framework the California Justices put in place?

In three significant ways, without creating a conflict, the Justices built upon *Actavis* to settle expectations surrounding reverse payments.

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10 The California Supreme Court found "the incentives to innovate far sturdier" than judges adopting the scope-of-the-patent test "had feared," and that "[i]ndeed, insufficient scrutiny of [reverse payment] settlements has the potential to hamper innovation by allowing weak patents to offer the exact same exclusionary potential and monopoly possibilities as strong ones, thus steering innovator incentives away from more costly true innovation and toward cheaper, less socially valuable pseudoinnovation." *Cipro*, 61 Cal. 4th at 140, 155 (footnote omitted). Similarly, "[f]ears of chilling even legitimate settlements are overstated; all that allowing antitrust scrutiny does is remove the incentive to settle as a way to split monopoly profits." *Id.* at 141.

11 *Actavis*, 133 S. Ct. at 2236.

12 *Cipro*, 61 Cal. 4th at 150 ("[A]s the leading antitrust treatise notes, 'the law does not condone the purchase of protection from uncertain competition any more than it condones the elimination of actual competition.' ") (quoting 12 Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law: An Analysis of Antitrust Principles and Their Application ¶ 2030b, at 220 (3d ed. 2008)).

13 Commonly known as Hatch-Waxman, the Drug Price Competition and Patent Term Restoration Act of 1984, Pub. L. No. 98-417, 98 Stat. 1585, codified as amended at 21 U.S.C. § 355, established the procedures that funnel brand and generic drug manufacturers into litigation over the brand's patent. In Hatch-Waxman patent cases between 2000 and 2004, before the scope-of-the-patent test's heyday, "not one of twenty reported agreements involved a brand firm paying a generic filer to delay entering the market. During this period, parties continued settling their disputes, but in ways less restrictive of competition, such as through licenses allowing early generic entry." Michael A. Carrier, *Unsettling Drug Patent Settlements: A Framework for Presumptive Illegality*, 108 Mich. L. Rev. 37, 75 (2009).

14 133 S. Ct. at 2238.

15 *Cipro*, 61 Cal. 4th at 141.

16 *Id.* at 160. This comment came in the course of *Cipro*'s reversal of the California Court of Appeal's secondary holding of federal preemption. The California Supreme Court further explained that the U.S. Supreme Court "has been quite clear that states may depart from federal rules—or, here, accept an invitation to develop a gap in the law explicitly left by the Supreme Court—absent evidence of a clear congressional purpose to the contrary." *Id.* at 162 (citing *California v. ARC America Corp.*, 490 U.S. 93, 103 (1989)).

First, *Actavis* says nothing about reverse payments that do not take the form of cash. The omission matters because pharmaceutical companies have lately been camouflaging reverse payments as transfers of intellectual property or other assets or valuable consideration providing the equivalent of cash to would-be challengers.[17] *Cipro,* by contrast, condemns outright this trend of "noncash forms of consideration": "courts considering Cartwright Act claims should not let creative variations in the form of consideration result in the purchase of freedom from competition escaping detection."[18] Nor, the California court declared, should side deals relating to other goods or services "be permitted to serve as fig leaves for agreements to eliminate competition."[19] These statements will prevent drug makers from defeating reverse payment cases under California law with contentions that their wealth transfer did not include cash.

Second, *Cipro* eschews "rigidly distinct analytic boxes" for antitrust analysis, endorsing a "more nuanced approach" by which courts tailor antitrust rules to particular restraints and legal or economic contexts.[20] Following this approach, *Cipro* lays out a detailed, "structured" rule of reason for reverse payment trials.[21] Plaintiffs make out their case-in-chief by showing that the patent settlement (1) limits the generic's market entry, and (2) includes cash or other financial consideration from the brand to the generic exceeding (a) the value of any other goods and services that the generic agrees to provide to the brand (apart from the delayed entry), plus (b) the brand's anticipated costs to litigate the patent suit to a conclusion.[22] *Actavis* mentions elements 2(a) and 2(b) without specifying how they might figure in a trial.[23] *Cipro,* however, realistically requires the antitrust defendants to come forward with evidence on these points, once the plaintiff has shown a payment for delay, because "these are matters about which the settling parties will necessarily have superior knowledge."[24] If the defendants fail to meet this burden of production, or if the plaintiff persuades the fact finder that the reverse payment exceeds the brand's remaining litigation costs plus the value of any collateral benefits it is to receive, the plaintiff has met its burden of proving anticompetitive effects and market power.[25] The reason is that "[i]f a brand is willing to pay a generic more than the costs of continued litigation, and more than the value of any collateral benefits, in order to settle and keep the generic out of the market, there is cause to believe

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17 *See e.g., In re Aggrenox Antitrust Litig.*, No. 3:14-md-2516, 2015 WL 1311352 (D. Conn. Mar. 23, 2015), *pet. for interlocutory review granted*, 2015 WL 4459607 (D. Conn. July 21, 2015).

18 *Cipro*, 61 Cal. 4th at 151 n.11. The first federal appellate opinion interpreting *Actavis* agrees: "We do not believe *Actavis*'s holding can be limited to reverse payments of cash. . . . We do not believe the Court intended to draw such a formal line. Nor did the *Actavis* Court limit its reasoning or holding to cash payments only." *King Drug Co. of Florence, Inc. v. Smithkline Beecham Corp.*, 791 F.3d 388, 403-06 (3d Cir. 2015) (footnotes omitted).

19 *Cipro*, 61 Cal. 4th at 152.

20 *Id.* at 146-47.

21 *Id.* at 161-63.

22 *Id.* at 151-53.

23 *Actavis*, 133 S. Ct. at 2236 ("Where a reverse payment reflects traditional settlement considerations, such as avoided litigation costs or fair value for services, there is not the same concern that a patentee is using its monopoly profits to avoid the risk of patent invalidation or a finding of noninfringement.").

24 *Cipro*, 61 Cal. 4th at 153.

25 *Id.* at 153-57.

some portion of the consideration is payment for exclusion beyond the point that would have resulted, on average, from simply litigating the case to its conclusion."[26] A payment of that nature violates the antitrust laws.[27]

Third, while the burden then shifts to the defendants to present evidence of procompetitive effects, the logic of *Cipro* forecloses all or most patent-based justifications for reverse payments. According to *Actavis,* "it is normally not necessary to litigate patent validity to answer the antitrust question (unless, perhaps, to determine whether the patent litigation is a sham)."[28] *Cipro* quotes this language and adds a significant gloss that cuts off the ability to relitigate the patent itself.[29] Most importantly, *Cipro* makes clear that "consideration of whether the agreement is justified as procompetitive *will not* turn on whether the patent would ultimately have been proved valid or invalid."[30] Nor can the drug makers assert that their agreement "allows competition earlier than would have occurred if the brand had won the patent action."[31] They therefore cannot contend that the patent would have been upheld absent the settlement, for "[a]greements must be assessed as of the time they are made, at which point the patent's validity is unknown and unknowable."[32] What matters is the state of affairs when the antitrust defendants settled their patent dispute, and a reverse payment larger than the brand's saved litigation costs and any side consideration *itself* demonstrates that the settlement resulted in more exclusion than would otherwise, on average, have prevailed in the market for the prescription drug.[33] *Cipro* thus lends support to the jury instruction that a group of distinguished antitrust scholars proposed, following *Actavis*, for reverse payment trials: "You may not consider the validity of the patent as a defense."[34]

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26 *Id*. at 154.

27 *Id*. at 150.

28 *Actavis*, 133 S. Ct. at 2236 (citation omitted).

29 *Cipro*, 61 Cal. 4th at 159 (quoting *Actavis*, 133 S. Ct. at 2236).

30 *Cipro*, 61 Cal. 4th at 158 (emphasis added).

31 *Id*.

32 *Id*. (citation omitted). Antitrust analysis considers whether an alleged restraint "promoted enterprise and productivity at the time it was adopted." *Polk Bros., Inc. v. Forest City Enters., Inc*., 776 F.2d 185, 189 (7th Cir. 1985) (Easterbrook, J.). An early reverse payment opinion, often cited by defendants, likewise holds that "the reasonableness of agreements under the antitrust laws are to be judged at the time the agreements are entered into." *Valley Drug*, 344 F.3d at 1306.

33 *Cipro*, 61 Cal. 4th at 149-50, 154, 159.

34 Aaron S. Edlin, C. Scott Hemphill, Herbert J. Hovenkamp & Carl Shapiro, *Activating Actavis*, 28 Antitrust 16, 21 (Fall 2013). The jury in a rule of reason case weighs anticompetitive against beneficial effects. *See* Cal. Civ. Jury Instr. No. 3411. If a plaintiff satisfies the elements in the reverse payment rule "and thereafter can dispel each additional justification the defendants put forward to explain the consideration, the conclusion follows that the settlement payment must include, in part, consideration for additional delay in entering the market. That payment for delay is condemned by the Cartwright Act, as by federal antitrust law. . . ." *Cipro*, 61 Cal. 4th at 159-60. It is as unclear after *Cipro* as it was after *Actavis*, however, what sort of justifications might legitimately be offered in defense of a reverse payment. One possibility: "a modest cash payment that enables a cash-starved generic manufacturer to avoid bankruptcy and begin marketing a generic drug might have an overall effect of increasing the amount of competition in the market." *K-Dur*, 686 F.3d at 218.

In these three areas, the California analysis reveals the common law process of iterative decision making at work: we now have *Cipro* corollaries to go along with the *Actavis* doctrine. And the California Supreme Court extended the U.S. Supreme Court's teachings in a manner that should give drug firms pause before striking more reverse payment deals and risking treble damages. For if there was one principle of law that the California court crystallized and amplified, it is that payments to eliminate the threat of competition deserve no protection, even when accompanied by the grant of a limited patent monopoly.

# OFF-LABEL USE OF THE CARTWRIGHT ACT: WILL *CIPRO* REQUIRE STATE COURTS TO ASSESS FEDERAL PATENT VALIDITY IN PAY-FOR-DELAY CASES?

*By Dylan M. Carson and Avril G. Love, Tucker Ellis LLP*[1]

## I. INTRODUCTION

In *FTC v. Actavis, Inc.,* the United States Supreme Court subjected so-called reverse payment settlements in pharmaceutical patent litigation to rule of reason antitrust analysis under Section 1 of the Sherman Act.[2] The *Actavis* decision, however, left it to lower courts to determine how best to perform that analysis. In May 2015, the California Supreme Court stepped into the breach with its decision in *In re Cipro Cases I & II*.[3] The *Cipro* Court held that reverse payment settlements may be challenged under California's primary antitrust statute, the Cartwright Act. In doing so, it attempted to fill in some of the blanks left by the *Actavis* decision on how to conduct a rule of reason analysis of reverse payment settlements.

The *Cipro* Court established (i) a four-part test for plaintiffs to present a prima facie case, (ii) how defendants can rebut that prima facie showing, and (iii) what plaintiffs must ultimately demonstrate to carry their burden of persuasion. Given the discretion left by the United States Supreme Court's *Actavis* decision to formulate the applicable rule of reason test, it would not be surprising to see other courts use the *Cipro* decision to model their analysis in so-called pay-for-delay litigation under either federal or state antitrust law. What is more, given the relatively low burdens of proof and persuasion *Cipro* places on plaintiffs and the significant burdens it places on defendants, California courts are likely to become even more of a hotbed for antitrust litigation arising from disputes around pharmaceutical patents and generic market entry.

In *Cipro,* the California Supreme Court became the first state high court to apply to state antitrust law the *Actavis* Court's resolution of the developing conflict between patent and antitrust law in the pharmaceutical arena.[4] In the process, the *Cipro* Court created new challenges for state courts analyzing reverse payment settlements. On its face, the *Cipro* decision requires fact finders to assess the strength of a federal patent—an invitation that further expands the growing scope of patent-related state law claims.[5] Whether this is the proper role of a state court judge or jury in a Cartwright Act case will likely be the subject of dispute in the trial and appellate courts in the near future. How California state court judges and juries will apply the new rules articulated in *Cipro* is unclear. What is clear is that *Cipro* continued California's long history as a pioneer in expanding the boundaries of antitrust jurisprudence.[6]

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1 Dylan M. Carson is a partner in the Antitrust and Competition Law Group of Tucker Ellis LLP. Avril G. Love is a counsel in the Antitrust and Competition Law Group of Tucker Ellis LLP. This article reflects the views of the authors and not necessarily those of Tucker Ellis LLP, its attorneys, or its clients.

2 133 S. Ct. 2223 (2013).

3 61 Cal. 4th 116 (2015), *reh'g denied* (July 8, 2015) ("*Cipro*").

4 The court noted that while "*Actavis* is not dispositive on matters of state law" under the Cartwright Act, it was the "latest word" from the United States Supreme Court on "the extent to which antitrust law—whether state or federal—must accommodate patent law's requirements." *Cipro*, 61 Cal. 4th at 141–42.

5 *Gunn v. Minton*, 133 S. Ct. 1059 (2013) (state law claim for legal malpractice in handling patent case does not implicate exclusive jurisdiction of federal courts over cases arising under patent laws).

6 *See, e.g. Cal. v. ARC Am. Corp.*, 490 U.S. 93 (1989) (upholding California state antitrust law allowing indirect purchasers to recover for overcharges).

## II. THE CONFLICT BETWEEN ANTITRUST LAW AND PATENT LAW

At the heart of pay-for-delay lawsuits is the tension between antitrust law and patent law. Antitrust and patent law are intended to coexist.[7] Both are intended to promote innovation and competition. The patent laws provide an incentive to innovate by granting a limited right to exclude others from making, using, or selling a useful new product or invention.[8] The antitrust laws, among other things, prohibit artificial barriers to competition and innovation. As a result, courts grapple with the tension between a patent's grant of the lawful right to exclude and antitrust law's proscription on exclusionary conduct.[9]

It is worth noting that the patent laws do not grant a monopoly in the antitrust sense.[10] Monopoly power is the power to exclude competition or control prices in a relevant market. A patent grants the right to exclude some competition for a limited period of time and can provide a patent holder with a significant barrier to entry against potential competition.[11] But exclusion does not necessarily result in market power.[12] For example, reasonably interchangeable substitutes may exist for the patented invention.[13]

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7 *U.S. v. Line Materials Co.*, 333 U.S. 287, 339 (1948) (Burton, J., dissenting) ("[S]ince the first anti-trust legislation in 1890, the patent laws and the anti-trust laws have coexisted without any irreconcilable conflicts between them.").

8 *See DVD Copy Control Ass'n, Inc. v. Bunner*, 31 Cal. 4th 864, 880 (2003) (discussing how patent law prompts "the independent innovator to proceed with the discovery and exploitation of his invention.") (quoting *Kewanee Oil Co. v. Bicron Corp.,* 416 U.S. 470, 485 (1974)); *Farmland Irrigation Co. v. Dopplmaier,* 48 Cal. 2d 208, 220 (1957) ("The purpose in granting a patent monopoly is to promote progress in science and the useful arts by stimulating invention and encouraging disclosure.").

9 *Simpson v. Union Oil Co.*, 377 U.S. 13, 24 (1964) ("The patent laws which give a 17-year monopoly on 'making, using or selling the invention' are *in pari materia* with the antitrust laws and modify them *pro tanto*."); *U.S. v. Westinghouse Elec. Corp.,* 648 F.2d 642, 646 (9th Cir. 1981) ("There is an obvious tension between the patent laws and antitrust laws. One body of law creates and protects monopoly power while the other seeks to proscribe it.").

10 *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 510 (1917) ("The patent law simply protects [the patent holder] in the monopoly of that which he has invented and has described in the claims of his patent."); *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1367 (Fed. Cir. 1984) ("The patent system, which antedated the Sherman Act by a century, is not an 'exception' to the antitrust laws, and patent rights are not *legal monopolies* in the antitrust sense of that word.") (emphasis in original).

11 *Blonder-Tongue Labs., Inc. v. Univ. of Ill.* Found., 402 U.S. 313, 347 (1971) ("invalid patents [may] serve almost as effectively as . . . valid patents as barriers to the entry of new firms—particularly small firms."); *Lear, Inc. v. Adkins*, 395 U.S. 653, 669 n.16 (1969) ("royalty charged by the patentee serves as a barrier to entry."). *See generally* Richard A. Posner, An Economic Analysis of Law 282 (7th ed. 2007) (discussing effect of patent as barrier to entry).

12 *Ill. Tool Works, Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 45-46 (2006) ("Congress, the antitrust enforcement agencies, and most economists have all reached the conclusion that a patent does not necessarily confer market power upon the patentee. Today, we reach the same conclusion"); *In re Indep. Serv. Orgs. Antitrust Litig.*, 203 F.3d 1322, 1325-26 (Fed. Cir. 2000) ("A patent alone does not demonstrate market power."); *USM Corp. v. SPS Techs., Inc.*, 694 F.2d 505, 511 (7th Cir. 1982) (Posner, J.) ("[O]f course, not every patent confers market power.").

13 *Jefferson Parish v. Hyde*, 466 U.S. 2, 37 n.7 (1984) (O'Connor, J., concurring) ("a patent holder has no market power in any relevant sense if there are close substitutes for the patented product."); *N. Pac. Ry. Co. v. U.S.,* 356 U.S. 1, 10 n.8 (1958) ("Of course it is common knowledge that a patent does not always confer market power over a particular commodity. Often the patent is limited to a unique form or improvement of the product and the economic power resulting from the patent privileges is slight."); *Virginia Panel Corp. v. MAC Panel Co.*, 133 F.3d 860, 872 (Fed. Cir. 1997) ("Violation of the antitrust laws always requires . . . market power in a defined relevant market (which may be broader than that defined by the patent . . .").

A wide array of patent law activity implicates the antitrust laws, from industry standard setting[14] and patent pools,[15] to fighting patent assertion entities[16] and settling patent infringement lawsuits.[17] Recently, the latter category has created a veritable cottage industry of pay-for-delay litigation for government antitrust enforcers and both the plaintiff class action and defense bar in the pharmaceutical industry.

## III. HATCH-WAXMAN AND THE RISE OF PARAGRAPH IV LITIGATION

An explosion of antitrust litigation has grown out of the settlements entered into between branded and generic manufacturers to resolve infringement litigation involving pharmaceutical patents. Such settlements grew rapidly since the 1984 passage of the Hatch-Waxman Act.[18] The Hatch-Waxman Act seeks to expedite and encourage the entry of lower-cost generic pharmaceuticals into the market through a streamlined process for generic manufacturers whereby they are permitted to submit Abbreviated New Drug Applications ("ANDAs") to the Food and Drug Administration, which rely of the applications and information already filed by the branded companies.[19]

One type of ANDA certification permitted under Hatch-Waxman is a Paragraph IV certification, whereby the generic applicant assures the FDA that the branded manufacturer's patent is either invalid or will not be infringed by the proposed generic pharmaceutical.[20] Because the generic manufacturer's submission is considered itself an act of patent infringement, patent litigation is all but certain to follow most Paragraph IV certifications filed before a pharmaceutical patent has expired.[21]

To incentivize generic manufacturers to file such ANDAs and certifications (thereby committing infringement and inviting litigation), Hatch-Waxman provides a 180-day period during which the first ANDA filer has market exclusivity as the only approved generic.[22] This exclusivity period can be very lucrative for a generic manufacturer when a branded drug reaches the "patent cliff," especially in states that have generic substitution laws requiring that prescriptions be filled with generic versions of branded pharmaceuticals.[23]

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14 *See* U.S. Dept. of Justice, Business Review Letter re: IEEE proposed update of its Standards Association's Patent Policy (Feb. 2, 2015), http://www.justice.gov/file/338591/download.

15 *See* Thomas D. Jeitschko & Nanyun Zhang, *Adverse Effects of Patent Pooling on Prod. Dev. & Comm.*, 14 The B.E. J. of Theoretical Econ., 27-57 (2014), http://www.justice.gov/atr/public/eag/283557a.html.

16 *See* Mark S. Popofsky & Michael D. Laufert, *Patent Assertion Entities and Antitrust: Operating Company Patent Transfers*, Antitrust Source (Apr. 1, 2013).

17 *See generally* Herbert Hovenkamp et al., *Anticompetitive Settlement of Intellectual Property Disputes*, 87 Minn. L. Rev. 1719 (2003); Daniel A. Crane, *Exit Payments in Settlement of Patent Infringement Lawsuits: Antitrust Rules and Economic Implications*, 54 Fla. L. Rev. 747 (2002); *U.S. v. Singer Mfg.* Co., 374 U.S. 174 (1963).

18 The Drug Price Competition and Patent Term Restoration Act, Pub. L. No. 98-417, 98 Stat. 1585 (1984) (codified as amended in scattered sections of 15, 21, 28, and 35 U.S.C.).

19 *See Eli Lilly & Co. v. Medtronic, Inc.*, 496 U.S. 661, 676 (1990); 21 U.S.C. § 355(j).

20 *Caraco Pharm. Labs., Ltd. v. Novo Nordisk A/S*, 132 S. Ct. 1670, 1676 (2012); 21 U.S.C. § 355(j)(2)(A)(viii)(IV).

21 35 U.S.C. § 271(e)(2)(A) ("It shall be an act of infringement to submit an application under section 505(j) of the Federal Food, Drug, and Cosmetic Act or described in section 505(b)(2) of such Act for a drug claimed in a patent or the use of which is claimed in a patent").

22 21 U.S.C. § 355(j)(5)(B)(iv).

23 *New York. v. Actavis PLC*, 787 F.3d 638, 644–47 (2d Cir. 2015) (discussing substitution laws and the patent cliff).

Once a potentially infringing ANDA and Paragraph IV certification is filed by a generic manufacturer, if the branded manufacturer files an infringement lawsuit within 45 days, the FDA must withhold approval of the application for two and a half years (unless the litigation resolves sooner than 30 months).[24]

## IV. A BRIEF HISTORY OF REVERSE PAYMENT PATENT LITIGATION

Given the competing incentives of branded and generic manufacturers, further spurred by the Hatch-Waxman Act and state substitution laws, significant patent litigation has arisen as generics have sought to take advantage of the six month exclusivity period. Pharmaceutical patent holders have the right to "enforce [their] patent rights against infringement or contributory infringement,"[25] and have done so often against would-be generic entrants. And, given the high cost of patent litigation, it was inevitable that the branded and generic manufacturers looked for ways to settle these lawsuits.

Some of those settlement agreements have prohibited the generics from entering the market for some agreed period of time.[26] These settlements have also included a payment or transfer of some other value from the branded company to the generic. In the view of some enforcers and judges, the payment to resolve the litigation flowed counterintuitively: from the branded plaintiff to the allegedly infringing generic defendant.[27] As a result, they gained the moniker "reverse payments."[28]

These settlements ultimately attracted the attention of both the Federal Trade Commission and the plaintiffs antitrust bar.[29] In the late 1990s, the FTC began investigating what it called "pay-for-delay" agreements whereby branded manufacturers paid generics

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24 21 U.S.C. § 355(j)(5)(B)(iii).

25 35 U.S.C. § 271(d)(3).

26 *See, e.g., Valley Drug Co. v. Geneva Pharm., Inc.*, 344 F.3d 1294, 1300 (11th Cir. 2003) (agreement not to market an infringing generic drug terminated when either another generic manufacturer marketed a generic product and any exclusivity period expired or patent expired); *In re Tamoxifen Citrate Antitrust Litig.*, 277 F. Supp. 2d 121, 125 (E.D.N.Y. 2003), *aff'd*, 466 F.3d 187 (2d Cir. 2006) (under parties' patent settlement, generic amended its ANDA application to certify that it would not seek to market its generic version of tamoxifen until the patent expired); *Time Ins. Co. v. Astrazeneca AB*, 52 F. Supp. 3d 705, 707 (E.D. Pa. 2014) (reverse payment settlement agreements included promises not enter the market until the expiration of the subject patents); *In re Loestrin 24 Fe Antitrust Litig.*, 45 F. Supp. 3d 180, 185 (D.R.I. 2014) (agreement not to market Loestrin 24 generic until time patent set to expire).

27 *In re Nexium Antitrust Litig.*, 777 F.3d 9, 16 (1st Cir. 2015) ("Unlike traditional settlements, where a party with a claim for damages receives a sum equal to or less than the value of its claim, in reverse payment settlements a party with no claim for damages walks away with money simply so it will stay away from the patentee's market.") (internal quotations omitted); David A. Balto, *Pharmaceutical Patent Settlements: The Antitrust Risks*, 55 Food & Drug L.J. 321, 335 (2000) ("Typically, in patent infringement cases the payment flows from the alleged infringer to the patent holder.").

28 *In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 261 F. Supp. 2d 188, 252 (E.D.N.Y. 2003) ("Reverse payments are a natural by-product of the Hatch-Waxman process.").

29 According to the FTC, "most pharmaceutical patent settlements do not raise antitrust concerns," but when settlements included compensation to the generic entrant, the FTC is committed to challenging them. Prepared Statement of the Federal Trade Commission on Pay-for-Delay Deals: Limiting Competition and Costing Consumers, at 2 n.8, U.S. Senate Committee on the Judiciary, July 23, 2013, https://www.ftc.gov/sites/default/files/documents/public_statements/prepared-statement-federal-trade-commission-pay-delay-deals-limiting-competition-and-costing/130723payfordelay.pdf.

companies to settle patent litigation and refrain from entering the market with generic products.[30] The FTC Staff described these agreements as a "win-win" for the companies because "brand-name pharmaceutical prices stay high, and the brand and generic share the benefits of the brand's monopoly profits," but a loss for consumers who do not see the benefits of dramatically reduced pricing after generic entry.[31]

In 1998, the first of many antitrust lawsuits challenging an alleged pay-for-delay agreement was filed.[32] In consolidated cases involving the hypertension medication Cardizem CD, several states and various direct and indirect purchasers challenged an agreement between the branded manufacturer and a generic that filed its ANDA and Paragraph IV certification seeking 180-day exclusivity.[33] In 2003, the Sixth Circuit held that the agreement paying the generic $40 million per year not to enter the market after the generic had received FDA approval was "a horizontal market allocation agreement and . . . per se illegal under the Sherman Act."[34]

While litigation proliferated, several Courts of Appeal decisions changed the tenor of the debate towards one reflecting the general policy in both patent and antitrust law in favor of settlements. In 2005, the Eleventh Circuit ignored the Sixth Circuit's per se treatment and required an antitrust analysis reflecting "the need to evaluate the strength of the patent."[35] In *Schering-Plough Corp. v. FTC,* the court considered an appeal from an FTC order, which held that a Paragraph IV patent infringement litigation settlement involving a $60 million reverse payment to the generic defendant in exchange for a deferred entry date violated Section 1 of the Sherman Act and Section 5 of the FTC Act.[36] The court rejected the FTC's reliance on the rule of reason analysis and ruled that "[s]imply because a brand-name pharmaceutical company holding a patent paid its generic competitor money cannot be the sole basis for a violation of antitrust law."[37] The court rejected "a rule of law that would automatically invalidate any agreement where a patent-holding pharmaceutical manufacturer settles an infringement case by negotiating the generic's entry date, and, in an ancillary transaction, pays for other products licensed by the generic."[38] Instead, the

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30 Fed. Trade Comm., "Pay-for-Delay: How Drug Company Pay-Offs Cost Consumers Billions" (January 2010), https://www.ftc.gov/reports/pay-delay-how-drug-company-pay-offs-cost-consumers-billions-federal-trade-commission-staff ("Pay-for-Delay FTC Staff Study").

31 Pay-for-Delay FTC Staff Study at 1.

32 *In re Cardizem CD Antitrust Litig.*, 105 F. Supp. 2d 618 (E.D. Mich. 2000).

33 *In re Cardizem CD Antitrust Litig.*, 332 F.3d 896 (6th Cir. 2003). The FTC also filed an administrative complaint in 2000 and secured a consent decree. *See In re Hoechst Marion Roussel, Inc.*, No. 9293 (FTC 2000), https://www.ftc.gov/enforcement/cases-proceedings/9810368/hoechst-marion-roussel-inc-carderm-capital-lp-andrx.

34 332 F.3d at 900. In finding the agreement for delayed-entry in exchange for payment "a classic example of a *per se* illegal restraint of trade," the Sixth Circuit noted that "it is one thing to take advantage of a monopoly that naturally arises from a patent, but another thing altogether to bolster the patent's effectiveness in inhibiting competitors by paying the only potential competitor $40 million per year to stay out of the market." *Id.* at 908.

35 *Schering Plough Corp. v. FTC*, 402 F.3d 1056, 1076 (11th Cir. 2005); *see also Valley Drug*, 344 F.3d 1294.

36 402 F.3d at 1062.

37 *Id.* at 1076.

38 *Id.* at 1076.

Eleventh Circuit ruled that courts must evaluate the "scope of the patent" to determine whether a settlement violates antitrust law: "the proper analysis of antitrust liability requires an examination of: (1) the scope of the exclusionary potential of the patent; (2) the extent to which the agreements exceed that scope; and (3) the resulting anticompetitive effects."[39] Under this "scope-of-the-patent" test, so long as a settlement did not extend beyond the temporal duration or subject matter of the patent (*i.e.,* exclude the generic from entering past the patent period), there was no antitrust violation.

In 2006, the Second Circuit followed the Eleventh Circuit by rejecting *per se* treatment of reverse payment settlements[40] and requiring an analysis of "whether the 'exclusionary effects of the agreement' exceed the 'scope of the patent's protection.'"[41] Two years later, the Federal Circuit chimed in, joining the other circuits in adopting a scope-of-the-patent test.[42] In 2012, the Third Circuit broke from the crowd, holding that reverse payments carried a presumption of illegality under the "quick look" rule of reason antitrust analysis.[43]

## V. *ACTAVIS*: SOMETIMES YOU WIN, SOMETIMES. . . .

After passing on several certiorari petitions, the Supreme Court provided *some* guidance in *Actavis*.[44] Asked whether reverse payments can violate the Sherman Act, the Supreme Court firmly responded, "sometimes."[45]

In January 2009, the FTC filed a federal lawsuit under Section 5 of the FTC Act against several branded and generic manufacturers who settled patent litigation involving AndroGel. The patent litigation arose when the pioneer, Solvay, acquired a patent and FDA approval to market, followed by an ANDA filing by Actavis and certification under Paragraph IV that Solvay's patent was invalid and that the proposed generic medication would not be infringing. In 2006, the patent settlement provided Actavis with nine years of payments of between $19 and $30 million for agreeing not to enter the market until 2015, over five years *before* Solvay's patent expired.[46] The FTC contended that the payments impermissibly

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39 *Id.* at 1066 (*citing Valley Drug*, 344 F.3d at 1312).

40 *In re Tamoxifen Citrate Antitrust Litig.*, 466 F.3d 187, 206 (2d Cir. 2005) ("We do not think that the fact that the patent holder is paying to protect its patent monopoly, without more, establishes a Sherman Act violation.").

41 *Id.* at 213; *see also id.* at 216 ("In the absence of any plausible allegation that the reverse payment provided benefits to Zeneca outside the scope of the tamoxifen patent, the plaintiffs have not stated a claim for relief with respect to the Settlement Agreement.").

42 *In re Ciprofloxacin Hyrdochloride Antitrust Litig.*, 544 F.3d 1323, 1336 (Fed Cir. 2008) ("The essence of the inquiry is whether the agreements restrict competition beyond the exclusionary zone of the patent. This analysis has been adopted by the Second and the Eleventh Circuits and by the district court below and we find it to be completely consistent with Supreme Court precedent.").

43 *In re K-Dur Antitrust Litig.*, 686 F.3d 197, 218 (3d Cir. 2012) (reverse payment to generic patent challenger "is *prima facie* evidence of an unreasonable restraint of trade" but "a patent holder may attempt to rebut plaintiff's *prima facie* case of an unreasonable restraint of trade by arguing that there is in fact no reverse payment because any money that changed hands was for something other than a delay in market entry.").

44 133 S. Ct. 2223 (2013); *see generally* Aaron S. Edlin et al., *Activating Actavis*, 28 ANTITRUST 16 (2013).

45 *Actavis*, 133 S. Ct. at 2227 ("reverse payment settlements such as the agreement alleged in the complaint before us can sometimes violate the antitrust laws.").

46 *Actavis*, 133 S. Ct. at 2229.

compensated a would-be competitor for delaying competition. But the district court and Eleventh Circuit disagreed because the settlement negotiated entry within the temporal scope of the patent (*i.e.,* 65 months before patent expiration).[47]

In June 2013, the Supreme Court swept the scope-of-the-patent test into the dustbin of pharmaceutical antitrust history. In a five-to-three opinion, the Supreme Court held that reverse payment settlement agreements "can sometimes violate the antitrust laws."[48] The Court rejected the by-then widely followed scope-of-the-patent test because referring "simply to what the holder of a valid patent could do does not by itself answer the antitrust question."[49] The Court noted that invalidated patents confer no rights to exclude competition and exact monopoly rents, and that a generic's Paragraph IV certification "put[s] [a] patent's validity at issue, as well as its actual preclusive scope."[50]

The Court held that "a reverse payment, where large and unjustified, can bring with it the risk of significant anticompetitive effects."[51] Rejecting the "quick look" approach and a presumption of illegality, the Court held that the rule of reason is the appropriate antitrust analysis because "the likelihood of a reverse payment bringing about anticompetitive effects depends upon its size, its scale in relation to the payor's anticipated future litigation costs, its independence from other services for which it might represent payment, and the lack of any other convincing justification."[52]

The Court noted "the size of the unexplained reverse payment can provide a workable surrogate for a patent's weakness," leading to an inference that the settlement was purely to forestall potential or actual competition.[53] While settling parties may demonstrate "legitimate justifications" for a large reverse payment under the rule of reason (although the Court appeared skeptical), the Court warned that "[i]f the basic reason is a desire to maintain and share patent-generated monopoly profits, then, in the absence of some other justification, the antitrust laws are likely to forbid the arrangement."[54]

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47 *FTC v. Watson Pharm., Inc.*, 677 F.3d 1298, 1312 (11th Cir. 2012) ("[A]bsent sham litigation or fraud in obtaining the patent, a reverse payment settlement is immune from antitrust attack so long as its anticompetitive effects fall within the scope of the exclusionary potential of the patent.").

48 *Actavis*, 133 S. Ct. at 2227. The Court distinguished reverse payment settlements from more typical litigation settlements because "[i]n reverse payment settlements, . . . a party with no claim for damages (something that is usually true of a paragraph IV litigation defendant) walks away with money simply so it will stay away from the patentee's market." *Id.* at 2233.

49 *Id.* at 2230–31.

50 *Id.* at 2231.

51 *Id.* at 2237.

52 *Id.*

53 *Id.* at 2236–37.

54 *Id.* at 2237; ("[O]ne who makes such a payment may be unable to explain and to justify it; such a firm or individual may well possess market power derived from the patent; a court, by examining the size of the payment, may well be able to assess its likely anticompetitive effects along with its potential justifications without litigating the validity of the patent; and parties may well find ways to settle patent disputes without the use of reverse payments.").

To perform the rule of reason analysis, however, and answer "the basic question—that of the presence of significant unjustified anticompetitive consequences," the Court left it to the lower courts to structure the analysis, as "the quality of proof required should vary with the circumstances."[55]

## VI. *CIPRO* BRINGS *ACTAVIS* TO CALIFORNIA AND THE CARTWRIGHT ACT

Once *Actavis* established that reverse payment pharmaceutical patent settlements are subject to the rule of reason, the lower courts began to struggle with exactly how to structure that analysis.[56]

On May 7, 2015, the California Supreme Court offered its view of how a post-*Actavis* rule of reason analysis of a reverse payment should be conducted in *In re Cipro Cases I & II*.[57] In doing so, the *Cipro* Court offered its own test for identifying whether a Hatch-Waxman settlement violates antitrust law—in this case, the Cartwright Act. And although "the Cartwright Act is broader in range and deeper in reach than the Sherman Act," the guidance in *Cipro* may well impact how federal courts assess the issue under the Sherman Act.[58]

The genesis of the *Cipro* decision was a Paragraph IV litigation settlement that spawned antitrust suits across the country.[59] In 1987, Bayer Corporation secured a patent on ciprofloxacin hydrochloride, the active ingredient in the antibiotic Cipro. In 1991, a generic manufacturer, Barr, filed an application with the FDA to market a generic version of Cipro. Barr certified under Paragraph IV that Bayer's patent was invalid and unenforceable. Bayer filed its patent infringement suit, and Barr counterclaimed for a declaratory judgment that Bayer's patent was invalid. After five years of litigation, the branded and generic manufacturers settled in 1997.[60]

Under the settlement, Barr agreed not to market its own generic version of Cipro until after the patent expired in 2003.[61] Barr was to receive branded Cipro product for licensed resale beginning six months before patent expiration, thereby mirroring the 180-day duopoly the Hatch-Waxman Act would have provided Barr if it had demonstrated invalidity or noninfringement of Bayer's patent.[62] Between 1997 and 2003, Barr received nearly $400 million from Bayer, for which profits from Cipro sales exceeded $1 billion during that time.[63]

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55 *Id.* at 2238.

56 To date, one pay-for-delay case (*In re Nexium*) has been tried to a jury. *In re Nexium (Esomeprazole) Antitrust Litig.*, No. 12-md-02409-WGY (D. Mass. Dec. 2014), Dkt. 1383 (defense verdict).

57 61 Cal. 4th 116 (2015).

58 *Cianci v. Super. Ct.*, 40 Cal. 3d 903, 920 (1985).

59 *See, e.g.*, *Ark. Carpenters Health & Welfare Fund v. Bayer AG*, 604 F.3d 98, 100 (2d Cir. 2010); *In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 544 F.3d 1323; *In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 261 F. Supp. 2d 188 (E.D.N.Y. 2003).

60 *Cipro*, 61 Cal. 4th at 132.

61 *Id.*

62 *Id.*

63 *Id.* at 132–33.

In California, indirect purchasers of Cipro brought nine coordinated class action suits against Bayer and Barr alleging violations of the Cartwright Act, unfair competition law, and the common law prohibition on monopolies. In short, the complaint alleged that Bayer and Barr's settlement of their patent litigation allowed them to preserve and split Bayer's monopoly profits at the expense of consumers.[64]

Following class certification, which was upheld on appeal, the parties stayed the action pending resolution of related federal cases. Based on the scope-of-the-patent test, the Federal Circuit and the Second Circuit both rejected the antitrust claims against Bayer and Barr.[65] Finding those rulings under the Sherman Act dispositive and applying the scope-of-the-patent test, the California trial court granted summary judgment in favor of Bayer and Barr, holding that the settlement agreement did not violate the Cartwright Act.[66] The Court of Appeal upheld summary judgment also based on the scope-of-the-patent test. After the California Supreme Court granted review in 2012, Bayer settled and was dismissed while Barr remained.[67] While the state high court appeal was pending, the United States Supreme Court issued its *Actavis* opinion.

The *Cipro* Court held that "pay-for-delay" Paragraph IV patent settlements are subject to antitrust scrutiny under the Cartwright Act, rejecting the scope-of-the-patent test because it "accords excess weight to the policies motivating patent law, [and] gives insufficient consideration to the concerns animating antitrust law."[68] The Court stated that "[p]arties illegally restrain trade when they privately agree to substitute consensual monopoly in place of potential competition that would have followed a finding of invalidity or noninfringement."[69] Relying on *Actavis,* the Court held that state antitrust law is violated by a reverse payment settlement designed "to maintain *supra*competitive prices to be shared among the patentee and the challenger rather than face what might have been a competitive market."[70]

## VII. THE FOUR PART RULE OF REASON TEST UNDER *CIPRO*

Having established that the Cartwright Act may prohibit reverse payment settlements, the Court purported to set out a structured rule of reason test for courts to identify whether a violation has occurred. To make a prima facie case of illegality, a third-party plaintiff must show four elements regarding a reverse payment patent settlement:

1. The settlement includes a limit on the settling generic challenger's entry into the market;
2. The settlement includes cash or equivalent financial consideration flowing from the brand to the generic challenger;

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64 *Id.* at 133.

65 Ark. Carpenters, 604 F.3d at 106; *In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 544 F.3d at 1336.

66 *Cipro*, 61 Cal. 4th at 133.

67 *Id.*

68 *Id.* at 139.

69 *Id.* at 130.

70 *Id.* at 148 (quoting *Actavis*, 133 S. Ct. at 2236).

3. The consideration exceeds the value of goods and services other than any delay in market entry provided by the generic challenger to the brand, and;

4. The consideration exceeds the brand's expected remaining litigation costs absent settlement.[71]

The first element is requisite to show some restraint of trade, without which there can be no antitrust violation. The second element is intuitive; there is no reverse payment settlement without some kind of "payment." The Court noted that cash payments have given way in practice to other forms of consideration, and thereby clarified for the Cartwright Act what is being debated in the federal courts under *Actavis*[72]—that non-cash consideration in the form of side deals is a payment that will trigger antitrust scrutiny.[73] The third and fourth elements incorporate safe harbors identified in *Actavis* that would justify a payment without implicating an illegal purpose to avoid the risk of competition; *e.g.,* a payment for valuable services or a settlement to avoid anticipated litigation costs is not anticompetitive.[74]

Although a Cartwright Act plaintiff bears the burden of proof as to these four elements, the "burden of producing evidence . . . is a slightly different matter."[75] Because manufacturer defendants have "superior knowledge" about their own litigation costs and the value of any collateral products or services provided to them as part of an agreement, they will bear the burden of production as to the third and fourth elements. "[O]nce a plaintiff has shown an agreement involving a reverse payment and delay, the defendants have the burden of coming forward with evidence of litigation costs and the value of collateral products and services."[76] If the defendants do not produce the requisite evidence, however, the plaintiff will be deemed to have satisfied the showing required for the latter two elements, resulting in a showing on all four elements.[77] If defendants do produce the requisite evidence, the plaintiff must persuade the trier of fact that the reverse payment exceeds the value of services provided and litigation costs saved.[78] The larger the gap between the payment and the value of justifiable consideration, the stronger the inference a jury will be permitted to draw about the anticompetitive effect of the settlement.[79] Satisfying the four elements establishes both a prima facie case that the settlement is anticompetitive and a presumption that a branded manufacturer has market power.[80]

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71 *Id.* at 151.

72 *King Drug Co. of Florence, Inc. v. SmithKlineBeecham Corp.*, No. 14-1243, 2015 WL 3967112 (3d Cir. June 26, 2015) (Hatch-Waxman settlement can still violate Sherman Act where it did not involve cash payment but included agreement by brand manufacturer not to sell authorized generic drug during generic's 180-day market exclusivity period); *In re Nexium (Esomeprazole) Antitrust Litig.*, 968 F. Supp. 2d 367, 392 (D. Mass. 2013) (declining to "limit [the] principles [in *Actavis*] to monetary-based arrangements alone.").

73 *Cipro*, 61 Cal. 4th at 152; *see also Getz Bros. & Co. v. Fed. Salt Co.*, 147 Cal. 115, 118 (1905) (payment for agreement not to compete included with purchase of bulk salt is still illegal).

74 *Cipro*, 61 Cal. 4th at 152-53.

75 *Id.* at 153.

76 *Id.*

77 *Id.*

78 *Id.* at 154.

79 *Id.*

80 *Id.* at 157.

If a plaintiff has made a prima facie showing by satisfying the four elements, then the burden shifts to the defendants to offer "legitimate justifications and come forward with evidence that the challenged settlement is in fact procompetitive."[81] Like the United States Supreme Court, the California Supreme Court appears skeptical that large reverse payments can be justified as procompetitive, but will not foreclose defendants from attempting to meet their burden.[82]

Assuming defendants can offer procompetitive justifications of a reverse payment, a plaintiff may show that those justifications are "unsupportable" to meet its ultimate burden under the rule of reason that defendants have paid for delay in violation of the Cartwright Act.[83]

Though plaintiffs nominally have the ultimate burden throughout the litigation, the true burdens lie with the defendants. Under the *Cipro* test, antitrust plaintiffs can prove their case with very little discovery. The only discovery plaintiffs would have to provide is the subject settlement agreement and the patent issuance and expiration, all of which are public information (through the Federal Trade Commission and the U.S. Patent and Trademark Office).[84] In short, it may be challenging to show the procompetitive effects of an agreement under which a sizable amount of value has been transferred to a would-be competitor—particularly at the motion to dismiss stage.

## VIII. "AVERAGE EXPECTED DURATION": THE NEW MODIFIED SCOPE-OF-THE-PATENT TEST?

Despite the "structured rule of reason" analysis formally adopted in California,[85] the ruling leaves trial courts and litigants with a challenging, if not impossible, task: divining the "average expected duration" of a federal patent being challenged in the Paragraph IV federal patent litigation. The *Cipro* Court explained:

> [T]he relevant benchmark in evaluating reverse payment patent settlements should be no different from the benchmark in evaluating any other challenged agreement: what would the state of competition have been without the agreement? In the case of a reverse payment settlement, the relevant comparison

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81 *Id.*

82 *Id.* at 158.

83 *Id.* at 159; *see Id.* at 160 ("We summarize the structure of the rule of reason applicable to reverse payment patent settlements. To make out a prima facie case that a challenged agreement is an unlawful restraint of trade, a plaintiff must show the agreement contains both a limit on the generic challenger's entry into the market and compensation from the patentee to the challenger. The defendants bear the burden of coming forward with evidence of litigation costs or valuable collateral products or services that might explain the compensation; if the defendants do so, the plaintiff has the burden of demonstrating the compensation exceeds the reasonable value of these. If a prima facie case has been made out, the defendants may come forward with additional justifications to demonstrate the settlement agreement nevertheless is procompetitive. A plaintiff who can dispel these justifications has carried the burden of demonstrating the settlement agreement is an unreasonable restraint of trade under the Cartwright Act.").

84 Medicare Prescription Drug Improvement & Modernization Act of 2003, Pub. L. No. 108-173, §§ 1111-1118, 117 Stat. 2066, 2461-64 (codified as amended at 21 U.S.C. § 355(j)) (requiring branded and generic manufacturers to file patent litigation settlements with the FTC and DOJ).

85 On July 8, 2015, the California Supreme Court denied rehearing of its *Cipro* decision.

> is with the average level of competition that would have obtained absent settlement, *i.e.,* if the parties had litigated validity/invalidity and infringement/noninfringement to a judicial determination.[86]

The Court noted that "*Actavis* makes clear that for antitrust purposes patents are no longer to be treated as presumptively ironclad. This means the period of exclusion attributable to a patent is not its full life, but its expected life had enforcement been sought. This expected life represents the baseline against which the competitive effects of any agreement must be measured."[87] In other words, "[t]he measure of the statutory grant, and the limit on the monopoly that may be preserved by agreement, is the average expected duration that would have resulted from judicial testing."[88]

According to the Court, the objective of a rule of reason test, therefore, is to determine whether a settlement agreement "eliminates competition beyond the point at which competition would have been expected in the absence of an agreement."[89] Indeed, in a *Cipro* analysis, "what matters is whether a settlement postpones market entry beyond the average point that would have been expected at the time in the absence of agreement."[90]

In short, the *Cipro* Court went to great and repeated lengths to explain that the key test of legality is to determine what the "average expected duration" of a particular patent was at the time of settlement of a litigation challenging its validity, and compare that duration to the entry date agreed to in the settlement agreement. According to the Court's logic, if a patent litigation settlement results in a generic manufacturer entering the market later than the "expected duration" that would have resulted from continued litigation, then a settlement may be found anticompetitive. If the settlement results in generic entry earlier than or precisely at the expected duration of the patent being challenged, then there is no anticompetitive effect. From this holding, it appears clear that determining the "average expected duration" of a patent monopoly, assuming a litigation challenge, would be the pivotal challenge for any state court judge or jury considering a reverse payment case under the Cartwright Act.

This new standard begs the question: how exactly does a state court judge or jury determine what the average expected duration of a federal patent would be? Calculating the remaining life of the patent at the time of settlement is an easily determinable fact. But the *Cipro* analysis at its core would require a state court jury to determine the odds that a federal patent would have withstood an attack on its validity.[91] The rationale in this new Cartwright Act standard is that a challenged pharmaceutical patent had a "chance of

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86 *Cipro*, 61 Cal. 4th. at 149; *see id*. at 158 ("[T]he relevant baseline is the average period of competition that would have obtained in the absence of settlement.").

87 *Id*. at 149.

88 *Id*. at 150.

89 *Id*.

90 *Id*. at 158–59; *see also id*. at 150 ("Purchasing freedom from the possibility of competition, whether done by a patentee or anyone else, is illegal. An agreement to exchange consideration for elimination of any portion of the period of competition that would have been expected had a patent been litigated is a violation of the Cartwright Act.").

91 *Id*. at 149 (offering an example that a patent with a 50% "chance of being upheld" in litigation means that "on average, consumers would be subject to a monopoly for half the remaining life of the patent" so a settlement setting generic entry at that halfway mark would not be anticompetitive).

being upheld" in litigation that is somewhere less than one hundred percent (otherwise the litigants would not have settled). The *Cipro* decision makes this fact-finding determination about the strength of a federal patent subject to federal patent litigation the lynchpin to any state court analysis under the Cartwright Act.

To do their jobs, California state court judges and juries would need to assess the strength of a federal patent (pharmaceutical or otherwise) and make factual findings regarding average expected duration at a singular point in time. Establishing average expected duration will surely become a heated topic of dueling expert testimony. Indeed, expert economists are already proposing economic models for how to determine the average expected duration of a patent and how to properly evaluate reverse payment settlements. Judges and juries may be asked to rule based on economic models like this one: $Pr(Loss) \geq (S - C_B) / (B^{no\ entry} - B^{entry})$.[92]

Trial lawyers will be forced to litigate, or re-litigate, patent validity issues from the underlying federal Paragraph IV litigation in the subsequent state antitrust trial. Thus, the new *Cipro* standard has the potential to create a patent trial within an antitrust trial. While this already occurs in certain types of federal patent/antitrust cases,[93] for a state court jury it may well be a bridge too far.

In *Actavis,* Justice Breyer stated that "it is *normally* not necessary to litigate patent validity" to determine if a settlement violates antitrust law because "the size of the unexplained reverse payment can provide a workable surrogate for a patent's weakness, all without forcing a court to conduct a detailed exploration of the validity of the patent itself."[94] The *Cipro* Court also adopted this imprecise proxy for patent strength: "stronger patent, smaller settlement; weaker patent, bigger settlement."[95] The Court stated that "it is entirely possible to resolve an antitrust challenge to a reverse payment patent settlement without adjudicating the patent's validity."[96]

While acknowledging Justice Breyer's opinion (and in fact relying on the non-necessity of litigating the patent in order to assert jurisdiction at the state level), litigating patent validity appears to be a virtual requirement of the *Cipro* Court's new "average expected duration" standard. The *Cipro* Court's rejection of the ironclad scope-of-the-patent test appears to have been followed by the creation of a probabilistic modified scope-of-the-patent test (*i.e.,* what is the scope of the patent assuming a litigation challenge?).

Because the expected duration test explicitly requires concrete calculations—"chance" of litigation success and remaining patent life compared to agreed-upon entry date—it is problematic to rely solely on the size of a reverse payment as a proxy for patent strength. A simplistic "big is bad" rule is not a practical means of assessing antitrust risk to guide conduct; it is an ambiguous quagmire that conflicts with a core principle of antitrust. The United States Supreme Court has "repeatedly emphasized the importance of clear rules in antitrust law."[97] As Justice Breyer has explained:

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92 Joshua Gans & Lisa Cameron, *An Empirical Approach To Reverse Payment Settlements*, Law360 (July 6, 2015), http://www.law360.com/articles/674387/an-empirical-approach-to-reverse-payment-settlements.

93 *See, e.g., Walker Process Equip., Inc. v. Food Mach. & Chem. Corp.*, 382 U.S. 172 (1965).

94 133 S. Ct. at 2236–37 (emphasis added).

95 61 Cal. 4th. at 135, 159.

96 *Id.* at 162, n.21.

97 *Pac. Bell Tel. Co. v. Linkline Commc'ns., Inc.*, 555 U.S. 438, 452 (2009).

> [A]ntitrust rules . . . must be clear enough for lawyers to explain them to clients. They must be administratively workable and therefore cannot always take account of every complex economic circumstance or qualification. . . . They must be designed with the knowledge that that firms ultimately act, not in precise conformity with the literal language of complex rules, but in reaction to what they see as the likely outcome of court proceedings.[98]

The new *Cipro* standard for Cartwright Act liability offers very little in terms of ultimate clarity on what a California state court judge or jury in a reverse payment litigation is likely to do.

## IX. REVERSE PAYMENT LITIGATION WILL HEAT UP IN CALIFORNIA

Despite its internal tension and seeming lack of clarity, the *Cipro* decision has already been heralded by one federal court as "one of the most thorough and thoughtful discussions of *Actavis* yet issued by any court."[99] To be sure, the new standard for a *prima facie* case places a small burden on plaintiffs and a significant burden on defendants. Purchasers and indirect purchasers of pharmaceutical drugs involved in settlements of Paragraph IV patent litigation will no doubt urge reliance on *Cipro* in both federal and state litigation. *Cipro* is likely to make California state court a favored jurisdiction for future antitrust litigation in the pay-for-delay arena. To paraphrase Chief Justice Roberts' dissent in *Actavis:* Good luck to the California Superior Courts.[100]

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98 *Concord v. Boston Edison Co.*, 915 F.2d 17, 22 (1st Cir. 1990).

99 *In re Aggrenox Antitrust Litig.*, No. 3:14-MD-2516 SRU, 2015 WL 4459607 *9 (D. Conn. July 21, 2015) (adopting *Cipro* approach that the period of exclusion attributable to patent is its expected life rather than full statutory grant).

100 *See Actavis*, 133 S. Ct. at 2245 (Roberts, C.J., dissenting).

# A TALE OF TWO STATUTES: *CIPRO*, *EDWARDS*, AND THE RULE OF REASON

*By Steven M. Perry and Sean F. Howell*[1]

## I. INTRODUCTION

This article tells the tale of two statutes that were enacted around the same time, that address many of the same issues, and that were interpreted for over one hundred years in the same way by the California courts. Recently, however, attempts have been made to tear apart these statutory neighbors. We speak, of course, of California's two antitrust statutes: the Cartwright Act, enacted in 1907, and Business & Professions Code section 16600, enacted in 1872.

The operative language of each of these statutes is set out below:

- **Section 16600**
  "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."

- **Cartwright Act—Section 16726**
  "Except as provided in this chapter, every trust is unlawful, against public policy and void."[2]

Although section 16600 and the Cartwright Act each employs absolutist language in describing its reach, the California Supreme Court has long interpreted both statutes as permitting "reasonable" restraints.[3] As a consequence, the Cartwright Act and section 16600 have existed in near-perfect harmony since the former was enacted. Under each statute, certain kinds of restraints on trade were presumed to be anticompetitive and were deemed invalid as a matter of law, while a more thorough analysis of market effects was employed when addressing other types of agreements.

Recently, however, litigants and *amici* have suggested that a 2008 Supreme Court decision, *Edwards v. Arthur Andersen LLP,*[4] created an enormous rift in California's antitrust landscape. Although *Edwards* concerned a covenant not to compete in an employment agreement, some have contended that the *Edwards* court established a broad rule that *all*

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2 A separate Cartwright Act provision, Cal. Bus. & Prof. Code § 16720, lists agreements that constitute an unlawful "trust," including agreements to "create or carry out restrictions in trade or commerce" and those that "prevent competition in manufacturing, making, transportation, sale or purchase of merchandise, produce or any commodity."

3 *See Fisher v. City of Berkeley*, 37 Cal. 3d 644, 665 (1984) ("[u]nder what has become termed the 'rule of reason,' many restraints are analyzed [under the Cartwright Act] in light of their economic effects on market conditions, and may be upheld if 'reasonable' . . .") (quoting *Chi. Bd. of Trade v. United States* 246 U.S. 231, 238 (1918) ("*Chi. Bd. of Trade*"); *Great Western Distillery Prods. v. John A. Walthen Distillery Co.*, 10 Cal. 2d 442, 448-49 (1937) (holding that under the predecessor to section 16600, a limited restriction will not be deemed invalid "although it in some degree may be said to restrain trade").

4 44 Cal. 4th 937 (2008).

agreements that in any way restrain trade, whether in the employment context or in the broader universe of commercial activity, are *per se* void. For example, the California Attorney General filed an amicus brief in the *Cipro* case[5] that asserted that *Edwards* "sets out a general rule in California making all contracts restraining trade illegal *per se* under California law (save for statutory exceptions), and not subject to a rule of reason analysis."[6] The Attorney General's brief relied on a statement in *Edwards* that "[s]ection 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect."[7]

The potential consequences of such a black-and-white legal regime—where all agreements that restrain trade to any extent are void, no matter how procompetitive they might be—are staggering. As Justice Brandeis observed in 1918 in the course of explaining why the Sherman Act forbade only unreasonable restraints, "[e]very agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence."[8] If the California Supreme Court in *Edwards* did, in fact, intend to hold that *all* agreements restraining trade are void, regardless of their procompetitive or limited nature, then every joint venture, lease, distribution agreement, license agreement and many other widely used business agreements that fall under California law would be at substantial risk of invalidation under section 16600.

This article posits that *Edwards*' precedential reach is not nearly so expansive. An examination of the procedural history of the *Edwards* case, both at the Court of Appeal and at the Supreme Court, reveals that those courts had limited the scope of their review and their holdings to non-competition provisions in employment agreements, where California's particularly strong public policy favoring employee mobility would play a significant role in the analysis. It is, of course, fundamental that a decision, even a Supreme Court decision, "is not authority for what is *said* in the opinion but only for the points *actually involved* and actually decided."[9] The *Edwards* court thus should not be presumed to have held invalid large numbers of agreements outside the employment context given that it had explicitly limited its review (and the parties' briefing) to the employment context.

In addition, as we explain in this article, any holding by the *Edwards* court that agreements challenged under section 16600 could never be subjected to a rule of reason analysis would be directly contrary to two California Supreme Court decisions that the *Edwards* court did not mention. It is very unlikely that the Supreme Court intended to overrule at least two of its own longstanding precedents without even mentioning those decisions or explaining why they were no longer good law.[10]

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5 *In re Cipro Cases I & II*, 61 Cal. 4th 116 (2015) ("*Cipro*").

6 Brief of California Attorney General as Amicus Curiae at 13, *Cipro*, 61 Cal. 4th 116 (2015) (March 19, 2014) (No. S198616) 2014 WL 1765268 ("Cal. AG *Cipro* Amicus").

7 *Edwards*, 44 Cal. 4th at 950.

8 *Chi. Bd. of Trade*, 246 U.S. at 238 (1918).

9 *Childers v. Childers*, 74 Cal. App. 2d 56, 61 (1946) (emphasis in original); *see also Trope v. Katz*, 11 Cal. 4th 274, 284 (1995) (quoting *Childers*, 74 Cal. App. at 61).

10 *See Shalala v. Ill. Council on Long Term Care, Inc.*, 529 U.S. 1, 18 (2000) ("This Court does not normally overturn, or so dramatically limit, earlier authority *sub silentio*.").

The *Edwards* opinion is thus best understood as another in a long line of Court of Appeal and Supreme Court cases that have treated employee non-compete agreements as presumptively invalid under section 16600. Under that approach, as described in this article, the mode of analysis under section 16600 would mirror the framework applied in Cartwright Act cases, as most recently described in *Cipro:* (1) Certain categories of agreements and practices that "can be said to always lack redeeming value" may be held *per se* invalid without extensive analysis; and (2) Agreements falling outside the *per se* category will be subject to a "nuanced" analysis of "the circumstances, detail, and logic" of the challenged restraint in order to "determine whether an agreement harms competition more than it helps."[11]

This proposed approach to *Edwards,* and to section 16600 analysis more generally, has two additional virtues: (1) By harmonizing the antitrust analysis applicable to California's two antitrust statutes, the proposed approach recognizes and applies the basic principle of statutory interpretation that courts "should adopt[ ] the construction that best harmonizes the statute internally and with related statutes;"[12] and (2) The proposed approach acknowledges that the California Legislature has "effectively codifie[d]" the traditional rule of reason in Cal. Bus. & Prof. Code § 16725, which provides that "[i]t is not unlawful to enter into agreements or form associations or combinations, the purpose and effect of which is to promote, encourage or increase competition in any trade or industry, or which are in furtherance of trade."[13]

In the pages that follow, we first describe the analytical framework set out by the California Supreme Court in *Cipro*. We then trace the history of section 16600 jurisprudence and explain how the California courts developed a two-pronged analytical framework for section 16600 claims that essentially mirrored the framework used by courts to address Sherman Act and Cartwright Act claims, set out most recently in *Cipro*. Finally, we explain why *Edwards* fits comfortably into the courts' two-pronged approach to section 16600 claims, and why it would be inappropriate to assume that the *Edwards* court intended to create a schism between section 16600 and the Cartwright Act by holding that all restraints on trade, no matter how limited or procompetitive, are void under section 16600.

## II. *CIPRO* AND THE RULE OF REASON UNDER THE CARTWRIGHT ACT

At issue in *Cipro* was the legality of "reverse payment" settlements of patent lawsuits involving pharmaceutical companies. The *Cipro* court described such settlements as involving a payment by a plaintiff (a brand-name drug manufacturer that holds fundamental patents on a drug) to a defendant (a generic drug manufacturer that has announced plans to enter the market for that drug).[14] In return for the payment by the patentholder, the generic drug manufacturer drops its challenges to the validity of the plaintiffs' patents and often agrees to stay out of the market for a period of time.[15] The case before the court involved consumer class actions under the Cartwright Act that had been filed against a brand-name drug manufacturer and a generic manufacturer who had reached such a settlement agreement in 1997.[16]

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11 *Cipro*, 61 Cal. 4th at 147.

12 *Pac. Gas & Elec. v. Stanislaus*, 16 Cal. 4th 1143, 1152 (1997).

13 *Cipro*, 61 Cal. 4th at 137 n.5 (quoting Cal. Bus. & Prof. Code § 16725).

14 *Cipro*, 61 Cal. 4th at 130.

15 *Id.*

16 *Id.* at 133.

The relevant portions of the *Cipro* decision for our purposes are those where the court addressed the analytical framework that would be used to decide the plaintiffs' Cartwright Act claims. The court began by explaining that although "the Cartwright Act is written in absolute terms, in practice not every agreement within the four corners of its prohibitions has been deemed illegal. "[17] Put differently, "deciding antitrust illegality is not as simple as identifying whether a challenged agreement involves a restraint of trade[18]," despite the "superficially absolute language" used in the Cartwright Act.[19] Instead, courts must "determine whether an agreement harms competition more than it helps," for "only unreasonable restraints of trade are prohibited."[20]

After surveying the historical development of the rule of reason under both federal and California antitrust law, the *Cipro* court confirmed that the rule of reason will continue to be applied to Cartwright Act claims unless the challenged restraint falls into one of the "categories of agreements or practices that can be said to always lack redeeming value and thus qualify as per se illegal," such as cartel agreements.[21] The *Cipro* court placed in the presumptively illegal category all agreements between competitors "to establish or maintain a monopoly."[22]

The *Cipro* court also explained that there is no rigid formula that courts must use when applying the rule of reason. Instead, because "nothing in the text of the Cartwright Act dictates the precise details of the per se and rule of reason approaches," the courts should consider "the circumstances, details, and logic" of the challenged restraint and employ a "nuanced" approach in order to achieve the ultimate goal of determining whether an agreement is "unreasonable."[23] The *Cipro* court also concluded that courts faced with a Cartwright Act challenge "must consider not simply whether per se or rule of reason analysis applies" in the case before it.[24] Instead, if and to the extent that a rule of reason analysis applies, a court "must also consider how the analysis should be structured to most efficiently differentiate between reasonable and unreasonable restraints of trade" in the case at hand.[25] The *Cipro* court proceeded to develop that structure, as applied to the patent settlements before it, at some considerable length.[26]

As noted in the introduction to this article, some *amici* in *Cipro* contended that the Supreme Court should, in considering the validity of the agreements at issue in that case, apply a per se standard instead of the "nuanced," multi-factor analysis that the court eventually chose as the appropriate approach under the Cartwright Act. The California Attorney General's office, in particular, urged the Supreme Court to harmonize the

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17 *Id.* at 136.

18 *Id.* at 145.

19 *Id.* at 145–46 (quoting *Marin County Bd. of Realtors, Inc. v. Palsson*, 16 Cal. 3d 920, 930 (1976)).

20 *Id.* at 145.

21 *Id.* at 146.

22 *Id.* at 148. As examples of such presumptively unlawful agreements, the *Cipro* court cited, *inter alia*, the agreements at issue in two early section 16600 cases: *Vulcan Powder Co. v. Hercules Powder Co.*, 96 Cal. 510, 514-15 (1892), and *Getz Bros. & Co. v. Fed. Salt Co.*, 147 Cal. 115, 119 (1905).

23 *Id.* at 146–147 (quoting *Cal. Dental Assn. v. FTC*, 526 U.S. 756, 781 (1986)).

24 *Id.* at 147.

25 *Id.*

26 *Id.* at 149–160.

Cartwright Act with section 16600 by adopting what it described as the holding in *Edwards* that "all contracts restraining trade [are] illegal per se [under section 16600] and not subject to a rule of reason analysis."[27] Under that approach, the court's analysis of the agreements at issue in *Cipro* would have begun *and* ended with the "simple" question of "whether a challenged agreement involves a restraint of trade."[28]

Although the *Cipro* court did not adopt the per se standard that it had been encouraged to embrace, it also did not comment on the scope of section 16600 or on the proper interpretation of the Supreme Court's earlier opinion in *Edwards*. We thus still face, and in this article try to answer, the question of whether section 16600 requires a black-and-white approach to *all* challenged agreements or should be interpreted as invalidating only unreasonable restraints. Answering that question requires, in part, a thorough understanding of section 16600's interpretation and application since its enactment in 1872. We turn to that history now, in principal part to explain why the broad statements in *Edwards* about the reach of section 16600 only make sense—and are only consistent with longstanding precedents—if *Edwards'* holdings are confined to non-compete provisions in employment agreements.

## III. SECTION 16600 AND THE RULE OF REASON: THE HISTORY

### A. The First Seventy Years (1868-1938)

In 1868, prior to California's enactment of any statute governing restraints of trade, the California Supreme Court in *Wright v. Ryder* addressed the legality at common law of a restrictive covenant involving a steamboat called the "New World."[29] The California Steam Navigation Company had sold the New World to the Oregon Steam Navigation Company for $75,000 and had extracted a covenant barring said steamboat from traveling on any California river, bay or other body of water for ten years. After a series of subsequent transactions, the New World ended up in the hands of James Ryder, who had purchased it to move passengers and freight between San Francisco and Vallejo. Only upon taking possession of the New World did Ryder learn of the covenant that barred the vessel from sailing in California waters. He then refused to pay for the boat, and litigation ensued.[30]

The primary question for the Supreme Court in *Wright* was the legality at common law of the restrictive covenant at hand. The court held the covenant invalid, but not without a lengthy history lesson:

> The general principles which govern contracts in restraint of trade are well settled, both in England and the United States. They proceed on the theory that the public welfare demands that private citizens should not be allowed, even by their own voluntary contracts, to restrain themselves unreasonably from the prosecution of trades, callings, or professions, or from embarking in business enterprises in the promotion and encouragement of which the public has an interest.

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27 *See* Cal. AG *Cipro* Amicus, *supra* note 6, at 15.

28 *Cipro*, 61 Cal. 4th at 145 (describing the starting point for Cartwright Act analysis).

29 36 Cal. 342 (1868).

30 *Id.* at 342-47.

> At an early period in English jurisprudence, when trade and the mechanic arts were in their infancy, it was deemed a matter of the greatest public importance to encourage their growth and to prohibit contracts which tended to abridge them. Hence the rule first established was, that all contracts were void which in any degree tended to the restraint of trade, even in a particular, circumscribed locality, either for a definite or unlimited period. But as population and trade increased, and there was consequently a greater competition in all useful pursuits, the necessity for the stringent rule which before prevailed had in a greater measure ceased, and the rule itself was greatly relaxed and modified . . . Instead of denouncing as void all contracts in restraint of trade, the rule, as relaxed, tolerated such as were restricted in their operations within reasonable limits.[31]

After reciting this history, the *Wright* court examined the covenant before it and found it to be void under a "long line of adjudications in England and America" that invalidated any covenant that restrained a party from operating a business in an *entire* state or nation.[32]

The *Wright* decision was followed in short order by the legislature's enactment in 1872 of California's first antitrust statute, section 1673 of the California Civil Code, which provided that:

> Every contract by which anyone is restrained from exercising a lawful profession, trade or business of any kind, otherwise than is provided by the next two sections, is to that extent void.[33]

The California Supreme Court did not explore this new statute's scope or meaning until 1892, some twenty years later. That year, in *Vulcan Powder Co.,* the court addressed a cartel agreement involving a group of dynamite manufacturers.[34] The manufacturers had agreed to production quotas and territorial limitations and had ceded pricing authority to a committee made up of cartel members.[35] When one of those members, Vulcan Powder, sued the other members for reneging on the deal, a defendant successfully demurred on the ground that the agreement restrained trade in violation of section 1673.[36] The Supreme Court affirmed the dismissal, holding that the agreement was "clearly in restraint of trade and against public policy."[37]

The court in *Vulcan Powder* prefaced its holding with a brief description of the common law principles that had governed claims of restraint of trade prior to section 1673's enactment, including the principle that "contracts in which the restraint was confined to reasonable

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31 *Id.* at 357 (paragraph breaks added).

32 *Id.* at 362. The *Cipro* court cited the covenant at issue in *Wright* as an example of agreements not to compete that are *per se* unlawful. *Cipro*, 61 Cal. 4th at 148.

33 The referenced exceptions involved covenants attendant to the sale of a business (Cal. Civ. Code § 1674) and to the dissolution of a partnership (Cal. Civ. Code § 1675), which were deemed legal in certain circumstances. Sections 1673-75 were moved into the Bus. & Prof. Code in the 1941 recodification as sections 16600-16602, with a few slight edits to the text. Cal. Bus. & Prof. Code § 16600 currently provides that: "[E]xcept as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."

34 96 Cal. at 514–15.

35 *Id.*

36 *Id.* at 512–13.

37 *Id.* at 515.

limits of time or place, and which were founded upon sufficient consideration," were valid.[38] The court explained that this common law rule "was uncertain, and led to much perplexing legislation," and had been replaced by section 1673.[39]

It is possible to construe this passage in *Vulcan Powder* as adopting a *per se* rule that *all* agreements that restrained trade in *any* respect are void under section 1673 unless they fall within the enumerated exceptions in sections 1674–75. The court in *Vulcan Powder* did not, however, simply invoke a blanket rule. Instead, in order to confirm that the agreement before it should be condemned as "clearly in restraint of trade," it engaged in a thorough review of the agreement that focused on the territorial and geographic extent of the restraints, the particularities of the production quotas agreed to, the procedure by which a cartel member would transfer its excess profits to other members if it exceeded its quota, and the fact that the pricing committee had the power to fine members who sold their dynamite at lower-than-allowed prices.[40] Only after that examination did the court find that the cartel agreement was "clearly in restraint of trade and against public policy."[41]

Subsequent California Supreme Court decisions demonstrated that *Vulcan Powder's* per se approach was limited to cartel cases and other pernicious restraints, while the rule of reasonableness would be applied to other claims under section 1673. In 1909, for example, the Supreme Court held squarely that section 1673 did not invalidate reasonable restraints on trade. The plaintiff in *Grogan v. Chaffee,* Charles Grogan, claimed to have invented a process for making "pure" olive oil, and he had gained a loyal following for his product through savvy advertising.[42] Grogan was also an early adopter of the shrink-wrap license—affixing a notice to every container of olive oil he sold that was intended to bind purchasers to "maintain [Grogan's] fixed retail selling price" if they resold the olive oil.[43] When H.G. Chaffee, a Pasadena grocer, resold Grogan's olive oil for less than the stipulated price, Grogan sought an injunction, claiming that Chaffee was violating the pricing restriction that had accompanied Chaffee's purchase of the olive oil.[44] The trial court dismissed Grogan's claims after concluding, *inter alia,* that the pricing restriction violated section 1673.[45]

The Supreme Court reversed, holding that section 1673 only barred unreasonable restraints of trade.[46] The court observed that "[t]he tendency of the modern decisions has been to view with greater liberality contracts claimed to be in restraint of trade."[47] Moreover, "[i]t is not every limitation on absolute freedom of dealing that is prohibited. . . . 'The question is whether, under the particular circumstances of the case, and the nature of the particular contract involved

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38 *Id.* at 513 (citing *Wright*, 36 Cal. 356).

39 *Id.*

40 *Vulcan Powder*, 96 Cal. at 515.

41 *Id.*

42 156 Cal. 611, 612 (1909).

43 *Id.*

44 *Id.* at 613.

45 *Id.*

46 *Id.* at 614–15.

47 *Id.* at 615.

in it, the contract is, or is not, unreasonable.'"[48] The *Grogan* court further held that "it must be taken to be settled" that section 1673 is "to be construed in the light of these [common law] principles."[49] The court distinguished *Vulcan Powder* on the ground that "the objectionable feature of the agreement" in that case was its "tendency to create a monopoly."[50]

The California Supreme Court soon signaled, however, that it would take a much stricter approach to agreements that restrained an individual's ability to practice his chosen profession. The defendant in a 1916 case, *Chamberlain v. Augustine,* had sold an interest in a Los Angeles-based foundry to the plaintiffs.[51] The defendant had agreed as part of the sale that if he conducted a foundry business in California, Oregon, or Washington in the following three years, he would pay $5,000 in liquidated damages to the plaintiffs.[52] Shortly after signing the agreement, the defendant took over a Los Angeles-based foundry, and the plaintiffs sued to recover the liquidated damages.[53] The trial court entered judgment for the defendant on the ground that the parties' agreement was invalid under section 1673. On appeal, the court rejected plaintiffs' argument that the covenant was valid because it acted as only a partial restraint and allowed the defendant to work at a foundry outside of the three designated states. "The obvious answer to" plaintiffs' argument, the court stated, "is the very language of section 1673," which made "no exception in favor of contracts only in partial restraint of trade."[54]

The court also discussed the application of section 1673 in a 1922 case, *Morey v. Paladini,* that involved territorial restrictions on the sale of lobsters.[55] The plaintiff had entered into contracts with fishing companies to buy virtually the entire supply of lobsters caught on the West Coast.[56] The defendant agreed to purchase certain quantities of lobsters from the plaintiff, who in turn agreed that the defendant would have the exclusive right to sell plaintiffs' lobsters in northern California and three western states."[57] After the defendant failed to purchase the agreed-upon quantities of lobsters, the plaintiff recovered $4,500 in damages in the trial court.[58] On appeal, the defendant raised an illegality defense, arguing that the agreement violated the Sherman Act.[59]

The California Supreme Court held that the parties' agreement was unlawful under the Sherman Act because it was "intended to effect a virtual monopoly of the lobster trade in the central and northern portions of this state, and so far as shipments to Oregon, Washington, and Nevada were concerned."[60] The court then discussed the question of

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48 *Id.* (quoting *Gibbs v. Consolidated Gas Co.*, 130 U.S. 396, 409 (1889)).

49 *Id.*

50 *Id.* at 613.

51 172 Cal. 285, 286–87 (1916).

52 *Id.*

53 *Id.* at 287.

54 *Id.* at 288–89.

55 187 Cal. 727, 732, 739 (1922).

56 *Id.*

57 *Id.*

58 *Id.* at 733.

59 *Id.*

60 *Id.* at 737.

whether the parties' contract also violated section 1673, even though neither party had addressed that statute.[61] The court stated that "[s]o far as our own statute is material," there was "no doubt" that the agreement was intended to create "a monopoly of the lobster business in the selected territory" and was therefore void under section 1673.[62] The court followed *Chamberlain* and an 1888 decision, *Santa Clara Valley Mill & Lumber Co. v. Hayes,* where the court had relied on the common law to strike down a cartel agreement in the lumber industry without mention of section 1673.[63]

In 1933, the Supreme Court reaffirmed the position it had set out in *Grogan*—that the ordinary analytical framework for a claim brought under section 1673 is "whether, under the particular circumstances of the case, and the nature of the particular contract involved in it, the contract is, or is not, unreasonable."[64] The plaintiff in *Associated Oil Co. v. Myers* had leased a service station from the defendants.[65] The lease gave the plaintiff the exclusive right to use the property for advertising its gasoline products, while allowing the defendants to continue operating the gas station as long as they bought all their gasoline from the plaintiff.[66] When the defendants began to purchase and sell gasoline from other vendors, the plaintiff sought injunctive relief.[67] The trial court sustained defendants' demurrer, in part on the ground that the parties' agreement was void under section 1673.[68]

The Supreme Court reversed, finding that the contractual restraints were reasonable and thus were not invalid under section 1673.[69] The court did not rely on the statutory exceptions set out in sections 1674 and 1675, finding them inapplicable. Instead, it applied *Grogan* and held squarely that in cases where the public welfare is not involved, and the challenged agreement does not fix prices or limit production, a restraint may be upheld if it is "reasonable."[70] The court also distinguished *Morey* and *Santa Clara Valley Mill & Lumber* on the ground that the contracts in those cases were designed "to secure a complete monopoly. . . ." and thus were *per se* void under section 16600.[71]

In 1937, California's Supreme Court again held squarely that section 1673 challenges are subject to the application of the rule of reason. In *Great Western Distillery Prods. v. John A. Wathen Distillery Co.,*[72] the plaintiff had obtained exclusive rights to sell the defendant's

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61 *Id.* at 736–38.

62 *Id.*

63 76 Cal. 387 (1888).

64 Grogan, 156 Cal. at 615 (quoting *Gibbs*, 130 U.S. at 409).

65 217 Cal. 297, 299 (1933).

66 *Id.* at 299–300.

67 *Id.*

68 *Id.* at 300.

69 *Id.* at 306.

70 *Id.*

71 *Id.* at 305.

72 10 Cal. 2d 442 (1937).

whiskey receipts (which were essentially securities) in certain territories.[73] When the defendant distillery breached the agreement by selling its receipts to other purchasers in the excluded territories, the plaintiff sued, complaining that its efforts to advertise the securities had gone to waste.[74] The defendant contended that the contract was invalid as an unreasonable restraint of trade under section 1673.[75] The trial court agreed and dismissed plaintiffs' claims.

The Supreme Court held that the trial court had erred in holding the agreement invalid. The court synthesized the cases interpreting section 1673 and endorsed "[t]he decisions in this state [that] have recognized and applied the distinction made by authority elsewhere that if the public welfare be not involved and the restraint upon one party be not greater than protection to the other requires, the contract will be sustained although it in some degree may be said to restrain trade."[76] The court then upheld the contract at issue because the exclusivity provision was reasonable under the circumstances: "[s]uch a limited restriction does not appear to affect the public interests and is obviously designed only to protect the respective parties in dealing with each other. Furthermore, it does not appear that it was the intent of the parties to control by monopoly the market price of the securities or in any manner to interfere with the normal fluctuations resulting from the law of supply and demand."[77]

The *Great Western* court also distinguished *Chamberlain* and *Morey*. The court suggested that the exclusive dealing contract for lobsters in *Morey* had run afoul of antitrust laws because "the evidence showed that the purpose of the plaintiff's assignor was to control the entire shipment of lobsters into the territory. . . ."[78] In other words, the challenged agreement in *Morey* was void under section 1673 not merely because it restrained trade, but because it threatened to create a monopoly that eliminated all competition in the market at hand.[79] As for *Chamberlain,* the court concluded that the employee non-compete agreement in that case had been "directly within the contemplation" of section 1673, because it had prevented the individual plaintiff from practicing his chosen profession.[80]

The court in *Great Western* thus could not have been clearer: Section 1673 does not invalidate "reasonable" restraints of trade, and many section 1673 claims should be analyzed using the traditional rule of reason approach.[81] In reaching this conclusion, the court cited and relied on several seminal cases decided by the United States Supreme Court in

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73 *Id.* at 444–45. Warehouse receipts are notes that convey an ownership interest in goods stored in warehouses. Whiskey distillers would sell receipts in whiskey after they barreled it, to pay for the expense of keeping the whiskey in the warehouse as it aged. *See* Hugh F. Owens, Securities and Exchange Commission, *A Review of the SEC's Enforcement Program* (Oct. 8, 1973), https://www.sec.gov/news/speech/1973/100873owens.pdf.

74 10 Cal. 2d at 445.

75 *Id.*

76 *Id.* at 448–49 (citing, *inter alia*, Assoc. Oil, 217 Cal. 297, and Grogan, 156 Cal. 611).

77 *Id.* at 449–50.

78 *Id.* at 447–48.

79 *Id.*

80 *Id.* at 448.

81 *Id.* at 448–49.

connection with the Sherman Act.[82] Indeed, the federal courts' somewhat circuitous path to the adoption of the rule of reason in Sherman Act cases is similar to the path taken by the California courts with respect to section 16600, and is thus worth reviewing here.

The Sherman Act, which was enacted in 1890, made illegal "[e]very contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States. . . ."[83] Initially, the United States Supreme Court held 5-4 that the Sherman Act outlawed *all* restraints of trade, regardless of whether they were reasonable or not.[84] The Court reasoned that "the plain and ordinary meaning of [the Sherman Act] is not limited to that kind of contract alone which is in unreasonable restraint of trade, but all contracts are included in such language, and no exception or limitation can be added without placing in the act that which has been omitted by congress."[85]

The United States Supreme Court "soon retreated from this manichean view" of the Sherman Act.[86] In 1911, the court explained that its holding in *Trans-Missouri* had necessarily included a reasoned consideration of "the nature and character of the contract or agreement" at issue, and it held that it would in the future resort to the rule of reason when determining whether any particular agreement violated the statute.[87] Several years later, Justice Brandeis provided a more nuanced explanation of why Sherman Act claims would be governed in part by the multi-faceted analysis that undergirds the rule of reason:

> [T]he legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable.[88]

As noted above, the California Supreme Court in *Great Western* cited and "applied" Justice Brandeis' reasoning in *Chi. Bd. of Trade* (and other Sherman Act cases) in the course of holding that section 16600 did not invalidate all agreements that restrained trade.[89] It was

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82 *Id.* at 449 (citing, *inter alia*, *Chi. Bd. of Trade*, 246 U.S. 231; *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 360–61 (1933); and *United States v. Am. Tobacco Co.*, 221 U.S. 106, 179–80 (1911)).

83 15 U.S.C. § 1.

84 *United States v. Trans-Missouri Freight Ass'n*, 166 U.S. 290, 328 (1897).

85 *Id.*

86 *Fisher v. City of Berkeley,* 37 Cal. 3d 644, 700 (1984).

87 *Standard Oil Co. v. United States,* 221 U.S. 1, 64–65 (1911).

88 *Chi. Bd. of Trade*, 246 U.S. at 238.

89 *Great Western*, 10 Cal. 2d at 449. The California Supreme Court also cited *Chicago Bd. of Trade* in 1953 in explaining that "it may be assumed that the broad prohibitions of the Cartwright Act are subject to an implied exception to the one that validates reasonable restraints of trade under the federal Sherman Antitrust Act," *People v. Bldg. Maint. Contactors' Ass'n*, 41 Cal. 2d 719, 727 (1953), and again in 1984, when it observed that "under what has been termed the 'rule of reason,' many restraints are analyzed in light of their economic effects on market conditions, and may be upheld if 'reasonable.'" Fisher, 37 Cal.3d at 665 (quoting *Chi. Bd. of Trade*, 246 U.S. at 238).

thus very clear by 1937 that the California Supreme Court, like the United States Supreme Court, had embraced the rule of reason as the primary mode of analysis in determining whether an agreement survived antitrust scrutiny.

### B. The Next Seventy Years Of Section 16600 Jurisprudence (1938-2008)

During the seventy years between the *Great Western* decision in 1937 and the Supreme Court's 2008 decision in *Edwards,* the California courts continued their practice of applying a two-pronged approach to section 1673 and section 16600 challenges: (1) Non-compete provisions in employment agreements were deemed presumptively invalid; and (2) The courts applied a reasonableness test to section 1673 and section 16600 challenges in cases outside of the employment context. For example, in a 1940 case, *Keating v. Preston,* the California Court of Appeal upheld a provision barring a lessor from leasing space to competing businesses, observing that "[t]he modern trend of authorities . . . is to construe such statutes as section 1673 of the Civil Code, and contracts between individuals intended to promote rather than to restrict a particular business, '[i]n the light of reason and common sense' so as to uphold reasonable limited restrictions."[90]

Forty years after *Keating,* the California Court of Appeal held in *Centeno v. Roseville Community Hospital* that a hospital's exclusive arrangement with a group of radiologists was valid under section 16600.[91] The court in that case held that "there must be a balancing test in light of *all* the circumstances to determine the validity of such an agreement," in part because "the antitrust laws prohibit only those contracts which unreasonably restrain competition."[92] The California Court of Appeal in *Martikian v. Hong* similarly relied on *Great Western* in upholding a provision in a shopping center lease that gave a lessee the exclusive right to sell liquor in the center while prohibiting him from selling anything other than liquor.[93] The court held that "only those restraints which *unduly* or *unreasonably* interfere with trade and commerce have been subject to . . . condemnation" under California's antitrust statutes.[94]

It appears that unlike the Courts of Appeal, the California Supreme Court did not, in the seventy-year period between *Great Western* and *Edwards,* consider the applicability of the rule of reason under section 1673 or section 16600 outside of the employment context.[95]

During this same period of time (after *Great Western* was decided in 1937 and before *Edwards* was decided in 2008), the California Courts of Appeal and the California Supreme Court also addressed section 16600 claims involving non-competition provisions in employment agreements. Those courts consistently held such provisions to be invalid and did so without any substantive analysis of market effects. For example, the Supreme Court held in 1965 that section 16600 "invalidate[d]" a provision in an employment contract

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90 42 Cal. App. 2d 110, 123 (1940) (quoting *Great Western*, 10 Cal. 2d at 446).

91 107 Cal. App. 3d 62, 72 (1979).

92 *Id.* at 70, 72 (emphasis in original).

93 164 Cal. App. 3d 1130, 1133 (1985).

94 *Id.* (emphasis in original).

95 The Supreme Court did observe in a 1951 case that section 16600 "has not been deemed to avoid express restrictive covenants as to the use of retained premises frequently incorporated in leases." *Stockton Dry Goods Co. v. Girsh*, 36 Cal. 2d 677, 680 (1951).

that forfeited an employee's pension rights if he were to work for a competitor.[96] Similarly, the Court of Appeal in *Metro Traffic Control, Inc. v. Shadow Traffic Network*[97] held invalid several post-employment non-competition provisions in the employment agreements of traffic reporters and producers. The court noted that "Section 16600 has specifically been held to invalidate employment contracts which prohibit an employee from working for a competitor when the employment has terminated, unless necessary to protect the employer's trade secrets."[98] The Court of Appeal arrived at a similar result in *D'Sa v. Playhut, Inc.,*[99] holding that an employer could be sued for wrongfully terminating an employee when the employee refused to sign a "very broad covenant not to compete" that, the court held, was unenforceable as a matter of law.[100]

It is clear from the foregoing discussion that California's courts had, over the course of the twentieth century, developed two separate strands of case law applying section 1673 and section 16600 to alleged restraints of trade. On the one hand, if the restraint involved a restrictive covenant arising from an employer-employee relationship, or if the challenged agreement involved such classic cartel conduct as price-fixing or supply restrictions, the restraint was deemed per se invalid and void. If, on the other hand, the challenged restraint arose outside the employer-employee context and did not involve cartel conduct, the courts would engage in a more robust "reasonableness" inquiry into the extent and scope of the restraint, its procompetitive nature, and its impact on the market in question. The Ninth Circuit, however, had taken a different approach to section 16600 by declining to apply a per se rule to employee non-competes.

That brings us to *Edwards* and to the question that we posed in the introduction to this article: Did the *Edwards* court intend to hold that *all* restraints on trade are per se invalid under section 16600, regardless of their duration, scope or market impact, and regardless of whether they are procompetitive? In the next section of this article, we present an answer to that question, along with a proposal for reconciling *Edwards* with existing precedent and with long-settled antitrust and jurisprudential principles.

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96 *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal. 2d 239, 242–3 (1965) (citing Chamberlain, 172 Cal. at 288).

97 22 Cal. App. 4th 853 (1994).

98 *Id.* at 859 (citing *Muggill*, 62 Cal. 2d at 242).

99 85 Cal. App. 4th 927, 931–34 (2000).

100 The Ninth Circuit, however, took a different approach to employee non-competition agreements in a series of cases beginning with its 1987 decision in *Campbell v. Bd. of Trustees*, 817 F.2d 499 (9th Cir. 1987). The Ninth Circuit declined in these cases to apply a *per se* standard to employee non-competes and instead construed section 16600 as prohibiting only those employee covenants that completely restrained the employee from practicing his profession. The Ninth Circuit approach came to be known as the "narrow-restraint" exception to section 16600. *See Edwards*, 44 Cal. 4th at 949.

## IV. DID THE *EDWARDS* COURT HOLD THAT ALL RESTRAINTS ON TRADE, NO MATTER HOW LIMITED OR PROCOMPETITIVE, ARE *PER SE* INVALID UNDER SECTION 16600?

### A. *Edwards v. Arthur Andersen LLP*

*Edwards* involved a dispute over a non-competition agreement between accounting firm Arthur Andersen LLP and Raymond Edwards, an employee.[101] The firm shuttered its United States operations in 2002 after being indicted during the federal government's investigation into the failure of Enron.[102] In connection with that development, Andersen sold off various practice groups, including the group that Edwards worked in, to HSBC.[103] Although HSBC offered Edwards a job, it required him to obtain a release from Andersen of his non-competition agreement. But Andersen would not release any employee from her or his non-compete unless the employee agreed to release Andersen from all claims for further compensation, which Edwards was unwilling to do.[104] At that point, HSBC withdrew its offer to Edwards, Andersen fired Edwards, and Edwards sued for intentional interference with prospective economic advantage.[105] Edwards contended that Andersen's refusal to release him from the non-compete agreement constituted the "wrongful act" required for an intentional interference claim because the non-compete violated section 16600.[106]

Andersen argued that its agreement with Edwards, while restraining him in certain ways from practicing his profession, was nonetheless "reasonable"—and thus not in violation of section 16600—because it had, on balance, an insignificant or pro-competitive effect on the market.[107] The trial court agreed, finding that the agreement did not violate section 16600 because it was "narrowly tailored" and did not completely deprive Edwards of the ability to pursue his profession.[108]

The California Court of Appeal reversed and rejected the trial court's conclusion that section 16600 allowed the use of "narrow restraints" in employment contracts.[109] The court concluded that "[i]n our view, section 16600 prohibits noncompetition agreements between employers and employees even where the restriction is narrowly drawn and leaves a substantial portion of the market available for the employee."[110]

The Supreme Court affirmed and "conclude[d] that section 16600 prohibits employee noncompetition agreements unless the agreement falls within a statutory exception. . . ."[111] The court also stated broadly that "[t]oday in California, covenants not to compete are void, subject to several exceptions discussed briefly below."[112] The court further observed that:

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101 44 Cal. 4th at 942.

102 *Id.*

103 *Id.* at 942–43.

104 *Id.*

105 *Id.* at 943.

106 *Id.*

107 *Id.* at 944.

108 *Id.*

109 *Id.* at 945.

110 *Edwards v. Arthur Andersen LLP*, 47 Cal. Rptr. 3d 788, 800 (2006).

111 *Edwards*, 44 Cal. 4th at 942.

112 *Id.* at 945.

> Section 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect. We reject Andersen's contention that we should adopt a narrow-restraint exception to section 16600 and leave it to the Legislature, if it chooses, either to relax the statutory restrictions or adopt additional exceptions to the prohibition-against-restraint rule under section 16600.[113]

## B. Debate Ensues Over The Contours And Scope Of The Supreme Court's Opinion In *Edwards*

Since *Edwards* was decided in 2008, commentators and courts have expressed uncertainty about its scope and whether the numerous cases upholding reasonable restraints under section 16600 survive its holdings. Some commentators and litigants have described *Edwards* as holding that *all* contracts in restraint of trade are per se void under California law, regardless of whether they are procompetitive and regardless of whether they would pass muster as reasonable restraints under the Cartwright Act. For example, an amicus brief submitted in *Cipro* by a group of professors contended that the *Edwards* court had "made clear that section 16600 is not subject to a general reasonableness defense."[114] The California Attorney General's amicus brief in *Cipro* similarly asserted that *Edwards* had held broadly that agreements challenged under section 16600 would not be subject to a rule of reason analysis.[115]

On the other hand, the Antitrust Section's treatise on California's antitrust laws continues to list "the types of restraints that have been upheld under section 16600," citing, inter alia, the *Centeno* case, where the Court of Appeal had rejected a section 16600 challenge to a hospital's exclusive arrangement with a group of radiologists and had held that "the antitrust laws prohibit only those contracts which unreasonably restrain competition.[116] But the treatise also notes that after *Edwards,* the "list is subject to application, if at all, only where the restraint is not contained in an employment agreement, and rather, is contained in a non-employment related legal instrument or context."[117] The Ninth Circuit has also expressed uncertainty about the scope of section 16600, stating that "[t]he courts of California have not clearly indicated the boundaries of section 16600's stark prohibition but have nevertheless intimated that they extend to a considerable breadth."[118]

The authors of this article do not believe that the *Edwards* court intended to overturn longstanding precedent, *sub silentio,* and adopt a blanket per se approach to all restraints of trade challenged under section 16600. We believe instead that the court in *Edwards* intended to, and did, hold that non-competition clauses in employment agreements fall into the category of per se illegal practices that are presumed to have a pernicious impact on competition. But the court did not extend that blanket condemnation to *all* agreements between two or

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113 *Id.* at 950.

114 Brief for 49 Professors as Amici Curiae Supporting Petitioners, *Cipro*, 61 Cal. 4th 116 (2015) (No. S198616) (Mar. 25, 2014), 2014 WL 1765271 at *19.

115 *See* Cal. AG *Cipro* Amicus, *supra* note 6, at 15.

116 Cal. Antitrust & Unfair Competition Law § 20.05(c) (2014 ed.)-(citing *Centeno*, 107 Cal. App. 3d at 72).

117 *Id.*

118 *Golden v. Cal. Emergency Physicians Med. Grp.*, 782 F.3d 1083, 1093 (9th Cir. 2015).

more economic actors in all settings and regardless of their duration, scope, market impact or procompetitive nature. We base our conclusion on the procedural nature of the *Edwards* case, the Supreme Court's orders and opinion in that case, and several well settled jurisprudential principles. The remainder of this article explains our reasoning in this regard.

### C. The Court Of Appeal In *Edwards* Expressly Limited Its Holding To The Employment Context, While Explicitly Excluding Other Types Of Agreements From Those Holdings.

The commentators who have advocated for a broad, manichean interpretation of *Edwards* have failed to note that the Court of Appeal in *Edwards* was careful to confine its holdings to the employment context. After stating that "[n]oncompetition agreements are invalid under section 16600 even if narrowly drawn, unless they fall within the statutory or trade secret exceptions,"[119] the Court of Appeal immediately acknowledged, citing *Centeno* and *Keating,* that California courts had held in the commercial context "that section 16600 and similar statutes should be construed 'in the light of reason and common sense' so as to uphold reasonable limited restrictions."[120] The Court of Appeal then stated that "[t]hese cases did not involve employee noncompetition contracts and are not germane to our analysis. *We express no opinion on the operation of section 16600 outside the context of employee noncompetition agreements*."[121]

In other words, *Edwards* arrived at the Supreme Court's doorstep without any holding by the Court of Appeal that extended beyond the employment context.

### D. The California Supreme Court Ordered The Parties in *Edwards* To Limit Their Briefing To The Impact Of Section 16600 On Employee Non-Competition Agreements, And The Parties Complied With That Order.

The parties' briefing in connection with Andersen's petition for review by the California Supreme Court, and the court's subsequent order limiting merits briefing, also shed light on the scope of the court's eventual holdings.

In its reply in support of its petition for review, Andersen argued that review should be granted in part because the Court of Appeal's opinion might be interpreted as "flatly prohibit[ing] 'every' contract which restrains a business 'of any kind' (throwing franchise agreements and other contracts into chaos). . . ."[122] The Supreme Court accepted Andersen's petition for review in November 2006.[123] Shortly thereafter, however, the court issued an order directing the parties to "limit their briefing" to two issues, including "(1) To what extent does Business and Professions Code Section 16600 prohibit *employee*

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119 *Edwards*, 47 Cal. Rptr. 3d at 803.

120 *Id.* at 803 n.6.

121 *Id.* (emphasis added).

122 Reply in Support of Petition for Review, *Edwards v. Arthur Andersen LLP* (No. 5147190) (Nov. 8, 2006), 2006 WL 3886776 at *7 n.3.

123 *Edwards v. Arthur Andersen LLP*, 147 P.3d 1013 (2006).

noncompetition agreements."[124] The Supreme Court's order limiting the scope of the merits briefs was thus consistent with the explicit limitations on the Court of Appeal's holdings that were under review.

In compliance with the Supreme Court's order, the parties' merits briefs focused on cases arising in the employment context and did not cite the Supreme Court's decisions, such as *Great Western, Associated Oil* or *Grogan,* that had applied the rule of reason to section 1673 and section 16600 claims outside the employment context, nor did those briefs cite any of the court's Cartwright Act decisions applying the rule of reason.[125]

In short, the Supreme Court's limitations on merits briefing were intended to and did eliminate any discussion of section 16600 cases arising outside of the employment context, including the court's own precedents.

### E. The Court's Opinion In *Edwards* Began With Confirmation That The Court Had Limited Its Review To The Impact Of Section 16600 On Employee Non-Competition Agreements.

At the outset of its opinion in *Edwards,* the Supreme Court confirmed that the court had indeed limited its review to the two issues it had ordered the parties to brief, one of which was whether "Business and Professions Code section 16600 prohibit[s] *employee* noncompetition agreements."[126] Consistent with that limitation, the *Edwards* court then stated that "[w]e conclude that section 16600 prohibits *employee* noncompetition agreements unless the agreement falls within a statutory exception."[127]

California case law is clear that language used in an opinion "is to be understood in the light of the facts and the issue then before the court,"[128] because cases are "not authority for propositions not considered."[129] Moreover, as the Supreme Court recently explained in *City of San Diego v. Board of Trustees,*[130] statements that are "not necessary to the decision" are dictum, not precedential holdings.[131]

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124 Order Limiting Issues, *Edwards v. Arthur Andersen LLP* (No. S147190) (Jan. 17, 2007) (emphasis added). The only other issue to be briefed involved the impact of a Labor Code section on a release provision. *Id.*

125 Opening Brief on the Merits, *Edwards v. Arthur Andersen LLP* (No. S147190) (Jan. 26, 2007), 2007 WL 1221499; Answering Brief on the Merits, *Edwards v. Arthur Andersen LLP* (No. S147190) (Mar. 27, 2007), 2007 WL 1335190; Reply Brief on the Merits, *Edwards v. Arthur Andersen LLP* (No. S147190) (April 13, 2007), 2007 WL 5288759.

126 44 Cal. 4th at 941 (emphasis added). The second listed issue involved the Labor Code's impact on a release provision. *Id.*

127 *Id.* at 942 (emphasis added).

128 *McDowell & Craig v. City of Santa Fe Springs*, 54 Cal. 2d 33, 38 (1960).

129 *Id.*, *see also Trope*, 11 Cal. 4th at 284; *Ginns v. Savage*, 61 Cal. 2d 520, 524 n.2 (1964); *Elisa B. v. Sup. Ct.*, 37 Cal. 4th 108, 118 (2005); *In re Tobacco II Cases*, 46 Cal. 4th 298, 323 (2009).

130 2015 WL 4605356 at *8-9 (Aug. 3, 2015).

131 *Id.* (explaining that a broad statement in a 2006 Supreme Court decision regarding the appropriate interpretation of a CEQA provision was "simply an overstatement" that "embodied dictum rather than a principle necessary to our decision. . . .").

Accordingly, and in light of the limitations placed by the Court of Appeal on the scope of its opinion and the limitations placed by the Supreme Court on the scope of briefing, the most, if not the only, reasonable assumption is that the *Edwards* court did not render a broad ruling on section 16600's application to agreements outside of the employee-employer setting.

### F. The *Edwards* Court Did Not Cite Any Of Its Own Precedents That Had Applied The Rule Of Reason To Section 16600 Claims Outside The Employment Context, And Jurisprudential Principles Discourage Any Presumption That The Court Would Have Overruled Such Precedents *Sub Silentio*.

The Supreme Court in *Edwards* nowhere mentions its own precedents, such as *Associated Oil, Great Western* and *Grogan,* that had applied a rule of reason analysis to claims under section 1673 or section 16600 in the commercial context. Settled jurisprudential principles discourage lower courts from presuming that a higher tribunal has overruled its own precedents without saying what it was doing. As the United States Supreme Court has observed, "[t]his Court does not normally overturn, or so dramatically limit, earlier authority *sub silentio*."[132] The California Supreme Court has similarly observed that "[a] precedent cannot be overruled in dictum, of course, because only the ratio decidendi of an appellate opinion has precedential effect. . . . [T]o hold otherwise . . . would be to conclude that a statement by this court that *is not* a precedent can somehow abrogate an earlier statement by this court that *is* a precedent. This is not the law."[133]

When these principles are placed alongside the Court of Appeal's limitation on its holdings, the Supreme Court's order limiting merits briefing, and the Supreme Court's subsequent description of the manner in which it had "limited [its] review,"[134] it is clear that *Edwards* should not be viewed as rendering a judgment on the invalidity under section 16600 of *all* restraints on trade.

### G. The *Edwards* Court Should Not Be Presumed To Have Deliberately Construed Section 1673 In A Radically Different Manner Than It Has Construed The Cartwright Act.

Another basic principle of statutory interpretation is that courts should "adopt[ ] the construction that best harmonizes the statute internally *and with related statutes*."[135] Therefore, if the *Edwards* court had intended to hold that section 16600 invalidates all restraints on trade in California, regardless of their scope, duration, impact on competition or benefits to consumers, it would likely have taken pains to explain why it had decided to open up such an enormous chasm between section 16600 and the Cartwright Act.

Indeed, it is self-evident that many Cartwright Act decisions issued over the past few decades would have been decided differently if the courts had employed a blanket *per se* approach that rendered unlawful every restraint of trade. For example, all vertical restraints,

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132 *Shalala*, 529 U.S. at 18; *see also S.F. Unified Sch. Dist. v. W.R. Grace & Co.*, 37 Cal. App. 4th 1318, 1332 (1995) ("If the California Supreme Court intended to overrule these cases, it is unlikely that it would do so—especially a landmark case such as *Seely—sub silentio*.").

133 *Trope*, 11 Cal. 4th at 287 (emphasis in original).

134 *Edwards*, 44 Cal. 4th at 941.

135 *Pac. Gas & Elec.*, 16 Cal. 4th at 1152 (emphasis added).

including all exclusive dealing contracts, would be *per se* unlawful under a broad interpretation of *Edwards,* although under the Cartwright Act, "exclusive dealing arrangements are not deemed illegal per se."[136] Similarly, the petroleum "exchange agreements" that the Supreme Court addressed at length in *Aguilar v. Atlantic Richfield Co.* would have been deemed *per se* invalid regardless of the fact that they are "common in the industry" and "have long been recognized as procompetitive in purpose and effect."[137] A blanket condemnation of all restraints of trade would also place at risk all joint ventures and other competitor collaborations that are formed or operate in California, even though such ventures are typically evaluated under the rule of reason.[138] It is extremely unlikely that the California Supreme Court would have deliberately put at risk such a broad swath of economic activity without an extended analysis of its reasons for so holding.

### H. The *Edwards* Court's Reliance On *Bosley* Also Supports The Proposition That Its Holdings Are Limited To Employment Agreements.

Commentators who have proposed a broad reading of *Edwards* have also pointed to the court's expressed understanding that the Legislature had in 1872 "settled public policy in favor of open competition, and rejected the common law 'rule of reasonableness.'"[139] The court's statement was accompanied not by any discussion of its own precedents that had applied the rule of reason to section 16600 challenges, but by a citation to a passage in a single case, *Bosley Medical Group v. Abramson*.[140] The Court of Appeal in *Bosley,* however, had limited the scope of the particular passage cited in *Edwards* to cases involving "restraint[s] on the practice of a trade or occupation."[141] Even more telling is the fact that the law review comment that the *Bosley* court had relied on, a 1953 case note in the *Southern California Law Review,* itself acknowledged the very different approach that the California courts had taken in cases outside the employment context.[142] The case note stated that "many" California cases, including *Associated Oil* and *Keating,* had upheld "reasonable" or limited restraints under section 16600.[143] The case note stated further that section 16600 "applies only when a person is restrained from pursuing an entire trade, business or profession, and conversely does not apply when he is restrained only as to some small part of it."[144]

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136 *Fisherman's Wharf Bay Cruise Corp. v. Sup. Ct.*, 114 Cal. App. 4th 309, 335 (2003) (holding that the illegality of exclusive dealing agreements "is tested under a rule of reason and 'requires knowledge and analysis of the line of commerce, the market area, and the affected share of the relevant market.'") (internal citations omitted).

137 25 Cal. 4th 826, 872–73 (2001).

138 *See Am. Needle, Inc. v. Nat'l Football League*, 560 U.S. 183, 202–03 (2010); *Texaco Inc. v. Dagher*, 547 U.S. 1, 7 (2006); *see also* U.S. Dept. of Justice, Antitrust Guidelines for Collaborations Among Competitors at 5–8, 13–15 (April 2000) (noting that competitor collaborations are "often procompetitive" and that "[g]iven the great variety of competitor collaborations, rule of reason analysis entails a flexible inquiry and varies in focus and detail depending on the nature of the agreement and market circumstances.").

139 44 Cal. 4th at 945.

140 161 Cal. App. 3d 284, 288 (1984).

141 *Id.*

142 *Id.* (citing *Mullender*, Contracts In Restraint Of Trade, 26 S. Cal. L. Rev. 208, 209 (1953)).

143 *Mullender*, *supra* note 142, at 209.

144 *Id.* at 210.

In short, the *Bosley* case that *Edwards* relied upon provides no support for any broad holding regarding the application of section 16600 outside the employment context.

## I. The *Edwards* Court's Treatment Of The Ninth Circuit's "Narrow-Restraint" Exception Also Demonstrates That The Court's Holdings Do Not Extend Outside The Employee-Employer Context.

The court's opinion in *Edwards* examined and rejected the Ninth Circuit cases that had adopted a "narrow-restraint" exception to section 16600 in employment cases.[145] Some commentators have asserted that the Supreme Court's rejection of the "narrow-restraint" exception in *Edwards* represents a broader rejection of the use of the rule of reason when considering contractual restraints outside the employment context. In fact, however, two of the points made by the *Edwards* court in rejecting the Ninth Circuit's "narrow-restraint" doctrine demonstrate clearly that its focus was solely on the employment context. First, the court was necessarily referring only to employment cases when it stated that "no reported California state court decision has endorsed the Ninth Circuit's reasoning."[146] The court could not have stated, and should not be presumed to have stated, that there are "no reported California state court decision[s]" applying the rule of reason to section 16600 claims outside of the employment context, for there are *many* reported decisions in that category, including *Centeno, Keating* and the court's own decisions in *Associated Oil, Great Western* and *Grogan*. The court's statement was thus necessarily limited to employment agreements.

Similarly, the *Edwards* court was necessarily referring only to employment cases when it stated that it was up to the legislature to enact clarifying legislation if it wished to endorse the Ninth Circuit's "narrow-restraint" approach to employee non-competes.[147] That statement cannot be interpreted as an invitation to the legislature to enact a statutory version of the rule of reason that would govern agreements *outside* the employment context, for the simple reason that the California Legislature had *already* enacted a general statute that, as *Cipro* reminded us, "effectively codifies" the traditional rule of reason.[148] That 1909 statute, currently residing in the Business and Professions Code as section 16725, provides that:

> It is not unlawful to enter into agreements or form associations or combinations, the purpose and effect of which is to promote, encourage or increase competition in any trade or industry, or which are in furtherance of trade.[149]

In light of this already-existing statutory embodiment of the rule of reason, which by its terms protects pro-competitive agreements from invalidation, the *Edwards* court's reference to potential legislation could not have represented a suggestion that the legislature enact a duplicate statute that provided the same protection. Instead, the court must have been focused on possible legislative disapproval of the court's decision to place employee non-competition agreements into the category of presumptively illegal agreements.

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145 44 Cal. 4th at 948–950.

146 *Id.* at 949.

147 *Id.* at 950.

148 *Cipro*, 61 Cal. 4th at 137 n.5 (citing Cal. Bus. & Prof. Code § 16725).

149 *Id.*

## VI. CONCLUSION

As noted earlier, seventy years passed between the California Supreme Court's opinions regarding the scope of section 16600 in *Great Western* and in *Edwards*. If that gap is any indication, a considerable amount of time may pass before the Supreme Court again takes an opportunity to address section 16600's contours. In the interim, we may see more battles involving the proper interpretation of *Edwards* and the proper role of the rule of reason in antitrust analysis. Such clashes should not, however, be prolonged or difficult to resolve, for it is clear that the *Edwards* court did not intend to overturn established precedents that hold—consistent with *Cipro's* approach to the Cartwright Act, and consistent with section 16725—that courts should employ the rule of reason when evaluating many types of agreements challenged under section 16600. It is simply implausible that the *Edwards* court intended to create a schism between California's two antitrust statutes without any explanation, and it is equally implausible that the court intended—again without explanation—to send California's economy back to that "early period in English jurisprudence when trade and the mechanic arts were in their infancy . . . [and] all contracts were [deemed] void which in any degree tended to the restraint of trade."[150] It is instead evident that the *Edwards* court intended only to confirm that under California law, non-competition agreements in the employment context fall within the "categories of agreements or practices that can be said to always lack redeeming value and thus qualify as per se illegal."[151]

150 *Wright*, 36 Cal. at 357.

151 *Cipro*, 61 Cal. 4th at 146.

# HEALTH CARE MERGER ANALYSIS IN THE ERA OF PAYMENT REFORM[1]

*By Kenneth W. Field and Douglas E. Litvack*

Health care providers, from the most acclaimed academic medical centers to independent primary care practitioners, have continued their blistering pace of consolidation and mergers in an effort to meet the demands of health care reform. It is through these mergers and affiliations that providers hope to generate the significant efficiencies required to survive as the world moves toward value and risk based reimbursement. But the provider mergers that stand to generate the largest efficiencies—those that involve proximately located providers who can optimize their delivery platforms—often raise the greatest antitrust concern because existing antitrust models suggest they may eliminate important localized competition.

As a result, the Federal Trade Commission ("FTC") has made health care merger antitrust enforcement a priority. In the past several years, the FTC has investigated hundreds of provider mergers and in each case it has applied largely the same analytic framework. And that framework, described in more detail below, has been validated by several federal district courts in the FTC's recent successfully litigated challenges to hospital and other provider mergers. As the healthcare industry evolves, however, it is natural to ask if the FTC's approach to analyzing provider mergers must change along with it.

Health plans and government payors are in the process of changing the manner in which providers are paid for services. The goal is to transition provider compensation to forms of value-based pay, which reward providers for the quality of the care delivered, not just the volume of care. While providers generally believe this fundamental shift away from fee-for service reimbursement will render the FTC's analytic framework irrelevant, the FTC is unlikely to change its ways. In fact, for the reasons explained below, the FTC's existing analytic tools are likely to continue to drive health care merger enforcement policy even as payment reforms takes hold. There is at least one type of transaction, however, where those very tools may actually help providers obtain antitrust clearance for their prospective mergers.

## HEALTHCARE PROVIDER MERGER ANALYSIS FRAMEWORK

The FTC and Department of Justice ("DOJ") (collectively, "Agencies") have overlapping jurisdiction to review transactions under the antitrust laws.[2] In the healthcare industry, the FTC typically reviews provider transactions and the DOJ reviews insurance transactions.

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1 Kenneth Field is a partner at Jones Day. Before rejoining Jones Day, Ken spent more than six years at the Federal Trade Commission as Counsel to the Director of the Bureau of Competition and as a lead attorney on major Commission health care investigations and litigation matters, including leading the FTC's successfully litigated challenge of the proposed acquisition of Rockford Health System by OSF Healthcare. Douglas Litvack is an associate at Jones Day and a former FTC staff attorney in the Mergers IV Division. He also was a member of the FTC's trial team for its successful challenge of the St. Luke's-Saltzer transaction and the OSF Healthcare-Rockford Health System transaction.

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2 15 U.S.C. § 18(a).

Nevertheless, the Agencies review transactions using the same analytical guidelines—the Horizontal Merger Guidelines.[3] These guidelines specifically set forth the factors the Agencies consider when investigating a transaction.

During a merger investigation, the Agencies focus on whether the transaction may substantially lessen competition, either by giving the combined entity market power to profitably increase its reimbursement rates or reducing the incentives to provide high quality care. To answer this question, the Agencies apply the Horizontal Merger Guidelines to the underlying transaction, which instruct them to:

- Define relevant product and geographic markets to analyze the transaction's competitive impact;
- Assess the market concentration for each relevant market;
- Review the likely competitive effects for each relevant market; and
- Determine whether mitigating factors, such as entry or efficiencies, would offset concerns about competitive harm.[4]

Typically, the majority of the Agencies' time and energy is spent understanding whether the transaction likely will produce competitive harm—e.g., higher prices or lower quality services. In most transactions, this inquiry goes well beyond looking at market shares. Indeed, agency staff gather and review a variety of evidence, including documents, data, and testimony, from the parties and other industry participants.[5] If this evidence suggests that a transaction eliminates important head-to-head competition between the two merging parties or an important barrier to coordination among the remaining firms, then the reviewing Agency may conclude that it violates the antitrust laws.[6]

In healthcare provider transactions, the FTC's competitive effects inquiry has focused on whether the transaction gives the combined entity the ability to obtain higher reimbursement rates during negotiations with managed care organizations (i.e., health plans).[7] To analyze the competitive impact of these provider transactions, the FTC has adopted the "Two-Stage Competition Model."[8] In its first stage, providers compete to be selected as in-network providers by health plans through bilateral negotiations with the plans.[9] The key terms that a provider and health plan negotiate are the reimbursement rates that the health plan will pay the provider when the health plan's members obtain

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3 *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 1 (rev. ed. August 19, 2010) ("Horizontal Merger Guidelines"), http://www.justice.gov/atr/public/guidelines/hmg-2010.html#5c ("These Guidelines outline the principal analytical techniques, practices, and the enforcement policy of the DOJ and FTC with respect to mergers and acquisitions . . . under the federal antitrust laws.").

4 *See generally* Merger Guidelines, *supra* note 3.

5 *See Id*. at § 2.2.1.

6 *See id* at § 1.

7 *See, e.g.*, FTC Compl. ¶¶ 21-23, *St. Alphonsus Med. Ctr. v. St. Luke's Health Sys.*, (D. Idaho 2012), Dkt. No. 98, Mar. 26, 2013 (No. 1:12-cv-00560); FTC Compl. ¶¶ 22-24, *FTC v. OSF Healthcare Sys.*, 852 F. Supp. 2d 1069 (N.D. Ill. 2012), Dkt. No. 1, Nov. 18, 2011 (No. 3:11-cv-50344).

8 FTC Compl. ¶¶ 22-24, *FTC v. OSF Healthcare Sys.*, 852 F. Supp. 2d 1069 (N.D. Ill. 2012), Dkt. No. 1, Nov. 18, 2011 (No. 3:11-cv-50344).

9 *Id*.

care from the provider.[10] A health plan's bargaining leverage over providers is a function of the number of alternative providers available among whom the health plan could form a substitute provider network for its members.[11] A transaction that significantly reduces the number of meaningful alternatives a health plan can turn to thereby increasing the merged entity's ability and leverage to negotiate higher reimbursement rates after the transaction.[12]

In the second stage, providers seek to attract patients enrolled in the plans by offering better services, amenities, convenience and quality of care than other in-network providers.[13] Because patients are largely insensitive to price (and face similar out-of-pocket payment for all in-network providers), the second stage of competition focuses primarily on non-price dimensions.[14] Most recently, the Ninth Circuit in *St. Alphonsus Medical Center—Nampa, Inc. v. St. Luke's Health System* confirmed the model's legitimacy, stating that the "two-stage model is the accepted model."[15]

## SHIFT IN HEALTHCARE PROVIDER PAYMENT METHODOLOGY

According to healthcare experts, the United States healthcare system is in need of reform.[16] Despite having the highest healthcare costs of any country in the world, the United States has a lower quality of care than other advanced countries.[17] It is widely believed that this fact is a by-product of the unique manner in which healthcare providers are paid for their services in the United States.[18] Today, providers are predominantly compensated on a

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10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.*

15 *St. Alphonsus Med. Ctr. v. St. Luke's Health Sys.*, 778 F.3d 775, 784 n. 10 (9th Cir. Idaho 2015); *see also OSF Healthcare*, 852 F. Supp. 2d at 1082, 1087 (concerning supracompetitive reimbursement rates); *In re ProMedica Health Sys., Inc.*, No. 9346, 2012 WL 1155392 *1-10 (F.T.C. June 25, 2012) (same).

16 *See* Michael E. Porter & Thomas H. Lee, *The Strategy That Will Fix Healthcare*, Harvard Bus. R. (October 2013), https://hbr.org/2013/10/the-strategy-that-will-fix-health-care; *see also* Centers for Medicare & Medicaid Serv., Better Care. Smarter Spending. Healthier People: Paying Providers for Value, Not Volume (Jan. 26, 2015), http://www.cms.gov/Newsroom/MediaReleaseDatabase/Fact-sheets/2015-Fact-sheets-items/2015-01-26-3.html; *see also* Mark B. McLennan, Improving Health Care: The Path Forward, Testimony before the U.S. Senate Committee on Finance (June 26, 2013), www.brookings.edu/research/testimony/2013/06/26-improving-health-care-quality-mclellan.

17 Karen Davis, Kirstof Stremikis, David Squires, Cathy Schoen, *Mirror, Mirror On The Wall, 2014 Update: How the U.S. Health Care System Compares Internationally*, The Commonwealth Fund (June 16, 2014), http://www.commonwealthfund.org/publications/fund-reports/2014/jun/mirror-mirror (reporting that "despite having the most expensive health care system, the United States ranks last overall among 11 industrialized countries on measures of health system quality, efficiency, access to care, equity, and healthy lives" based on a recent study); Nat'l. Research Council & Inst. Of Med., Rep.: U.S. Health in Int'l. Perspective: Shorter Lives, Poorer Health ix (Steven H. Woolf & Laudan Aron, eds.) (January 9, 2013) ("The United States spends much more money on health care than any other country. Yet Americans die sooner and experience more illness than residents in many other countries.").

18 The Miller Center, Cracking the Code on Health Care Costs, A Report by the State Health Care Cost Containment Commission, (Jan. 2014) ("Cracking the Code") (crediting fee-for-service payment model with being the main driver of overly-expensive care in the United States); Rep.of the Nat'l. Comm. on Physician Payment Reform (March 2013) ("Physician Payment Reform Report") (describing fee-for-service payment as the driver behind increasing health care expenditures while failing to provide substantial improvements in care).

fee for service ("FFS") basis, meaning a provider is paid whenever it provides a service to a patient.[19] Under FFS payment, the amount of payment a provider receives for treating a patient increases as it performs more services. Importantly, a provider receives no financial reward for keeping a patient healthy. As such, the FFS payment model incentivizes volume of care rather than quality.[20] This perverse incentive structure may explain why Americans pay the highest healthcare costs, but experience only average outcomes.[21]

Recognizing the flaws of FFS payment, healthcare stakeholders have started a sea change in the healthcare payment system. Ignited by the Patient Protection and Affordable Care Act of 2010[22], the industry participants (e.g., hospitals, physicians, and insurers) are transitioning from FFS compensation to forms of value-based compensation and "risk sharing."[23] In risk sharing arrangements, providers and payers each have incentives to keep patients healthy and limit total health care costs.[24] Risk and value based models expose the providers to potential loss or windfall, depending on care outcomes.[25]

There are three broad types of risk-based payments. The first type is gain-sharing payments. Here, the providers are paid on a fee-for-service basis, but receive a bonus payment if the expected cost of care is greater than the actual cost of care.[26] While the providers do not forfeit payments (i.e., take on risk) if the actual treatment costs exceed the expected treatment cost, they do receive a bonus payment for providing higher-quality care below its expected cost.[27] This payment model is thought of as a stepping stone for providers to take on downside risk.[28] For example, NYU Langone Medical

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19 Ctr. for Quality Healthcare Reform, The Payment Reform Glossary 22 (2015).

20 Jeffrey B. Millburn & Mary Maurer, Strategies for Value-Based Physician Compensation 2 (2013).

21 *See* Cracking the Code and Physician Payment Reform Rep., *supra* note 18.

22 Patient Protection and Affordable Care Act, 42 U.S.C. § 18001 et seq. (2010).

23 *See* Sylvia Matthews Burwell, *Progress Toward s Achieving Better Care, Smarter Spending, Healthier People,* HHS.gov (Jan. 26, 2015), www.hhs.gov/blog/2015/01/26/progresstowardsbettercaresmarterspendinghealthierpeople.

24 *See* Matt Chock, *A Review of Value-Based Compensation and its Potential Impact on Healthcare Spend*, Med. Ind. Leadership Inst. (May 2013); HealthLeaders Media,Valuing Physician Compensation, http://healthleadersmedia.com/slideshow.cfm?content_id=313534; Melanie Evans & Bob Herman, *Where Healthcare is Now on March to Value-Based Pay,* Modern Healthcare.com (Jan. 28, 2015), http://www.modernhealthcare.com/article/20150128/NEWS/301289952; Teresa Odle, *Facing the Trend: Preparing for Value-Based Compensation*, Practicelink.com (Fall 2014), http://www.practicelink.com/magazine/featured/facing-the-trend-preparing-for-value-based-compensation/.

25 Payment Reform Glossary, *supra* note 19, at 22.

26 *See Id.; see also* David Seligman & Gail S. Chorney, *Aligning Physician and Hospital Goals through Gainsharing*, AAOS Now (August 2013), http://www.aaos.org/news/aaosnow/aug13/managing5.asp.

27 Am. Med. Assoc., Shared Savings (July 20, 2015), http://www.ama-assn.org/ama/pub/advocacy/state-advocacy-arc/state-advocacy-campaigns/private-payer-reform/state-based-payment-reform/evaluating-payment-options/shared-savings.page.

28 The MSSP, for example, initially required participants to move from a gain-sharing model to one that included downside risk after three years in the program. It, however, later made that shift optional due to concerns from providers. *See* Mark B. McClellan, S. Lawrence Kocot, Ross White, *What the New Medicare Shared Savings Program Proposed Rule Means for ACOs,* Brookings Inst, (Dec. 4, 2014), http://www.brookings.edu/blogs/health360/posts/2014/12/04-medicare-aco-proposed-rule-risk; *see also* Judy Packer-Tursman, *ACO Squeeze: How Much Can They Really Save?* Managed Healthcare Exec. (Aug. 5, 2014), http://managedhealthcareexecutive.modernmedicine.com/managed-healthcare-executive/content/tags/aco/aco-squeeze-how-much-can-they-really-save?page=full.

Center in New York City recently transitioned an experimental gain-sharing program into a broader integrated care arrangement with Cigna by compensating more services with gain-sharing arrangements.[29]

Another type of risk-based payment is the partial-risk payment model. Under this payment scheme, the provider puts a portion of its compensation at "risk," while receiving the majority of its payment on a FFS basis. For example, providers enrolled in the Medicare Shared Savings Program ("MSSP") accept risk-based payments for Medicare-eligible care, but rely on FFS for other services.[30] This model has proven popular. As of 2015, over four hundred voluntarily enrolled provider groups, known as Accountable Care Organizations ("ACOs"), are engaged in the MSSP.[31] Partial-risk arrangements can be seen as an incremental step, allowing providers to build toward full-risk arrangements.

The third, and final, type of risk-based payment is the two-sided risk, or full risk, model. In this structure, providers assume the full risk for treating their patient population and thus receive no FFS-based payment.[32] Instead, the provider receives a fixed amount of payment for treating its defined patient population, with payment penalties if it does not meet or exceed pre-determined quality benchmarks. In 2009, Blue Cross Blue Shield of Massachusetts launched a full risk-based payment contract—the Massachusetts Alternative Quality Contract ("AQC")—with eight providers.[33] The AQC pays participating providers a fixed amount for patient care delivered during a defined period, and awards bonuses when groups meet performance targets.[34] Providers enrolled in the AQC are at risk (i.e., will lose money) if healthcare costs exceed the target.[35] Of the three models, full-risk agreements are considered the most effective means to drive value-based compensation and generate better patient outcomes.

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29 David Seligman & Gail S. Chorney, *Aligning Physician and Hospital Goals through Gainsharing*, AAOS Now (August 2013),http://www.aaos.org/news/aaosnow/aug13/managing5.asp; Mark Slitt, *NYUPN Clinically Integrated Network, LLC & Cigna Start Accountable Care Program to Improve Health & Lower Costs,* Cigna.com (June 27, 2013), http://newsroom.cigna.com/NewsReleases/nyupn-clinically-integrated-network—llc-and-cigna-start-accountable-care-program-to-improve-health-and-lower-costs.htm.

30 *See* Shared Savings, *supra* note 26.

31 Centers for Medicare & Medicaid Serv. Fast Facts—All Medicare Shared Savings Programs (April 2015), https://www.cms.gov/Medicare/Medicare-Fee-for-Service-Payment/sharedsavings program/Downloads/All-Starts-MSSP-ACO.pdf.

32 *See* Shared Savings, *supra* note 26.

33 Michael E. Chernew, Robert E. Mechanic, Bruce E. Landon, Dana Gelb Safran, *Private-Payer Innovation in Massachusetts: The "Alternative Quality Contract"* 30, HealthAffairs (Jan. 2011), http://content.healthaffairs.org/content/30/1/51.full.

34 *Id.*

35 *See Chernew*, et. al., *Private Payer Innovation in Mass., supra* note 32, at 30.

The healthcare industry's transition to risk-based payment is motivated by this desire to incentivize higher quality, lower-cost care. But, at this stage, it is too early to determine whether risk-based payment systems will accomplish that goal.[36] Nevertheless, healthcare stakeholders are committed to moving away from FFS and toward risk-based compensation schemes. Because of the continued drive toward risk-based payments, the healthcare industry can expect that the risk-based model will be the prevalent form of compensation in the near future.[37] Under the risk-based model, the key terms that providers will negotiate with health plans are the target healthcare spending level and the quality benchmark targets. Indeed, these key terms will replace the prior focus on the reimbursements.

## RISK-BASED CONTRACTS AND ANTITRUST ANALYSIS OF PROVIDER TRANSACTIONS

The Agencies' antitrust review of transactions is an arduous task, requiring a fact-specific inquiry that must predict a transaction's future competitive impact.[38] Because industries tend to evolve over time, the Agencies cannot—and do not—get wedded to a particular analytical model to assess a transaction's competitive implications. Instead, they tend to remain flexible and open to new approaches as changing markets may make their prior approach obsolete. Indeed, the FTC in its recent investigation into the Office Depot-Office Max merger, noted that "yesterday's market dynamics may be very different from the market dynamics of today" and therefore it "must take into account the evolving nature of markets" when analyzing a transaction's likely competitive impact.[39] There, the FTC found that "[a]lthough sixteen years ago the Commission blocked a proposed merger between Staples, Inc. and Office Depot, the nation's two largest OSS, our current investigation has show that the market for the sale of consumable office supplies *has changed significantly in the intervening years*."[40] As the FTC now reviews a revived Staples-Office Depot merger, their analysis may change yet again.

As the healthcare industry moves away from FFS to risk-based payment, the FTC likely will reassess its approach to analyzing healthcare provider transactions. Healthcare stakeholders therefore may wonder whether transactions that would previously be

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36 Since adopting a full risk-sharing compensation model, providers in the Massachusetts AQC have exhibited no reduction in quality outcomes, while reducing medical spending by ten percent. *See* Josh Seidman, et al., *Payment Reform on the Ground, supra* note 31 at 30. Similarly, in its most recent evaluation, the MSSP reported savings of over $417 million in Medicare costs with simultaneous improvements in quality of care. Centers for Medicare & Medicaid Serv., Factsheet: Medicare ACOs Continue To Succeed In Improving Care, Lowering Cost Growth (Sept. 16, 2014), http://www.cms.gov/Newsroom/MediaReleaseDatabase/Fact-sheets/2014-Fact-sheets-items/2014-09-16.html. More generally, earlier studies suggest that providers with compensation structures tied to quality metrics, rather than FFS, show improved quality outcomes for patients. Laura Peterson, et al., *Does Pay-for-Performance Improve the Quality of Health Care?*, 145 Annals of Internal Med. 265, 268 (Aug. 15, 2006).

37 Jason Millman, *The Obama Administration Wants to Dramatically Change How Doctors are Paid*, Wash. Post Wonk Blog (Jan. 26, 2015), http://www.washingtonpost.com/blogs/wonkblog/wp/2015/01/26/the-obama-administration-wants-to-dramatically-change-how-doctors-are-paid/.

38 Merger Guidelines, *supra* note 3,.§ 1.

39 *FTC Statement Concerning the Proposed Merger of Office Depot, Inc. and OfficeMax, Inc.*, FTC File No. 131-0104, (Nov. 1, 2013) at 1, https://www.ftc.gov/system/files/documents/public_statements/statement-commission/131101officedepotofficemaxstatement.pdf.

40 *Id.*

challenged by the FTC may now receive clearance. That question hinges on whether risk-based contracting materially changes the FTC's prior approach to analyzing healthcare provider transactions—i.e., the Two-Stage Competition Model.

The presence of gain-sharing or partial risk-based contracts is unlikely to alter the FTC's approach to evaluating healthcare provider transactions. Providers engaged in these contracts with health plans continue to receive FFS compensation. Accordingly, these providers negotiate the reimbursement rates that the health plan will pay the provider when the health plan's members obtain care from the provider.[41] But, according to the FTC, a health plan's bargaining leverage over providers will remain a function of the number of alternative providers available to form its member provider network.[42] A provider combination that significantly reduces the number of meaningful alternatives a health plan can turn to will thereby allow the merged-entity to raise its reimbursement rates.[43] These higher reimbursement rates will be passed on to consumers in the form of higher premiums, co-pays, and deductibles. Put simply, a provider combination that leaves few viable alternatives will continue to raise significant antitrust problems in the eyes of the FTC and other enforcement agencies.

In addition, any argument that a transaction which facilitates the engagement of these types of contracts with health plans likely will not tip the scales in favor of clearance. To do so, the Horizontal Merger Guidelines require transaction-specific, cognizable consumer benefits "of a character and magnitude such that the merger is not likely to be anticompetitive."[44] But the FTC appears to believe that the consumer benefits from gain-sharing or partial risk-based contracts are questionable. In *St. Luke's,* for example, the FTC appeared to take the position that only full risk contracts would remove the perverse FFS incentives to provide costly, wasteful services that are unsupported as the best treatment course.[45] And the defendants there did not appear to dispute this position.[46] For these reasons, the FTC unlikely will credit the facilitation of these contracts as a potential transaction-related benefit.

Unlike gain-sharing and partial risk contracts, full risk based contracts have no fee-for-service component. Because of this material difference, the existence of full risk-based contracts may stand a chance to alter the FTC's approach to analyzing healthcare provider transactions. But a careful examination of risk-based contracts reveals that it likely does little to change the negotiating dynamic between the providers and health plans outlined in Stage One of the Two-Stage Competition Model. And it is that negotiating dynamic—not the payment mechanism—which drives the FTC's model for analyzing provider transactions. That is, in full risk-based contracts, just like FFS contracts, providers and health plans negotiate the basis for which the provider is paid for services. Indeed, the FTC's economic expert in *St. Luke's*

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41 *Id.*

42 *See supra* note 6.

43 *Id.*

44 Merger Guidelines, *supra* note 3,.§ 10.

45 *See* Plaintiffs Amended Corrected Proposed Findings of Fact ¶¶ 402-05, *St. Luke's,* (D. Idaho 2012), Dkt. No. 454, Dec. 30, 2013 (No. 1:12-cv-00560), https://www.ftc.gov/system/files/documents/cases/131105stlukefof.pdf.

46 *See generally* Defs. Amended Corrected Proposed Findings of Fact, *St. Luke's,* (D. Idaho 2012), Dkt. No. 454, Dec. 30, 2013 (No. 1:12-cv-00560), https://www.ftc.gov/system/files/documents/cases/131104stlukefof.pdf.

testified that the bargaining dynamics apply equally in negotiating for fee for service contracts and full risk contracts.[47] For example, a provider and health plan negotiate the fixed amount to pay the provider for treating its patient population. So, a transaction that significantly increases providers' bargaining leverage vis-via health plans will allow the provider to obtain a higher fixed payment amount, thereby increasing consumers' healthcare costs.

Although the analysis likely will remain unchanged, transactions that enable providers to engage in risk-based contracts, by for example giving a provider the requisite scale to assume risk, may create cognizable consumer benefits to offset some degree of antitrust concerns. As the FTC appeared to recognize in *St. Luke's,* full risk-based contracts do benefit consumers by incentivizing lower-cost, higher-quality care.[48] The key question here is whether the benefits of risk-based contracting are transaction-specific, meaning the benefit would not be achieved without the transaction. In *St. Luke's,* the FTC (and the court) found that a merger between a health system and multi-specialty physician group was not necessary for the physicians to engage in full risk-based contracts with health plans.[49] Instead, the FTC argued, and the court agreed, that the scale needed to assume risk could be achieved through a loose affiliation between the physicians and health system.[50] It is, however, an open issue whether other provider combinations (e.g., hospital-hospital or hospital-ambulatory surgery center) could achieve these benefits through loose affiliations. This open issue may be parties best chance to use risk-based contracting to help gain antitrust clearance of a provider transaction.

## CONCLUSION

Given that the FTC believes the bargaining dynamic between providers and health plans remains materially unchanged, it seems unlikely that risk-based contracting will alter the FTC's approach to analyzing provider transactions. Indeed, providers considering mergers with competitors will need to continue to exercise caution, even if FFS payments disappears. But, for those transactions that may enable full risk-based contracts that could not otherwise be done, there may be a chance that it helps those provider combinations obtain antitrust clearance.

47 Trial Tr. 1308:12-1309:8, *St. Luke's* (D. Idaho 2012), Dkt. No. 454, Dec. 30, 2013 (No. 1:12-cv-00560).

48 *St. Luke's*, 778 F.3d at 788-89 (9th Cir. 2015).

49 *Id.*

50 *Id.*

# ANTITRUST TREATMENT OF STATE LICENSING BOARDS IN THE WAKE OF *NORTH CAROLINA STATE BOARD OF DENTAL EXAMINERS V. F.T.C.*

*By David Gringer*[1]

## I. INTRODUCTION

In its decision formulating the state action immunity doctrine, the Supreme Court rested its holding primarily on respect for the political processes in the states: "in a dual system of government in which . . . the states are sovereign . . . an unexpressed purpose to nullify a state's control over its officers and agents is not to be likely attributed to Congress."[2] In light of this principle, the Supreme Court held that the federal antitrust laws were not intended to, and in fact did not reach state action.[3] In so doing, the Court recognized Congress' desire to "embody in the Sherman Act the federalism principle that the States possess a significant measure of sovereignty under our constitution."[4] A failure to recognize this principle would require the promotion of "competition at the expense of other values a State may deem fundamental" thereby "impos[ing] an impermissible burden on the States' power to regulate."[5]

State action immunity offers its most robust protection where the actor in question is the state acting as sovereign.[6] In such cases, the only showing that is required is that the challenged conduct was that of the state itself.[7] As a result, the Sherman Act simply does not apply "to anticompetitive restraints imposed by the States as an act of government."[8] Many cases have also held that actions pursuant to state agency regulation are entitled to the same protection.[9]

Municipalities and other political subdivisions may receive state action immunity as well—but only if their conduct is undertaken pursuant to a clearly articulated state policy.[10] Private parties may also receive state action immunity, but only if they are able to satisfy both prongs of the Supreme Court's state action immunity test. That is, the challenged conduct must be pursuant to a clearly articulated state policy *and* the challenged conduct must be actively supervised by the state.[11] The rationale for this distinction is:

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1 Counsel, Wilmer Cutler Pickering Hale and Dorr LLP. The views expressed in this article are the author's and do not necessarily reflect those of WilmerHale, its attorneys, or its clients.

2 *Parker v. Brown*, 317 U.S. 341, 351 (1943); *see also* Note, *The State Action Exemption and Antitrust Enforcement Under the Federal Trade Comm'n Act*, 89 Harv. L. Rev. 715, 721 (1976).

3 *Parker*, 317 U.S. at 351.

4 *Community Communications Co. v. Boulder*, 455 U.S. 40, 53 (1982).

5 *North Carolina State Bd. of Dental Examiners v. F.T.C.*, 135 S. Ct. 1101, 1109 (2015); *see also Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 133 (1978).

6 *See, e.g., Southern Motor Carriers Rate Conf., Inc. v. U.S.*, 471 U.S. 48, 63 (1985).

7 *Id.*

8 *City of Columbia v. Omni Outdoor Advertising, Inc.*, 499 U.S. 365, 370-71 (1991).

9 *See, e.g., Neo Gen Screening, Inc. v. New England Newborn Screening Program*, 187 F.3d 24 (1st Cir. 1999); *Automated Salvage Transport, Inc. v. Wheelabrator Environmental Systems, Inc.*, 155 F.3d 59 (2d Cir. 1998).

10 *Omni*, 499 U.S. at 374.

11 *See, e.g., Southern Motor Carriers Rate Conf., Inc. v. U.S.*, 471 U.S. 48, 64 (1985).

> Where a private party is engaging in the anticompetitive activity, there is a real danger that he is acting to further his own interests, rather than the governmental interests of the State. Where the actor is a municipality, there is little or no danger that it is involved in a private price-fixing arrangement. The only real danger is that it will seek to further purely parochial public interests at the expense of more overriding state goals. This danger is minimal, however, because of the requirement that the municipality act pursuant to a clearly articulated state policy.[12]

In several decisions, the Court appeared to suggest that state action immunity was at its strongest when a state acted to regulate a profession, such as a state board of lawyers, and where the defendant was the state entity itself. Yet, in its most recent state action decision—*North Carolina State Bd. of Dental Examiners v. F.T.C.,*[13] the Court held that state agencies, if controlled by active market participants, were required to not only demonstrate that they were acting pursuant to a clearly articulated state policy to displace competition with regulation, but also that in engaging in the challenged conduct, they were actively supervised by the state. That is, despite their status as state agencies, for state action purposes they were to be treated like private entities.

The decision, while not entirely surprising (prior opinions by the Court and Courts of Appeals had reached similar conclusions)[14] does raise significant questions for state licensing boards regarding their future antitrust liability. And while the decision did clarify one issue under the state action doctrine, the Court, in fashioning its new "active market participant" test, added several new ambiguities in resolving state action immunity claims.

## II. THE *NORTH CAROLINA STATE BOARD* DECISION

### A. Factual Background

The facts of the Court's decision in *North Carolina State Board of Dental Examiners* are relatively straightforward. North Carolina, like the other 49 states, regulates the practice of dentistry. Under the State's Dental Practice Act, the North Carolina State Board of Dental Examiners is "the agency of the State for the regulation of the practice of dentistry."[15] The legislature requires that six of eight Board members must be licensed dentists who actively practice dentistry.[16] The dentists who serve on the Board "are elected by other licensed dentists in North Carolina, who cast their ballots in elections conducted by the Board."[17] The Board is subject to the State's Administrative Procedure Act, Public Records Act, and

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12 *Town of Hallie v. City of Eau Claire*, 471 U.S. 34, 46-47 (1985).

13 135 S. Ct. 1101 (2015).

14 *See, e.g.*, *Bates v. State Bar of Arizona*, 433 U.S. 350, 359-63 (1977); *see also Washington State Electrical Contractors Ass'n v. Forrest*, 930 F.2d 736 (9th Cir. 1991) (holding state agency comprised of public and private members required to satisfy active supervision prong because "[t]he Council has both public and private members, and the private members have their own agenda which may or may not be responsive to state labor policy"); *Federal Trade Commission v. Monahan*, 832 F.2d 690 (1st Cir. 1987) (Whether Massachusetts Board of Registration in Pharmacy required active supervision depended on "how the Board functions in practice, and perhaps upon the role played by its members who are private pharmacists."). The Court in *North Carolina State Board of Dental Examiners* appeared fully aware of the *Bates* decision's relevance. Slip Op. at 13.

15 N.C. Gen. Stat. Ann. § 90-22(b).

16 *Id.* § 90-22.

17 *North Carolina State Bd.*, 135 S. Ct. at 1108.

open-meetings law.[18] The Board also possesses the authority to issue rules and regulations governing the practice of dentistry in North Carolina, but those rules and regulations must be approved by a State Commission comprised of representatives appointed by the State Legislature.[19]

Notably, the challenged conduct at issue did not stem from the Board's authority to promulgate rules and regulations governing the practice of dentistry. Rather, the Board, responding to the rise of nondentist teeth whitening service providers, "issued at least 47 cease-and-desist letters on its official letterhead to nondentist[s]. . . . directed the recipient[s] to cease all activity constituting the unlicensed practice of dentistry; warned that the unlicensed practice of dentistry is a crime; and strongly implied (or expressly stated) that teeth whitening constitutes the practice of dentistry."[20] The Board also coerced another state created Board, the Board governing Cosmetic Arts, to urge its members not to provide teeth whitening services.[21] Apparently, the Board's efforts were successful. Nondentists ceased to offer teeth whitening services in North Carolina.[22]

In 2010, the FTC challenged the Board's actions under Section 5 of the Federal Trade Commission Act.[23] The Board moved to dismiss before an ALJ on state action immunity grounds, but the ALJ denied the motion. The entire FTC affirmed, holding that the Board was required to show—but could not show—that its challenged conduct was actively supervised by the State. After a trial on the merits, the Board appealed to the Fourth Circuit, which affirmed the FTC in all respects.[24] The Supreme Court granted certiorari to resolve the issue of whether the Board—as a state agency controlled by so-called active market participants—was, in fact, required to be actively supervised by the state.

### B. Prior Legal Framework Governing Immunity of Licensing Boards

Arguably, the treatment of licensing boards for purposes of state action immunity was an issue that the Court had already resolved. In a prior case involving state licensing boards, the Supreme Court had assumed that the State Bar of Arizona was a private actor and was required to be actively supervised before claiming state action immunity for its actions.[25] In contrast, when a plaintiff had challenged regulations that were implemented by the State Supreme Court at the behest of the State Bar association, no active supervision was required because the Defendant there was the state itself. However, in its seminal state action decision *Town of Hallie v. City of Eau Claire,*[26] the Court had called the entire regime into question when, in the course of holding that municipalities were not subject to the

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18 *Id.*

19 *See* N.C. Gen. Stat. Ann. §§ 90–48, 143B–30.1, 150B–21.9(a).

20 *North Carolina State Bd.*, 101 S. Ct. at 1108.

21 *Id.*

22 *Id.*

23 15 U.S.C. § 45. It is not clear from the facts presented whether there could have been the requisite agreement to violate Section 1 of the Sherman Act; an issue both the FTC and the Defendants appear not to have grappled with at any stage of the litigation.

24 *North Carolina State Bd.*, 101 S. Ct. at 1108-09.

25 *Bates*, 433 U.S. at 363.

26 471 U.S. 34.

state action requirement, it stated, albeit in dicta, that "[i]n cases in which the actor is a state agency, it is likely that active state supervision would also not be required,"[27] without distinguishing state agencies controlled by active market participants.

In any event, some post-*Town of Hallie* courts assumed that all state agencies, no matter their composition, did not have to satisfy the active supervision prong. Most notably, the Fifth Circuit held that a State Board of Public Accountants did not have to meet the active supervision test.[28] The plaintiff in that case argued that the Board should have to satisfy active supervision to be immune because it was comprised wholly of the very parties it was regulating. The Fifth Circuit squarely rejected this argument: "Despite the fact that the Board is comprised entirely of CPAs who compete in the profession they regulate, the public nature of the Board's actions means that there is little danger of a cozy arrangement to restrict competition. So long as the Board is acting within its authority and pursuant to a clearly established state policy, there is no need for active supervision of the exercise of properly delegated authority."[29] The antitrust agencies clearly viewed these decisions as an unwarranted extension of *Town of Hallie*. Starting with its 2003 State Action Task Force Report, the FTC began urging that the identity of a governmental entity's decision-makers, rather than its mere status as a governmental entity, should control whether or not the active supervision prong applied.[30] In particular, the Task Force's Report approvingly cited an article by Einer Elhauge, which argued that "financially interested actors cannot be trusted to decide which restrictions on competition advance the public interest; disinterested, politically accountable actors can."[31]

### C. State Agencies Controlled by Active Market Participants Must be Actively Supervised to Receive State Action Immunity

It was this difference between actors with private interests on the one hand, and political accountability on the other that formed the basis of the *North Carolina State Board of Dental Examiners* decision. In upholding the Fourth Circuit, the Supreme Court held that a "state board on which a controlling number of decisionmakers are active market participants in the occupation that the board regulates" were required to not only prove that their challenged conduct was pursuant to a clearly articulated state policy; but also that such conduct was

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27 *Town of Hallie*, 471 U.S. at 46 n. 10. The leading antitrust treatise had come to the same conclusion. *See* Areeda & Hovenkamp, ¶ 212.7a ("Dispensing with any supervision requirement for municipalities implies, a fortiori, the same for departments and agencies of the state itself.").

28 *Earles v. State Bd. of Certified Pub. Accountants of Louisiana*, 139 F.3d 1033 (5th Cir. 1998).

29 *Id.* at 1041-42. Other Circuits had reached similar decisions although did not grapple with the underlying issue. *See, e.g., Porter Testing Lab. v. Board of Regents for Okla. Agric. & Mechanical Colleges*, 993 F.2d 768, 772 (10th Cir.) (where the antitrust defendants included "a constitutionally created state board, its executive secretary, and a state created and funded university . . . a showing of active supervision is unnecessary to qualify for state action antitrust immunity") *cert. denied*, 510 U.S. 932 (1993); *Cine 42nd Street Theater Corp. v. Nederlander Org., Inc.*, 790 F.2d 1032, 1047 (2d Cir. 1986); *Haas v. Oregon State Bar*, 883 F.2d 1453, 1460 (9th Cir. 1989).

30 *See* FTC, *FTC State Action Task Force Report 37-38, available at* https://www.ftc.gov/sites/default/files/documents/advocacy_documents/report-state-action-task-force/stateactionreport.pdf.

31 *Id.* at 38 n. 167 (citing Einer Richard Elhauge, *The Scope of Antitrust Process*, 104 Harv. L. Rev. 668, 688 (1991)).

actively supervised by the state.[32] At the same time, the Court reaffirmed its 30-year old precedent from *Town of Hallie* that municipalities (and other public entities controlled by elected decision-makers) were not subject to the active supervision requirement.[33]

On the surface, the *North Carolina Board* Court's distinction between the treatment of state agencies controlled by active market participants on the one hand, and municipalities on the other, might seem anomalous. As Justice Alito's dissent correctly notes, the decision appears to create a tension within the state action doctrine: "municipalities, although not sovereign, nevertheless benefit from a more lenient standard for state action immunity than private entities. Yet, under the Court's approach . . . a full fledged state agency is treated like a private actor and must demonstrate that the State actively supervises its actions."[34]

The majority has its reasons for treating the Board as being akin to a private entity. In particular, the Court appears persuaded by arguments that state licensing boards—particularly those controlled by active market participants—are pursuing their own financial interests and not state policy.[35] The Court concludes that municipalities do not pose the same concerns because they are electorally accountable. In the Court's view, it is this fact—that decision-makers in municipalities must stand before the electorate—that controls whether an entity must be actively supervised.[36]

Thus, post-*North Carolina State Board of Dentistry,* one (relative) ambiguity in the state action doctrine has been clarified. State agencies that are controlled by participants in the market that they are regulating, where those participants are not electorally accountable,[37] must satisfy both prongs of the state action doctrine to receive immunity.

## III. IMPACT OF THE *NORTH CAROLINA STATE BOARD* DECISION

### D. New Ambiguity in the State Action Doctrine

The decision also raises at least three new ambiguities in the application of the doctrine. The first ambiguity stems from the Court's statement that active supervision must occur *by the state*.[38] It is not clear, however, whether the Court really means what it says. The Supreme Court has stated in prior decisions that the challenged conduct must be "supervised by the state itself."[39] Most courts and commentators have previously declined to take the

32 *North Carolina State Board of Dental Examiners*, 135 S. Ct. at 1115.

33 *Id.*

34 *North Carolina State Bd.*, 101 S. Ct. at 1122 (Alito, J. dissenting).

35 Aaron Edlin & Rebecca Haw, *Cartels by Another Name: Should Licensed Occupations Face Antitrust Scrutiny?*, 162 U. Pa. L. Rev. 1093, 1141-42 (2014).

36 *North Carolina State Bd.*, 101 S. Ct. at 1112-13.

37 That is they are accountable to an electorate that is broader than other active market participants.

38 *North Carolina State Bd.*, 101 S. Ct. at 1113.

39 *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980); *See also Patrick v. Burget*, 486 U.S. 94, 100; *Town of Hallie*, 471 U.S. at 46 n.10.

Court literally and have held that active supervision by a municipality also suffices.[40] But in an environment where state action immunity is being (somewhat) curtailed, it is at least reasonable to ask the question of whether municipal supervision will continue to suffice. And, of course, it follows that a municipality cannot delegate supervision to an entity controlled by active market participants.

The second major ambiguity stems from what the Court means by "active market participants." The state regime at issue here made that determination an easy one. The statute limited participation on the Board to those "licensed to practice dentistry in North Carolina and actually engaged in the practice of dentistry."[41] Other regimes may provide more challenging questions about just who exactly is an active market participant and who is not. For example, what if previously active market participants were required to be inactive during their tenure of service. Presumably, such individuals would, after serving, subsequently return to their active market participation, and would, as a result, have a future financial interest in the industry that they were regulating. Because that would give rise to an almost identical concern about financial self-interest to the one that animated the Court's decision,[42] one would think that active supervision in such a situation would be required. However, if this were the rule, it could quickly lead to line drawing problems and would require a case-by-case inquiry about whether officials were, in fact, likely to return to their industry after service.

This ambiguity is not limited to determining who is an "active" market participant. Determining who is a "market participant" may also vex courts and litigants alike. Antitrust litigation frequently turns on disputed definitions of the relevant markets,[43] and determining precisely who is (and isn't) a market participant could be a complicated issue in future cases. To give just one example of how the market definition inquiry could confuse, the North Carolina Board of Dental Examiners also includes a dental hygienist representative.[44] Normally, one might say that hygienists and dentists cannot compete in the same market.[45] But that is surely not true for all dental services. Indeed, in *North Carolina State Board of Dental Examiners* itself, the Board took action against the competitive threat posed by cosmetologists, who under

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40 *See, e.g.*, *Tri-State Rubbish v. Waste Management*, 998 F.2d 1073, 1079 (1st Cir. 1993) ("municipal supervision of private actors is adequate where authorized by or implicit in the state legislation"); *Gold Cross Ambulance & Transfer v. City of Kansas City*, 705 F.2d 1005 (8th Cir. 1983) (once state authorization is found, supervision can come from a municipality); Areeda and Hovenkamp at 386 ("The relevant supervision must generally come from the same level of government that has created the regulatory scheme under consideration—thus for example. . . . supervision under a municipal waste disposal scheme would generally come from the municipality through a designated agency or official.").

41 N.C. Gen. Stat. Ann. § 90-22(b).

42 *North Carolina State Bd.*, 101 S. Ct. at 1113.

43 *See, e.g.*, *U.S. v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 415 (1956) (Warren, J. dissenting) ("This case, like many under the Sherman Act, turns upon the proper definition of the market."); *F.T.C. v. Whole Foods Market, Inc.*, 548 F.3d 1028, 1051 (D.C. Cir. 2008) (Kavanagh, J. dissenting) ("As in many antitrust cases, the analysis comes down to one issue: market definition.").

44 N.C. Gen. Stat. Ann. § 90-22.

45 *See Barton & Pittinos, Inc. v. SmithKline Beecham Corp.*, 118 F.3d 178, 180 (3d Cir. 1997) (finding plaintiff was not a competitor in the market for vine sales because it "lacked the required [regulatory] license to . . . sell the vine"); *Ethypharm S.A. France v. Abbott Labs.*, 707 F.3d 223, 235-36 (3d Cir. 2013) (finding that plaintiff "does not and cannot compete with [defendant]" because "[i]t did not enter the United States market and receive the required FDA approval").

normal circumstances might not be thought of as market participants. Thus, a licensing board could find itself in the awkward position of being controlled by active market participants depending on the type of conduct the challenged restraint reaches.

A third ambiguity exists where a state board has active market participant members, but is not controlled by those members. As an example, a state board could have a minority of active participants but have "independent" representatives make up a majority of the board. The *North Carolina State Board of Dental Examiners* does not say whether those types of boards would need to be actively supervised. If one wanted to predict, however, it would seem like those boards would also need to be actively supervised to qualify for state action immunity. Even where a board is made up of only a minority of active market participants, there is no guarantee that those representatives in coalition with one another could not obtain the private aims that concern the Court. But the opinion itself provides states and boards with no guidance as to how such boards are to be treated, and this question will surely be resolved in future cases.

### E. State Agencies Cannot Lose Immunity Through Regulatory Capture

Where no ambiguity exists—despite Justice Alito's suggestions to the contrary—is on the question of whether state action immunity can somehow be lost if a particularly agency suffers from regulatory capture. Justice Alito describes the majority decision as resting on an "assessment of the varying degrees to which a . . . state agency like the North Carolina Board are likely to be captured by private interests."[46] As Justice Alito points out, correctly, such a holding would be at odds with the Court's prior state action decisions, including, most notably *City of Columbia v. Omni Outdoor Advertising, Inc.*[47] In *Omni*, the Court refused to recognize an exception to state action immunity where the defendants had acted in a manner against the public interest.[48] Overruling *Omni* would potentially place any public entity at risk of antitrust liability if it acted in a corrupt manner or as a participant in a conspiracy.

Justice Kennedy, however forcefully rebuts Justice Alito. The *North Carolina State Board* defendants must always be actively supervised, in the Court's view, precisely because there will not be a case-by-case inquiry into whether the Board has acted to further the public—or private—interests. As Justice Kennedy writes, "*Omni* made clear that recipients of immunity will not lose it on the basis of ad hoc and *ex post* questioning of their motives for making particular decisions."[49] So understood, the majority has set an *ex ante* rule, to identify those entities who, by their very composition, are likely to "pursue private interests in restraining trade."[50]

### F. Ramifications for State Licensing Boards

Taken at face value, the Court's decision in *North Carolina State Board of Dental Examiners* may appear to be unremarkable. The Court did not hold that restraints issued by licensing boards controlled by active market participants can never receive state action immunity; nor did it hold that such restraints are subject to any particular or close form of scrutiny. And

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46 *North Carolina State Bd.*, 101 S. Ct. at 1121 (Alito, J. dissenting).

47 499 U.S. 365.

48 *Id.* at 374.

49 *North Carolina State Bd.,* 101 S. Ct. at 1105.

50 *Id.*

unlike most gatherings of competitors, state licensing board regulations are unlikely to be treated as consistently illegal *per se*. Instead, all that is required is that state agencies satisfy the same test for immunity as a private entity.

However, in practice, many state licensing boards will face an increased vulnerability to antitrust challenge. It seems likely that many state licensing boards controlled by active market participants will not be actively supervised by the state through no fault of their own,[51] and, given the nature of their work—limiting output by placing restrictions on who can and can't practice in a particular profession—may face regular antitrust challenge.[52]

These appear to be the facts in the first antitrust challenge to a state licensing board post-*North Carolina State Board*. In *Teladoc, Inc. v. Texas Medical Board*,[53] the plaintiffs challenged a regulation from the Defendant Board that barred physicians from treating a patient without a prior in-person physical examination.[54] The Texas Medical Board—like the North Carolina State Board of Dentistry—is a state agency created by statute. And also like its North Carolina dentist-counterpart, it is made up of a majority of licensed physicians.[55] The regulation in question was challenged by a telemedicine company who alleged that the regulation had the effect of precluding them from operating in Texas. Interestingly, the Defendant Board did not even attempt to allege that it was immune under the state action doctrine, which they almost certainly would have done prior to *North Carolina State Board*. The District Court granted the plaintiff's request for a preliminary injunction and precluded the regulation from coming into effect.[56]

One can imagine countless other regulations across the licensing spectrum facing a similar outcome, even where there is no anticompetitive intent present. Indeed, state licensing boards may almost be viewed as an antitrust trap of sorts for the unwary. The state mandates regulation by active market participants in a particular manner and the exercise of that authority may, almost definitionally, give rise to antitrust liability (or at least a lengthy judicial proceeding with expensive discovery before the licensing board can prove that it had legitimate justifications for enacting the regulation in question).

Indeed, the Court's analogy of state licensing boards to private trade associations[57] suggests significant antitrust exposure for licensing boards moving forward. The Court has observed that private trade associations "often have economic incentives to restrain competition and that the product standards set by such associations have a serious potential for anticompetitive

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51 Presumably, in most cases, the board at issue will not be able to decide for itself whether its challenged conduct will or will not be actively supervised. Instead, the regulatory regime enacted by the State Legislature will make that decision. A unique aspect of the North Carolina State Board of Dental Examiners was that the Board elected not to exercise its more formal authority.

52 *See, e.g.*, *NCAA v. Board of Regents*, 468 U.S. 85, 99 (1984) (where "the challenged practices create a limitation on output . . . our cases have held that such limitations are unreasonable restraints of trade").

53 —F. Supp. 3d—, 2015 WL 4103658 (W.D. Tex. May 29, 2015).

54 *Id.* at *2.

55 *Id.* at *1.

56 *Id.* at *12.

57 *North Carolina State Bd.*, 101 S. Ct. at 1114.

harm."[58] Accordingly, there is no shortage of cases finding trade associations liable for antitrust violations.[59] And what must be of particular concern to licensing boards, trade associations are, in and of themselves, units of joint action sufficient to satisfy section 1 of the Sherman Act.[60]

State licensing boards may even face unique risks that trade associations do not. "[C]oncerted action does not exist every time a trade association member speaks or acts."[61] Instead, liability is reserved for agreements that bear the imprimatur of official action, "such as by a vote or passage of a resolution."[62] Some state licensing boards may only be able to take action through official processes, and thus may not be able to evade the concerted action requirement in any circumstances.

Interestingly, the regulatory regime in *North Carolina State Board* almost certainly illustrates the safest path to avoid antitrust liability for licensing boards moving forward. As noted, the Board possesses the authority to promulgate rules, subject to the approval of the North Carolina Rules Review Commission.[63] But the Board did not chose not to use that route. As Justice Kennedy, writing for the majority observed, the Board elected to issue cease-and-desist letters "rather than any of the powers at its disposal that would invoke oversight by a politically accountable official."[64] Since the Court goes on to state that the requirements of active supervision are that "[t]he supervisor must review the substance of the anticompetitive decision, not merely the procedures followed to produce it; the supervisor must have the power to veto or modify particular decisions to ensure they accord with state policy . . . [and] [f]urther the state supervisor may not itself be an active market participant," it stands to reason that had the Board invoked its rulemaking authority and had those rules been approved by the Rules Review Commission, the Board would have satisfied the active supervision requirement.

States may also alter their regulatory regime to allow for representatives on state licensing boards to be elected in broader elections. It follows from the Court's opinion that elected boards do not give rise to the same concerns of private price-fixing that animate the Court's decision and thus are not subject to the active supervision requirement. Of course, if states are altering their regulatory regime, they may also simply provide for active supervision by a state agency that is not controlled by active market participants.

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58 *Id.* (quoting *Allied Tube & Conduit Corp. v. Indian Head, Inc.*, 486 U.S. 492, 500 (1988)).

59 *See, e.g., American Soc'y of Mechanical Eng'rs v. Hydrolevel Corp.*, 456 U.S. 556 (1982); *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975); *Fashion Originators Guild of America v. F.T.C.*, 312 U.S. 457 (1941); *United States v. Topco Assoc., Inc.*, 405 U.S. 596 (1972).

60 *See* G.D. Webster, *The Law of Associations* § 9a.01[1], 9A3–4 (1991) ("There is no question that an association is a 'combination' within the meaning of Section 1 of the Sherman Act. Although a conspiracy requires more than one person, an association, by its very nature a group, satisfies the requirement of joint action. Thus, any association activity which restrains interstate commerce can be violative of Section 1 even if no one acts in concert with the association."); Stephanie W. Kanwit, *FTC Enforcement Efforts Involving Trade and Professional Associations*, 46 Antitrust L.J. 640, 640 (1977) ("Because trade associations are, by definition, organizations of competitors, they automatically satisfy the combination requirements of § 1 of the Sherman Act.").

61 *Alvord-Polk, Inc. v. F. Schumacher & Co.*, 37 F.3d 996, 1007-08 (3d Cir. 1994).

62 *Id.* at 1008.

63 *See* note 19 and accompanying text *supra.*

64 *North Carolina State Bd.*, 101 S. Ct. at 1116.

It may also be that individual board members will not face damages for antitrust liability in conjunction with their board service. The Court suggests, without deciding, that board members may be immune from antitrust money damages.[65] It is not clear what exactly Justice Kennedy is referencing when he alludes to this immunity, and he offers only a citation to a footnote in the Supreme Court's *Goldfarb* decision. That footnote references the possibility of state agencies receiving Eleventh Amendment immunity from damages.[66] But it is far from certain whether state licensing boards qualify for Eleventh Amendment immunity, and the *North Carolina State Board* decision cannot be said to advance the cause. A more likely scenario is Congressional action. When municipalities became subject to antitrust damages after the *City of Boulder* decision, Congress responded with the Local Government Antitrust Act immunizing political subdivisions and their employees from damages.[67] Licensing boards should, and likely will, push for similar treatment.

## IV. CONCLUSION

As with the Supreme Court's other recent state action immunity decision, *FTC v. Phoebe Putney*, the Court took action to both clarify and cabin the state action immunity doctrine. Unlike *Phoebe Putney*, which was essentially an exercise in error correction, the *North Carolina State Board of Dental Examiners* decision clearly expands antitrust liability beyond the prior state of the law. State licensing boards controlled by active market participants face increased exposure to antitrust suits unless they are actively supervised by the state. Such exposure will be inherent in the nature of such boards, which bring together competitors under the aegis of the state. At the same time, municipalities and other political subdivisions have had their state action immunity reinforced; public entities controlled by elected decision-makers will not need to satisfy the active supervision prong to obtain immunity.

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65 *Id.* at 1115. The FTC was seeking only injunctive relief.

66 *Goldfarb*, 421 U.S. at 791 n.22.

67 15 U.S.C. § 34 *et seq.*

# WHAT YOU SEE ISN'T WHAT YOU GET: HOW THE *COLGATE* DOCTRINE MAY APPLY TO THE DISPOSABLE CONTACT LENS ANTITRUST LITIGATION

*By James M. Mulcahy & Filemon Carrillo*[1]

## I. INTRODUCTION

The four largest disposable contact lens manufacturers[2] have, within months of each other, implemented minimum resale pricing policies that govern the sales of specific contact lens models. Given the unique prescription method and downstream distribution characteristics of the disposable contact lens industry, many contact lens retailers and consumers maintain that: (a) these policies are anticompetitive and have no legitimate procompetitive justification; and (b) both *intrabrand* and *interbrand*[3] competition in the disposable contact lens relevant product market are severely limited as a direct result of these pricing policies.

The disposable contact lens manufacturers now are facing claims that have been brought by retailers and disposable contact lens consumers under Section 1 of the federal Sherman Act and Section 16720 the California Cartwright Act.[4] These actions allege that the policies implemented by the contact lens manufacturers are anticompetitive and unlawful. The manufacturers, on the other hand, argue that because the policies were implemented *unilaterally,* they are immune from antitrust liability.

At bottom, each of the defendants contends that it unilaterally adopted a pricing policy imposing a minimum resale price and thereafter each defendant will deal only with those retailers who adhere to that policy.[5] The defendants implicitly also argue that the fact that each of them simultaneously implemented similar retail price maintenance (RPM) programs represents nothing more than "conscious parallel conduct" which, as a matter of law, does not allow an inference of a conspiracy—*i.e.,* their "conscious parallel conduct" is

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2 They are (1) Cooper Vision, Inc.; (2) Alcon Laboratories, Inc.; (3) Bausch & Lomb; and (4) Johnson & Johnson Vision Care, Inc. Together, they allegedly control 97% of the disposable contact lens relevant product market.

3 When all competing manufacturers adopt minimum resale price maintenance policies, sales are not shifted from one manufacturer to another. The end result is higher prices and elevated gross profit margins for all manufacturers.

4 15 U.S.C. § 1; Cal. Bus. & Prof. Code § 16720. *See generally In re: Disposable Contact Lens Antitrust Litigation,* Transfer Order, MDL No. 2626 (J.P.M.L. June 8, 2015). As of this writing, there are 56 law suits pending against the Manufacturers. The United States Judicial Panel on Multidistrict Litigation has consolidated seven of these cases and recently transferred the cases to the Middle District of Florida.

5 *See United States v. Colgate,* 250 U.S. 300 (1919).

entirely consistent with unilateral action.[6] Given that the defendants' conduct is unilateral, according to the defendants, it matters not that the combined effect of their RPM policies may represent an anticompetitive and unreasonable restraint on *interbrand* competition.[7]

In 1911, the United States Supreme Court in *Dr. Miles Med. Co. v. John D. Parker & Sons Co.* held that an agreement between a manufacturer and its distributor establishing an RPM program was *per se* unlawful under Section 1 of the Sherman Act (15 U.S.C. § 1).[8]

In 1919, the United States Supreme Court in *United States v. Colgate* qualified *Dr. Miles,* and held that when a firm *unilaterally* announces its minimum retail pricing policy, and thereafter simply refuses to sell to distributors who do not comply, it is not subject to antitrust scrutiny under Section 1 of the Sherman Act.[9] This has become known as the *Colgate* doctrine.

In 2007, ninety six years after the *Dr. Miles* decision, the Supreme Court in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.,*[10] reversed *Dr. Miles,* and announced that RPM agreements are no longer *per se* unlawful under the Sherman Act. Now, they are subject to the rule of reason analysis.[11] Some now argue that because the *Colgate* doctrine merely offered a way to escape the *per se* condemnation of RPM agreements set forth in *Dr. Miles,* the *Leegin* holding may have limited the availability and application of the *Colgate* doctrine.

This article suggests that *Colgate* is still good law and that the *Leegin* decision did not affect the ongoing viability of the *Colgate* doctrine. Thus, even if it is assumed that the contact lens manufacturers' collective RPM policies are manifestly anticompetitive and lack any pro-competitive justification or redeeming value—*e.g.,* there is no legitimate basis for arguing that the RPM policies promote the deterrence of free riding on reseller investments in presale promotional services—the *Colgate* doctrine still insulates the disposable contact lens manufacturers from antitrust liability as long as each manufacturer's RPM policy was implemented unilaterally. Nevertheless, the Disposable Contact Lens Antitrust Litigation well may test that conclusion.

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6 *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 588 (1986); *see also Brooke Grp. v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 227 (1993) ("conscious parallelism, describes the process, not in itself unlawful, by which firms in a concentrated market might in effect share monopoly power, setting their prices at a profit-maximizing, *supra*competitive level by recognizing their shared economic interests and their interdependence with respect to price and output decisions"); *Ralph C. Wilson Indus., Inc. v. Chronicle Broad. Co.,* 794 F.2d 1359, 1365 (9th Cir. 1986) ("We have held that the mere existence of parallel conduct is insufficient to establish a conspiracy."); *City of Tuscaloosa v. Harcros Chems.,* 158 F.3d 548, 570 (11th Cir. 1998) ("It is well settled in this circuit that evidence of conscious parallelism [alone] does not permit an inference of conspiracy unless the plaintiff establishes that, assuming there is no conspiracy, each defendant engaging in the parallel action acted contrary to its economic self-interest." (citations omitted)).

7 *See, e.g., The Jeanery, Inc. v James Jeans, Inc.* 849 F.2d 1148, 1152 (9th Cir. 1988) (unilateral conduct by a single entity, "even if it appears to restrain trade unreasonably, is not unlawful" under the Sherman Act) (internal quotation marks omitted).

8 *Dr. Miles Med. Co. v. John D. Parker & Sons Co.*, 220 U.S. 373, 404 (1911).

9 *United States v. Colgate,* 250 U.S. 300 (1919).

10 551 U.S. 877 (2007).

11 *See Leegin,* 551 U.S. at 899. Note that the California *per se* condemnation of RPM agreements under the Cartwright Act announced in *Mailand v. Burckle,* 20 Cal. 2d 367 (Cal. 1978) has survived the *Leegin* holding. *See Alsheikh v. Superior Court,* 2013 Cal. App. Unpub. LEXIS 7187, *10 (Cal. App. 2d Dist. Oct. 7, 2013).

## II. BACKGROUND

### A. The disposable contact lens industry inherently is susceptible to anticompetitive conduct

The disposable contact lens industry is unique. By its very nature, the industry is highly susceptible to anticompetitive behavior. It is distinguished by five principal competitive characteristics.

*First,* consumers must obtain written prescriptions from optometrists and ophthalmologists (eye care providers or "ECPs") before they can purchase their contact lenses.[12]

*Second,* the ECPs perform eye exams and contact lens fittings and receive payment for *both* services. Because ECPs are paid separately for their eye exam and contact lens fitting services, ***they are not subject to free riding by discount rivals in connection with their sales of disposable contact lenses to their patients.***

*Third,* based upon their eye examinations, ECPs prescribe a *specific contact lens brand—e.g.,* Bausch & Lomb—for the patient. The law does not permit the consumer to substitute another brand for the prescribed brand, and generic equivalents cannot be obtained for branded contact lenses.[13] This practice is in stark contrast to the general pharmaceutical industry, where primary care physicians write prescriptions for various drugs, but the consumer-patients can freely substitute equivalent generic or competing brands when they go to a pharmacy to fill the prescription.[14]

*Fourth,* the industry is highly concentrated and dominated by four manufacturers—Cooper Vision, Inc.; Alcon Laboratories, Inc.; Bausch + Lomb; and Johnson & Johnson Vision Care, Inc. (J&J) (collectively the "Manufacturers"). Together, the Manufacturers comprise 97% of the relevant contact lens product market.

*Fifth,* ECPs communicate with each other and the Manufacturers through their largest supplier of contact lenses—ABB Optical Group ("ABB"). ABB is the "nation's largest distributor of soft contact lenses. [It] [purportedly] suppl[ies] more than two-thirds of [ECPs] in America with brand name contact lenses."[15] ABB allegedly also "surveys its ECP customers to find out how much they are charging their patients for each different type and brand of contact lenses [and thereafter] publishes the results of the surveys in its periodic *Retail Price Matrix*."[16]

Theoretically, when patients visit their ECPs and obtain prescriptions for their contact lenses, they can purchase their contact lenses from any retailer that sells the prescribed product *and brand*. These retailers include 1-800 CONTACTS and Costco. In practice, however, the ECPs apparently historically have declined to give their patients a copy of their contact lens prescriptions unless the patients purchase their disposable contact lenses directly from the prescribing ECP.[17]

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12 *See Machikawa et al. v. Cooper Vision, Inc. et al.,* No. 15-CV-01001-HSG, Compl. ¶ 4 (N.D. Cal. Mar. 3, 2015) ("Machikawa Compl.").

13 *See id.*

14 *See* FCLC § 7603(f).

15 Machikawa Compl. ¶ 6.

16 *Id.*

17 *See Miller et al. v. Alcon Labs., Inc. et al.,* No. 15-cv-01028-HSG, Compl. ¶ 49 (N.D. Cal. Mar. 4, 2015).

This practice foreclosed any ability on the part of the patients to effectively participate in competitive price discovery for the prescribed brand of contact lenses, and effectively eliminated entirely all *intrabrand* price competition. This changed, however, when in 2003 Congress enacted the Fairness to Contact Lens Consumer Act ("FCLCA").[18] Under the FCLCA, ECPs now *must* provide a copy of their contact lens prescriptions to the patient. This, then, provides patients with the opportunity to engage in certain competitive price discovery—*e.g.,* they can go to retailers such as 1-800 CONTACTS and Costco—but only as it relates to *intrabrand* competition. This, of course, does not necessarily suggest that these *intrabrand* restrictions are unlawful under the antitrust laws. This is so because the purpose of the antitrust laws is "the protection of competition, not competitors,"[19] and because "the antitrust laws are designed primarily to protect *interbrand* [–not *intrabrand*–] competition."[20]

### B. The Manufacturers implement minimum resale price maintenance policies

Beginning in June 2013, each of the Manufacturers more or less simultaneously implemented so-called "unilateral pricing policies" (UPPs) on specific contact lens models. In general, the pricing policies identify the minimum retail price that retailers, including the ECPs, must charge consumers for specific models—*e.g.,* ACUVUE® OASYS® Brand Contact Lenses (6 lenses per box) must have a minimum retail price of $34.00.[21] The net price of any advertisement or bundled sale cannot be lower than the UPP set price.[22] And, although the pricing policy is a UPP, it clearly is RPM. Because the four dominant disposable contact lens manufacturers each implemented so-called UPP policies in tandem, the *collective* effect of those policies very well may be nothing other than a purely anticompetitive effect on *interbrand* competition.

### C. The Senate holds hearings regarding Manufacturers' RPMs

On July 30, 2014, the Senate Committee on the Judiciary, Subcommittee on Antitrust, Competition Policy and Consumer Rights of the United States Senate held hearings on: "Pricing Policies and Competition in the Contact Lens Industry: Is What You See What You Get?"[23] The Committee was concerned by the fact that all of the large contact lens manufacturers have adopted parallel so-called UPPs, and the effect on competition may well be manifestly anticompetitive without any procompetitive or other redeeming virtue.

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18 15 U.S.C. § 7601 *et seq.* (2012).

19 *See Atlantic Richfield Co. v USA Petroleum Co,* 495 U.S. 328, 338 (1990).

20 *See Leegin Creative Leather Products, Inc. v. PSKS, Inc.,* 551 U.S. 877, 895 (2007).

21 Machikawa Compl. Ex. E ("Acuvue Brand Contact Lenses: Unilateral Price Policy—Cub Store Retailer Amendment").

22 *Id.*

23 United States Senate Committee on the Judiciary, Pricing Policies and Competition in the Contact Lens Industry: Is What You See What You Get? ("Senate Hearing") *available at* http://www.judiciary.senate.gov/meetings/pricing-polices-and-competition-in-the-contact-lens-industry-is-what-you-see-what-you-get.

At the hearing before the Senate Judiciary Committee, representatives from J&J and Alcon Laboratories, Inc. appeared and testified. J&J's representative testified that it had "made the decision to implement a UPP after a thorough consideration of a number of options and *independent of pricing decisions of other contact lens manufacturers*."[24] J&J further testified that by establishing its UPP, J&J is "creating lower prices for the most widely prescribed" contact lens.[25] Part of J&J's reasoning was that *"[s]ubstantial time spent reviewing costs during a patient examination takes away valuable time from the clinical discussion."*[26]

Alcon Laboratories, Inc. ("Alcon") testified that the idea of implementing its UPP *came from an Alcon employee*.[27] Alcon further testified that its purpose in implementing its UPP was *to promote the investment of time by ECPs in learning about contact lenses* without the fear of free riding retailers that do not have to prescribe the contacts.[28]

The Senate has taken no further action.

### D. The American Antitrust Institute writes to the FTC and DOJ

Three months later, on October 24, 2014, the American Antitrust Institute ("AAI") sent a letter to Chairwoman Ramirez of the FTC and to AAG Baer of the DOJ Antitrust Division.[29] In its letter, the AAI argued that the Manufacturers' UPPs are anticompetitive and have no procompetitive or redeeming virtue whatsoever.[30] That very well may be so. Still, under *Colgate,* that is a necessary but not a sufficient underlying basis for asserting liability. There must be a showing of vertical concerted conduct or other evidence demonstrating some participation in a manufacturer cartel.

Neither the FTC nor the DOJ has taken any action.

### E. The disposable contact lens consumers sue the Manufacturers

During the past six months, these UPPs have triggered significant private litigation against the Manufacturers. On March 3, 2015, John Machikawa, Bernadette Goodfellow, and Georgina Lepe ("Consumers") filed a putative class action against the Manufacturers and ABB, alleging violations

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24 *See* Testimony of Dr. Millicent L. Knight, Johnson & Johnson Vision Care, North America at 1, July 30, 2014 http://www.judiciary.senate.gov/meetings/pricing-polices-and-competition-in-the-contact-lens-industry-is-what-you-see-what-you-get (J&J Testimony).

25 *Id.* at 2.

26 *Id.* at 4.

27 *See* Written Statement of Alcon Laboratories, Inc. Before the Subcommittee on Antitrust of the Senate Committee on the Judiciary at 2, July 30, 2014 *Klobuchar Record Submission* at 2, http://www.judiciary.senate.gov/meetings/pricing-polices-and-competition-in-the-contact-lens-industry-is-what-you-see-what-you-get.

28 *Id.*

29 Letter from The American Antitrust Institute to Chairwoman Ramirez and AAG Baer, October 24, 2014, http://www.antitrustinstitute.org/sites/default/files/AAI%20Letter%20on%20RPM%20in%20Contact%20Lenses.pdf.

30 *Id.* at 4.

of Section 1 of the Sherman Act and Section 16720 of the Cartwright Act.[31] In their complaint, Consumers allege that the ECPs and ABB have long supported the adoption of the UPPs by the Manufacturers.[32] Their allegations are based on publications and speeches given by ECPs in support of such policies.[33] Consumers also point to a letter sent by J&J to the ECPs wherein J&J stated that the ECPs' feedback was *"instrumental in helping [J&J] create their enterprise strategy which included the new pricing strategy along with an invitation to continue giving feedback."*[34] Angel Alvarez, the CEO and founder of ABB, also stated that "ABB has been working closely with manufacturers to develop [UPPs], which we believe enable a better overall patient experience by supporting competitiveness of prescribing practitioners."[35] ABB goes on to encourage ECPs to charge prices higher than UPPs.[36]

The complaint describes the enforcement methods employed by some of the Manufacturers. J&J allegedly uses both its own employees and independent firms to monitor market prices, online and in-store.[37] The complaint goes on to allege that:

> Murphy of Alcon confirmed that it warns violators that they are selling below the MRPM and gives them an opportunity to cure. After a third-party auditor confirms a violation, *the retailer is communicated with and 'asked to make a correction' within five days*. Only if the violator refuses to increase its price does Alcon *punish the violation by prospectively denying access to the product for up to one year.*

(emphasis supplied).[38] If true, then *these* allegations well may "tend[] to exclude the possibility of independent action by the [m]anufacturer."[39] And, if so, then the Consumers well may be able to allege and prove facts that give rise to a "contract, combination or conspiracy" between one or more of the Manufacturers and one or more of the ECPs. Under those circumstances, *Colgate* will not shield the Manufacturer(s) from liability for their alleged anticompetitive conduct. But that merely begs the question whether the *Colgate* doctrine itself remains alive and well.

These lawsuits are pending.

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31 15 U.S.C. § 1; Cal. Bus. & Prof. Code § 16720. The Machikawa Complaint reflects the same general allegations and claims in many of the other 56 cases filed on behalf of consumers. *See generally Machikawa et al. v. Cooper Vision, Inc. et al.*, No. 15-CV-01001-HSG (N.D. Cal. Mar. 3, 2015) ("Machikawa Compl."); *See Miller et al. v. Alcon Labs., Inc. et al.*, No. 15-cv-01028-HSG, Compl. ¶ 49 (N.D. Cal. Mar. 4, 2015).

32 *See* Machikawa Compl. ¶¶ 91-107.

33 *See* Machikawa Compl. ¶¶ 91-107.

34 *See* Machikawa Compl. ¶ 98.

35 *See* Machikawa Compl. ¶ 102.

36 *See* Machikawa Compl. ¶ 105.

37 *See* Machikawa Compl. ¶ 84.

38 *See* Machikawa Compl. ¶ 89. Consumers also allege that the Manufacturers agreed to implement the UPPs. Without more, these types of conclusory allegations are not sufficient to allege a valid cause of action. *Bell Atl. Corp. v Twombly,* 550 U.S. 544, 553-58 (2006). Of course, any agreement between the manufacturers would constitute a horizontal conspiracy, and *Colgate* would not apply. Instead, the price agreement would constitute a *per se* violation of Section 1 of the Sherman Act and Section 16720 of the Cartwright Act. *See* Machikawa Compl. ¶¶ 108-17.

39 *See Monsanto Co. v Spray-Rite Serv. Corp.,* 465 U.S. 752, 768 (1984).

## F. The retailer (Costco) sues the Manufacturers

On March 6, 2015, Costco also filed a law suit against J&J alleging violations of Section 1 of the Sherman Act and Section 16720 of the Cartwright Act.[40] Costco alleges that after J&J found that Costco was not complying with J&J's RPM policy, J&J not only gave Costco time to comply, but also revised the RPM policy five times in order to permit Costco to mitigate its losses.[41] On April 17, 2015, J&J filed a motion to dismiss, arguing in part that there was no showing of an agreement between it and the ECPs or distributors. As of the date of writing this article, that motion has not been decided.

## G. Utah bans the UPPs

The state of Utah very recently passed legislation outlawing the implementation of these UPPs when the Utah Legislature amended its Contact Lens Consumer Protection Act by adding a provision which states that "[a] contact lens manufacturer or a contact lens distributor may not: (1) take any action, by agreement, *unilaterally, or otherwise,* that has the effect of fixing or otherwise controlling the price that a contact lens retailer charges or advertises for contact lenses. . . ."[42] (the "Amended CLCPA") (emphasis added).[43]

After the Amended CLCPA was passed by the Utah Legislature, the Manufacturers sued in federal court claiming that the Utah law "violates the Commerce Clause of the United States Constitution because it impermissibly interferes with commercial conduct outside of Utah, discriminates against interstate commerce, and imposes an excessive burden on interstate commerce."[44] The Manufacturers sought temporary injunctive relief, enjoining the enforcement of the Amended CLCPA, but their motion for preliminary equitable relief was denied.[45] In denying the motion, the federal district court in Utah reasoned that, because the law only disallows UPPs within the state of Utah, it therefore does not affect the validity of UPPs outside the state.[46] The court described the Utah law as "nothing more than a state antitrust statute, tailored to a specific industry, which the state has the power to enact."[47]

The case is currently before the Court of Appeals for the Tenth Circuit.

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40 *See generally Costco Wholesale Corp. v. Johnson & Johnson Vision Care, Inc.*, No. 15-CV-00941-HSG (N.D. Cal. Mar. 6, 2015) ("Costco Compl.").

41 *See* Costco Compl. ¶¶ 53-60.

42 *See* Utah Code Ann. § 58-16a-905.1.

43 Other states, including California, have proposed similar legislation. *Alcon Labs., Inc. v. Reyes*, No. 2:15-cv-252-DB, Order at 7 (D. Utah, May 11, 2015) (order denying temporary injunction).

44 *Id.* at 9.

45 *Id.*

46 *Id.* at 10-19.

47 *Id.* at 13.

## III. *COLGATE* AND THE DISPOSABLE CONTACT LENS ANTITRUST LITIGATION

### A. Introduction: Vertical Resale Price Maintenance

To plead a valid claim under Section 1 of the Sherman Act, a plaintiff must plead evidentiary facts to show:

> (1) *a contract, combination or conspiracy among two or more persons or distinct business entities;* (2) by which the persons or entities intended to harm or restrain trade or commerce among the several States, or with foreign nations; (3) which actually injures competition.[48]

Certainly by now, it is widely understood that a bare assertion of the existence of an unlawful agreement is not entitled to the presumption of truth.[49] Proof of a potential agreement is essential to the claim. Without an agreement, there is no liability under Section 1. In similar fashion, the Cartwright Act—California's primary antitrust statute—also requires the formation of an "agreement."[50]

Although the antitrust statutes are worded in broad terms, in limited circumstances, certain proscribed conduct may be *per se* unlawful. *Per se* condemnation under both the Sherman Act and the Cartwright Act is reserved for "conduct that is manifestly anticompetitive, . . . that is, conduct that would always or almost always tend to restrict competition and decrease output."[51] In *Dr. Miles,* the Supreme Court announced a *per se* condemnation of any agreement between a manufacturer and its distributor which establishes an RPM policy. In so holding, the Court found that there was no redeeming or procompetitive value in setting a minimum retail price. The Court's holding was based on the common law belief that the "right of alienation is one of the essential incidents of a right of general property" and that "restraints upon alienation have been generally regarded as obnoxious to public policy."[52]

#### 1. The *Colgate* Doctrine

Eight years after *Dr. Miles' per se* condemnation of RPM agreements, the Supreme Court in *United States v. Colgate* announced that the Sherman Act "does not restrict the long recognized right of . . . [the] manufacturer . . . freely to exercise his own *independent*

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48 *Kendall v. Visa U.S.A., Inc.*, 518 F.3d 1042, 1047 (9th Cir. 2008) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 553-58 (2006)) (emphasis supplied).

49 *Twombly*, 550 U.S. at 555.

50 To plead a valid claim under the Cartwright Act, a claimant must plead that a defendant (1) participated in the formation and operation of an agreement to restrain trade; (2) engaged in illegal acts with the purpose of furthering that agreement; and (3) caused the plaintiff damage as a result of those acts. *See* Cartwright Act, Bus. & Prof. § 16720; *see also Smith v. State Farm Mutual Auto. Ins. Co.*, 93 Cal. App. 4th 700, 721-22 (Cal. App. 4th Dist. 2001); *Quelimane Co. v. Stewart Title Guar. Co.*, 19 Cal. 4th 26, 48-49 (1998).

51 *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 723 (1988) (quoting *Nw. Wholesale Stationers Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284, 289-90 (1985)); *Fisher v. City of Berkeley*, 37 Cal. 3d 644, 668, 670-71 n.20-21 (Cal. 1984).

52 *Dr. Miles Med. Co. v. John D. Parker & Sons Co.*, 220 U.S. 373, 404 (1911).

*discretion* as to parties with whom he will deal."[53] The Court distinguished *Colgate* from *Dr. Miles* by stating that in *Dr. Miles,* "the unlawful combination was effected through *contracts* which undertook to prevent dealers from freely exercising the right to sell."[54] Conversely, in a case where a manufacturer unilaterally imposes an RPM policy without establishing a contract combination or conspiracy to that effect, Section 1 liability does not attach.[55] The Supreme Court in *Colgate* specifically held that *even conduct that may be interpreted as having no redeeming value and otherwise is purely anticompetitive* nevertheless escapes Section 1 liability if there is no "contract, combination or conspiracy."[56]

### a. The *Colgate* Doctrine under the Sherman Act

During the past ninety four years, the *Colgate* doctrine consistently has received explicit validation and approval by the United States Supreme Court:

***United States v. Schrader's Son, Inc.* (1920):** In *United States v. Schrader's Son, Inc.,*[57] the Supreme Court stated that *Colgate* was not intended to "overrule or modify the doctrine of *Dr. Miles* . . . where the effort was to destroy the dealers' independent discretion through restrictive agreements."[58] In distinguishing unilateral conduct from concerted action, the Court found it "unnecessary to dwell upon the *obvious* difference between" a *Colgate* policy and an RPM agreement.[59] "In the first, the manufacturer but exercises his independent discretion concerning his customers [with no agreement that] imposes any limitation on the purchaser. In the second, the parties are combined through agreements designed to take away dealers' control of their own affairs and thereby destroy competition."[60]

***Frey & Son, Inc. v. Cudahy Packing Co.* (1921):** In *Frey & Son, Inc. v. Cudahy Packing Co.,*[61] the Supreme Court held that facts establishing that a manufacturer implemented an MSRP program that fixed the minimum price at which wholesalers must sell to retailers; that the manufacturer brought the MSRP program to the attention of the wholesalers; and that the wholesalers thereafter acquiesced in the MSRP program, did not establish an "agreement."[62] The Court did state, however, that "the essential agreement, combination or conspiracy might be implied from a course of dealing or other circumstances."[63]

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53 *Id.* at 307.

54 *Id.* (emphasis added).

55 *See United States v. Colgate*, 250 U.S. 300 (1919).

56 *See generally id. See also, The Jeanery, Inc. v James Jeans, Inc.,* 849 F.2d 1148, 1152 (9th Cir. 1988). But too, a *Colgate* policy may face Section 2 liability which reaches unilateral conduct where there is a danger of monopolization. *See* 15 U.S.C § 2 (2012).

57 252 U.S. 85 (1920).

58 *Id.* at 99.

59 *Id.* (emphasis supplied).

60 *Id.* at 99-100.

61 256 U.S. 208 (1921).

62 *Id.* at 210-11.

63 *Id.* at 210.

***FTC v. Beech-Nut Packing Co.* (1922):** In *FTC v. Beech-Nut Packing Co.,*[64] the Supreme Court found an "agreement" where the manufacturer set uniform prices that were maintained through "cooperation," but without an express agreement.[65] The Court held:

> [F]rom the course of conduct a court may infer, indeed cannot escape the conclusion, that competition among retail distributors is practically suppressed . . . by methods in which the company secures the cooperation of its distributors and customers, which are quite as effectual as agreements express or implied intended to accomplish the same purpose.[66]

In *Beech-Nut Packing Co.,* the manufacturer refused to sell to wholesalers that sold to discounting retailers, instituted a reporting system, and reinstated discounting retailers who subsequently agreed to abide by the minimum prices.[67] Finding an agreement, the Court announced that an express agreement was not necessary to satisfy the first prong of Section 1 and that reinstating recalcitrant retailers can amount to establishing an agreement.[68] Instead, "plus-factors," as they later became known, could be used to infer a tacit agreement.

***United States v. Parke, Davis and Co.* (1960):** In *United States v. Parke, Davis and Co.,*[69] the *Colgate* doctrine again came into question. Parke Davis, a pharmaceutical product manufacturer, announced an RPM policy in its catalogues and enforced it by refusing to sell to wholesalers that sold to retailers who refused to abide by the minimum price.[70] In effect, Parke Davis "used the refusal to deal with the wholesalers in order to elicit their willingness to deny Parke Davis products to retailers and thereby help gain the retailers' adherence to its suggested minimum retail price."[71] Parke Davis supplied its wholesalers with a list of those retailers that did not comply with its pricing policy. Wholesalers who continued to sell to noncompliant retailers were told that Park Davis would not do business with them. Park Davis would reinstate recalcitrant retailers only after assurances that they would comply with the pricing policy. The Supreme Court, acknowledging the "limited dispensation which [*Colgate*] confers," nevertheless found that Parke Davis' conduct "plainly exceeded the limitations of the *Colgate* doctrine."[72]

***Monsanto Co. v. Spray-Rite Serv. Corp.* (1984):** In *Monsanto Co. v. Spray-Rite Serv. Corp.,*[73] the manufacturer terminated Spray-Rite's distributorship agreement after receiving complaints from competing distributors about Spray-Rite's low prices.[74] In holding that a jury properly could find an agreement to establish concerted action, the Court relied on "direct evidence of agreements to maintain prices."[75] The Court expressed its concern,

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64 257 U.S. 441 (1922).

65 *Id.* at 447-51.

66 *Id.* at 455.

67 *Id.*

68 *Id.*

69 362 U.S. 29 (1960).

70 *Id.* at 32, 45-46.

71 *Id.* at 45.

72 *Id.* at 45-46.

73 465 U.S. 752 (1984).

74 *Id.* at 767.

75 *Id.* at 765.

however, that if an inference of an agreement "may be drawn from highly ambiguous evidence, there is considerable danger that the [*Colgate* doctrine] will be seriously eroded."[76] Instead, "there must be evidence that tends to exclude the possibility of independent action by the manufacturer. That is, there must be direct or circumstantial evidence that reasonably tends to prove that the manufacturer and others had a conscious commitment to a common scheme designed to achieve an unlawful objective."[77] The *Monsanto* Court thereby expressly emphasized and endorsed the continued vitality of the *Colgate* doctrine.

### b. The *Colgate* Doctrine under the Cartwright Act

California courts are free to interpret and apply the California antitrust laws in accordance with state policies and are not bound by federal interpretations of the Sherman Act. Nevertheless, "California courts [do] often look to federal precedents under the Sherman Act for guidance."[78]

California courts first applied the *Colgate* doctrine to the Cartwright Act in *R.E. Spriggs Co. v. Adolph Coors Co*.[79] Although it expressly adopted the *Colgate* doctrine, the Court of Appeal of California found that it was not applicable where Coors had adopted an RPM policy, but also thereafter attempted to convince its retailers and distributors to abide by the pricing policy.[80] The Court recognized that part of Coors' pricing policy was drafted to stay within the *Colgate* protections, but focused on the practical implications of the conduct of the parties to make its decision.[81] The Court went on to find Coors liable for entering into agreements to control retail prices.[82]

In *Chavez v. Whirlpool Corp.,*[83] the Court of Appeal of California, again recognized that the *Colgate* doctrine is alive and well under the Cartwright Act.[84] The Court applied the *Colgate* doctrine where Whirlpool merely announced a "KitchenAid Unilateral Price Policy."[85] Acknowledging the importance of the *Colgate* doctrine in California, the Court made clear that if "measures to monitor compliance that *do not interfere* with the dealers' freedom of choice" are not protected, the announced policy would be rendered ineffective and the *Colgate* doctrine would be undermined.[86]

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76 *Id.* at 763.

77 *Id.* at 768.

78 *Chavez v. Whirlpool Corp.*, 93 Cal. App. 4th 363, 369 (Cal. App. 2d 2001).

79 94 Cal. App. 3d 419 (Cal. App. 2nd Dist. 1979). Furthermore, note that the California *per se* condemnation of RPM agreements under the Cartwright Act announced in *Mailand v. Burckle*, 20 Cal. 2d 367 (Cal. 1978), survived the *Leegin* holding. *See Alsheikh v. Superior Court,* 2013 Cal. App. Unpub. LEXIS 7187, *10 (Cal. App. 2d Dist. Oct. 7, 2013).

80 *See Chavez* at 425-26.

81 *Id.* at n.1.

82 *See generally id.*

83 93 Cal. App. 4th 363 (Cal. App. 2d 2001).

84 *Id.* at 370 ("California Courts have adopted the *Colgate* doctrine for purposes of applying the Cartwright Act.").

85 *Id.* at 373.

86 *Id.* The Court also held that if the *Colgate* doctrine applies to conduct, then it cannot be unfair under Section 17200 of the Business and Professions Code.

### c. *Colgate:* Practical Application

The seemingly straightforward *Colgate* doctrine has sparked a great deal of "fact intensive" litigation that necessarily looks to conduct by the manufacturer relating to the enforcement of its mandatory vertical pricing policy. And, although the Supreme Court has said that there is an "obvious difference" between a unilateral RPM policy and an RPM agreement,[87] subsequent cases have demonstrated that the difference is neither simple nor "obvious." An express agreement is not required because courts look to the practical implications of the conduct of the parties.[88] And, courts have recognized that including language in the policy to make it sound like a *Colgate* policy does not by itself avoid liability.[89]

The Supreme Court's statement in *Monsanto* perhaps best illustrates what a truly unilateral pricing policy would look like:

> Under *Colgate,* the manufacturer can announce its resale prices in advance and refuse to deal with those who fail to comply. And a distributor is free to acquiesce in the manufacturer's demand in order to avoid termination. . . . [T]here must be evidence that tends to exclude the possibility of independent action by the manufacturer.[90]

Enforcing the policy without stepping over the line is tricky business. "Courts have long distinguished between a manufacturer that takes affirmative action to ensure compliance with its pricing policies (unlawful) and a manufacturer that merely announces such a policy (lawful)" and thereafter enforces it simply by refusing to deal with those who do not abide by it.[91]

For example, a manufacturer may not maintain prices through the "cooperation" of its distributors, such as by enlisting dealers and other agents to report which retailers are not abiding by the policy, and then putting them on a list of undesirable retailers, only to reinstate them after receiving satisfactory assurances that the retailers will follow the manufacturer's RPM policy.[92] Similarly, a manufacturer may not use a wholesaler to enforce its RPM policy against recalcitrant retailers by providing the wholesalers with a list of retailers and then refusing to deal with wholesalers who distribute to them.[93]

Courts have recognized, however, that "measures to monitor compliance that do not interfere with the dealers' freedom of choice are permissible [and that] [t]o hold otherwise would render the manufacturer's announced policy ineffective and thereby undermine the

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87 *See United States v. Schrader's Son, Inc.*, 252 U.S. 85, 99 (1920).

88 *See FTC v. Beech-Nut Packing Co.*, 257 U.S. 441, 455 (1922) ("From this course of conduct a court may infer, indeed cannot escape the conclusion, that competition among retail distributors is practically suppressed . . . by methods in which the company secures the cooperation of its distributors and customers, which are quite as effectual as agreements express or implied intended to accomplish the same purpose.").

89 *See R.E. Spriggs Co. v. Adolph Coors Co.*, 94 Cal. App. 3d 419, nn. 1, 425-26 (Cal. App. 1979) (citing *United States v. Parke, Davis and Co.*, 362 U.S. 29 (1960)).

90 *Monsanto Co. v Spray-Rite Serv. Corp.*, 465 U.S. 752, 761, 768 (1984).

91 *Edward J. Sweeney & Sons, Inc. v. Texaco, Inc.*, 478 F.Supp 243, n. 36 (E.D. Pen. 1979).

92 *See Beech-Nut Packing Co.*, 257 U.S. at 454-55.

93 *See Parke, Davis and Co.*, 362 U.S. at 45.

rights protected by the *Colgate* doctrine."[94] As the *Monsanto* Court unequivocally said, "[p]ermitting an agreement to be inferred merely from the existence of complaints, or even from the fact that termination came about 'in response to' complaints, could deter or penalize perfectly legitimate conduct."[95]

### d. The *Leegin* Decision

In *Leegin,*[96] a leather belt manufacturer instituted an RPM policy and offered compliant retailers with various incentives.[97] PSKS, a retailer, refused to comply and insisted upon selling belts below the mandatory minimum resale price. The manufacturer refused to continue providing incentives to PSKS and litigation ensued.[98] The case made it to the Supreme Court, which overruled *Dr. Miles* and announced that RPM agreements now are subject to the rule of reason analysis.[99] The Court stated that the "reasons upon which *Dr. Miles* relied do not justify a *per se* rule."[100]

The *Leegin* Court expressly recognized that a "manufacturer has a number of legitimate options to achieve benefits similar to those provided by vertical price restraints."[101] Among those options, according to the Court, is the "right to refuse to deal with retailers that do not follow its suggested prices."[102] Even the dissent in *Leegin* understood and recognized that, following *Leegin,* "*Colgate* would remain good law [even] with respect to *unreasonable* price maintenance."[103] Consequently, although the *per se* condemnation announced in *Dr. Miles* did not survive *Leegin,* the *Colgate* doctrine remains in effect.

## B. The *Colgate* Doctrine After *Leegin*

Since *Leegin* was decided in 2007, courts implicitly have recognized that *Colgate* still is good law. In *N. Tex. Speciality Physicians v. FTC,*[104] an organization of independent physicians took a poll of its member physicians to collect the minimum price they would take for treatment contracts with payers, such as insurance companies.[105] The Fifth Circuit recognized

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94 *Chavez v. Whirlpool Corp.*, 93 Cal. App. 4th 363, 373 (Cal. App. 2001); *see also Monsanto*, 465 U.S. at 763-64. Thus, for example, the fact that ABB "surveys its ECP customers to find out how much they are charging their patients for each different type and brand of contact lens" does not necessarily suggest concerted action. *See supra* note 15.

95 *Monsanto*, 465 U.S. at 763-64.

96 *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

97 *Id.* at 883.

98 *Id.* at 884.

99 *Id.* at 907.

100 *Id.* at 889.

101 *Id.* at 902.

102 *Id.* at 902-03.

103 *Id.* at 924 (Breyer, J., dissenting) (emphasis in original).

104 528 F.3d 346 (5th Cir. 2008).

105 *Id.* at 352-53.

that unilateral conduct would evade illegality under the antitrust laws,[106] but declined to apply it to the conduct of the NTSP.[107] Likewise, in *In re Pool Products Distribution Market Antitrust Litigation,*[108] the United States District Court for the Eastern District of Louisiana recognized *Colgate* as good law,[109] but refused to apply it where the pool products distributor had agreements with manufacturers to set prices and exclude competing distributors.[110] Furthermore, even the FTC, Bureau of Competition, has recognized *Colgate* as good law.[111]

In *Leegin,* the Supreme Court did specifically acknowledge that RPM policies do have economic dangers, and that courts must be diligent in eliminating their anticompetitive uses from the market.[112] The Court identified "certain factors" that are relevant in determining whether an RPM policy is manifestly anticompetitive and unlawful *under the rule of reason:*

> For example, the number of manufacturers that make use of the practice in a given industry can provide important instruction. When only a few manufacturers lacking market power adopt the practice, there is little likelihood it is facilitating a manufacturer cartel, for a cartel then can be undercut by rival manufacturers.
>
> * * *
>
> *[But r]esale price maintenance should be subject to more careful scrutiny, by contrast, if many competing manufacturers adopt the practice.*

(emphasis supplied).[113]

It certainly is correct that in *Leegin,* the Supreme Court made clear that "the potential anti-competitive consequences of vertical price restraints must not be ignored or underestimated."[114] It also is correct that the Supreme Court encouraged the courts "to establish the litigation structure to ensure that the rule [of reason] operates to eliminate anti-competitive restraints from the market and to provide more guidance to businesses."[115] It also directed the courts "to be diligent in eliminating [the] anticompetitive uses [of RPM agreements] from the market."[116]

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106 *Id.* at 356 ("nothing in the antitrust laws prohibits an individual trader, absent an anticompetitive intent, from announcing in advance the terms on which he will deal") (citations omitted).

107 *Id.* at 367 ("The Commission concluded, and we agree, that NTSP engaged in concerted action to increase its bargaining power.").

108 940 F. Supp. 2d 367 (E.D. La. 2013)

109 *Id.* at 396.

110 *Id.* at 374-75, 396.

111 The FTC Bureau of Competition, in a blog post, indicated that the law on refusals to deal is that a firm may unilaterally choose its "business partners." Alan Friedman, *from the antitrust mailbag: refusals to deal*, FTC Blogs, Competition Matters (May 14, 2014) https://www.ftc.gov/news-events/blogs/competition-matters/2014/05/antitrust-mailbag-refusals-deal. The FTC recognized the *Colgate* doctrine as a "fundamental rule of federal antitrust law." *Id.*

112 *Leegin Creative Leather Prods., Inc. v PSKS, Inc.,* 551 U.S 877, 897 (2007).

113 *Id.* (emphasis supplied).

114 *Id.* at 894.

115 *Id.* at 898-99.

116 *Id.* at 897.

Since the *Leegin* decision was decided in 2007, however, no other court has established a structured test or truncated rule of reason analysis. That does not suggest that courts may not do so. And, of course, the FTC has suggested that "[t]he *Leegin* decision may be read to suggest a truncated analysis . . . might be suitable for analyzing resale price maintenance agreements, at least in some circumstances. . . ."[117] It does not follow, however, that the *Colgate* doctrine must be minimized—or discarded entirely—simply because RPM *agreements* now are analyzed under the rule of reason—whether truncated or not.[118]

*Leegin* was predicated upon an express—indeed, undisputed—finding of an RPM *agreement* between the manufacturer and its retailer. The Court's comments were intended to suggest that where many competing manufacturers in a highly concentrated industry each enter into *vertical* RPM "*agreements*" with their downstream retailers (absent any horizontal conspiracy among the competing manufacturers), then the court should subject the *vertical* RPM policy of each manufacturer to "more careful scrutiny" under the rule of reason.[119] But, in the absence of any vertical *agreement—i.e.,* "contract, combination or conspiracy"—the rule of reason simply *does not apply*. *Leegin* amply demonstrated this when the Court, acknowledging the continued application of the *Colgate* doctrine, made clear that a "manufacturer can exercise its right to refuse to deal with retailers that do not follow its suggested prices," despite the fact that *"[t]he [anticompetitive] economic effects of unilateral and concerted price setting in general [may be] the same."*[120]

As implausible as it may sound, if the dominant manufacturers in a highly concentrated industry do in fact *unilaterally* implement *vertical* price fixing policies, then *Colgate* will shield their vertical price restrictions from liability under Section 1 of the Sherman Act and Section 16720 of the Cartwright Act. The issue is not whether the *collective* RPM policies are anticompetitive and represent unreasonable restraints lacking any procompetitive justification. Indeed, it very well may be that they are nothing more than abject restrictions that "always or almost always tend to restrict competition and decrease output."[121] This, however, does not mean that either the Sherman Act or the Cartwright Act has been violated. Indeed, the *Colgate* court itself recognized and acknowledged this paradox.[122]

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117 *See In re Nine West Group, Inc.*, FTC Dkt. C-3937, Order Granting In Part Petition To Reopen and Modify Order Issued April 11, 2000, at 12, 2008 WL 2061410 (May 6, 2008).

118 Nevertheless, the notion that the FTC might avoid *Colgate* altogether by prosecuting RPM cases, including the disposable contact lens manufacturers, as separate and discreet Section 5 violations, without any proof of agreement, could be an open question. *See* 15 U.S.C. § 45 (a). But, the FTC Bureau of Competition views *Colgate* as good law. *See supra* note 110.

119 *See Leegin* at 897.

120 *Id.* at 902 (emphasis supplied).

121 *See supra* note 50.

122 *See supra* note 55.

## IV. CONCLUSION

The *Colgate* doctrine is alive and well. This means that *if* each of the Manufacturers in the Disposable Contact Lens Antitrust Litigation (a) *has not* acted in concert with the other Manufacturers in the facilitation of a manufacturer cartel; and (b) *has* acted unilaterally in the implementation of its RPM policy—*as improbable as that may seem*—then none of them have violated either Section 1 of the Sherman Act or Section 16720 of the Cartwright Act. Paradoxically, notwithstanding that *collectively* their so-called UPP vertical price restraints have "manifestly anticompetitive effects"[123] on *interbrand* competition and may "lack any redeeming virtue," their "unilateral" conduct does not fall within the ambit of the antitrust laws.[124] Stated somewhat differently, absent evidence of a horizontal conspiracy or manufacturer cartel, if each Manufacturer is in fact setting its prices at a *supra*competitive level by merely recognizing its shared economic interest and interdependence with respect to price and output determinations in this concentrated market—*i.e.,* each is participating in the process of "conscious parallelism"—then no antitrust liability will attach to any of the Manufacturers.[125]

123 *See Continental T.V., Inc. v GTE Sylvania, Inc.,* 433 U.S. 36, 50 (1977).

124 *See Nw. Wholesale Stationers, Inc. v Pacific Stationery & Printing Co.,* 472 U.S. 284, 289 (1985).

125 *See supra* note 5.

# BREAKING A MONOPOLY: VIGILANTE JUSTICE OR THE SORT OF INNOVATIVE APPROACH WE CELEBRATE?

*By Ryan McCauley*[1]

The Second Circuit's recent decision in *United States v. Apple, Inc.* (the "Opinion"),[2] like Judge Denise Cote's decision and judgment in the district court, paints a scintillating conspiracy story of Apple and five of the nation's largest book publishers ganging up to take on Amazon and, as the majority argues, raising consumer prices. There are numerous factual aspects of the district court's judgment that Apple will undoubtedly continue to dispute in its recently announced appeal to the Supreme Court, but the real policy question is whether relatively short term concerted action that is designed to facilitate entry into a monopolized market should be illegal *per se*, particularly where the monopolist is likely undertaking a preemptory price cutting regime to prevent entry.[3]

One of my antitrust professors offered what I find to be a helpful analogy when thinking about *per se* rules and the "rule of reason" standard in the antitrust realm: he analogized that a *per se* rule is like a numerical speed limit while the "rule of reason" was comparable to the state of Montana's widely publicized former "reasonable and prudent" standard for judging whether a driver was speeding.[4] *Per se* rules are incredibly efficient for our legal system—there is very little analysis when it comes to the question of whether a driver exceeded a numeric speed limit—but the necessary trade-off is that cases deserving deeper analysis are quickly categorized along a bright line and justice is meted out roughly without respect to unique circumstances. To their credit, *per se* rules provide certainty and deter conduct that falls on the wrong side of the bright line. At the other end of the spectrum, rule of reason analyses take account of each cases' unique aspects and, therefore, result in more accurate judgments, but require a significant dedication of parties' and judicial resources. That antitrust law has long employed, depending on the circumstances, either *per se* or rule of reason analyses to efficiently adjudicate cases is one of the most interesting aspects of this body of law. But as economic thinking about certain types of conduct has grown more sophisticated and nuanced, the natural evolution for our legal regime has been to reduce the types of conduct judged illegal *per se* to only those types that are clearly anticompetitive.[5]

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1 The views expressed here are my own and not the views of the firm I am associated with or my clients. I have personal and professional ties to both Apple and Amazon, where both friends and former colleagues work. My closest tie, however, is to Apple because it is my wife's employer. With that disclosure, I should also note that my views are not informed by these personal relationships.

2 791 F.3d 290 (2nd Cir. 2015).

3 *Apple*, 791 F.3d at 341-42 (Jacobs, J. dissenting) (describing extent of Amazon's monopoly). As both the majority and dissent make clear, Amazon is not on trial here. That said, it is impossible to analyze Apple's conduct without recognizing the outsized impact that Amazon (with its undisputed monopoly power and 90% of the market share). Nevertheless, it is important to note that Amazon has not had the opportunity to defend its own conduct in the e-book market. *See Id.* at 341-42.

4 My law school antitrust professors are Dr. Steven Salop and Mark Popofsky. This particular analogy was offered by Professor Popofsky.

5 Ironically, the evolution has gone the other direction when it comes to speed limits. Early in the days of driving, numerous states had speed standards similar to Montana's but moved to numeric limits for ease of enforcement. Indeed, Montana followed suit and enacted a numerical limit after its "reasonable and prudent" standard was struck down by its state supreme court as unconstitutionally vague—a type of challenge to the rule of reason not yet seriously considered in the modern antitrust regime. *See* Jim Robbins, *Montana's Speed Limit of ?? M.P.H. Is Overturned as Too Vague,* N.Y. Times, Dec. 25, 1998.

We are now sixteen years past Justice Souter's famous invocation of "an enquiry meet for the case" when endorsing the use of the rule of reason to analyze horizontal agreements among a trade group[6] and almost a decade past Justice Kennedy's declaration that vertical price fixing requires a rule of reason review.[7] Those decisions built on more than a century of experience, which though uneven, has arrived at the consensus that few agreements are easily categorized as so pernicious or damaging to consumer welfare that they should be labeled *per se* illegal. The *Apple* case brings the question of the right test to the last significant circumstance where the *per se* rule has been essentially unquestioned: concerted conduct. The answer for the typical cartel scenario is that the *per se* rule bars concerted action among horizontal competitors because it is presumed to be designed to attain monopoly power. But the twists in this case—the largest being the presence of an overwhelming monopolist in the relevant retail market—is important. To put the question slightly differently, should there be a *per se* prohibition on concerted action that involves a non-integrated retailer agreeing on a new business model with upstream distributors in an attempt to enter a monopolized retail market? Is that a resort to socalled "marketplace vigilantism" as the Second Circuit majority saw it,[8] or is that a competitor finding an efficient and innovative path into the marketplace?

Some will cast this as a question of whether any conduct should continue to be adjudged *per se*, rather than by the searching rule of reason analysis or even some middle-ground "quick look" analysis. But the question is actually much narrower: Is concerted action so obviously detrimental when used to take on a monopolist exercising monopoly power? If not, the district court and Second Circuit have erred and this case should be retried applying some variant of a rule of reason analysis. That does not mean that Apple and the publishers are off the hook—the result may well be the same after that analysis is genuinely undertaken—but it does mean that the trial court needs to look at the full set of facts in this unique case.[9]

This comment addresses three concepts stemming from the Second Circuit's Opinion. *First*, how does the Supreme Court's evolving jurisprudence, most recently the *Leegin* decision, guide this case? *Second*, the Opinion effectively articulates the anticompetitive rationales attendant to concerted action and, in keeping with a *per se* analysis, dismissed any potential procompetitive rationales. Are there really no procompetitive rationales in this circumstance? *Third*, and following from the first two, does a *per se* rule have a place when analyzing concerted action against a monopolist?

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6 *California Dental Ass'n v. FTC*, 526 U.S. 756, 781 (1999).

7 *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 551 U.S. 877 (2007).

8 *Apple*, 791 F.3d at 297-298, 332.

9 In a single paragraph constituting dicta, the district court stated that it also analyzed the *Apple* case under an alternative rule of reason assessment and stated that it reached the same conclusion that Apple was liable for a price fixing conspiracy whether tested under a *per se* or rule of reason analysis. Writing the majority opinion, Judge Livingston agreed with the district court's tactic of bulletproofing its decision by asserting that Apple would be liable in all events, but Judge Lohier declined to join that conclusion (and Judge Jacobs dissented entirely). *See Apple,* 791 F.3d at 339-40 (Lohier, J., concurring), 341-42 (Jacobs, J., dissenting), 348-49 (Jacobs, J.) ("Once a court finds that a party acted unreasonably *per se* in a set of transactions, an epiphany is required for the court to conclude that the same party acted reasonably doing the same acts in the same role at the same time. The influence arising from the district court's *per se* accusation of wrongdoing infected all analysis that followed. Once Apple was deemed to have joined a conspiracy that was illegal *per se*, its goal, motive, and conduct seemingly needed (and got) no additional scrutiny—legal or moral or economic.").

## A. *Leegin*'s Reverberations

The majority and dissenting opinions at the Second Circuit each invoke *Leegin*, which reversed a century-long *per se* ban on vertical price fixing, to support their arguments that Apple should or should not be tried under a *per se* regime. In the eight years since it was handed down, *Leegin* has been widely regarded as the near-final word on the Supreme Court's evolution about the application of *per se* rules in antitrust. The earliest case, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*,[10] effectively held that vertical price restraints—minimum resale price maintenance ("RPM") agreements—were *per se* illegal.[11] For the remainder of the Twentieth Century, the Supreme Court, Congress and the states wrote a lurching novel which vacillated between high and low points for vertical agreements.[12] Bolstered by the economic rationales supporting the valuable, but often intangible, services that producers seek for retailers to provide to their ultimate customers, *Leegin* overturned the *per se* rule against RPM and declared that vertical pricing agreements must be evaluated using a rule of reason analysis. The Supreme Court left it to the lower courts to fashion the appropriate analysis under the circumstances.[13]

### 1. The Economic Rationale for Analyzing Vertical Agreements Between Producers and Retailers By the Rule of Reason.

The basic purpose of vertical agreements among producers and retailers is to forsake intra-brand competition among retailers (*e.g.*, Target and Walmart) in favor of more aggressive inter-brand competition among rival producers (*e.g.*, Colgate and Crest). One way to visualize the relationship between retailers and manufacturers is to view retailers as a

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10 220 U.S. 373 (1911).

11 RPM is sometimes used broadly to refer to vertically imposed price floors as well as price ceilings. *Leegin* was concerned with *minimum* RPM—*i.e.*, price floors below which retailers could not offer a manufacturer's product for sale. The Supreme Court ruled a decade earlier that *maximum* RPM (price ceilings) would be analyzed using the rule of reason. *State Oil Co. v. Khan*, 522 U.S. 3, 18-19 (1997).

12 *See U.S. v. Colgate & Co.*, 250 U.S. 300, 307 (1919) (allowing "unilateral" RPM—an illusory denial of the agreement element of a Sherman Act claim when manufacturers made statements that they would not sell to price-cutting retailers (therefore acting only unilaterally and without any agreement)); *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (distinction between price and non-price vertical agreements that allowed for a rule of reason analysis in non-price (*e.g.*, territorial) agreements); and *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752, 764 (1984) (cabining the *per se* rule of illegality for RPM by effectively elevating the burden of proof concerning an RPM agreement). Despite the Court's decision in *Leegin*, there are still twists in treatment of RPM as several states have adopted laws or regulations banning or curtailing its use by producers.

13 In the words of Justice Kennedy, writing for the majority in *Leegin:*

> The rule of reason is designed and used to eliminate anticompetitive transactions from the market. This standard principle applies to vertical price restraints. A party alleging injury from a vertical agreement setting minimum resale prices will have, as a general matter, the information and resources available to show the existence of the agreement and its scope of operation. As courts gain experience considering the effects of these restraints by applying the rule of reason over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses. Courts can, for example, devise rules over time for offering proof, or even presumptions where justified, to make the rule of reason a fair and efficient way to prohibit anticompetitive restraints and to promote procompetitive ones.
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> 127 S. Ct. at 2720.

means to distribute finished products from manufacturers into the hands of consumers.[14] This analogy, though imperfect, is a good starting point for considering pro-competitive benefits that flow from vertical agreements between producers and retailers: Retail distribution is an input that adds value to manufacturers' goods by delivering them to consumers.[15] In theory, the value added by a retailer should reflect the value that the manufacturer places in a particular distributional scheme.[16] If the costs to transport and promote the products are low and the profit margins charged by retailers are low, then the product price will reflect these lower costs of distribution. Producers compete on numerous levels, but price competition is undoubtedly important. Thus, lower retail mark-ups (and lower prices generally) will result in more sales for producers. In contrast, if the costs of distribution are high and the retailers charge large mark-ups on each good sold, the higher prices will reduce the quantity of goods sold and cause the manufacturer's total revenue to shrink.[17] As a result, manufacturers rationally desire to deliver their goods via the least expensive distribution channel.

But if manufacturers want cheap distribution, why would they set minimum resale prices, and more importantly for the legal question, why would the courts allow manufacturers to eliminate intra-brand price competition among retailers? The basic answer is that manufacturers compete for sales on many factors besides price. A major competitive factor is distribution—be it by the internet or in-store sales. By guaranteeing retailers a particular margin on every sale, producers gain some control over the retailers as a means of distribution. In return for those guaranteed profits, manufacturers can require retailers to offer particular services. And beyond this idea of direct control over retailers (dictating how a retailer will display a product, how it will market that product, or which services the retailer must provide), the manufacturers establish indirect control by creating an incentive

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14 For purposes of broadly illustrating the basic vertical relationship between the firm that actually produces goods and the second firm which uses some means of distribution to deliver those goods to ultimate consumers, I refer to the former as the "manufacturer" or "producer" and the latter as the "retailer." However, as described below, the *Apple* case is more complicated. Amazon and Apple can fairly be described as retailers of one sort or another, but the true producers are authors, not publishing houses, which add value by editing and marketing the authors' books, but are probably best described as an intermediate distributor. The publishers are arguably not essential—Amazon has attempted to disrupt the publishing chain with its direct publishing service, named Kindle Direct Publishing, which "allows authors to bypass traditional publishers and instead deal directly with Amazon[.]" John D. Sutter, *Self-published e-book author: 'Most of my months are six-figure months,'* CNN.com (Sept. 7, 2012), http://www.cnn.com/2012/09/07/tech/mobile/kindle-direct-publish/. Amazon reported that, at one point in 2012, 27 of its top 100 selling e-books were published solely through this program. *Id.*

It should also be noted that there is a completely different way to perceive retailers vis-à-vis consumers and producers: rather than being the sales agents and distribution channels of producers, retailers could be thought of as the "purchasing agents" of consumers. *See* Pamela Jones Harbour, Commissioner of the Federal Trade Comm'n, Opening Remarks at 9 (Feb. 17, 2009), *available at* http://www.ftc.gov/speeches/harbour/090217rpmwksp.pdf. Given the widely acknowledged brand loyalty owing to both Apple and Amazon, it is entirely plausible that ebook consumers view these companies as their "purchasing agents." *See, e.g.,* Scott Goodson, *Is Brand Loyalty the Core to Apple's Success?*, Forbes.com (Nov. 27, 2011 6:50 PM), http://www.forbes.com/sites/marketshare/2011/11/27/is-brand-loyalty-the-core-to-apples-success-2/.

15 Thomas A. Lambert, *Dr. Miles Is Dead. Now What?: Structuring A Rule of Reason for Evaluating Minimum Resale Price Maintenance*, Univ. of Missouri Sch. of Law Legal Studies Research Paper No. 2008-25 at 10, *available at* http://ssrn.com/abstract=1263376, *citing* R.H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937).

16 *Id.* at 10-12.

17 *Id.*

for retailers to push their products instead of competitors' goods. So, if manufacturers believe that increasing their retailers' margins will cause more units to be sold, then the manufacturers would choose to be less competitive on price in order to be more competitive in point-of-sale services that add value to the purchased product. RPM accomplishes its goal of increased services related to distribution by eliminating intra-brand price competition through a price floor. From an economic perspective, the theory behind RPM is that there is a "bargain" being struck—consumers pay higher prices for increased services related to a particular brand, all the while there remains price competition between brands.[18]

## 2. What Does *Leegin* Tell Us About *Apple?*

All of this discussion about vertical price fixing is important background to understand what is really happening in distributional chains. The big question, however, is how does *Leegin* really apply to the *Apple* case? There are at least five considerations to keep in mind about *Leegin.*

To start, the right understanding of Apple, Amazon, and the book publishers' roles in the market are important. Apple and Amazon are both fairly described as e-book retailers. Though they obviously use an entirely different medium, they are not markedly different than retailers who sell hard copy books, like Walmart, Target or Barnes & Noble. As noted above, the real producers in this mix are authors. And, without intending to diminish their role, each publisher is a sort of middleman. The publishers undoubtedly provide value in the form of editing, promoting and distributing books, but they do not generate the basic content and are not what one thinks of when describing a "brand." To the extent there are brands in the broader book market, they are the authors who are publicly recognized. As the world witnessed this summer, authors like Harper Lee, rather than publishers like HarperCollins, are the brands that sell books.[19] Certain bestselling authors work exclusively with particular publishers, and publishers' marketing efforts certainly matter a great deal to books' success, but there is not inter-brand competition of the same type that we typically perceive among manufacturers of other consumer goods. So at this basic level, the e-book market is likely distinct from the types of product markets that the Court had in mind in *Leegin.*

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18 This rationale is sensible, but the interests of the retailer and manufacturer are not aligned at this point. While retailers are likely to jump at an opportunity for a higher margin in return for improved point-of-sale services, they are very fearful of free-riding. That is, retailers are worried that consumers will utilize their expanded services and then go across the street or to another web address to buy the same product at a lower price from a discount store that does not offer comparable services. RPM provides a solution to this free-riding problem: By setting a minimum resale price, intra-brand price competition is eliminated. With RPM, retailers compete based on nonprice factors like point-of-sale service, post-sale support, home delivery and alike. Manufacturers desiring all of those additional distribution-related services use RPM as a tool to incentivize their retailers and solve the free-riding problem. There are several potential solutions to address this free-rider problem: (1) charge consumers small fees for enhanced retail services, (2) allow manufacturers to implement non-price vertical restraints (e.g., territorial restrictions or mandatory retail service standards imposed by manufacturers), or (3) allow manufacturers to use RPM. *See* Lambert, *supra* note 15 at 13-14. The first of these would be counterintuitive for most American consumers; for example, the idea of paying for customer service at an Apple store would upset most consumers. The second concept—usually territorial restrictions—is actually worse for consumers than RPM. It has the effect of eliminating not only intra-brand price competition but also removing the incentive for those retailers with exclusive territories from competing based on the level of service.

19 The unique nature of the book marketplace has long been recognized. As reported in the Wall Street Journal, one publishing executive described it this way: "This is a title-driven business . . . If you have a good book, price isn't an issue." Jeffrey A. Trachtenberg, *E-Book Prices Rise, and Sales Suffer,* The Wall Street Journal, at B1, B4 (Sept. 4, 2015).

But that is not to say that *Leegin* is not instructive for the *Apple* case. To the contrary, the procompetitive rationales for vertical agreements identified in *Leegin* should carry significant weight in this case. First, *Leegin* instructs that non-price competition is important. That does not diminish considerations about price effects caused by some conduct, but is important to assess both when attempting to determine the whether a vertical agreement is anticompetitive. For example, many loyal Apple users undoubtedly prefer having a single integrated platform with their music libraries, data and ebooks (and a single retailer with their credit card information), and are willing to pay a premium for such "one-stop shopping." Loyal Amazon consumers may feel exactly the same way about Amazon. Consumers may also perceive that one company's speeds for downloading content are faster or that their downloads are less buggy. Whatever the reason, provided that there are reasonable competitive alternatives, consumers vote with their feet after weighing price and non-price (*i.e.,* service-related) options together. *Leegin* instructs that the legal analysis must do the same and take non-price aspects into consideration.

Second, and relatedly, more viable retail options for consumers is a benefit in itself: Vertical price agreements "also ha[ve] the potential to give consumers more options so that they can choose among low-price, low-service brands; high-price, high-service brands; and brands that fall in between."[20] To say this differently, the distinctions in service provided by Apple, Amazon and other e-book retailers is important to consumers.[21]

Third, the agency model agreed upon by Apple and the publishers, which the publishers then sought to enter with Amazon, sounds a lot like a conventional RPM scheme where upstream participants in the supply chain have the ability to reasonably set price floors and pay a percentage "commission" to retailers. Indeed, on this point, the publishers' agreements with Apple are presumably an easier question because they instituted only price *ceilings,* not floors.[22] The nuances and distinctions of the agency model as proposed in Apple's contracts have to be teased out, but as a general matter, the publishers were gaining pricing power that is akin to the pricing power that other upstream distributors or producers have in competitive markets.

Finally, Judge Jacobs makes a persuasive argument from the plain language of *Leegin* that all vertical agreements are to be analyzed by the rule of reason, even those that are ostensibly intended to facilitate collusion among horizontal competitors upstream in the distribution channel.[23] Because the harm that so concerns antitrust is collusion among horizontal competitors rather than between non-competing intermediaries and retailers, Judge Jacobs argues that even a so-called "hub and spoke" conspiracy must be analyzed under the rule of

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20 *Leegin*, 127 S. Ct. at 2715.

21 Generally, vertical agreements are also a vehicle to protect new entrants to a marketplace. For example, RPM prevents discounting and provides retailers with a guaranteed profit margin. As a result, retailers may be more likely to take the risk of placing an unknown good from a smaller producer in their inventory because they will not fear that other retailers will slash prices and force them to sell at a loss. While this rationale is secondary to improving efficiency and is less salient as it concerns e-books where unmoved inventories do not present the same risk to retailers, the Supreme Court universally recognized this pro-competitive rationale for RPM in *Leegin*, 127 S. Ct. at 2731 (Breyer, J., dissenting) ("[I]f forced to decide now, at most I might agree that the *per se* rule should be slightly modified to allow an exception for the more easily identifiable and temporary condition of 'new entry.'").

22 *See State Oil*, 522 U.S. at 18-19.

23 *Apple,* 791 F.3d at 347-348 (Jacobs, J., dissenting).

reason as it concerns any vertically-aligned participant.[24] Notwithstanding the language cited by Judge Jacobs, I am not so thoroughly convinced that the Supreme Court ruled out the idea that a vertical participant that facilitates a horizontal price fixing conspiracy may be tried using the *per se* rule. But as I explain below, from my perspective, Amazon's undisputed monopoly and market power are what should exempt this case from a *per se* analysis.

## B. Pro-Competitive Benefits from Apple's Vertical Agreements and Entry into the EBook Market.

In concluding that Apple's conduct should be judged illegal *per se*, the district court and Second Circuit each concluded that there are no significant potential procompetitive benefits to Apple's vertical agreements that allowed its entry into the market. As noted above, the district court and majority Opinion spend a great deal of time chronicling the alleged collusion narrative that Apple continues to dispute.[25] As Judge Jacobs did in his dissent, this narrative can be spun in a different, far less nefarious manner. But the real pitfall of the district court's and majority's analysis is its failure to seriously assess the procompetitive effects of having a significant new entrant in the market. There are at least two points that the Supreme Court will need to consider should it grant *certiorari*.

*First*, it is important to appreciate exactly what the district court and majority considered as the scope of their analysis. As the majority Opinion states, "[t]he district court did not analyze the state of competition between ebook retailers" because "the relevant market in this case is 'the trade e-books market, not the e-reader market or the e-books system market.'"[26] Notwithstanding any agreement on this point among the parties, it is not clear to me that Apple's entry to the e-book market can be distinguished from its entry to these other "markets," particularly at the then-nascent stage of e-books, or whether these other markets actually existed independent of the e-books market at the time. Establishing the relevant market is typically a complex analysis itself and an examination of other closely intertwined markets is often central to a rule of reason review. But understanding that interconnectivity is imperative to reaching the right answer. Moreover, the e-books market at the time was dominated by Amazon (holding some 90% of the market) selling its own Kindle with limited competition from Barnes & Noble.[27] Other than tablets and "e-readers," there was no other medium through which to access e-books. Given that, to divorce the e-books markets from these other markets, is to say effectively that potential pro- and anticompetitive effects are judged without respect to a retailer's actual means of distribution. That is simply too narrow a stricture for a complex case like this one.

*Second*, there are several potentially significant procompetitive effects stemming from Apple's entry to the market. The first is the real prospect of consumer choice and strong competition that Apple offered. While the traditional barriers to entry are presumably fairly

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24 *Id.*

25 One particular facet that stood out to me is that Apple never tried to conceal its discussions with the publishers. Unlike most alleged cartels, these agreements' terms were known by Amazon and reported on publicly. *See, e.g.*, *Apple*, 791 F.3d at 306-07.

26 *Apple*, 791 F.3d at 312 (quoting the district court judgment and noting that this was agreed upon by the parties).

27 *Id.* at 299, 301.

low in the e-books market (one could argue that any savvy techie could quickly write a killer e-books app), the players in the broader publishing market are well established and the means of distribution for ebooks were extremely limited. As a well-capitalized entrant with a platform for distributing ebooks, Apple presented the prospect of quickly providing real competition to challenge Amazon's monopoly for the long run. Moreover, as an initial observation, Apple is predominantly a computer company. Its entry to the ebooks market was only incidental to its entry into the tablet computing market with the launch of the iPad and, as established by the record in this case, the ebooks component was not critical to Apple's decision to enter the tablet market.[28] Apple had a new product, saw its potential as an e-book reader and also observed that a complimentary market—the e-books market—was potentially lucrative.[29] E-books, however, are not a core business for Apple and likely never will be. That suggests that accounting for what is happening in complimentary/intertwined markets is all the more justified here.

The next potentially significant procompetitive effect of Apple's entry is the likelihood of non-price competition between Amazon and Apple and resulting customer service improvements. Other than doing just well enough to keep new entrants out, a monopolist has little incentive to provide expensive customer service that can add significant value for consumers. In particular, Apple touts a user "experience" that focuses on customer service and reliability.[30] While it is always difficult to quantify this, it cannot be ignored that a significant new entrant's presence in the marketplace would very likely lead to an improving customer experience across the market. As noted above, this user experience includes the ability for consumers to pay a premium to have all of their electronic lives—their email, work documents, photos, music libraries and their reading material—in one location. Price-conscious consumers may not be willing to pay more for this sort of thing, and Amazon or other retailers may cater specifically to those consumers, but as other studies have shown, many of Apple's very loyal consumers are not particularly price conscious, suggesting that they place significant value in the services Apple provides.

### C. Is a *Per Se* Analysis Appropriate to Evaluate Concerted Action to Challenge a Retail Monopoly?

This last question is largely answered by the prior two sections, but there are two last areas that deserve attention. The first is whether the district court and majority's assessment of overwhelming anticompetitive effects is accurate. The second is whether allowing concerted action to challenge a monopolist is really anticompetitive, or as Judge Jacobs suggests, the sort of "self-help (which used to be a virtue)."[31]

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28 *See id*. at 301 (noting that "the iPad would go to market with or without the iBookstore").

29 As an innovative but inexperienced entrant to a monopolized market, Apple is exactly the type of disruptive "maverick" that is usually lauded. *See Apple*, 791 F.3d at 349 (Jacobs, J., dissenting).

30 A simple Google search turns up numerous news and analyst reports saying something along the lines of "these companies must innovate—particularly on the user experience—to compete with Apple." Forrester Research Report, "Apple's iPhone Changes the Stakes, Not the Game"; *see also* Ben Bajarin, "Why Only Apple Can Promise a Better Experience to Customers Every Year," Time.com (June 12, 2012), *available at* http://techland.time.com/2012/06/12/why-only-apple-can-promise-a-better-experience-to-customers-every-year/.

31 *Apple*, 791 F.3d at 349 (Jacobs, J., dissenting).

*First*, the district court and majority each placed a great deal of emphasis on the shift in models within the e-book industry and what they attributed to be corresponding increases in e-book prices. The timing certainly provides circumstantial evidence that the move to the agency model and Apple's entry to the market corresponded with an increase in e-book prices. However, the correlation and causation are not clear, particularly given the existence of significant intervening forces. As Judge Jacobs notes, the most significant of these is the fact that Amazon was previously artificially depressing the retail price of e-books by selling bestselling books significantly below cost.[32] Whenever Amazon stopped that practice, prices would inevitably rise.

Similarly, while Apple believed that the "agency" model and protections like a "most favored nation" provision in its contracts with the publishers were important for it to enter the market on a level playing field with Amazon, that did not *guarantee* a shift away from the "wholesale" model that Amazon favored at the time. Indeed, a majority of book publishers (52%), including the largest single publisher (Random House), did not agree to Apple's proposed agency model.[33] This strongly suggests that the influence of the publishers' cartel at the intermediate level did not rise to the level of monopoly power.[34] Given its own monopoly position at the retail level, it is hard to imagine that Amazon's back was entirely against the wall.[35] And at the very least, the market power of the publishers' cartel requires analysis.

Last on this topic of the agency model, it is not clear that its adoption is intrinsically anticompetitive. As noted above, the agency model it is not much different than many other relationships (including RPM) between producers/intermediaries and retailers.[36] The best evidence of this is what has happened recently in the ebooks market. Several of the publishers agreed not to enter into agreements of this type for fixed periods as part of their settlements with the DOJ, but at the expiration of those injunctions, each of those publishers and Amazon promptly agreed on agency model pricing.[37] The DOJ has not intervened, suggesting that it finds no problem with the agency model itself, despite a reported increase in e-book prices and corresponding decrease in sales.[38] In short, there are real anticompetitive risks, but those risks in this case, as measured against potential procompetitive benefits, are not so clear as to justify the application of a *per se* rule.

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32 *Id.* Amazon's practice of "loss-leading" with bestsellers was the simplest way for Amazon to erect a barrier to entry. *Id.* at 342, n.2. At the same time that it erected this barrier, it is not clear that Amazon, like other retailers who employ similar tactics, did not profit from its lossleading strategy. A complete analysis would require an assessment of whether the prices of books that Amazon did not discount were relatively overpriced and the impact of that conduct on consumer welfare.

33 *Id.* at 310 & n.13.

34 To be sure, the group of five publishers had leverage and the lack of monopoly power does not mean that the group may not have acted anticompetitively, but it casts doubt on the conclusion that this group's move to an agency model *necessarily* raised consumer prices.

35 Amazon is also not known to back down without a fight in the e-books market generally. *See* David Streitfeld & Melissa Eddy, *As Publishers Fight Amazon, Books Vanish*, N.Y. Times, May 23, 2014.

36 See discussion, *supra* at p. 81.

37 *See* Trachtenberg, *supra* note 19, at B1.

38 *Id.*

*Second*, it is important to acknowledge that this really is the exceptional case of concerted action. The harm of concerted action is that a cartel's members will jointly exercise *monopoly* power to the detriment of consumer welfare. In this case, Amazon was (and arguably still is) a monopolist at the retail level. There was (is) not a monopoly at the publishers' intermediate level and the cartel among five of the major publishers joined only a significant *minority* of the overall market share at that level. At the retail level, Apple presented a real threat to break into Amazon's 90% market share, but there is no serious suggestion that it was going to displace Amazon as a monopolist at the retail level. Additionally, Apple's model imposed price caps (not price floors) on e-book prices. Thus, if authors and publishers desired to compete more aggressively on price, they certainly had the option to do so, and because there is real competition at the publishers' level, "it can be safely assumed that if competition sharpens, prices will take care of themselves."[39] Given all this, it is not clear that anticompetitive harms necessarily followed from Apple's knowledge or tacit consent for the publishers' imperfect cartel. As noted above, e-book prices have risen in the past 18 months with a broader agency model. Price increases are always strong circumstantial evidence of a loss of consumer welfare, but this market is too dynamic and, on this record, there are simply too many unknowns to definitively conclude that Apple's conduct was illegal *per se*.[40] That is precisely the circumstance where we should be applying the rule of reason.[41]

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39 791 F.3d at 351 (Jacobs, J., dissenting).

40 Judges Jacobs and Livingston each conduct thoughtful rule of reason analyses. I argue, however, that there is insufficient information on the current record to conduct the type of rule of reason analysis that this complex case requires. I agree with Judge Jacobs that, having determined that the *per se* rule applied, the district court's very brief mention of an alternative rule of reason analysis is insufficient to sustain the current judgment.

41 *See, e.g., California Dental*, 526 U.S. at 781.

# MOBILE APPS: REDEFINING THE VIRTUAL CALIFORNIA ECONOMY AND THE LAWS THAT GOVERN IT

*By Alexandra McDonald, Jason McDonell, and Caroline Mitchell*[1]

## I. INTRODUCTION.

As the virtual world integrates seamlessly into our everyday lives, mobile applications ("apps") have become a hub of both social and commercial activity. As a result, they have drawn increasing attention from courts and regulators. In California's Silicon Valley driven economy, savvy businesses closely monitor their apps portfolios, making sure they have the legal protections necessary to optimize their value, while also guarding against the legal and regulatory pitfalls that could plunge them into high profile and costly disputes. This article reviews the rapid rise of apps in the economy and the legal issues that companies using apps to drive their business need to manage.

## II. THE NEW FACE OF CONSUMERISM.

The recent proliferation of mobile apps has rapidly changed the way consumers interact with businesses, and there are no signs that these changes will slow down. According to Statista.com, the global mobile app industry has grown from an $8 billion a year market in 2011, to a $45 billion market in 2015.[2] Statista.com projects that the industry will generate $76 billion, with an estimated 268 billion downloads, in 2017.[3] Mobile device sales and use are staggering: as of 2014, 91% percent of the U.S. adult population owned a cell phone, and 61% percent of those owned a smartphone.[4] Mobile devices now outsell personal computers by double and by 2016, mobile devices in use worldwide will exceed the number of people on the planet, with each person owning approximately 1.4 devices.[5] Similarly, mobile app availability and consumer use are on the rise. At the end of 2013, 57% of U.S. mobile users said they use their apps daily and, on average, mobile device owners each use 26.8 apps collectively for more than 30 hours per month, with users age 25 to 34 logging even more time on their apps.[6]

On any given day, the average mobile user could use an app to make a credit card payment, get a ride with a private driver, share photos on social media, chat with a potential date, purchase extra lives in their favorite game, sublet an apartment, track the number of steps taken throughout the day, trade stock, video chat with a doctor, and have dry cleaning delivered. It's no wonder we are used to hearing the catchphrase: "There's an app for that." Among the apps with the most usage by mobile app audiences are: Facebook, reaching

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2 *Worldwide mobile app revenues from 2011 to 2017 (in billion U.S. dollars),* STATISTA.COM, http://www.statista.com/statistics/269025/worldwide-mobile-app-revenue-forecast/ (last visited August 3, 2015).

3 *Id.*

4 *The Future of Mobile Application Development,* ENTREPRENEUR.COM, http://assets.entrepreneur.com/article/1409068924-by-2017-app-market-will-be-77-billion-dollar-industry-infographic.jpg (last visited August 3, 2015).

5 *Id.* One billion mobile devices are expected to be sold in 2015.

6 *Id.*

74% of users per month; Google Play, Google Search, and YouTube, reaching around 50%; and Pandora, Google Mail and Maps, Instagram, and Twitter, reaching roughly 30 to 45% of user per month.[7] Notably, as of mid-2014, there were 399 million Facebook users who accessed the site exclusively through a mobile device.[8] In terms of availability on Apple's App Store, games account for over 20% of available apps, with education, business, entertainment, and lifestyle apps following.[9]

California is at the epicenter of this revolution in how consumers use mobile devices and the economic and legal issues that come with it. As of July 2015, the California-based Google Play Store and Apple App Store had 1.6 million and 1.5 million apps available for download, respectively.[10] Google and Apple each offer about twice as many apps as Amazon, Windows, and BlackBerry combined.[11]

While most apps are offered at little or no cost, they are able to generate tremendous amounts of revenue. They do so in five ways: by charging to download the app; by promoting advertisements; by offering in-app purchases; by completing purchases of out-of-app goods and services; and by selling the user data they collect. "In-app purchases" or IAPs are purchases of a virtual good delivered within an app—like virtual coins in the Bejeweled app or a Kindle e-book delivered via the Kindle app to your iPhone.[12] This is in contrast to a purchase of a tangible good or service external to an app, like a pair of shoes purchased within the Nike app or an Uber ride.[13] The majority of apps in which IAPs take place are initially free to download but allow access to premium content at a price, earning these apps the moniker "freemium."[14] But don't let the word "free" fool you: in 2012, global revenue from mobile IAPs was $2.11 billion, with future growth projected at

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7 To view percentage of users reached as of September 2013, see *Mobile App Usage,* Forbes.com, http://blogs-images.forbes.com/niallmccarthy/files/2014/10/Giant-social-apps_Forbes.jpg (last visited August 3, 2015). To view the number of unique monthly users as of 2013, see *Most popular mobile apps in the U.S. for iOS and Android,* Statista.com, http://www.statista.com/statistics/324922/top-mobile-apps-average-unique-users/ (last visited August 3, 2015)

8 *Mobile App Usage, supra* note 7.

9 Niall McCarthy, *Mobile App Usage By The Numbers [Infographic],* Forbes.com (October 29, 2014, 9:00 AM), http://www.forbes.com/sites/niallmccarthy/2014/10/29/mobile-app-usage-by-the-numbers-infographic/. *See also, Most popular Apple App Store categories in June 2015,* Statista.com, http://www.statista.com/statistics/270291/popular-categories-in-the-app-store/ (last visited August 3, 2015).

10 *Number of apps available in leading app stores as of July 2015,* Statista.com, http://www.statista.com/statistics/276623/number-of-apps-available-in-leading-app-stores/ (last visited August 3, 2015).

11 *Id.*

12 Forrest Stroud, *in-app purchase,* Webopedia, http://www.webopedia.com/TERM/I/in-app_purchase.html (last visited August 3, 2015). *See also,* Jay Yarow, *Amazon Has Found a Clever Way to Avoid Giving Apple a 30% Cut of eBook Sales—Here's How,* Business Insider (January 11, 2012, 11:30 AM), http://www.businessinsider.com/amazon-kindle-ipad-store-2012-1?op=1. Apple take a 30% cut of all "in-app purchases" delivered via an app to the iPhone. Amazon has skirted this IAP fee by delivering content through its store app or Kindle app to non-iPhone devices.

13 Oscar Waczynski, *How do apps like Lyft, Uber, AirBnB skirt Apple's 30% cut on each transaction?,* Designer News, https://www.designernews.co/stories/9695-how-do-apps-like-lyft-uber-airbnb-skirt-apples-30-cut-on-each-transaction (last visited August 3, 2015).

14 71% of in-app purchases take place in apps that are initially free to download. *See, In-app purchases from 'freemium' titles account for 71% of iPhone app revenue,* appleinsider.com (March 29, 2013, 08:58 AM), http://appleinsider.com/articles/13/03/29/in-app-purchases-from-freemium-titles-account-for-71-of-iphone-app-revenue.

$14 billion for 2015 and $35 billion for 2017.[15] IAPs—the majority of which take place in games—also generated ten times more revenue than advertising for games and substantially more than pre-paid games (meaning those games that a user pays to download on a mobile device or game console).[16]

But free and low cost apps do more than generate enormous revenue: the data they collect and store is, by itself, extremely valuable—generating an estimated $5.5 billion in revenue in 2013.[17] The ubiquitous availability and use of mobile apps has resulted in an unprecedented collection of rich, inter-connected consumer data. The emergence of the term "big data" refers to the omnipresent tracking of every digital process we undertake and apps play an essential role in this process.[18] Apps can access a mobile-device-user's contacts, text messages, photos and videos, credit card information, and even facial features. They can then combine user data with the mobile device's unique ID, wireless signals, and geolocation history to create a down-to-the-minute profile of any user, whether or not an app is open or in use.[19]

The app provider or distributor can then sell this layered and complex profile to third-party researchers and even companies and advertisers trying to target consumers. For example, Verizon's "Precision Market Insights"[20] collects and sells statistical data about the activities of mobile phone users in locations like malls, stadiums, and near billboards; Air Sage uses wireless signals from mobile phones to track consumer habits, such as movements of California commuters;[21] and Sprint, among many other companies, collects and sells aggregated and anonymized data of its mobile users for market research purposes.[22] As every detail of our lives become linked to Internet-connected devices and associated apps—from smartphones and fitness trackers to interconnected thermostats and self-driving cars—the data this "Internet of Things" will supply will become more and more valuable.[23]

With this new app-economy and the proliferation of "big data" come an array of legal issues, as the law tries to catch up with the new realities in the marketplace. Existing legal doctrines and regulations are just beginning to address these issues, which include consumer rights, contractual relationships, privacy, data protection, and regulated industries. As a result, the legal landscape related to apps is changing rapidly, and will continue to evolve as app use and the data generated from it grow exponentially.

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15 *Total worldwide in-app purchase revenues from 2011 to 2017 (in million U.S. dollars),* Statista.com, http://www.statista.com/statistics/220186/total-global-in-app-revenue-forecast/ (last visited August 3, 2015).

16 Tero Kuittinen, *In-app purchases now dominate the portable game market,* BGR.com (June 13, 2013, 2:10 PM), http://bgr.com/2013/06/13/mobile-gaming-in-app-purchases-analysis/#.

17 *Mobile Operator Guide 2013, The Evolution of Mobile Services,* SAP Mobile Services, http://www.sap.com/bin/sapcom/el_gr/downloadasset.2013-02-feb-07-18.mobile-operator-guide-2013-pdf.html (last visited August 3, 2015).

18 *What is Big Data,* IBM, http://www.ibm.com/big-data/us/en/ (last visited August 3, 2015).

19 John Kennedy, *Reining In Mobile App Privacy Practices,* LAW360.com (January 25, 2013, 12:23 PM ET), www.law360.com/articles/407974.

20 Precision Market Insights From Verizon, http://precisionmarketinsights.com.

21 *See* airsage, www.airsage.com; *White Paper,* airsage, http://www.airsage.com/Contact-Us/White-Paper/.

22 *See* Sprint Corporation Privacy Policy, *available at* http://www.sprint.com/legal/privacy.html#contact.

23 *See* Philip Blum, *'Internet Of Things' 101: Legal Concerns,* LAW360.com (April 14, 2014, 11:51 AM ET), http://www.law360.com/articles/526266.

## III. THE LEGAL FOUNDATION FOR APPS.

### A. Creation and Distribution of Mobile Apps.

The mobile app ecosystem includes providers of hardware, software, and services. Mobile devices are manufactured by original equipment manufacturers (OEMs) such as Apple or Samsung. Content providers, like Facebook, create the apps using software development kits and related tools licensed from the owners of the major mobile operating systems (*e.g.* Apple's iOS, Google's Android, and Microsoft's Windows Phone).[24] Wireless telecommunications service providers, like Verizon Wireless and AT&T Mobility, operate the wireless networks necessary for mobile communications. The vast majority of apps are sold through a handful of distribution platforms:

| COMPANY | PLATFORM | DATE OF ENTRY | AVAILABLE APPS[24] |
|---|---|---|---|
| Apple Computer | App Store | July 2008 | 1.5 million |
| Google Inc. | Google Play | October 2008 | 1.6 million |
| Amazon.com, Inc. | Amazon App Store | March 2011 | 360,000 |
| Microsoft Corporation | Windows Store | February 2012 | 340,000 |

Layered on top of these elements, are providers of many specialized technologies and services that can be built into or linked to an app. These include advertising, measuring tools (such as Google Analytics for Mobile Apps, which measures the value of apps), cloud storage services, network messaging, monetization services, and payment systems.[26]

### B. Contractual Building Blocks.

In bringing an app to market, there are important contracts entered into between (1) the app providers or developers and distributors; (2) the providers and end users; and (3) the distributors and end users. These agreements define and protect the parties' intellectual property rights and confidential information, establish basic commercial terms for the distribution, purchase and use of the apps, and provide for compliance with privacy and data security laws and policies.

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24 Content providers are sometimes assisted by a growing industry of services providers. For example, Amazon Web Services (AWS) provides tools to create mobile apps, will manage the backend, so the content providers does not have to provision, scale, or monitor servers. *See Develop apps quickly. Scale, test and run reliably,* AWS MOBILE SERVICES, https://aws.amazon.com/mobile/?nc1=f_dr (last visited August 3, 2015).

25 *Number of apps available in leading app stores as of July 2015,* STATISTA.COM, http://www.statista.com/statistics/276623/number-of-apps-available-in-leading-app-stores/ (last visited August 3, 2015).

26 These are just the basics of what is involved in creating a mobile app. In practice, an app development may include any or all of following: the handset OEM; the application programming interface (API) software development kit (SDK); a mobile services provider; an API manager; identity and access management (IAM) authorization controls; middleware; a database; security; a platform-as-a-service (PaaS) provider; *infra*structure-as-a-service (IaaS); a mobile enterprise application platform (MEAP); mobile device management (MDM); mobile application management (MAM); and other service providers of social media, location, and many others.

### 1. Agreements between App Providers or Developers and Operating System Distributors.

To create an app for a particular operating system, the developer must enter into agreements with the operating system owners/distributors to get access to the software development kits (SDKs) and related tools that are used to build the apps. Each of the major distributors has a standard developer license agreement for this purpose. In addition, the providers must accept the distributors' terms and conditions for making the apps available through the distributors' mobile stores.

Apple licenses its operating system to developers through its iOS Developer Program License Agreement.[27] This agreement governs the app provider's use of Apple software to develop iOS-compatible applications as well as the app's submission to and distribution on Apple's App Store. Google has separate agreements for development of the app using its Android software and distribution on the Google Play store. Google makes Android software available under the Android Open Source Project[28] and uses the Android Software Development Kit License Agreement[29] to license its SDK to Android-compatible app developers. Google's terms for distribution are set forth in its Google Play Developer Distribution Agreement.[30]

These agreements address compliance with privacy and other consumer protection laws. For example, Apple's iOS Development Program License Agreement provides that use of the app "must comply with all applicable privacy laws. . . ."[31] It provides that the app "may not collect user or device data without prior user consent, and then only to provide a service or function that is directly relevant to the use of the Application, or to serve advertising. . . ."[32] It further requires the app developer to "provide clear and complete information to users regarding Your collection, use and disclosure of user or device data, *e.g.,* a link to Your privacy policy on the App Store."[33] Also included are provisions concerning warranty and support of the app; non-disclosure of any information deemed confidential by the operating system owner; and indemnification of operating system owner from losses arising from breach, violation of intellectual or proprietary rights, and end-user claims regarding the provider's app.

### 2. Agreements between App Distribution Platforms and End-Users.

Each of the major distributors requires consumers to agree to the distributor's terms and conditions the first time the consumer accesses the store to download an app. The terms and conditions then control subsequent app downloads. The app distribution platforms include similar provisions in these end user agreements. Agreements from both Apple and Google cover

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27 *iOS Developer Program License Agreement,* APPLE.COM, https://developer.apple.com/programs/terms/ios/standard/ios_program_standard_agreement_20140909.pdf (last visited August 3, 2015).

28 *Welcome to the Android Open Source Project!,* SOURCE.ANDROID.COM, https://source.android.com/ (last visited August 3, 2015).

29 *Terms and Conditions,* DEVELOPER.ANDROID.COM (November 13, 2012), https://developer.android.com/sdk/terms.html.

30 *Google Play Developer Distribution Agreement,* GOOGLE.COM (May 5, 2015), https://play.google.com/about/developer-distribution-agreement.html.

31 *See Id.* § 3.3.8.

32 *Id.* § 3.3.9.

33 *Id.* § 3.3.10.

payment and refund policies and various user restrictions.[34] For example, Apple's agreement provides that the user is "solely responsible . . . for all activities that occur on or through your account."[35] Furthermore, both agreements disclose that the distribution platform is acting as a marketing agent and that some content may have been developed by a third-party provider. In addition, the agreements include provisions concerning termination, limitation of liability, indemnification, and possible disclosure of personal information to law enforcement.

Agreements from Apple and Google incorporate by reference their respective privacy policies.[36] Privacy policies generally explain what information is collected, why and how it is used, and how it is protected. Collected information includes, but is not limited to: personal information such as names, contact information, and credit card numbers; device information such as a device's universally unique identifier (*e.g.* the IMEI of a mobile phone); and GPS location information. Furthermore, these policies include information about the disclosure and transfer of information to third-parties. These policies state that collected information is used to protect, maintain, improve upon, and develop services for users. Additionally, the distribution platforms disclose that they may make limited aggregate data available to third-party app providers on request to ensure improvement of products.

### 3. Agreements between App Providers and End Users.

App providers typically require end users to accept terms and conditions of use when they download the app. As an example, the photo sharing app Instagram's Terms of Use provide, among other things: a minimum age requirement (13 years); prohibitions on certain content (*e.g.*, "violent," "infringing," "hateful"); and that the user is responsible for their own conduct and posts to the site.[37] These agreements disclose privacy policies of the provider, and set forth other general legal provisions such as terms of warranty, termination, limitation of liability, severability, waiver and construction, export control, and dispute resolution.

## IV. THE LEGAL LANDSCAPE.

### A. Apps Enter the Courtroom and the Regulatory Arena.

In many ways, a mobile app is treated like any other internet-based business or website under the law. Consumers and private parties bring individual or class action lawsuits against app owners or distribution platforms for the harm suffered under private causes of action. Concomitantly, federal and state agencies and state Attorneys General may bring enforcement actions against app owners and distribution platforms for the violation of

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34 *See Terms And Conditions,* Apple.com (June 30, 2015), http://www.apple.com/legal/internet-services/itunes/us/terms.html. *See also Google Play Terms of Service*, Google.com (December 10, 2014), https://play.google.com/intl/en_us/about/play-terms.html. *See also Amazon Appstore for Android Terms of Use,* Amazon.com (April 2, 2014), https://www.amazon.com/gp/help/customer/display.html?nodeId=201485660. *See also Microsoft Services Agreement*, Microsoft.com (August 14, 2013), http://windows.microsoft.com/en-us/windows/windows-store-terms-of-use.

35 *See Terms And Conditions,* Apple.com, *supra* note 34.

36 *Privacy Policy,* Apple.com, http://www.apple.com/legal/privacy/en-ww/ (last updated December 10, 2014). *See also, Welcome to the Google Privacy Policy,* Google.com, https://www.google.com/intl/en/policies/privacy/ (last updated June 30,215).

37 *Terms of Use,* Instagram.com (January 19, 2013), https://instagram.com/about/legal/terms/.

federal and state regulations. Special considerations arise for apps related to the new ways in which consumers are able to interface with businesses, the ease with which apps may collect rich and often unexpected consumer data, and the efforts of "disruptive" apps, in particular, to circumvent existing government regulations. These characteristics, among others, pose new legal challenges for private parties, regulators, Attorneys General, and the courts.

The Federal Trade Commission (FTC) has the broadest reach in regulating mobile apps and does so most often through Section 5 of the FTC Act, which prohibits "unfair or deceptive acts or practices in or affecting commerce."[38] Through this mechanism, the FTC has brought many enforcement actions for deceptive trade practices against companies for violation of their own privacy policies. FTC publications relating to mobile apps[39] emphasize the FTC's main privacy concern: companies must fulfill the promises they make, so as not to mislead consumers and they must get the consent of parents for interactions with children who are 13 and under. The FTC oversees and can bring enforcement actions related to the FTC Truth in Advertising Act,[40] the Fair Credit Reporting Act,[41] the Graham Leach-Bliley Act, [42] and the Children's Online Privacy Protection Act of 1998.[43] Other federal agencies, such as the Federal Communications Commission (FCC), the Office of Civil Rights (OCR) of the Department of Health and Human Services, the Food and Drug Administration (FDA), the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission (SEC) have an interest in and the power to regulate apps as they relate to telecommunication, protected health information under HIPAA,[44] medical devices and pharmaceutical products, mobile banking, and publicly traded securities, respectively.

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38 15 U.S.C. § 45 (2006). *See also* FTC Policy Statement on Deception (Oct. 14, 1983), *available at* https://www.ftc.gov/public-statements/1983/10/ftc-policy-statement-deception; *Cases and Proceedings*, FTC.GOV, https://www.ftc.gov/enforcement/cases-proceedings (last visited August 12, 2015).

39 *See Mobile Privacy Disclosures: Building Trust Through Transparency,* FTC STAFF REPORT (February 2013), *available at* http://www.ftc.gov/sites/default/files/documents/reports/mobile-privacy-disclosures-building-trust-through-transparency-federal-trade-commission-staff-report/130201mobileprivacyreport.pdf. *See also Marketing Your Mobile App: Getting it Right from the Start* FTC (Sept. 2012), https://www.ftc.gov/system/files/documents/plain-language/pdf-0140_marketing-your-mobile-app.pdf. *See also Complying with COPPA: Frequently Asked Questions*, FTC (March 20, 2015), http://www.business.ftc.gov/documents/0493-Complying-with-COPPA-Frequently-Asked-Questions.

40 15 U.S.C. §§ 41-58 requires all advertisements to be "truthful, not misleading, and, when appropriate, backed by scientific evidence. The Federal Trade Commission enforces these truth-in-advertising laws. When the FTC finds a case of fraud perpetrated on consumers, the agency files actions in federal district court for immediate and permanent orders to stop scams; prevent fraudsters from perpetrating scams in the future; freeze their assets; and get compensation for victims." *See also Truth in Advertising,* FTC, https://www.ftc.gov/news-events/media-resources/truth-advertising (last visited August 3, 2015).

41 15 U.S.C. § 1681. The FTC brings enforcement actions against credit reporting agencies, data brokers, and companies furnishing information to credit agencies to promote the "accuracy, fairness, and privacy of information in the files of consumer reporting agencies." *See also Credit Reporting,* FTC, https://www.ftc.gov/news-events/media-resources/consumer-finance/credit-reporting (last visited August 3, 2015).

42 15 U.S.C. § 6801 (2011), *et seq.* requires financial institutions to explain information sharing practices to consumers and safeguard personal and sensitive data.

43 5 U.S.C. §§ 6501-6505 (2010). Companies that fail to obtain express parental consent before collecting personal information online from children under age 13 are subject to FTC enforcement actions.

44 45 CFR §§ 160, 162, and 164 (1996).

While there is no comprehensive federal law regulating apps (a proposed "APPS Act"[45] failed to leave the House in 2013), this hasn't stopped state Attorneys General and state legislatures from taking their own action. California, in particular, has led the way by passing the California Online Privacy Protection Act (CalOPPA)[46] and amending it to address consumer tracking practices,[47] in addition to its pre-existing requirements that all websites and apps post conspicuous and accurate privacy policies.[48] The California Attorney General has sent a clear message to app developers and distributors, most recently, by promulgating extensive recommendations for mobile app privacy practices in the 2013, "Privacy on the Go: Recommendations for the Mobile Ecosystem" publication,[49] and by initiating the first-of-its-kind lawsuit against Delta Air Lines for failure to post an app privacy policy.[50] Prior to this, Attorney General Harris reached a 2012 agreement with Amazon, Apple, Google, Facebook, Hewlett-Packard, and others, to require the display of app privacy policies and subsequently sent warning letters to 100 mobile app companies giving them 30 days to post a conspicuous privacy policy.[51] The New Jersey Attorney General has also been active in regulating the app landscape, reaching settlements with two California-based app developers for alleged children's privacy violations,[52] and with an Ohio-based developer for allowing malware to "mine" app users' devices for virtual currencies.[53]

## B. Where is Jurisdiction Proper?

As consumer app cases begin to enter courtrooms, the first line of defense to these cases is often a challenge to personal jurisdiction.[54] To recap, specific jurisdiction requires that a non-resident defendant (1) "purposefully directed" activities to the forum or one of its residents, or performed "some act by which he purposefully avails himself of the privilege of conducting

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45 Application Privacy, Protection and Security Act of 2013, H.R. 1913, 113th Cong. (2013), *available at* https://www.govtrack.us/congress/bills/113/hr1913/text.

46 California Online Privacy Protection Act, Cal. Bus. & Prof. Code §§ 22575-22579 (2004), *available at* http://www.leginfo.ca.gov/cgi-bin/displaycode?section=bpc&group=22001-23000&file=22575-22579.

47 California's AB 370 is an amendment to CalOPPA that requires entities that collect PII to disclose in a privacy policy how the entity treats "do not track" options enabled in web browsers, codified at: Cal. Bus. & Prof. Code § 22575(b)(5-6), *available at* http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201320140AB370.

48 CalOPPA, Cal. Bus. & Prof. Code §§ 22575-22579 (2004).

49 Kamala D. Harris, *Privacy On The Go, Recommendations For The Mobile Ecosystem,* California Department of Justice (January 2013), *available at* http://oag.ca.gov/sites/all/files/agweb/pdfs/privacy/privacy_on_the_go.pdf.

50 *People v. Delta Air Lines Inc.*, No. CGC 12-526741, 2013 WL 1951360 (Cal. Super. Ct. May 9, 2013) (dismissing complaint).

51 *Attorney General Kamala D. Harris Notifies Mobile App Developers of Non-Compliance with California Privacy Law,* State of California Department of Justice Office of the Attorney General (October 30, 2012), *available at* https://oag.ca.gov/news/press-releases/attorney-general-kamala-d-harris-notifies-mobile-app-developers-non-compliance.

52 Consent Decree and Order for Injunction and Other Relief, *Chiesa v. 24 x 7 Digital, LLC*, No. 2:12-cv-03402 (D.N.J. Jun. 26, 2012) (ECF No. 5).

53 *See New Jersey Division of Consumer Affairs, FTC, Reach Settlement with Developer of Mobile App that Allegedly Hacked New Jersey Smartphones with Harmful Malware,* State of New Jersey Office of the Attorney General (June 29, 2015), *available at* http://nj.gov/oag/newsreleases15/pr20150629a.html.

54 *See, e.g., Tomelleri v. Medl Mobile, Inc.*, No. 2:14-CV-02113-JAR, 2015 U.S. Dist. LEXIS 55943 at *8-40 (D. Kan. April 20, 2015) (granting dismissal for lack of personal jurisdiction and declining to transfer).

activities in the forum, thereby invoking the benefits and protections of its laws"; (2) the claim must "arise out of" defendant's forum related activities; and (3) the exercise of jurisdiction must comport with fair play and substantial justice, that is, it must be reasonable.[55]

General jurisdiction can be an even heavier lift for plaintiffs because with respect to an individual, the "paradigm jurisdiction" is the individual's domicile.[56] With respect to a corporation, *Bauman v. Daimler*[57] teaches that general jurisdiction only exists in the state where it is incorporated, where its principal place of business is located, or the state where its contacts are so continuous and systematic as to render it essentially "at home" in the state. Courts have been reluctant to rely on the "at home" exception and it is rarely evoked.[58]

The presence of Apple in Northern California resulted in a finding of specific jurisdiction in the Northern District of California for a consumer related case. In *Opperman v. Path, Inc.,*[59] plaintiffs sued seventeen defendants in the Western District of Texas in 2012, alleging that apps developed and distributed by defendants secretly uploaded and disseminated user information from the devices on which they were installed.[60] The Western District of Texas transferred the case to the Northern District of California, finding that "[a]ll allegations in this matter run through Apple and its app store."[61] The Northern District of California treated this ruling as law of the case and refused one defendant's invitation to revisit it.[62] If this theory of specific personal jurisdiction takes root in consumer cases, then the Northern District of California will be the hub for consumer-related app litigation.[63] General jurisdiction will also often be found in California because so many of the companies involved in creating and distributing apps are incorporated or headquartered in the state.

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55 *See Schwarzenegger v. Fred Martin Motor Co.*, 374 F.3d 797, 802 (9th Cir. 2004).

56 *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 564 U.S.—, 131 S.Ct. 2846, 2854 (2011).

57 571 U.S.—, 134 S.Ct. 746, 760-62 and n.9 (2014).

58 Discussing rigor of "essentially at home" test, *see Tomelleri v. Medl Mobile, Inc.*, No. 2:14-CV-02113-JAR, 2015 U.S. Dist. LEXIS 55943, at 8-12 (D. Kan. Apr. 29, 2015).

59 No. 13-cv-00453-JST, 2014 WL 246972 (N.D. Cal. Jan. 22, 2014).

60 *Id.*

61 Quoting the transfer order, *see id.* at 13.

62 *Id.* at 13-17.

63 Outside of the consumer context, courts do not necessarily adopt this theory of specific jurisdiction. For example, in a copyright infringement case relating to the Move the Box app, even though Move the Box app was sold through the Apple iTunes Store, the court ruled that defendants had not directed conduct causing injury to plaintiff, a non-California resident, in California. *See Zherebko v. Reutskyy,* No. C 13-00843 JSW, 2013 U.S. Dist. LEXIS 113493, 4-15 (N.D. Cal. Aug. 12, 2013). Nor does the mere sale of a company's products in a state confer jurisdiction there if someone other than the buyer alleges the claim. *In Intercarrier Communs. LLC v. WhatsApp Inc.*, No. 3:12-cv-776-JAG, 2013 U.S. Dist. LEXIS 131318 (E.D. Va. Sept. 13, 2013), the court found no jurisdiction over WhatsApp Inc. in the Eastern District of Virginia, when WhatsApp was a Delaware Corporation with its principal place of business in California. The court noted that WhatsApp's products were sold through third party stores (*e.g.* Apple's iTunes Store) and the third party—Apple—both collected payment and distributed the app to the purchaser. Under these circumstances, the fact that the app was available in Virginia, users used it there and WhatsApp collected data from users using in Virginia was not enough to establish personal jurisdiction over WhatsApp. *Id.* at 9-19.

## C. Protecting Consumer Expectations.

Consumers bring individual and class action lawsuits, while regulators bring enforcement actions, both on their own volition and in conjunction with existing private suits, aimed at closing the gaps between the law and technology. The FTC has a keen interest in business practices that result in a gulf between what consumers expect and what is actually happening. In particular, app owners and distributors alike are facing major class action lawsuits related to children's in-app purchases (IAPs), as well as attempts by litigants to bring suits for the loss of IAPs and misleading advertising.

### 1. Minors' In-App Purchases.

Instances of children making hundreds and even thousands of dollars of in-app purchases on their parents' mobile devices have been garnering big headlines and lawsuits for the last several years.[64] App distributors have faced class action suits as well as FTC enforcements, while Amazon came under FTC scrutiny related to kids' in-app game purchases[65] and Facebook will face a class action suit in October 2015.[66] The app distribution platforms, rather than the apps in which purchases were made, were the subject of these suits and enforcements because, as a condition of making in-app sales, purchases had to go through the relevant app stores, which then retain a portion of the sale—usually 30%.

Class actions involving Apple[67] and Google[68] presented essentially the same facts and legal claims based on two novel arguments. First, parents argued that in-app purchases by a minor create a contract between the minor and the app store which parents may then disaffirm, while the app store argued that a minor's purchase is governed by the app stores' terms and conditions that the parent who owned the device agreed to by registering an account with the app store. The parents also argued that by marketing apps as "free" and failing to inform users that entering a password opened a 15 or 30 minute purchase window, the app store engaged in unfair or deceptive business in violation of the California Consumer Legal Remedies Act (CLRA)[69] and the California Unfair Competition Law (UCL).[70] Jurisdiction for both cases was in the Northern District of California, but the presiding Judges, Judge Davila in Apple and Judge Whyte in Google, came to different conclusions when deciding the motions to dismiss.

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64 *See e.g.*, Chris Foresman, *Apple facing class-action lawsuit over kids' in-app purchases,* ARSTECHNICA.COM (April 15, 2011, 12:31 PM PDT), http://arstechnica.com/apple/2011/04/apple-facing-class-action-lawsuit-over-kids-in-app-purchases/. *See also Google facing US lawsuit over $66 of in-app purchases,* THE GUARDIAN, http://www.theguardian.com/technology/2014/mar/11/google-us-lawsuit-in-app-purchases (last viewed August 3, 2015).

65 Jeff John Roberts, *Amazon will battle the FTC over kids' in-app purchases, rejecting a Google-style settlement,* GIGAOM (October. 6, 2014, 4:02 PM PDT), https://gigaom.com/2014/10/06/amazon-will-battle-the-ftc-over-kids-in-app-purchases-rejecting-a-google-style-settlement/.

66 *See Bohannon v. Facebook*, No. 12-cv-01894-BLF, 2014 U.S. Dist. LEXIS 156281 (N.D. Cal. Nov. 3, 2014). Class certification granted in March 2015.

67 *In re Apple In-App Purchase Litig.*, 855 F. Supp. 2d 1030 (N.D. Cal. 2012).

68 *See Imber-Gluck v. Google, Inc.*, No. 5:14-01070-RMW, 2014 U.S. Dist. LEXIS 98899 (N.D. Cal. July 21, 2014).

69 Cal. Civ. Code § 1780, *et seq.*

70 Cal. Bus. & Prof. Code § 17200, *et seq.*

Judge Whyte granted Google's motion to dismiss on the contract and unfair competition issues, finding that the terms and conditions were unambiguous that the device owner would be responsible for all purchases made in the app store, and that the plaintiffs failed to allege that they were unaware of a 30-minute password window.[71] However, Judge Whyte denied Google's motion to dismiss the UCL claim for misleading advertising based on the allegation that Google's practice of marketing apps as free was likely to deceive the public.[72]

On the other hand, Judge Davila denied Apple's motion to dismiss on all of these issues, finding, with respect to the contract issue, that Apple had failed to cite any case law supporting the contention that terms and conditions for the app store govern all subsequent purchases.[73] With respect to the unfair competition claims, Judge Davila found one plaintiff's assertion that she downloaded an app for her son because it was free, and more than one plaintiffs' assertion that they were not informed by Apple of the 15-minute password window to be sufficient to move forward with the UCL and CLRA claims.[74] Ultimately, the cases did not proceed very far.

Apple[75] and Google[76] also faced FTC enforcement actions for deceptive practices concurrently with these lawsuits. Apple settled with the class litigants in February 2013 to allow over 23 million in-app purchasers to receive a $5 credit, and subsequently, settled with the FTC for $32.5 million. As a condition of settlement, the FTC specifically required Apple to implement measures designed to obtain informed, express consent prior to every in-app charge, and, if Apple obtains consent for future charges, such as a periodic replenishment, it must give consumers the option to withdraw consent at any time.[77] Now Apple requires password entry immediately before every purchase and has eliminated the 15-minute password window. Google settled with the FTC for $19 million in September 2014[78] and avoided class certification in March 2015 because most class members would have been covered in the FTC settlement.[79]

Writing in dissent to the Apple settlement, FTC Commissioner Joshua D. Wright argued that the penalty was out of proportion to the "miniscule" percentage of Apple customers who were allegedly injured and could hamper innovation.[80] On the other hand,

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71 *Imber-Gluck*, 2014 U.S. Dist. LEXIS 98899 at 11-12, 17.

72 *Id.*

73 *In re Apple In-App Purchase Litig.*, 855 F. Supp. 2d at 1030, 1036.

74 *Id.*

75 Complaint, *In the Matter of Apple Inc., A Corp.*, 112-3108, *available at* https://www.ftc.gov/sites/default/files/documents/cases/140115applecmpt.pdf.

76 Complaint, *In the Matter of Google Inc., A Corp.*, 122-3237, *available at* https://www.ftc.gov/system/files/documents/cases/140904googleplaycmpt.pdf.

77 Agreement Containing Consent Order, *In the Matter of Apple Inc., A California Corp.*, 112-3108 (Jan. 15, 2014), *available at* https://www.ftc.gov/sites/default/files/documents/cases/140115appleagree.pdf.

78 Agreement Containing Consent Order, *In the Matter of Google Inc., A Corp.*, 122-3237 (Sept. 4, 2014), https://www.ftc.gov/system/files/documents/cases/140904googleplayorder.pdf.

79 Order Granting Motion to Deny Class Certification, *Imber-Gluck v. Google, Inc.*, No. 5:14-cv-01070-RMW (N.D. Cal. Apr. 3, 2015), *available at* http://classifiedclassaction.com/wp-content/uploads/2015/04/imber-gluck-v-google.pdf.

80 Agreement Containing Consent Order, *In the Matter of Apple Inc., A California Corp.* (Jan. 15, 2014), *available at* https://www.ftc.gov/sites/default/files/documents/cases/140115appleagree.pdf.

consumer advocates note that even the new password entry system is flawed in that it only exists within certain iOS operating systems.[81] Others continue to press for better labeling of freemium apps.[82]

An FTC enforcement action against Amazon is underway as of the time of this publication in the Western District of Washington.[83] The FTC is seeking an injunction requiring refunds to consumers for unfairly billing Amazon account holders for charges made by children without the account holder's consent.[84] At the introduction of IAPs, Amazon required no password entry; it later implemented a password requirement with a fifteen-minute window for any IAP of $20 or more.[85] However, shortly before the FTC filed its complaint, Amazon updated its billing practices to obtain the account holder's informed consent prior to every purchase on its newer mobile devices. As a result, Amazon has indicated that it intends to fight the enforcement action and will not settle with the FTC.[86]

### 2. Misleading Advertising.

Misleading advertising claims related to the functionality of specific apps have not found a successful path yet. Class action suits were filed against Apple for misleading advertising related to its Apple Maps for iPhone 5,[87] which failed to perform as depicted in advertisements, and related to Siri,[88] which occasionally malfunctioned. In both cases the court found that the plaintiffs failed to allege the specific fraudulent statement made by Apple, reasoning that plaintiffs did not allege that Apple said the apps would never malfunction.[89]

### 3. Virtual Currency.

Apps that deploy their own virtual currency are exposed to an additional array of potential legal issues. For example, if the user expends some currency to play the game again or to play a higher level, but the game malfunctions for some reason, that could impose liability absent a refund of the virtual currency or equivalent credit. Games with virtual currency can also give rise to securities claims. In at least one case, a company involved in online gaming was sued for securities fraud for failing to disclose the portion

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81 Rene Ritchie, *In-app purchases and the App Store: What every parent needs to know*, IMORE.COM (July 18, 2014, 7:36 pm EDT), http://www.imore.com/app-purchases-and-app-store-what-every-parent-needs-know.

82 *Id.*

83 *F.T.C. v. Amazon.com, Inc.*, No. C14-1038, 71 F. Supp. 3d 1158 (W.D. Wash. Dec. 1, 2014).

84 Complaint for Permanent Injunction and Other Equitable Relief, *F.T.C. v. Amazon.com, Inc.,* No. C14-1038 (W.D. Wash. Jul. 10, 2014), *available at* https://www.ftc.gov/system/files/documents/cases/140710amazoncmpt1.pdf.

85 *FTC Alleges Amazon Unlawfully Billed Parents for Millions of Dollars in Children's Unauthorized In-App Charges,* FTC (July 10, 2014), https://www.ftc.gov/news-events/press-releases/2014/07/ftc-alleges-amazon-unlawfully-billed-parents-millions-dollars.

86 *Amazon says it will fight FTC on in-app purchases made by children,* LA TIMES (July 2, 2014), http://www.latimes.com/business/technology/la-fi-tn-amazon-ftc-kids-20140702-story.html.

87 *Minkler v. Apple, Inc.*, 65 F. Supp. 3d 810, 820-21 (N.D. Cal. 2014).

88 *In re iPhone 4S Consumer Litig.*, No. C 12-1127 CW, 2014 U.S. Dist. LEXIS 19363, at *4-9 (N.D. Cal. Feb. 14, 2014).

89 *Minkler,* 65 F. Supp., at 816-21 (dismissing with leave to amend); *iPhone 4S Consumer Litig.*, 2014 U.S. Dist. LEXIS 19363, at *14-30 (dismissing without leave to amend).

of its disclosed users who were "gold farmers"—that is people who play a game to exploit in-app opportunities to acquire virtual currency and then sell it in the real world—and that the number of users would be negatively affected by an undisclosed rule change that curtailed gold farming.[90] Another issue with gold farming is that it can create inflation in a game, detracting from the value for other players.[91] Risk also arises if the app owner pairs with partners to offer promotional ways to acquire virtual currency, without full disclosure of how the partner will interact with consumers who take advantage of the promotion.[92] A decision to discontinue a game or to alter or discontinue its virtual currency in which consumers have invested can also give rise to claims.[93]

### D. Preserving and Redefining Consumer Privacy.

While apps may provide at least a basic privacy policy,[94] few mobile users seem to be aware of the depth and breadth of data their apps collect and share. Over three-quarters of Americans consider data stored on their mobile device to be as private as information stored on their home computer, and 81% percent of those surveyed by the Berkeley Center for Law and Technology would not want a social media site to access their contacts to suggest connections.[95] Furthermore, over half of app users surveyed by the Pew Research Center in 2012 decided not to install an app after they were informed of how much data the app would collect, and 30% decided to uninstall the app after learning the same.[96] The fervor at which app owners are interested in collecting user data is clearly not reflected in mobile users' expectations, or even understandings, of the apps they use.

Private parties and regulators are undertaking efforts to preserve and redefine privacy in an ever-changing technological landscape by imposing either formal requirements or informal guidelines that apps that collect personally identifiable information (PII) have privacy policies. The National Institute of Standards and Technology defines PII as: "any information about an individual maintained by an agency, including (1) any information that can be used to distinguish or trace an individual's identity, such as a name, social

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90 *See In re Giant Interactive Group, Inc. Sec. Litig.*, 643 F. Supp. 562, 569 -74 (S.D.N.Y. 2009). This complaint survived a motion to dismiss.

91 *Id.* at 567-68.

92 *Cf. Swift v. Zynga Game Network, Inc., No.* C 09-05443 SBA, 2010 U.S. Dist. LEXIS 117355, at *2-8 (N.D. Cal. Nov. 3, 2010) (consumer in putative class action alleged that when they participated in promotional offers to obtain virtual currency, they ended up obtaining goods or services they did not want or need and that obtaining cancellation or refund was thwarted).

93 *Cf. Abreau v. Slide*, No. C 12-00412 WHA, 2012 U.S. Dist. LEXIS 47217, at *2-5 (N.D. Cal. Apr. 3, 2012) (consumer brought putative class actions when online game was cancelled because the game's virtual currency, "gold," would then not have value).

94 Note, however, that many apps do not provide even a basic privacy policy, or do not provide adequate information: a recent Future of Privacy Forum survey "found that 22 out of the 30 most popular mobile apps lacked even a basic privacy policy where consumers could learn about what data is collected or exchanged when they download the app." *See Future of Privacy Forum Launches App Privacy Site,* Future of Privacy Forum, http://www.futureofprivacy.org/2011/05/26/future-of-privacy-forum-launches-app-privacy-site/ (last visited August 3, 2015).

95 Jennifer M. Urban, Chris Jay Hoofnagle, & Su Li, *Mobile Phones and Privacy,* U.C. Berkeley Public Law Research paper No. 2103405 (July 10, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2103405.

96 Jan Lauren Boyles, Aaron Smith, & Mary Madden, *Privacy and Data Management on Mobile Devices,* Pew Internet & Am. Life Project (Sept. 5, 2012), *available at* http://pweinternet.org/Reports/2012/Mobile-Privacy.aspx.

security number, date and place of birth, mother's maiden name, or biometric records; and (2) any other information that is linked or linkable to an individual, such as medical, educational, financial, and employment information."[97] So, for instance, data that might not otherwise be classified as PII, such as geolocation or IP address, would be classified as PII if it can be linked to an individual.

Privacy policy requirements are enforceable under Section 5 of the FTC Act, as well as state laws such as CalOPPA,[98] and statutes in Connecticut,[99] Pennsylvania,[100] and Nebraska.[101] CalOPPA is the most extensive of these laws in that it affirmatively requires websites that collect information from consumers in California to conspicuously post a privacy policy and fulfill other specific requirements.[102] To comply with California law, the California Attorney General guidelines, the FTC's expectations, and more, mobile app privacy policies, generally, should disclose: (1) what information is collected from users when they use an app, no matter whether the data is PII or not; (2) how the information is used (for example, for analytics purposes) even if the users do not have to enter any PII to use the app; (3) how the information is disclosed or shared with third parties; (4) how users can update or remove personal information and notice as to how users will be informed in the event that the privacy policy changes. Most problems arise in connection with the third requirement. While most concerns center around the disclosure of PII for profit-seeking purposes, even the disclosure of anonymized and aggregated data for analytics purposes without user consent can result in litigation.[103]

Consumers have brought significant lawsuits against companies for failure to properly disclose information collection and sharing practices in their app privacy policies. In *Opperman v. Path,* plaintiffs alleged that sixteen app developer defendants secretly uploaded and disseminated user information from devices on which the apps were installed, and that a final defendant, Apple, was complicit in allowing the apps, available in the App Store and downloaded to Apple devices, to do so.[104] Plaintiffs brought a variety of claims under California and federal laws[105] all but one of which were dismissed for failure to demonstrate that plaintiffs relied upon the allegedly deceptive privacy policies in purchasing Apple

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97 Erika McCallister, Tim Grance, & Karen Scarfone, *Guide to protect the confidentiality of personally identifiable information,* NIST (April 2010), http://csrc.nist.gov/publications/nistpubs/800-122/sp800-122.pdf.

98 Cal. Bus. & Prof. Code § 22575-22579 (2004).

99 Conn. Gen. Stat. § 42-471 (2009).

100 18 Pa. C.S.A. § 4107(a)(10) (2005) (prohibiting misleading statements on websites under state Fraudulent Business Practices Statute).

101 R.R.S. Neb. § 87-302 (14) (2003) (prohibiting making knowingly false statements in privacy policy).

102 CalOPPA, Cal Bus. & Prof. Code §§ 22575-22579 (2004). The privacy policy must identify the categories of PII that the Company collects, the categories of third parties with which the Company may share the information, the process by which consumers may review and request changes to their PII, and the process the company will undertake in notifying customers of changes to the privacy policy.

103 *See* California Bookkeeping Statute, Cal. Civ. Code §1799, *et seq.* (prohibiting disclosure of aggregate financial data to third parties without data owner's consent in traditional bookkeeping context).

104 *Opperman v. Path*, No. 13-CV-00453-JST, 2014 WL 1973378 (N.D. Cal. May 14, 2014) (order denying in part and granting in part defendants' motions to dismiss).

105 Claims included violation of the California UCL, the False and Misleading Advertising Law, the CLRA, the Comprehensive Computer Data Access and Fraud Act, and the California Wiretap Act, as well as the federal Computer Fraud and Abuse Act and the Electronic Communications Privacy Act, among others.

devices.[106] Although the defendants dodged potentially huge liability, the lawsuit led to a public apology by the Path app, Apple's revision of its privacy settings, and the initiation of a Senate investigation into public allegations that Apple encourages apps to surreptitiously collect information from mobile devices in violation of its outward-facing policy.[107]

Plaintiff, Svenson, on the other hand successfully survived motions to dismiss related to breach of contract and UCL claims against dissemination of user information to app developers upon a user's purchase of that app.[108] Judge Labson Freeman, relying on the Ninth Circuit's 2014 *In re Facebook Privacy Litigation*[109] decision, which held that Facebook users were "harmed both by dissemination of their personal information and by losing the sales value of that information," found that the mobile app user plaintiff had stated a claim for breach of contract based on the diminution of value of her information as well as a loss of the benefit of the bargain.[110] The plaintiff's UCL claim also survived.[111] As of the publication of this article, this case was still pending in the Northern District of California.

The FTC is also active in bringing enforcement actions related to misleading privacy policies in apps. Most notably, the FTC obtained a settlement[112] against Snapchat—an app that's main selling point was its privacy—for misleading consumers that photos and videos taken through the app "disappear forever" when they did not.[113] Snapchat had also failed to inform users of its collection and use of geolocation data, as did Goldenshores in its Flashlight App.[114] The FTC was particularly concerned with the Flashlight App collection of geolocation data because such a practice would not have been expected by consumers, nor necessary for the app to function.[115] The FTC has further emphasized the need for transparent and accurate disclosures related to the collection of geolocation data through its Congressional testimony in 2014[116] and a 2015 publication on the topic.[117]

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106 *See Opperman*, 2014 WL 1973378.

107 *See* Sarah Gilbert, *Apple, App Makers Escape iDevice Snooping Class Action Lawsuit,* TOPCLASSACTIONS.COM (May 19, 2014), http://topclassactions.com/lawsuit-settlements/lawsuit-news/27439-apple-app-makers-escape-idevice-snooping-class-action-lawsuit/. See also, *Espitia v. Hipster, Inc.*, No. 3:13-cv-00432, (N.D. Cal. Aug. 13, 2013) (alleging similar facts and claims and resulting in public apology by Hipster app), *available at* http://digitalcommons.law.scu.edu/cgi/viewcontent.cgi?article=1419&context=historical.

108 *Svenson v. Google Inc.*, No. 13-CV-04080-BLF, 2015 WL 1503429 (N.D. Cal. 2015).

109 *Facebook Privacy Litig. v. Facebook, Inc.,* 572 Fed. Appx. 494 (9th Cir. 2014).

110 *Svenson*, 2015 WL 1503429 at 5.

111 *Id.* at 10.

112 Decision and Order, *In the Matter of Snapchat, Inc., A Corp.*, 132-3078 (Dec. 23, 2014), *available at* https://www.ftc.gov/system/files/documents/cases/141231snapchatdo.pdf.

113 *See FTC Approves Final Order Settling Charges Against Snapchat,* FTC (December 31, 2014), https://www.ftc.gov/news-events/press-releases/2014/12/ftc-approves-final-order-settling-charges-against-snapchat.

114 Agreement Containing Consent Order, *In the Matter of Goldenshores Technologies, Inc. and Erik M. Geidl*, 132-3087 (Dec. 2013), *available at* https://www.ftc.gov/sites/default/files/documents/cases/131205goldenshoresorder.pdf.

115 *Id.*

116 *FTC Testifies on Geolocation Privacy,* FTC (June 4, 2014), https://www.ftc.gov/news-events/press-releases/2014/06/ftc-testifies-geolocation-privacy.

117 *Location, location, location, FTC* (February 11, 2015, 9:59 AM), https://www.ftc.gov/news-events/blogs/business-blog/2015/02/location-location-location.

Highly-regulated categories, such as children, health, and finance are associated with even stricter privacy policy requirements. If children will be using an app or will be inherently drawn to an app, there are particularly onerous privacy policy requirements under COPPA, on which the FTC has issued guidelines[118] and conducted a study.[119] Mobile apps must not collect PII from users under age 13 and if an app does collect PII, the app's owner should take several measures to avoid any liability under COPPA. The measures include: explicitly stating in the app privacy policy that the app is not intended for use by anyone under age 13; requiring users to certify that they are over age 13 and enter their birthday; or requiring users to connect to the app via Facebook Connect, as Facebook requires its users be at least 13 years old. In 2011, in its first enforcement action against a mobile app, the FTC handed the BrokenThumbs children's game app a $50,000 penalty for collecting and disseminating children's' information without parental consent.[120]

## E. Imposing Data Protection Requirements.

A number of states have passed legislation requiring companies to protect PII by imposing specific security measures, refraining from sharing or selling consumers' PII, and ensuring secure disposal of PII.[121] The depth and detail of these laws varies by state, but an app owner may be held accountable if it does not reasonably secure user information. Additionally, the FTC has brought claims under Section 5 of the FTC Act charging companies with engaging in unfair practices by implementing "unreasonable" security practices.[122] Although both Apple and Google provide default data security protections in their mobile operating systems, which are then automatically incorporated into apps running on those platforms, some apps have found a way to disable the security features. This was the case with the Credit Karma and Fandango apps, which purposefully overrode the standard security processes, exposing customers' payment information to interceptions.[123] In March 2014, the FTC secured settlements against both of these companies for their failures to take reasonable steps to secure the transmission of consumers' personal data through their apps.[124]

Other federal agencies are also ruling on data protection requirements. For example, the FCC ruled that the FCC Act requiring protection of consumer information such as call logs, call duration and phone numbers extends to mobile devices and pre-installed mobile

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118 *Complying with COPPA: Frequently Asked Questions, FTC* (March 20, 2015), http://www.business.ftc.gov/documents/0493-Complying-with-COPPA-Frequently-Asked-Questions.

119 *Mobile Apps for Kids,* FTC (February 2012), https://www.ftc.gov/sites/default/files/documents/reports/mobile-apps-kids-current-privacy-disclosures-are-disappointing/120216mobile_apps_kids.pdf.

120 *United States v. W3 Innovations, LLC*, No. CV-11-03958, 2011 U.S. Dist. LEXIS 100914 (N.D. Cal. Sept. 8, 2011). Consent Decree and Order *available at* https://www.ftc.gov/sites/default/files/documents/cases/2011/09/110908w3order.pdf.

121 *See* Cal. Civ. Code §1798.81 (2010). *See also* Standards for the Protection of Personal Information of Residents of the Commonwealth, 201 CMR 17.03 (2015).

122 Federal Trade Commission Act, Sec. 5, 15 U.S.C. § 45.

123 Complaint, *In the Matter of Fandango, LLC*,132-3089, *available at* https://www.ftc.gov/system/files/documents/cases/140328fandangocmpt.pdf; Complaint, *In the Matter of Credit Karma, Inc.*, 132-3091, *available at* https://www.ftc.gov/system/files/documents/cases/140328creditkarmacmpt.pdf.

124 Decision and Order, *In the Matter of Fandango, LLC*,132-3089, *available at* https://www.ftc.gov/system/files/documents/cases/140819fandangodo.pdf; Decision and Order, *In the Matter of Credit Karma, Inc.*, 132-3091, *available at* https://www.ftc.gov/system/files/documents/cases/1408creditkarmado.pdf.

apps. Protected information under the Act also includes geolocation data about where a call starts and ends.[125] However, apps that are not pre-installed on mobile devices are free to collect and use data without concern for the FCC Act, as are mobile providers that do not fall into the regulated category of telecommunications providers.[126]

Furthermore, forty-seven states, Guam, Puerto Rico, the Virgin Islands, and the District of Columbia have laws imposing notification requirements on entities in the event of unauthorized access to PII.[127] Failure to comply with such laws can be costly. State Attorneys General can and do bring enforcement actions and cooperate on multi-state data breach investigations, as they have in the high-profile breaches of Anthem, Target, and the Internal Revenue Service.

While many may be familiar with the headline-garnering security breaches at well-known corporations like Sony[128] and Neiman Marcus, among others, mobile apps are quickly becoming hackers' new targets because of the sheer volume and complexity of valuable data they collect, as well as the recent decline in PC use. However, Gartner, Inc. found that hackers don't need to be technically sophisticated to access mobile data: 75% of "[m]obile security breaches are—and will continue to be—the result of misconfiguration and misuse on an app level, rather than the outcome of deeply technical attacks on mobile devices."[129] Another entity has identified 1,500 iPhone apps that contain a "crippling bug" making iPhones extremely vulnerable to hackers' attempts to obtain passwords, bank account numbers, and other sensitive data.[130] Dating apps, in particular, pose serious security risks due to users' willingness to share personal information and respond to messages that may contain harmful malware, making BYOD company data vulnerable to breach.[131] These factors combined with a finding that 60% of popular dating apps for Android had medium or high security vulnerabilities and one in ten Americans have used a dating site or app, make dating apps an especially concerning category of apps.[132]

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125 For the FCC's declaratory ruling see 28 FCC Rcd 9609, 9609, 2013 FCC LEXIS 2834, 58 Comm. Reg. (P & F) 739, 2013 FCC LEXIS 2834, 58 Comm. Reg. (P & F) 739 (F.C.C. 2013), *available at* http://transition.fcc.gov/Daily_Releases/Daily_Business/2013/db0628/FCC-13-89A1.pdf.

126 *Id.*

127 Under Section 1798.82(a) of the California Civil Code, a business that is the target of a security breach must notify any California resident that his or her information was acquired, or reasonably believed to have been acquired, by an unauthorized person. The law further requires that a business report a security breach to the California Attorney General's Office if more than 500 California residents were subject to the breach.

128 Jeffrey Roman, *Sony Settles Data Breach Lawsuit Data Breach Today,* DATA BREACH TODAY (June 16, 2014), http://www.databreachtoday.asia/sony-settles-data-breach-lawsuit-a-6960#.

129 *Gartner Says 75 Percent of Mobile Security Breaches Will Be the Result of Mobile Application Misconfiguration,* GARTNER (May 29, 2014), http://www.gartner.com/newsroom/id/2753017.

130 Dan Goodin, *1,500 iOS apps have HTTPS-crippling bug. Is one of them on your device?,* ARSTECHNICA.COM (April 20, 2015, 2:08 PM PDT), http://arstechnica.com/security/2015/04/1500-ios-apps-have-https-crippling-bug-is-one-of-them-on-your-device/.

131 Nicole Arce, *Using Dating Apps On Company Smartphone? You Might Be Putting Trade Secrets At Risk,* TECH TIMES (February 13, 10:20 PM), http://www.techtimes.com/articles/32399/20150213/using-dating-apps-on-company-smartphone-you-might-be-putting-trade-secrets-at-risk.htm.

132 *IBM Security Finds Over 60 Percent of Popular Dating Apps Vulnerable to Hackers,* IBM, https://www-03.ibm.com/press/us/en/pressrelease/46023.wss (last viewed August 3, 2015).

## F. Developing Comprehensive App Terms of Use.

Terms of Use are a legal agreement between an app owner and every user of the app. An app user automatically agrees to the terms by downloading the app. The Terms of Use set forth what the app is, how it should be used, what constitutes improper use, and what the consequences of improper use will be. Terms of Use should be present in every app that requires interactivity or that collects any personal information.

Many apps present opportunities for misuse; comprehensive Terms of Use can help protect app owners from liability if a user violates federal or state laws. However, as the potential uses for apps become more complex and unexpected, there is an increasing gap between expectations of the public, the laws that cover certain behavior, and the capabilities of mobile apps. For example, live streaming video apps Meerkat and Periscope launched in spring 2015 and took the app world by storm.[133] Both apps allow users to stream live video footage directly onto social media without any opportunity to review or cut footage. Brand marketers have taken a quick liking to the apps because of the ability to capture real-world footage of people using advertised products. However, posting live video of individuals for profit without their consent could come with hefty risk.[134] This technology also poses serious potential for copyright infringement. Although the Twitter-owned Periscope warns users against streaming copyrighted material in its Terms of Use, HBO issued take-down notices to Periscope within months of its launch after users broadcast a Game of Thrones episode through the app.[135] It is important for apps entering new technological frontiers to evaluate and protect against potential risk, especially risk that could imperil the whole venture.

Similarly, apps that collect facial recognition data for commercial use such as the NameTag app[136] are unleashed in a regulatory and legal environment that has not accounted for them yet. To the extent they present serious privacy concerns and can be used for commercial gain by tracking consumer habits, they need to plan for change in the legal and regulatory landscape. As the proliferation of up-to-the-second live footage and facial recognition apps become more and more common, courts and regulators will surely attempt to make legal innovations to allow the law to catch up with technology.

## G. Regulating Industries For Consumer Safety And Fair Competition.

Regulated industries such as common carrier transportation, housing, hotels, medical devices, health providers, insurance, and even aviation are facing innovative technological advances and business models, fueled, oftentimes, by the "sharing economy" that threaten to disrupt—or have already disrupted—their fundamental modes of operation. "Disruptive technology" businesses, such as Uber, Lyft, Airbnb, and Zenefits, to name a few, often operate mainly or even entirely through mobile apps and are associated with a widespread

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133 Zach Miners, *Live streaming apps like Meerkat and Periscope pose legal risks for users,* PC World (April 20, 2015, 1:27 PM), http://www.pcworld.com/article/2912272/live-streaming-apps-pose-legal-risks-for-users.html.

134 Live stream footage captured for commercial purpose without consent could present private cause of action. *See id*.

135 Natalie Jarvey, *HBO Criticizes Periscope Over 'Game of Thrones' Live Streams, Issues Takedown Notices,* hollywoodreporter.com (April 14, 2015, 1:32 PM PDT), http://www.hollywoodreporter.com/news/hbo-criticizes-periscope-game-thrones-788734.

136 For name tag app, *see* http://www.nametag.ws/.

belief that their innovative business models should fall outside the existing regulatory framework. However, the sharing economy has exploded—according to one study, there are now 17 billion-dollar companies with approximately 60,000 employees in the sharing economy—and regulators, not surprisingly, are taking notice.

Ride-sharing companies like Uber and Lyft have been the scapegoat of the taxi cab industry's woes,[137] but have also faced increasing scrutiny from district attorneys nationwide, seeking to subject the companies to pre-existing taxi regulations. The District Attorneys for Los Angeles and San Francisco are taking action against Uber and Lyft for using fare calculations that are not approved by the state,[138] while the California Labor Commission recently ruled that Uber must treat its drivers as employees rather than independent contractors.[139] The examples do not end with ride-sharing companies. Municipal regulations that prohibit short-term housing may stifle Airbnb in major U.S. cities, and apps like FlightCar, which facilitates rentals of private car owners' vehicles, and EatWith, which connects diners with home chefs, are battling car rental regulations and health code violations, respectively.[140]

Beyond the sharing economy, innovative and potentially life-saving health and medical apps, which generated an estimated $718 million worldwide in 2012 and grow in number by 150% a year, are coming under fire by the FDA and FTC.[141] The FTC hit MelApp and Mole Detective, two apps that purported to diagnose melanoma with the snap of a photo, with a deceptive practices claim based on a lack of scientific evidence to back up the apps' advertised diagnosis capabilities.[142] In February 2015, the FDA released guidelines[143] asserting jurisdiction over "mobile medical apps" that are intended for use in diagnosing medical conditions "and whose functionality could pose a risk to the patient's safety if the mobile app were not to function as intended."[144] Despite the recent publication, this has long been the FDA's practice: remote X-ray, MRI and CT imaging app Nephosity sought FDA

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137 Rubin, Alissa and Scott, Mark, *Clashes Erupt Across France as Taxi Drivers Protest Uber,* New York Times (June 25, 2015), http://www.nytimes.com/2015/06/26/business/international/uber-protests-france.html?_r=0.

138 Ellen Huet, *SF, LA District Attorneys Sue Uber, Settle with Lyft Over 'Misleading' Business Violations,* Forbes.com (December 9, 2014), http://www.forbes.com/sites/ellenhuet/2014/12/09/sf-la-district-attorneys-sue-uber-and-lyft-over-misleading-business-violations/.

139 *Berwick v. Uber Technologies, Inc.*, No. 11-46739, California Labor Commission, *available at* http://www.scribd.com/doc/268911290/Uber-vs-Berwick.

140 Andrew Bender, *New Regulations To Wipe Out 80% Of Airbnb Rentals In California's Santa Monica,* Forbes.com (June 15, 2015, 3:55 PM), http://www.forbes.com/sites/andrewbender/2015/06/15/new-regulations-to-wipe-out-80-of-airbnb-rentals-in-californias-santa-monica/.

141 Dina ElBoghdady, *Health-care apps for smartphones pit FDA against tech industry,* The Washington Post (June 22, 2012), *available at* http://www.washingtonpost.com/business/economy/health-care-apps-for-smartphones-pit-fda-against-tech-industry/2012/06/22/gJQAHCcBvV_story.html.

142 *FTC Cracks Down on Marketers of 'Melanoma Detection'Apps,* FTC (February 23, 2015), https://www.ftc.gov/news-events/press-releases/2015/02/ftc-cracks-down-marketers-melanoma-detection-apps.

143 *Mobile Medical Applications, Guidance for Industry and Food and Drug Administration Staff,* U.S. Department of Health and Human Services Food and Drug Administration, Center for Devices and Radiological Health & Center for Biologics Evaluation and Research (February 9, 2015), *available at* http://www.fda.gov/downloads/MedicalDevices/ . . . /UCM263366.pdf.

144 *Id.* at 4.

clearance in 2008, finally gaining approval in 2013[145] and Sanofi's glucose monitor app, the iHealth blood pressure monitor, and WiThing's body-fat percentage tracker all obtained FDA approval before hitting the market.[146]

What the recent guidelines do make clear, however, is that there is a broad range of mobile health apps that fall outside the definition of a "medical device" and therefore are not subject to FDA approval prior to market availability.[147] Such apps include activity trackers, diet logs, BMI calculators, medical reference apps, and apps that facilitate video communication between patients and providers (termed "telemedicine" and garnering serious HIPAA concerns), to name a few of the more than 18,000 health-related apps in existence as of 2012.[148] The amalgamation of such extensive health and medical data, especially if not within the purview of the FDA, in combination with the data already being collected is beginning to catch the eye of consumer advocates and regulators.

These examples demonstrate that regardless of apps' attempts to operate outside the existing regulatory framework, regulators will no longer ignore consumers' unprecedented level of app use, the revenue these apps generate, or their own duty to protect public interests in regulated industries. A failure by app developers and investors to heed existing regulations in advance of launching new businesses could easily expose the company to growth-crippling regulatory actions.

## V. CONCLUSION.

Apps represent a burgeoning component of the California economy. With the meteoric rise in spending on apps during this decade, apps and the relationships they create with consumers are moving front and center in companies' asset portfolios and are garnering the attention of regulators and plaintiffs' attorneys alike. Plaintiffs' lawyers are currently testing various theories to find a footing that will lead to large damage awards. California courts will likely lead the way in resolving disputes relating to apps. Companies, whether they use apps as the centerpiece to drive their business or as a way of enhancing existing products and services, need to understand that the constellation of legal and regulatory considerations that factor into managing an apps portfolio is both complex and constantly evolving.

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145 Neil Versel, *FDA clears Nephosity iPad app for diagnostic imaging,* Mobi Health News (May 22, 2013) http://mobihealthnews.com/22554/fda-clears-nephosity-ipad-app-for-diagnostic-imaging/.

146 ElBoghdady, *supra* note 141.

147 *Mobile Medical Applications, Guidance for Industry and Food and Drug Administration Staff*, *supra* note 143.

148 *Id.*

# THE MAGNA CARTA AND THE SHERMAN ACT

*By David G. Meyer*[1]

This year marks the 800th anniversary of the Magna Carta. Recent books and articles discussing the history of the influential document are ubiquitous.[2] Those histories typically explore the ways in which the agreement between King John and his nobles in 1215 influenced America's founders and contributed to the development of American Constitutional law. A frequent theme is that the *idea* of the Magna Carta—especially its perceived status as the seminal document establishing the concept of freedom under the rule of law—has been as influential as the actual content of the document (which primarily addressed a list of feudal rights and obligations).[3]

In light of its special place in our understanding of legal history, it is no surprise that the Supreme Court has referred to the Magna Carta in more than 200 opinions. As one might expect, many of these references occurred in the context of discussing the origin of fundamental Constitutional rights such as due process.[4] However, it *is* perhaps a surprise that the Supreme Court has also regularly invoked the Magna Carta in deciding antitrust cases.

## A Curious Analogy

Of course the Magna Carta did not address agreements in restraint of trade, and was hardly the precursor to the Sherman Act.[5] But its image as the seminal charter of freedom has served as an inspiration for the Court's understanding of the importance of antitrust laws.

In *United States v. Topco Associates, Inc.*, 405 U.S. 596, 610 (1972), the Court declared that "[a]ntitrust laws in general, and the Sherman Act in particular, are the Magna Carta of free enterprise. They are as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental

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1 Mr. Meyer is a partner at Jones Day. The views expressed in this article do not necessarily reflect the views of Jones Day, its attorneys or its clients.

2 *See, e.g.,* Podgers, J., *Americas's Magna Carta,* ABA Journal, v. 101, n. 6 (June, 2015); Clancy, M., *Magna Carta* 2015: *The Eight Hundredth Anniversary of Liberty*, 41 San Francisco Att'y 36 (Spring, 2015); Landau, J., *Magna Carta Turns 800: An Anniversary Worth Remembering*, 75 Or. St. B. Bull. 17 (June, 2015); Holt, Garnett & Hudson, *Magna Carta* (3d ed. 2015).

3 For example, the 1215 document contains impenetrable directives such as: "If a man holds land of the Crown by 'fee-farm,' 'socage,' or 'burgage,' and also holds land of someone else for knight's service, we will not have guardianship of his heir, nor of the land that belongs to the other person's 'fee,' by virtue of the 'fee-farm,' 'socage,' or 'burgage,' unless the 'fee-farm' owes knight's service." *See* British Library translation, *available at* http://www.bl.uk/magna-carta/articles/magna-carta-english-translation.

4 *See, e.g., Kerry v. Fauzia*, 135 S. Ct. 2128, 2132 (2015) ("The Due Process Clause has its origin in Magna Carta"); *Boumediene v. Bush*, 553 U.S. 723, 740 (2008) ("[G]radually the writ of habeas corpus became the means by which the promise of Magna Carta was fulfilled"); *Den v. The Hoboken Land and Improvement Company*, 59 U.S. 272, 276 (1856) ("The words, 'due process of law,' were undoubtedly intended to convey the same meaning as the words, 'by the law of the land,' in Magna Charta").

5 However, the Magna Carta did address some trade issues that modern competition lawyers will recognize, such as the requirement that "[T]here shall be standard measures of wine, ale, and corn (the London quarter), throughout the kingdom." Den, 59 U.S. at 276.

personal freedoms." That comparison to the Magna Carta in *Topco* built upon the Court's earlier descriptions of the Sherman Act as a "charter of freedom" (*Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 359-60 (1933)), and a "comprehensive charter of economic liberty" (*Northern Pacific Railway Co. v. United States*, 356 U.S. 1, 4 (1958)). These various formulations of the Sherman Act as a charter protecting economic freedom appear in at least fifteen Supreme Court decisions as well as numerous federal circuit court opinions.

Most recently, the Court reiterated the *Topco* language in *North Carolina State Board of Dental Examiners v. FTC*, 135 S. Ct. 1101 (2015), again comparing the role of the antitrust laws in preserving economic freedom to the role of the Bill of Rights in the protection of personal freedom. 135 S. Ct. at 1109. The California Supreme Court has relied upon the analogy as well, citing the U.S. Supreme Court's "charter" language in cases concerning both the Sherman Act and the Cartwright Act. *Rice v. Alcoholic Beverage Control Appeals Bd.*, 21 Cal. 3d 431, 453 (1978); *Oakland-Alameda County Builders' Exch. v. F.P. Lathrop Constr. Co.*, 4 Cal. 3d 354, 361 (1971).

Comparing the Sherman Act to the Magna Carta or the Bill of Rights may seem a curious choice to the modern antitrust lawyer or economist who views antitrust laws solely as a practical instrument to enhance economic efficiency and further consumer welfare. A "charter of freedom" is perhaps not the most obvious title for a body of law that has evolved to focus on the efficient delivery to consumers of the goods and services that they want at a competitive price. It is not immediately apparent what individual freedoms these laws are supposed to address—certainly not the freedom of businesses to act collectively in setting prices or allocating markets. Moreover, a "charter" is typically an instrument that *grants* particular "rights, liberties or powers" to citizens. *See* Black's Law Dictionary (2d Ed.). In contrast, the Sherman Act is a statute that *proscribes* certain conduct by private parties upon pain of criminal punishment. And, unlike the Bill of Rights, antitrust laws restrain the behavior of private actors in the market, not the government in its dealings with citizens. *See Mass. Food Ass'n v. Mass. Alcoholic Bev's Contro*l, 197 F.3d 560, 565 (1st Cir. 1999) ("The Sherman Act is a "charter of economic liberty' . . . but only as against *private* restraints") (emphasis in original).

So what did the Supreme Court mean when it compared the Sherman Act to the Magna Carta? And why do courts continue to refer to antitrust laws as a "charter of freedom?" Not surprisingly, different courts at different times have used the analogy to different ends. The variety of references is an interesting study in itself, but it also provides a helpful window into the evolving purposes of the antitrust laws.

## A Variety of Meanings

One practical sense in which the courts have compared the Sherman Act to a "charter" concerns its form rather than its function. For example, in *Appalachian Coals*, the Supreme Court observed that, "[a]s a charter of freedom, the Act has a generality and adaptability comparable to that found to be desirable in constitutional provisions." 288 U.S. at 359-60. In *United States v. E.I. DuPont de Nemours & Co.*, 366 U.S. 316 (1961), the dissenting justices echoed this theme. They quoted the language in *Appalachian Coals* while noting that the "sweeping generality of the antitrust laws differentiates them from ordinary statutes." They agreed with the proposition that "'[i]n the antitrust field, the courts have been accorded, by common consent, an authority they have in no other branch of enacted law. . . . '" *Id.* at 363 (quoting *United States v. United Shoe Machinery Corp.*, 110 F. Supp. 295, 348).

Some judges have also viewed the generality of the Sherman Act's language, like the broad language in the Bill of Rights, as an expression of fundamental values that should be interpreted in light of the nation's experience over time. The Supreme Court's observation in *Appalachian Coals* about the "generality and adaptability" of the Sherman Act was accompanied by a summary of its purpose that suggests such fundamental values: "The purpose of the Sherman Anti-Trust Act is to prevent undue restraints of interstate commerce, to maintain its appropriate freedom in the public interest, to afford protection from the subversive or coercive influences of monopolistic endeavor." *Id.* at 359-60.

Occasionally courts have used this quasi-constitutional view of the antitrust laws in a utilitarian way to add to the weight given to antitrust principles when balanced against other rights actually identified in the Constitution. For example, in *Cal. Retail Liquor Dealers Ass' v. Midcal Aluminum, Inc.*, 445 U.S. 97 (1980), the Court considered whether the Twenty-First Amendment (which reserves to the states certain powers to regulate traffic in liquor) took precedence over the federal antitrust laws with respect to California's retail price maintenance system for liquor sales. The Court emphasized the importance of the antitrust laws by invoking the *Topco* Court's comparison to the Magna Carta and the Bill of Rights, while noting additionally that "[a]lthough the federal interest is expressed through a statute rather than a constitutional provision, Congress '[exercised] all the power it possessed under the Commerce Clause when it approved the Sherman Act.'" *Id.* at 111 (quoting *Atlantic Cleaners & Dyers v. United States*, 286 U.S. 427, 435 (1932)). Several circuit courts have also relied upon the Supreme Court's *Topco* language in upholding the "sham" litigation exception to the *Noerr-Pennington* doctrine, equating the importance of the antitrust laws to the First Amendment rights protected by *Noerr-Pennington*. *See, e.g., Litton Systems, Inc. v. AT&T*, 700 F.2d 785, 813-14 (2d Cir. 1983); *Ernest W. Hahn, Inc. v. Codding*, 615 F.2d 830, 843 and n.16 (9th Cir. 1980).

But it also seems that Justice Marshall had something more particular in mind in authoring the majority opinion in *Topco*. In comparing the Sherman Act to the Magna Carta and the Bill of Rights, Justice Marshall appears to have had a quite specific idea of the freedom that the Sherman Act protects. The language that he chose and the holding that the Court reached in *Topco* both suggest that he intended specifically to address the rights of individual businesses to compete free of restraints imposed by more powerful economic agents.

The particular restraints at issue in *Topco* were restrictions on the territories in which members of a grocery purchasing collective could sell food under a private label. In finding that particular restriction unlawful, the Court described the nature of the "economic freedom" it thought important to protect: "[T]he freedom guaranteed each and every business, no matter how small, is the freedom to compete—to assert with vigor, imagination, devotion, and ingenuity whatever economic muscle it can muster." 405 U.S. at 610.

The dissent that Justice Marshall authored that same year in *Flood v. Kuhn*, 407 U.S. 258, 291-92 (1972), provides additional insight into his intent in using the Magna Carta comparison in the *Topco* majority opinion. Justice Marshall dissented from the Court's ruling in *Flood v. Kuhn* that upheld Major League Baseball's "reserve system." The reserve system imposed a uniform contract term on all professional baseball teams requiring their players to play only for the team for which they were "reserved" unless they were traded to another team. *Id.* at 260. The liberty interest at stake in that system was obvious. Indeed, the plaintiff, Curt Flood, asserted a Thirteenth Amendment involuntary servitude claim along with his antitrust claims. Although Justice Marshall agreed that the Thirteenth Amendment claim was properly dismissed, he also

noted that, "[t]o non-athletes it might appear that petitioner was virtually enslaved by the owners of major league baseball clubs who bartered among themselves for his services." *Id.* at 289-90. Justice Marshall concluded that the Court's prior cases upholding the reserve system should be overruled, as they denied the substantial federal right "to compete freely and effectively to the best of one's ability as guaranteed by the antitrust laws." *Id.* at 292-93.

Consistent with this focus on the freedom to compete, a number of subsequent cases employed the language characterizing antitrust laws as a "charter" or the "Magna Carta" of freedom in the context of considering various restraints on the freedom of competitors. *See, e.g., Cmty. Commc'ns Co., Inc. v. City of Boulder*, 455 U.S. 40, 56-57 (1982) (quoting Magna Carta language in holding that the state action defense did not apply to municipality's moratorium on competition by a cable company); *Lafayette v. La. Power & Light*, 435 U.S. 389, 398 n.16 (1978) (holding that city owned electric utilities that allegedly excluded competitors were not immune from antitrust liability); *Hecht v. Pro-Football, Inc.*, 444 F.2d 931, 935 (D.C. Cir. 1971) (challenging covenant in lease agreement for Robert F. Kennedy stadium precluding any professional football team other than the Washington Redskins from using the stadium).

This characterization of the Sherman Act as a quasi-constitutional charter guaranteeing the freedom to compete has also provided ammunition for some judges' defense of the perceived original purpose of the Sherman Act to protect small business concerns against larger rivals. For example, Justices White and Stevens cited this interpretation in dissenting from the Court's holding in *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990). The Court in that case held that an independent gasoline distributor could not challenge a vertical agreement between ARCO and its dealers establishing a maximum, non-predatory resale price for gasoline, because the agreement did not cause antitrust injury. The Court firmly linked the concept of antitrust injury to consumer welfare: "Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition." *Id.* at 340. On the other hand, the dissenters warned that the Court's decision "cast aside a century of understanding that our antitrust laws are designed to safeguard more than efficiency and consumer welfare. . . ." *Id.* at 360. In support of that understanding, they cited the "charter of freedom" language in *Appalachian Coals* and the Magna Carta comparison in *Topco*, along with Judge Learned Hand's observation in *United States v. Aluminum Co. of America*, 148 F. 2d 416, 428-29 (2d Cir. 1945), that Congress intended through the Sherman Act to "strengthen small business concerns and to 'put an end to great aggregations of capital because of the helplessness of the individual before them.'" *Id.* at 360, n.19.

In contrast to this interpretation of the "charter of freedom" as a bill of rights for the individual competitor, some courts have taken a broader view of the charter analogy. Rather than protecting small competitors, that view focuses on protecting the system of free enterprise itself.

For example, in *Board of Regents of the Univ. of Wis. Sys. v. Phoenix Int'l Software*, 653 F.3d 448 (7th Cir. 2011), the Seventh Circuit cited the *Topco* Magna Carta language:

> Capitalism and private ownership have served the United States well. Even though there is no clause in the Constitution explicitly committing the country to such an economic system (although the Takings Clause of the Fifth Amendment may come close), the antitrust laws have been called quasi-constitutional, and there seems little doubt that economic freedom is high on the list of cherished rights.

*Id.* at 477. The court thus equated the economic freedoms protected by the antitrust laws with the freedoms that are fundamental to a capitalist free enterprise system.

This broader interpretation of the "charter of freedom" also has deep roots. As early as 1940, the Supreme Court used the phrase to explain the importance of antitrust laws to the free enterprise system. In *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 220-21 (1940), the Court held that the reasonableness of fixed prices could not be a defense in price fixing cases. The Court explained that, if the defense were allowed, "the Sherman Act would soon be emasculated; its philosophy would be supplanted by one which is wholly alien to a system of free competition," and it would not be the "charter of freedom" that its "framers intended."

## The Broader View Prevails

Two cases decided in different courts years apart illustrate these contrasting interpretations of the "Magna Carta of free enterprise" as a bill of rights for the small entrepreneur and as a "charter" protecting the system of free enterprise itself. In *Redwood Theatres, Inc. v. Festival Entertainment Enterprises, Inc.*, 200 Cal. App. 3d 687 (1988), the California Court of Appeal held that the plaintiff, a film exhibitor, could maintain a claim under California's Cartwright Act against several film distributors for allegedly entering into "unwritten" agreements with a larger film distributor to provide that distributor with the valuable first-run films that distributors need to be profitable.[6] The court analyzed the issue under both boycott and exclusive dealing theories, and ultimately concluded that the challenged arrangement, if proved, could unreasonably "entrench the position of established motion picture exhibitors and pose formidable barriers to entrepreneurs seeking to enter (or expand) operations in the theatre business." *Id.* at 708.

In reaching that decision, the court interpreted the Supreme Court's invocation of the Magna Carta in *Topco* as a desire to protect "the entrepreneur's right to freely compete in new or expanded markets." *Id.* at 711-12. The court grounded this concern for the "entrepreneur's right to compete" in Congress' historical distrust of monopoly power, observing that "[w]ithin American political traditions, monopoly has long been perceived as a threat to individual liberties."[7] *Id.* at 708. The court even characterized the "central purpose" of the Sherman Act as "assuring freedom of opportunity in the face of accumulations of corporate wealth. . . ." *Id.* at 708, n.10.

Sixteen years later, the Supreme Court took a different approach to the Magna Carta analogy in *Verizon Communications, Inc. v. Trinko*, 540 U.S. 398, 415-16 (2004). In *Trinko*, the Court rejected the claim that traditional antitrust principles imposed an obligation on

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6 The case was decided before the California Supreme Court clarified in *State ex rel. Van de Kamp v. Texaco*, 46 Cal. 3d 1147, 1165 (1988) that the Cartwright Act was not derived from the Sherman Act, but from the law of other states, and that decisions interpreting the Sherman Act therefore are not necessarily probative of the intent underlying the Cartwright Act. The court in *Redwood Theatres* therefore relied on federal cases interpreting the Sherman Act in making its decision, concluding that they are "applicable to problems arising under the Cartwright Act." 200 Cal. App. 3d at 694.

7 In this context, the court noted that "Jefferson had proposed that a prohibition against monopoly be included in the Bill of Rights." *Id.* at 708. *See Thomas Jefferson to James Madison* (Dec. 20, 1787), in I THE FOUNDERS' CONSTITUTION Ch. 14, Document 30 (University of Chicago Press) (*available at* http://press-pubs.uchicago.edu/founders/documents/v1ch14s30.html) ("I will now add what I do not like. First the omission of a bill of rights providing clearly and without the aid of sophisms for freedom of religion, freedom of the press, protection against standing armies, restriction against monopolies. . . .").

the defendant, Verizon, to share its network with its competitor, AT&T, in the newly deregulated market for local telephone service. In doing so, the Court quoted *Topco*, not to emphasize the rights given to upstart competitors by the "Magna Carta of free enterprise," but to point out the Sherman Act's limitations: "The Sherman Act is indeed the 'Magna Carta of free enterprise' . . . but it does not give judges *carte blanche* to insist that a monopolist alter its way of doing business whenever some other approach might yield greater competition." *Id.* at 415-16. Indeed, the Court explained the potentially beneficial effects of a monopoly in a free enterprise system:

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices—at least for a short period—is what attracts "business acumen" in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive *conduct*.

*Id.* at 407 (emphasis in original).

Whatever meaning the Court ascribed to the "Magna Carta of free enterprise" in *Trinko*, it is clear that the analogy does not stand for the rights of the small competitor or new entrant against the competitive force of a monopoly simply because the monopolist has more power. This, of course, is in accord with the state of Section 2 law as it has evolved since the early days of the Sherman Act.

## IV. The Magna Carta Lives On

In light of the evolution of the Sherman Act toward its modern focus on enhancing consumer welfare, it is difficult to imagine the Supreme Court again using the Magna Carta analogy as Justice Marshall apparently intended in *Topco* in defense of the right of individuals to compete free of restraints imposed by more powerful economic actors.[8] It is even more difficult to envision the Court using the comparison as in *Redwood Theatres* in support of the purpose of the antitrust laws "to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other." 200 Cal. App. 3d at 710-11 (quoting *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 429 (2d Cir. 1945)).

However, the description of the Sherman Act as a charter of freedom is far from dead. The Supreme Court's reference to the *Topco* Court's Bill of Rights language just this year in *North Carolina State Board of Dental Examiners* shows that it continues to provide inspiration for the importance of the antitrust laws.

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8 Several cases have noted that the holding in *Topco*—at least in its broadest interpretation—also may not have stood the test of time. *See Rothery Storage & Van Co. v. Atlas Van Lines*, 792 F.2d 210, 226 (D.C. Cir. 1986) ("to the extent that *Topco* and *Sealy* stand for the proposition that all horizontal restraints are illegal per se, they must be regarded as effectively overruled"); *Guild Wineries and Distilleries v. J. Sosnick & Son*, 102 Cal. App. 3d 627, 645 (1980) ("The *Topco* court referred to the antitrust laws as 'the Magna Carta of free enterprise" . . . which guaranteed every business the freedom to compete in every section of the economy, whether intrabrand or interbrand. . . . This is contrary to the *Sylvania* court's explicit sanctioning of limits on wholesale and retail dealer autonomy").

But the Court's opinion in *Dental Examiners* (as well as the discussion in *Trinko* discussed above) suggest that the idea for which the Magna Carta or the Bill of Rights is likely to be invoked in the future is the importance of protecting the free enterprise system itself, not the rights of any particular competitors. Even though *Dental Examiners* dealt with a foreclosure of competition (it concerned the ability of non-dentists to compete in providing tooth whitening services), the Court's language certainly suggests this broader focus:

> Federal antitrust law is a central safeguard for the Nation's free market structures. In this regard it is "as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms." [quoting *Topco*]. The antitrust laws declare a considered and decisive prohibition by the Federal Government of cartels, price fixing, and other combinations or practices that undermine the free market.

135 S. Ct. at 1109.

There is another, rhetorical, reason why references to the Magna Carta and the Bill of Rights are likely to continue in antitrust cases. It arises from the same challenge that trial lawyers face in explaining the purpose of the antitrust laws to a jury, and that the government faces in communicating that purpose to the public. It can be difficult to explain to a jury that the antitrust laws generally promote competition, not cooperation, even when business documents use aggressive language about inflicting damage on a competitor. And it is much easier and more compelling for the U.S. Department of Justice to describe price fixing cartels as a form of "theft" from consumers than to explain the ways in which price fixing agreements inhibit the functioning of free market forces.[9] More than ever, antitrust laws import the principles of economics, which are not always easily expressed as intuitive moral concepts.

On the other hand, freedom is a concept that we can all grasp and embrace. Whatever its precise meaning in any particular antitrust case, courts are likely to continue to use the concept of a charter of freedom to communicate the fundamental importance of antitrust laws. Economic efficiency may be the Sherman Act's modern goal, but its rhetoric will likely continue to include the language of liberty.

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9 Scott D. Hammond, Director of Criminal Enforcement, Antitrust Division, U.S. Department of Justice, The Fly On The Wall Has Been Bugged: Catching An International Cartel In The Act, Address at International Law Congress, Dublin, Ireland (May 15, 2001) (*available at* www.justice.gov/atr/speech/fly-wall-has-been-bugged-catching-international-cartel-act) ("Price fixing is nothing less than theft by well-dressed thieves.").

# CAPITALIZING ON JUDICIAL ANTITRUST EXPERIENCE

*By Peter K. Huston*[1]

## I. INTRODUCTION

Federal antitrust cases are rarely simple. The statutes themselves are short enough and written in plain language, but they are broad. Courts have had to layer on all sorts of complex doctrines and constructs over the last 100-plus years as they have applied the statutes to real-world disputes. The list of thorny concepts is long: "Relevant product and geographic markets," "unilateral and coordinated effects," "conscious parallelism," "*Illinois Brick*/pass on," "dual distribution," "quick look," "recoupment," "foreclosure," "small-but-significant-non-transitory-increases-in-price (SSNIP)," and on and on. In addition, the influence of economics on antitrust law has steadily increased and econometric tools have become more sophisticated. And to make things even more complicated, both antitrust law and economics are moving targets. Cases decided in the past can reflect outmoded thinking, even if they haven't been specifically overruled, creating a minefield for the uninitiated.

Of course, it becomes a little easier to mentally wrestle difficult antitrust concepts to the ground the more one is exposed to them. But many judges have little, if any, experience with antitrust cases. Others get a relatively steady diet. While hundreds of antitrust cases are filed in the federal court system every year, they are not filed evenly across all 94 districts. For a variety of reasons a few districts get far more than their fair share. In fact, statistics from the last few years show that more civil antitrust cases have been filed in the top five districts—the Northern District of California, the Southern District of New York, the Eastern District of Michigan, the Eastern District of Pennsylvania, and the District of New Jersey—than all of the other 89 districts combined.[2]

It stands to reason that the districts that routinely deal with antitrust concepts will have an easier time with them than those that hardly ever see them. On the other hand, we generally expect our federal judges to be able to handle whatever legal issues come their way,[3] and a judge's breadth of experience across disciplines is perhaps as valuable as a depth of experience in the field relevant to any given case. For these reasons, creation of specialized antitrust courts, which would require an Act of Congress (that no one appears to be clamoring for), does not make sense. But a district's experience with antitrust law can and should give it an edge in terms of where a case lands in the context of a motion to transfer venue.

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2 *See Federal Court Management Statistics*, U.S. Courts, http://www.uscourts.gov/statistics-reports/analysis-reports/federal-court-management-statistics (last updated March 31, 2015).

3 *See Hawkes v. Hewlett-Packard Co.*, No. 10-05957, 2012 WL 506569, at *5 (N.D. Cal. Feb. 15, 2012) ("District courts are 'equally capable of applying federal law'") (quoting Allstar Mktg. Grp. LLC v. Your Store Online, Inc., 666 F. Supp. 2d 1109, 1133 (C.D. Cal. 2009)).

## II. PLAINTIFF'S CHOICE OF VENUE AND MOTIONS TO TRANSFER

Venue in antitrust cases is often proper in any judicial district in which a defendant is subject to the court's personal jurisdiction.[4] For many cases that is most districts because the defendants transact business nationally,[5] giving plaintiffs multiple jurisdictions from which to choose. Indeed, it is not uncommon to see private antitrust class actions pop up in many districts simultaneously following a precipitating event, such as the announcement of a Department of Justice investigation. In those circumstances, the Judicial Panel on Multidistrict Litigation, a group of seven circuit and district judges from around the country appointed by the Chief Justice of the Supreme Court, is typically called on to decide where to consolidate the cases for pretrial purposes. The panel decides motions to transfer based on the "convenience of parties and witnesses and [the promotion of] the just and efficient conduct of such actions."[6]

The standard is similar in solo antitrust cases when a court considers a motion to transfer venue. Under Section 1404 of the Judicial Code, the district court can transfer a case to another venue "[f]or the convenience of the parties and witnesses" and "in the interest of justice."[7] District court judges have wide discretion on such motions, and according to the Supreme Court, the statute permits a "flexible and individualized analysis."[8]

While assessing the convenience of witnesses is relatively straightforward,[9] the "interests of justice" is not so concrete. In evaluating which venue best serves the interest of justice, courts weigh a host of factors, including (in no particular order):

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4 The Clayton Act provides that "[a]ny suit, action, or proceeding under the antitrust laws against a corporation may be brought not only in the judicial district whereof it is an inhabitant, but also in any district wherein it may be found or transacts business; and all process in such cases may be served in the district of which it is an inhabitant, or wherever it may be found." 15 U.S.C. § 22 (2012).

The general venue provision for civil actions provides that they "may be brought in—(1) a judicial district in which any defendant resides, if all defendants are residents of the State in which the district is located; . . . or (3) if there is no district in which an action may otherwise be brought . . . , any judicial district in which any defendant is subject to the court's personal jurisdiction with respect to such action." 28 U.S.C. §1391(b) (2012). "For all venue purposes—. . . (2) an entity . . . shall be deemed to reside, if a defendant, in any judicial district in which such defendant is subject to the court's personal jurisdiction . . . ; and (3) a defendant not resident in the United States may be sued in any judicial district. . . ." 28 U.S.C. § 1391(c) (2012).

5 See *KM Enters., Inc. v. Global Traffic Technologies, LLC*, 725 F.3d 718, 723-31 (7th Cir. 2013) for a thorough discussion of the interplay between the general venue provisions and the venue and personal jurisdiction provisions specific to the Clayton Act (and the circuit split on the subject).

6 28 U.S.C. § 1407(a) (2012).

7 *Id.* § 1404(a).

8 *Stewart Organization, Inc. v. Ricoh Corp.*, 487 U.S. 22, 29 (1988).

9 The convenience of important nonparty witnesses is often cited as the most significant factor in ruling on a motion to transfer venue. *See* 15 Charles Alan Wright , et al., Federal Practice and Procedure § 3851 (4th ed. 2014); *see also Lipnick v. United Air Lines, Inc.*, No. 11-2028, 2011 WL 4026647, at *2 (N.D. Cal. Sept. 9, 2011).

- the plaintiff's choice of forum;[10]
- the ability to compel the attendance of unwilling nonparty witnesses;
- the ease of access to sources of proof;
- the respective parties' contacts with the forum;
- the relationship of each community to the controversy;
- relative court congestion;
- the location where relevant agreements were negotiated and executed;
- applicable forum selection clauses;
- the differences in the costs of litigation in the two forums;
- the unfairness of burdening citizens in an unrelated forum with jury duty;
- the interest in avoiding litigation in a forum where there is a question over whether personal jurisdiction exists; and
- familiarity with the applicable law.[11]

This last factor leads some parties in antitrust cases to argue that the interests of justice favors having the case remain with (or go to) districts with significant antitrust experience. For example, in *Le, et al. v. Zuffa LLC*, an antitrust challenge to the Ultimate Fighting Championship (UFC) organization, the defense moved to transfer venue from the Northern District of California, where the case was originally filed, to the District of Nevada.[12] In opposing the motion, the plaintiff contrasted the 476 civil antitrust cases that had been filed in the Northern District of California over the last

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10 Courts have noted that plaintiffs' chosen forum is entitled to less weight where they seek to represent a nationwide class. As the Supreme Court explained in *Koster v. Lumbermens Mutual Casualty Co.*, "where there are hundreds of potential plaintiffs, . . . all of whom could with equal show of right go into their many home courts, the claim of any one plaintiff that a forum is appropriate merely because it is his home forum is considerably weakened." 330 U.S. 518, 524 (1947); *see also, e.g.*, *Lou v. Belzberg*, 834 F.2d 730, 739 (9th Cir. 1987) ("If the operative facts have not occurred within the forum and the forum has no interest in the parties or subject matter, [the plaintiffs'] choice is entitled to only minimal consideration."); *Hawkins v. Gerber Prods. Co.*, 924 F. Supp. 2d 1208, 1214-15 (S.D. Cal. 2013) ("In part, the reduced weight on plaintiff's choice of forum in class actions serves as a guard against the dangers of forum shopping, especially when a representative plaintiff does not reside within the district"); *Job Haines Home for the Aged v. Young*, 936 F. Supp. 223, 228 (D.N.J. 1996) ("[T]he weight of authority holds that in class actions and derivative law suits the class representative's choice of forum is entitled to lessened deference.").

11 *See Van Dusen v. Barrack*, 376 U.S. 612, 645 (1964) (explaining that "to the extent that Pennsylvania laws are difficult or unclear and might not defer to Massachusetts laws, it may be advantageous to retain the actions in Pennsylvania where the judges possess a more ready familiarity with the local laws."); *Research Automation, Inc. v. Schrader-Bridgeport Int'l., Inc.*, 626 F.3d 973, 978 (7th Cir. 2010) (discussing the factors courts consider under the interests of justice analysis, and explaining that "the interests of justice may be determinative, warranting transfer or its denial even where the convenience of the parties and witnesses points toward the opposite result."); *Jones v. GNC Franchising, Inc.*, 211 F.3d 495, 498-99 (9th Cir. 2000) (enumerating the factors courts consider under the interests of justice analysis); *Coffey v. Van Dorn Iron Works*, 796 F.2d 217, 221-22 (7th Cir. 1986) (same); *Nyulassy v. Lockheed Martin Corp.*, No. 12-1182, 2012 WL 2906572, at *2 (N.D. Cal. July 16, 2012) (same); *King v. Sam Holdings, LLC*, No. 10-04706, 2011 WL 4948603, at *4 (N.D. Cal. Oct. 18, 2011) (same); *SoccerSpecific.com v. World Class Coaching, Inc.*, No. 08-6109, 2008 WL 4960232, at *5 (D. Or. Nov. 18, 2008) (same).

12 Defendant Zuffa, LLC's Consolidated Notice of Motion and Motion to Transfer Venue Under 28 U.S.C. § 1404(a), *Le, et al. v. Zuffa LLC*, No. 14-05484 (N.D. Cal., Apr. 10, 2015), ECF No. 31.

several years with just 19 that had been filed in Nevada.[13] The plaintiffs argued that the disparity gave California a distinct edge in terms of which court could most efficiently manage the complex action.[14]

A group of plaintiffs in the contact lens multidistrict litigation made a similar argument. They pointed out the depth of experience of the Northern District of California judges in dealing with coordinated class action antitrust suits, citing a series of cases the court has handled, including *In re Cathode Ray Tube (CRT) Antitrust Litigation* (MDL No. 1917), *In re TFT-LCD (Flat Panel) Antitrust Litigation* (MDL No. 1827), *In re Optical Disk Drive Prods. Antitrust Litigation* (MDL No. 2143), and *In re Lithium Ion Batteries Antitrust Litigation* (MDL No. 2420).[15]

In both the UFC case and the contact lens case, the plaintiffs' efforts to keep the cases in the Northern District of California were unsuccessful. In the UFC case, contractual choice of law provisions helped convince the court to send the case to Nevada.[16] In the contact lens cases, the MDL Panel coordinated the cases in the Middle District of Florida based on the presence of defendants in that state and the Florida judge's familiarity with the industry from prior litigation.[17]

Despite these results, a disproportionate number of antitrust cases will continue to be filed in the districts traditionally favored by plaintiffs, and those plaintiffs will fight to keep them there citing the districts' antitrust expertise.

## III. DOES JUDICIAL ANTITRUST EXPERIENCE LEAD TO MORE JUST OR EFFICIENT OUTCOMES?

Some antitrust cases, regardless of where they are filed, should not survive the pleading stage. Others deserve to pass that threshold, but should be dismissed on summary judgment. Others should rightfully proceed to trial, but one or more expert witnesses should not be allowed to testify, or their testimony should be restricted. District court judges stand watch at each of these gates. And their decisions matter. Obviously, a dismissal is hugely consequential to plaintiffs. On the flip side, allowing an antitrust case to proceed into the discovery phase is incredibly expensive for defendants, as the Supreme Court noted when it tightened the pleading standard several years ago.[18]

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13 Plaintiffs' Opposition to the UFC's Motion to Transfer Venue at 23, *Le, et al. v. Zuffa LLC*, No. 14-05484 (N.D. Cal., Jan. 30, 2015), ECF No. 69.

14 *Id.* (explaining that the Northern District of California has had more than 25 times the number of antitrust actions as the District of Nevada, and could be "expected to rely on its substantial experience to more efficiently manage" the case).

15 Response of Plaintiffs Joanne Buckley, et al. for Centralization in Northern District of California Pursuant to 28 U.S.C. § 1407 at 4, *In re* Disposable Contact Lens Antitrust Litigation, No. 2626 (J.P.M.L., Mar. 30, 2015), ECF No. 59.

16 *See* Order Granting Defendant's Motion to Transfer Venue at 3, *Le, et al. v. Zuffa LLC*, No. 14-05484 (N.D. Cal., June 2, 2015), ECF No. 94 ("At the final bell, it is Defendants arguments that clinch this round because the relevant forum selection clause and the § 1404(a) convenience considerations both favor a Nevada forum.").

17 *See* Transfer Order at 2, *In re* Disposable Contact Lens Antitrust Litigation, No. 2626 (J.P.M.L., June 8, 2015), ECF No. 186.

18 *See Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007).

It is reasonable to think that a judge who has had to make these tough decisions in antitrust cases many times before is more likely to make the correct decisions in an efficient manner. Judges familiar with current antitrust legal and economic principles presumably are able to quickly zero-in on the relevant authorities, analyze the issues and cogently explain their reasoning using the most appropriate terminology.

This proposition, if true, and taken to its logical extreme, presents an argument for specialized antitrust courts. The idea has its appeal and has been considered. For example, Senior Circuit Judge Douglas H. Ginsburg of the District of Columbia Circuit and Federal Trade Commissioner Joshua D. Wright contemplated a specialist antitrust court staffed by judges drawn, on a rotating temporary basis, from generalist courts.[19] They pointed out that allowing judges to specialize on antitrust cases would likely yield more satisfactory results in terms of efficiency, uniformity, and higher quality decisions.[20] But there are countervailing arguments. The tradition of generalist Article III judges is strong, and as Seventh Circuit Chief Judge Diane Wood has noted:

> The need to explain even the most complex area to the generalist judge (and often to a jury as well) forces the bar to demystify legal doctrine and to make the law comprehensible. . . . [And] the generalist judge is less likely to become the victim of regulatory capture than her specialized counterpart, despite the best intentions of the latter's side. If one never emerges from the world of antitrust . . . one can lose sight of the broader goals that lie behind this area of law; one can forget the ways in which it relates to other fields of law like business torts, breaches of contract, and consumer protection, and more broadly the way this law fits into the loose 'industrial policy' of the United States. Economic mumbo-jumbo is already prevalent in the field, but lawyers talk of the trade-off between the deadweight loss 'triangle' and the income transfer 'rectangle' at their peril in front of a judge who does not live and breathe the field. Specialists need to come out of their cocoons from time to time and find out how their smaller worlds fit in with the larger one.[21]

Moreover, it is not clear that additional exposure to antitrust cases alone leads to significantly better results. In a 2011 article in the Journal of Law and Economics, Commissioner Wright and economist Michael Baye published the results of a study which sought to empirically test whether the economic issues in antitrust cases had become too complex for generalist judges.[22] They looked at whether economic

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19 *See* Hon. Douglas H. Ginsburg & Joshua D. Wright, *Antitrust Courts: Specialists Versus Generalists, in* International Antitrust Law & Policy: Fordham Competition Law (Barry E. Hawk ed., 2012), *reprinted in* 36 Fordham Int'l L. J. 788 (2013); *see also* Joshua D. Wright & Angela M. Diveley, *Do Expert Agencies Outperform Generalist Judges? Some Preliminary Evidence from the Federal Trade Commission,* 1 J. Antitrust Enforcement 82 (2012). The issue has also come up in the context of patent law. *See* Jay P. Kesan & Gwendolyn G. Ball, *Judicial Experience and the Efficiency and Accuracy of Patent Adjudication: An Empirical Analysis of the Case for a Specialized Patent Trial Court,* 24 Harv. J.L. & Tech. 393 (2011) (discussing the general arguments for judicial specialization and presenting empirical evidence of a "real but moderate case for the development of . . . a specialized patent trial court.").

20 Ginsburg & Wright, *supra* note 19, at 793-98.

21 Diane P. Wood, *Generalist Judges in a Specialized World*, 50 SMU L. Rev. 1755, 1767 (1997).

22 Michael R. Baye & Joshua D. Wright, *Is Antitrust Law Too Complicated for Generalist Judges? The Impact of Economic Complexity and Judicial Training on Appeals*, 54 J.L. & Econ. 1 (2011).

complexity in antitrust cases and the economic training of judges impacted the decisions. In order to test their hypotheses, they collected antitrust decisions from both Article III federal district court judges and administrative law judges and categorized them in terms of economic complexity. They also collected data on the judges, including their antitrust experience and economic training. Lastly, they correlated these and other variables with the quality of the decisions as measured by whether they were appealed. The authors explained the rationale for selecting appeals as the relevant variable for assessing the quality of the decision:

> [T]he parties—who have typically invested in expert economists and thus are in a strong position to understand the strengths and weaknesses of complex economic arguments—can assess relatively well whether the initial court got the economics right or wrong in a case. Thus, by revealed preference, the fact that a party is willing to bear the cost of appealing a judge's opinion signals that (at least it believes) that the judge made a potentially reversible error.[23]

Baye and Wright concluded that economic complexity significantly increases the probability of appeal.[24] They also concluded that judicial economic training reduces the probability of appeal in simple cases but not complex cases.[25] Lastly, they found that in terms of getting decisions right, "repeated exposure to complex antitrust issues is *not* a close substitute for economic training."[26]

This last finding presents another argument against separate antitrust courts. Higher levels of exposure to antitrust issues did, in fact, correlate with higher quality decisions in Baye and Wright's study (as measured by lower appeal rate, as noted above), however the results were small and not as statistically significant as economic training.[27] The weak correlation does support a major shake-up of the judiciary. But it does not detract from using a district's antitrust experience as a factor to help decide venue motions. While antitrust experience might lead to only a mildly higher number of good decisions, it almost surely allows judges to resolve issues more quickly. And efficiency is a driving force behind the change of venue statute. The Supreme Court has said that the purpose of the statute is "to prevent the waste of time, energy and money and to protect litigants, witnesses and the public against unnecessary inconvenience and expense."[28]

These goals are advanced when cases are heard by judges who, by virtue of their experience with prior cases, can quickly and confidently recognize a claim that should be dismissed, a bankrupt argument, or an expert witness who is relying on junk science. And allowing antitrust experience to affect venue decisions does not compromise the values

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23 *Id.* at 5.

24 *Id.*

25 *Id.* This finding supports training judges in economics, a conclusion also reached by the American Bar Association Antitrust Section Economic Evidence Task Force. *See* Memorandum from Jonathan B. Baker & M. Howard Morse, Final Report of Economic Evidence Task Force (Aug. 1, 2006), http://www.americanbar.org/content/dam/aba/migrated/antitrust/at-reports/01_c_ii.authcheckdam.pdf.

26 Baye & Wright, *supra* note 22, at 16, 20 (emphasis added).

27 *Id.* at 16.

28 *Van Dusen v. Barrack*, 376 U.S. 612, 616 (1964) (internal quotation marks and citations omitted).

touted by Judge Wood (and shared by many). Even in the districts with the highest number of antitrust cases, those cases will represent a relatively small fraction of the judges' overall caseload, allowing judges to maintain the broader perspective of which Judge Wood spoke.

## IV. Conclusion

Some federal district courts get many more antitrust cases than others. The experience gained from dealing with these cases likely makes the courts more efficient, if not better, at dealing with the complex concepts that arise. There are solid reasons why antitrust cases should continue to be decided by generalist rather than specialist judges, as has been the long tradition in this country. The perspective generalist judges bring from hearing a variety of types of cases is likely a net benefit to the development of antitrust law, as is the more accessible writing and speaking mode that antitrust lawyers must adopt when presenting their arguments to generalist judges. Yet relative antitrust expertise is a legitimate factor to be considered in deciding which district should get a case in the context of a motion to transfer venue or motion to consolidate multidistrict litigation.

# PLEADING AN ANTITRUST CONSPIRACY IN A POST-*TWOMBLY* WORLD

*By Joshua Stokes and Jordan Ludwig*[1]

## I. INTRODUCTION

*Bell Atlantic Corp. v. Twombly* is one of the most important cases to ever be decided interpreting the Federal Rules of Civil Procedure.[2] At its core, *Twombly* clarified what Federal Rule of Civil Procedure 8(a)(2) means when it asks for a "short and plain statement of the claim showing that the pleader is entitled to relief" and how a complaint survives a motion to dismiss for failure to state a claim upon which relief can be granted brought under Rule 12(b)(6). The Court's new interpretation of these rules—described in detail below—abrogated its prior decision in *Conley v. Gibson*,[3] which merely required the plaintiff to provide fair notice of the claim to the defendant.

*Twombly's* significance is undeniable. According to Westlaw, as of July 31, 2015, it has been cited in a breathtaking 118,866 judicial opinions. But despite its near universal relevance, *Twombly* is of special import in antitrust cases—and, more specifically, conspiracy cases under Section 1 of the Sherman Act.[4] *Twombly* itself was a Section 1 conspiracy case alleging an agreement between telephone companies to thwart competition by preventing upstart companies from expanding in the market and by agreeing not to compete with one another.[5] The Court's holding in *Twombly* was grounded largely in antitrust principles—so much so that it led some lower courts to initially conclude that the rule in *Twombly* applied *only* in conspiracy cases.[6] The Supreme Court clarified *Twombly's* broader application two years later in *Ashcroft v. Iqbal*—notably, over the dissent of Justice Souter, *Twombly's* author.[7]

This article highlights principal decisions, circuit by circuit, discussing the standards for pleading an antitrust conspiracy under *Twombly*. Although some familiarity with *Twombly* is assumed, Section II contains a refresher of *Twombly's* facts and holding. The heart of the article, Section III, discusses the various approaches the circuit courts have taken with regard to *Twombly*. Specifically, this section is broken down into conspiracies that are pleaded based on direct evidence (Section III.A) and—much more significantly—conspiracies that are pleaded based on circumstantial evidence (Section III.B). Given

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1 The views expressed by the authors in this article are their own and not those of any of their clients or of Crowell & Moring LLP.

2 550 U.S. 544 (2007).

3 355 U.S. 41 (1957).

4 15 U.S.C. § 1.

5 550 U.S. at 550.

6 *See, e.g., Aktieselskabet AF 21. Nov. 2001 v. Fame Jeans Inc.*, 525 F.3d 8, 17 (D.C. Cir. 2008) ("In sum, *Twombly* was concerned with the plausibility of an inference of conspiracy, not with the plausibility of a claim."). This confusion was understandable. The opinion in *Twombly* expressly says, "We granted certiorari to address the proper standard *for pleading an antitrust conspiracy* through allegations of parallel conduct." 550 U.S. at 553 (emphasis added).

7 556 U.S. 662 (2009).

that the majority of antitrust conspiracies are pleaded with circumstantial evidence, the latter category is of distinct consequence. In this section, we strive to provide a survey of the most important cases from each circuit to assist practitioners trying to navigate this murky intersection between antitrust law and civil procedure. Finally, Section IV contains our concluding remarks on the subject and ties together the key areas of divergence that have emerged from this body of case law.

## II. A BRIEF *TWOMBLY* CRASH COURSE

Although most readers of this article have almost certainly studied *Twombly* at one point, this section provides a review of *Twombly's* facts and holding.

### A. The Facts

Following the 1984 divestiture of AT&T's local telephone business, a system of regional local monopolies known as—among other things—Incumbent Local Exchange Carriers (ILECs) or "Baby Bells" was established.[8] For a time, the ILECs maintained their regional monopolies for local telephone service but were excluded from the competitive market for long-distance services.[9] This changed when the Telecommunications Act of 1996 ("the 1996 Act") was passed. Among other things, the 1996 Act was meant to engender competition and "'facilitate market entry'" into the local telephone service markets.[10] It attempted to accomplish this goal by requiring each ILEC to share its network with competitors—known as Competitive Local Exchange Carriers (CLECs).[11] To compensate the ILECs for this, the 1996 Act provided a path for the ILECs to enter the competitive long-distance market.[12]

In 2002, William Twombly and Lawrence Marcus filed a class-action complaint against a group of ILECs under Section 1 of the Sherman Act.[13] The complaint alleged that the ILECs conspired to restrain trade in two ways: (1) by "engaging in parallel conduct" to thwart the upstart CLECs' growth; and (2) by refraining from competing against each other.[14] More specifically, as to the first alleged restraint of trade, the plaintiffs claimed that the ILECs suppressed competition by making unfair agreements with the CLECs to access ILEC networks, providing the CLECs with inferior connections to the ILEC networks, overcharging the CLECs, and billing the CLECs in a manner intended to sabotage their customer relationships.[15] As to the second alleged restraint of trade, the plaintiffs alleged that the ILECs failed to pursue "attractive business opportunities" in each other's markets. In support, the plaintiffs referred to a public statement made by the CEO of one ILEC noting that competing in another ILEC's territory "might be a good way to turn a quick dollar but

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8 *Twombly*, 550 U.S. at 549.

9 *Id.*

10 *Id.* (quoting *AT & T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999)).

11 *Id.* at 549-50.

12 *Id.* at 549.

13 *Id.* at 550.

14 *Id.* at 551.

15 *Id.* at 550-51.

that doesn't make it right."[16] In summary, the complaint alleged that because there was no "meaningful competition" between the ILECs in each other's markets and because of the "parallel course of conduct that each engaged in to prevent competition from CLECs within their respective" markets, the defendants had entered into a conspiracy to restrain trade.[17]

A district judge in the Southern District of New York dismissed the complaint under Rule 12(b)(6) for failing to state a claim.[18] The district court held that consciously parallel conduct, without more, did not state a claim under Section 1.[19] The court also noted that the alleged behavior of the ILECs in resisting emerging competition was "fully explained" by each ILEC's economic self-interest in defending its territory.[20] The Second Circuit reversed. It held that the district court applied the incorrect standard for evaluating a motion to dismiss.[21] The reversal was guided by the Second Circuit's view that a plaintiff need not plead "plus factors" in a complaint to support a conspiracy premised on parallel conduct.[22] While the court noted that on summary judgment a plaintiff is required to come forward with such plus factors, at the pleading stage, "we are concerned only with whether the defendants have 'fair notice' of the claim, and the conspiracy that is alleged as part of the claim, against them."[23] The Supreme Court granted certiorari to review the Second Circuit's decision.

## B. The Holding

The Court reversed the Second Circuit's ruling. It began by noting that "[t]his case presents the antecedent question of what a plaintiff must plead in order to state a claim under § 1 of the Sherman Act."[24] The Court proceeded to discuss what Rule 8 requires a complaint to contain to survive a motion to dismiss. In a now oft-quoted portion interpreting Rules 8 and 12, the Court wrote, "While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations . . . a plaintiff's obligation to provide the grounds of his entitle[ment] to relief requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do. . . . Factual allegations must be enough to raise a right to relief above the speculative level, on the assumption that all the allegations in the complaint are true (even if doubtful in fact)."[25] Under these general principles, the Court held that to successfully plead a Section 1 claim, a complaint must contain "enough factual matter (taken as true) to suggest that an agreement [to restrain trade] was made."[26] This standard, according to the Court, did not "impose a probability requirement at the pleading stage"; rather, the

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16 *Id.* at 551 (internal quotation marks omitted).

17 *Id.*

18 *Id.* at 552.

19 *Id.*

20 *Id.*

21 *Id.* at 553.

22 *Id.*

23 *Twombly v. Bell Atl. Corp.*, 425 F.3d 99, 116 (2d Cir. 2005).

24 *Twombly*, 550 U.S. at 554–55.

25 *Id.* at 555–56 (citations and internal quotation marks omitted).

26 *Id.* at 556.

allegations must "plausibly suggest[]" that an agreement was made and not be "merely consistent with" an agreement.[27] In the context of agreements pleaded on the basis of parallel conduct, the Court forcefully stated that "an allegation of parallel conduct and a bare assertion of conspiracy will not suffice. Without more, parallel conduct does not suggest conspiracy, and a conclusory allegation of agreement at some unidentified point does not supply facts adequate to show illegality."[28] Instead, the Court held that the allegations of parallel conduct "need[] some setting" or "further factual enhancement" to cross the line from possible to plausible.[29] The Court noted in a footnote, however, that it was not applying any heightened pleading standard or attempting to broaden the scope of Federal Rule of Civil Procedure 9 to antitrust cases or otherwise.[30]

In reaching this conclusion, the Court abrogated its prior holding in *Conley v. Gibson*. In particular, the Court took issue with the language in *Conley* stating that, "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove *no set of facts* in support of his claim which would entitle him to relief."[31] In *Twombly*, the Court discussed a history of misinterpreting this phrase as literal, which according to the Court would allow any conclusory statement of a claim to survive a motion to dismiss so long as the complaint left open any possibility of recovery.[32] The Court was unwilling to accept this interpretation of *Conley*. Consequently, it held that this language from *Conley* was "best forgotten as an incomplete, negative gloss on an accepted pleading standard" and "earned its retirement."[33]

The Court then proceeded to apply these principles to the allegations in the plaintiffs' complaint. At the very outset, the Court noted that this was a conspiracy pleaded on parallel conduct and not on allegations of direct agreement among the ILECs.[34] It acknowledged that there were a few "stray" references to a direct agreement, but dismissed these allegations as mere legal conclusions that need not be accepted as true by the Court.[35] Instead, the "nub" of the complaint as read by the Court was that the ILECs' "parallel behavior, consisting of steps to keep the CLECs out and manifest disinterest in becoming CLECs themselves" pleaded the requisite agreement.[36] The Court disagreed that the alleged parallel behavior sufficed to plead a plausible antitrust conspiracy.

First, the Court noted that the structure of the 1996 Act provided the ILECs with a powerful economic incentive to resist competition in their markets. Resisting competition, in the Court's words, constituted "routine market conduct," and was

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27 *Id.* at 556-57.

28 *Id.*

29 *Id.* at 557.

30 *Id.* at 569 n.14

31 355 U.S. 41, 45-46 (1957) (emphasis added).

32 *Twombly*, 550 U.S. at 561.

33 *Id.*at 563.

34 *Id.* at 564.

35 *Id.* & n.9. For example, allegations that the ILECs engaged in a contract, combination or conspiracy and agreed not to compete with one another were mere the legal conclusions referenced by the Court. *Id.*

36 *Id.* at 565.

fully consistent with a "natural, unilateral reaction" to preserving market dominance.[37] This principle held particularly true under the 1996 Act, which imposed cumbersome requirements on the ILECs—most notably, forcing them to share their *infra*structure and subsidize their own competition.[38] The Court was unwilling to infer an agreement among the defendants from "do[ing] what was only natural" in such circumstances.[39]

Second, the Court was similarly unwilling to infer a conspiracy under the plaintiffs' second theory. This was because the Court found an "obvious alternative explanation" for the failure of the ILECs to compete with one another: monopoly was the "norm" in telecommunications and the ILECs "were born in that world, doubtless liked the world the way it was, and surely knew the adage about him who lives by the sword."[40] Significantly, any ILEC that attempted to become a CLEC "faced nearly insurmountable barriers to profitability."[41] It therefore made no economic or practical sense for the ILECs to become CLECs in other contiguous markets.

In a nutshell, the Court was unwilling to infer a conspiracy where the plaintiffs had not "nudged their claims across the line from conceivable to plausible."[42] Two years after *Twombly*, in *Iqbal*, the Court reiterated that *Twombly* set the standard for "evaluating whether a complaint is sufficient to survive a motion to dismiss" in all cases—not just antitrust conspiracy cases.[43]

## III. PLEADING A SECTION 1 ANTITRUST CONSPIRACY POST-TWOMBLY

A claim under Section 1 of the Sherman Act has three elements: (1) a contract, combination, or conspiracy; (2) an unreasonable restraint of trade in the relevant market; and (3) an accompanying injury.[44] Section 1 claims may involve a wide variety of restraints of trade, including those to fix prices, engage in a group boycott, allocate customers or markets, rig bids, and more.[45] This article focuses on only the first element, which was the element at issue in *Twombly*, and the element most frequently litigated in conspiracy cases. A "contract, combination, or conspiracy" may be proven by direct evidence of agreement or through circumstantial evidence permitting the inference of an agreement. As then-Judge Sotomayor wrote, "in the absence of direct 'smoking gun' evidence, a horizontal price-fixing agreement may be inferred on the basis of conscious parallelism, when such interdependent conduct is accompanied by circumstantial evidence and plus factors such as defendants' use of facilitating practices."[46]

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37 *Id.* at 566.

38 *Id.*

39 *Id.*

40 *Id.* at 567-68.

41 *Id.*

42 *Id.* at 570.

43 556 U.S. 662, 669 (2009).

44 *Denny's Marina, Inc. v. Renfro Prods., Inc.*, 8 F.3d 1217, 1220 (7th Cir. 1993).

45 *See DM Research, Inc. v. Coll. of Am. Pathologists*, 170 F.3d 53, 55 (1st Cir. 1999) ("[A]lmost any agreement between independent actors that restrains competition is potentially subject to examination for 'reasonableness' under section 1.").

46 *Todd v. Exxon Corp.*, 275 F.3d 191, 198 (2d Cir. 2001) (Sotomayor, J.).

As stated in the Introduction, this section is broken down into two broader subsections: (1) pleading a conspiracy after *Twombly* based on direct evidence; and (2) pleading a conspiracy after *Twombly* based on circumstantial evidence. The difference is critical. Indeed, the Court *began* its analysis in *Twombly* by drawing this very distinction: "the complaint leaves no doubt that the plaintiffs rest their § 1 claim on *descriptions of parallel conduct* and not on any *independent allegation of actual agreement*."[47] In this section, we first address what the standard is for the fortunate plaintiff who is able to plead a conspiracy based on an "independent allegation of actual agreement." We then survey the circuit courts of appeal to discuss what a plaintiff in each circuit must allege to render a claim based on circumstantial evidence "plausible" under *Twombly*. As will be explored in depth, this varies—sometimes significantly—by circuit.

## A. Direct Evidence

At the outset, "direct evidence" must be defined: "Direct evidence in a Section 1 conspiracy must be evidence that is explicit and requires no inferences to establish the proposition or conclusion being asserted."[48] Stated differently, direct evidence must "show an explicit understanding between the [alleged conspirators] to collude."[49] Some courts have gone so far as to say that if there is any ambiguity in the evidence, the evidence is not "direct"; rather, true direct evidence is "'tantamount to an acknowledgment of guilt.'"[50] Perhaps most simply put, direct evidence is essentially a "smoking gun."[51] Examples of such evidence may come in the form of documents, meetings, and participant testimony.[52] Given this narrow definition and the sophistication of modern businesses, it is not controversial to state that true direct evidence is a rarity.[53]

Given the paucity of cases turning on direct evidence of conspiracy, there has not been much occasion for courts to consider the pleading standard for such cases under *Twombly*. Nevertheless, a few courts have opined on the issue. The Third Circuit led the pack, holding that "[i]f a complaint includes non-conclusory allegations of direct evidence of an agreement, a court need go no further on the question whether an agreement has been adequately pled."[54] But it is not enough to merely plead that the

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47 550 U.S. at 564 (emphasis added).

48 *In re Baby Food Antitrust Litig.*, 166 F.3d 112, 118 (3d Cir. 1999).

49 *Golden Bridge Tech., Inc. v. Motorola Inc.*, 547 F.3d 266, 272 (5th Cir. 2008).

50 *Hyland v. HomeServices of Am., Inc.*, 771 F.3d 310, 318 (6th Cir. 2014) (quoting *In re High Fructose Corn Syrup Antitrust Litig.*, 295 F.3d 651, 662 (7th Cir. 2002) (Posner, J.)).

51 *Todd*, 275 F.3d at 198.

52 6 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 1410a, at 69 (3d ed. 2010); *see also In re Ins. Brokerage Antitrust Litig.*, 618 F.3d 300 n.23 (3d Cir. 2010) (providing as an example of direct evidence of agreement "a document or conversation explicitly manifesting the existence of the agreement in question").

53 *In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig.,* 906 F.2d 432, 439 (9th Cir. 1990) (noting that "direct evidence will rarely be available"); *Milgram v. Loew's, Inc.*, 192 F.2d 579, 583 (3d Cir. 1951) ("[I]t is rare indeed for a conspiracy to be proved by direct evidence."); *Battle v. Lubrizol Corp.*, 673 F.2d 984, 992 (8th Cir. 1982) ("However, we think that it is most unlikely that antitrust plaintiffs, like any other plaintiffs alleging conspiracy, will have direct evidence.").

54 *W. Penn. Allegheny Health Sys., Inc. v. UPMC*, 627 F.3d 85, 99-100 (3d Cir. 2010); *accord In re Ins. Brokerage Antitrust Litig.*, 618 F.3d at 323-24 ("Allegations of direct evidence of an agreement, if sufficiently detailed, are independently adequate.").

defendants reached an agreement, which would constitute a mere legal conclusion: "After *Twombly*, if a plaintiff expects to rely exclusively on direct evidence of conspiracy, its complaint must plead 'enough fact to raise a reasonable expectation that discovery will reveal' this direct evidence."[55] The Second Circuit appears to have agreed with the Third Circuit's conclusion that direct allegations of agreement, such as a "recorded phone call in which two competitors agreed to fix prices," will suffice to allege the agreement element.[56] Other district courts have also followed suit with these cases.[57] In short, there does not appear to be much disagreement on the issue: if a complaint pleads true direct evidence of conspiracy with sufficient factual support, this will suffice to plead the "agreement" element on a Section 1 claim.[58]

An interesting issue arises concerning whether the rigors of *Twombly's* "plausibility" requirement even apply in direct-evidence cases. On the one hand, the Fourth Circuit has noted that "*Twombly's* requirements with respect to allegations of illegal parallel conduct are inapplicable where, as here, the concerted conduct is not a matter of inference or dispute."[59] On the other hand, one district court judge expressly rejected the argument that the *Twombly* plausibility standard did not apply to their allegations of direct evidence.[60] That judge held that direct evidence must meet *Twombly's* plausibility standard.[61]

There is a potentially useful parallel to be drawn here between the standard on summary judgment and the standard on a motion to dismiss that may shed some light on the direction in which the law is heading. In *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, the Supreme Court placed certain limits on the inferences that district courts may draw from ambiguous conduct in an antitrust case on summary judgment.[62] But since then, several circuits have held "those limits on inferences do not apply to a plaintiff's direct evidence of an unlawful agreement under § 1."[63] And the Second Circuit joined "at least three" of its sister circuits in noting that "summary judgment is generally not appropriate where a plaintiff has produced direct, as opposed to circumstantial,

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55 *In re Ins. Brokerage Antitrust Litig.*, 618 F.3d at 324. In *Twombly*, the Supreme Court held that an allegation that the defendants engaged in a "contract, combination or conspiracy"—while directly alleging agreement—was a mere legal conclusion that did not suffice to directly plead an agreement. *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 565-65 & n.9 (2007).

56 *Mayor & City Council of Balt., Md. v. Citigroup, Inc.*, 709 F.3d 129, 136 (2d Cir. 2013).

57 *E.g., Suture Exp., Inc. v. Cardinal Health 200, LLC,* 963 F. Supp. 2d 1212, 1223-24 (D. Kan. 2013) ("[B]ut allegations of direct evidence, that are adequately detailed, are sufficient alone."). Disclosure: Crowell & Moring LLP was counsel for one of the defendants in this case.

58 It is worth noting that courts often reject a plaintiff's characterization of its allegations as "direct evidence" and will proceed to analyze the allegations as "circumstantial" evidence. *See, e.g., Burtch v. Milberg Factors, Inc.*, 662 F.3d 212, 225-30 (3d Cir. 2011); *Corr Wireless Commc'ns, L.L.C. v. AT & T, Inc.*, 893 F. Supp. 2d 789, 805 (N.D. Miss. 2012). Disclosure: Crowell & Moring LLP was counsel for one of the defendants in *Corr Wireless.*

59 *Robertson v. Sea Pines Real Estate Cos., Inc.*, 679 F.3d 278, 290 (4th Cir. 2012).

60 *LaFlamme v. Societe Air France*, 702 F. Supp. 2d 136 (E.D.N.Y. 2010).

61 *Id.*

62 475 U.S. 574, 587-88 (1986).

63 *Toledo Mack Sales & Serv., Inc. v. Mack Trucks, Inc.*, 530 F.3d 204, 219-20 (3d Cir. 2008).

evidence of an agreement to fix prices."[64] It is likely that over time, courts will further explore the issue of whether a true "plausibility" analysis is required in direct-evidence cases at the pleading stage.

### B. Circumstantial Evidence

As discussed, direct evidence of a conspiracy is exceedingly difficult to come by. For that reason, "[d]irect evidence of conspiracy is not a sine qua non. . . . Circumstantial evidence can establish an antitrust conspiracy."[65] Courts have creatively riffed on the notion that circumstantial evidence will often be the only way to prove an antitrust conspiracy.[66]

If direct evidence has been narrowly defined to be "tantamount to an acknowledgment of guilt," circumstantial evidence has been described as "everything else *including* ambiguous statements."[67] In order to prove a conspiracy, this nebulous and large body of potential circumstantial evidence—whatever form it may take—must show a "unity of purpose or a common design and understanding, or a meeting of minds in an unlawful arrangement."[68] As discussed above, at the motion to dismiss stage, *Twombly* requires that a plaintiff allege parallel conduct in addition to "some setting suggesting the agreement necessary to make out a § 1 claim"—a "further circumstance pointing toward a meeting of the minds."[69] This standard raises a bevy of issues such as the weight afforded to conflicting inferences, what allegations must be accepted as true, the extent that allegations of "plus factors" are required, the level of factual specificity required, and more. Many circuit courts have written detailed opinions analyzing these issues in the context of a Section 1 claim after *Twombly*. They have not been completely uniform in answering the questions that inhere in conspiracies pleaded based on circumstantial evidence. Below, we address what we view as the most important opinions from circuits that have ruled on the issue.

#### 1. First Circuit

The First Circuit had occasion to address the standard for pleading an antitrust conspiracy in *Evergreen Partnering Group, Inc. v. Pactiv Corp.*, a group boycott case.[70] Relying on *Twombly*, the district court dismissed Evergreen's complaint and held that Evergreen had failed to plausibly allege that the Defendants had entered into an agreement to boycott it.

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64 *In re Publ'n Paper Antitrust Litig.*, 690 F.3d 51, 63-64 (2d Cir. 2012).

65 *In re Text Messaging Antitrust Litig.*, 630 F.3d 622, 629 (7th Cir. 2010); s*ee also U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526, 534 n.13 (1973) (noting that "circumstantial evidence is the lifeblood of antitrust law").

66 *See, e.g., Esco Corp. v. U.S.*, 340 F.2d 1000, 1007 (9th Cir. 1965) ("A knowing wink can mean more than words."); *Park v. El Paso Bd. of Realtors*, 764 F.2d 1053, 1059 (5th Cir. 1985) ("It has been said that a conspiracy need not be hatched in the dark of the night by men in conical hats."); *In re Delta/AirTran Baggage Fee Antitrust Litig.*, 733 F. Supp. 2d 1348, 1360 (N.D. Ga. 2010) ("Plaintiffs need not allege the existence of collusive communications in 'smoke-filled rooms' in order to state a § 1 Sherman Act claim.").

67 *In re High Fructose Corn Syrup Antitrust Litig.*, 295 F.3d 651, 662 (7th Cir. 2002) (emphasis in original).

68 *Am. Tobacco Co. v. U.S.*, 328 U.S. 781, 810 (1946).

69 550 U.S. 544, 557 (2007).

70 720 F.3d 33 (1st Cir. 2013). Disclosure: At his prior firm, Jordan Ludwig was counsel for Evergreen in this appeal.

Specifically, the district court held that "'as in *Twombly*, there are legitimate business reasons that can as easily explain defendants' refusal to deal with Evergreen or to compete with one another for market share *as can* any insinuation of a conspiratorial agreement.'"[71]

The First Circuit reversed the district court's dismissal. It noted early in its analysis that the distinction between alleging "merely" parallel conduct and alleging a "plausible agreement" has "elicited considerable confusion among the lower courts as to how much of a 'setting' is required to sufficiently contextualize an agreement in the absence of direct evidence."[72] The court identified the "slow influx" of what it perceived as "unreasonably high pleading requirements at the earliest stages of antitrust litigation"—due, in its view, to citations to case law at the summary judgment and trial stages of litigation.[73] After summarizing the state of the law, the court concluded that under *Twombly* a plaintiff may not rest its complaint exclusively on parallel conduct alone; rather, it must allege the "general contours" of when an agreement was made and support those allegations with a "context that tends to make said agreement plausible."[74] Explaining further, the First Circuit specified that a plaintiff *need not* allege plus factors at the pleading stage—although such allegations may assist a court in evaluating the plausibility of an agreement.[75] The court expressed sympathy to antitrust plaintiffs, stating that plus-factor evidence has become "increasingly complex[]" and would "not likely be available" at the pleading stage.[76] Notably, the First Circuit also held that on a motion to dismiss, the plaintiff's allegations "need not make any unlawful agreement more likely than independent action nor need they rule out the possibility of independent action" because, in the court's view, this would "frustrate the purpose of antitrust legislation and the policies informing it."[77]

Based on these principles, the First Circuit vacated the district court's dismissal of Evergreen's complaint. The court found that Evergreen's allegations of agreement went "much further" than the allegations in *Twombly* and provided the necessary context to infer a plausible conspiracy.[78] The court enumerated a number of allegations that it believed differentiated Evergreen's complaint from the complaint in *Twombly*.[79] In view of these allegations, the First Circuit concluded that the district court "improperly applied a heightened pleading standard" and "improperly occupied a factfinder role when it both chose among plausible alternative theories interpreting defendants' conduct and adopted as true allegations made by defendants in weighing the plausibility of theories put forward by the parties."[80] The court also took issue with the fact that the district court evaluated defendants' proffered "legitimate business reasons" against the complaint's

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71 *Id.* at 42 (quoting *Evergreen Partnering Grp., Inc. v. Pactiv Corp.*, 865 F. Supp. 2d 133, 140 (D. Mass. 2012)).

72 *Id.* at 43–44.

73 *Id.* at 44.

74 *Id.* at 46.

75 *Id.* at 46–47.

76 *Id.* at 47.

77 *Id.*

78 *Id.*

79 *See id.* at 48–49.

80 *Id.* at 50.

conflicting allegations.[81] In summary, the First Circuit held that the district court had erred in acting as a factfinder, demanding detailed allegations, and weighing inferences in the defendants' favor.[82]

### 2. Second Circuit

The Second Circuit has considered *Twombly* on several occasions. First, shortly after *Twombly* was decided, the Second Circuit affirmed the dismissal of the complaint in *In re Elevator Antitrust Litigation*.[83] The court noted that "'[c]onsiderable uncertainty' surrounds the breadth of the Supreme Court's recent decision in *Twombly*."[84] But this case did not contain any detailed analysis of *Twombly*. In the court's own words, "we need not draw fine lines here."[85] The court made short shrift of the plaintiffs' claims, disregarding the conclusory allegations of agreement and rejecting the argument that parallel conduct allowed a conspiracy to be inferred.[86]

The Second Circuit gave *Twombly* a far more fulsome analysis in two subsequent cases: *Starr v. Sony BMG Music Entertainment*,[87] a price-fixing case, and *Anderson News, L.L.C. v. American Media, Inc.*, a group boycott case.[88] Because the two cases set forth similar (and, in our view, consistent) principles, and because both reverse the district court's dismissal of the plaintiff's complaint under Rule 12(b)(6), we discuss only *Anderson News* because it is more recent, more detailed, and builds on the opinion in *Starr*.

*Anderson News* involved an alleged conspiracy by the plaintiff's suppliers and business competitors to boycott the plaintiff and drive it out of business. In particular, Anderson—a wholesaler of single-copy magazines—complained that following its announcement of an upstream distribution surcharge, magazine publishers, distributors, and one of Anderson's competitors conspired to cut off Anderson's supply and drive it out of business.[89] The district court held that under *Twombly*, the conspiracy alleged by Anderson was facially implausible and dismissed the complaint.[90]

The Second Circuit reversed the dismissal. The court's analysis began by providing a detailed explication of *Twombly's* mandates. Off the bat, the court wrote that it would not hold a plaintiff to summary judgment or trial standards on a motion to dismiss: "to present a plausible claim at the pleading stage, the plaintiff need not show that its

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81 *Id.*

82 Recently, the district court dismissed Evergreen's case on summary judgment. *Evergreen Partnering Grp., Inc. v. Pactiv Corp.*, No. 11-10807, 2015 WL 4205293 (D. Mass. July 10, 2015). Evergreen filed a notice of appeal.

83 502 F.3d 47 (2d Cir. 2007).

84 *Id.* at 50 (quoting *Iqbal v. Hasty*, 490 F.3d 143, 155 (2d Cir. 2007)).

85 *Id.*

86 *Id.* at 50-51.

87 592 F.3d 314 (2d Cir. 2010).

88 680 F.3d 162 (2d Cir. 2012).

89 *Id.* at 168-72.

90 *Id.* at 167.

allegations suggesting an agreement are more likely than not true or that they rule out the possibility of independent action, as would be required at later litigation stages."[91] Second, the court noted that circumstantial allegations of conspiracy are often subject to divergent interpretations. But the court explained that district courts may not choose between these conflicting inferences on a Rule 12(b)(6) motion, even if it finds the defendant's version of the events more plausible.[92] Finally, the court emphasized that district courts must accept the factual allegations in the complaint as true—again, even if the veracity of the allegations seems doubtful.[93]

According to the Second Circuit, the district court went astray in applying *Twombly*. Most notably, it held that the district court had improperly "cho[se] among plausible alternatives," which it was not permitted to do on a motion to dismiss—rather, "[t]he question at the pleading stage is not whether there is a plausible alternative to the plaintiff's theory; the question is whether there are sufficient factual allegations to make the complaint's claim plausible."[94] Second, the court stated that the district court had "essentially" made factual findings at the pleading stage.[95] Unlike the district court, the Second Circuit found Anderson's complaint "vastly different from the complaint at issue in *Twombly*."[96] Of note to the court was the fact that Anderson had alleged that all of the defendants ceased dealing with it in lockstep and included certain dates and individuals (from the defendant companies) who had met in the two-week period prior to defendants' cancellation of Anderson.[97] The court also found persuasive Anderson's allegations of certain statements the defendants had made to Anderson and a similarly situated wholesaler.[98]

Because Anderson's allegations were plausible, "the district court could not properly make an interpretive finding on a Rule 12(b)(6) motion."[99] In sum, it appears that the Second Circuit is also of the view that district courts may not weigh competing plausible inferences and may not render factual findings on a motion to dismiss.[100]

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91 *Id.* at 184.

92 *Id.* at 185.

93 *Id.* One principle that we add from Starr not mentioned in *Anderson News* is that the Second Circuit has rejected the notion that *Twombly* requires that "a plaintiff identify the specific time, place, or person related to each conspiracy allegation" where the claim rests on parallel conduct. 592 F.3d 314, 325 (2d Cir. 2010).

94 *Anderson News*, 680 F.3d at 189-90.

95 *Id.* at 190.

96 *Id.* at 186-87.

97 *Id.* at 187.

98 *Id.* at 187-88.

99 *Id.*

100 In fact, the First Circuit relied heavily on *Anderson News* in deciding *Evergreen*. *See Evergreen Partnering Group, Inc. v. Pactiv Corp.*, 720 F.3d 33, 45-46 (1st Cir. 2013). Finally, the district court recently dismissed Anderson's case on summary judgment. *Anderson News, L.L.C. v. Am. Media, Inc.*, No. 09 Civ. 2227 PAC, 2015 WL 4991868 (S.D.N.Y. Aug. 20, 2015). Anderson has filed a notice of appeal.

### 3. Third Circuit

The Third Circuit has given in-depth consideration to pleading antitrust conspiracy based on circumstantial evidence on two occasions. The first was in *In re Insurance Brokerage Antitrust Litigation*—an alleged customer-allocation scheme among the defendant insurers.[101]

In *In re Insurance Brokerage Antitrust Litigation*, after summarizing Section 1's requirements and *Twombly's* holding, the Third Circuit quickly raised an important issue—the relationship between the pleading standard and the summary judgment standard in antitrust cases. In answering that question, the court wrote, "We think *Twombly* aligns the pleading standard with the summary judgment standard in at least one important way: Plaintiffs relying on circumstantial evidence of an agreement must make a showing at both stages (with well-pled allegations and evidence of record, respectively) of 'something more than merely parallel behavior,' something 'plausibly suggest[ive of] (not merely consistent with) agreement."[102] The court went on to note that if obvious alternative explanations existed for the facts alleged, the allegations of conspiracy are not plausible.[103] In this sense, the court was limiting the range of permissible inferences that a district court can draw from ambiguous evidence—much like on summary judgment and at trial.[104] As far as plus-factor evidence was concerned, the Third Circuit held that plaintiffs relying on circumstantial evidence of conspiracy must allege facts that, if true, would establish at least one "plus factor."[105] The court summarized its reading of *Twombly* as follows: "In sum, *Twombly* makes clear that a claim of conspiracy predicated on parallel conduct should be dismissed if 'common economic experience,' or the facts alleged in the complaint itself, show that independent self-interest is an 'obvious alternative explanation' for defendants' common behavior."[106] Based on this standard, the Third Circuit affirmed the district court's dismissal of the plaintiffs' antitrust claims except those involving bid rigging.[107]

The Third Circuit differs from the First and Second Circuits in that the pleading standard is more closely aligned with the summary judgment standard. A plaintiff must allege facts supporting plus-factor evidence and must dispel obvious alternative explanations for the defendants' conduct.

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101 618 F.3d 300 (3d Cir. 2010). The Third Circuit again addressed *Twombly* in detail in *Burtch v. Milberg Factors, Inc.*, 662 F.3d 212 (3d Cir. 2011). This opinion, however, relies very heavily on *In re Insurance Brokerage Litigation*, and a detailed discussion of *Burtch* would be cumulative. Consequently, we do not discuss that decision here.

102 618 F.3d at 322 (citations omitted); *see also Superior Offshore Int'l, Inc. v. Bristow Grp., Inc.*, 490 F. App'x 492, 499 (3d Cir. 2012) (same).

103 *In re Insurance Brokerage Antitrust Litig.*, 618 F.3d at 322-23.

104 *Id.* at 361.

105 *Id.* at 323.

106 *Id.* at 326.

107 *Id.* at 336-37, 361-62. Because of the opinion's factual complexity, we find it beyond the scope of this article to address those facts here.

### 4. Fourth Circuit

The Fourth Circuit's most significant consideration of *Twombly* in a circumstantial pleaded conspiracy case comes in the unpublished decision of *Loren Data Corp. v. GXS, Inc.*[108] In that case, Loren Data alleged that GXS engaged in a concerted refusal to deal with it in the electronic data interchange industry.[109] The district court dismissed Loren Data's complaint, holding that Loren Data had failed to allege specific facts to support a Section 1 conspiracy.[110]

The Fourth Circuit affirmed the district court's dismissal. The court first reviewed *Twombly's* principles and the general law under Section 1—that is, "when concerted conduct is a matter of inference, a plaintiff must include evidence that places the parallel conduct in 'context that raises a suggestion of a preceding agreement' as 'distinct from identical, independent action.'"[111] It concluded that Loren Data had failed to provide any allegations suggesting circumstantial evidence of a conspiracy. Citing to the Supreme Court's decision in *Matsushita*, the Fourth Circuit stated that the "reviewing court must 'take account of the absence of a plausible motive to enter into the alleged . . . conspiracy.'"[112] The court went on to hold that if the alleged conspirators did not have a rational, economic motive to conspire, and their conduct was consistent with equally plausible lawful explanations, the court could not infer a conspiracy.[113] For this reason, the court concluded, the complaint's allegations "must tend to exclude the possibility that the alleged co-conspirators acted independently, and the alleged conspiracy must make practical, economic sense."[114] Under this standard, the Fourth Circuit concluded that Loren Data's allegations contradicted any inference of conspiracy. In particular, the Fourth Circuit found that the allegations "reflect[ed] GXS's unilateral business judgment as to the parameters under which it was willing to deal with Loren Data" and the conspiracy as alleged "simply ma[de] no practical economic sense."[115]

In sum, assuming published decisions in the Fourth Circuit follow *Loren Data*, a plaintiff in the Fourth Circuit must plead a plausible economic motive to conspire and the allegations must tend to exclude the possibility that the conduct was unilateral—similar to summary judgment standards.

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108 501 F. App'x 275 (4th Cir. 2012). The Fourth Circuit also considered *Twombly* in *Robertson v. Sea Pines Real Estate Companies*, but that case, which is cited above, rested on direct evidence. *See* 679 F.3d 278, 289 (4th Cir. 2012) ("Circumstantial evidence sufficient to 'suggest[] a preceding agreement,' is thus superfluous in light of the direct evidence in the by-laws of the agreement itself." (citation omitted)).

109 *Loren Data*, 501 F. App'x at 277.

110 *Id.* at 278.

111 *Id.* at 281 (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 556 (2007)).

112 *Id.* (quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 595 (1986)).

113 *Id.* at 280-281.

114 *Id.* at 281.

115 *Id.*

### 5. Fifth Circuit

The Fifth Circuit has not issued a detailed opinion on *Twombly* in the context of pleading an antitrust conspiracy. Nevertheless, the Fifth Circuit was faced with a *Twombly* issue in an antitrust conspiracy in *Marucci Sports, L.L.C. v. National Collegiate Athletic Association*, which provides some—but not detailed—guidance.[116] In *Marucci Sports*, the plaintiff alleged that the NCAA and the National Federation of State High School Associations ("NFHS") conspired to design the standard for non-wood baseball bats—known as the BBCOR standard—to favor incumbent competitors and exclude new market entrants such as Marucci.[117] After several of Marucci's bats failed compliance testing on multiple occasions, it sued under Section 1, and the district court dismissed its case on Rule 12 motion to dismiss.[118]

The Fifth Circuit stated outright that "[a]ntitrust claims do not necessitate a higher pleading standard and a plaintiff need only plead enough facts to state a claim to relief that is plausible on its face."[119] Nevertheless, the court affirmed the district court's dismissal. In the court's view, the plaintiff needed to plead facts showing that the alleged concerted action resulted from an agreement to unreasonably restrain trade.[120] While Marucci alleged that the NCAA and NFHS had engaged in a conspiracy to enforce the BBCOR standard to exclude new market entrants and favor the incumbent manufacturers, the Fifth Circuit dismissed these allegations as insufficient.[121] The court noted that the complaint had failed to allege any "specific *facts*" demonstrating the intent to engage in a conspiracy.[122] Without these specific facts, the Fifth Circuit was unwilling to differentiate Marucci's case from *Twombly*, and found that the "various conclusory allegations . . . support one of many inferential possibilities."[123] *Marucci Sports* provides some guidance, but not a detailed blueprint for district courts and practitioners evaluating an antitrust conspiracy.[124]

### 6. Sixth Circuit

The Sixth Circuit has perhaps given more detailed consideration to the *Twombly* standard than any other; it has written detailed opinions on *Twombly* in the antitrust context on four occasions. These opinions have arguably resulted in an intracircuit split of authority. Rather than discussing each of these cases in detail, we instead summarize the most important rules that each announced.

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116 751 F.3d 368 (5th Cir. 2014).

117 *Id.* at 372.

118 *Id.* at 372-73.

119 *Id.* at 373 (citations and internal quotation marks omitted).

120 *Id.* at 375.

121 *Id.*

122 *Id.* (emphasis in original).

123 *Id.*

124 A more extensive *Twombly* analysis in the Fifth Circuit is found in the case of *Lormand v. US Uniwired, Inc.*, 565 F.3d 228 (5th Cir. 2009)—a securities fraud case. In *Lormand*, the Fifth Circuit held, among other things, that when evaluating the element of loss causation in a securities fraud case, "we are not authorized or required to determine whether the plaintiff's plausible inference of loss causation is equally or more plausible than other competing inferences." *Id.* at 266.

The Sixth Circuit first confronted *Twombly* in a Section 1 case in *Total Benefits Planning Agency, Inc. v. Anthem Blue Cross and Blue Shield*, a group boycott case.[125] Most significantly, the court in *Total Benefits* held that a plaintiff cannot offer "bare allegations" of agreement without any reference to the "who, what, where, when, how or why" of the alleged conspiracy.[126] The Sixth Circuit faulted the plaintiff for failing to allege when each defendant joined the conspiracy, where or how each defendant joined the conspiracy, and for what purpose they joined the conspiracy.[127] Similarly, the court criticized the plaintiff for failing to identify the individuals who allegedly made certain statements that facilitated the alleged boycott and for not explaining where or when the conspiracy occurred during the alleged conspiracy period.[128] For these reasons, the Sixth Circuit affirmed the dismissal of the plaintiff's complaint.

The court revisited *Twombly* the following year in *In re Travel Agent Commission Antitrust Litigation*, a case brought by a putative class of travel agents who alleged that the defendant airlines conspired to reduce, cap, and eliminate the payment of commissions to plaintiffs.[129] According to the Sixth Circuit, which affirmed the dismissal of the plaintiffs' complaint, "The *Twombly* decision provides an additional safeguard against the risk of 'false inferences from identical behavior' at an earlier stage of the trial sequence—the pleading stage."[130] Of greatest note, relying on *Matsushita*, the court wrote that "the plausibility of plaintiffs' conspiracy claim is inversely correlated to the magnitude of defendants' economic self-interest."[131] Based on this principle and certain allegations and evidence, the Sixth Circuit concluded that "it is just as likely that American's 2001 commission cap was an effort to reduce its internal commission costs, with the ancillary hope that its competitors would follow its lead" as the alleged conspiracy.[132] Finally, the court found that the plaintiff's allegations lacked the necessary detail to "nudge" the claim from conceivable to plausible.[133] For instance, the plaintiffs failed to allege any "specific meetings" involving the remaining defendants other than trade association meetings, which the Sixth Circuit held was insufficient under *Twombly*.[134] Despite an impassioned dissent from Judge Merritt—who wrote that "district courts across the country have dismissed a large majority of Sherman Act claims on the pleadings misinterpreting the standards from *Twombly* and *Iqbal*, thereby slowly eviscerating antitrust enforcement under the Sherman Act[135]—two judges voted to affirm the district court's dismissal.

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125 552 F.3d 430 (6th Cir. 2008).

126 *Id.* at 437.

127 *Id.* at 436.

128 *Id.*

129 583 F.3d 896 (6th Cir. 2009).

130 *Id.* at 904.

131 *Id.* at 909.

132 *Id.* at 910.

133 *Id.*

134 *Id.* at 910–11.

135 *Id.* at 914 (Merritt, J., dissenting).

One year later, in *Watson Carpet & Floor Covering, Inc. v. Mohawk Industries, Inc.*, the Sixth Circuit again considered the *Twombly* standard in another group boycott case.[136] But unlike in the prior two cases, this time, the Sixth Circuit reversed the district court's dismissal in an opinion arguably premised on a different interpretation of *Twombly*. Most importantly here, the Sixth Circuit was unwilling to adopt the inference-weighing approach used in prior cases. The district court found that the defendant had offered "an eminently plausible reason for the refusal to deal"—namely that the plaintiff had previously sued the defendant.[137] On review, however, the Sixth Circuit rejected this line of reasoning. It wrote, "Often, defendants' conduct has several plausible explanations. Ferreting out the most likely reason for the defendants' actions is not appropriate at the pleading stage. In this case, the plausibility of Watson Carpet's litigiousness as a reason for the refusals to sell carpet does not render all other reasons implausible."[138] In sum, unlike in *In re Travel Agent Commission Antitrust Litigation*, this panel of judges was unwilling to weigh—or "ferret out"—the various inferences that arose from the defendant's conduct.

Finally, the Sixth Circuit's most recent *Twombly* opinion was *Erie County, Ohio v. Morton Salt, Inc.*[139] Even though the Sixth Circuit ultimately affirmed dismissal of the plaintiff's complaint, it criticized the district court for "not clearly distinguish[ing] between the antitrust standards applicable on summary judgment and those that apply to a motion to dismiss."[140] The appellate court clarified two important points. First, it noted that "at the pleading stage, the plaintiff is not required to allege facts showing that an unlawful agreement is more likely than lawful parallel conduct."[141] In the court's view, all that a plaintiff must plead are facts sufficient to "raise a plausible inference of an unlawful agreement to restrain trade."[142] Second, the court held that, "in order to state a Section One claim, a plaintiff need not allege a fact pattern that 'tends to exclude the possibility' of lawful, independent conduct."[143] The court noted that this language was drawn from summary judgment and trial decisions and that in *Twombly*, the Supreme Court "nowhere held that the same standard applies on a motion to dismiss."[144] And in the panel's view, "[i]f a plaintiff were required to allege facts excluding the possibility of lawful conduct, almost no private plaintiff's complaint could state a Section One claim" because "a plaintiff is very unlikely to have factual information that would exclude the possibility of non-conspiratorial explanations *before* discovery."[145] Despite this seemingly more expansive pleading standard, the Sixth Circuit affirmed the dismissal of the plaintiff's complaint. It first found that allegations of suspicious bidding patterns

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136 648 F.3d 452 (6th Cir. 2011).

137 *Id.* at 458.

138 *Id.*

139 702 F.3d 860 (6th Cir. 2012).

140 *Id.* at 868.

141 *Id.*

142 *Id.* at 869.

143 *Id.*

144 *Id.*

145 *Id.*

mirrored the "failure-to-compete claim that *Twombly* rejected."[146] It then rejected the plaintiff's sham-bidding claim in view of a unique "Buy Ohio" law; according to the court, the plaintiff's sham-bidding theory "makes sense only in a market subject to the lockout interpretation of the Buy Ohio law."[147]

As these four cases demonstrate, there appears to be some disagreement within the Sixth Circuit regarding what a plaintiff is required to plead under *Twombly* and how far a district court may go in ruling on a motion to dismiss.

### 7. Seventh Circuit

The Seventh Circuit considered the *Twombly* pleading standing in the context of an antitrust conspiracy in *In re Text Messaging Antitrust Litigation*—an opinion written by Judge Posner.[148] *Text Messaging* was an interlocutory appeal from the denial of the defendants' motion to dismiss in a series of cases alleging a conspiracy to fix the prices of text messaging services. In deciding to accept the interlocutory appeal, Judge Posner wrote that, "Pleading standards in federal litigation are in ferment after *Twombly* and *Iqbal*, and therefore an appeal seeking a clarifying decision that might head off protracted litigation is within the scope of section 1292(b)."[149] The Seventh Circuit affirmed the district court's denial of the defendants' motion to dismiss and provided its explanation of the *Twombly* pleading standard.

The court endeavored to explain the difference between "plausibility," "probability," and "possibility," as used in *Twombly*. In the court's view, these terms were all "a little unclear" because they all overlap.[150] Judge Posner wrote, "Probability runs the gamut from a zero likelihood to a certainty. What is impossible has a zero likelihood of occurring and what is plausible has a moderately high likelihood of occurring. The fact that the allegations undergirding a claim could be true is no longer enough to save a complaint from being dismissed; the complaint must establish a nonnegligible probability that the claim is valid; but the probability need not be as great as such terms as 'preponderance of the evidence' connote."[151]

Under this standard, the Seventh Circuit concluded that the plaintiffs had alleged a plausible conspiracy. Of note to the court was the fact that the plaintiffs had alleged a mix of parallel behaviors, details of the industry structure, and certain industry practices (such as the exchange of price information at trade association meetings), that all "facilitate collusion."[152] The court similarly found persuasive allegations that the defendants allegedly changed their pricing structures and increased their prices simultaneously in the face of falling costs—behavior that the court found "anomalous" under economic principles.[153] Finally, the court regarded all of these allegations as circumstantial evidence,

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146 *Id.* at 870.

147 *Id.* at 872.

148 630 F.3d 622 (7th Cir. 2010).

149 *Id.* at 627.

150 *Id.* at 629.

151 *Id.*

152 *Id.* at 627-28.

153 *Id.* at 628.

and noted its limited role on a motion to dismiss in evaluating such evidence: "We need not decide whether the circumstantial evidence that we have summarized is sufficient to *compel* an inference of conspiracy; the case is just at the complaint stage and the test for whether to dismiss a case at that stage turns on the complaint's 'plausibility.'"[154] And, in fact, when confronted with a greater record on summary judgment, the Seventh Circuit recently affirmed the dismissal of this case.[155]

### 8. Eighth Circuit

The Eighth Circuit has not issued a highly detailed opinion analyzing *Twombly* in the antitrust sphere but has just recently issued two opinions touching on the subject. First, in *Robbins v. Becker*, the court affirmed the dismissal of a complaint alleging a Section 1 conspiracy as one of many claims, but this opinion contains only a cursory analysis of *Twombly*.[156] Just over two weeks later, the court issued a significantly more in-depth opinion in *Insulate SB, Inc. v. Advanced Finishing Systems, Inc.*[157] This opinion affirmed the dismissal of a Section 1 case alleging that a manufacturer and its distributors violated Section 1 through "agreements in restraint of trade" to "reduce competition."[158] More specifically, the plaintiff complained that the manufacturer's alleged threats in two letters not to deal with any of its distributors that carried a competitor's product violated Section 1.[159] The Eighth Circuit was not persuaded.

In reviewing the legal standard, the court wrote, "Given the unusually high cost of discovery in antitrust cases, the limited success of judicial supervision in checking discovery abuse, and the threat that discovery expense will push cost-conscious defendants to settle even anemic cases, the federal courts have been reasonably aggressive in weeding out meritless antitrust claims at the pleading stage."[160] With this lens, the court proceeded to first analyze the alleged "written" exclusive agreements. The court concluded that the complaint merely "contain[ed] several conclusory references to a contract" but "the alleged facts do not suggest [the manufacturer] entered into explicit exclusivity agreements with any distributors."[161] The court rejected the notion that the manufacturer's unilateral announcement that it would not sell to distributors who also sold a competitor's products—an announcement made after it signed the distribution agreements—could "transform a prior innocuous distributor agreement into a contract for exclusive dealing" to support an inference of an agreement not to compete.[162] Second, the court considered the plaintiff's claim that the manufacturer's letters and the distributors' compliance with those letters' suggestions could circumstantially evidence a conspiracy. It rejected the plaintiff's "vague references to concerted action" among

154 *Id.* at 629.

155 *In re Text Messaging Antitrust Litig.*, 782 F.3d 867 (7th Cir. 2015).

156 No. 14-1435, 2015 WL 4508749 (8th Cir. July 27, 2015).

157 No. 14-2451, 2015 WL 4760287 (8th Cir. Aug. 13, 2015).

158 *Id.* at *2.

159 *Id.*

160 *Id.* at *3 (citations and internal quotation marks omitted).

161 *Id.* at *4.

162 *Id.*

certain distributors for failing to "provide any factual allegations beyond the bare conclusion that there was a conspiracy."[163] The court found lacking allegations such as "when the agreements occurred" and "which of the distributors named as defendants—if any—are among the 'key distributors' who were party to the agreements."[164] In sum, the Eighth Circuit concluded that repeated allegations that an "unnamed set of distributors generally conspired to restrain trade," did not provide the "'factual enhancement' necessary to move [the] complaint forward."[165]

Neither *Robbins* nor *Insulate* make it entirely clear where the Eighth Circuit lands on the post-*Twombly* spectrum. It bears noting that in another context, the Eighth Circuit "refuse[d] . . . to incorporate some general and formal level of evidentiary proof into the 'plausibility' requirement of *Iqbal* and *Twombly*."[166] Given some of the language in *Insulate*, it is possible that the Eighth Circuit will demand a higher degree of factual specificity from antitrust plaintiffs.

### 9. Ninth Circuit

The Ninth Circuit has issued a series of rulings—two within the past few months—that when read in conjunction, help define the pleading standard in the Ninth Circuit. The first of these cases is *Kendall v. Visa U.S.A., Inc.*, a Section 1 case decided shortly after *Twombly* that alleged a conspiracy to set the fees charged to merchants for the payment of credit card sales.[167] In *Kendall*, the Ninth Circuit made clear that after *Twombly*, a plaintiff must plead "not just ultimate facts (such as a conspiracy), but evidentiary facts."[168] According to the court, "[a] bare allegation of a conspiracy is almost impossible to defend against."[169] Although the court does not spend much time analyzing *Twombly*, it affirmed the dismissal of the plaintiff's complaint because the plaintiff had failed to allege any such evidentiary facts. Notably, the court wrote, "the complaint does not answer the basic questions: who, did what, to whom (or with whom), where, and when?"[170] At bottom, the court found that the plaintiffs had alleged no more than parallel conduct, which is insufficient under *Twombly*.[171]

Very recently, the Ninth Circuit had occasion to again consider the *Twombly* standard in *name.space, Inc. v. Internet Corp. for Assigned Names and Numbers*.[172] And again, it did not thoroughly analyze the appropriate standard for pleading an antitrust conspiracy. But, in reliance on *Kendall, Matsushita*, and other Ninth Circuit case law interpreting *Twombly*, the court affirmed the Rule 12(b)(6) dismissal of the plaintiff's complaint. Most importantly here, the Ninth Circuit held that "ICANN's decision-making was fully

163 *Id.* at *6.

164 *Id.*

165 *Id.* at *7 (quoting *Twombly*, 550 U.S. at 557).

166 *Whitney v. Guys, Inc.*, 700 F.3d 1118, 1128 (8th Cir. 2012).

167 518 F.3d 1042 (9th Cir. 2008).

168 *Id.* at 1047.

169 *Id.*

170 *Id.* at 1048.

171 *Id.*

172 No. 13-55553, 2015 WL 4591897 (9th Cir. July 31, 2015).

consistent" with rational and lawful business behavior.[173] Specifically, the court cited its prior decision in a civil RICO case standing for the proposition that "courts *must* consider obvious alternative explanations for a defendant's behavior when analyzing plausibility."[174] Under these principles, the Ninth Circuit was unwilling to "infer an illegal agreement with outside interests simply because ICANN's rational business decisions favor the status quo rather than name.space's untested alternative business model."[175]

Most recently, the Ninth Circuit affirmed the district court's Rule 12(b)(6) dismissal in *In re Musical Instruments and Equipment Antitrust Litigation*.[176] This case alleged a "hub-and-spoke" conspiracy between a musical-instrument retailer and several musical-instrument manufacturers.[177] After addressing the law behind such conspiracies, the court noted that it was principally concerned with the alleged horizontal agreements between the manufacturers—that is, the "rim" of the conspiracy.[178]

The Ninth Circuit began its plausibility analysis by noting that parallel conduct, "such as competitors adopting similar policies around the same time in response to similar market conditions[] may constitute circumstantial evidence of anticompetitive behavior."[179] But, the court noted, "*Twombly* takes into account the economic reality that mere parallel conduct is as consistent with agreement among competitors as it is with independent conduct in an interdependent market."[180] Explaining further, the court wrote, "In an interdependent market, companies base their actions in part on the anticipated reactions of their competitors. And because of this mutual awareness, two firms may arrive at identical decisions independently, as they are cognizant of—and reacting to—similar market pressures."[181] According to the court, certain plus factors—that is, "economic actions and outcomes that are largely inconsistent with unilateral conduct but largely consistent with explicitly coordinated action"—can place allegations of parallel conduct in a context suggesting agreement.[182]

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173 *Id.* at *4.

174 *Id.* (citing *Eclectic Props. E., LLC v. Marcus & Millichap Co.*, 751 F.3d 990, 996 (9th Cir. 2014)) (emphasis added). Before *Eclectic Properties*, the Ninth Circuit had held similarly in a prior securities case explaining *Twombly* and *Iqbal*: "When faced with two possible explanations, only one of which can be true and only one which results in liability, plaintiffs cannot offer allegations that are 'merely consistent with their favored explanation but are also consistent with the alternative explanation. Something more is needed, such as facts tending to exclude the possibility that the alternative explanation is true, on order to render plaintiffs' allegations plausible within the meaning of *Iqbal* and *Twombly*." *In re Century Aluminum Co. Securities Litig.*, 729 F.3d 1104, 1108 (9th Cir. 2013).

175 *Id.* at *5.

176 No. 12-56674, 2015 WL 5010644 (9th Cir. Aug. 25, 2015). Disclosure: Crowell & Moring LLP was counsel for one of the defendants in this litigation.

177 *Id.* at *4.

178 *Id.* at *3-*4.

179 *Id.* at *5.

180 *Id.*

181 *Id.*

182 *Id.*

The plaintiffs attempted to allege six different plus factors: (1) a common motive to conspire; (2) actions against self-interest; (3) simultaneous adoption of a policy; (4) an FTC investigation and decree; (5) participation in a trade association; and (6) rising retail prices as the number of units sold declined.[183] Relying on *Twombly*, the court rejected each in turn. For instance, it held that a common motive to collude "does not suggest an agreement" because "alleging 'common motive to conspire' simply restates that a market is interdependent (*i.e.*, that the profitability of a firm's decisions regarding pricing depends on competitors' reactions)."[184] Likewise, in considering the important "action against self-interest" plus factor, the court wrote that, "[a]n action that would seem against self-interest in a competitive market may just as well reflect market interdependence giving rise to conscious parallelism."[185] In the court's view, while "[m]ore extreme action against self-interest, however, may suggest prior agreement—for example, where individual action would be so perilous in the absence of advance agreement," the plaintiff's complaint did not rise to this standard.[186] The court's analysis of the remaining alleged plus factors is similar.[187] In summary, it concluded that while the plaintiffs provided a "context" for their allegations, this context did not "plausibly suggest [the defendants] entered into illegal horizontal agreements."[188]

Based on its rulings in *Kendall*, *name.space*, and *In re Musical Instruments*, it appears that the Ninth Circuit requires a plaintiff to plead the "who, what, where, and when" of the alleged conspiracy and must allege facts that tend to exclude the possibility of independent action.[189] As the Ninth Circuit noted in its first detailed explication of *Twombly*, the Supreme Court "made clear in *Twombly* that it was concerned that lenient pleading standards facilitated abusive antitrust litigation."[190] All indications thus far—in antitrust and other complex business cases—seem to indicate that the Ninth Circuit has taken a rigid view of *Twombly* and elevated the pleading bar for plaintiffs.[191]

### 10. Tenth Circuit

The Tenth Circuit does not appear to have addressed *Twombly* in the context of pleading an antitrust conspiracy. In one case, the court quickly affirmed the dismissal of the plaintiff's "conspiracy" claim—(the plaintiff's complaint did not even mention Section 1)—but there is no real analysis of that claim other than noting "there is simply nothing more

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183 *Id.* at *6.

184 *Id.*

185 *Id.*

186 *Id.*

187 *See id.* at *7-*8.

188 *Id.* at *8.

189 *See also PharmaRX Pharm., Inc. v. GE Healthcare, Inc.*, 596 F. App'x 580, 581 (9th Cir. 2015) (relying on *Kendall* and affirming dismissal of the plaintiff's antitrust complaint where the plaintiff failed to plead "who, did what, to whom (or with whom), where, and when" and where the conduct just as easily suggested "rational, legal business behavior by the defendants").

190 *Starr v. Baca*, 652 F.3d 1202, 1213 (9th Cir. 2011).

191 But *see Stetson v. West Pub. Corp.*, 457 F. App'x 705 (9th Cir. 2011) (reversing dismissal of complaint where the complaint "sets forth detailed facts about the dealings" between the defendants).

than conclusory allegations that a civil conspiracy exists, and this is not enough to satisfy the requirement of 'concerted action.'"[192] The Tenth Circuit has, however, given detailed consideration to *Twombly* and *Iqbal* in other contexts. For example, in a § 1983 opinion, the court suggested that in "complex cases against multiple defendants," the *Twombly* standard "may have greater bite."[193] Antitrust conspiracy cases, too, are frequently complex and are against multiple defendants. It remains to be seen whether the Tenth Circuit will import this apparent sliding-scale analysis to the antitrust domain.

### 11. Eleventh Circuit

The Eleventh Circuit was confronted with *Twombly* in a Section 1 case in *Jacobs v. Tempur-Pedic International, Inc.*[194] The plaintiffs in *Jacobs* alleged that Tempur-Pedic engaged in two restraints of trade: enforcing vertical resale price maintenance agreements and engaging in horizontal price fixing with its distributors.[195] The district court dismissed the complaint for failing to state a claim, and the Eleventh Circuit affirmed. After summarizing *Twombly* and *Iqbal*, the court wrote, "after determining whether the complaint's averments are more than bare legal conclusions, we examine the complaint for a sufficient quantum of allegations to plausibly suggest that TPX agreed with its distributors to restrain trade in violation of the Sherman Act."[196] The court concluded that Jacobs had failed to set forth this "sufficient quantum of allegations" for either Section 1 theory. Here, we address only the discussion of the alleged horizontal price-fixing conspiracy.[197]

The plaintiffs alleged that in employing a dual distribution system where it would sell its mattresses through authorized distributors and its own website, Tempur-Pedic had engaged in a horizontal price-fixing conspiracy with its distributors.[198] The court noted that there were two possible inferences to be drawn from this allegation—one that favored Jacobs and one that favored Tempur-Pedic.

The court adopted the inference that favored Tempur-Pedic. Significantly, it reasoned that "Jacobs had the burden to present allegations showing why it is more plausible that [Tempur-Pedic] and its distributors—assuming they are rational actors acting in their economic self-interest—would enter into an illegal price-fixing agreement (with the attendant costs of defending against the resulting investigation) to reach the same result realized by purely rational profit-maximizing behavior."[199] Stated differently, the Eleventh Circuit concluded that it was the plaintiff's obligation to allege facts showing why the inference favorable to it was more plausible than the inference favorable to the defendants.

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192 *Native Am. Distrib. v. Seneca-Cayuga Tobacco Co.*, 546 F.3d 1288, 1298 (10th Cir. 2008).

193 *Robbins v. Okla.*, 519 F.3d 1242, 1249 (10th Cir. 2008); *see also Kansas Penn Gaming, LLC v. Collins*, 656 F.3d 1210 (10th Cir. 2011) (equal protection case).

194 626 F.3d 1327 (11th Cir. 2010).

195 *Id.* at 1331.

196 *Id.* at 1333.

197 This is not to say that the court's discussion of relevant market, market power, and harm to competition are not important; rather, they are just not as pertinent to this article, whose focus is on pleading an agreement or conspiracy.

198 *Id.* at 1340.

199 *Id.*

In the court's own words it "juxtaposed" the two inferences and found the complaint implausible in light of the defendant's conflicting inference.[200] And the court went further, holding that even if the inference of tacit collusion was the more plausible inference, Jacobs would have had to allege that "TPX and its authorized distributors somehow signaled each other on how and when to maintain or adjust prices"—in other words, how the conspiracy operated.[201] The court provided the example of an allegation of "dates on which distributors moved prices together, or the amounts by which the prices moved."[202] For those reasons, the court affirmed the dismissal of the horizontal conspiracy.

In sum, under *Jacobs*, an antitrust plaintiff in the Eleventh Circuit hoping to rely on circumstantial evidence will likely need to carefully plead facts demonstrating why the inferences it is asking the reviewing court to make are more plausible than other conflicting inferences. Additionally, the plaintiff will likely need to include more detailed factual allegations showing the formation and operation of the conspiracy than it might in other circuits.

### 12. D.C. Circuit

The D.C. Circuit just recently first considered *Twombly* in an antitrust conspiracy case. While the case—*Osborn v. Visa Inc.*[203]—does not provide a highly detailed analysis of *Twombly*, it provides at least some perspective on pleading a conspiracy in this important circuit. Previously, the circuit's most in-depth *Twombly* analysis appears to have occurred in *Aktieselskabet AF 21*, a trademark case.[204] But this case—which preceded *Iqbal* and held that *Twombly* "was concerned with the plausibility of an inference of conspiracy, not with the plausibility of a claim"—is arguably no longer good law.[205]

*Osborn* involved an alleged conspiracy over the pricing of non-bank ATM access fees.[206] Among other reasons for dismissing the complaint, the district court concluded that the plaintiffs had failed to allege an agreement in restraint of trade. The D.C. Circuit reversed the dismissal because it found that the plaintiffs had alleged a horizontal agreement that "suffices at the pleadings stage."[207] In particular, the court found allegations that "a group of retail banks fixed an element of access fee pricing through bankcard association rules" as the "sort of concerted action necessary to make out a Section 1 claim."[208] The court rejected the defendants' argument that the plaintiffs had pleaded "mere membership" in an association—finding instead that the plaintiffs had alleged the "member banks *used* the

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200 *Id.* at 1343.

201 *Id.*

202 *Id.*

203 No. 14-7004, 2015 WL 4619874 (D.C. Cir. Aug. 4, 2015).

204 *Aktieselskabet AF 21. Nov. 2001 v. Fame Jeans Inc.*, 525 F.3d 8, 11 (D.C. Cir. 2008).

205 *Id.* at 17. A subsequent D.C. Circuit case, which does not contain any in-depth analysis of *Twombly* or *Iqbal* suggests that the previous construction of *Twombly* advanced in A*ktieselskabet AF 21* may now be invalidated. *Tooley v. Napolitano*, 586 F.3d 1006, 1007 (D.C. Cir. 2009).

206 2015 WL 4619874 at *1.

207 *Id.* at *7.

208 *Id.* at *8.

bankcard associations to adopt and enforce a *supra*competitive pricing regime for ATM access fees," which was "enough to satisfy the plausibility standard.[209] Again, although *Osborn* does not provide a wealth of guidance, it is at least something for lower courts and litigants in the D.C. Circuit to consider in pleading and attacking a complaint.

## IV. CONCLUDING THOUGHTS

As we believe is evident from the above, the standards for pleading an antitrust conspiracy under *Twombly* continue to be refined. With regards to direct evidence, there does not appear to be any division of authority just yet. But that may be because there have simply not been enough cases that have considered the issue. The same cannot be said of cases pleaded on circumstantial evidence. Almost every circuit has given *Twombly* detailed consideration, and while they overlap in the main, there are differences at the margin, particularly those listed below.

First, and most importantly, is the treatment of conduct susceptible to multiple inferences. The First, Second, and Sixth Circuits have mandated that district courts are not to weigh inferences on a motion to dismiss. Instead, the only relevant inquiry is whether the plaintiff's allegations create a plausible inference in their own right—independent of the degree of plausibility or probability of any inferences that the defendants suggest. By contrast, the Third, Fourth, Sixth (again), Ninth, and Eleventh Circuits have permitted the weighing of inferences in one manner or another. In other words, these circuits have permitted district courts to look to whether an inference of unilateral conduct is more plausible than conspiratorial conduct or whether the plaintiff's allegations tend to exclude the possibility of independent conduct. The Supreme Court has so far rejected petitions for certiorari in many of these cases.[210]

Second, some circuits have disagreed on the level of detail required to render a complaint plausible. On the one hand, the Sixth and Ninth Circuits have held that a plaintiff must plead the "who, what, where, when, why, and how" of the alleged conspiracy. Other circuits—such as the First and Second Circuits—do not appear to require that level of detail. This split likely comes from *Twombly* itself. While *Twombly* states that it was not applying any heightened pleading standard,[211] it also criticized the plaintiff for failing to mention any "specific time, place, or person involved in the alleged conspiracies."[212] Until and unless the Supreme Court grants certiorari on this issue, it may just be that some circuits require more specific facts in a pleading than others.

Finally, a split has begun to emerge concerning whether a plaintiff must allege "plus-factor" evidence in a complaint. There is a sharp division here between the First and the Third Circuits. The former concluded that while allegations of plus-factor evidence may enhance the plausibility of a conspiracy, they are not necessary. On the other hand,

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209 *Id.*

210 *E.g., Curtis Circulation Co. v. Anderson News, L.L.C.*, 133 S. Ct. 846 (2013) (denying certiorari); *Loren Data Corp. v. GXS, Inc.*, 133 S. Ct. 2835 (2013) (denying certiorari); *Tam Travel, Inc. v. Am. Airlines*, 131 S. Ct. 896 (2011) (denying certiorari); *Cellco P'Ship v. Morris*, 131 S. Ct. 2165 (2011) (denying certiorari).

211 *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 569 n.14 (2007).

212 *Id.* at 565 n.10.

the Third Circuit requires that plaintiffs allege at least one plus factor that will support a finding of conspiracy. As the other circuits begin to weigh in on the issue, this may be something that will eventually catch the attention of the Supreme Court.

In summary, what a plaintiff must allege to plead a "plausible" antitrust conspiracy remains in flux. The issue will undoubtedly continue to arise, and the divisions between the circuits may very well deepen. If that is the case, the Supreme Court may have cause to revisit the issue again and clarify what exactly is needed to plead an agreement under the Sherman Act.

# THE NORTHERN DISTRICT OF CALIFORNIA OPENS ITS DOORS TO THE WORLD'S CIVIL ANTITRUST DISPUTES

*By Lee F. Berger and Sophie J. Sung*[1]

## I. INTRODUCTION

Policy choices dominate antitrust law. The U.S. Supreme Court made a policy choice, enshrined in its *Illinois Brick* decision, that under federal antitrust law, only direct purchasers have standing to bring claims, and that under *Hanover Shoe*, those direct purchasers may recover for 100% of the overcharge—empowering the direct purchasers to enforce the antitrust laws and avoid the complexities of pass-on calculations. The U.S. Congress made another policy choice, enshrined in the Foreign Trade Antitrust Improvements Act ("FTAIA"), that U.S. antitrust law would be applied within the United States, and only reach outside the United States when activity in foreign commerce had a direct effect on U.S. commerce.

Each of these two doctrines is meant to be read narrowly, with few and strict exceptions. Yet in the last two years, these two doctrines have been expanded beyond their intended ranges under Northern District of California precedent. As to the bar on indirect purchasers, the Ninth Circuit recognized an exception permitting indirect purchasers to sue when they purchased their product from an innocent direct purchaser which is owned or controlled by a conspirator. The Northern District of California recently doubled that exception, extending it to instances in which the ownership or control relationship exists in the opposite direction, that is, the innocent direct purchaser owns or controls the conspirator. As to the bar on extraterritorial application, the Northern District of California has improperly expanded the "import commerce" exception to the FTAIA to include instances in which the conspiracy occurred in some part in import commerce, even if the plaintiff did not purchase the product in import commerce.

When these expansive precedents are employed together, an unintentionally broad level of antitrust standing for a certain category of potential civil antitrust plaintiffs arises: foreign corporations, engaging in foreign commerce, who have claims based on foreign purchases, can bring direct purchaser claims for their foreign purchases under U.S. antitrust law. This development contradicts the purpose of both *Illinois Brick* and the FTAIA. The Northern District of California has gone too far.

The Seventh Circuit, when looking at the same issues in the context of the same conspiracy, decided that disputes between foreign parties regarding purchases occurring abroad should be decided under the laws of those foreign nations, not under the Sherman Act. The Ninth Circuit would be wise to follow the Seventh Circuit here.

Section II of this article discusses the Ninth Circuit's recent consideration of the FTAIA's limits in the criminal conspiracy case of *United States v. Hsiung*, and the application of *Hsiung* in the civil context. Section III presents the background of *Illinois*

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1 Mr. Berger is Of Counsel and Ms. Sung is an Associate at Paul Hastings LLP. The views expressed by the authors in this article are their own and not those of any of their clients or of Paul Hastings LLP. The authors would like to thank Sabin Chung and Marion Cory for their assistance with this article.

*Brick* and its federal bar on indirect purchaser claims, and examines the current contours of the "ownership and control" exception to the *Illinois Brick* bar as applied by the Ninth Circuit and its district courts. Section IV examines the intersection of the "ownership and control" exception and the holding of *Hsiung*, as applied by district courts in the Ninth Circuit. Section IV also examines how the Seventh Circuit has approached the question of the proper reach of U.S. antitrust laws in the *Motorola Mobility* litigation.

## II. THE FOREIGN TRADE ANTITRUST IMPROVEMENTS ACT

Congress enacted the FTAIA[2] in 1982 as a limit on the extraterritorial reach of the Sherman Act and the Federal Trade Commission Act.[3] The FTAIA prohibits the application of U.S. antitrust law to conduct taking place in foreign commence or in export commerce; it permits the application of U.S. antitrust law to conduct taking place in domestic commerce or import commerce. Excepted from the prohibition on the application of U.S. antitrust law to conduct in foreign commerce is conduct that has a "direct, substantial, and reasonably foreseeable effect" on domestic or import commerce, if such effect gives rise to a Sherman Act claim.[4]

Since the FTAIA's enactment, courts have struggled to define the precise scope of the exception for "import commerce."

### A. *United States v. Hsiung*

In *United States v. Hsiung*,[5] the Ninth Circuit upheld the criminal convictions of a Taiwanese electronics manufacturer and two of its executives. The U.S. Department of Justice had alleged that, in a conspiracy spanning more than four years, the defendants conspired with Taiwanese and Korean electronics manufacturers to fix prices of thin film transistor liquid crystal display ("LCD") panels, a display technology incorporated in LCD products such as computers and television monitors.[6] Ultimately, the LCD panels

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2 The Foreign Trade Antitrust Improvement Act of 1982 ("FTAIA"), 15 U.S.C. § 6a ("Sections 1 to 7 of this title shall not apply to conduct involving trade or commerce (other than import trade or import commerce) with foreign nations unless—

**(1)** such conduct has a direct, substantial, and reasonably foreseeable effect—

**(A)** on trade or commerce which is not trade or commerce with foreign nations, or on import trade or import commerce with foreign nations; or

**(B)** on export trade or export commerce with foreign nations, of a person engaged in such trade or commerce in the United States; and

**(2)** such effect gives rise to a claim under the provisions of sections 1 to 7 of this title, other than this section.

If sections 1 to 7 of this title apply to such conduct only because of the operation of paragraph (1)(B), then sections 1 to 7 of this title shall apply to such conduct only for injury to export business in the United States.").

3 *See, e.g., F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155, 156 (2004) ("Empagran I") ("[T]he FTAIA's language and history suggest that Congress designed the Act to clarify, perhaps to limit, but not to expand, the Sherman Act's scope as applied to foreign commerce.").

4 *Id.*

5 *United States v. Hui Hsiung*, 758 F.3d 1074 (9th Cir. 2014).

6 *Id.* at 1078-79.

were sold to companies in the United States and to companies abroad. The DOJ charged the defendants with conspiracy to fix prices of LCD panels in violation of the Sherman Act. Rejecting the defendants' motion to dismiss the indictment, the district court held that "the [FTAIA] is inapplicable to [the] import activity conducted by defendants."[7] A jury found the defendants guilty.[8]

On appeal, the Ninth Circuit affirmed the district court's decision that the conduct involved import commerce, and therefore the FTAIA limited the Sherman Act's application to the defendants' conduct.[9] The court held that the defendants' conduct constituted import trade because they "engaged in the business of producing and selling LCDs to customers in the United States,"[10] insofar as there was some direct importation of foreign LCD panels into the United States.[11] Responding to the defendant's contention that it was not an importer, the Ninth Circuit explained that the argument "misses the point" and that the relevant fact was that "the panels were sold in the United States, falling squarely within the scope of the Sherman Act."[12] A defendant does not technically need to be an "importer" to engage in import commerce. The relevant inquiry, the court found, centers on whether the defendant directly imported at least some products to the United States.[13]

### B. The Northern District of California Misapplies *Hsiung* in Civil Context

Before *Hsiung*, courts in the Northern District of California applied the FTAIA's import exception in civil cases to those purchases the plaintiffs made in import commerce, not to purchases made in foreign commerce.[14] But the Northern District of California has read *Hsiung* to change that interpretation, permitting under import exception any civil claim regarding a conspiracy that took place in part in import commerce, even claims for purchases of price-fixed products abroad. This interpretation confuses the application of criminal and civil case law, and renders the FTAIA almost impotent in the age of global price-fixing conspiracies.

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7 *Id.*

8 *Id.* at 1080. The district court sentenced the executives to thirty-six months imprisonment and a $200,000 fine each, in addition to a $500 million fine on the corporate defendant. *Id.*

9 *Id.* at 1089.

10 *Id.* at 1091.

11 *Id.* at 1090 n.7.

12 *Id.* at 1091.

13 *Id.*

14 *See, e.g. Sun Microsystems Inc. v. Hynix Semiconductor Inc.*, 534 F. Supp. 2d 1101, 1105 (N.D. Cal. 2007) (finding FTAIA did not apply where plaintiffs purchased the price-fixed product in the U.S., for delivery to and consumption in the U.S.); *In re Rubber Chemicals Antitrust Litig.*, 504 F. Supp. 2d 777, 783 (N.D. Cal. 2007) ("Interpreting the FTAIA to permit Plaintiffs to bring claims for independent foreign injury, merely because they also suffered domestic injury arising from the same conduct, would significantly encroach upon the traditional jurisdictional prerogatives, and run afoul of principles of prescriptive comity."); *In re Dynamic Random Access Memory (DRAM) Antitrust Litig.,* No. C 02-1486 PJH, 2006 WL 515629, at *3-5 (N.D. Cal. Mar. 1, 2006) aff'd, 538 F.3d 1107 (9th Cir. 2008), withdrawn from bound volume opinion amended and superseded, 546 F.3d 981 (9th Cir. 2008) and aff'd, 546 F.3d 981 (9th Cir. 2008) (finding FTAIA did not apply where plaintiffs failed to allege a sufficient direct link between their foreign injury and any direct effect on domestic commerce).

In a separate civil litigation involving the same LCD price-fixing cartel at issue in *Hsiung*, plaintiff TracFone brought a claim under Florida state law.[15] TracFone was an indirect purchaser—it purchased handsets from Motorola and Nokia, who had purchased LCD panels from the defendants and incorporated them into the products that TracFone purchased.

In the district court's view, *Hsiung* short-circuited any application of the FTAIA to Florida state law. The *Hsiung* court had found that, for the same underlying conspiracy, "defendants' conduct was outside of FTAIA's scope because 'the conspiracy's intent, as alleged, was to 'suppress and eliminate competition' by fixing prices for panels that [defendants] sold to manufacturers 'in the United States and elsewhere.'"'[16] The district court interpreted *Hsiung's* finding to mean that as long as a conspiracy intended to impact import commerce, then the import exception applies, even if the plaintiff's purchases were not in import commerce.[17]

The district court obscured *Hsiung's* central holding while broadly expanding the Sherman Act's extraterritorial application. When evaluating the *Hsiung* case, it is important to keep in mind its context: the decision concerns a criminal conviction. Even if the defendants conspired regarding the price of only a single LCD panel subject to the Sherman's Act territorial jurisdiction, there is a violation of the Sherman Act. Thus, the question of the relevance of a particular imported LCD panel to the case is immaterial—any imported LCD panel is sufficient to give rise to a criminal conviction. In *Hsiung*, there was no dispute that there were some LCD panels that were imported into the United States, and that is all that is required for the criminal conviction.[18]

In contrast, in the civil context the central evidentiary question is not whether *some* portion of the underlying conspiracy occurred in import commerce, but whether a defendant's business activities at issue in the plaintiffs' specific claims occur in import commerce. The FTAIA's import exception, by its terms, applies only to plaintiffs' purchases made in import commerce.[19] Nothing in *Hsiung* changes this, because *Hsiung* was decided solely within the criminal context, where the central issue is one of whether there was even a single violation of the Sherman Act sufficient to justify conviction.

The implications here are difficult to limit. Given the size of the U.S. economy and the global nature of many price-fixing conspiracies, virtually any conspiracy will have *some* effect on U.S. import commerce. That means that any civil plaintiff, including a

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15 *In re TFT-LCD (Flat Panel) Antitrust Litig.*, No. C 10-3205 SI, 2014 WL 4652126 (N.D. Cal., Sept. 18, 2014).

16 *Id.* at *2 (quoting *Hsiung*, 758 F.3d at 1091).

17 *Id.* at *3-4. In another separate civil litigation, also involving the same LCD price-fixing cartel at issue in *Hsiung*, the court again applied *Hsiung* in the same manner, holding that the FTAIA did not apply to the plaintiff's California state law claims. *Proview Tech., Inc. v. AU Optronics Corp.*, No. 3:12-cv-03802, 2014 WL 2916933 (N.D. Cal. May 9, 2014).

18 *See United States v. Bowman*, 260 U.S. 94, 98 (1922) (explaining that the presumption that Congress intended a particular law to apply only within U.S. boundaries "should not be applied to criminal statutes which are, as a class, not logically dependent on their locality for the Government's jurisdiction, but are enacted because of the right of the Government to defend itself against obstruction, or fraud wherever perpetrated").

19 *Sun Microsystems*, *supra* note 14.

foreign defendant, could sue for purchases made entirely in foreign commerce simply because that conspiracy somehow touched U.S. import commerce. If followed, this ruling renders the FTAIA's limitations as no limit at all.

## III. INDIRECT PURCHASER CLAIMS BARRED TO PROMOTE ENFORCEMENT AND LIMIT DIFFICULT PASS-ON ANALYSES

Two Supreme Court decisions, *Hanover Shoe*[20] and *Illinois Brick*,[21] set out the Supreme Court's policy on U.S. civil antitrust enforcement: direct purchasers have standing to bring claims for 100% of the overcharge, therefore encouraging direct purchasers to act as private attorneys general and avoiding complex pass-on analyses. The flipside to this policy is that indirect purchasers do not have antitrust standing. For over 40 years, this rubric has been the dominant enforcement policy under civil federal antitrust law. The Ninth Circuit has created an exception to the bar on indirect purchaser standing, for instances in which an indirect purchaser purchased from an innocent subsidiary of a defendant. But the Northern District of California has expanded this exception to the breaking point.

### A. *Hanover Shoe* Empowers Direct Purchasers to Enforce U.S. Federal Antitrust Law

In *Hanover Shoe*, the Supreme Court prohibited the pass-on defense, consolidating damages to the direct purchasers to encourage private enforcement of federal antitrust laws while conserving judicial resources.[22] The Court believed that recognizing the pass-on defense would impair the deterrent function of treble damages actions: individual end-users would bear the brunt of any overcharges, yet would have little incentive to sue because their individual damages would be so small.[23] Concentrating the full amount of the damages in the hands of the first purchasers, usually U.S. companies that would later resell to end-users or others, created greater incentive for those direct purchasers to pursue their claims and enforce the antitrust laws. Additionally, the Court was concerned about the uncertainties and difficulties in analyzing price and out-put decisions, and reasoned that the pass-on defense would trigger unwieldy and complicated evidentiary analyses.[24]

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20 *Hanover Shoe, Inc. v. United Shoe Machine Corp.*, 392 U.S. 481 (1968).

21 *Ill. Brick Co. v. Illinois*, 431 U.S. 720 (1977).

22 The *Hanover Shoe* court recognized two limited exceptions to the general rule against allowing a defendant to assert a pass-on defense: (1) "when an overcharged buyer has a pre-existing 'cost-plus' contract, thus making it easy to prove that he has not been damaged—where the considerations requiring that the passing-on defense not be permitted in this case would not be present"; and (2) "where no differential can be proved between the price unlawfully charged and some price that the [defendant] was required by law to charge." *Hanover Shoe*. 392 U.S. at 494.

23 *Id.* at 494. Given the prevalence of consumer class actions in modern price-fixing cases brought under state laws seeking hundreds of millions of dollars, this justification now rings hollow.

24 *Id.* at 493 ("[T]here would remain the *nearly insurmountable* difficulty of demonstrating that the particular plaintiff could or would not have raised his prices absent the overcharge or maintained the higher price had the overcharge been discontinued."). The Court also reasoned that the antitrust violation was already complete once the violation caused its customers to pay overcharges, and the actions taken by the first purchasers are irrelevant. *Id.* at 489.

As a corollary to *Hanover Shoe*, in *Illinois Brick* the Supreme Court found that because all of the damages are consolidated into the hands of direct purchasers, indirect purchases have no damages left and therefore have no standing to sue under federal antitrust law. The Court held that an indirect purchaser plaintiff may not use a pass-on theory to claim damages against an alleged antitrust violator.[25]

First, the Court noted that the use of pass-on "would create a serious risk of multiple liability for defendants," because under *Hanover Shoe*, "[e]ven though an indirect purchaser had already recovered for all or part of an overcharge passed on to it, the direct purchaser would still recover automatically the full amount of the overcharge that the indirect purchaser had shown to be passed on."[26] The indirect purchaser would be able to sue to recover for all or part of an overcharge from the direct purchaser following such automatic recovery, causing overlapping recoveries.[27]

Second, the Court held that the same evidentiary complexities and uncertainties involved in a pass-on defense barred in *Hanover Shoe* would be present in its use by plaintiffs, or even multiplied for a plaintiff several steps removed from the defendant in the chain of distribution.[28]

Finally, the Court reasoned that "the antitrust laws will be more effectively enforced by concentrating the full recovery for the overcharge in the direct purchasers rather than by allowing every plaintiff potentially affected by the overcharge to sue only for the amount it could show was absorbed by it."[29] The Court was concerned that dividing the potential recovery among a much larger group would diffuse the benefits of bringing a treble-damages action,[30] and introduce complex tracing problems into already complex and costly antitrust litigation, reducing the effectiveness of treble damages actions.[31]

The Court recognized certain exceptions to the rule barring indirect purchaser claims, but only in two narrowly defined circumstances. The first exception was the pre-existing cost-plus exception, where the direct purchaser is insulated from any decrease in its sales as a result of trying to pass on the overcharge, because its customer is committed to buying a fixed quantity regardless of price.[32] In a footnote, the Court also suggested a second possible exception: in situations where the plaintiff owns or controls the direct purchaser, indirect purchaser standing may be permitted.[33]

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25 *Ill. Brick*, 431 U.S. at 730.

26 *Id.*

27 *Id.*

28 *Id.* at 732, 737 ("Permitting the use of pass-on theories under s 4 essentially would transform treble-damages action into massive efforts to apportion the recovery among the potential plaintiffs that could have absorbed part of the overcharged from direct purchasers to middlemen to ultimate consumers.").

29 *Id.* at 735.

30 *Id.* at 745.

31 *Id.* at 732 n.12.

32 *Id.*

33 *Id.* at 736 n.16.

## B. The Ninth Circuit Creates A New Defendant Ownership and Control Exception

In *Royal Printing*,[34] the Ninth Circuit created a new exception from the *Illinois Brick* bar on indirect purchaser claims, allowing a plaintiff that purchased from a direct purchaser owned or controlled by defendant to recover, where the controlled direct purchaser did not participate in the conspiracy.

The *Royal Printing* defendants were paper manufacturers who sold paper products to their wholesaling divisions or wholly-owned subsidiaries. Those wholesalers in turn sold the products to the plaintiffs, including a retail printer (Royal Printing). The wholesalers were not alleged to have participated in the conspiracy.[35] Therefore, Royal Printing was an indirect purchaser—it did not purchase the price-fixed product directly from a defendant who fixed the price of the product, but instead from an innocent middleman.

The Ninth Circuit allowed Royal Printing's claims to proceed because it had purchased from wholly-owned subsidiary wholesalers.[36] The Ninth Circuit reasoned that the concerns of *Hanover Shoe* and *Illinois Brick* were minimized in the case of a wholly-owned subsidiary, because the subsidiary is unlikely to sue its parent or its parent's co-conspirators.[37] In addition, the Ninth Circuit held that Royal Printing should be allowed to claim for the entire amount of the overcharge to the wholesalers.[38] This method, the Ninth Circuit explained, would resolve the *Illinois Brick* complexities of apportionment, and also prevent a complete barring of private antitrust enforcement, as the direct purchasers in such a case would never sue.[39]

A series of Ninth Circuit decisions followed, reconfirming the existence of the conspirator ownership or control exception, including *Freeman v. San Diego Association of Realtors*, 322 F.3d 1133 (9th Cir. 2003), *Delaware Valley Surgical Supply Inc., v. Johnson & Johnson,* 523 F.3d 1116 (9th Cir. 2008), and *In re ATM Fee Antitrust Litig.*, 686 F. 3d 741 (9th Cir. 2012).[40]

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34 *Royal Printing Co., v. Kimberly-Clark Corp. et al.*, 621 F.2d 323 (9th Cir. 1980).

35 *Id.*

36 *Id.* at 327-28.

37 *Id.* at 326.

38 *Id.* at 327.

39 *Id.*

40 It is noteworthy that the Ninth Circuit in *Royal Printing* characterized the *Illinois Brick's* exception for customer ownership or control of the direct purchaser as only "illustrative," and stated that the real exception lies where "the effect of the overcharge is essentially determined in advance, without reference to the interaction of supply and demand." *Royal Printing*, 621 F.2d at 326 n.4. The court, however, conceded that this exception did not apply to *Royal Printing* because wholesalers' pricing decisions are determined by market forces, although they are owned or controlled by the manufacturers. *Id.* In doing so, the Ninth Circuit recognized that it had created a new conspirator ownership exception. But in *Kansas v. UtiliCorp United, Inc.*, 497 U.S. 199, 216-17 (1990), the Supreme Court prohibited the lower courts from creating new exceptions not expressly stated in *Illinois Brick*. Therefore, the *Royal Printing* conspirator ownership exception should be recognized as abrogated by *Utilicorp*. *See* Lee F. Berger and Michael W. Stevens, *Meritorious Circumstances Are Not Enough: Antitrust Standing Drifts Further Astray in the Ninth Circuit after In re ATM Fee*, 22 Competition: The J. of the Antitrust and Unfair Competition L. Sec. of the State Bar of Cal. 177, at 191-94 (April 29, 2013).

### C. Recent District Court Precedent Expands *Royal Printing*'s Ownership and Control Exception

The Northern District of California, in *In re TFT-LCD (Flat Panel) Antitrust Litigation*,[41] has taken the conspirator ownership or control exception a step further, finding not only does it apply, as in *Royal Printing* and its progeny, where "a conspirator owns or controls the direct purchaser," but also where the innocent direct purchaser owns or controls a conspirator.[42]

The defendants argued that *In re ATM Fee* and its predecessors limited the ownership and control exception to only those situations in which the conspirator owns or controls the direct purchaser.[43] But the district court disagreed, noting that "*ATM Fee* did not purport to change the *Royal Printing* standard," and "[n]owhere in the *ATM Fee* decision did the court mandate that the ownership/control relationship be limited *only* to a manufacturer/seller and direct purchaser."[44] The court held that although the plaintiffs had purchased finished products containing price-fixed LCD panels—as opposed to the raw panels themselves—they had standing so long as there was an ownership or control relationship between the middleman and a conspirator, regardless of the direction of control.[45]

This decision, if followed by other courts, broadly expands the scope of the ownership or control exception, in contradiction to the policy underlying the Ninth Circuit's decisions. The ownership or control exception was recognized primarily because a parent defendant had the power to require a subsidiary not to sue it or its coconspirators, thereby leaving the antitrust law unvindicated.[46] But the reverse does not make sense—a conspiring subsidiary does not have the power to tell the innocent direct purchaser parent company not to sue it. Instead, the policy here is not that a subsidiary has the power to stop a parent direct purchaser from suing, but that it is unlikely to do so.[47] But *ATM Fee* holds that the fact that a direct purchaser may be unlikely to sue because of its own interest calculation is not enough; instead, the direct purchaser has to be controlled.[48] The *LCD* decision runs afoul of this ruling, and is bad policy. In doing so, it opens up huge new classes of indirect purchasers for standing under federal law, while denying the rights of innocent parent company direct purchasers to sue their subsidiary's coconspirators.

But, as discussed below, the unintended consequence for extraterritorial application of U.S. antitrust law is even more troubling.

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41 *In re TFT-LCD (Flat Panel) Antitrust Litig.*, No. C 09-4997 SI, 2012 WL 5869588 (N.D. Cal. Nov. 19, 2012).

42 *Id.* at *1.

43 *Id.* at *2.

44 *Id.* at *3 (emphasis in original).

45 *Id.* at *3, 5 (providing that the ownership/control relationship may be demonstrated between a direct purchaser and a co-conspirator, rather than just a seller).

46 *In re ATM Fee Antitrust Litig.*, 686 F. 3d 741, 756 (9th Cir. 2012); *Royal Printing Co., v. Kimberly-Clark Corp. et al.*, 621 F.2d 323, 326 (9th Cir. 1980).

47 *In re TFT-LCD,* 2012 WL 5869588 at *3-4. It is unclear why the court believed an innocent parent company—one not involved in the alleged conspiracy—would not have an economic incentive to sue its subsidiary's co-conspirators. It would be against that parent company's economic interests to leave such money on the table.

48 *In re ATM Fee,* 686 F.3d at 757.

## IV. THE NORTHERN DISTRICT OPENS ITS DOORS TO RESOLVING THE WORLD'S CIVIL ANTITRUST DISPUTES

### A. The Northern District of California Permits Foreign Plaintiffs To Bring Claims Based on Purchases Abroad Under the Sherman Act

With its recent expansion of both the FTAIA's import exception and the *Royal Printing* ownership and control exception, the Northern District of California has opened itself up to becoming the world's forum for civil antitrust cases. A hypothetical scenario helps illustrate this idea: assume defendants are Chinese entities selling widgets, who conspire to fix the prices of widgets through agreements reached in China. These defendants sell their widgets both in China and internationally, including in the United States. Plaintiff is a Chinese purchaser of widgets, who purchased price-fixed widgets directly from the conspiring defendants in China.

First, consider the application of the FTAIA's import commerce exception to this hypothetical. This dispute is not one that belongs in a U.S. courtroom. It concerns a dispute between Chinese companies regarding sales that occurred entirely in China, and price-fixing agreements reached entirely in China. Such conduct falls under China's sovereign authority to regulate and resolve internal disputes.[49] Yet under the Northern District of California's recent interpretations of the FTAIA's import commerce exception, because the defendants sold price-fixed widgets to other purchasers in the United States, this dispute would satisfy the import commerce exception and thus be within the Sherman Act's territorial jurisdiction. But if the FTAIA has any meaning at all, surely it is meant to exclude cases arising solely between foreign companies, based on conduct occurring abroad and sales made outside of the United States.[50]

Next, consider the application of the *Illinois Brick* bar to this hypothetical scenario. Assume that the Chinese widget purchaser has a U.S. subsidiary. This U.S. subsidiary buys the widgets from the Chinese parent and sells the widgets to customers located within the United States. Could the Chinese direct purchaser get its subsidiary to bring its claims under the Sherman Act?

As discussed, *Illinois Brick* recognized an exception for situations in which the plaintiff owns or controls the direct purchaser.[51] That exception would not apply to the hypothetical, because the plaintiff subsidiary does not own or control the direct purchaser parent.

But under recent Northern District of California precedent, that ownership and control exception can now operate bi-directionally, such that any parent-subsidiary relationship may be sufficient to give rise to the ownership or control exception. Not

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49 *See, e.g., F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155, 156 (2004) ("[T]his Court ordinarily construes ambiguous statutes to avoid unreasonable interference with other nations' sovereign authority. This rule of construction reflects customary international law principles and cautions courts to assume that legislators take account of other nations' legitimate sovereign interests when writing American laws.").

50 *Id.* ("[I]t is not reasonable to apply American laws to foreign conduct insofar as that conduct causes independent foreign harm that alone gives rise to a plaintiff's claim.").

51 *Ill. Brick Co. v. Illinois*, 431 U.S. 720, 736 n.16 (1977).

only does the exception apply where the direct purchaser's customers own or control the direct purchaser, but also where a conspirator owns or controls the direct purchaser.[52] Under that precedent, the U.S. subsidiary can bring direct purchaser claims for their purchases from their parent company in China, allowing the Chinese direct purchaser effectively to circumvent any territorial restrictions on application of the Sherman Act.

Taken together, the Northern District's recent expansions of exceptions to the *Illinois Brick* bar and the FTAIA suggest that a foreign plaintiff may be permitted to bring its claims as direct purchaser claims in the U.S., and seek recovery for purchases made entirely abroad, based on conduct occurring outside of the U.S. Such a scenario would confer on foreign plaintiffs the right to act essentially as private attorneys general enforcing U.S. antitrust law outside the United States.

The Northern District of California has gone too far. The implications of its recent rulings on the import exception and ownership and control exception do not make sense from a policy perspective, unless U.S. courts are to become arbiters of not only domestic disputes arising from anti-competitive conduct, but international ones as well.

### B. Contrast: the Seventh Circuit Approach in *Motorola Mobility LLC v. AU Optronics Corp.*

The Seventh Circuit recently faced a scenario similar to the foreign price-fixing hypothetical above in *Motorola Mobility LLC v. AU Optronics Corp.* (*Motorola II*).[53] There, a foreign purchaser bought LCD panels abroad from foreign defendants, at prices that were artificially inflated due to an alleged foreign price-fixing conspiracy. The foreign purchaser then incorporated the panels into cell phones in Asia, and imported the phones into the U.S. for resale to retailers and consumers.[54] The Seventh Circuit affirmed the grant of summary judgment against the plaintiff, holding that the FTAIA barred plaintiff's Sherman Act price-fixing claims arising from its foreign subsidiaries' purchases of price-fixed LCD panels.[55]

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52 Although these are two distinct ownership and control exceptions, it would not be a far leap for a court to apply the reasoning of one to the other.

53 *Motorola Mobility LLC v. AU Optronics Corp. (Motorola II)*, 775 F.3d 816 (7th Cir. 2015).

54 *Id.* at 817. Approximately 1% of the panels sold by the defendants to Motorola and its subsidiaries were bought by, delivered to, Motorola in the U.S. for assembly into cellphones. Among the remaining 99% of the cartelized component that were bought by foreign subsidiaries of Motorola, 42% were incorporated by the subsidiaries, sold and shipped to Motorola for resale in the U.S., while the other 57% never entered the U.S. *Id.*

55 *Id.* at 819-20, 827. This case had been originally been decided in *Motorola I* in which the court held that the requirement of a "direct effect" could not be met because "[t]he effect of component price fixing on the price of the product of which it is a component is indirect." *Motorola Mobility LLC v. Au Optronics Corp. (Motorola I)*, 746 F.3d 842, 844 (7th Cir. 2014), *vacated and reh'g granted*, No. 14-8003, 2014 WL 1243797 (7th Cir. Jul. 1, 2014). The Department of Justice was concerned that such a holding could be interpreted to preclude *all* Sherman Act claims based on foreign conduct involving components of foreign-made products imported into the United States, and filed amicus briefs seeking reversal. *See* Brief for the United States and Federal Trade Commission as Amici Curiae in Support of Neither Party at 24. The Court vacated its judgment and in *Motorola II*, reversed itself on this "direct effect" point. *Motorola II*, 775 F.3d at 819 (if prices of the components were fixed, the effect on U.S. commerce would be sufficiently direct for purposes of the FTAIA).

Judge Posner, writing for the *Motorola II* court, affirmed that the FTAIA barred Motorola's subsidiaries' antitrust claims because Motorola's injuries occurred wholly in foreign commerce when its subsidiaries, the direct purchasers, purchased the price-fixed panels abroad; thus, the effect of the alleged price fixing did not give rise to a federal antitrust claim.[56] While the court recognized that Motorola had purchased a small portion (1%) of the panels directly in import commerce, the fact that some price-fixed panels arrived to the U.S. through import commerce did not mean that claims based on the other 99% of the panels that Defendants sold abroad satisfied the FTAIA's import exception.[57]

*Motorola II* rejected the argument that the conspiracy targeted import commerce as a way to satisfy the import exception.[58] The Seventh Circuit rejected this targeting theory because it would "nullify the doctrine of *Illinois Brick*."[59] The court stated its concern that "a cartel almost always *knowingly* causes injury to indirect purchasers, yet those purchasers are barred from suit by *Illinois Brick* and the doctrine of antitrust standing that the rule of that case instantiates."[60] This, the Seventh Circuit also recognized the "collision" between Motorola's case, *Illinois Brick*, and the FTAIA, noting that Motorola and its customers were indirect panel purchasers, yet Motorola had failed to assert "any basis that we can see, that the [FTAIA], because it does not mention *Illinois Brick* (or the indirect-purchaser doctrine, announced in that case), is not subject to it."[61]

Motorola also tried effective to shoehorn its claim into the *Illinois Brick* plaintiff ownership and control exception, arguing that it "functioned with its subsidiaries as a single enterprise" to support the import commerce exception argument.[62] Again, the Seventh Circuit rejected these arguments as immaterial, holding that "the immediate victims of the price fixing were its foreign subsidiaries and [that the] U.S. antitrust laws are not to be used for injury to foreign customers."[63] Therefore, Motorola was not covered by the import commerce exception, and thus obliged to prove that the price-fixing had "a direct, substantial, and reasonably foreseeable effect" on U.S. domestic commerce giving rise to a federal antitrust claim.[64]

In addition, the Seventh Circuit relied on the notion of international comity. To support its decision, the court reiterated the concerns addressed in *Empagran I* that "rampant extraterritorial application of U.S. law 'creates a serious risk of interference with a foreign nation's ability independently to regulate its own affairs."[65] That, of course, is the exact consequence of the Northern District of California's recent precedent.

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56 *Motorola II,* 775 F.3d at 818-19.

57 *Id.* at 817.

58 Appellant's Opening Brief at 17, *Motorola Mobility LLC v. AU Optronics Corp.*, No. 14-8003 (7th Cir. Aug. 29, 2014) (hereinafter "Appellant's Opening Brief").

59 *Motorola II*, 775 F.3d at 822.

60 *Id.*

61 *Id.* at 821.

62 Appellant's Opening Brief, *supra* note 58, at 9.

63 *Motorola II*, 775 F.3d at 822.

64 *Id.* at 818.

65 *Motorola II*, 775 F.3d at 824 (quoting *F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155, 165 (2004)).

## V. CONCLUSION

Taken together, the Northern District of California's approach to the FTAIA and *Illinois Brick* doctrines serves to expand the scope of who can bring antitrust claims based on foreign purchases in U.S. courts. The Northern District's exceedingly broad views give standing under the Sherman Act to plaintiffs with no business bringing cases in the United States: foreign plaintiffs, suing foreign defendants engaged in conspiracies abroad, for purchases made abroad in foreign commerce, regarding injury sustained entirely abroad. Congress intended the FTAIA to limit the Sherman Act's territorial jurisdiction to injuries incurred in and effects in the United States. The Northern District's recent applications of both doctrines open the courthouse doors to injuries incurred entirely abroad. And the Supreme Court's intention in *Illinois Brick* and *Hannover Shoe* were to limit standing to direct purchasers so they could act as private attorneys general enforcing U.S. antitrust law, but the Northern District's opinions now permit foreign plaintiffs to act as private attorney generals enforcing U.S. antitrust laws in disputes arising entirely abroad. Courts should not follow these overbroad precedents, and leave the resolution of entirely foreign disputes to foreign courts and foreign laws.

# PROMOTING ANTITRUST COMPLIANCE

## THE ANTITRUST DIVISION'S SUBTLE SHIFT REGARDING CORPORATE COMPLIANCE: A STEP TOWARD INCENTIVIZING MORE ROBUST ANTITRUST COMPLIANCE EFFORTS

*By Heather Tewksbury, Ryan D. Tansey, and Alicia Berenyi*[1]

## INTRODUCTION:

A surprising feature of many corporate compliance programs is their limited emphasis on antitrust. Compliance efforts are a key feature of modern corporate governance initiatives, and it stands to reason that such initiatives should include safeguards against the severe reputational and financial penalties that may arise from antitrust violations. Nevertheless, corporate antitrust compliance efforts often lag behind initiatives addressed to other high-risk legal areas, such as the Foreign Corrupt Practices Act. Some critics believe that the lack of emphasis on antitrust compliance results from the Antitrust Division's opposition to giving credit for compliance programs under the United States Sentencing Guidelines, which contrasts with efforts to credit effective compliance programs in the FCPA space. In a recent, positive shift, the Antitrust Division has begun crediting compliance in less formulaic ways. This article proposes that the Antitrust Division go further, by establishing a more concrete, transparent structure for crediting antitrust compliance. In addition, this article recommends changes to the Sentencing Guidelines to codify the role that compliance can play in mitigating criminal antitrust sanctions.

Part One of this article details the surprising lack of focus on corporate antitrust compliance despite the increased risks of criminal prosecutions and civil liability. This is in contrast to FCPA compliance which has, by all accounts, increased in response to heightened DOJ enforcement efforts. Part Two describes the Antitrust Division's historical treatment of corporate compliance and the tension between the Sentencing Guidelines' structure and the policies and incentives within the Antitrust Division, how this treatment diverges from the practices of the rest of the Department of Justice, and how the relative faltering of antitrust compliance may be attributable to this divergence. Part Three explains how, very recently, the Antitrust Division has begun departing from its historical practice by crediting compliance in less formulaic ways at sentencing. Part Four proposes that, moving forward, the Antitrust Division should continue to credit compliance at sentencing and adopt a more transparent approach to maximize its incentive effect on corporate antitrust compliance. Part Five proposes that the Sentencing Guidelines incorporate a mechanism for crediting compliance programs in a way that the Antitrust Division can support within the context of the leniency program and existing DOJ policy.

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# I. CURRENT COMPLIANCE CULTURE

## A. Antitrust Compliance—Big Risks But Little Recognition

Corporate compliance has become a central fixture of many modern corporate governance initiatives. Logic would thus dictate that antitrust compliance programs would be of particular concern to companies looking to minimize the steep risks and penalties inherent in criminal antitrust violations. The goal of all effective antitrust compliance programs is to curb the risk of collusive behavior by educating executives and employees concerning potentially anticompetitive conduct.[2] If effective, the benefits of antitrust compliance programs can be substantial. They may protect a company and its employees from massive and costly lawsuits by preventing antitrust violations altogether, and may also root out cartel behavior in its infancy, increasing the chances that a company will be the first to detect and report anticompetitive conduct and thus secure leniency from the Antitrust Division.[3]

Today, companies that collude with their competitors to fix prices, rig bids, or allocate markets face historically severe penalties from criminal antitrust enforcement in both the United States and abroad. Average total corporate fines for such criminal violations have steadily increased in the U.S. from $535 million between 2005 and 2008, to at least $1 billion in all but two years between 2009 and 2014.[4] The severity of criminal antitrust penalties has also increased for company employees. An average of 13 individuals per year were sentenced to prison in the U.S. for antitrust violations between 1990 and 1999, compared to the 44 individuals sentenced in 2014 alone. The average prison sentence also increased from eight months between 1990 and 1999 to 25 months between 2010 and 2014.[5] In addition to the increasing costs of government prosecution, there is also the virtual certainty of tag-along private litigation, which exposes companies to joint and several liability, treble damages, and counsel fees in connection with class action and opt out suits by direct and indirect purchasers—not to mention exposure to enforcement by the now extensive competition regimes across the world.

The increases in amount and severity of criminal antitrust sanctions can be attributed to a number of factors, including: statutory increases in maximum allowable penalties, the Antitrust Division's focus on international cases, which tend to implicate larger volumes of commerce, newfound attention paid by judges to the seriousness of antitrust violations, and increased utilization of the Antitrust Division's leniency program. The global reach of antitrust enforcement is also not limited to American enforcement. "Dozens of countries have effective and aggressive cartel enforcement programs,"[6] thus a violator may face stiff penalties in multiple jurisdictions.

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2 Brent Snyder, Dep'y Ass't Att'y Gen., Antitrust Div., U.S. DOJ, Speech Presented at the International Chamber of Commerce and United States Council of International Business Joint Antitrust Compliance Workshop: Compliance is a Culture, Not Just a Policy 1, 6 (Sept. 9, 2014) (transcript *available at* http://www.justice.gov/atr/public/speeches/308494.pdf) [hereinafter Compliance is a Culture].

3 *Id.* at 3.

4 *Division Update Spring 2015*, Department of Justice Antitrust Division, http://www.justice.gov/atr/division-update/2015/criminal-program-update (last visited June 16, 2015).

5 *Id.*

6 Snyder, Compliance is a Culture, *supra* note 2, at 3.

Given the current antitrust enforcement backdrop, one would expect companies to work diligently to improve their internal antitrust compliance protocols. However, critics and anecdotal evidence suggests this has not been the case. Indeed, instead of tracking the constant uptick in detection and prosecution of anticompetitive conduct over the past decade, corporate focus on antitrust compliance has never seemed to get off the ground in the same way as FCPA compliance. Although there has not been extensive study in this area, a 2012 survey indicates that 92% of companies discussed antitrust compliance in the company code of business conduct, whereas only 60% of those companies reported conducting any kind of antitrust compliance training program.[7] This means that a staggering 40% of companies had no substantial antitrust compliance program. And even for the subset of companies that require some antitrust compliance trainings, the effectiveness of those programs is questionable. For instance, a mere 22% of all respondents required compliance training for employees attending "high risk gatherings of competitors," like trade association meetings.[8] Furthermore, 64% of companies reported that they did not conduct comprehensive internal audits, a key safeguard that detects illegal activity.[9]

Thus, despite the substantial benefits of a successful antitrust compliance program—avoidance of high fines, prison for individuals,[10] legal costs, and treble damages in civil actions—antitrust compliance efforts remain largely deficient.

### B. Rise In Other Forms of Compliance

In contrast to the antitrust arena, recent proliferation in FCPA enforcement has seen an attendant *increase* in FCPA corporate compliance programs. Like antitrust, criminal and civil enforcement of the FCPA has seen significant growth in recent years. A 1998 Amendment to the FCPA broadened the statute's jurisdictional reach,[11] and the DOJ has since prioritized FCPA enforcement, resulting in a spike of prosecutions.[12] While there were only five FCPA enforcement actions in 2004, that number ballooned to over 70 in 2010.[13]

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7 Society of Corporate Compliance and Ethics, Antitrust: A Dangerous But Underappreciated Compliance Issue 3 (March & April 2012), *available at* http://www.corporatecompliance.org/Resources/View/ArticleId/227/Antitrust-Compliance-How-Does-the-Government-Impact-Your-Program.aspx.

8 *Id.*

9 *Id.* at 6.

10 The Division will not prosecute cooperating officers, directors and employees of the leniency applicant. *See* Scott Hammond, Dep'y Ass't Att'y Gen., Antitrust Div., U.S. DOJ, Speech Presented at the National Institute of White Collar Crime: The Evolution of Criminal Antitrust Enforcement Over the Last Two Decades 2 (Feb. 25, 2010) (transcript *available at* http://www.justice.gov/atr/public/speeches/255515.pdf) .

11 Paul Enzinna, *The Foreign Corrupt Practices Act: Aggressive Enforcement and Lack of Judicial Review Create Uncertain Terrain for Business*, Manhattan Institute (Jan. 17, 2013), http://www.manhattan-institute.org/html/ib_17.htm#.VgHBkU3H_mQ.

12 Lanny Breuer, Ass't Att'y Gen., Criminal Div., U.S. DOJ, Speech Presented at the National Conference on the Foreign Corrupt Practices Act (Nov. 16, 2010) (transcript *available at* http://www.justice.gov/opa/speech/assistant-attorney-general-lanny-breuer-speaks-24th-national-conference-foreign-corrupt).

13 Gwendolyn L. Hassan, *The Increasing Risk of Multijurisdictional Bribery Prosecution: Why Having an FCPA Compliance Program Is No Longer Enough*, 42 Int'l L. News 1 (2013) (*available at* http://www.americanbar.org/publications/international_law_news/2013/winter/the_increasing_risk_multijurisdictional_bribery_prosecution_why_having_fcpa_compliance_program_no_longer_enough.html). While the number of resolved FCPA enforcement actions in 2010 was higher than the combined total of all FCPA enforcement actions from its inception in 1977 through 2005, FCPA prosecutions then began to slow. In 2011 there were fewer than 50 cases. *Id.* Thus far in 2015 there have been only four. *SEC Enforcement Actions: FCPA Cases*, Securities and Exchange Commission, http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml (last visited June 16, 2015).

Although the stakes are high for companies accused of FCPA violations, they are not nearly as high as in the antitrust context. For example, the four most recent settlements by FCPA corporate offenders included payments ranging from $3.4 million to $25 million.[14] By contrast, on May 20, 2015, four banks agreed to plead guilty to price fixing in the foreign currency exchange spot markets, and agreed to fines ranging from $395 million to $925 million.[15] And these massive differences in exposure are not limited to public enforcement: in contrast to antitrust, there is little risk of tag-along private civil actions in the context of the FCPA—under which there is no statutory private right of action[16]—and certainly none that can result in treble damages.

However, despite the less severe nature of FCPA penalties, unlike antitrust compliance FCPA compliance efforts have significantly expanded as enforcement efforts have increased. Although empirical studies on this issue are also scarce, the trend is apparent. Companies are investing large sums to minimize their FCPA exposure by implementing robust compliance programs, devoting "often scarce resources into the development, benchmarking, monitoring, and auditing of detailed and exhaustive FCPA compliance programs."[17] These programs have become more sophisticated, with companies overhauling "bulky" programs into "smarter risk-based compliance regimes."[18] Many companies have even adopted robust "enterprise wide 'zero tolerance' policies" regarding FCPA violations.[19] Other anecdotal examples of the split between antitrust and FCPA compliance abound. Two national compliance conferences in 2014 saw only a single panel on antitrust compliance, whereas both conferences held numerous FCPA related panels and programming.[20]

## II. IMPACT OF INCENTIVES ON CORPORATE COMPLIANCE

The divergent trajectories of antitrust and FCPA corporate compliance may be attributable, at least in part, to the different treatment that antitrust and FCPA compliance programs have historically received by the Department of Justice throughout the investigation, prosecution, and sentencing of corporate offenders.

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14 *SEC Enforcement Actions: FCPA Cases*, Securities and Exchange Commission, http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml (last visited June 16, 2015). BHP Billiton agreed to pay $25 million on May 20, 2015. FLIR systems agreed to pay $9.5 million on April 8, 2015. Goodyear Tire & Rubber Company agreed to pay $16 million on February 24, 2015. Walid Hatoum / PBSJ Corporation agreed to pay $3.4 million on January 22, 2015. *Id.*

15 Press Release, Department of Justice, Five Major Banks Agree to Parent-Level Guilty Pleas (May 20, 2015) (*available at* http://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas). Citicorp agreed to a $925 million fine. Barclays agreed to a $650 million fine. JP Morgan agreed to a $550 million fine. RBS agreed to a $395 million fine. *Id.*

16 *E.g., Lamb v Phillip Morris, Inc*, 915 F 2d 1024, 1029-1030 (6th Cir 1990).

17 Hassan, *supra* note 13.

18 Gavin Parrish & Greg Esslinger, *Beyond FCPA: A Look at the emerging compliance landscape*, Inside Counsel (July 15, 2014), http://www.insidecounsel.com/2014/07/15/beyond-fcpa-a-look-at-the-emerging-compliance-land.

19 David Kennedy & Dan Danielson, *Busting Bribery: Sustaining the Global Momentum of the Foreign Corrupt Practices Act* (Sept. 2011), at 11 (*available at* http://www.opensocietyfoundations.org/reports/busting-bribery-sustaining-global-momentum-foreign-corrupt-practices-act).

20 Robert Connolly, *In the competition for compliance $$, don't forget Antitrust. Here's Why . . .* , CartelCapers (October 8, 2014), http://cartelcapers.com/blog/competition-compliance-dont-forget-antitrust-heres/.

## A. The Antitrust Division's Historical Position Against USSG Credit For Compliance

In policy speeches,[21] the Antitrust Division has expressed the view that compliance programs advance two significant objectives in antitrust enforcement: the prevention and detection of anticompetitive behavior. As to prevention, the Antitrust Division views an effective compliance program as one that successfully prevents unlawful conduct that could expose a company to significant criminal liability. In this sense "the true benefit of compliance programs" is to prevent antitrust crimes, "not to enable organizations that commit such violations to escape punishment for them."[22] As to detection, the Antitrust Division believes that a successful compliance program may lead to early detection of reportable conduct, while the damages are still small. Early detection of antitrust crimes will give a company a head start in the race for amnesty. As AAG Bill Baer has noted, "[e]ffective compliance programs . . . maximize the chance for a company guilty of price fixing to find out about the conspiracy early enough to qualify for corporate leniency or otherwise cooperate with our investigation."[23] But, equally important, "it will enable it to nip the wrongdoing in the bud before the damages from the cartel become so large that they would be material to the company's bottom-line."[24]

However, the Antitrust Division has historically rejected the proposition that compliance programs that were initially unsuccessful at detecting anticompetitive conduct can mitigate criminal penalties, and has thus refused to credit such compliance programs through the Sentencing Guidelines.[25] The Antitrust Division has offered three rationales for this often-criticized policy: (1) antitrust cases go to the heart of the corporation's business, (2) almost all antitrust violations involve high-level company personnel and rarely (if ever) involve "rogue" employees, and (3) the leniency program already rewards effective compliance programs. Further, certain provisions in the Sentencing Guidelines have reinforced the Antitrust Division's historical policy.

*Antitrust Violations Go To The Heart Of The Corporation's Business*. The Antitrust Division has stated that antitrust crimes are unique compared to other corporate crimes because they almost always implicate a corporation's entire culture, and thus it has refused to credit compliance programs that fail to detect antitrust violations in the first place.[26] The U.S. Attorneys' Manual specifically endorses this view, noting that although usually prosecutors should consider voluntary disclosure, cooperation, remediation or restitution

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21 Speechmaking is a means for the Division to publicly explain the "legal analytical frameworks" it employs. "The Division periodically publishes speeches, guidelines, policy statements, and closing statements that provide guidance on the legal and economic analytical frameworks the Division employs when reviewing proposed transactions and conducting investigations." Division Update Spring 2014, *supra* note 4.

22 William Kolasky, Dep'y Ass't Att'y Gen., Antitrust Div., U.S. DOJ, Speech Presented at the Corporate Compliance 2002 Conference: Antitrust Compliance Programs—The Government Perspective (July 12, 2002) (transcript *available at* http://www.justice.gov/atr/speech/antitrust-compliance-programs-government-perspective).

23 Bill Baer, Ass't Att'y Gen., Antitrust Div., U.S. DOJ, Speech Presented at the Global Antitrust Enforcement Symposium: Prosecuting Antitrust Crimes 7 (Sept. 10, 2014) (transcript *available at* http://www.justice.gov/atr/speech/prosecuting-antitrust-crimes).

24 Kolasky, *supra* note 22.

25 Snyder, Compliance is a Culture, *supra* note 2, at 7-8.

26 *Id.* at 5-7.

in determining whether to seek an indictment, these considerations "would not necessarily be appropriate in an antitrust investigation" because "Antitrust violations, by definition, go to the heart of the corporation's business."[27] "With this in mind, the Antitrust Division has established a firm policy, understood in the business community, that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government."[28]

*Antitrust Violations Usually Involve Senior Company Personnel.* The Antitrust Division has been resistant to recognizing or crediting compliance programs in antitrust prosecution because, in the Antitrust Division's experience, antitrust violations have almost always involved high level personnel.[29] Indeed, the Antitrust Division has publicly acknowledged that it is almost never the case that a "rogue" employee, acting solely in his/her own self-interest, commits an antitrust violation.[30] Because the Antitrust Division's perspective is that top level executives are typically involved in anticompetitive schemes, any compliance program that exists in a corporation that commits an antitrust violation must not have had the true support of corporate leadership and, therefore, should not receive credit.

*Leniency Already Rewards Effective Compliance.* The Antitrust Division has historically taken the view that the steep penalties for antitrust violations and the opportunity to take advantage of the Antitrust Division's corporate leniency program provide sufficient motivation to companies to invest in antitrust compliance programs. As Brent Snyder, Deputy Assistant Attorney General for Criminal Enforcement for the Antitrust Division, recently explained:

> A company with at least a partially effective compliance program should be able to discover the cartel early, increasing its chances of seeking leniency before its co-conspirators do, and then promptly stop its participation, disclose its antitrust crimes completely, and fully cooperate with the Division's investigation.[31]

In other words, the Antitrust Division has viewed leniency as the benefit for those companies whose compliance efforts fall short of preventing a violation, but are able to detect the violation as a result of an effective compliance program.[32] The Antitrust Division has thus refused to credit or otherwise take account of corporate compliance

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27 U.S. Attorney's Manual, 9-28.400, *available at* http://www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations.

28 *Id.*

29 Kolasky, *supra* note 22 ("I want to emphasize that once a violation occurs, a compliance program can do little, if anything, to persuade the Division not to prosecute. Organizational liability, both civil and criminal, is grounded on the theory of respondeat superior. We have rarely, if ever, seen a case where an employee who committed an antitrust violation was acting solely for his own benefit and not the company's. A strong corporate compliance program can, however, help at the sentencing stage, so long as the employees who committed the violation were not "high-level personnel" of the organization. Again, however, it is important to emphasize that in our experience most antitrust crimes are committed by just such high-ranking officials, which would disqualify the company from receiving any sentence mitigation, no matter how good its corporate compliance program. This again shows why it is so important if a company learns of a violation that it report it promptly and seek to qualify for our amnesty program.").

30 Like Garth Peterson, the FCPA defendant discussed in Part IIB, *infra*, a rogue employee acts unlawfully on her own accord, bypassing compliance safeguards without the knowledge or consent of her company.

31 Snyder, Compliance is a Culture, *supra* note 2, at 3.

32 *Id.* at 2-3.

programs because, in the Antitrust Division's view, a "truly" effective compliance program "would have prevented the crime in the first place or resulted in its early detection," thus there is no rational for permitting non-leniency applicants to escape criminal antitrust liability based on the preexistence of a compliance program that failed to fulfill these basic functions.[33]

*Impact on Credit at Sentencing.* One significant result of these historical Antitrust Division policies is that the Antitrust Division has categorically declined to account for the existence of or improvements to compliance programs when calculating corporate fines at sentencing. This approach has been further reinforced by the Sentencing Guidelines.

Under the Organizational Sentencing Guidelines, which apply to any corporate defendant, not just antitrust offenders, corporate fines are calculated by deriving a "culpability score" by adding up various aggravating factors and subtracting mitigating factors listed in the Guidelines. Higher culpability scores translate into larger fines.[34] Under §8C2.5(f), effective compliance and ethics programs are considered a mitigating factor, and reduce a culpability score by up to three points.

Receiving such a credit for antitrust crimes could account for savings in hundreds of millions of dollars in fine payments for corporate defendants. Take hypothetical Company Z that is pleading guilty to one count of price fixing. Under the guidelines, Company Z's base fine is $100 million. Company Z has greater than 5,000 employees and the company cooperated with the DOJ. Without crediting compliance, this could result in a fine range between $160 and $320 million. By contrast, given the same facts, if Company Z received a three point reduction in its culpability score for an effective compliance program, it would result in a fine range between $100 and $200 million (before any 5k departure under § 2R1.1).[35]

In reality, Company Z would never receive the additional three point reduction. Under previous versions of the Sentencing Guidelines §8C2.5(f)(3), a compliance program could not be considered effective, and thus not credited at sentencing, if an employee with substantial authority participated in, condoned or was willfully ignorant of the offense.[36] According to Antitrust Division policy, this describes the vast majority of cartel cases. Since "most antitrust crimes are committed by just such high-ranking officials," companies were automatically disqualified "from receiving any sentence mitigation, no matter how good its corporate compliance program."[37]

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33 *Id.*at 7.

34 *See generally*, Fed. Sentencing Guidelines, Chapter Eight—Sentencing of Organizations, *available at* http://www.ussc.gov/guidelines-manual/2010/2010-chapter8.

35 This assumes a $500 million volume of commerce.

36 Ethics Res. Ctr., The Federal Sentencing Guidelines at Twenty Years 27 (2012), *available at* http://www.ethics.org/files/u5/fsgo-report2012.pdf.

37 Kolasky, *supra* note 22.

In 2010, the United States Sentencing Commission softened this hard-line rule, transforming it into a rebuttable presumption.[38] It is now possible for a company to obtain up to a three point reduction in its culpability score as credit for an effective compliance and ethics program, even if a high-level person were involved.[39] Under §8C2.5(f)(3)(C), there are four conditions for receiving this benefit:

> (i) the individual or individuals with operational responsibility for the compliance and ethics program . . . have direct reporting obligations to the governing authority or an appropriate subgroup thereof (e.g., an audit committee of the board of directors);
>
> (ii) the compliance and ethics program detected the offense before discovery outside the organization or before such discovery was reasonably likely;
>
> (iii) the organization promptly reported the offense to appropriate governmental authorities; and
>
> (iv) no individual with operational responsibility for the compliance and ethics program participated in, condoned, or was willfully ignorant of the offense.[40]

Through this revision, the Commission removed the previous "credit blocker" language regarding high level personnel.[41] However, the Antitrust Division has not viewed this change as meaningful because unless a company was first into the Leniency Program it could not meet the requirement that "the compliance and ethics program detected the offense before discovery outside of the organization or before such discovery was reasonably likely."

Thus, although §8C2.5(f)(3)(C) affords up to a three point reduction in the culpability score for a company compliance program, as a practical matter, that change has not materially impacted the Antitrust Division's view about the unworkability of this provision in light of its Corporate Leniency Program.

### B. Treatment of Compliance in Other Components of the DOJ

Since the Corporate Leniency Program is unique to the Antitrust Division, other components of the Department of Justice—which do not have that avenue for crediting compliance available to them—readily take advantage of the incentives offered under the Sentencing Guidelines for incentivizing compliance. For example, in 2012, the DOJ and SEC jointly published the "A Resource Guide to the US Foreign Corrupt Practices Act." The 120 page Resource Guide includes ten pages devoted exclusively to the role of compliance in FCPA investigations and prosecutions. The DOJ and SEC make clear that "a well-constructed, thoughtfully implemented, and consistently enforced compliance and ethics program helps prevent, detect, remediate, and report misconduct, including

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38 Fed. Sentencing Guidelines §8C2.5(f)(3)(B)(i)-(ii), *available at* http://www.ussc.gov/guidelines-manual/2010/2010-chapter8.

39 Ethics Res. Ctr., *supra* note 36, at 27.

40 Fed. Sentencing Guidelines §8C2.5(f)(3)(C), *available at* http://www.ussc.gov/guidelines-manual/2010/2010-chapter8

41 Ethics Res. Ctr., *supra* note 36, at 27.

FCPA violations,"[42] unequivocally explaining the value of compliance. The Resource Guide explains the ways in which the agencies will consider compliance programs throughout an investigation as a means to encourage compliance:

> [The agencies] may decline to pursue charges against a company based on the company's effective compliance program, or may otherwise seek to reward a company for its program, even when that program did not prevent the particular underlying FCPA violation that gave rise to the investigation.[43]

In FCPA enforcement, compliance programs are factored into charging decisions, including in deciding whether to enter into a Deferred Prosecution Agreement (DPA) or Non-Prosecution Agreement (NPA), and in imposing fines or other sanctions.[44]

The Criminal Division, the unit responsibility for FCPA enforcement, has routinely utilized DPAs and NPAs as a tool in FCPA enforcement.[45] Between 1993 and 2009, the Government Accountability Office reported that the Criminal Division entered into a total of 49 DPAs and NPAs.[46] Such agreements "encourage compliance" rather than merely "punish prior bad acts."[47] Their use "reflects a balanced judgment by the DOJ that compliance and self-monitoring are ultimately the surest route to effective enforcement."[48] Yet, DPAs and NPAs have their own complications. Because they are products of prosecutorial discretion, they are not the ideal vehicles for sending the types of clear, predictable signals to the business community to incentivize investment in robust compliance. Further, once DPAs or NPAs are signed, companies become subservient to the Division, with prosecutors playing the role of probation officers in monitoring corporate compliance efforts for a designated period of time. For example, Barclays entered into a non-prosecution agreement with the Criminal Division of the DOJ related to the bank's conduct in the LIBOR conspiracy. The NPA had a two year term, during which Barclays agreed to "further strengthen" its compliance and internal controls, and was prohibited

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42 Crim Div. of the U.S. DOJ & Enforcement Div. of the U.S. SEC, A Resource Guide to the U.S. Foreign Corrupt Practices Act 56 (Nov. 14, 2012), *available at* http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf [hereinafter Resource Guide].

43 *Id.*

44 *Kennedy*, *supra* note 19, at 29.

45 The Speedy Trial Act of 1974, 18 U.S.C. 3161(h)(2) gives the government the power to enter into DPAs and NPAs. NPAs consist of a letter from the government signed by both parties, and no criminal charge, guilty plea, or conviction is required. In comparison, DPAs require that the government file criminal charges, and declines to prosecute, contingent upon the offending company fulfilling its obligations set forth in the agreement. A company with a DPA usually has more "comprehensive and onerous" obligations than a company with a NPA. In both instances, the agreement is usually contingent on significant compliance efforts, often overseen by an independent monitor. *See, e.g.*, Kellie Lerner and Elizabeth Friedman, *When You Lose the Race to Corporate Leniency*, Law360, Mar. 15, 2013, http://www.law360.com/articles/424203/when-you-lose-the-race-to-corporate-leniency

46 Government Accountability Office, DOJ Has Taken Steps To Better Tracks Its Use of Deferred and Non-Prosecution Agreements, but Should Evaluate Effectiveness 14 (Dec. 2009), *available at* http://www.gao.gov/new.items/d10110.pdf.

47 Kennedy, *supra* note 19, at 13.

48 *Id.*

from committing any U.S. crime during that time.[49] Three years later, Barclays pled guilty to participating in the alleged foreign exchange conspiracy, and some of the alleged illicit conduct had occurred during the term of the NPA. The government exercised its discretion and declined to prosecute the bank for the breach of the agreement. Instead a penalty of $60 million was negotiated.[50]

Furthermore, the DOJ has also considered a company's track record of compliance in deciding whether to move forward in prosecuting a company. In 2012, the Department of Justice declined to prosecute Morgan Stanley for an FCPA violation. Garth Peterson, a Morgan Stanley employee, circumvented Morgan Stanley's internal controls to transfer a multi-million dollar ownership interest in a Shanghai building to himself and a Chinese official of a state-owned enterprise with whom he had a personal friendship. The DOJ charged Peterson with FCPA violations, but declined to prosecute his employer Morgan Stanley, specifically crediting Morgan Stanley's strong compliance program.[51] The Department of Justice noted that Morgan Stanley constructed and maintained a system of internal controls (i.e., a compliance program) which provided reasonable assurances that its employees were not bribing government officials.[52]

The FCPA Resource Guide acknowledges that "no compliance program can ever prevent all criminal activity by a corporation's employees," and companies will not be held "to a standard of perfection."[53] The DOJ considers and integrates compliance into the entire FCPA enforcement process and, as discussed above, this has resulted in many noting an increase in company resources being put towards FCPA compliance efforts.

### C. The Tension Between the Antitrust Division's Corporate Leniency Policy and Creating Incentives At the Penalty Phase

In the past two decades of antitrust enforcement, the emphasis on leniency, "combined with dramatic increases in the largest fines, has led to the demise of many cartels that had negatively affected global markets." Despite the incredible progress in fighting cartels, "there are limitations to the effectiveness of these policies as currently designed" because "cartels continue to form."[54] Part of the problem, as discussed in Part IA, *supra*, is that the emphasis on and investment in corporate antitrust compliance programs is not keeping pace with the upward trend in enforcement and sanctions.

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49 Non-prosecution Agreement at 3, *United States v. Barclays PLC*, *available at* http://www.justice.gov/iso/opa/resources/337201271017335469822.pdf.

50 Plea Agreement, at 9 *United States v. Barclays PLC* (*available at* http://www.justice.gov/file/440481/download) [hereinafter Barclays Plea Agreement].

51 Philip Urofsky et. al., *How Should We Measure the Effectiveness of the Foreign Corrupt Practices Act? Don't Break What Isn't Broken-the Fallacies of Reform*, 73 Ohio St. L.J. 1145, 1155 (2012); *See also*, Press Release, Dept. of Justice, Former Morgan Stanley Managing Director Pleads Guilty for Role in Evading Internal Controls Required by the FCPA (Apr. 25, 2012), *available at* http://www.justice.gov/opa/pr/former-morgan-stanley-managing-director-pleads-guilty-role-evading-internal-controls-required [hereinafter Morgan Stanley FCPA Press Release].

52 Morgan Stanley FCPA Press Release, *supra* note 51.

53 Resource Guide, *supra* note 42, at 56.

54 Margaret C. Levenstein & Valarie Y. Suslow, Cartels and Collusion: Empirical Evidence, in Oxford Handbook of International Antitrust Economics

Critics believe that the Antitrust Division's historical failure to take account of compliance programs of non-leniency applicants at any point in criminal antitrust prosecutions may be a contributor to the current state of antitrust compliance.[55] The few studies in this area indicate that an "overwhelming majority" of company respondents pointed to government lack of recognition of compliance programs as a motivating factor in their compliance decisions.[56] Not every compliance program will prevent or immediately detect all collusive behavior, yet the Antitrust Division will not credit compliance otherwise. Yet, while it is true that the ultimate compliance incentive is the Antitrust Division's Corporate Leniency Program, the disparity between corporate efforts to implement FCPA and antitrust compliance programs suggests that there is still room for even greater incentives in the antirust space.

## III. THE ANTITRUST DIVISION'S CHANGING POSITION ON CREDITING COMPLIANCE

### A. Signals that the Division May Begin Crediting Significant Improvements to Compliance Programs when Recommending Fines at Sentencing

While the Antitrust Division long maintained a policy of refusing to credit compliance directly in any phase of the antitrust enforcement process, the Antitrust Division's recent remarks and actions make clear that this approach is evolving. In September 2014, top Antitrust Division officials gave public remarks indicating that it was reconsidering its resistance to crediting compliance in antitrust enforcement. DAAG Snyder noted that while no new policies had been formalized, the Antitrust Division was "actively considering ways in which [it] can credit companies that proactively adopt or strengthen compliance programs after coming under investigation."[57] He cautioned that any acknowledgement of compliance in the enforcement process would require a company to demonstrate that "its program or improvements are more than just a façade . . . [T]rue compliance starts at the top, is not optional, and is part of the company's culture."[58]

Less than one year later, for the first time in modern history, the Antitrust Division openly credited a non-Leniency company for implementing an effective compliance program after the start of an investigation. As noted above, on May 20, 2015, Barclays PLC and four other banks entered into plea agreements with the DOJ in the FX investigation. The Barclays PLC plea agreement contained a single sentence that immediately gained notoriety in the antitrust community because it acknowledged and credited post-investigation improvements to Barclays' compliance program:

> The parties further agree that the Recommended Sentence is sufficient, but not greater than necessary to comply with the purposes set forth in 18 U.S.C. §§ 3553(a), 3572(a), in considering, among other factors, the substantial improvements to the defendant's compliance and remediation program to prevent recurrence of the charged offense.[59]

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55 Society of Corporate Compliance and Ethics, *supra* note 7, at 6.

56 *Id.*

57 Snyder, Compliance is a Culture, *supra* note 2, at 9.

58 *Id.*

59 Barclays Plea Agreement, *supra* note 50 at 16.

This brief sentence indicates that the substantial improvements Barclays made to its corporate compliance program, coupled with its cooperation efforts, caused the Antitrust Division to reduce its recommended fine down to $650 million.[60]

Since the Barclays plea was announced, the Antitrust Division has provided several public statements about its decision to credit Barclays' compliance efforts. At the Sixth Annual Forum on International Antitrust Issues in Chicago on June 8, 2015, DAAG Snyder noted that while "it can be challenging to separate the rhetoric from true commitment" when evaluating improvements in compliance programs, there were "demonstrable differences" which separated Barclays' compliance efforts from the other banks prosecuted as part of the FX conspiracy.[61]

In a speech on June 11, 2015, at the ABA Americas Cartel Panel in Brazil, DAAG Snyder further elaborated on the steps Barclays took that resulted in the compliance credit, indicating that new management had embraced compliance and created accountability at the highest levels of the company.[62] He also enumerated several specific attributes of well-run compliance programs. He remarked that compliance trainings should be innovative, interesting, and proactive; that the company should monitor and give feedback to employees who are working in areas of the company particularly vulnerable to anticompetitive conduct; and suggested that compliance departments could set up an internal anonymous hotline for employees to report possible violations.[63]

And most recently, at the Annual Global Antitrust Enforcement Symposium at Georgetown on September 29, 2015, DAAG Snyder announced that the Antitrust Division had given KYB Corp. a discount on its $62 million fine for price-fixing shock absorbers because it adopted an effective compliance program. See http://www.mlex.com/US/Content.aspx?ID=723322 (Sept. 29, 2015). Although Snyder declined to provide details about KYB's compliance program, he stated that "where we can see that the company has fundamentally taken steps to change its business culture and you can see actual results from the company's efforts in that regard, we have indicated a willingness to credit that in connection with sentencing and have done so a couple of times over the last few months—and anticipate that we will be doing so again in the not-so-distant future." *See Id.*

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60 Barclays further agreed that its FX trading and sales practices and collusive conduct violated a principal term of its June 2012 non-prosecution agreement resolving the department's investigation of the manipulation of LIBOR and other benchmark interests rates. Barclays thus also agreed to pay an additional $60 million criminal penalty based on its violation of the non-prosecution agreement. *Id.* at 9-10.

61 Brent Snyder, Deputy Ass't Att'y Gen., Antitrust Div., U.S. DOJ, Speech Presented at Sixth Annual Chicago Forum on International Antitrust 7 (June 8, 2015) (transcript *available at* http://www.justice.gov/opa/speech/deputy-assistant-attorney-general-brent-snyder-delivers-remarks-sixth-annual-chicago) [hereinafter Sixth Annual Chicago Forum].

62 Brent Snyder, Deputy Ass't Att'y Gen. for Criminal Enforcement, Antitrust Division, address at ABA Americas Cartel Panel, JW Marriott Hotel, Rio De Janeiro, Brazil (June 11, 2015) [hereinafter ABA Americas Cartel Panel] (notes on file with author).

63 *Id.*

## B. Other Signals that the Antitrust Division's Stance on Compliance is Shifting

The language in the Barclay's plea and related remarks by Antitrust Division officials are the strongest indicators of internal Antitrust Division policy shifts concerning recognition of antitrust compliance programs. However, these are not the only signals of a shift in the Antitrust Division's historical stance on antitrust compliance.

For instance, the Antitrust Division may also be taking greater count of compliance at the charging stage. At the Antitrust Spring Meeting, the Antitrust Division noted the door is "open a crack" to a case where a low-level rogue employee is the sole actor charged in a price-fixing case.[64] As discussed in Part IIA, *supra*, by charging an individual price-fixer and declining to pursue a case against that individual's company, the Antitrust Division would presumably be acknowledging that the company had sufficient compliance procedures in effect that were circumvented by a rogue employee. However, this small acknowledgement by Snyder is not likely to result in meaningful changes in the Antitrust Division's practices: Snyder has also recently compared rogue employees in antitrust cases to Bigfoot, "often rumored but seldom seen."[65]

At bottom, the sentencing credit awarded to Barclays and other recent actions indicates that the Antitrust Division's historical view of corporate compliance has shifted, and that it may be prepared to reward companies that improve their compliance programs post-violation. This position has a very different focus than an analysis under the Sentencing Guidelines, which rewards pre-existing corporate compliance programs. It allows the Antitrust Division to give credit under other sentencing provisions, such as 18 U.S.C. §§ 3553(a), without conceding that it is possible for a non-leniency applicant to have an effective compliance program when it failed to discover the conduct in the first instance.

While crediting compliance without having to do so under the specified Guidelines' provision helps the Antitrust Division balance its policy concerns with its apparent desire to credit corporate defendants beyond the leniency applicant, it gives little insight into what it takes to satisfy the Antitrust Division in that context. And nothing about the recent credit given by the Antitrust Division suggests that any articulation of the requirements necessary for securing compliance credit are forthcoming. Thus, while these shifts in the Antitrust Division's position regarding compliance are apparent to attentive antitrust counsel, they have, for the most part, been slow to recognize by the business community at large. Accordingly, many companies and their corporate counsel remain uncertain about the circumstances in which the Antitrust Division may be willing to credit antitrust compliance programs going forward. While the Antitrust Division may have an "I'll know it when I see it" mentality about crediting compliance, companies need transparency and structure to appreciate the necessary steps that will lead to compliance credit. And the Antitrust Division is no stranger to witnessing what success can come from having transparent and concrete guidelines. Indeed, the Corporate Leniency Program is a shining example of just that.

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64 Robert Connolly, *Some Highlights from the ABA Antitrust Spring Meeting*, CartelCapers (April 20, 2015), http://cartelcapers.com/blog/some-highlights-from-the-aba-antitrust-spring-meeting/.

65 *Id.*

## IV. SHORT TERM SOLUTION: TURN AD HOC AND LESS FORMULAIC PRACTICES INTO EXPLICIT POLICIES

To better incentivize compliance in the short term, the Antitrust Division should turn its ad hoc practices into transparent policies. The Antitrust Division has already demonstrated that it has an available mechanism for crediting certain compliance programs at sentencing under 18 U.S.C. § 3553(a) and 18 U.S.C. § 3572. Accordingly, the Antitrust Division could take a number of short-term steps to increase transparency and improve compliance incentives.

First, the Antitrust Division should take additional steps to publicly explain its new perspective on compliance. Instead of subtle references buried in plea agreements or ad-hoc exercises of prosecutorial discretion, the Antitrust Division should take advantage of the momentum created by this recent, positive shift and promulgate guidelines that will more concretely incentivize corporations to implement and maintain robust compliance programs. While the DOJ cannot comment specifically on the Barclays plea until the company has been sentenced, the Antitrust Division could make an official policy statement explaining generally its approach to compliance and sentencing. There have certainly been hints in recent public pronouncements and comments to the press about what the Antitrust Division may be looking for, but the time is ripe for more transparency. These factors should be clearly described and publicly disseminated by the Antitrust Division.

Second, the Antitrust Division should draw upon its vast experience to assemble and disseminate the attributes of corporate compliance programs that it determined were successful or substantially improved. It need not create a "one size fits all" compliance policy; but could simply set out the types of programs and qualities that have worked, and share that with the antitrust community.

Third, as in the Barclays plea, the Antitrust Division can operationalize these policy changes in the short term by continuing to recommend credit for exceptional existing compliance programs or marked improvements to compliance programs under 18 U.S.C. § 3553(a) and 18 U.S.C. § 3572(a).[66] Crediting of compliance should be both "backwards facing" (i.e. applied to existing compliance programs that were well-conceived and implemented, but failed to detect the instant offense) and "forwards facing" (i.e. applied to improvements to compliance made in response to the discovery of the crime). To only

66 In sentencing an organization, a judge calculates a fine range based on the defendant's culpability score, calculated under the Sentencing Guidelines. Then, the judge considers if any of the § 3553(a) and § 3572 (a) factors are applicable, which gives the judge discretion to consider the individual nature of the defendant. By invoking these two provisions, the judge can set the fine above or below that guidelines range. *See* USSC, Guidelines Manual, Chapter 8: Organizational Defendants, *available at* http://www.ussc.gov/guidelines-manual/2014/2014-chapter-8 (§8C2.8: "Determining the Fine Within the Range (Policy Statement) (a) In determining the amount of the fine within the applicable guideline range, the court should consider: (1) the need for the sentence to reflect the seriousness of the offense, promote respect for the law, provide just punishment, afford adequate deterrence, and protect the public from further crimes of the organization."; Commentary to §8C2.8(a): "Subsection (a) includes factors that the court is required to consider under 18 U.S.C. §§ 3553(a) and 3572(a) as well as additional factors that the Commission has determined may be relevant in a particular case.").

consider "forward facing" compliance, as currently supported by the Antitrust Division,[67] would misalign incentives by causing companies to delay investing in antitrust compliance programs until the Antitrust Division detected a crime—which is the only way a non-leniency applicant could receive compliance credit at sentencing. To encourage up-front investments, pre-existing compliance programs, i.e., those in existence prior to action by the Antitrust Division, should be credited, when deserving.

More specifically, the existence or improvements to compliance programs fit neatly within two sub-sections of § 3553(a). Section 3553(a)(1) provides that judges should consider "the nature and circumstances of the offense and the history and characteristics of the defendant." The language in this section is very broad, allowing for the implementation of a compliance program to be part of the characteristics of an offending company.

Section 3553(a)(2)(B-C) requires that judges consider if the sentence imposed will "afford adequate deterrence to criminal conduct," and "protect the public from further crimes of the defendant."[68] In the antitrust context, crediting meaningful compliance by reducing fines would further deterrence and prevention. If companies receive credit for improvements to their compliance program, it sends a powerful signal to other corporations that the Antitrust Division and the courts will reward robust compliance programs. The stronger a compliance program, the greater likelihood that a company will not engage in pernicious anticompetitive behavior.

Furthermore, 18 U.S.C. § 3572(a) enumerates factors that can impact the amount, time for payment and method of payment of a fine. Section 3572(a)(8) requires that, for organizational defendants, judges consider "any measure taken by the organization to discipline any officer, director, employee, or agent of the organization responsible for the offense and to prevent a recurrence of such an offense." Improvements to compliance fit squarely within § 3572(a)(8), because it is an effort by a company to prevent future anticompetitive conduct.

In the Barclays FX plea agreement, the Antitrust Division provided a pathway grounded in the current law for compliance to be recognized at sentencing. Formalizing and explaining the policy will send a clear message to companies that their compliance efforts may help them mitigate their antitrust penalties, thus incentivizing corporate compliance.

## V. LONG TERM SOLUTION: PROPOSED AMENDMENT TO SENTENCING GUIDELINES

While in the short term, with clear policy announcements, invoking § 3553(a) and § 3572(a) provides an opportunity for the Antitrust Division to acknowledge the importance of compliance at sentencing, ultimately, the Sentencing Commission should

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67 Snyder, Sixth Annual Chicago Forum, *supra* note 61 ("It is important here to distinguish between "backward looking" and "forward looking" compliance efforts. I do not mean that we are now willing to credit "backward looking" compliance efforts—preexisting compliance programs that failed to deter or detect the illegal cartel conduct. The U.S. Sentencing Guidelines sets out how earlier compliance efforts should be credited. A compliance program that fails to deter or detect cartel behavior cannot qualify for that credit.")

68 *See* 18 U.S.C. § 3553(a)(1); 18 U.S.C. § 3553(a)(2)(B-C)

amend the guidelines to explicitly allow up to a 2 point penalty reduction for an effective compliance program. Such a revision is necessary to standardize the role that compliance plays in the sentencing process, ensuring consistency across like-situated companies. Providing this type of certainty and fairness in the sentencing process is in fact the mission of the Sentencing Commission and the goal of the Guidelines.[69]

As discussed in Part IIA, *supra*, while the normal credit for an effective compliance program is three points under the Guidelines, the Guidelines foreclose any such point reduction for an antitrust compliance program because of the Antitrust Division's policies and the structure of the leniency program. A second or third-in-the-door company cannot meet the requirement in the Guidelines that its compliance program "detected the offense before discovery outside the organization or before such discovery was reasonably likely." The very existence of a leniency applicant means that no other company can qualify for compliance credit. However, as discussed above, critics have posited that the Antitrust Division's historical refusal to provide any compliance credit to non-leniency applicants may have contributed to a relative stagnation of antitrust compliance efforts. Accordingly, the Guidelines should be amended to permit companies to obtain up to a two point reduction for their compliance and ethics programs in certain circumstances.

The current all-or-nothing approach to compliance credit does not acknowledge that while compliance may be imperfect, it may still be effective and worthy of credit. The current scheme sends the message that any compliance effort short of perfection is not worth a company's resources. Partial credit could be given in situations, like the following:

- A company discovers cartel activity through its compliance program, investigates and reports the violation, without ever knowing that the Antitrust Division had already accepted a co-conspirator into its leniency program.
- The violation is discovered without self-reporting, but between the time of discovery and sentencing the company has implemented a robust compliance program and taken legitimate steps to curb future violations.
- A company has a pre-existing (though imperfect) antitrust compliance program, is a first time offender, and shows that it intends to improve its compliance policy to better detect future violations.

Permitting up to a two point reduction, instead of a three point reduction, would achieve the goal of incentivizing companies to adopt robust compliance programs while acknowledging that any compliance program that failed to prevent or first detect collusive behavior does not deserve full credit at sentencing.

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69 United States Sentencing Commission, An Overview of the United States Sentencing Commission 1, *available at* http://isb.ussc.gov/files/USSC_Overview.pdf ("The sentencing guidelines established by the Commission are designed to . . . provide certainty and fairness in meeting the purposes of sentencing by avoiding unwarranted disparity among offenders with similar characteristics convicted of similar criminal conduct, while permitting sufficient judicial flexibility to take into account relevant aggravating and mitigating factors.").

*Proposed Amendment to the Guidelines:*

Any revision to the sentencing guidelines should make clear that a company can qualify for a partial compliance credit, notwithstanding that they did not attain leniency. We propose that the following new language be added to § 2R1.1: "(d)(4): When applying § 8C2.5(f)(3)(C), items (ii) and (iii) of that section may still be satisfied despite another party's qualification for leniency for overlapping conduct under the Antitrust Division's Corporate Leniency Policy."

We further support adding the following limiting language to the comments in § 2R1.1: "under no circumstances may an organization receive greater than a 2 point penalty reduction in the circumstances described in (d)(4)."

Finally, the following point structure could be added to the comments to evaluate a company's qualification for up to a 2 point reduction under the Guidelines:

- Effectiveness of Compliance Program
  - The company discovered the violation through its compliance program, and investigated and reported the violation independently without knowing that the Antitrust Division had already accepted a co-conspirator into its leniency program. (subtract 2 points)
- Quality of Compliance Program
  - The company had a robust compliance program prior to the violation, which included all of the following: (1) commitment of senior management to Antitrust compliance; (2) participation of all employees in compliance efforts; (3) proactive compliance through monitoring and auditing high risk activities; (4) discipline procedures for those who violate Antitrust laws; (5) acceptance of responsibility for violations and demonstrated commitment to improve the program. (subtract 2 points)
  - The company had a poor compliance program prior to the violation but shows marked improvement and commitment on all of the following between the violation and sentencing: (1) commitment of senior management to Antitrust compliance; (2) participation of all employees in compliance efforts; (3) proactive compliance through monitoring and auditing high risk activities; (4) discipline procedures for those who violate Antitrust laws; (5) acceptance of responsibility for violations and demonstrated commitment to improve the program. (subtract 1 point)
  - The company had no compliance program prior to the violation but between discovery and sentencing implemented a compliance program with each of the above factors and shows commitment and has taken substantial steps to enforce that program. (subtract 1 point)
- Recidivism
  - The company is a first time offender and had a compliance program prior to the violation (subtract 1 point)

- The additional proposed examples for use in comments to § 2R1.1 amendments:
  - Example 1: Company A comes to the Antitrust Division and begins negotiations to secure leniency. Before leniency is granted, or before Company A has had a chance to provide all documents or witnesses for interviews, Company B, a first time offender, proffers its involvement and immediately begins cooperating as well. If Company B had a compliance program prior to violation that independently detected violation and had all characteristics of a model compliance program, a 2 point reduction for Company B would be appropriate.
  - Example 2: Company C is the third in the door and did not detect the violation through its own compliance program. They are an international conglomerate that has many different divisions. Even though this division has never violated antitrust laws, another division had been prosecuted in the past. Company C had ineffective pre-existing compliance program, but shows marked improvement and commitment to creating a compliance program with each of the five factors above. If the company demonstrates these significant improvements to their compliance program, across all divisions, a 1 point reduction for Company C would be appropriate.

* * *

Corporate antitrust compliance has lagged behind compliance initiatives addressed to other high-risk legal areas, such as the FCPA. The Antitrust Division's historical opposition to giving credit for compliance programs under the Sentencing Guidelines has likely contributed to this disparity. The Antitrust Division has begun crediting compliance in less formulaic ways, but it can and should go further by establishing a concrete, transparent structure for crediting antitrust compliance in the short term, and ultimately amending the Sentencing Guidelines to codify the role that compliance can play in mitigating criminal antitrust sanctions. Such changes will provide companies with the transparency necessary to appreciate the steps that will lead to compliance credit, which will in turn better incentivize them to implement and maintain robust compliance programs.

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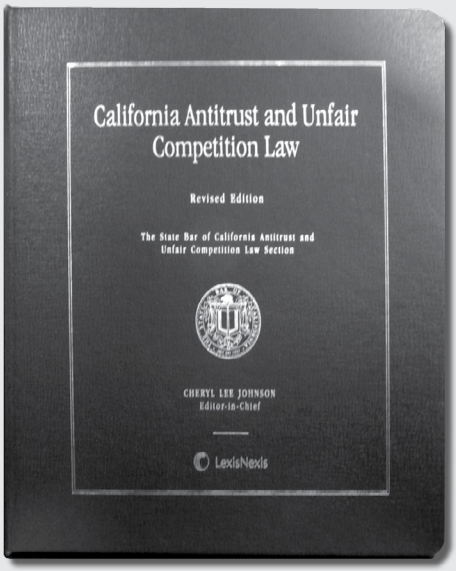


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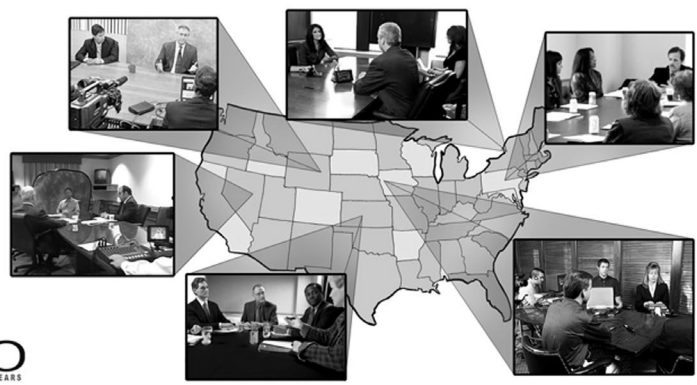

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