The Settlement of IP Disputes Through Merger and the Thicket of Probabilistic Competition [top]

Scott Sher*

Partner–Wilson Sonsini Goodrich & Rosati, PC

Introduction

Consider this increasingly common scenario: Party A ("A") and Party B ("B") each manufacture one product. A claims that B's product practices A's valid and enforceable patent portfolio. A sues B for patent infringement.

The case proceeds through a long and convoluted pre-trial discovery and motion practice period, costing both parties millions of dollars in legal fees. In the middle of this expensive litigation, A decides to (i) settle the litigation, which, to date, has cost the companies an incredible amount of time, resources, and money, and (ii) as part of that settlement, acquire B. No court has made a final determination as to whether B's products infringe A's patents. Summary judgment motions were pending.

Combined, A and B would have a high share of sales in the product market in which they compete, command a substantial portion of a locked-in customer base, and there would be, at best, only a remote chance of new entry or expansion. Further complicating the antitrust analysis, A's internal documents discussing the deal with B make reference to the ability to sustain long-term price hikes, with no fear of discipline from other vendors once the merger is complete.

When the parties notify the agencies of the proposed acquisition under the Hart-Scott-Rodino Act, how should the agencies evaluate the transaction in light of this pending IP dispute?

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This scenario will become increasingly common over time. High-tech companies today employ litigation–and most prominently IP litigation–as an important component of their competitive arsenal, e.g., alleging patent infringement, trade secrets theft, and other violations of IP rights. Even where the outcome of a lawsuit is fairly predictable, litigation is still costly and time-consuming. Faced with the uncertainty, parties often settle, and some even decide to merge as part of that global settlement. The antitrust agencies are then placed in the position of deciding whether the merger passes muster under Section 7 of the Clayton Act, which in turn forces them to consider the impact of the IP litigation on the competitive landscape in the market. As a result, a consistent, clear and manageable antitrust framework is necessary in order to ensure that these settlement/merger arrangements are afforded suf-

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ficient review by the agencies, and at the same time, are not necessarily subject to the same full-blown litigation in the antitrust tribunal that the parties sought to avoid by settling the litigation in the first place.

The Questions Raised by IP Settlements in the Merger Process

Fortunately, in most circumstances, the settlement of IP litigation and simultaneous corporate combination likely will not raise significant antitrust issues, and will be in fact procompetitive.[1] However, in limited circumstances, where, for example, the market in which the parties compete is highly concentrated (as in the example of the acquisition of B by A, discussed above), the acquisition will be subject to antitrust scrutiny. The agencies will be forced to consider the motivations of the parties in settling their IP dispute and the potential impact of the IP suit on competition in the market, if that dispute were to be resolved through litigation, rather than by settlement and acquisition.

These settlement/acquisitions can raise significant antitrust questions when the proposed settlement/merger results in significant market consolidation, and none of these questions have easy or obvious answers. This article raises questions regarding some issues that agencies and parties must consider:

- As a threshold matter, should the antitrust agencies even consider the effects of pending IP litigation in determining whether a combination is likely to reduce competition? Or should the agencies instead ignore the pending IP litigation, and presume that absent a court order to the contrary, B and A lawfully compete?

- If the agencies are to consider the impact of the litigation on the state of future competition between the feuding parties, who should bear the burden of demonstrating the likely outcome of the IP litigation–the agencies or the merging parties? Recognizing that the antitrust agencies are not the ideal setting to conduct a trial into the merits of the parties' respective positions in the IP dispute, how much evidence is necessary before the agencies are able to make their determination?

- Should the agencies pay substantial deference to the parties' decision to resolve a patent dispute through settlement as the Eleventh Circuit suggested in Schering-Plough,[2] or should the parties instead be required to put forth affirmative evidence that the IP dispute was likely to result in the acquired party's exit from the market?

- If the agencies consider the merits of the IP dispute and conclude that it was likely that the acquired party's products infringed upon the acquiring party's patent portfolio, how should the agencies assess the outcome of such a finding? Should the agencies have to investigate further and ascertain whether the acquired party could "work around" the patent, or whether it would be forced to stop selling its product? Should the agencies take into account the costs of having to work around the infringement, and determine whether it is

[1] See, e.g., Schlegel Mfg. Co. v. U.S.M. Corp., 525 F.2d 775, 783 (6th Cir. 1975).

[2] See Schering-Plough Corp. et al. v. Federal Trade Comm'n, 402 F.3d 1056 (11th Cir. 2005) (pending the Commission's motion for rehearing en banc).

plausible, possible or likely that the infringer would develop a work-around?

- On a related point, how do the agencies assess whether there is a "less restrictive alternative" to a merger? If, for example, the acquired company had other products in development that did not infringe upon the acquiring party's patents, should the agencies consider something "less than a merger" (e.g., a patent cross-license on the infringing product) as a viable and less anticompetitive result that would enable the allegedly infringing party to continue competing in the market?

- Should the agencies consider the consumer welfare associated with interim competition between the parties? When and how much weight should such interim competition be afforded in the competitive effects analysis? Where a dispute is likely to be long and drawn out, should the agencies conclude that–even if it is likely that the acquired party infringed and would exit–consumers benefit from competition between the parties in the market prior to the resolution of the dispute? More fundamentally, if it is relatively clear that the acquired party did indeed infringe upon the acquiring party's patents, should interim competition be a factor in the antitrust analysis, or is it appropriate to conclude that such interim competition is irrelevant in an antitrust analysis because consumers are not entitled to the benefit of that unlawful competition?

Both because the agencies have not yet articulated a framework by which they will analyze such two-step transactions and because the law on the antitrust implications of IP settlements is in flux (see, e.g., Schering-Plough), there is considerable uncertainty in the business world as how best to approach the agencies with their antitrust arguments when advocating transactions involving these issues. There is also a natural hesitation–among members of the bar and the agencies themselves–to demand that the antitrust agencies conduct in depth analyses of patent disputes that the parties themselves determined was too difficult to litigate fully in the court system. Depending upon one's perspective, this hesitation may lead to one of two arguments–(1) that the agencies should pay substantial deference to the good faith decision of the parties to resolve their IP disputes, and should not interfere with that determination;[3] or (2) that these disputes are too difficult to resolve, and in the absence of conclusive evidence that both parties believed that the result of the litigation would be that the acquired party would exit the market, that the agencies should simply ignore the existence of the IP dispute.[4] Neither argument sits well with this author. As is the case with many issues lying at the intersection of antitrust and intellectual property, a more substantial architecture for analysis is necessary.

An Overview of the Analytical Rubric

Analysis of Burdens in the IP Litigation Context: Proving Infringement and Validity

Without delving into the analysis in any great detail, it is fairly clear that the party advocat-

[3] See, e.g., Kevin McDonald, Hatch Waxman Patent Settlements and Antitrust: On Probabilistic Patent Rights and False Positives, 17 Antitrust 68 (Spring 2003).

[4] See, e.g., Carl Shapiro, Antitrust Limits to Patent Settlements, 34 RAND J. Econ. 391 (2003), available at http://faculty.haas.berkeley.edu/shapiro/settle.pdf; see also In re Schering-Plough Corp. et al., Dk. No. 9297, 2003 WL 22989651 (F.T.C.), rev'd by Schering-Plough v. F.T.C., 402 F.3d 1056 (11th Cir. 2005).

ing infringement in IP litigation has the burden of demonstrating infringement, and doing so by a preponderance of the evidence: "To establish infringement, every limitation set forth in a patent claim must be found in an accused product. . . . The patentee bears the burden of proving infringement by a preponderance of the evidence."[5]

When a patentee moves for a preliminary injunction in a patent infringement suit, it bears the burden of demonstrating "(1) a reasonable likelihood of success on the merits; (2) irreparable harm if an injunction is not granted; (3) a balance of hardships tipping in its favor; and (4) the injunction's favorable impact on the public interest."[6]

As we will see below, courts have created a significant degree of confusion in this area by shifting the burden of proof away from the patentee in the context of analyzing patent settlements.

Analysis of Burdens in Demonstrating Valid Settlements: The Uncertainty Following Schering-Plough

There is considerable confusion as to who bears the burden of proof in the determination of whether a settlement of an intellectual property dispute is immune from (or largely shielded from) antitrust liability. In Schering-Plough, the Eleventh Circuit held that because "[b]y their nature, patents create an environment of exclusion and consequently, cripple competition," once the parties demonstrate that a settlement was a good faith attempt to resolve a patent dispute, a court (or the FTC) should not interfere with that resolution.[7]

In Schering-Plough, the FTC challenged a patent infringement settlement between two drug companies that had the effect of keeping one party from entering the market for several years. The FTC alleged that the settlement was an unlawful market allocation between two firms. The central issue before the Eleventh Circuit was who had the burden of demonstrating that the patent settlement was valid. This, in turn, required the court to decide whether to require the patentee (i.e., the party who brought the infringement suit) to demonstrate that the company it sued actually infringed its patent, or the FTC to demonstrate that the settlement was a sham.

By its terms–if it remains good law–Schering-Plough suggests that the settling parties' only burden in demonstrating the appropriateness of an intellectual property dispute resolution is showing that they believed in good faith that the acquiring party's patent was valid. At that point, according to Schering-Plough, the burden shifts to the antitrust agency to prove invalidity or non-infringement. The Eleventh Circuit there held:

> By virtue of its '743 patent, Schering obtained the legal right to exclude Upsher and ESI from the market until they proved either that the '743 patent was invalid or that their products . . . did not infringe Schering's patent.[8]

This seems to stand on its head traditional patent law which requires the patentee to demonstrate infringement by a preponderance of the

[5] Kegel Co., Inc. v. AMF Bowling, Inc., 127 F.3d 1420, 1425 (Fed. Cir 1997); see also Laitram Corp. v. Rexnord Inc., 939 F.2d 1533, 1535 (Fed. Cir. 1991).

[6] Amazon.com, Inc. v. barnesandnoble.com, inc., 239 F.3d 1343, 1350 (Fed. Cir. 2001).

[7] 402 F.3d at 1065-66.

[8] Id. at 1066-67 (emphasis added).

evidence.[9] Presciently, three years before the Schering-Plough decision, Professor Joseph Scott Miller, in an excellent article on the subject in Antitrust Law Journal, responded to the Eleventh Circuit's proposed analytical framework:

> The proponents of a dubious patent license agreement may urge that, because the patent enjoys a statutory presumption of validity . . . the agency cannot challenge a license agreement as anticompetitive without proving by clear and convincing evidence that the patent is invalid. By doing so, the license proponents ignore the question of infringement altogether. A patentee has no right to exclude from the market persons who are not infringing, i.e., not practicing the claimed invention in all its detail. As a result, a patent cannot justify the change from competition in fact between rivals to coordination under a license between now-friendly firms until the patentee caries its usual burden of showing that the licensee's conduct actually meets every limitation of at least one claim in the patent. The patentee's usual burden in this regard does not vanish merely because it walks through the door of an antitrust enforcement agency.[10]

Professor Miller's position, however, creates tension with the legal presumptions afforded to the patentee's decision to enforce its patent rights. As courts have held, most prominently the Federal Circuit in Loctite,[11] a patentee's decision to enforce its IP rights generally should be shielded from judicial review. In Loctite, the Federal Circuit reviewed the dismissal of a defendant's counterclaim alleging bad faith enforcement of a patent based on the patentee's alleged knowledge that the defendant did not infringe the relevant patent. In holding that a "clear and convincing evidence standard" should apply to an antitrust claim based on allegations of bad faith enforcement, the court concluded that the "threat of antitrust liability should not be used to thwart good faith efforts at patent enforcement."[12] In other words, when a patentee brings suit to enforce its patents, the courts should respect that constitutionally granted right in the absence of clear and convincing evidence that such a suit was brought in bad faith.

Analysis of Burdens in the Merger Context: Positioning the Effects of the IP Litigation and Settlement in Failing Firm Defense and Competitive Effects Analysis

IP disputes often lead to "bet-the-company" litigation. Patent infringement suits, if successful, can lead to an injunction prohibiting

[9] For two excellent articles on the subject, see Herbert Hovenkamp, Mark Janis & Mark Lemely, Anticompetitive Settlement of Intellectual Property Disputes, 87 Minn. L. Rev. 1719 (2003); Carl Shapiro, Antitrust Analysis of Patent Settlements Between Rivals, 17 Antitrust 70 (Summer 2003).

[10] See Joseph Scott Miller, The Bitter Has Some Sweet: Potential Antitrust Enforcement Benefits from Patent Law's Procedural Rules, 70 Antitrust L.J. 875, 884 (2003).

[11] Loctite Corp. v. Ultraseal Ltd., 781 F.2d 861 (Fed. Cir. 1985).

[12] Id. at 876-77.

the infringing parties from selling the offending products (in antitrust parlance, the infringer must "exit the market"). Thus, where competitors merge, and the agencies commence an inquiry into whether the merger is likely to reduce competition, how should the agencies consider the possibility that the unresolved IP dispute could have resulted in the exit of the merger target/alleged infringer from the relevant market? Alternatively, where the IP dispute had only the possibility of harming the infringer, and was not likely to force a full exit by the infringer, how should the agencies consider the evidence of this weakened competitor in its analysis?

One thing seems certain: if it is 100% clear that the merger target/alleged infringer infringed upon the IP rights of the acquiring party and the result of that infringement would be an order requiring that company to exit the market, antitrust liability for merging should not attach. Under the Merger Guidelines, the transaction should not raise any competitive concerns because the target is tantamount to an "Exiting Asset."[13]

Where it is certain that the target would be required to exit the market because of an adverse finding in an infringement suit, that company is in no different a position than a true failing firm as recognized under the Merger Guidelines. "[A]bsent the acquisition, the assets of the firm would exit the relevant market"[14] and in the face of an order from a court so demanding, there is no possibility that it could reorganize under the Bankruptcy Act (because it has no product that it could lawfully sell), and there would be no other firm interested in such assets (because they would be enjoined from participating in the market).

Most cases are not so clear, however, creating a tension as to who should bear the burden–the merging parties or the government–in setting forth the role of an IP dispute in the merger analysis. On the one hand, as noted by Professor Miller, "an antitrust agency should be no worse off when assessing the erstwhile competitor's good faith basis for sacrificing its independence to the patentee than it would be if it were challenging a merger that the parties defend on failing firm grounds."[15] Thus, where the merging parties are attempting to demonstrate that the IP dispute would force the acquired party out of the market, Professor Miller believes that their burden of proof should be the same as the high hurdles erected by the failing firm defense.

On other hand, in the context of a Section 7 analysis where it is the government's–not the parties'–ultimate burden to demonstrate that a merger will likely result in anticompetitive effects, placing too high of a burden on the merging parties to prove the outcome of the IP dispute is inappropriate and contradicts two fundamental jurisprudential principles: First, it will frustrate the judicial intent behind promoting litigation settlements. Second, and perhaps more fundamentally, by placing a high

[13] See Dep't of Justice and Federal Trade Comm'n, 1992 Horizontal Merger Guidelines, § 5.1 (1997), available at http://www.ftc.gov/bc/docs/horizmer.htm. See also Joint Statement in Matter of The Boeing Co./McDonnell-Douglas Corp., available at http://www.ftc.gov/opa/1997/07/boeingsta.htm ("Our decision not to challenge the proposed merger was a result of evidence that (1) McDonnell Douglas, looking to the future, no longer constitutes a meaningful competitive force . . . and (2) there is no economically plausible strategy that McDonnell Douglas could follow . . . that would change that grim prospect").

[14] Dep't of Justice and Federal Trade Comm'n, 1992 Horizontal Merger Guidelines, § 5.1 (1997).

[15] See Miller, The Bitter Has Some Sweet: Potential Antitrust Enforcement Benefits from Patent Law's Procedural Rules, supra note 10, 70 Antitrust L.J. at 884.

burden upon the merging parties, the agencies may be undercutting the presumption that a patentee's decision to bring its patent infringement suit was in good faith, and under decisions such as Loctite, this presumption should only be undercut where the government can produce "clear and convincing evidence" of bad faith.

Regardless, even where it is not clear that the acquired party will have to exit the market (regardless of the level of deference paid by the agencies to the settlement), the IP dispute and its likely outcome still can have a significant impact on the merger analysis. It should not be irrelevant, for example, that the acquiring party had a strong–albeit uncertain–case against the acquired party.

The Merger Guidelines allow room for such arguments. Section 1.52 of the Merger Guidelines provides that "in some situations, market share and market concentration data may either understate or overstate the likely future competitive significance of a firm or firms in the market or the impact of a merger."[16] Where the IP dispute (if followed through to judgment) would have debilitated the acquired party or lessened its competitive impact going forward, then surely this would be a significant factor in explaining that current high market shares "overstate the likely future competitive significance of" the acquired party, and the agencies should most certainly consider that in their analysis.[17]

Understanding the role of the settlement of the IP dispute in the merger analysis is only the first–and arguably easier–step in this process. Practically, the most difficult issue confronting the parties is how to demonstrate the likely effects of the IP litigation without being required to reenact the entire IP litigation before the antitrust tribunal during a fast-paced merger investigation.

The Most Significant Issues Lying in the Intersection: How do the Parties Meet Their Burden?

For the merging parties to demonstrate infringement–or under Schering-Plough, for the FTC to demonstrate non-infringement–is no small task, and some proclaim the job is outside the jurisdictional expertise of the antitrust agencies. Without the benefit of a full-blown trial, how does a party demonstrate infringement or lack thereof with certainty sufficient to permit the agencies to conclude that the acquired party's product would have exited the market were the litigation allowed to proceed?

This article offers several observations. First and foremost, the antitrust agencies are ill-equipped to independently determine whether a product infringes upon a patent. Conducting claims construction hearings, accepting expert testimony on the issue of infringement, and surveying the evidence to determine the consequence of infringement is a difficult task. If the agencies conducted that analysis each time they were confronted with determining the question of infringement then the benefits of settlement–certainty, cost reduction, and closure–would largely be eliminated. And in the merger context, where speed is essential, such a full investigative hearing seems implausible and ill-advised.

Does that mean that ultimately the antitrust agencies should simply ignore the pending lawsuit because its outcome is too difficult and time consuming to predict? Surely not. There

[16] See Dep't of Justice and Federal Trade Comm'n, 1992 Horizontal Merger Guidelines, § 1.52, available at http://www.ftc.gov/bc/docs/horizmer.htm.

[17] See also United States v. General Dynamics Corp., 415 U.S. 486 (1974).

are alternative ways for the parties to put forth sufficient circumstantial evidence to convince the agencies of the likely impact of the IP litigation on the future of the market without having to conduct a full trial. This article points out two sources of potentially significant information:

- Opinions of IP Counsel: The opinion of IP litigation counsel of both parties, as conveyed to the decision makers throughout the progress of the trial, should be informative when assessing the strength of the parties' claims, and the likely impact of the final remedy on the acquired company (and competition). If the parties agree (or are forced) to waive privilege in order to advance their affirmative "failing firm defense," then conceivably the agencies could rely on the opinions of counsel as a proxy for the likely outcome of the lawsuit.

  The reliability and probative value of opinion letters and other evidence reflecting the opinion of IP counsel is a function of how informed the parties are of the underlying facts. Thus, this evidence is likely to be most valuable if the IP litigation has progressed into the advanced stages, and genuinely reflects the opinions of an advocate attempting to prevail in the IP litigation (rather than manufactured record designed to convince the antitrust agencies of a different outcome).[18]

  Interestingly, the parties could prove too much: if they demonstrate to the agencies that they believed that the acquiring party was going to prevail in establishing liability and also in forcing the acquired party to exit the market, they will be in the position of having to defend any merger consideration offered beyond the sum of the cost of defense and the spoliation of assets (such as lost engineering talent, compromised good will, and the loss of positive network externalities as the customer base declines). Thus, if the parties' IP counsel represent this conclusion to the agencies, then they must explain any consideration paid to the acquired party by the acquiring party beyond (1) the cost avoided of defending the action and (2) the savings accrued from an early resolution, rather then a gradual decline in asset value during the pending litigation, while the acquired company's customers and derivative product/service providers switch to other alternatives, knowing that their provider will be forced to exit the market.

- Market Guidance. Market guidance is less reliable than an opinion of counsel because it presupposes that the market has perfect information about the likely outcome of an IP litigation dispute. However, if the agencies require confirmation of their conclusions regarding whether the acquired company would be forced to exit, the agencies could look to, for example, (i) pronounced drops in share price of the acquired party, signaling that the market believed that the likely outcome of the litigation would harm (or destroy) the alleged infringer; and (ii) whether customers have shifted buying patterns away from the acquired company, fearing that they would be required to exit the market.

This evidence is relevant whether the parties are seeking to satisfy the burdens of the failing

[18] There are complex issues related to waiver of privilege. Although the merging parties could shield against using waived materials against each other in the event that the litigation is forced to resume (because, for example, the antitrust agencies blocked the merger) by signing an agreement so promising, that agreement only protects against waiver with regard to the signatories of the agreement–privilege is still waived, and any third party potentially could gain access to that information in the discovery process.

firm defense, or attempting to position the acquired party as a diminished competitive presence because of the pending IP dispute and its likely outcome. In the latter scenario, the agencies must evaluate the merger's impact on competition, which necessarily includes a comparison to a baseline state of the world where the parties continue to compete and litigate, rather than merge. If the acquired company was instead forced to litigate, and faced dire–but not completely debilitating–results from the pending litigation, it would be in the position of losing a significant quantity of sales, and likely would not provide the acquiring company with the same competitive threat in the goods or innovation markets absent the litigation. The parties should present evidence normally produced in defending its merger, including a demonstration that the IP litigation has resulted in lost or deferred sales; decreasing levels of support from service/product vendors in derivative markets; decreasing value of the alleged infringer's products to consumers (if, for example, it was a network product) as the user base declines because of the uncertainty posed by the litigation; lost engineering talent (or other harm to the acquired company's assets which compromises its ability to compete); and continuing declines in share value and revenue streams that cause the company to forego R&D projects that are necessary to ensure its competitive viability.

Conclusion

The settlement and simultaneous merger between parties engaged in bet-the-company litigation could raise substantial antitrust issues–issues that have not yet been resolved by the courts or private parties. Where such a corporate combination raises antitrust concerns which could be eliminated if the underlying litigation was resolved in favor of the acquiring party, the antitrust agencies are placed in the uncomfortable position of having to decide whether to ignore the existence of that dispute or attempt to determine the likely outcome of the litigation. While it typically would be a mistake for an antitrust agency to ignore the existence of a dispute, an agency also should not attempt to litigate the underlying patent dispute. In this next frontier of merger antitrust review, many open issues remain that need to be confronted and placed in the appropriate framework for an adequate antitrust analysis of the role of probabilistic competition.

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