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There's a New Defense in Price-Fixing Cases in California, Pass It On: California Court of Appeals Rules That Pass-On Defense Is Available to Defendants Accused of Price-Fixing

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The California Court of Appeals for the First Appellate District recently ruled in a case of first impression that defendants accused of price-fixing may assert as an affirmative defense that the plaintiffs "passed on" all of the claimed overcharges to their customers. *Clayworth v. Pfizer, Inc.*, 08 C.D.O.S. 9697 (July 25, 2008). The ruling is especially significant for companies targeted in price-fixing cases whose products are sold through intermediaries.

A Brief History of the Pass-On Defense and California Antitrust Law

A brief history of the law concerning the pass-on defense is necessary in order to place the *Clayworth* decision in context. In *Hanover Shoe v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968), a shoe manufacturer brought a claim in federal court against a manufacturer of equipment used in the shoe-making process for monopolizing the market for shoe-manufacturing equipment. The shoe manufacturer alleged that its damages consisted of the difference between the amount it paid to lease the equipment and what it would have paid to purchase the equipment if the equipment manufacturer had been willing to sell its machines rather than lease them.

The equipment manufacturer claimed that the shoe manufacturer suffered no damages because any overcharges were passed on to the plaintiff's customers. The equipment manufacturer also asserted that the shoe manufacturer would have passed on any cost savings to its customers if it were

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allowed to purchase the shoe-manufacturing equipment.

The United States Supreme Court ruled that the equipment manufacturer could not use the pass-on defense because of numerous evidentiary problems. First, establishing the amount of the overcharge passed on to the consumer would present potentially insurmountable problems. Second, the Court reasoned that it was "equally difficult" to determine what effect a company's price would have on its total sales, as well as what a company's costs per unit would be for a different volume of sales. Finally, the Court reasoned that violators of the antitrust laws "would retain the fruits of their illegality" if direct purchasers of goods such as the shoe manufacturer were not allowed to sue for overcharges passed on to indirect purchasers.

The Court stopped short of creating an absolute bar to the use of the pass-on defense. The Court recognized that there might be situations where the pass-on defense would be viable, such as where an overcharged plaintiff has a "cost-plus" contract for the resale of the goods at issue.

Nine years after *Hanover Shoe*, the United States Supreme Court decided the case of *Illinois Brick v. Illinois*, 431 U.S. 720 (1977). In *Illinois Brick*, the State of Illinois brought an action against several manufacturers and distributors of concrete block, which they sold primarily to masonry contractors. The State asserted that the concrete block manufacturers fixed the price of concrete block, and that the inflated prices of the product were eventually passed on to end users such as the State. The Court held that the rule prohibiting the use of the pass-on theory "must apply equally to plaintiffs and defendants" because "allowing offensive but not defensive use of pass-on would create a serious risk of multiple liability for defendants." As a result, only direct purchasers of goods have standing to sue for violations of the federal antitrust laws.

Following *Illinois Brick*, several states, including California, enacted "*Illinois Brick* repealer amendments" in order to give indirect purchasers standing to sue for violations of their state antitrust laws.

The Facts and Procedural History of *Clayworth*

The plaintiffs in *Clayworth* were a group of retail pharmacies that sold brand-name pharmaceuticals to third-party insurance and drug benefit plans, as well as to uninsured customers. The defendants were companies that

manufacture, market, and/or distribute brand-name pharmaceutical products throughout the United States and Canada. The plaintiffs alleged that the defendants conspired to fix the prices of pharmaceutical goods by using Canadian prices as a "floor" for the price of their products in the U.S.

The defendants sold their drugs to wholesalers at a price known as the Wholesale Acquisition Cost (WAC). The wholesalers resold the drugs to the plaintiffs using a formula that was mathematically tied to the WAC known as the Average Wholesale Price (AWP). The plaintiffs then resold the drugs to their customers at a contractually or statutorily fixed amount, which allowed plaintiffs to recoup a fixed profit in excess of their acquisition cost.

The Court's Reasoning in Allowing the Use of the Pass-On Defense

The Court of Appeals concluded that the plaintiffs suffered no damages as a result of the overcharge because the total amount of the overcharge was passed on to their customers. The defendants' act of allegedly inflating the WAC caused the AWP to rise to a level that was higher than it otherwise would have been.

The Court rejected the plaintiffs' argument that "California's strong stated public policy in favor of enforcing the antitrust laws" mandates that defendants not be permitted to use the pass-on defense in Cartwright Act cases. The Court also rejected the plaintiffs' arguments that they should be permitted to recover damages even where such recovery would constitute a windfall, and rejected the plaintiffs' contention that allowing the pass-on defense would deprive future plaintiffs of the incentive to sue for antitrust violations.

Future Implications of *Clayworth*

When will California courts allow defendants to assert the pass-on defense in the future? The Court noted that the contracts in *Clayworth* between plaintiffs and their customers were not quite "cost-plus" contracts, but they were analogous. The determination of whether the plaintiffs passed on the alleged overcharge was therefore not particularly complicated. The Court also noted that technological advancements, especially with respect to "the ease with which computers can gather and distill data," have ameliorated the proof problems that concerned the *Hanover Shoe* court in 1968.

There still may be significant difficulties in calculating the amount of the overcharge that plaintiffs passed on to their customers in certain circumstances. Contrast the facts of *Clayworth*, where finished goods were passed through various intermediaries unchanged, with the situation in *Hanover Shoe*, where the machines at issue were but one of many costs associated with the manufacture of the shoes. An economist's calculation of the pass-on might need to include several other factors, including costs for other inputs in the manufacturing process, interest rates, taxes, or retail and wholesale demand for various styles of shoes manufactured using the machines at issue. The pass-on calculation might be too speculative under such circumstances.

The *Clayworth* decision does not leave intermediaries such as the retail pharmacists at issue without a remedy where the defendants successfully employ the pass-on defense. The Court was careful to note that an intermediary may still claim damages for lost sales or delayed sales due to the fact that it was forced to charge higher prices because of the defendants' conduct. These damages were not available to the *Clayworth* plaintiffs because they admitted in their discovery responses that they solely sought damages as a result of the alleged overcharge, and did not seek damages based on their lost profits or sales.

The *Clayworth* decision is a significant victory for defendants accused of price-fixing whose products are sold through a distribution chain. It eliminates the potential for a double recovery of damages by multiple plaintiffs in the chain of distribution. If the Court had not allowed the defendants to use the pass-on defense, the potential existed for damages stemming from the alleged overcharge to be recovered at least twice – once by the plaintiffs, and again by their customers.

back to top

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David P. Nemecek Mr. Nemecek has significant experience in the field of antitrust litigation, and has litigated class actions involving claims of price fixing and monopolization. He was a member of the trial team for two of the largest antitrust cases in California and Minnesota history. He also has experience litigating cases involving the California unfair competition laws, including claims involving California Business & Professions Code

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