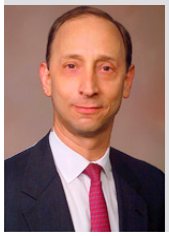
Economists Incorporated
Economists INK
SUMMER 2014
A BRIEF ANALYSIS OF POLICY AND LITIGATION

Rate Manipulation and Antitrust Liability

Stuart D. Gurrea and Jonathan A. Neuberger

EI Vice President Stuart D. Gurrea has extensive experience in constructing and assessing economic models. His experience includes calculating damages and performing financial analyses.



EI Principal Jonathan A. Neuberger specializes in financial economics, valuation, and damages analysis in complex commercial litigation. He also has extensive experience in constructing and assessing economic models.

A court recently dismissed plaintiffs' antitrust claims in *Laydon v. Mizuho Bank Ltd., et al.* (12-03419, U.S. District Court, Southern District of New York) (*Laydon*). Claims under the Commodities Exchange Act survived the motion to dismiss. *Laydon* involves the alleged manipulation of benchmark interest rates and the resulting distortion of the prices of futures contracts. The dismissal of the claim of a violation of Section 1 of the Sherman Act is potentially very significant because other recent instances of alleged manipulation of benchmark (or reference) rates include analogous claims of anticompetitive behavior.

Laydon concerned the alleged manipulation of the European Tokyo Interbank Offered Rate (Euroyen TIBOR), the London Interbank Offered Rate for the Japanese Yen (Yen LIBOR), and the prices of Euroyen TIBOR futures contracts. TIBOR and Yen-LIBOR rates were based on daily rate quotes provided by members of a bank association and were widely referenced by financial contracts. The complaint alleged that defendants made false rate submissions as part of a conspiracy that violated the Sherman Act.

The court found that plaintiffs failed to allege an antitrust conspiracy. The alleged misconduct involved cooperation in setting reference rates, a process the court concluded did not involve competition among contributor banks. The pooling of information to set a reference price was found to be a cooperative, not a competitive, effort. Plaintiffs had not made the required showing that price manipulation has anticompetitive effects, such as a reduction in competition among banks.

The court also found that plaintiffs failed to allege antitrust injury. Plaintiffs took short positions in derivative futures contracts referencing the Euroyen TIBOR. The court found that the losses plaintiffs claimed resulted from defendants' alleged manipulation of TIBOR rates, not from a reduction in competition.

Moreover, the court found plaintiffs lacked antitrust standing because of the weak causal link between the alleged conspiracy and the alleged injury. Damage claims were based on the effect of reference prices on a contracted price. The court found the effect of the reference rates on the contracted prices to be remote and uncertain. That uncertainty would make it difficult to calculate damages, as it would be difficult to separate the influence of the alleged conduct from other effects.

The court's decision highlights the challenges faced by plaintiffs alleging indirect harm from the manipulation of reference prices. Economic techniques can identify the link between the manipulation of reference rates and the alleged harm to support an antitrust claim and substantiate a damages claim.

Also In This Issue

Reverse Payments Cases After *Actavis*

Barry C. Harris and Matthew B. Wright discuss how the FTC and the courts should judge reverse payments settlements under the rule of reason, as required by the Supreme Court's *Actavis* decision. Some have suggested that any reverse payment that cannot be explained by avoided litigation costs and the services provided by the generic drug producer should be taken as evidence the settlement is anticompetitive. That approach, however, fails to account for factors that indicate settlements with reverse payments can be procompetitive because they result in faster entry by the generic drug producer. Anticompetitive effects can be inferred from reverse payments in excess of the incumbent producer's direct litigation costs only under specific circumstances. Furthermore, adopting that inference would prevent some procompetitive settlements.

Life After Comcast: The Economist's Obligation to Decompose Damages Across Theories of Harm

Kevin W. Caves and Hal J. Singer consider the implications of *Comcast Corp. v. Behrend*. In that decision, the Supreme Court reversed certification of a class because plaintiffs' economist could not decompose damages between two principal theories of harm. *Comcast* confirms that economic experts need not decompose damages in Section 2 "monopoly broth" cases involving two or more theories of harm—provided that all theories remain part of the case. If one or more theories do not survive scrutiny, damages should be considered separable if both theories of harm are *sufficient* to generate price effects. In contrast, if both theories of harm are *necessary* to generate price effects—that is, removing the behavior referred to in either theory would cause prices to revert to competitive levels in the hypothetical "but-for world" used to quantify overcharges—then damages should be considered inseparable.

Reverse Payments Cases After *Actavis*

Barry C. Harris and Matthew B. Wright

In *FTC v. Actavis*, Inc. the Supreme Court addressed settlements that sometimes occur when an incumbent pharmaceutical producer (the Brand) sues for patent infringement a firm that plans to begin selling a generic version of its product. Such suits are typically triggered when the generic producer (the Generic) files an Abbreviated New Drug Application under Hatch-Waxman with a Paragraph IV Certification, which involves a claim that the generic product does not infringe an enforceable patent. The Court in *Actavis* concluded that a patent settlement agreement involving a so-called reverse payment from Brand to Generic can sometimes unreasonably diminish competition by delaying entry by the Generic. (*FTC v. Actavis, Inc.*, 133 S. Ct. 2223, 2227 (2013)) The *Actavis* Court, however, rejected the FTC's view that settlements involving reverse payments should be deemed presumptively unlawful. The Court also rejected a "quick look" approach for evaluating such agreements, which would presume illegality unless the Brand could prove that the settlement agreement had procompetitive effects. Instead, the *Actavis* Court held that in cases involving settlements with a "large" reverse payment, "the FTC must prove its case as in other rule-of-reason cases."

The *Actavis* decision leaves the FTC and the courts with the question of how to judge reverse payments settlements under the rule of reason. One recent article proposes that once the plaintiff establishes that the Generic agreed not to compete using the patented technology for any length of time, the plaintiff could establish a prima facie case by valuing the payment from the Brand to the Generic and establishing that the payment was greater than the litigation costs that the Brand avoided through the settlement. If the plaintiff makes such a showing, the defendant(s) must then prove that the excess reverse payment was reasonable consideration for services that the Generic provided to the Brand. Under this proposed rule, any reverse payment that cannot be explained by avoided litigation costs and the value of services provided by the Generic is understood to be a payment to the Generic for delaying entry and thus evidence the agreement is anticompetitive. That approach, however, fails to account for a variety of factors that indicate settlements with reverse payments can be procompetitive because they result in entry by the Generic occurring earlier than would have been expected without the settlement.

Barry C. Harris is EI's Chairman of the Board and Matthew B. Wright is an EI Principal. This article is based on work done with EI Senior Vice-President Michael G. Bauman. With co-authors, they have written "Activating Actavis: A More Complete Story," Antitrust, Spring 2014, at 83 (available at www.ei.com/downloadables/Sprng14_haris.pdf).

As the Court in *Actavis* recognized, an analysis of reverse payments in any particular settlement is complex. For a settlement to occur, both the Brand and the Generic must view it as preferable to their expected outcomes from litigation. If both the Brand and the Generic would incur costs to pursue a litigated outcome to their patent dispute, are risk-neutral, have the same time value of money, and share the same view about the likely outcome of litigation, there exist potential settlements without reverse payments that both parties should prefer to litigation. Settlements are possible under these circumstances because each party can agree on entry on or near the date that corresponds to the entry date that would be expected under litigation, while avoiding litigation costs.

> "... if the Brand is risk-averse, then it may agree to a settlement that involves a reverse payment that exceeds out-of-pocket litigation costs but is procompetitive."

The factors that influence a negotiated settlement, however, are not limited to out-of-pocket litigation costs, and several of these factors may lead to a patent settlement involving a reverse payment. Such factors may include inter alia the risk tolerance of the parties, the level of the drug's sales, differences in the parties' expectations and information related to future competition for the drug, the parties' subjective views of the likely outcome of the litigation, differences in the parties' time-value of money, and the applicability of Hatch-Waxman first-filer exclusivity. Other factors that might affect the competitive analysis of a potential settlement are the size of the alleged net reverse payment, and the extent of the alleged delay and associated diminution of competition.

For example, if the Brand is risk-averse, then it may agree to a settlement that involves a reverse payment that ex-

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Life After *Comcast*: The Economist's Obligation to Decompose Damages Across Theories of Harm

Kevin W. Caves and Hal J. Singer

In *Comcast Corp. v. Behrend*, the Supreme Court reversed certification of a class of cable subscribers because plaintiffs' economist could not decompose damages between the two principal theories of harm: clustering of cable systems (a horizontal restraint), and exclusive dealing of sports programming (a vertical restraint). *Comcast* confirms that economic experts need not decompose damages in Section 2 "monopoly broth" cases involving two or more theories of harm—provided that all theories remain part of the case. If one or more theories do not survive scrutiny, however, *Comcast* highlights the need for the economist to adhere to the basic principle that the harm suffered by class members must flow only from the anticompetitive conduct encompassed by the surviving theory.

From an economic perspective, these standards for class certification imply that allocation of damages may be necessary in cases where both theories of harm are *sufficient* to generate price effects. In contrast, in cases where both theories of harm are *necessary* to generate price effects—that is, removing the behavior referred to in either theory would cause prices to revert to competitive levels in the hypothetical "but-for world" used to quantify overcharges—the economic expert should not be required to allocate damages. Economic logic implies that, if one theory of harm is discarded, then damages should be attributed in full to the surviving theory of harm.

By way of analogy, a three-legged stool remains standing because exactly three separate points of reference (the three legs) are necessary to delineate a flat plane (the floor). Removal of one leg causes the stool to lose exactly the same amount of functionality as if two or three legs had been removed. The same logic can be applied to a monopoly broth case involving two (or more) theories of harm. Assume, for example, that plaintiffs allege they suffered harm via both horizontal restraints (e.g., anticompetitive consolidation) and vertical restraints (e.g., exclusionary conduct), resulting in $100 million of overcharges to class members. Suppose further that plaintiffs demonstrate that both types of restraints were necessary for the defendant to cause any anticompetitive harm. If both theories of harm survive scrutiny, then overcharges would be $100 million, as both the horizontal and vertical restraints would be absent in the but-for world.

But what if, say, only the horizontal theory survives scrutiny?

Kevin W. Caves is a Senior Economist and Hal J. Singer is a Principal at Economists Incorporated. Prior to the class certification hearing, both authors served as consultants to plaintiffs in Comcast Corp. v. Behrend. A longer version of this article appeared in the Spring 2014 issue of Antitrust.

Plaintiffs' theory collapses under its own logic, and damages fall to zero, if defendants can show that they did not actually practice the necessary vertical restraint. In many cases, however, modeling the but-for world would require that the economist construct a counterfactual in which the vertical restraints remain in place (e.g., they are deemed procompetitive or not susceptible to common proof of injury). The horizontal restraints, are, by definition, removed in the but-for world. Because the defendants could not have imposed any overcharges in a but-for world without the horizontal restraints, it follows that overcharges should remain unchanged (at $100 million). Exactly the same logic applies if only the vertical restraint survives scrutiny. The surviving theory is like one leg of a three-legged stool; its removal will cause a collapse.

By this logic, plaintiffs in *Comcast* cannot necessarily be faulted for failing to put forth a model allocating damages specifically to Comcast's horizontal and vertical restraints. Provided that plaintiffs were prepared to argue that Comcast's horizontal clustering, as the sole surviving theory, was a *necessary* ingredient in the monopoly broth, removing the clustering would return prices to competitive levels.

In general, there are two logical possibilities for damages allocation in monopoly broth cases. *First*, if both theories of harm are necessary ingredients for generating anticompetitive price effects, then, by the logic above, the economist would not need to engage in any allocation exercise. Overcharges in this scenario can be described as "inseparable." To establish inseparability and avoid allocation, plain-

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Reverse Payments Cases After *Actavis*

ceeds out-of-pocket litigation costs but is procompetitive. Litigation is risky in that the outcome is uncertain. Given a choice between receiving a guaranteed payment and an uncertain outcome that has an expected value equal to that payment, a risk-averse Brand prefers the certain payoff and, thus, may be willing to accept a settlement that allows for Generic entry on a date before the entry date expected under litigation. A settlement that allows for entry on this earlier date would benefit consumers and is considered to be procompetitive under the *Actavis* standards.

Consumers can only benefit from a procompetitive settlement if both the Brand and the Generic agree to it. Under certain conditions, mutually beneficial settlements may occur between the Brand and the Generic that do not involve reverse payments. When these conditions do not hold, reverse payments may be required for the parties to reach a settlement that enhances consumer welfare and therefore should be judged lawful under the Supreme Court's rule-of-reason standard.

The clearest examples where a reverse payment may facilitate a procompetitive settlement occur when two conditions hold. First, absent a reverse payment, the latest entry date on which the Generic is willing to settle (the Generic's reservation entry date) is earlier than the earliest entry date on which the Brand is willing to settle (the Brand's reservation entry date). Second, the Brand's reservation entry date is earlier than the expected entry date under litigation. Any increase in the reverse payment will delay the Generic's reservation entry date by more than the Brand's. Thus, a reverse payment may facilitate a settlement by moving the Generic's reservation entry date later, so it no longer conflicts with the Brand's reservation entry date. While a reverse payment will result in a later reservation entry date for the Brand, that date may still be earlier than the expected date under litigation. As a result, entry with the settlement may happen before it would have with litigation, and the settlement would be procompetitive.

The conclusion that anticompetitive effects can be inferred from reverse payments in excess of the Brand's direct litigation costs holds only under specific circumstances. An economic model supporting that inference is a special case and does not support a generally applicable result. Furthermore, adopting that inference would prevent some procompetitive settlements from occurring.

Life After *Comcast*

tiffs must offer proof that each theory of harm is necessary, such as a profitability analysis demonstrating that removal of either type of restraint would have rendered the allegedly anticompetitive price hikes unprofitable in the but-for world. The standard tools of "critical loss" or "critical elasticity" may also be informative here. *Second*, it could be the case that each theory of harm is sufficient, on its own, to raise prices significantly above competitive levels. Under this scenario, overcharges are separable. If one theory does not survive scrutiny, the economist will, in general, be required to estimate the overcharges attributable to the surviving theory. Techniques such as multiple regression may be necessary to empirically gauge the relative contribution of each restraint.

Plaintiffs might also assert monopoly broth claims that incorporate a theory that is neither necessary nor sufficient to generate anticompetitive harm (e.g., where the horizontal restraints are necessary, and the vertical restraints increase prices but cannot cause any anticompetitive harm on their own). As long as the horizontal restraints remain part of the case, the economist would not need to decompose damages: Prices revert fully to competitive levels in a but-for world in which the horizontal restraints are removed. However, disggregation may be necessary if only the vertical restraints remain in the case, but the horizontal restraints remain in the but-for world. In this instance, overcharges would be limited to the price increase induced by the vertical restraints, making it necessary for the economist to quantify that increase. Here again, multiple regression may be informative.

Finally, note that there is no need to consider cases in which one theory of harm is necessary and the other sufficient, because such a theory of causality is incoherent. For example, if the horizontal restraints in Comcast were necessary to achieve anticompetitive price effects, then the vertical restraints could not have been sufficient to generate price effects on their own.

After Comcast, plaintiffs electing to assert Section 2 monopoly broth claims or other antitrust claims involving multiple types of challenged conduct may be subjected to more scrutiny than those alleging a single theory of harm. Nevertheless, the additional burden may not be as broad as an initial reading of Comcast might imply. The allocation question arises only if one theory does not survive scrutiny. In that event, the question then turns on whether or not the surviving theory encompasses conduct that would be necessary for the defendant to inflict any anticompetitive harm. In cases where damages are not separable, no purpose is served by requiring the plaintiffs' economist to try to disaggregate damages among types of alleged anticompetitive conduct and injury.

EI News and Notes

TransCanada defeats price discrimination and other claims

EI Principal John R. Morris testified before the Federal Energy Regulatory Commission (FERC) on behalf of TransCanada Energy Ltd. TransCanada sold electric energy to the California Energy Resources Scheduling (CERS) division of the California Department of Water Resources. California alleged that TransCanada sold at excessively high and discriminatory prices and seriously harmed the public interest. Dr. Morris explained that TransCanada's prices to CERS were similar to prices it received from others and consistent with supply and demand conditions. Moreover, TransCanada's sales to CERS were too small to have seriously harmed the public interest even if one accepted California's other claims. The Administrative Law Judge denied the California claims. EI economists Keith Everhart, Lona Fowdur, Gale Mostseller, and Su Sun assisted Dr. Morris. Dr. Morris worked with attorneys at Andrews Kurth on the matter.

EI Economists Contributed to Antitrust Section Econometrics Book

EI economists contributed to several chapters of *Econometrics: Legal, Practical and Technical Issues* (Second Edition), recently published by the American Bar Association (ABA) Antitrust Section. Allison I. Holt and Su Sun worked on Chapter 4, "Collecting Relevant and Useful Data." Henry B. McFarland, Philip B. Nelson and David D. Smith worked on Chapter 13, "Applying Econometrics to Address Class Certification." Erica E. Greulich worked on the Appendix, which provided a primer on basic statistical concepts and regression analysis, and the glossary of technical terms.

Patent Infringement Damages

Thomas R. Varner's article "Is the Nash Bargaining Solution an Adequate Basis for Patent Infringement Damages?" was published in *IPLaw360* on April 21. Some experts have recently used the Nash Bargaining Solution, a concept from economic game theory, as the basis for calculating patent infringement damages. Courts require that estimates of damages, including patent infringement damages, be based on sound economic principles. As the article describes, the Nash Bargaining Solution must overcome significant challenges before it meets this requirement.

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