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District Court Orders Break-Up of Microsoft

On April 3, Judge Thomas Penfield Jackson issued his long-awaited legal conclusions in the *Microsoft* case. He held that Microsoft violated Sections 1 and 2 of the Sherman Act (and similar laws in 19 states and the District of Columbia). The decision found that Microsoft illegally maintained its monopoly in the operating systems market, illegally attempted to monopolize the web browser market, and illegally tied its operating system to its browser product. Although the government had accused Microsoft of illegal exclusive dealing agreements, the court found there were alternative distribution channels available to competing products and ruled in Microsoft's favor on that count.

On June 7, Judge Jackson issued a final judgment ordering that Microsoft be divided into two separate businesses, one for the development and sale of operating system products and the other for the development and sale of applications software. The court also imposed a conduct remedy that for a period of three years following the divestiture of the applications business: 1) imposes certain restrictions on Microsoft's licensing practices; 2) requires Microsoft to disclose certain information to its licensees; 3) requires Microsoft to offer a version of its operating system without certain bundled software applications; and 4) limits Microsoft from entering into certain types of exclusive dealing relationships. Although implementation of the divestiture was stayed by Judge Jackson pending appeal, he ordered that the conduct remedy go into effect in 90 days.

The final judgment imposes the relief sought by the government - splitting Microsoft into two separate companies to ensure competition in the future. Microsoft, in its opposition to the proposal, had excoriated the government's proposed remedy as disproportionate and largely unrelated to the violations found by the court. While preserving its right to challenge the court's liability findings on appeal, Microsoft's proposed remedies had included: providing information about the Windows operating system to other companies; granting the ability to add icons to the Windows screen to other software firms; and requiring the sale of Windows without the Microsoft Internet browser installed.

Judge Jackson issued a memorandum and order with the final judgment in which he expressed the view that, "Microsoft as it is presently organized and led is unwilling to accept the notion that it broke the law or accede to an order amending its conduct." For this reason, the court was unpersuaded that Microsoft's proposed non-structural remedy would be either appropriate or effective. In looking forward, the court acknowledged the "substantial body of public opinion, some of it rational," that Microsoft will be vindicated on appeal. That process is expected to proceed expeditiously.

Federal Circuit Rejects Ninth Circuit's *Kodak* Approach and Protects Patent Holders' Rights to Exclude

There is an age-old tension between the antitrust and patent laws. Patents explicitly allow the holder to exclude others from using its invention, which clearly diminishes at least short run competition in the affected market. Obviously, the antitrust laws aim to maximize competition. As the economy changes and patent rights take on an ever-increasing importance, the courts' balancing of these two divergent interests becomes increasingly significant. Recently, the Federal Circuit placed its thumb on the balance in favor of patent holders. *In re Independent Service Org. Antitrust Litigation*, No. 99-1323 (Feb. 17, 2000).

The case was brought by a group of independent service organizations ("ISOs") who sought to service Xerox photocopy machines, but were prevented from doing so by Xerox's refusal to sell them patented parts. Xerox responded to the ISO's suit with counterclaims alleging patent infringement.

The court held that absent a showing that patents "were obtained by unlawful means," or were used unlawfully to extend monopoly power, a patent holder need not supply any ISO with whom it competes. The Federal Circuit refused even to consider Xerox's subjective motivation for the refusal, concluding that such an inquiry was irrelevant absent patent misuse. The court rejected the Ninth Circuit's *Kodak* analysis of subjective intent, which in that case required a patent holder to sell to a competing service provider, and instead adopted the analysis used by the First Circuit in Data General.

Having concluded that a patent holder has unbridled licensing discretion, so long as a patent was not obtained by fraud, the court then noted that the ISOs had not even alleged fraud. Alternatively, the court found Xerox could be subject to antitrust liability if its patent litigation was objectively baseless and knowingly brought to achieve anticompetitive results. Finding merit in Xerox's patent counterclaims, this theory also failed.

Finally, Xerox could have been liable if it had used its patents to gain a competitive advantage in another market not covered by the patents. Because the patents were for parts and the refusal to sell impacted only those parts and their use, Xerox was within the rights the patent laws grant, regardless of any anti-competitive effect which the refusal to sell might cause. The ISOs also brought copyright claims which the court dismissed, using essentially the same analysis.

The Federal Circuit's decision makes a strong statement about where it strikes the balance between statutorily granted patent rights and competition. So long as a patent holder is acting within the scope of the patent and obtained the patent fairly, any competitive effect resulting from a refusal to license is irrelevant.

Spice Company Consent Splits Commission

The McCormick spice company recently agreed to a consent decree resolving FTC allegations that its pricing practices violated the Robinson-Patman Act by unfairly discriminating among retail grocers who sold its products. *McCormick & Co., Inc.*, File No. 9610050 (March 15, 2000). While McCormick had a single price list in effect, the FTC alleged that it often provided discounts and other incentives so that some stores paid less than list price for the products. On at least five occasions, the FTC alleged that the price charged to one grocer was substantially less than the price charged to another. Because of McCormick's substantial market share (about 90%) and the competitive nature of the grocery industry, the majority of the FTC presumed (under *Morton Salt*) that the pricing differential caused competitive harm in the grocery market - commonly referred to as a secondary-line injury. The majority consisted of Chairman Pitofsky, and Commissioners Anthony and Thompson.

Commissioners Swindle and Leary dissented because they felt the record contained no evidence of actual secondary-line injury, but instead rested on a presumption of such injury. Absent proof that the stores given the lower prices purchased in larger quantities (and thus were diverting sales from disfavored grocers), these commissioners did not believe there was any reason to assume harm to grocery store competition. This is due to the large number of products carried in the stores and the minimal impact the spice products have on a customer's overall purchasing decisions and shopping choices.

This case highlights the continued vitality of the *Morton Salt* presumption of competitive harm, and at the same time demonstrates controversy within the FTC about applying such a presumption.

The FTC Seeks to Protect Generic Drugs

Firms litigating the validity of a patent often settle their disputes before trial. Typically, the alleged infringer pays the patent holder for a license allowing use of the invention, and agrees not to challenge the validity of the patent. In two recent cases, the Federal Trade Commission investigated payments in the other direction - from a patent holder to an alleged infringer - and brought complaints against branded drug manufacturers who allegedly attempted to interfere with the introduction of generic alternatives to their products. *See In re Hoechst Marion Roussel Inc.,* FTC File No. 981-0368 (March 16, 2000); *In re Abbott Labs,* FTC, Dkt. No. 9273 (March 16, 2000). In both cases, the branded drug maker paid the generic manufacturer considerable sums which the FTC alleged were compensation for the generic manufacturer's agreement not to bring the drug to market.

As required by the Hatch-Waxman Act (designed to promote generic alternatives to branded drugs), at the time they applied for FDA approval, the generic manufacturers asserted either that the patents held by the brand name makers were invalid or not infringed by the generic alternatives. In response, both branded manufacturers sued the generic makers alleging patent infringement. After the filing of the litigation, the branded manufacturers reached agreements with the generic makers in which the generic makers received significant payments for agreeing not to market their products (which effectively prevented any generic entry because the Hatch-Waxman Act grants the first generic application an exclusive right to sell for some period after it brings its product to market).

One defendant, Abbott Labs, has accepted a consent decree to resolve the case while the other, Hoechst Marion Roussel Inc. - now Aventis - intends to proceed to an administrative trial. The FTC is not seeking disgorgement of profits in either case. Future violators in this area, however, are now on notice that the government may seek the return of ill-gotten profits in future instances.

These recent initiatives are consistent with the government's prior statements that the settlement of patent litigation may be investigated. The aim is to identify sham settlements designed to continue monopoly power sustained by questionable patents. How this can be accomplished without litigation of the underlying patent challenge remains an interesting question.

Hale and Dorr Lawyers Complete Second Request Proceedings at DOJ and FTC

In two separate matters recently, Hale and Dorr antitrust lawyers represented clients in successfully completing Second Request review, one at the DOJ and one at the FTC.

Hale and Dorr represented Arch Communications Group, Inc. in its merger with Paging Networks, Inc., which was announced in November 1999 and is now due to close this summer. Both firms offer wireless communications (paging and advanced messaging services) over frequencies licensed to them by the Federal Communications Commission. The DOJ issued a Second Request and thoroughly investigated the current state of the firm's business as well as the rapid changes which characterize the wireless market today. In April, the DOJ closed its investigation after both parties had completed their Second Request responses.

Hale and Dorr lawyers also represented Sepracor Inc. in the FTC's Hart-Scott-Rodino (HSR) review of an exclusive license agreement between Sepracor and Eli Lilly. Eli Lilly presently markets one of the world's leading antidepressants, Prozac® (active ingredient, fluoxetine). Sepracor had begun development efforts on a chemically related compound, R-fluoxetine, on which it obtained patent rights for use of the compound to treat depression and related neurological conditions. Sepracor's December 1998 agreement to exclusively license the R-fluoxetine patent to Eli Lilly was fileable under HSR because such an exclusive license is considered an "asset" transfer.

The FTC issued a Second Request early in 1999, and investigated the transaction and the industry for over one year. After compliance with the Second Request, and multiple presentations by the parties, the Commissioners determined to close the investigation in April 2000.

Hale and Dorr Helps Dragon Systems Avoid a Second Request

On March 28, Dragon Systems agreed to sell its business to Lernout & Hauspie. Both firms design and market speech recognition technology. The DOJ quickly responded to the news of the pending sale by requesting information from both parties – even before the parties had filed for HSR clearance. After providing substantial information, making presentations to the DOJ and submitting written explanations of the effect of the transaction in the market place, the DOJ agreed to close its investigation without issuing a Second Request, freeing the parties to proceed.

High Tech - New Rules or More of the Same?

The FTC's newest commissioner, Thomas B. Leary, spoke to a group in Seattle suggesting that the rules do not need to change in order to apply antitrust laws and principles in the emerging high technology markets, but rather that the traditional rules can be applied to today's emerging markets. Leary expressed a strong belief in market forces and cautioned that today's innovation can be bypassed by other technologies very quickly.

Another FTC official, David A. Balto, agreed that e-commerce and the Internet do not demand new rules, but rather only the careful application of existing rules. Nevertheless, e-commerce does have unique aspects which should be weighed in applying traditional antitrust concepts. First, consumer choice has increased dramatically as people can search and buy from remote locations to which they have never before had access. However, this puts pressure on existing local competitors and may cause them to attempt to curtail pervasive electronic competition.

Standard setting and network effects also challenge the application of traditional principles. While the FTC historically has viewed private standard setting with suspicion, it recognizes that in high tech industries standards often can benefit consumers by making new products and industries possible. The FTC continues to study standard setting and to compare the procompetitive benefits and the anticompetitive effects to determine what action is in the consumer's best interest.

Firms operating in the new economy cannot assume that they are exempt from traditional rules. They are not - technology firms must be aware of retail price maintenance, price discrimination and exclusive dealing rules (among others) in order to be assured that they are operating lawfully. The absence of factually identical antitrust precedent does not mean the government will be deterred from concluding that emerging high technology companies' practices violate the law. Applying old rules to new situations is always complicated, but the FTC says it is willing to make whatever efforts are necessary to protect consumers and ensure vigorous competition in every type of market.

The DOJ appears to agree with the FTC and is applying that approach now as the *Microsoft* case makes it way through the court system, forcing the application of old rules to new technology.

Restructuring Scrutinized in Merger Contexts

Divesting overlapping assets often allows companies to proceed with a merger, gain most of the benefits of the combination, and satisfy the government that the combination will not harm competition. A recent speech by FTC Chairman Robert Pitofsky confirmed that divestitures and restructurings continue to be important to the FTC and are also subject to intense scrutiny. Pitofsky reminded companies that the purpose of divestiture is to maintain competition and to benefit consumers. Obviously, some asset sales are more likely to achieve that result than others. The emphasis should be on the competitive viability of the divested assets, rather than on simple disposal.

As previously reported, last year the FTC studied past divestitures to ascertain which preserved competition and which did not. Pitofsky said that both the Commission's increased insistence that a viable buyer be presented prior to the merger and that the buyer present a business plan, are a direct result of the study.

While Pitofsky was careful to conclude that the FTC remains interested in proposed divestitures and restructuring, he made it clear both that the merging parties (not the FTC) should make the initial proposal, and that certain proposals are more likely to win approval than others. Pitofsky carefully avoided any categorical rejection of divestiture concepts, but did offer some further guidance.

Divestitures of entire businesses are favored over those disposing of a mix of assets from various companies. Divestitures which require no continuing cooperation between buyer and seller are favored over those which have supply, licensing, or other components which require continued FTC monitoring and the new entrant's reliance on the other competitor. Divestitures in industries with a history of unsuccessful past restructuring are less likely to win approval.

Merging parties need to give serious consideration to divestiture options when the government expresses concern about a merger. Once the government has clearly identified the areas in which it believes the merger may harm competition, it will look to the parties for suggested alternative solutions. While creativity is not discouraged, Pitofsky certainly suggested a strong preference for simple solutions with little or no ongoing involvement between competitors.

FTC and DOJ Continue to Seek More Money; Merger Reform May Provide Funds

As the number of mergers and premerger filings continues to increase year after year, the FTC and the DOJ argue that their budgets and staff are inadequate. The Clinton Administration's FY2001 budget proposes to give the agencies more money, largely funded by an increase in filing fees for the largest transactions (though the filing threshold for smaller transactions also would be raised). There have been a variety of competing bills introduced in Congress seeking to make changes to the fees and the definition of reportable transactions.

Currently, the acquiring firm pays a $45,000 HSR filing fee. One current proposal would retain that fee for transactions with a value of between $35 million and $100 million. Transactions between $100 million and $200 million would trigger a $100,000 fee, and those larger than $200 million would require payment of a $200,000 fee. Other bills would raise the threshold to $50 million and specify even higher fees for the largest of transactions.

In hearings on the FTC portion of the proposed budget, Commissioner Thomas Leary endorsed the graduated fee approach which he believed would require those companies consuming more agency resources to pay higher fees. Other pending legislation has proposed an across-the-board fee increase. The debate over this issue is likely to continue and the resolution is uncertain, but the idea of revising the filing requirements and fees is gaining momentum and may soon become law.

Other antitrust reform legislation pending before Congress would give indirect purchasers the right to sue for antitrust injuries - presently the Supreme Court opinion in *Illinois Brick* prohibits such suits. In addition, this consumer-oriented legislation would increase the maximum statutory fine for antitrust violations from $10 million to $100 million.

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