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California Supreme Court Holds "Pass-On" Defense Unavailable in Antitrust Suit

On July 12, 2010, in *Clayworth et al. v. Pfizer et al.*,[1] the Supreme Court of California held for the first time that suits brought by an indirect purchaser of goods under California antitrust law against participants in an alleged price-fixing conspiracy could go forward regardless of whether the claimants had passed on any overcharge to the end consumers. This ruling overturned decisions at the trial and intermediate-appellate level, bringing California law on the "pass-on" defense in line with federal law and potentially opening the door to new state-law antitrust actions. This client publication provides an overview of the decision and some of its possible implications.

Background

In *Clayworth*, a group of California pharmacies brought suit under California's Cartwright Act[2] and Unfair Competition Law (UCL)[3] against a group of pharmaceuticals manufacturers, alleging that the manufacturers had unlawfully conspired to fix prices on their products. The pharmacies alleged that the manufacturers had agreed to set artificially high prices and acted in concert to restrain reimportatation of their drugs into the United States and to restrain price competition from generic drug makers. The pharmacies further alleged that they were forced to pay more to drug wholesalers than they would have paid in a competitive market and sought treble damages, restitution, and injunctions against the manufacturers.[4]

The manufacturers denied the allegations and asserted that the pharmacies claims were barred because the pharmacies had

[1] Case No. S166435, 2010 WL 2721021 (Cal., July 12. 2010).

[2] Cal. Bus. & Prof. Code § 16700 *et seq.*

[3] Cal. Bus. & Prof. Code § 17200 *et seq.*

[4] *Clayworth* at *2.

passed on any purported overcharge to their customers and therefore that they had not suffered a compensable injury.[5] The trial court granted the manufacturers' motion for summary judgment, holding that a "pass-on" defense was available under the Cartwright Act and finding that the pharmacies had passed on all overcharges and had, therefore, sustained no damages. The trial court also found that the pass-on defense defeated the pharmacies' claims under the UCL, holding that the pharmacies lacked standing because they had not lost money or property. The Court of Appeals affirmed, holding that the pass-on defense was available and finding that the pharmacies could show no damages.[6]

Federal Law

Under federal law, it is long settled that a pass-on defense is generally not available to defendants in antitrust cases. In 1968, in *Hanover Shoe v. United Shoe Machinery Corporation*,[7] the U.S. Supreme Court held that when a buyer shows that he paid an illegally high price and shows the amount of the overcharge, "he has made out a prima facie case of injury and damage."[8] The Court explained that no matter how a buyer reacts to an overcharge, he is injured: (1) if he absorbs the overcharge cost he has excess costs, (2) if he maintains his price but takes other steps to increase his volume or decrease other costs, he might maintain his profits, but he would have made more if his purchases were at a lower price, and (3) if he passes on the overcharge, he might lose sales or, if demand remains the same, he would lose the additional profit from the higher price. Additionally, allowing the pass-on defense would require courts to consider numerous complex factors such as the impact of different prices on actual sales and would create a risk that no potential plaintiffs with injuries significant enough to warrant bringing suit would remain.[9] Accordingly, the defense is generally not permitted.

In addition to barring the defense, federal law also prohibits the offensive use of the pass-on theory – in other words, under federal law, indirect purchasers cannot bring an antitrust claim on the theory that they were overcharged due to the defendant's conduct. In 1977, in *Illinois Brick Co. v. Illinois*,[10] the U.S. Supreme Court held that indirect purchasers could not use a pass-on theory to sue for illegal overcharges. The majority in *Illinois Brick*, found that the pass-on prohibition should go both ways because (1) allowing offensive but not defensive use would create the possibility of a double recovery in cases in which both direct and indirect purchasers sued, (2) the uncertainties of tracing the passed-on charges were equally present in an offensive use, and (3) the antitrust laws would be more effectively enforced by allowing for full recovery by direct purchasers.[11]

Under federal law, then, the pharmacies (who are indirect purchasers) could not have brought their suit against Pfizer and the other pharmaceutical manufacturers, and the manufacturers could not have asserted a pass-on defense against a direct purchaser, such as a wholesaler or distributor.

[5] *Id.*

[6] *Id.* at *3.

[7] 392 U.S. 481 (1968).

[8] *Id.* at 489; *Clayworth* at *4.

[9] *Id.* at 489. 493-94; *Clayworth* at *4-5.

[10] 431 U.S. 720 (1977).

[11] *Id.* at 730-32; *Clayworth* at *13.

California Law Prior to *Clayworth*

California antitrust law, by contrast, specifically allows for suits by indirect purchasers. The California legislature, in direct response to *Illinois Brick*, passed a statute allowing suit by any injured person "regardless of whether such injured person dealt directly or indirectly with the defendant."[12] The pharmacies' suit, then, is expressly permitted under California law. The manufacturers' pass-on defense, however, had not previously been taken up by the California Supreme Court.

The *Clayworth* Decision – Cartwright Act Claims

In *Clayworth*, the California Supreme Court filled in the gap. California law authorizes the recovery of three times the "damages sustained" by anyone "injured in his or her business or property" by actions forbidden under the Cartwright Act.[13] The *Clayworth* court rejected the manufacturers' argument that this text provides for the availability of the pass-on defense and concluded that the California legislature, as it indicated through subsequent amendments to the Cartwright Act, had intended to accept the general federal bar on defensive use of the pass-on theory.

Beginning with the text of the statute itself, the court found the language to be ambiguous and also that it was "implausible" that the legislature had expressed any specific intention through those phrases with respect to the issues presented. The generic phrases in the statute could not be presumed to resolve the complex questions before the court.[14]

Finding no guidance in the text, the court analyzed the history of certain amendments to the Cartwright Act and the overarching purpose of the state antitrust statutes. First, the court looked to the legislature's response to the passage of the Hart-Scott-Rodino Act (HSR) by the U.S. Congress. HSR allowed state attorneys general to file suits for violation of the Sherman Act on behalf of injured consumers, and the court noted that HSR expressly contemplated that antitrust violators could be sued by both direct and indirect purchasers (through attorneys general) and provided a safeguard against double recoveries in a provision on damages – in other words it took *Hanover Shoe*'s bar on the pass-on defense into account. In response to HSR's passage, the California legislature incorporated it into California law, including the damages provision. The court reasoned that in so doing, the legislature approved application of *Hanover Shoe* to the California statute.[15]

Second, the court looked to the California statute noted above that provided for suits by indirect purchasers. The court found that, in passing this statute, the legislature embraced the arguments of the dissent in *Illinois Brick*, including that *Hanover Shoe* remained good law. The legislative history suggested that, rather than repudiate *Hanover Shoe*, the law allowing indirect purchaser suits was intended to be reconciled with the bar on the pass-on defense through procedural devices such as joinder and interpleader.[16]

[12] Cal. Bus. & Prof. Code § 16750.

[13] *Id.*

[14] *Clayworth* at *6-8.

[15] *Id.* at *11-12.

[16] *Id.* at *12-14.

Finally, the court found that "broader legislative policy considerations" supported denying the pass-on defense in most cases. It held that disallowing the defense would further the general intent of the California antitrust laws – that is to punish violators for the purpose of promoting free competition – and allowing "defendants universally to assert a pass-on defense, even in cases such as this that present no risk of duplicative recovery, would hamper enforcement by reducing incentives to sue and police antitrust violations" and forcing the court to conduct "minitrials" attempting to track overcharges.[17] It also rejected the manufacturers' own policy suggestion that the pharmacies were not damaged and the law should not support a windfall to them, holding that some or all of the injuries identified in *Hanover Shoe*, and discussed above, were present.[18]

In sum, the court found that California law did not support the pass-on defense in all but a few limited circumstances[19] and allowed the pharmacies' case to proceed.

The *Clayworth* Decision – Unfair Competition Law Claims

The court also considered the pharmacies' related claims under the UCL. As noted above, the lower courts had held that the pharmacies lacked standing to bring a claim. The court reversed, finding that the pharmacies did, indeed, have standing and holding that they were entitled to seek injunctive relief.[20]

Since a 2004 amendment, standing under the UCL is limited to persons who have "suffered injury in fact and [have] lost money or property" as a result of unfair competition.[21] The court found that in passing the amendment, the voters "had preserved standing for those who had had business dealings with a defendant and had lost money or property as a result of the defendant's unfair business practices."[22] The court held that, under that standard, the pharmacies had established standing, as they had had indirect business dealings with the manufacturers, had lost money, and the loss was the result of an unfair business practice.[23] In doing so, the court again rejected the manufacturers' argument that the pharmacies had suffered no losses, holding that "this argument conflates the issue of standing with the issue of the remedies to which a party may be entitled. That a party may ultimately be unable to prove a right to damages . . . does not demonstrate that it lacks standing to argue for its entitlement to them."[24] The pharmacies had standing, and therefore could seek an injunction.

[17] *Id.* at *15.

[18] *Id.* at *15-16.

[19] The court held that exceptions to this general preclusion of the pass-on defense included cases involving cost-plus contracts and cases in which consideration of such a theory was necessary to avoid duplication of recovery.

[20] *Id.* at *18-20.

[21] Cal. Bus. & Prof. Code § 17204; *Clayworth* at *18.

[22] *Clayworth* at *18.

[23] *Id.*

[24] *Id.* at 19.

Conclusions

Following *Clayworth* the number and types of antitrust suits in California are likely to increase. Although it can be expected that the courts or the legislature will find a means of avoiding duplicative damage recoveries, forum shoppers – especially indirect purchasers – may well see the California courts as providing an opportunity for recovery. Where such plaintiffs previously would have had to rely on convoluted difficult-to-prove theories, they possibly have a clearer path to recovery.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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James Donato
San Francisco
+1.415.616.1143
james.donato@shearman.com

Heather Lamberg Kafele
Washington, D.C.
+1.202.508.8097
hkafele@shearman.com

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