IP Issues in the Antitrust Treatment of Mergers

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I. Introduction.

On July 15 of last year, the Federal Trade Commission ("FTC") ordered Aspen Technology to divest the assets it had acquired in its consummated 2002 purchase of Hyprotech, Ltd. *See* http://www.ftc.gov/opa/2004/07/aspen.htm. The acquisition that the FTC unwound two years after the fact had a total value of only $106.1 million. It was not even reportable under the provisions of the Hart-Scott-Rodino Act. Aspen Technology is but the latest in a series of antitrust investigations and challenges brought against merger agreements involving little-known technology companies with modest revenues serving niche markets obscure to most of us.

Certainly the antitrust agencies have not ignored multi-billion dollar transactions between technology companies. Hewlett-Packard Company's $18.7 billion acquisition of Compaq, investigated by the FTC for six months, is one example. Another is the Department of Justice's ("DOJ's") failed attempt to block Oracle's hostile tender offer for its enterprise software rival PeopleSoft. Judge Walker's September 2004 decision reveals the complexities inherent in assessing the competitive effects of mergers involving differentiated products in fast moving markets. *See United States v. Oracle Corporation*, 331 F. Supp. 1098 (N.D. Cal 2004) (hereinafter "*Oracle*"). But the evidence accumulates that special characteristics of technology companies, with their heavy reliance on intellectual property, have caused both the DOJ and FTC increasingly to drill far below the daily headlines in ferreting out even minor transactions.

The aggregate size of a transaction is theoretically irrelevant in determining whether a given merger will tend to substantially lessen competition as proscribed by Section 7 of the Clayton Act. Size should nevertheless matter—if only through the proper application of prosecutorial discretion at the antitrust agencies. The agencies' resources, after all, are finite and should be focused on only those transactions most likely to harm consumer welfare. Even the 2001 legislation raising the reporting thresholds under the Hart-Scott-Rodino Act reflected

recognition that mergers valued at less than $50 million were less likely to warrant government review. It seems, nevertheless, that no longer is a merger's size or celebrity a predictor of antitrust scrutiny. It may be helpful to consider just why that has come to pass.

II. The Relevance of Relevant Markets.

One factor encouraging closer scrutiny of technology mergers is the predicate need to define a relevant market—the Achilles' heel of the DOJ's failure to stop the Oracle deal. Only from that can concentration levels be measured, and inferences drawn about market power and harm to competition. Frequently, the agencies have defined technology markets down virtually to the line-item product level.

In October 2001, for example, the FTC challenged two small acquisitions by MSC Software Corporation based on a relevant market consisting of "nastran-finite element analysis solver" software. That "market" comprised at most $60 million in total annual sales—less than one-tenth of the revenues Wal-Mart enjoys in a single day. The FTC rejected MSC's broader market, which included non-Nastran types of finite-element analysis solvers performing similar stress-simulation functions.

In its *Aspen Technology* Consent and Order, the FTC asserted seven distinct markets, of ever-diminishing size, for "continuous," or "batch," or "integrated" engineering simulated flow-sheet software serving process industries; upstream oil and gas process industries; and downstream refining process industries.

And in 1995 the DOJ challenged Computer Associates' acquisition of Legent Corporation, another supplier of software for mainframe computers. The government's complaint defined six separate relevant product markets—one for each product overlap. No market was larger than $10 million; several were less than $5 million in sales.

At the other end of the size spectrum, the DOJ attempted in *Oracle* to prove up a relevant market consisting of "high function human resources management and financial management software" for large enterprises. "A large number of factors" were offered to refine that definition, which was tweaked by the government several times until final briefs were filed. 331

F. Supp. at 1124-25. The court was not persuaded, showing particular disregard for the DOJ's "unhelpful" customer testimony: "[U]nsubstantiated customer apprehensions do not substitute for hard evidence." *Id*. At 1131. *Oracle* came on the heels of a similar courtroom defeat based upon market definition in *FTC v. Arch Coal*, 329 F. Supp. 109 (D.D.C. 2004).

This is not to suggest that the agencies' market claims are uninformed by diligent review and analysis. Quite the contrary is the case. However, I do suggest that the agencies' default position, faced with a nascent, novel, changing or complex product set, may sometimes be to draw a circle around the specific line items where the parties compete, followed by undue reliance on near-term or anecdotal customer perceptions. The agencies' tendency may be to reject as speculative the competitive constraints imposed by adjacent technologies, future product iterations and upcoming market convergences or transformations. Combining technology companies will no doubt find it useful to echo the *Oracle* court, itself citing the Areeda, Hovenkamp & Solow text: "the use of the submarkets doctrine has, in fact, misled courts into identifying artificially narrow groupings of sales on the basis of noneconomic criteria having little to do with the ability to raise prices above cost." *Oracle*, 331 F. Supp. at 1119.

The fact is that technology markets are often difficult to pin down, and subject to U-turns or radical morphing with every new development. As the Court of Appeals for the D.C. Circuit observed in *Microsoft:* "[r]apid technological change leads to markets in which firms compete through innovation for temporary market dominance, from which they may be displaced by the next wave of product advancements," *United States v. Microsoft Corp.*, 253 F.3d 35, 49 (D.C. Cir. 2002). In essence, concentration does not result in anticompetitive market power if the market itself is only short lived. Unfortunately for merging parties, the burden is often on them to prove that the current 'market' will not last. Proving how, when and why it may recast itself can be problematic, at best.

As a practical matter, however, the agencies' penchant for asserting narrow markets can be used offensively. When dealing with differentiated products, one should be mindful that markets may be defined down to the point where the parties' products lose any competitive overlap. In a number of deals, arguing for the ***narrowest*** possible market was actually the best strategy.

III. Innovation Markets and Potential Competition.

Another factor explaining the government's enthusiasm for investigating technology mergers is the continuing debate on innovation markets and the thorny issues involving potential competition.

The FTC's recent *Genzyme* decision seems to have painfully bruised, if not put a fork into, the corpus of innovation market theory. *See* Statement of Chairman Timothy J. Muris in the Matter of Genzyme Corp. and Novazyme Pharmaceuticals, P.23 (Jan 13, 2004), *available at* http://www.ftc.gov/os/2004/01/murisgenzymestmt.pdf. First articulated by the DOJ/FTC in their 1995 IP Licensing Guidelines—and nowhere mentioned in the Horizontal Merger Guidelines—innovation market analysis has been under assault almost since birth. *See* Ilene Knable Gotts and Richard T. Rapp, *Antitrust Treatment of Mergers Involving Future Goods*, 19 Antitrust 100 (Fall 2004). But technology markets and the examination of potential competition—for both current market and future entry purposes—remain important parts of the agencies' antitrust analysis. A merger target that, but for the merger, would soon have introduced a directly competitive product or technology, clearly involves a loss of competition within the proper purview of the antitrust agencies. The parties' IP and technology roadmaps are therefore of high and appropriate interest to the agencies.

By way of example, the DOJ opposed Varian Medical Systems' attempt to purchase IMPAC Medical Systems not long ago. *See* http://www.usdoj.gov/atr/public/press_releases/2000/6908.htm. Though the target IMPAC had a mere $21 million in annual revenues, Varian had decided shortly before the merger announcement to develop software that would compete directly with IMPAC in the future. That factor weighed heavily in the DOJ's decision to oppose the merger, which the parties then abandoned.

IV. The Importance of IP in Merger Review.

Technology mergers provide yet another illustration of the increasingly stormy interface between intellectual property rights and the mandate of the antitrust laws to preserve consumer-

enhancing competition. The significance of IP rights in merger analysis is perhaps the most compelling driver of the agencies' focus on technology transactions.

A. The Developing Patent Thicket.

Technology companies over the past 15 years have "seen the light" on the strategic need to build up their patent portfolios—for both offensive and defensive purposes. For many Silicon Valley companies, the wake-up call came when Texas Instruments turned its patent portfolio into a separate and significant profit center more than a decade ago. Before then, small company innovation was not driven by a race to the PTO; rather, it was a race for first mover advantage or for some breakthrough that would create an entirely new market. Companies relied upon trade secret law, not patents, to protect the fruits of their labor. But those times are over.

Reportedly, the number of new U.S. patents granted doubled in 14 years from 1985 to 1999. Similarly, from 1978 to 1995, the number of patent suits filed rose by almost tenfold, much of that occurring in the 1990s. *See* Carl Shapiro, *Antitrust Limits to Patent Settlements*, 33 Rand J. of Econ. 394 (Aug. 2003) (citing earlier reports by others).

As George Cumming recently articulated, floating on the rising tide of newly-issued patents is an expanding armada of "bad" patents. *See* George Cumming, *Antitrust/Intellectual Property Interface in High Tech Markets*, ABA Annual Meeting, Business Law and Antitrust Section Panel (Aug. 6, 2004). And with both has come a thicker fog of uncertainty—not just about the validity and scope of the thousands of patents being asserted to block competition—but also about the patentee's intentions, and the resulting competitive harm. As a result, merger antitrust analysis has become a far more tricky enterprise for IP-driven companies.

B. Typical Merger Scenarios.

In his February 2002 speech marking the opening of the recent IP/AT Hearings, Antitrust Division Head Charles James alluded to a few of the difficulties that are unique to merger analysis of technology mergers:

> [S]uppose that significant questions exist about the breadth of a firm's patent position. The patents may not completely block the field, but no one knows for sure. In determining the ease and likelihood of entry into that relevant market, should we assess a potential entrant's risk of infringement and the cost of defending a possible infringement? Does potential rivalry mean the ability to compete free from risk of infringement liability?

http://www.ftc.gov/opp/intellect/james.htm. Generally, there are three scenarios in which IP issues are likely to arise in an antitrust merger review.

The first scenario involves the combination of the acquiring company's patents with those of the target, which together may suffice to block or delay future entry by others into the relevant market. One illustration is the June 2001 DOJ challenge to the merger between 3D Systems, Inc. and its competitor DTM Corporation. *See* http://www.usdoj.gov/atr/public/press_releases/2001/8810.htm. The two parties' combined sales, worldwide, totaled only $150 million; the value of the transaction was only $45 million. The DOJ's challenge was based not only on its definition of a very small market (rapid prototyping systems that transform computer designs into three dimensional prototypes or models), but also the fact that the combined patent portfolio of the two companies would have made it impossible for existing foreign competitors, not to mention greenfield entrants, to enter into competition in the United States.

To remedy the alleged entry barrier, the parties were required in a consent decree to grant a third party a perpetual, assignable, transferable and non-exclusive license to sell and distribute rapid prototyping machines in the United States, and were precluded from asserting any claims for patent or copyright infringement against the acquirer of this license.

Technology mergers often stand or fall on the ease of entry defense. In assessing that defense in problematic mergers, counselors should routinely explore with their clients the depth and scope of their patent portfolios and those of the other party, to assess whether IP is, in whole or in part, a barrier to entry. A history of aggressive patent enforcement against current or

potential competitors—particularly when successful—also weighs against clearance in a close case. Even repeated threats by a merging party to enforce its patents against potential entrants can be damaging in the context of a merger between competitors. By contrast, if the parties have a history and—more importantly—obvious *incentives* to license their intellectual property portfolios on reasonable and nondiscriminatory terms, there should be little concern.

The second scenario in which IP issues impact antitrust merger review relates to instances where one of the parties' competitors might have launched or threatened patent litigation against others in the market which, if successful, could profoundly change the level of concentration and competitive dynamics facing the merging companies. As Charles James asked in his 2002 speech: "What weight should the agencies give to existing market conditions in situations where there are numerous firms competing—notwithstanding a claimed IP-blocking position?"

Finally, IP issues can dominate antitrust analysis in situations where the merger also represents a global settlement of threatened or ongoing patent litigation between the parties, which if successful, could eliminate a competitor from the market. An example is Boston Scientific Corporation's acquisition of Cardiovascular Imaging Systems, Inc. ("CVIS") and SCIMED Life Systems, Inc. in 1995. That merger both ended the ongoing patent litigation between Boston Scientific and CVIS, and also took out potential competitor SciMed, whose IVUS product was in the prototype stage. The parties argued, unsuccessfully, that either Boston Scientific or CVIS would soon be excluded from the market anyway, due to legitimate patent enforcement. In a Consent Decree, the parties were required to divest—*i.e.*, license—the relevant IVUS technology sufficiently to create a new competitor. *See* http://www.ftc.gov/opa/predawn/F95/boston.scient.htm.

C. Areas for Future Concern.

How the antitrust agencies should deal with the competitive impact of an existing patent litigation between merging parties, or against another major competitor, is one of the toughest questions today. Should the agency accept the presumptive validity of patents, absent strong evidence to the contrary, and make the conservative assumption that the patent holder will

succeed in ongoing litigation and therefore eliminate one or more competitors? If the merger will simply accomplish the same result, because it involves the same companies, it should follow that no substantial lessening of competition is caused by the merger. Continuing with the same logic, should the parties' merger be challenged if ongoing patent litigation threatens to block critical entry or eliminate the only other major competitor?

There is no consensus or easy resolution to these questions. Technology mergers continue to present the agencies with the dilemma of whether the outcome of antitrust merger analysis should be resolved by a determination over the likely outcome of existing patent litigation. As such, merger policy must grapple with many of the same thorny issues raised by pharmaceutical companies that use "reverse payments" to settle their patent litigation (discussed more fully below).

Regardless of the specific scenario in which IP assets affect the antitrust review of mergers, ultimately each situation sheds light on a common theme. In markets characterized by increasing reliance upon intellectual property and escalating enforcement of patent rights through litigation, the antitrust agencies face a complex and difficult dilemma in conducting traditional antitrust analysis under the 1992 Horizontal Merger Guidelines. Given this uncertainty counselors to technology mergers are advised to take the following precautions:

- If contemplating a merger with a competitor whom you are suing for patent infringement, do not rely on your patents as a free pass to an otherwise anticompetitive merger. Likewise, consider the likelihood that you may be required for clearance to license any IP essential for entry by others.

- Expect the agencies' to apply a Merger Guidelines approach, which may entail an initial, but thorough, inquiry into the strength of the underling IP claims and the feasibility of alternate means of settlement.

- As in all things today, beware of the document trail. Assiduously protect attorney-client privilege in discussions about the validity and scope of the

company's IP and whether to bring litigation, not to mention dialog about the settlement of such litigation.

- That said, appreciate the distinct possibility that you may be required to waive attorney-client privilege and present evidence from patent counsel to carry your burden of persuasion on the strength of your blocking patent.

V. Patent Settlements.

A. Assessing Patents in Antitrust Cases.

Delicate issues arise when the government or private parties mount antitrust challenges to patent settlements entered into by erstwhile competitors. As with technology mergers, some of the same conundrums arise: Should the underlying patent be assumed valid? Is the antitrust trier of fact competent to be assessing the patent's validity and scope, and the likely result of the ongoing litigation, in determining whether the settlement agreement constitutes an antitrust violation?

Additional questions arise that are peculiar to the patent settlement context: (1) should the *per se* rule or Rule of Reason be applied to settlement agreements between horizontal competitors that eliminate competition or allocate markets? (2) What weight should be given to the patent holder's intent or belief in the strength and scope of the patent asserted against competitors? (3) Should the policies favoring litigation settlement call for less stringent antitrust enforcement in this context?

Indeed, patent settlements are sufficiently fraught with antitrust concerns that some settling parties are now subject to HSR-like notification obligations to the antitrust agencies. Following the recent enactment of the Medicare and Prescription Drug Improvement Act, all pioneer and generic drug manufacturers are required to file notice of their patent settlements with the FTC and DOJ within 10 days of resolving their dispute. *See* http://www.ftc.gov/os/2004/01/040106pharmrules.pdf. Those filings will give the agencies increased opportunity to investigate or challenge settlements seen as adversely impacting competition.

B. Recent Decisions in the Pharmaceutical Industry.

Settlements of patent litigation, particularly within the pharmaceutical industry, has been a huge topic over the past few years—one that cannot be addressed fully in this paper. Where patent settlements eliminate competition or allocate markets between horizontal competitors, perhaps the first issue is whether such agreements are *per se* illegal, or should more appropriately be evaluated under the Rule of Reason. There appears to be a split between the Sixth and Eleventh Circuits on this, with the FTC advocating a compromise position under a truncated review standard. Closely related is the question of whether courts are required to engage in a post-hoc analysis of patent validity before finding antitrust liability. A frothy mix of federal court decisions and agency actions—particularly in the pharmaceutical industry—continue to explore these issues, with as yet no clear consensus.

Instructive recent federal cases (roughly in reverse chronological order) include:

- The Sixth Circuit's decision ***In re Cardizem CD Antitrust Litigation***, 332 F.3d 896 (2003) (*per se* rule applied where settlement agreement restricted competition beyond the patent's exclusivity term);

- The Eleventh Circuit's ***Valley Drug Co. v. Geneva Pharms., Inc.***, 334 F.3d 1294 (2003) (applying the Rule of Reason to settlement agreement that was no broader than the potentially exclusionary effect of the patent—which, however, was later declared invalid);

- ***In re Ciprofloxacin Hydrochloride Antitrust Litigation***, 261 F. Supp. 2d 188 (E.D.N.Y. 2003) (using Rule of Reason because the patent had withstood scrutiny, settlement agreements are favored by the courts, and the 'novel' Hatch-Waxman statutory scheme was involved);

- ***Asahi Glass Co. v. Pentech Pharms., Inc.,*** 289 F. Supp. 2d 986 (N.D. Ill. 2003) (Per Judge Posner, no antitrust challenge unless the settled patent litigation was "objectively baseless," citing the policy favoring settlements and dismissing as

immaterial defendant's subjective motivation and views as to the validity of its patent);

- ***In re Terazonsin Hydrochloride Antitrust Litigation***, 352 F. Supp. 2d 1279 (S.D. Fl. 2005) (On remand from *Valley Drug*, the district court found the use of "reverse payments" to be *per se* illegal after finding that the pioneer was unlikely to demonstrate that its patent was valid and infringed at the preliminary injunction stage);

- ***Schering Plough v. FTC***, 402 F.3d 1056 (11th Cir. 2005) (Refusing to engage in a post-hoc review of the patent's validity, the court rejected the Commission's operating presumption that reverse payments are anticompetitive, holding instead that patent settlements limited to the exclusionary potential of the patent are presumptively pro-competitive and lawful. The FTC has moved for reconsideration *en-banc*); and

- ***In re Ciprofloxacin Hydrochloride Antitrust Litigation***, 2005 WL 736604 (E.D.N.Y. Mar. 31, 2005) (applying a Rule of Reason review, the court embraced the increasingly popular view that courts should not engage in a post-hoc analysis of a patent's validity to determine the legality of a settlement that is limited to the term of the patent's exclusionary zone).

C. Practical Suggestions in Settling Patent Litigation.

First, treat patent litigation settlements no differently than licensing in protecting yourself against antitrust challenge—*i.e.*, do not rely on the public policy favoring settlements.

Second, in any litigation settlement, as in a license, seek and accept no restrictions broader than the exclusionary scope of the underlying IP itself. For example, agreements not to compete for terms longer than, or with scope broader than the underlying patent risks antitrust liability.

Finally, calibrate patent enforcement actions, including your infringement suits, to the good faith belief the company has in the validity and scope of the patent sued on. It goes without saying that sham or baseless litigation is anticompetitive. Aggressive enforcement may be equally imprudent when relying upon weak or uncertain patents.