



CPI Antitrust Chronicle

May 2015 (1)

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We need directions. Without them, we would be lost. Ditto for rules on how firms with market power may behave in the marketplace. How can I set prices inside and outside this bundle without running afoul of the antitrust laws? How can I settle a lawsuit with a generic firm that potentially infringed on my patent? Under what conditions may I establish a minimum retail price for my distributors?

In some circumstances, the law provides a “surrogate”² to be used in conjunction with a full-blown rule-of-reason analysis: If A is greater than B , then, all else equal, the likelihood of an antitrust violation increases—at least relative to a world in which A does not exceed B . As the name suggests, a surrogate allows the fact finder to make an inference about market power or anticompetitive effects based on the results of the test.

Most (if not all) surrogates generate at least some false positives and some false negatives. But so long as a surrogate merely shifts the needle—as opposed to triggering automatic violations (or safe harbors)—it provides utility to courts (by separating meritless cases from meritorious ones), to industry participants (by providing general guidance on how to behave), and to attorneys general and antitrust agencies (by offering guidance on the evidence necessary to prosecute a case). No surrogate will get it right all the time, but such instruments remain useful as long as the outcome of the test is sufficiently correlated with the economically correct answer.

Consider two surrogates: In *Actavis*, the Supreme Court rejected the FTC’s “quick-look” approach, under which *any* reverse payment settlement was “presumptively unlawful,”³ and ruled instead that the likelihood of finding an antitrust violation increases if the payment⁴ from a branded firm to a generic (A) exceeds the avoided litigation costs and/or the value of services

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² A surrogate that is incorporated into a rule of reason analysis is different from a truncated, “quick-look” case, which deprives defendants of the opportunity to challenge the initial inference of an anticompetitive effect. See Aaron Edlin, Scott Hemphill, Herbert Hovenkamp, & Carl Shapiro, *Actavis and Error Costs: A Reply to Critics*, ANTITRUST SOURCE 3 (Oct. 2014), available at http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/oct14_edlin_10_21f.authcheckdam.pdf.

³ *Actavis*, 133 S. Ct. at 2237; see also Reply Brief for Petitioner at 7–8, *FTC v. Actavis* (No. 12-416), 2013 WL 1099171.

⁴ Some district courts have interpreted payments from *Actavis* to include non-cash payments, including “lucrative manufacturing and distribution agreements and prospective future revenue under an exclusive marketing privilege.” See, e.g., Summary Judgment Opinion, In re Nexium (Esomeprazole) Antitrust Litig., (D. Mass. 2013), Sept. 4, 2014, at 20 [hereafter *Nexium Summary Judgment*].

rendered (B).⁵ For brevity, we refer to this *Actavis* surrogate as the “avoided-litigation benchmark.” In *Cascade*, the Ninth Circuit ruled that exclusionary bundled discounting claims, in addition to the usual requirements for proving liability under §2 of the Sherman Act, also require plaintiffs to prove that the imputed price of the tied product (A) is less than the defendant’s incremental cost of producing the tied product (B).⁶ We refer to this *Cascade* surrogate as the “discount-attribution test.”

In other instances, the law provides a fuzzy standard based on a host of factors that do not neatly map into a formula. For example, in *Leegin*,⁷ the Supreme Court articulated an exclusionary theory for establishing liability of a retail-price-maintenance (“RPM”) program, but did not set out any surrogate. Because certain retailers enjoy the shared benefit of a vertical practice such as RPM, the Court reasoned, a manufacturer with market power may provide the incentive for retailers to foreclose small manufacturers or new rivals. It was not until two economists formalized this theory a few years later, however, that any litigant would know that the two key factors for establishing anticompetitive effects from RPM under this exclusionary theory are (1) that the manufacturer imposing the vertical pricing scheme has market power, and (2) that entry requires accommodation by retailers.⁸

Fuzzy standards like these leave litigants with the “I’ll-know-exclusionary-conduct-when-I-see-it” standard. In principle, this could favor either plaintiffs (who might rationalize more fact patterns as being consistent with a fuzzy standard), or defendants (how can a plaintiff marshal evidence of a violation when the initial evidentiary burden is so nebulous?) Fuzzy standards also leave firms scratching their heads as to how best to conduct their business.

But surrogates have their warts too; the major demerit is the possibility that some bad conduct will not trigger the test (a “false negative”), and that some good conduct will be presumptively condemned (a “false positive”). Yet these error costs can be mitigated so long as the parties have an opportunity to offer evidence that the test has given the wrong answer.

⁵ The Supreme Court initially identified two benchmarks (or “traditional settlement considerations”) against which to compare the size of the reverse payment: (1) the patent holder’s anticipated litigation costs; and/or (2) the value of other services that the payment might reflect. A reverse payment in excess of these benchmarks may suggest anticompetitive harm because it constitutes a signal that the patentee may be “using its monopoly profits to avoid the risk of patent invalidation or a finding of non-infringement.” Conversely, a reverse payment below these benchmarks does not imply the same degree of “concern that a patentee is using its monopoly profits to avoid the risk of patent invalidation or a finding of non-infringement.” *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 non-infringement.”).

⁶ *Cascade Health Solutions (f/k/a McKenzie-Willamette Hospital) v. PeaceHealth*, No. 05-35627, (9th Cir. Sept. 4, 2007), 11221, n. 13 (“[E]ven if the exclusionary conduct element is satisfied by bundled discounts at price levels that yield a conclusion of below-cost sales, under the appropriate measure, there cannot be Sherman Act § 2 liability for attempted monopolization unless the other elements of a specific intent to monopolize and dangerous probability of success are satisfied.”).

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

⁸ See John Asker & Heski Bar-Isaac, *Raising Retailers’ Profits: On Vertical Practices and the Exclusion of Rivals*, 104(2) AMER. ECON. REV. 672-686 (2014).

Another potential weakness is that many surrogates are based on an underlying economic model, whose policy implications critically depend on certain simplifying assumptions. Relax those assumptions and the test is not as reliable. In other cases, the policy implications are sound only when the proxy for consumer welfare is accurate. For example, because the discount-attribution test uses the welfare of an equally efficient rival as a proxy for consumer welfare, it is straightforward to construct a hypothetical bundle that improves consumer welfare by expanding the choice set of consumers yet forecloses an equally efficient rival from competing in the tied market—a false positive.⁹ It is equally straightforward to construct a bundle that degrades consumer choices yet permits entry in the tied market—also a false positive.¹⁰ To be fair, competitor welfare often provides a proxy for competition, and is therefore often correlated with consumer welfare.

Of course, there are other surrogate tests for exclusionary bundling. For example, we would prefer an alternative surrogate based on a squeezing-surplus model that focuses on consumer welfare.¹¹ For multi-product bundled rebates, the test would work as follows: If the stand-alone price of the tying product (*A*) exceeds the independent monopoly price (*B*), then the likelihood of finding an antitrust violation would increase.¹² As in other models, this crisp policy implication breaks down to the extent that the key assumption of the underlying model (homogenous tied products) gives a poor approximation of the real world.¹³

Despite these obvious drawbacks, surrogates such as the discount-attribution test provide utility to a court so long as the test results (1) correlate with changes in consumer welfare, and (2) merely alter the *likelihood* of finding a violation—that is, so long as the story does not end there. If forced to choose between the discount-attribution test and no surrogate—for example, a nebulous exclusive-dealing framework¹⁴—we would begrudgingly prefer the discount-attribution test, if only because it provides some guidance (however imperfect) to firms and courts.

⁹ Before a bundle, a firm charges \$10 (the monopoly price) for *A* and \$5 (the competitive price and marginal cost) for *B*. After the bundle, a firm continues to charge \$10 for *A* when purchased on a standalone base, but charges \$14 for the bundle. Because the imputed price of the tied product is \$4 (equal to \$14 less \$10), the equally efficient rival is foreclosed, and *Cascade* would condemn this pro-competitive offer.

¹⁰ Before a bundle, a firm charges \$10 (the monopoly price) for *A* and \$5 (the competitive price) for *B*. After the bundle, a firm raises the standalone price for *A* to \$12, and charges \$17 for the bundle. Because the imputed price of the tied product is \$5 (equal to \$17 less \$12), the equally efficient rival may compete, and *Cascade* would condone this anticompetitive offer.

¹¹ See Patrick Greenlee, David Reitman, & David S. Sibley, *An Antitrust Analysis of Bundled Loyalty Discounts*, 26 INT'L J. IND. ORG. (2008).

¹² In the case of single-product loyalty rebates, the analogous test would be: If the standalone price of the non-contestable portion of the buyer's demand (*A*) exceeds the independent monopoly price (*B*), then a rebuttable presumption of anticompetitive harm would be established.

¹³ Greenlee et al., *supra*, note 11. ("If products in the tied market are homogeneous, simple price comparison tests exist that can distinguish bundled rebates that raise consumer surplus from those that do not.")

¹⁴ See, e.g., Joshua D. Wright, Simple but Wrong or Complex but More Accurate? The Case for an Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts, Remarks at the Bates White 10th Annual Antitrust Conference (June 3, 2013), available at http://www.ftc.gov/sites/default/files/documents/public_statements/simple-wrong-or-complex-more-accurate-case-exclusive-dealing-based-approach-evaluating-loyalty/130603bateswhite.pdf.

In contrast, the avoided-litigation benchmark adopted in *Actavis* does not use rival welfare as a proxy for consumer welfare; in this sense it is less prone to false positives than the discount-attribution test. It can also prevent anticompetitive settlements that might occur if courts could not infer a higher likelihood of an antitrust violation from unexplained payments. Borrowing on the scholarship of Edlin, Hemphill, Hovenkamp, & Shapiro (“EHHS”),¹⁵ the Supreme Court set out a simple yet elegant model that mapped payments to generics onto but-for generic entry dates. The central logic of the model is that a brand would not make payments to a generic in excess of the avoided litigation costs *unless* entry were postponed relative to the expected entry date in the absence of a settlement. Thus, one may infer from any otherwise unexplained payment that the purpose of the payment was to extend the brand’s monopoly at the expense of consumers. To mitigate the risk of false positives, defendants can present compelling efficiency justifications to provide a procompetitive rationale for the payment.

By tweaking the underlying assumptions of a model, clever economists can construct counterexamples in which a surrogate condemns pro-competitive conduct (a false positive).¹⁶ These circumstances permit settlements that involve payments in excess of litigation costs that nevertheless expedite generic entry (or at least do not delay entry, relative to the expected entry date under litigation).

It should also be noted that a strict application of the avoided-litigation benchmark (which the Court does not appear to call for) could produce a false negative whenever the profits to generics under competition are small relative to the brand’s litigation costs. Under these circumstances, the brand can, in theory, delay entry indefinitely, and without violating the avoided-litigation benchmark, by offering to share a relatively small portion of its monopoly rents with the generic, which is still made better off than it would have been under competitive entry.

To illustrate, consider the following example, which adopts notation analogous to that of EHHS: Suppose that, absent entry, the brand will earn monopoly profits M_B per unit of time. If

¹⁵ *Actavis*, 133 S. Ct. at 2235 (citing Brief for 118 Law, Economics, and Business Professors as Amici Curiae, signed by, among others, Carl Shapiro and Aaron Edlin) (for the proposition that “patentees sometimes pay a generic challenger a sum even larger than what the generic would gain in profits if it won the paragraph IV litigation and entered the market”). *Id.* at 2237 (citing AREEDA & H. HOVENKAMP, *ANTITRUST LAW* ¶2046, p. 338 (3d ed. 2012)) (for the proposition that “the size of the unexplained reverse payment can provide a workable surrogate for a patent’s weakness”). These views were distilled into an article that appeared after the *Actavis* decision. See Aaron Edlin, Scott Hemphill, Herbert Hovenkamp, & Carl Shapiro, *Activating Actavis*, *ANTITRUST*, 16 (Fall 2013).

¹⁶ Barry C. Harris, Kevin M. Murphy, Robert D. Willig, & Matthew B. Wright, *Activating Actavis: A More Complete Story*, *ANTITRUST*, 83 (Spring 2014). The authors construct two such examples: (1) when the brand is risk averse; and (2) when the brand is risk averse *and* the generic is more optimistic about its chances in litigation than the brand. See also Joshua D. Wright, *Antitrust Analysis of Reverse Payment Settlements After Actavis: Three Questions and Proposed Answers*, available at http://www.ftc.gov/system/files/documents/public_statements/591131/141010actavisspeech.pdf. Wright observes that the EHHS model presumes that the generic can earn duopoly profits after entry (in the absence of a settlement), when its duopoly profits are protected via Hatch Waxman for only 180 days. This, combined with another institutional detail (collateral estoppel), results in a significantly broader settlement range than under the simply monopoly-to-duopoly model. Wright concludes that this “broad settlement range renders attempts to regulate the size of patent settlements, or infer anticompetitive effects based upon payment size ineffective.” Instead, he advocates for a “more full-blown rule of reason inquiry.” *Id.*

entry occurs, then both the brand and the generic earn duopoly profits D . If competition under duopoly is Bertrand in price (or close to it), then $M_B \gg 2^*D$.¹⁷ Under litigation, the most that the entrant could expect to gain is $(1-P)^*T^*D$, where T is the remaining patent lifetime, and P is the probability that the patent will be found valid and infringed. Accordingly, the generic is made better off by any reverse payment X , so long as $X > (1-P)^*T^*D$. (If the generic is risk averse, or if the generic would incur infringement fees in the event that the patent were upheld, then the generic would also accept a range of payments below this amount.) Let C_B denote the brand's litigation cost. As long as $C_B > (1-P)^*T^*D$, then there exists a range of reverse payments that would not trigger the avoided-litigation benchmark, but would still make the generic better off staying out of the market altogether than it would have been under competitive entry. Moreover, as competition approaches Bertrand (as $D \rightarrow 0$), the inequality is guaranteed to hold for any positive value of C_B .

Unlike *Cascade*,¹⁸ failure to trigger the avoided-litigation benchmark in *Actavis* does not appear to create a safe harbor.¹⁹ To mitigate the risk of false negatives—which could occur when the reverse payment is approximately equal to the avoided litigation costs or the fair market value of services rendered—the Court invites plaintiffs to bring forward supplemental evidence, including direct evidence, as to why the settlement (with reverse payment) was secured in the first instance.²⁰ Because there are other paths to proving a violation under *Actavis*, the avoided-litigation benchmark is best understood as a sufficient, but not necessary, condition to moving the needle in favor of finding an antitrust violation.

The avoided-litigation benchmark, like any stylized model, is not immune to prediction error. So long as it merely moves the needle, however, we do not have to worry as much about whether the test is ideal. Without a surrogate to narrow the focus, “there would be many false negatives, as antitrust plaintiffs struggled in every case to compare the settlement to a reconstructed measure of the expected litigation outcome.”²¹ Stated differently, without the surrogate, plaintiffs would have to pinpoint the but-for entry date using other tools.

Which brings us full circle to the question advanced at the beginning of this essay: Should we prefer surrogates for antitrust violations that permit errors, or should we instead rely on a

¹⁷ The notation “ $X \gg Y$ ” implies that the first quantity is much greater than the second.

¹⁸ See, e.g., Einer Elhauge, *Tying, Bundled Discounts, and The Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397, 461–75 (Dec. 2009) (criticizing the safe harbor for effectively immunizing conduct that may harm consumer welfare).

¹⁹ In contrast to *Cascade*, there is no discussion of safe harbors in *Actavis*.

²⁰ *Actavis*, 133 S. Ct. at 2237 (“Although the parties may have reasons to prefer settlements that include reverse payments, the relevant antitrust question is: What are those reasons? If the basic reason is a desire to maintain and to share patent-generated monopoly profits, then, in the absence of some other justification, the antitrust laws are likely to forbid the arrangement.”). See also *Nexium Summary Judgment* at 60 (“The Court does not agree, however, that *Actavis* counsels such a narrow view of fair market value as a dispositive issue. The *Actavis* opinion makes it clear that evidence of a fair value exchange can “redeem[]” an otherwise suspicious reverse payment. 133 S. Ct. at 2236. The Court understands this to mean that establishing fair market value is just one of many possible defenses available to a Defendant seeking to demonstrate procompetitive justifications for a reverse payment.”).

²¹ See Aaron Edlin, Scott Hemphill, Herbert Hovenkamp, & Carl Shapiro, *Actavis and Error Costs: A Reply to Critics*, ANTITRUST SOURCE 7 (Oct. 2014), available at http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/oct14_edlin_10_21f.authcheckdam.pdf.

more nebulous rule-of-reason inquiry? It turns out that question presents a false choice: We can use both. Certain benchmarks reveal meaningful economic information regarding likely anticompetitive effects in the first instance, without forfeiting the chance for plaintiffs and defendants to argue their respective theories of the case under the rule of reason.

While a comprehensive assessment of any particular surrogate is outside the scope of this brief essay, it bears emphasis that some tests are more closely tethered to consumer welfare than others, at least when their assumptions provide a reasonable representation of the market in question. Conditional on satisfying that initial burden, the likelihood of finding a violation increases. Because the story does not end there, plausible efficiency justifications can be incorporated into this second stage of the inquiry.