Fried Frank Attends International Competition Network’s Second Annual Conference in Merida, Mexico—Easing the Burden of Multi-Jurisdictional Merger Review

Antitrust enforcers from 46 countries met at The International Competition Network’s (ICN) annual conference in Merida, Mexico, on June 23-25. Formed in 2001, the ICN is a voluntary network of antitrust enforcement authorities from 71 countries formed to support new competition authorities in enforcing their laws and to promote substantive and procedural convergence among jurisdictions.

The Analytical Framework subgroup of the ICN Merger Working group, led by prominent antitrust experts in the private sector, presented a comprehensive analysis and assessment of twelve “core” merger guidelines in respect to the key substantive issues of market definition, unilateral effects, coordinated effects, barriers to entry and expansion and efficiencies, and offered recommendations in each area. Fried Frank partner Deborah A. Garza led the team addressing entry and expansion and presented its paper and recommendations to the Merida conference. The final report is expected to be published later this year.

At the end of the conference, ICN members adopted recommended practice proposals that they hope will help streamline multi-jurisdictional merger review and promote global convergence on substantive standards. These recommended practices address issues of particular concern to companies involved in cross-border transactions, calling for countries to:

- assert jurisdiction only where the transaction has an appropriate nexus to the country;
- make notification thresholds clear, understandable, objectively quantifiable, and based on readily accessible information;
- permit parties to notify proposed transactions based on a good faith intention to consummate, rather than requiring that a definitive agreement already be in place, and to impose reasonable filing deadlines;
- complete merger reviews within a reasonable and determinable time, allowing for expedited treatment where appropriate;
- limit initial notification requirements to information necessary to identify issues that merit further review, avoid imposing unnecessary burdens on parties, provide pre-notification guidance to parties where appropriate, and limit translation requirements and authentication burdens;
- apply merger control laws with a high level of transparency; and
- periodically review merger control provisions to seek improvement in the merger review process, and consider reforms that promote convergence towards recognized best practices.

Although the ICN has no rulemaking authority, many jurisdictions have expressed a willingness to ease the burden of multi-jurisdictional merger review. Adoption of the recommended practice proposals is seen as a step in that direction. The conference was addressed by Mexican President Vicente Fox, who reaffirmed Mexico’s commitment to antitrust enforcement as a key element of Mexico’s continued economic development.
Airline Prevails Against DOJ in Major Predatory Pricing Case—Tenth Circuit Rejects DOJ’s Alternative Measures for Below-Cost Pricing

The Tenth Circuit, in a closely-watched and controversial predatory pricing case, United States v. AMR Corporation, recently affirmed a lower court’s dismissal on summary judgment of a suit initially brought by the Clinton-era Department of Justice (“DOJ”) against American Airlines, Inc. (“American”).1 In AMR, DOJ alleged that American engaged in an unlawful predatory pricing scheme that targeted and sought to eliminate low-cost carriers (“LCCs”) on routes connecting the Dallas/Fort Worth airport (“DFW”), one of America’s hubs. (American’s share of non-stop passengers at DFW at the time of the 1999 suit was alleged to exceed 70%.) The government’s case relied in part on a novel theory under which it was alleged that American saturated four “core” routes (the targeted routes) with additional capacity at a cost that was greater than the revenues derived from the additional capacity. It was alleged that one purpose of this strategy was to establish a “reputation for predation” and deter potential competition on several DFW routes, including those not directly targeted by American’s predatory conduct. The government asserted that American was able to recoup its losses on the targeted routes through the revenues it derived from the non-targeted routes.

Some observers have criticized the government’s case as the product of an activist enforcement policy. Judge Lucero, writing for the Tenth Circuit, rejected the government’s claim under Section 2 of the Sherman Act because American, despite being a “brutal competitor” and pursuing aggressive tactics, did not engage in below-cost pricing, the first element of a predatory pricing claim under the test articulated by the Supreme Court in Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.2 On appeal, the Tenth Circuit did not consider the government’s “reputation for predation” theory or any issue concerning the probability of American recouping its losses incurred through its alleged predation, the second element under Brooke Group. Thus, AMR leaves open a number of questions about the viability of the government’s “reputation for predation” theory and the appropriateness of looking to multiple markets to assess recoupment in predatory pricing cases.

In the mid-1990’s, American faced increased competition and drastically reduced fares from LCCs in the DFW area. The airline responded with an aggressive business strategy for four “core” routes that: (i) matched LCC fares, (ii) increased the number of seats eligible for lower fares (a practice referred to as yield management), and (iii) further increased capacity in the form of additional flights. (The government viewed each route as a separate relevant market.) This strategy—which DOJ characterized as predatory because, among other practices, American was allegedly spending more to add capacity than the revenues it generated from such capacity increases—caused LCCs to abandon or avoid operations on the targeted routes. Thereafter, in the absence of LCC competition, American raised its fares and reduced the number of flights on the targeted routes. In addition, DOJ asserted, American’s strategy involved establishing a reputation for predatory conduct in the DFW area, thereby discouraging potential LCC competitors on other non-targeted DFW routes. Without LCC competition on those routes, American could charge supra-competitive prices and recoup losses incurred on the four routes directly targeted by the scheme.

As of May 2000, American’s share of passengers boarded at DFW was 70.2%, while LCCs’ collective share in the DFW market was only 2.4%, a substantially lower LCC share than in other areas of the country such as New York and Chicago. The Tenth Circuit’s opinion in AMR primarily focuses on the first prerequisite to a predatory pricing claim—whether the government could prove that “the prices complained of are below an appropriate measure of [American’s] costs.” The Supreme Court has never precisely defined what constitutes an appropriate measure of cost, so lower courts have been provided with some flexibility to develop their own measures. The Tenth Circuit, like other circuits, views marginal cost as an “ideal” measure for purposes of evaluating predatory pricing claims because where prices exceed marginal costs, each additional sale is profitable and therefore not considered to be below cost. However, given the difficulties of measuring marginal cost, the Tenth Circuit and other courts have looked to various proxies for marginal cost such as average variable cost. (Average variable cost is the sum of all variable costs—those costs that vary with output—divided by output.) Although courts have employed slightly different standards for measuring costs in predatory pricing cases, some measure of average variable cost is typically considered. At issue in AMR was the viability of DOJ’s alternative proxies for average variable cost.

In AMR, even though American responded to competition from LCCs by substantially lowering prices and increasing the number of flights per route, the government did not contend that American’s fares were below average variable cost. Alternatively, DOJ advanced four other relatively complex proxies for marginal cost (“tests”), each of which was based on American’s internal accounting systems. Judge Lucero deemed the government’s tests to be “invalid as a matter of law, fatally flawed in their application, and fundamentally unreliable.” According to Judge Lucero, the tests failed for the following reasons. Two tests were rejected because they relied on cost measures that were “not in large part, variable or avoidable with respect to American’s capacity increases.” They failed because they incorporated fixed costs (i.e., costs not related to the operation of a particular flight or route) in addition to variable cost measures. Another test was found to be inappropriate because it merely measured the change in profitability from increased capacity on a particular route rather than the costs associated with American’s capacity additions.

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1. 2003 WL 21513205 (10th Cir. 2003), aff’g 140 F. Supp. 2d 1141 (D. Kan. 2001). It is notable that while AMR was initially brought under Assistant Attorney General (“AAG”) Joel Klein, a Clinton appointee, the decision to appeal the case was made in June 2001 by R. Hewitt Pate, the current AAG. In June 2001, R. Hewitt Pate was Deputy AAG, but supervised the case because then AAG Charles James had recused himself. Following James’ departure from the Antitrust Division in November 2002, Pate became Acting AAG and was confirmed as AAG by the Senate in June 2003.

In other words, the court determined that the test was a short-run profit maximization test, a type of test that has been discredited by Brooke Group. Finally, the fourth test, which purported to measure incremental passenger revenues from adding capacity and the average avoidable cost of such capacity, was inappropriate because it included arbitrarily allocated variable operational costs that were not related to actual flight activity and therefore did not measure average avoidable costs. Although each of the government’s putative marginal cost proxies was rejected, Judge Lucero’s opinion acknowledges the potential viability of measures other than average variable cost, assuming such proxies are accurate and reliable. As the court explained, average variable cost is “not favorable to the exclusion of other proxies for marginal cost,” though the district court had suggested otherwise. However, the Tenth Circuit did not identify any specific measures that it considers to be appropriate.

On a separate issue, AMR raises serious doubts about the viability of a “meeting competition” defense in predatory pricing cases brought before the Tenth Circuit. In dismissing the government’s case on summary judgment, the district court in AMR held that American was entitled to summary judgment because American had only matched, and not undercut, the fares of LCCs. The “meeting competition” defense, which is a statutory defense to price discrimination claims under the Robinson-Patman Act, has been recognized by some circuits in predatory pricing cases. The underlying rationale for the defense is that it does not make sense to find anticompetitive, and thus prohibit, conduct whereby a company reduces its prices to meet lower prices first offered by other competitors. In a footnote, Judge Lucero notes that while there may be “strong arguments for application of the meeting competition defense in the Sherman Act context,” the Supreme Court has not recognized such a defense and therefore the Tenth Circuit declined to do so in AMR.

Finally, it is notable that the Tenth Circuit court did not address the government’s “reputation by predation” theory, the most controversial aspect of the government’s case. Because the government failed to satisfy the first element of Brooke Group, the court did not address the second element—whether American had a “dangerous probability of recouping its investment in below-cost prices”—even though the district court determined that the government failed to satisfy both elements. In the government’s case against American, it was critical to its theory that American recouped losses incurred in a small set of markets (the routes targeted by American’s predatory conduct) through revenues generated from a much larger set of markets (the routes that were the focus of American’s “reputation for predation” strategy). However, the district court, in its assessment of recoupment, refused to consider any market beyond each specific DFW route.

According to the district court, the government’s approach to recoupment was “fundamentally misguided [and] contrary to law.” Following Brooke Group, the court stated that “recoupment analysis must be focused on ‘an estimate of the cost of the alleged predation and a close analysis of both the scheme alleged by the plaintiff and the structure and conditions of the relevant market’ (i.e., each separate route).” The district court further explained that the “government’s broad-based claims of predation by (subjectively-felt) reputation offer no principled basis for distinguishing between a reputation for predation, and a reputation for lawfully vigorous competition.” Thus, the government’s case failed because, among other reasons, it could not demonstrate recoupment based on each separate route (as opposed to multiple routes).3

Before the Tenth Circuit issued its opinion in AMR, some might have expected the court to resolve certain fundamental issues concerning the legitimacy of predatory pricing claims, such as whether recoupment in multiple markets from predatory conduct in a smaller set of markets is a viable theory. In the past, predatory pricing issues have fostered much debate among antitrust lawyers and scholars. Followers of the influential Chicago School have historically viewed predatory pricing claims with great skepticism. As a policy matter, they see an inherent tension between prohibiting unlawful predatory conduct and not deterring otherwise lawful pro-competitive and beneficial behavior (lowering prices and increasing capacity). Chicago School theorists have further argued that unlawful predatory pricing is implausible and irrational given the uncertainties of recoupment. However, adherents to the post-Chicago School have supported theories similar to the government’s in AMR as objectively and economically sound. In AMR, while the lower court embraced the Chicago School – taking the view that most claims of predation are “subject to dismissal . . . due to the absence of objective evidence of predation and recoupment” – the Tenth Circuit, by contrast, did not fully commit to either judicial philosophy. Although the court reaches the same result, Judge Lucero’s opinion does not share the district court’s fealty to Chicago-School skepticism and, indeed, speaks approvingly of “post-Chicago economists that have theorized that price predation is not only plausible, but profitable, especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets.”

In AMR, the Tenth Circuit did not shut the door on multiple-market recoupment theories. Had there been sufficient evidence of below-cost pricing, the court might have been more receptive to the government’s “reputation by predation” theory. The court’s nod to post-Chicago School philosophy supports this view. At the same time, however, AMR clearly illustrates the difficulties of pursuing predatory pricing cases without evidence of pricing below average variable cost. It might be possible to use alternative proxies to average variable cost, but such measures will be closely scrutinized by the court. The significant hurdles involved in demonstrating below-cost pricing should not be ignored. While Judge Lucero left the door open to plaintiffs pursuing multiple-market recoupment theories, the viability of such post-Chicago School theories ultimately remain untested in the Tenth Circuit.

3. The district court concluded that, as a matter of law, recoupment from each targeted route could not be established because DFW was not characterized by the sort of structural barriers that made supercompetitive pricing plausible. Several LCCs had entered the market in recent years and continued to operate there. Furthermore, there was no evidence that American’s pre-LCC competition fares had been supercompetitive.
Sixth Circuit Upholds Finding of Per Se Liability in "Reverse Payment" Case

On June 13, 2003, the United States Court of Appeals for the Sixth Circuit upheld the district court’s finding that an agreement under which Hoechst Marion Roussel ("Hoechst") paid Andrx Pharmaceuticals, Inc. ("Andrx") $40 million per year not to enter the United States market for Cardizem CD and its generic equivalents amounted to a per se horizontal market allocation agreement under the Sherman Act.

This case is significant in that the Sixth Circuit essentially upheld a controversial finding of per se liability in a “reverse payment” case. However, the facts in this particular case could be viewed as more egregious than other reverse payment cases and, thus, possibly more suitable for per se liability. During the past five years, various reverse payment cases have either been brought or pursued by the Federal Trade Commission (“FTC”) or other private litigants. Many of those cases have either been settled or are still pending.

In September 1995, Andrx filed an Abbreviated New Drug Application ("ANDA") with the Food and Drug Administration ("FDA") to manufacture and distribute a generic version of the drug Cardizem CD. Under the Hatch-Waxman Act, a company can seek approval from the FDA to market a generic drug before the expiration of a patent relating to the brand name drug upon which the generic is based. The first company to file such an ANDA gets an exclusive right to market the generic product for 180 days, meaning that no other generic can obtain FDA approval until the conclusion of this 180-day period.

Hoechst sued Andrx for patent infringement, which triggered a 30-month stay on the FDA’s approval of Andrx’s ANDA. Hoechst and Andrx subsequently entered an agreement by which Andrx agreed that even after it received FDA approval, it would continue to keep its generic Cardizem CD off the market during the 180-day exclusivity provision, would not give up or transfer its 180-day exclusivity right, and would not market a non-infringing generic version of Cardizem CD during the 180-day period. In exchange, Hoechst paid Andrx $10 million per quarter, beginning when Andrx gained FDA approval for its product. Hoechst also agreed to pay Andrx an additional $60 million per year from the receipt of FDA approval to the conclusion of the lawsuit if Andrx prevailed (the suit was later settled for $50.7 million).

In this class action case, the plaintiffs alleged that, but for the agreement (specifically the payment of $40 million per year), Hoechst would have faced competition from both Andrx and other generic competitors. The trial court denied the defendants’ dispositive motions, ruling that the agreement was a naked, horizontal restraint of trade and, as such, per se illegal.

On appeal, the Sixth Circuit agreed with the trial court that the agreement between Andrx and Hoechst was a per se illegal market allocation. According to the court, the agreement "guaranteed to Hoechst that its only potential competitor at that time, Andrx, would, for the price of $10 million per quarter, refrain from marketing its generic version of Cardizem CD even after it had obtained FDA approval." Further, the court noted that "[b]y delaying Andrx’s entry into the market, the agreement also delayed the entry of other generic competitors, who could not enter until the expiration of Andrx’s 180-day period of marketing exclusivity."

The court concluded that "the [a]greement . . . was, at its core, a horizontal agreement to eliminate competition in the market for Cardizem CD throughout the entire United States, a classic example of a per se illegal restraint of trade." The Sixth Circuit rejected defendants’ argument that "the [a]greement lacked anticompetitive effects and had procompetitive benefits" as irrelevant given the per se treatment of the conduct. It further rejected the defendants’ arguments that per se treatment was improper because the agreement was related to enforcing a patent, and because of the "novel" area of law involved.

With respect to the issue of whether the plaintiffs properly alleged antitrust injury, the court ultimately concluded that paying higher prices for a product due to a lack of competition in the market is the type of injury that can flow from the anticompetitive effects of an agreement along these lines. Further, the defendants’ claim that Andrx’s decision to stay off the market was motivated not by the $40 million per year it was being paid by Hoechst, but by its fear of damages in the pending patent infringement litigation, raised a disputed issue of fact as to whether the agreement in question was a "necessary predicate" for the injury or the only means by which the injury could have been caused. Accordingly, the Sixth Circuit denied the defendants’ motions to dismiss for failure to allege antitrust injury.

In March 2000, the FTC settled a case against Hoechst and Andrx arising out of the same agreement. The settlement barred each of the companies from entering into any agreement in which a first-filing generic company would agree (1) not to give up or transfer its 180-day Hatch-Waxman Act exclusivity or (2) not to bring a non-infringing drug to market. In addition, any future agreements by the companies involving payments to a generic company to stay off the market made during the pendency of patent litigation would have to be notified to the FTC and approved by the court, and the companies would be required to give the FTC 30 days’ notice before entering into such agreements in other contexts.

A discussion of reverse payment theories is presented as a featured topic in the Summer 2003 issue of Antitrust magazine. Fried Frank partner Deborah A. Garza is the Editorial Chair of Antitrust, which is available for free to members of the American Bar Association’s Antitrust Section.