Section 3: Business

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Under U.S. Supreme Court precedent, the sole test for determining whether a claimed “process” is patent-eligible under 35 U.S.C. § 101 is the machine-or-transformation test, under which the process either must be tied to a particular machine or apparatus, or must transform a particular article into a different state or thing that is central to the purpose of claimed process.

**Questions Presented:** (1) Did Federal Circuit err by holding that “process” must be tied to a particular machine or apparatus, or transform a particular article into a different state or thing (“machine-or-transformation” test), to be eligible for patenting under 35 U.S.C. § 101, despite this court’s precedent declining to limit broad statutory grant of patent eligibility for “any” new and useful process beyond excluding patents for “laws of nature, physical phenomena, and abstract ideas”? (2) Does Federal Circuit’s “machine-or-transformation” test for patent eligibility, which effectively forecloses meaningful patent protection to many business methods, contradict clear congressional intent that patents protect “method[s] of doing or conducting business,” 35 U.S.C. § 273?

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**IN RE Bernard L. BILSKI and Rand A. Warsaw**

United States Court of Appeals for the Federal Circuit

Decided October 20, 2008

[Excerpt: some footnotes and citations omitted]

**OPINION** MICHEL, Chief Judge.

Bernard L. Bilski and Rand A. Warsaw (collectively, “Applicants”) appeal from the final decision of the Board of Patent Appeals and Interferences (“Board”) sustaining the rejection of all eleven claims of their U.S. Patent Application Serial No. 08/833,892 (“’892 application”). Specifically, Applicants argue that the examiner erroneously rejected the claims as not directed to patent-eligible subject matter under 35 U.S.C. § 101, and that the Board erred in upholding that rejection. The appeal was originally argued before a panel of the court on October 1, 2007. Prior to disposition by the panel, however, we sua sponte ordered en banc review. Oral argument before the en banc court was held on May 8, 2008. We affirm the decision of the Board because we conclude that Applicants’ claims are not directed to patent-eligible subject matter, and in doing so, we clarify the standards applicable in determining whether a claimed method constitutes a statutory “process” under § 101.

I.

Applicants filed their patent application on April 10, 1997. The application contains
eleven claims, which Applicants argue together here.

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In essence, [Claim 1] is for a method of hedging risk in the field of commodities trading. For example, coal power plants (i.e., the “consumers”) purchase coal to produce electricity and are averse to the risk of a spike in demand for coal since such a spike would increase the price and their costs. Conversely, coal mining companies (i.e., the “market participants”) are averse to the risk of a sudden drop in demand for coal since such a drop would reduce their sales and depress prices. The claimed method envisions an intermediary, the “commodity provider,” that sells coal to the power plants at a fixed price, thus isolating the power plants from the possibility of a spike in demand increasing the price of coal above the fixed price. The same provider buys coal from mining companies at a second fixed price, thereby isolating the mining companies from the possibility that a drop in demand would lower prices below that fixed price. And the provider has thus hedged its risk; if demand and prices skyrocket, it has sold coal at a disadvantaged price but has bought coal at an advantageous price, and vice versa if demand and prices fall. Importantly, however, the claim is not limited to transactions involving actual commodities, and the application discloses that the recited transactions may simply involve options, i.e., rights to purchase or sell the commodity at a particular price within a particular timeframe.

The examiner ultimately rejected claims 1-11 under 35 U.S.C. § 101, stating: “[r]egarding . . . claims 1-11, the invention is not implemented on a specific apparatus and merely manipulates [an] abstract idea and solves a purely mathematical problem without any limitation to a practical application, therefore, the invention is not directed to the technological arts.” See Board Decision, slip op. at 3, 2006 Pat. App. LEXIS 51. The examiner noted that Applicants had admitted their claims are not limited to operation on a computer, and he concluded that they were not limited by any specific apparatus.

On appeal, the Board held that the examiner erred to the extent he relied on a “technological arts” test because the case law does not support such a test. Further, the Board held that the requirement of a specific apparatus was also erroneous because a claim that does not recite a specific apparatus may still be directed to patent-eligible subject matter “if there is a transformation of physical subject matter from one state to another.” . . .

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II.

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A.

As this appeal turns on whether Applicants’ invention as claimed meets the requirements set forth in § 101, we begin with the words of the statute:

Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.

35 U.S.C. §101. The statute thus recites four categories of patent-eligible subject matter:
processes, machines, manufactures, and compositions of matter. It is undisputed that Applicants’ claims are not directed to a machine, manufacture, or composition of matter. Thus, the issue before us involves what the term “process” in § 101 means, and how to determine whether a given claim—and Applicants’ claim 1 in particular—is a “new and useful process.”

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The true issue before us then is whether Applicants are seeking to claim a fundamental principle (such as an abstract idea) or a mental process. And the underlying legal question thus presented is what test or set of criteria governs the determination by the Patent and Trademark Office (“PTO”) or courts as to whether a claim to a process is patentable under § 101 or, conversely, is drawn to unpatentable subject matter because it claims only a fundamental principle.

The Supreme Court last addressed this issue in 1981 in Diehr, which concerned a patent application seeking to claim a process for producing cured synthetic rubber products. The Court declared that while a claim drawn to a fundamental principle is unpatentable, “an application of a law of nature or mathematical formula to a known structure or process may well be deserving of patent protection.” Id. (emphasis in original).

The Court in Diehr thus drew a distinction between those claims that “seek to pre-empt the use of” a fundamental principle, on the one hand, and claims that seek only to foreclose others from using a particular “application” of that fundamental principle, on the other. 450 U.S. at 187. Patents, by definition, grant the power to exclude others from practicing that which the patent claims. Diehr can be understood to suggest that whether a claim is drawn only to a fundamental principle is essentially an inquiry into the scope of that exclusion; i.e., whether the effect of allowing the claim would be to allow the patentee to pre-empt substantially all uses of that fundamental principle. If so, the claim is not drawn to patent-eligible subject matter.

In Diehr, the Court held that . . . [a] claimed process is surely patent-eligible under § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing. A claimed process involving a fundamental principle that uses a particular machine or apparatus would not pre-empt uses of the principle that do not also use the specified machine or apparatus in the manner claimed. And a claimed process that transforms a particular article to a specified different state or thing by applying a fundamental principle would not pre-empt the use of the principle to transform any other article, to transform the same article but in a manner not covered by the claim, or to do anything other than transform the specified article.

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B.

Applicants and several amici have argued that the Supreme Court did not intend the machine-or-transformation test to be the sole test governing § 101 analyses.

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. . . [W]e agree that future developments in technology and the sciences may present difficult challenges to the machine-or-transformation test, just as the widespread use of computers and the advent of the
Internet has begun to challenge it in the past decade. Thus, we recognize that the Supreme Court may ultimately decide to alter or perhaps even set aside this test to accommodate emerging technologies. And we certainly do not rule out the possibility that this court may in the future refine or augment the test or how it is applied. At present, however, and certainly for the present case, we see no need for such a departure and reaffirm that the machine-or-transformation test, properly applied, is the governing test for determining patent eligibility of a process under § 101.

C.

As a corollary, the Diehr Court also held that mere field-of-use limitations are generally insufficient to render an otherwise ineligible process claim patent-eligible. We recognize that tension may be seen between this consideration and the Court’s overall goal of preventing the wholesale pre-emption of fundamental principles. Why not permit patentees to avoid overbroad pre-emption by limiting claim scope to particular fields of use? This tension is resolved, however, by recalling the purpose behind the Supreme Court’s discussion of pre-emption, namely that pre-emption is merely an indication that a claim seeks to cover a fundamental principle itself rather than only a specific application of that principle. . . .

D.

We discern two other important aspects of the Supreme Court’s § 101 jurisprudence. First, the Court has held that whether a claimed process is novel or non-obvious is irrelevant to the § 101 analysis. . . .

Second, the Court has made clear that it is inappropriate to determine the patent-eligibility of a claim as a whole based on whether selected limitations constitute patent-eligible subject matter. After all, even though a fundamental principle itself is not patent-eligible, processes incorporating a fundamental principle may be patent-eligible. Thus, it is irrelevant that any individual step or limitation of such processes by itself would be unpatentable under § 101.

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IV

We now turn to the facts of this case. As outlined above, the operative question before this court is whether Applicants’ claim 1 satisfies the transformation branch of the machine-or-transformation test.

We hold that the Applicants’ process as claimed does not transform any article to a different state or thing. Purported transformations or manipulations simply of public or private legal obligations or relationships, business risks, or other such abstractions cannot meet the test because they are not physical objects or substances, and they are not representative of physical objects or substances. Applicants’ process at most incorporates only such ineligible transformations. As discussed earlier, the process as claimed encompasses the exchange of only options, which are simply legal rights to purchase some commodity at a given price in a given time period. The claim only refers to “transactions” involving the exchange of these legal rights at a “fixed rate corresponding to a risk position.” See ’892 application cl.1. Thus, claim 1 does not involve the transformation of any physical object or substance, or an electronic signal
representative of any physical object or substance. Given its admitted failure to meet the machine implementation part of the test as well, the claim entirely fails the machine-or-transformation test and is not drawn to patent-eligible subject matter.

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... [W]hile we agree with the PTO that the machine-or-transformation test is the correct test to apply in determining whether a process claim is patent-eligible under § 101, we do not agree, as discussed earlier, that this amounts to a “technological arts” test. Neither the PTO nor the courts may pay short shrift to the machine-or-transformation test by using purported equivalents or shortcuts such as a “technological arts” requirement. Rather, the machine-or-transformation test is the only applicable test and must be applied, in light of the guidance provided by the Supreme Court and this court, when evaluating the patent-eligibility of process claims. When we do so here, however, we must conclude, as the PTO did, that Applicants’ claim fails the test.

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CONCLUSION

Because the applicable test to determine whether a claim is drawn to a patent-eligible process under § 101 is the machine-or-transformation test set forth by the Supreme Court and clarified herein, and Applicants’ claim here plainly fails that test, the decision of the Board is

AFFIRMED.

CONCUR BY: DYK
CONCUR
DYK, Circuit Judge, with whom LINN, Circuit Judge, joins, concurring.

While I fully join the majority opinion, I write separately to respond to the claim in the two dissents that the majority’s opinion is not grounded in the statute, but rather “usurps the legislative role.” In fact, the unpatentability of processes not involving manufactures, machines, or compositions of matter has been firmly embedded in the statute since the time of the Patent Act of 1793, ch. 11, 1 Stat. 318 (1793). It is our dissenting colleagues who would legislate by expanding patentable subject matter far beyond what is allowed by the statute.

I

[Judge Dyk examines the Patent Act, noting that the Acts of 1790 and 1793 were heavily influenced by the English System. The practice was essentially the same, with limited differences. Each of the patentable subject matter categories comes from the English Statute of Monopolies or later interpretations. These categories deal with inventions and the creation of processes that improve manufacture of goods]

II

[Judge Dyk examines the types of processes that were patentable at the time of the 1793 Act. Concluding that Bilski’s method would not be patentable. Patentable subject matter was limited to manufacturing, and organization of human activity does not fall into that category. In fact, the only processes that were patentable were those that were processes for creating other patentable things.]

B

The dissenters here, by implication at least, appear to assume that this consistent English practice should somehow be ignored in interpreting the current statute because of
technological change. There are several responses to this.

The first of these is that the Supreme Court has made clear that when Congress intends to codify existing law, as was the case with the 1793 statute, the law must be interpreted in light of the practice at the time of codification.

Second, the Supreme Court language upon which the dissents rely offers no warrant for rewriting the 1793 Act. To be sure, Congress intended the courts to have some latitude in interpreting § 101 to cover emerging technologies, Chakrabarty, 447 U.S. at 316, and the categorical terms chosen are sufficiently broad to encompass a wide range of new technologies. But there is no evidence that Congress intended to confer upon the courts latitude to extend the categories of patentable subject matter in a significant way.

Third, we are not dealing here with a type of subject matter unknown in 1793. In the hundreds of patents in Woodcroft’s exhaustive list of English patents granted from 1612 to 1793, there appears to be only a single patent akin to the type of method Bilski seeks to claim. That sole exception was a patent granted to John Knox in 1778 on a “Plan for assurances on lives of persons from 10 to 80 years of age.” Later commentators have viewed this single patent as clearly contrary to the Statute of Monopolies.

In short, the need to accommodate technological change in no way suggests that the judiciary is charged with rewriting the statute to include methods for organizing human activity that do not involve manufactures, machines, or compositions of matter.

Since the 1793 statute was reenacted in 1952, it is finally important also to inquire whether between 1793 and 1952 the U.S. Patent Office and the courts in this country had departed from the English practice and allowed patents such as those sought by Bilski. In fact, the U.S. Patent Office operating under the 1793 Act hewed closely to the original understanding of the statute. As in the English practice of the time, there is no evidence that patents were granted under the 1793 Act on methods of organizing human activity not involving manufactures, machines or the creation of compositions of matter.

Likewise, Supreme Court decisions before the 1952 Patent Act assumed that the only processes that were patentable were those involving other types of patentable subject matter. In later cases the Supreme Court has recognized that these cases set forth the standard for process patents in the pre-1952 period.

Finally, nothing in the legislative history of the 1952 Act suggests that Congress intended to enlarge the category of patentable subject matter to include patents such as the method Bilski attempts to claim. As discussed above, the only change made by the 1952 Act was in replacing the word “art” with the word “process.” The Supreme Court has already concluded that this change did not alter the substantive understanding of the statute.
In short, the history of § 101 fully supports the majority's holding that Bilski's claim does not recite patentable subject matter. Our decision does not reflect "legislative" work, but rather careful and respectful adherence to the Congressional purpose.

CONCUR

DISSENT BY: NEWMAN; MAYER; RADER

NEWMAN, Circuit Judge, dissenting.

The court today acts en banc to impose a new and far-reaching restriction on the kinds of inventions that are eligible to participate in the patent system. The court achieves this result by redefining the word "process" in the patent statute, to exclude all processes that do not transform physical matter or that are not performed by machines. The court thus excludes many of the kinds of inventions that apply today's electronic and photonic technologies, as well as other processes that handle data and information in novel ways. Such processes have long been patent eligible, and contribute to the vigor and variety of today's Information Age.

This exclusion of process inventions is contrary to statute, contrary to precedent, and a negation of the constitutional mandate. Its impact on the future, as well as on the thousands of patents already granted, is unknown. This exclusion is imposed at the threshold, before it is determined whether the excluded process is new, non-obvious, enabled, described, particularly claimed, etc.; that is, before the new process is examined for patentability. For example, we do not know whether the Bilski process would be found patentable under the statutory criteria, for they were never applied.

The innovations of the "knowledge economy"—of "digital prosperity"—have been dominant contributors to today's economic growth and societal change. Revision of the commercial structure affecting major aspects of today's industry should be approached with care, for there has been significant reliance on the law as it has existed, as many amici curiae pointed out. Indeed, the full reach of today's change of law is not clear, and the majority opinion states that many existing situations may require reassessment under the new criteria.

Uncertainty is the enemy of innovation. These new uncertainties not only diminish the incentives available to new enterprise, but disrupt the settled expectations of those who relied on the law as it existed. I respectfully dissent.

DISCUSSION

***

From the first United States patent act in 1790, the subject matter of the "useful arts" has been stated broadly, lest advance restraints inhibit the unknown future. The nature of patent-eligible subject matter has received judicial attention over the years, as new issues arose with advances in science and technology. The Supreme Court has consistently confirmed the constitutional and legislative purpose of providing a broadly applicable incentive to commerce and creativity, through this system of limited exclusivity. Concurrently, the Court early explained the limits of patentable subject matter, in that "fundamental truths" were not intended to be included in a system of exclusive rights, for they are the general foundations of knowledge. Thus laws of nature, natural phenomena, and abstract ideas are not subject to patenting. Several rulings of the Court have reviewed patent
eligibility in light of these fundamentals. However, the Court explicitly negated today’s restrictions. My colleagues in the majority are mistaken in finding that decisions of the Court require the per se limits to patent eligibility that the Federal Circuit today imposes. The patent statute and the Court’s decisions neither establish nor support the exclusionary criteria now adopted.

[The dissenting opinion reviews Supreme Court decision making to reach the conclusion that Court decisions] cannot be held now to require exclusion, from the Section 101 definition of “process,” of all processes that deal with data and information, whose only machinery is electrons, photons, or waves, or whose product is not a transformed physical substance.

The English Statute of Monopolies and English common law do not limit “process” in Section 101

I comment on this aspect in view of the proposal in the concurring opinion that this court’s new two-prong test for Section 101 process inventions was implicit in United States law starting with the Act of 1790, because of Congress’s knowledge of and importation of English common law and the English Statute of Monopolies of 1623. The full history of patent law in England is too ambitious to be achieved within the confines of Bilski’s appeal, and the concurring opinion’s selective treatment of this history may propagate misunderstanding.

The concurrence places primary reliance on the Statute of Monopolies, which was enacted in response to the monarchy’s grant of monopolies “to court favorites in goods or businesses which had long before been enjoyed by the public.” Graham v. John Deere Co., 383 U.S. 1, 5 (1966). The Statute of Monopolies outlawed these “odious monopolies” or favors of the Crown, but, contrary to the concurring opinion, the Statute had nothing whatever to do with narrowing or eliminating categories of inventive subject matter eligible for a British patent.

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. . . [I]n the United States the patent right has never been predicated upon importation, and has never been limited to “manufactures.” The differences between the American and English patent law at this nation’s founding were marked, and English judicial decisions interpreting the English statute are of limited use in interpreting the United States statute. In all events, no English decision supports this court’s new restrictive definition of “process.”

***

The Section 101 interpretation that is now uprooted has the authority of years of reliance, and ought not be disturbed absent the most compelling reasons. “Considerations of stare decisis have special force in the area of statutory interpretation, for here, unlike in the context of constitutional interpretation, the legislative power is implicated, and Congress remains free to alter what [the courts] have done.” Shepard v. United States, 544 U.S. 13, 23. Where, as here, Congress has not acted to modify the statute in the many years since Diehr and the decisions of this court, the force of stare decisis is even stronger.

Adherence to settled law, resulting in settled expectations, is of particular importance “in cases involving property and contract rights, where reliance interests are involved.” Payne v. Tennessee, 501 U.S. 808, 828. This
rationale is given no weight by my colleagues, as this court gratuitously disrupts decades of law underlying our own rulings. The only announced support for today’s change appears to be the strained new reading of Supreme Court quotations. But this court has previously read these decades old opinions differently, without objection by either Congress or the Court. My colleagues do not state a reason for their change of heart.

It is the legislature’s role to change the law if the public interest so requires. In *Chakrabarty* the Court stated: “The choice we are urged to make is a matter of high policy for resolution within the legislative process after the kind of investigation, examination, and study that legislative bodies can provide and courts cannot.” 447 U.S. at 317.

***

*The Bilski invention has not been examined for patentability*

To be patentable, Bilski’s invention must be novel and non-obvious, and the specification and claims must meet the requirements of enablement, description, specificity, best mode, etc. I don’t know whether Bilski can meet these requirements—but neither does this court, for the claims have not been examined for patentability, and no rejections apart from Section 101 are included in this appeal.

Instead, the court states the “true issue before us” is “whether Applicants are seeking to claim a fundamental principle (such as an abstract idea) or mental process,” maj. op. at 7, and answers “yes.” With respect, that is the wrong question, and the wrong answer. Bilski’s patent application describes his process of analyzing the effects of supply and demand on commodity prices and the use of a coupled transaction strategy to hedge against these risks; this is not a fundamental principle or an abstract idea; it is not a mental process or a law of nature. It is a “process,” set out in successive steps, for obtaining and analyzing information and carrying out a series of commercial transactions for the purpose of “managing the consumption risk costs of a commodity sold by a commodity provider at a fixed price.” Claim 1, preamble.

***

Several amici curiae referred to the difficulties that the PTO has reported in examining patents in areas where the practice has been to preserve secrecy, for published prior art is sparse. The Federal Trade Commission recognized that the problem of “questionable” patents stems mostly from “the difficulty patent examiners can have in considering all the relevant prior art in the field and staying informed about the rapid advance of computer science.” FTC, To Promote Innovation: The Proper Balance of Competition & Patent Law and Policy at ch. 3, pp. 44 (Oct. 2003). However, this problem seems to be remedied, for the PTO reported in 2007 that for Class 705, “[t]he cases the examiners are now working on have noticeably narrower claims” than the cases filed in or before FY 2000. PTO Report at 9. The PTO reports that its search fields have been enlarged, staff added, and supervision augmented. If this court’s purpose now is to improve the quality of issued patents by eliminating access to patenting for large classes of past, present, and future inventions, the remedy would appear to be excessive.

A straightforward, efficient, and ultimately fair approach to the evaluation of “new and
useful” processes—quoting Section 101—is to recognize that a process invention that is not clearly a “fundamental truth, law of nature, or abstract idea” is eligible for examination for patentability. I do not suggest that basic scientific discoveries are a proper subject matter of patents (the Court in Chakrabarty mentioned $E=mc^2$ and the law of gravity), and I do not attempt an all-purpose definition of the boundary between scientific theory and technological application. But it is rare indeed that a question arises at the boundary of basic science; more usual is the situation illustrated by Samuel Morse’s telegraph, in which the Court simply held that Morse’s general claim was “too broad,” exceeding the scope of his practical application.

Bilski’s process for determining risk in commodity transactions does not become an abstraction because it is broadly claimed in his first claim. It may be claimed so broadly that it reads on the prior art, but it is neither a fundamental truth nor an abstraction. Bilski’s ten other claims contain further details and limitations, removing them farther from abstraction. Although claim 1 may have been deemed “representative” with respect to Section 101, the differences among the claims may be significant with respect to Sections 102, 103, and 112. Bilski’s application, now pending for eleven years, has yet to be examined for patentability.

CONCLUSION

In sum, the text of Section 101, its statutory history, its interpretation by the Supreme Court, and its application by the courts, contravenes this court’s redefinition of the statutory term “process.” The court’s decision affects present and future rights and incentives, and usurps the legislative role. The judicial role is to support stability and predictability in the law, with fidelity to statute and precedent, and respect for the principles of stare decisis.

Patents provide an incentive to invest in and work in new directions. In United States v. Line Material Co., 333 U.S. 287, 332 (1948), Justice Burton, joined by Chief Justice Vinson and Justice Frankfurter, remarked that “the frontiers of science have expanded until civilization now depends largely upon discoveries on those frontiers to meet the infinite needs of the future. The United States, thus far, has taken a leading part in making those discoveries and in putting them to use.” This remains true today. It is antithetical to this incentive to restrict eligibility for patenting to what has been done in the past, and to foreclose what might be done in the future.

DISSENT

MAYER, Circuit Judge, dissenting.

The en banc order in this case asked: “Whether it is appropriate to reconsider State Street Bank & Trust Co. v. Signature Financial Group, Inc., 149 F.3d 1368 (Fed. Cir. 1998), and AT&T Corp. v. Excel Communications, Inc., 172 F.3d 1352 (Fed. Cir. 1999), in this case and, if so, whether those cases should be overruled in any respect?” I would answer that question with an emphatic “yes.” The patent system is intended to protect and promote advances in science and technology, not ideas about how to structure commercial transactions. Claim 1 of the application of Bernard L. Bilski and Rand A. Warsaw (“Bilski”) is not eligible for patent protection because it is directed to a method of conducting business. Affording patent protection to business methods lacks constitutional and statutory support, serves to hinder rather than promote innovation and usurps that which rightfully belongs in the
public domain. State Street and AT&T should be overruled.

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II.

Business method patents have been justified, in significant measure, by a misapprehension of the legislative history of the 1952 Patent Act. In particular, proponents of such patents have asserted that the Act’s legislative history states that Congress intended statutory subject matter to “include anything under the sun that is made by man.” AT&T, 172 F.3d at 1355 (Fed. Cir. 1999) (citations and internal quotation marks omitted). Read in context, however, the legislative history says no such thing. The full statement from the committee report reads: “A person may have ‘invented’ a machine or a manufacture, which may include anything under the sun that is made by man, but it is not necessarily patentable under section 101 unless the conditions of the title are fulfilled.” S. Rep. No. 1979, 82d Cong., 2d Sess. 5 (1952) (emphasis added); H.R. Rep. No. 1923, 82d Cong., 2d Sess. 6 (1952) (emphasis added).

This statement does not support the contention that Congress intended “anything under the sun” to be patentable. To the contrary, the language supports the opposite view: a person may have “invented” anything under the sun, but it is “not necessarily patentable” unless the statutory requirements for patentability have been satisfied. Thus, the legislative history offsets to support business method patents undercuts, rather than supports, the notion that Congress intended to extend the scope of section 101 to encompass such methods. Moreover, the cited legislative history is not discussing process claims at all. The quoted language is discussing “machines” and “manufactures;” it is therefore surprising that it has been thought a fit basis for allowing patents on business processes.

III.

The Constitution does not grant Congress unfettered authority to issue patents. Instead, the patent power is a “qualified authority . . [which] is limited to the promotion of advances in the ‘useful arts.’” Graham, 383 U.S. at 5. Therefore, by mandating that patents advance the useful arts, “[t]he Constitution explicitly limited patentability to . . . ‘the process today called technological innovation.’” Comiskey, 499 F.3d at 1375.

Before State Street led us down the wrong path, this court had rightly concluded that patents were designed to protect technological innovations, not ideas about the best way to run a business. We had thus rejected as unpatentable a method for coordinating firefighting efforts, Patton, 127 F.2d at 326-27, a method for deciding how salesmen should best handle customers, In re Maucorps, 609 F.2d 481 (CCPA 1979), and a computerized method for aiding a neurologist in diagnosing patients, In re Meyer, 688 F.2d 789 (CCPA 1982). We stated that patentable processes must “be in the technological arts so as to be in consonance with the Constitutional purpose to promote the progress of ‘useful arts.’” In re Musgrave, 431 F.2d 882, 893, 57 C.C.P.A. 1352 (CCPA 1970) (emphasis added).

Business method patents do not promote the “useful arts” because they are not directed to any technological or scientific innovation. Although business method applications may use technology—such as computers—to accomplish desired results, the innovative aspect of the claimed method is an
entrepreneurial rather than a technological one. Thus, although Bilski’s claimed hedging method could theoretically be implemented on a computer, that alone does not render it patentable. Where a claimed business method simply uses a known machine to do what it was designed to do, such as using a computer to gather data or perform calculations, use of that machine will not bring otherwise unpatentable subject matter within the ambit of section 101.

Although the Supreme Court has not directly addressed the patentability of business methods, several of its decisions implicitly tether patentability to technological innovation. Indeed, the Supreme Court has repeatedly emphasized that what renders subject matter patentable is “the application of the law of nature to a new and useful end.” Funk Bros. Seed Co. v. Kalo Inoculant Co., 333 U.S. 127, 130 (1948). Applying laws of nature to new and useful ends is nothing other than “technology.” As the Supreme Court has made clear, “the act of invention ... consists neither in finding out the laws of nature, nor in fruitful research as to the operation of natural laws, but in discovering how those laws may be utilized or applied for some beneficial purpose, by a process, a device or a machine.” United States v. Dubilier Condenser Corp., 289 U.S. 178, 188.

Methods of doing business do not apply “the law of nature to a new and useful end.” Because the innovative aspect of such methods is an entrepreneurial rather than a technological one, they should be deemed ineligible for patent protection. “[T]he primary purpose of our patent laws is not the creation of private fortunes for the owners of patents but is ‘to promote the progress of science and useful arts.’” Motion Picture Patents Co. v. Universal Film Mfg. Co., 243 U.S. 502, 511 (1917). Although business method patents may do much to enrich their owners, they do little to promote scientific research and technological innovation.

IV.

State Street has launched a legal tsunami, inundating the patent office with applications seeking protection for common business practices. Applications for Class 705 (business method) patents increased from fewer than 1,000 applications in 1997 to more than 11,000 applications in 2007.

Patents granted in the wake of State Street have ranged from the somewhat ridiculous to the truly absurd. There has even been a patent issued on a method for obtaining a patent. Not surprisingly, State Street and its progeny have generated a thundering chorus of criticism.

There are a host of difficulties associated with allowing patents to issue on methods of conducting business. Not only do such patents tend to impede rather than promote innovation, they are frequently of poor quality. Most fundamentally, they raise significant First Amendment concerns by imposing broad restrictions on speech and the free flow of ideas.

A.

* * *

B.

“[S]ometimes too much patent protection can impede rather than ‘promote the Progress of Science and useful Arts,’ the constitutional objective of patent and copyright protection.” Lab. Corp. of Am. Holdings v. Metabolite Labs., Inc., 548 U.S. 124, 126 (2006). This is particularly true in
the context of patents on methods of conducting business. Instead of providing incentives to competitors to develop improved business techniques, business method patents remove building blocks of commercial innovation from the public domain. Dreyfuss, supra at 275-77. Because they restrict competitors from using and improving upon patented business methods, such patents stifle innovation. When “we grant rights to exclude unnecessarily, we ... limit competition with no quid pro quo. Retarding competition retards further development.” Pollack, supra at 76. “Think how the airline industry might now be structured if the first company to offer frequent flyer miles had enjoyed the sole right to award them or how differently mergers and acquisitions would be financed ... if the use of junk bonds had been protected by a patent.” Dreyfuss, supra at 264. By affording patent protection to business practices, “the government distorts the operation of the free market system and reduces the gains from the operation of the market.” Sfekas, supra at 214.

It is often consumers who suffer when business methods are patented. Patented products are more expensive because licensing fees are often passed on to consumers. Further, as a general matter, “quantity and quality [of patented products] are less than they would be in a competitive market.” Dreyfuss, supra at 275.

Patenting business methods makes American companies less competitive in the global marketplace. American companies can now obtain exclusionary rights on methods of conducting business, but their counterparts in Europe and Japan generally cannot. Producing products in the United States becomes more expensive because American companies, unlike their overseas counterparts, must incur licensing fees in order to use patented business methods.

* * *

V.

The majority’s proposed “machine-or-transformation test” for patentability will do little to stem the growth of patents on non-technological methods and ideas. Quite simply, in the context of business method patent applications, the majority’s proposed standard can be too easily circumvented. Through clever draftsmanship, nearly every process claim can be rewritten to include a physical transformation. Bilski, for example, could simply add a requirement that a commodity consumer install a meter to record commodity consumption. He could then argue that installation of this meter was a “physical transformation,” sufficient to satisfy the majority’s proposed patentability test.

Even as written, Bilski’s claim arguably involves a physical transformation. Prior to utilizing Bilski’s method, commodity providers and commodity consumers are not involved in transactions to buy and sell a commodity at a fixed rate. By using Bilski’s claimed method, however, providers and consumers enter into a series of transactions allowing them to buy and sell a particular commodity at a particular price. Entering into a transaction is a physical process: telephone calls are made, meetings are held, and market participants must physically execute contracts. Market participants go from a state of not being in a commodity transaction to a state of being in such a transaction. The majority, however, fails to explain how this sort of physical transformation is insufficient to satisfy its proposed patent eligibility standard.
We took this case en banc in a long-overdue effort to resolve primal questions on the metes and bounds of statutory subject matter. The patent system has run amok, and the USPTO, as well as the larger patent community, has actively sought guidance from this court in making sense of our section 101 jurisprudence. The majority, however, fails to enlighten three of the thorniest issues in the patentability thicket: (1) the continued viability of business method patents, (2) what constitutes sufficient physical transformation or machine-implementation to render a process patentable, and (3) the extent to which computer software and computer-implemented processes constitute statutory subject matter. The majority’s “measured approach” to the section 101 analysis, see ante at 25, will do little to restore public confidence in the patent system or stem the growth of patents on business methods and other non-technological ideas.

VI.

Where the advance over the prior art on which the applicant relies to make his invention patentable is an advance in a field of endeavor such as law (like the arbitration method in Comiskey), business (like the method claimed by Bilski) or other liberal—as opposed to technological—arts, the application falls outside the ambit of patentable subject matter. The time is ripe to repudiate State Street and to recalibrate the standards for patent eligibility, thereby ensuring that the patent system can fulfill its constitutional mandate to protect and promote truly useful innovations in science and technology. I dissent from the majority’s failure to do so.

***

DISSENT
RADE, Circuit Judge dissenting.

This court labors for page after page, paragraph after paragraph, explanation after explanation to say what could have been said in a single sentence: “Because Bilski claims merely an abstract idea, this court affirms the Board’s rejection.” If the only problem of this vast judicial tome were its circuitous path, I would not dissent, but this venture also disrupts settled and wise principles of law.

Much of the court’s difficulty lies in its reliance on dicta taken out of context from numerous Supreme Court opinions dealing with the technology of the past. In other words, as innovators seek the path to the next techno-revolution, this court ties our patent system to dicta from an industrial age decades removed from the bleeding edge. A direct reading of the Supreme Court’s principles and cases on patent eligibility would yield the one-sentence resolution suggested above. Because this court, however, links patent eligibility to the age of iron and steel at a time of subatomic particles and terabytes, I must respectfully dissent.

I

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II

With all of its legal sophistry, the court’s new test for eligibility today does not answer the most fundamental question of all: why would the expansive language of section 101 preclude protection of innovation simply because it is not transformational or properly linked to a
machine (whatever that means)? Stated even more simply, why should some categories of invention deserve no protection? This court, which reads the fine print of Supreme Court decisions from the Industrial Age with admirable precision, misses the real import of those decisions. The Supreme Court has answered the fundamental question above many times. The Supreme Court has counseled that the only limits on eligibility are inventions that embrace natural laws, natural phenomena, and abstract ideas. In Diehr, the Supreme Court’s last pronouncement on eligibility for “processes,” the Court said directly that its only exclusions from the statutory language are these three common law exclusions: “Our recent holdings . . . stand for no more than these long-established principles.” Id. at 185.

* * *

IV

... What constitutes “extra-solution activity?” If a process may meet eligibility muster as a “machine,” why does the Act “require” a machine link for a “process” to show eligibility? Does the rule against redundancy itself suggest an inadequacy in this complex spider web of tests supposedly “required” by the language of section 101?

One final point, reading section 101 as it is written will not permit a flurry of frivolous and useless inventions. Even beyond the exclusion for abstractness, the final clause of section 101—“subject to the conditions and requirements of this title”—ensures that a claimed invention must still satisfy the “conditions and requirements” set forth in the remainder title 35. Id. These statutory conditions and requirements better serve the function of screening out unpatentable inventions than some vague “transformation” or “proper machine link” test.

In simple terms, the statute does not mention “transformations” or any of the other Industrial Age descriptions of subject matter categories that this court endows with inordinate importance today. The Act has not empowered the courts to impose limitations on patent eligible subject matter beyond the broad and ordinary meaning of the terms process, machine, manufacture, and composition of matter. It has instead preserved the promise of patent protection for still unknown fields of invention.

Innovation has moved beyond the brick and mortar world. Even this court’s test, with its caveats and winding explanations seems to recognize this. Today’s software transforms our lives without physical anchors. This court’s test not only risks hobbling these advances, but precluding patent protection for tomorrow’s technologies. “We still do not know one thousandth of one percent of what nature has revealed to us.” Attributed to Albert Einstein. If this court has its way, the Patent Act may not incentivize, but complicate, our search for the vast secrets of nature. When all else fails, consult the statute.

DISSENT.
The Supreme Court agreed on Monday to decide what sorts of business methods might be patented, an issue with the potential to reshape significant parts of the economy.

“This is the most important patent case in 50 years, in particular because there is so much damage and so much good the court could do,” said John F. Duffy, a law professor at George Washington University who submitted a brief in the appeals court in support of neither side.

“The newest areas of technology are most threatened by the issues at stake here,” Professor Duffy said. “The court taking this is likely to make a lot of people nervous, including software manufacturers and biotechnology companies.”

In October, the United States Court of Appeals for the Federal Circuit in Washington significantly narrowed the processes eligible for patent protection, ruling that only those “tied to a particular machine or apparatus” or transforming “a particular article into a different state or thing” qualified.

The petitioners in the case, Bernard L. Bilski and Rand A. Warsaw, had sought to patent a method of hedging risks in the sale of commodities, including the risks associated with bad weather. The appeals court ruled against them, and it disavowed statements in earlier cases suggesting that business processes could be patented so long as they yielded useful, concrete and tangible results.

In urging the Supreme Court to hear the case, the petitioners said the appeals court’s decision put tens of thousands of patents at risk.

They added that the decision “threatens to stifle innovation in emerging technologies that drive today’s information-based economy.”

The appeals court attracted supporting briefs on both sides of the issue from many kinds of businesses, including management consulting, computer software, insurance and tax accounting firms.

One brief, from several financial services companies, urged the appeals court to be wary of protecting business processes not tied to devices or tangible changes. “Business method patents often stifle, rather than promote, innovation,” the brief said.

The brief also quoted a 2002 article from Judge Richard A. Posner, of a federal appeals court, who said that business method patents created the potential for “enormous monopoly power (imagine if the first person to think up the auction had been able to patent it).”

The federal government urged the Supreme Court not to hear the case, saying the hedging method at issue was plainly not patentable and that the case did not affect software or more exotic business methods.

But courts have relied on the decision of the appeals court since October to deny patent protection to methods of marketing software products, detecting fraud in credit card
transactions and creating real estate investment instruments. In March, a federal judge in San Francisco wrote that the appeals court’s decision signaled that “the closing bell may be ringing for business method patents, and their patentees may find they have become bagholders.”
The U.S. Supreme Court was asked Wednesday to review the infamous Bilski business methods patent decision handed down en banc in October by the Court of Appeals for the Federal Circuit limiting patents to things that “transform an article to a different state or thing” or are “tied to a particular machine.”

The decision, which rocked the patent world, has serious implications for software patents. That’s why companies like Microsoft, Red Hat and IBM filed friend-of-the-court briefs.

It now remains to be seen whether the Supremes will deign to hear the case. Their decision could come before the end of the current term in June.

The appeals court, which expected a Supreme Court review, consciously sidestepped the issue of software patents, leaving it, it said, to future cases.

Unresolved, for instance, is whether a computer, the point on which many software patents rest, makes the cut as the machine. The Patent and Trademark Office these days thinks general-purpose computers don’t but it has reportedly been inconsistent in applying the Bilski principle.

The October ruling, called a “throwback to the 19th century when the economy was manufacturing-based,” overturned the 1998 State Street Bank decision that opened the door to business method patents. It said the test for patentability was simply a “useful, concrete and tangible result.”

Amicus briefs are due by February 27.
The loss of a patent case by a Pittsburgh company before the U.S. Court of Appeals could have huge negative consequences for hundreds of intellectual property patents, attorneys believe.

The 9-3 ruling by the appeals court in Washington against former Equitable Gas Co. executives and WeatherWise USA Inc. founders Rand Warsaw and Bernard Bilski is the latest setback in a saga dating back to the partner’s original patent application for a mathematical way to manage bad weather risk by making hedged trades in the commodities market. The original patent was filed in April 1997.

“The situation is just atrocious,” said a disgruntled Warsaw, who took over as president of the South Side-based company when Bilski left in 2003. WeatherWise USA uses computerized modeling to develop products and services for energy providers, along with commercial companies and consumers. The company uses hedging principles, techniques designed to reduce or eliminate financial risk, such as taking two positions that will offset each other if prices change.

The appeals court based its October rejection of the Warsaw-Bilski appeal on a simplified test based on U.S. Supreme Court decisions dating back at least a quarter-century. It ruled there was no machine or transformation of a substance involved in their patent. In effect, their patent application didn’t involve what the court called “the machine or transformation test.”

The problem with the ruling is that about a year after the partners’ initial patent application, the Court of Appeals approved a patent in the so-called State Street case involving what’s today known as a “business method,” opening the floodgates for similar patent applications, including Warsaw and Bilski’s, according to their attorney David Hanson.

In the State Street case, the appeals court approved a patent applied for by Boston-based investment firm State Street Corp. for a way of pooling mutual-fund assets. That approval produced an explosion in business-method patent filings.

“There were a lot of patents filed and a lot of (business method) patents issued in the last 10 years,” said Hanson, with The Webb Law Firm, Downtown.

With the Warsaw-Bilski ruling, the appeals court has reversed itself, now saying that unless there’s a machine involved or a substance is in some way transformed, a patent shouldn’t be issued.

“The impact of this ruling potentially could be huge,” said David Oberdick, of counsel to the law firm Meyer, Unkovic & Scott. “The ruling could impose more restrictions on patents in the examination process, and on a second level, it could mean that a large number of patents already granted could be subject to review.”

Some experts said the appeals court ruling will be felt strongly in areas like the Silicon Valley.
Valley, places where entrepreneurs and their lawyers patent business ideas. It also could affect so-called patent acquisition firms like Intellectual Ventures, financed by major technology companies such as Microsoft Corp., Google, Intel, Apple and Nokia.

“The original State Street patent might be reviewed based on the Circuit Court’s Bilski ruling, as could Amazon.com’s ‘One click’ patent,” Buchanan Ingersoll & Rooney attorney Lynn Alstadt said. . . .

The one-click patent, issued to Amazon.com in 1999, refers to the technique of allowing customers to make online purchases with a single computer mouse click, with the payment information needed to complete the purchase previously entered by the user.

Another possible patent to be reviewed would be Priceline.com’s “name your own price” patents, some experts said. Oberdick said there has been growing criticism concerning business method patents almost since the State Street case more than a decade ago, with review of such patents taking as long as three years.

The problem is, with a number of such patents approved, banks have lent money, business plans have been conceived and put into play. Now, what happens next, Oberdick asked.

“This ruling potentially upsets what businesses thought was appropriate,” Oberdick said.

Warsaw said he’s currently reviewing his options. Attorney Hanson said his client has until Jan. 31 to determine whether or not to petition the U.S. Supreme Court to be heard on another appeal.
When does a great idea become a patentable invention?

That was a question easier to answer when Thomas Edison came up with the lightbulb and Whitcomb Judson devised the zipper—Industrial Age innovations that clearly fit with old ideas of what it meant to invent something.

But a recent case before the U.S. Court of Appeals for the Federal Circuit points up the difficulty of making such judgments in the age of the Internet.

Bernard Bilski and Rand Warsaw of WeatherWise USA Inc. in Pittsburgh developed a computerized method for using weather data to predict commodities prices and energy costs. But their efforts to patent the formula were rejected by the U.S. Patent and Trademark Office, a decision upheld by the federal appeals court.

The inventors and their intellectual property lawyers argue that novel business concepts deserve patent protection as much as physical machines that transform industries. They have petitioned the U.S. Supreme Court to review the appeals court ruling. They say that without the ability to profit from such inventions, the biotech and information services companies that have put such places as Silicon Valley and Redmond, Wash., on the world innovation map won’t be willing to invest in research and development of other breakthroughs.

The patent office’s and court’s rejections of Bilski and Warsaw’s business method patent claim follows years of rather liberal interpretations by patent examiners as to what qualified as an invention. And the new standard imposed, that the invention must involve a machine or a physical transformation, threatens to put the brakes on the busiest area of patent application and analysis. Of the 13,779 “process” patents sought last year, just 1,643 were granted.

Californians hold 24% of the 20-year patents issued in the United States, more than residents of any other state.

The Oct. 30 ruling in the case, referred to in legal shorthand simply as Bilski, already has been cited by the patent office as grounds for rejecting applications on seismic data analysis and a method of converting an Internet domain name to read both left to right, for languages like English, and in the opposite direction, for languages like Arabic and Hebrew.

Before the ruling, patent examiners used the test of whether an invention was “new, useful and not obvious.” Now, they are deciding whether a process is “tied to a particular machine or apparatus, or transforms a particular article into a different state or thing.”

At least four subsequent patent denials based on the Bilski precedent led attorney Michael Jakes, acting on behalf of Bilski, Warsaw and other inventors, to petition the high court, which hasn’t updated its definition of what can be patented for 28 years.

“There are companies out there that have
been getting process patents and right now they don’t know if that has value anymore,” Jakes said.

Neither the patent appeals board nor the federal court ruled that business methods can’t be patented, but patent attorneys fear that will be the end result as few would pass the revised test.

“This is one of those rare times in over 200 years of the U.S. patent system that the courts have taken a very constricted view of what is patentable,” said Wayne Sobon, founder of the NewEconomyPatents.org website and director of intellectual property for Accenture, a global management consulting, technology services and outsourcing firm. “A lot of observers, including our company, view that as an undermining of the incentive the patent system was created to provide.”

The biggest problem with the Bilski decision, said Stanford University law professor Mark A. Lemley, is that it has thrown into question all innovations that involve more mental than physical activity, not just those on business methods. That could jeopardize existing patents on some medical diagnostic procedures and scientific data evaluations, as well as withhold patents from future innovations.

“What does it mean to be tied to a machine? If you attach ‘in a computer’ to your application for a process patent, is that enough to pass the machine-or-transformation test? The patent office has been saying no, that you need to show a special machine has been built for this purpose,” Lemley said.

The Supreme Court hasn’t ruled on what is patentable since 1981, Lemley said, leaving the federal appeals courts to apply standards set in the infancy of the information age to complex modern innovations.

“The computer world has changed a lot since 1981. The courts have the power to adapt the law and keep it up with changing technologies, and they had been doing that. But Bilski is a step backward,” Lemley said.

Not all high-tech leaders want Bilski overturned. Although it’s true that health science industries often rely on patents to recover research and development investments, information technology advances move too fast to benefit much from patent protections.

“Patents like the one at issue in Bilski give a bad name to the patent system,” said Horacio Gutierrez, a Microsoft vice president for intellectual property and licensing and deputy general counsel.

Inventor Bilski, arguing for the Supreme Court review, says business methods like his formula are crucial to spurring economic growth. He says the appeals court decision is “a throwback to the 19th century, when our economy was primarily manufacturing-based, and fails to recognize that many inventions are based on ideas not necessarily tied to a machine or piece of equipment.”
Although a drug manufacturer’s widely publicized 2001 study showed that users of its Vioxx painkiller had a higher incidence of cardiovascular events than naproxen users, the manufacturer at the time attributed the difference to the beneficial effects of naproxen’s blocking of platelet aggregation, rather than to the harmful effects of Vioxx. Market analysts, scientists, press, and even the Food and Drug Administration at that time agreed that the manufacturer’s hypothesis was at least very plausible, and none suggested that the manufacturer believed otherwise. The study did not significantly affect the market price of the manufacturer’s stock; thus, news of the 2001 study was not a “storm warning” sufficient to put investors on inquiry notice of the manufacturer’s alleged fraudulent cover-up of Vioxx users’ increased risk of heart attacks.

Question Presented: Did Third Circuit err in holding, in accord with the Ninth Circuit but in contrast to nine other courts of appeals, that under the “inquiry notice” standard applicable to federal securities fraud claims, the statute of limitations does not begin to run until an investor receives evidence of scienter without the benefit of any investigation?
I. Factual Background

In May 1999, the Food and Drug Administration (“FDA”) approved Vioxx, a new drug introduced by the pharmaceutical company Merck. Vioxx is the brand name of rofecoxib, a nonsteroidal anti-inflammatory drug (“NSAID”) used in the treatment of arthritis and other acute pain.

Merck marketed Vioxx as possessing the beneficial effects of traditional NSAIDs but without the harmful GI (gastrointestinal) side effects associated with those drugs. The market viewed Vioxx as a potential “blockbuster” drug for the company and as its “savior.” Merck repeatedly touted the safety profile, sales, and commercial prospects of the drug in press releases, public statements, and Securities and Exchange Commission (“SEC”) filings throughout the class period.

A. Pre-FDA Approval and the VIGOR Study (1996 - March 2000)

Prior to the FDA’s approval of Vioxx, officials at Merck were concerned that Vioxx could cause harmful cardiovascular (“CV”) events, such as heart attacks. Internal emails from 1996 and 1997 demonstrate that Merck employees were aware that there was “a substantial chance” and a “possibility” of CV events that could “kill [the] drug.” App. at 496. In 1998, an unpublished internal Merck clinical trial entitled Study 090 revealed that Vioxx caused a greater incidence of CV events than a placebo or a different arthritis drug.

In January 1999, Merck commenced the VIOXX Gastrointestinal Outcomes Research (“VIGOR”) study, which compared Vioxx to naproxen, the active ingredient in brand-name pain relievers such as Aleve and Naprosyn. Although the study showed that Vioxx had a GI safety profile superior to that of naproxen, it also showed that Vioxx users had a higher incidence of CV events than naproxen users.

Merk did not attempt to conceal the results of the VIGOR study. It made them public in a press release on March 27, 2000, that emphasized Vioxx’s superior GI safety profile but also noted the incidence of CV events.

The press release also stated that “[a]n extensive review of safety data from all other completed and ongoing clinical trials, as well as the post-marketing experience with Vioxx, showed no indication of a difference in the incidence of thromboembolic events between Vioxx, placebo and comparator NSAIDs.” App. at 766.

The VIGOR study results were widely reported in the press, medical journals, and securities analyst reports. Market analysts and members of the press immediately understood that CV events could be a side effect of Vioxx. Nonetheless, many observers also took notice of Merck’s hypothesis that naproxen lowered CV events (the “naproxen hypothesis”). The naproxen hypothesis attributed the results of the VIGOR study to the beneficial effects of naproxen’s blocking of platelet aggregation rather than to the harmful effects of Vioxx in causing thromboembolic events. The issue whether naproxen lowered the heart attack risk or Vioxx caused it was thus presented. While many analysts noted that the naproxen hypothesis was unproven, some
also concluded that it was the most likely explanation for the increased CV events observed in the VIGOR study.

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**B. FDA AAC Hearing (February 8, 2001)**

On February 8, 2001, the FDA’s Arthritis Advisory Committee (“AAC”) held a public hearing to consider Merck’s request to include the positive GI results from the VIGOR study in its Vioxx labeling.

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At the public portion of the hearing, the panel subsequently discussed whether to call for the inclusion of a warning in the Vioxx labeling stating that it was “uncertain” whether the CV events noticed in VIGOR were “due to beneficial cardioprotective effects of naproxen or prothrombotic effects of [Vioxx], and leave it at that, that basically we don’t know the reason.” App. at 1143.

Nonetheless, some press accounts reported that certain AAC panel members asserted that “[d]ifferences in cardiac risk between Vioxx and naproxen appeared to result from a beneficial effect of naproxen, not a danger from Vioxx,” App. at 2311, and that there was “some reassurance that what we see, in effect, is a protective effect of naproxen,” App. at 2306. In subsequent coverage, many securities analysts reported that the hearing had benefited Merck and they continued to project substantial future revenues for Vioxx. However, at least one investment firm issued a report stating, “our skepticism relating to naproxen having a cardioprotective effect is reinforced” by the AAC hearing. App. at 2703.

**C. First Vioxx Product Liability Lawsuit (May 2001)**

In May 2001, a product liability lawsuit was filed jointly against Merck and the makers of Celebrex, a rival COX-2 selective inhibitor. The complaint alleged that the pharmaceutical companies “have consistently marketed Vioxx and Celebrex as highly effective pain relief drugs for patients suffering from osteoarthritis,” despite the fact that “Merck’s own research” demonstrated that “users of Vioxx were four times as likely to suffer heart attacks as compared to other less expensive medications, or combinations thereof.” App. at 1748. The plaintiffs sought “emergency notice to class members and revised patient warnings, in the form of additional medical labeling which is presently being considered by the FDA . . . .” App. 1748.

**D. JAMA Article (August 22, 2001)**

On August 22, 2001, the Journal of the American Medical Association (“JAMA”) reported the results of a study of Vioxx and Celebrex clinical trials. The JAMA article asserted that available data raised a “cautionary flag” about the risk of CV events associated with COX-2 inhibitors. App. at 748. It also stated that “[c]urrent data would suggest that use of selective COX-2 inhibitors might lead to increased cardiovascular events.” App. At 752. The day before that article was published, Bloomberg News reported the statement of a Merck scientist that “[w]e already have additional data beyond what they cite, and the findings are very, very reassuring. VIOXX does not result in any increase in cardiovascular events compared to placebo.” App. at 539. The JAMA article garnered extensive coverage. Some securities analysts responding to the article on the date of its
publication referred to the basic content of the article as “not new news,” App. at 2749, and noted that the FDA “debated many of the same issues in February of this year.”

The day after the JAMA article’s publication, Merck issued a press release stating that it “stands behind the overall and cardiovascular safety profile . . . of VIOXX.” App. at 540. Merck also sent “‘Dear Doctor’ letters to physicians throughout the country disparaging the article as ‘not based on any new clinical study’ and assuring the physicians that Merck ‘stands behind the overall and cardiovascular safety profile’ of VIOXX.” App. at 540.

E. FDA Warning Letter (September 21, 2001)

On September 21, 2001, the FDA posted on its website a warning letter that its Division of Drug Marketing, Advertising, and Communications (“DDMAC”) had sent to Merck four days earlier regarding its marketing and promotion of Vioxx. In the letter, the DDMAC stated that Merck’s “promotional activities and materials” for the marketing of Vioxx were “false, lacking in fair balance, or otherwise misleading in violation of the Federal Food, Drug, and Cosmetic Act (the Act) and applicable regulations.” App. at 713.

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The letter also directed Merck to issue “Dear Healthcare provider” letters “to correct false or misleading impressions and information.” App. at 719.

The FDA warning letter received widespread coverage by the media and securities analysts.

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In the five days between September 20, 2001 and September 25, 2001, Merck’s stock price declined by $ 4.16, or 6.6%, closing at $59.11 on September 25. Reuters reported this drop on September 25, explaining that “[s]hares of Merck & Co. fell . . . after U.S. regulators accused the firm of making unsubstantiated claims about its hot-selling arthritis drug Vioxx and downplaying a possible risk of heart attack from taking the medicine.” App. at 2357. By October 1, 2001, however, Merck’s stock price had rebounded to $64.66, $1.39 higher than its closing price before the warning letter was made public just over a week earlier.

F. Additional Vioxx Lawsuits (September 27, 2001)

A consumer fraud lawsuit was filed against Merck on behalf of Vioxx users on September 27, 2001. A second product liability lawsuit and a personal injury lawsuit followed shortly thereafter. In articulating their allegations of fraud and misrepresentations by Merck to consumers and Vioxx users, the consumer fraud and product liability suits relied in large part on the JAMA article, the FDA warning letter, and various media reports concerning Vioxx.

G. New York Times Article (October 9, 2001)

On October 9, 2001, the New York Times published an article about COX-2 inhibitors entitled “The Doctor’s World; For Pain Reliever, Questions of Risk Remain Unresolved.” App. at 653. The article reported on “troubling questions about whether Vioxx may have an unexpected side
effect—a very slight increase in the risk of heart attack.” App. at 653.

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The article addressed defendant Scolnick’s statements at length. According to the article, Scolnick said that Merck “look[ed] specifically for excess heart attacks and strokes in” the VIGOR study and found a higher incidence in the patients taking Vioxx. App. At 654. “There are two possible interpretations,” Dr. Scolnick said. ‘Naproxen lowers the heart attack rate, or Vioxx raises it.’” App. at 654. The article went on. “while [Merck] announced the heart attack findings to doctors and the public, it looked back at its data from studies using different drugs or dummy pills in comparison to Vioxx. It found no evidence that Vioxx increased the risk of heart attacks, Dr. Scolnick said.” App. at 654. “He said that the company decided that ‘the likeliest interpretation of the data is that naproxen lowered . . . the thrombotic event rate.’ . . . He added that without the theoretical question raised by [the University of Pennsylvania scientist], ‘no one would have a question remaining in their mind that their [sic] might be an additional interpretation.’” App. at 654. The article reported Scolnick as conceding that “none of the findings to date are enough to prove that the issue is fully resolved. That lack of proof is why the F.D.A. demanded that Merck explain both sides of the hypothesis, telling doctors and patients that it is not known whether naproxen protects against heart attacks or Vioxx makes them more likely.” App. at 654.

There was no significant movement in Merck’s stock price following the publication of the New York Times article.

H. Vioxx’s Labeling Modified to Include CV Risks (April 2002)

Merck was not required to include the risk of CV events in its labeling until April 2002. The labeling ultimately incorporating that information explained the VIGOR study results and stated, “the risk of developing a serious cardiovascular thrombotic event was significantly higher in patients treated with VIOXX . . . as compared to patients treated with naproxen. . . . The significance of the cardiovascular findings . . . is unknown.” App. at 553. This language was incorporated into the “precautions” section of the Vioxx labeling, rather than the “warnings” section. In a conference call discussing the labeling changes, a Merck spokesperson reiterated the company’s “belief that the effect seen in VIGOR were [sic] the results of the anti-platelet effect of naproxen. . . . So, I think that’s a position Merck has always had and now it’s quite clearly laid out in the labeling.” App. at 559.

I. Falling Vioxx Sales and the Harvard Study (October 2003)

On October 22, 2003, Reuters published an article entitled “Merck to Cut 4,400 Jobs, posts Flat Earnings,” in which it reported that Merck was “hurt by falling sales of arthritis medicine VIOXX and a paucity of profitable new drugs. . . . The arthritis drug is suffering from clinical trial data suggesting it might slightly raise the risk of heart attacks. . . .” App. at 570. That day, Merck’s stock price dropped from $48.91 to $45.72, down 6.5%.

On October 30, 2003, the Wall Street Journal published an article entitled “VIOXX Study Sees Heart-Attack Risk,” which addressed a recent study by the
Harvard-affiliated Brigham and Women's Hospital in Boston that found an increased risk of heart attack in patients taking Vioxx compared with patients taking Celebrex and placebo (the "Harvard study"). App. at 571. According to the article, "[i]n the first 30 days, the researchers found, VIOXX was linked to a 39% increased heart-attack risk compared with Celebrex. Between 30 and 90 days, that increased relative risk was 37%." App. at 571. A researcher stated that this was "the best study to date" and that it "greatly substantiates our concerns about the cardiac side effects" of Vioxx. App. at 571.

Merck’s stock price dropped below the S&P 500 Index during this time, and did not rise above that index during the remainder of the class period.

J. Merck Withdraws Vioxx from the Market (September 2004)

On September 30, 2004, Merck announced that it was withdrawing Vioxx from the market based on a new study showing an "increased risk of confirmed cardiovascular events beginning after 18 months of continuous therapy." App. at 584. Merck’s stock price dropped more than $12 per share that day, to close at $33.00, down 27% from the previous day’s close. Securities analysts expressed their surprise at the suddenness of Merck’s action.

On November 1, 2004, the Wall Street Journal reported, “internal Merck e-mails and marketing materials as well as interviews with outside scientists show that the company fought forcefully for years to keep safety concerns from destroying the drug’s commercial prospects.” App. at 589. Merck’s stock price dropped another 9.7% based on this news. The news, which was first published nearly a year after Appellants filed their complaint, prompted one securities analyst to remark, “new information indicates to us that the situation might not be as innocent as we thought... We recommend that investors sell Merck shares.” App. At 594.

II. Procedural History

The first class action securities complaint initiating this lawsuit was filed on November 6, 2003, just weeks after the media reported the results of the Harvard study and declining Vioxx sales. After numerous nationwide class actions were consolidated, Appellants filed a fourth amended consolidated class action complaint. The complaint alleged that “Defendants’ statements and omissions during the Class Period materially misrepresented the safety and commercial viability of VIOXX,” App. at 489, in violation of sections 11, 12(a)(2), and 15 of the Securities Act of 1933, sections 10(b), 20(a), and 20A of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder.

Merck moved to dismiss Appellants’ claims on the grounds that they were time-barred and that Appellants had failed to state a claim. The District Court granted that motion on the basis that the claims were time-barred. Appellants timely filed a notice of appeal.

III. Jurisdiction and Standard of Review

[The Court established jurisdiction and granted plenary review of the District Court’s actions.]

IV. Discussion

The relevant statutes each contain their own statute of limitations. A complaint alleging “fraud, deceit, manipulation, or contrivance”
under the Securities Exchange Act "may be brought not later than the earlier of . 2 years after the discovery of the facts constituting the violation; or . . . 5 years after such violation." 28 U.S.C. § 1658(b). Claims under the Securities Act are subject to a shorter, one-year limitation period from the time of discovery, but in no event may be filed later than three years after the public offering or sale of the security. Thus, if Appellants knew of the basis for their claims prior to November 6, 2001, two years before the first securities complaint was filed, all of their claims are barred by the statute of limitations.

"Whether the plaintiffs, in the exercise of reasonable diligence, should have known of the basis for their claims depends on whether they had 'sufficient information of possible wrongdoing to place them on 'inquiry notice' or to excite 'storm warnings' of culpable activity.'" Benak ex rel. Alliance Premier Growth Fund v. Alliance Capital Mgmt., L.P., 435 F.3d 396, 400 (3d Cir. 2006) This is an objective question; thus, an investor is not on inquiry notice until a "reasonable investor of ordinary intelligence would have discovered the information and recognized it as a storm warning." In re NAHC, 306 F.3d at 1325.

"If the existence of storm warnings is adequately established the burden shifts to the plaintiffs to show that they exercised reasonable due diligence and yet were unable to discover their injuries." DeBenedictis, 492 F.3d at 216. Here, the District Court held that Appellants were on inquiry notice of their claims no later than October 9, 2001, the date the New York Times published the article reporting that defendant Scolnick "acknowledged that Merck knew that the cardioprotective effect of naproxen was not proven and, further, that Merck admitted that VIOXX may raise the risk of heart attack or other thrombotic event." In re Merck, 483 F. Supp. 2d at 419. The Court also noted what it characterized as the "overwhelming collection of information signaling deceit by Merck with respect to the safety of VIOXX [that] had accumulated in the public realm" by that date, in particular, the FDA warning letter. Id. In concluding that sufficient storm warnings of fraud existed more than two years prior to the filing of Appellants' complaint, the District Court observed that Appellants' "position that their claims did not accrue until the existence of fraud was a probability, as opposed to a possibility . . . is simply not supported by Third Circuit law." Id. at 422. Finally, noting that Appellants had "not argued that they conducted a diligent investigation, and nothing in the Complaint demonstrates that they were unable to uncover pertinent information during the limitations period," the Court concluded that Appellants' claims were time-barred and granted Merck's motion to dismiss. Id. at 424.

A. Principles of Inquiry Notice

Before reviewing the District Court's decision, we must address an ambiguity in our inquiry notice jurisprudence. Appellants contend that the statute of limitations does not begin to run until there is sufficient evidence of probable, rather than possible, wrongdoing by the defendants. Predictably, Merck supports the latter standard, arguing that inquiry notice may be triggered by evidence of possible wrongdoing. Both formulations find support in this court's precedents.

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[Although we have occasionally stated that inquiry notice may be triggered by evidence alerting an investor to the probability of}
wrongdoing, we have just as often emphasized that inquiry notice may be triggered by sufficient information of possible wrongdoing. This implies that a probability, in the sense of a nearly certain likelihood, of wrongdoing is not necessary to trigger storm warnings in this circuit.

Therefore, we reaffirm that “whether the plaintiffs, in the exercise of reasonable diligence, should have known of the basis for their claims depends on whether they had sufficient information of possible wrongdoing to place them on inquiry notice or to excite storm warnings of culpable activity.” *Benak*, 435 F.3d at 400. In so holding, we note that the majority of courts of appeals to have addressed the question employ a possibility standard when evaluating the likelihood of wrongdoing sufficient to constitute storm warnings.

Nonetheless, simply repeating the word “possibility” or “probability” with ever-increasing frequency and intensity (as both parties did in their briefs and at oral argument) is hardly useful. Rather, we review the information set forth by the parties with an eye toward the practical effect of drawing the inquiry notice line at a particular date. In this vein, we have emphasized that “[u]ndergirding the inquiry notice analysis is the assumption that a plaintiff either was or should have been able, in the exercise of reasonable diligence, to file an adequately pled securities fraud complaint as of an earlier date.” *Benak*, 435 F.3d at 401. Similarly, the Court of Appeals for the Seventh Circuit, which has also applied a possibility standard, has reasoned that “[t]he facts constituting [inquiry] notice must be sufficiently probative of fraud—sufficiently advanced beyond the stage of a mere suspicion, sufficiently confirmed or substantiated—not only to incite the victim to investigate but also to enable him to tie up any loose ends and complete the investigation in time to file a timely suit,” *Fujisawa*, 115 F.3d at 1335. In other words, simply stating that a smattering of evidence hinted at the possibility of some type of fraud does not answer the question whether there was “sufficient information of possible wrongdoing . . . to excite storm warnings of culpable activity” under the securities laws. *Benak*, 435 F.3d at 400. This concern is reenforced by the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (“PSLRA”), 15 U.S.C. § 78u-4(b). Surely, Congress did not envision a statute of limitations that would open the floodgates to a rush of premature securities litigation when its primary foray into this field in recent decades has been to deter poorly pleaded allegations of securities fraud.

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B. Basis of Appellants’ Claims

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Appellants contend that their complaint challenges the veracity of Merck’s statements of opinion and belief regarding the naproxen hypothesis whereas the District Court analyzed whether Merck misrepresented the fact that the results of the VIGOR study could support multiple hypotheses (i.e., that naproxen lowers the risk of CV events or that Vioxx raises that risk). Thus, they argue that the District Court mischaracterized their claims by considering whether there were storm warnings that put them on notice of a fraud different from that which they have asserted in their complaint.

We have explained that for “misrepresentations in an opinion” or belief to be actionable, plaintiffs must show that the statement was “issued without a
genuine belief or reasonable basis’ . . . .” Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 185. Thus, to trigger “storm warnings of culpable activity,” in the context of a claim alleging falsely-held opinions or beliefs, investors must have sufficient information to suspect that the defendants engaged in culpable activity, i.e., that they did not hold those opinions or beliefs in earnest. Appellants’ theory in the complaint is that Merck’s statements about the validity of the naproxen hypothesis were falsely-held statements of opinion or belief and that there was no information available to investors prior to November 6, 2001, that would have led them to suspect that such statements were not held in earnest. The District Court rejected this argument, concluding that “[i]t is preposterous for Plaintiffs to argue that because they did not have a ‘smoking gun’ that demonstrated that Defendants’ misrepresentation was even more egregious than the [FDA] Warning Letter charged, they were not on inquiry notice of a general fraudulent scheme regarding the safety of VIOXX.” In re Merck, 483 F. Supp. 2d at 422-23. We disagree.

It is true that “[p]laintiffs cannot avoid the time bar simply by claiming they lacked knowledge of the details or narrow aspects of the alleged fraud. Rather, the clock starts when they should have discovered the general fraudulent scheme.” Benak, 435 F.3d at 400. The “fraudulent scheme” referred to must be one “in connection with the purchase or sale of any security . . . .” 15 U.S.C. § 78j(b). Appellants have brought a securities fraud action, not a consumer fraud action, against Merck. Thus, the fact that the FDA sent a letter to Merck about its possible misrepresentations in connection with its promotion of Vioxx to health care professionals would not have provided a storm warning unless it put Appellants on inquiry notice of actionable misrepresentations under the securities laws.

The asserted basis of Appellants’ claims is that Merck defrauded investors by proposing and reasserting the naproxen hypothesis at the same time that it knew the hypothesis was false. We must analyze the existence of storm warnings relative to that allegation in order to determine whether Appellants were on inquiry notice of the alleged fraud.

C. Existence of Storm Warnings

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Appellants argue that to the extent the disclosures identified by Merck might be seen as triggering storm warnings, such storm warnings were dissipated by Merck’s reassuring statements, and are undermined by the failure of the identified disclosures to have any significant impact on Merck’s stock price or the projections of securities analysts covering Merck. Merck argues that stock price movement is irrelevant to the inquiry notice analysis. We cannot agree.

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Because information that is material to reasonable investors is immediately incorporated into the stock price, the effect of a purported storm warning on the market, while insufficient on its own to compel the conclusion that inquiry notice has not been triggered, is, contrary to Merck’s position, relevant to our inquiry.

The District Court (and Merck on this appeal) emphasized five classes of information, each of which was disclosed on or before October 9, 2001, which purportedly triggered storm warnings: (1) articles and reports commenting on the hypothetical explanations for the results of the VIGOR study; (2) the JAMA article, which asserted that available data (i.e.,
VIGOR and a Celebrex study) raised a “cautionary flag” about the risk of CV events in COX-2 inhibitors, App. at 748; (3) the FDA warning letter, which charged Merck with “engag[ing] in a promotional campaign for Vioxx that minimizes the potentially serious cardiovascular findings that were observed in the [VIGOR] study, and thus, misrepresents the safety profile for Vioxx,” App. at 713; (4) the consumer fraud, product liability, and personal injury lawsuits filed against Merck throughout 2001; and (5) the New York Times article, in which Scolnick stated there were “two possible interpretations” for the VIGOR results, App. at 654.

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The FDA warning letter demands more scrutiny. In analyzing the effect of that letter through the prism of inquiry notice, we must not lose focus of the nature of the allegations in the letter and the scope of the FDA’s regulatory authority. The FDA targeted Merck’s “promotional campaign for Vioxx,” App. at 713, under its authority to regulate prescription drug advertisements.

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The FDA chastised Merck’s promotional campaign for “discount[ing] the fact that in the VIGOR study, patients on Vioxx were observed to have a four to five fold increase in myocardial infarctions (MIs) compared to patients on” naproxen, and “selectively present[ing]” the naproxen hypothesis as the reason for the incidence of increased CV events. App. at 713. The FDA stated that Merck’s promotional campaign “fail[ed] to disclose that [its] explanation is hypothetical, has not been demonstrated by substantial evidence, and that there is another reasonable explanation, that Vioxx may have pro-thrombotic properties.” App. at 713. For a number of reasons, we are hesitant to conclude that the FDA warning letter was sufficient to trigger inquiry notice.

To begin with, the FDA was acting as a regulator of drug advertising, rather than as a regulator of the securities markets. Thus, contrary to Merck’s contention at oral argument, the FDA’s actions are hardly analogous to allegations of accounting fraud issued by the SEC, which regulates the securities markets. Indeed, the FDA’s drug advertising regulations and the securities laws provide wholly different standards with respect to what constitutes a misrepresentation. FDA regulations provide that advertisements must not be “lacking in fair balance,” 21 C.F.R. § 202.1(e)(6), and prohibit advertisements that “[c]ontain[] a representation or suggestion that a drug is safer than it has been demonstrated to be by substantial evidence or substantial clinical experience . . . or otherwise selects information from any source in a way that makes a drug appear to be safer than has been demonstrated,” id. § 202.1(e)(6)(iv). In contrast, under the securities laws, “a fact or omission is material only if ‘there is a substantial likelihood that it would have been viewed by the reasonable investor as having significantly altered the “total mix” of information’ available to the investor.” In re NAHC, 306 F.3d at 1330.

Second, the FDA’s description of the truth about the VIGOR study is quite similar to the evidence that Merck had long acknowledged and which the market had incorporated. Specifically, the FDA stated that the naproxen hypothesis “is hypothetical, has not been demonstrated by substantial evidence, and that there is another reasonable explanation, that Vioxx may have pro-thrombotic properties.” App. at 713. This information is implicit in Merck’s long-standing admission that the
posited anticoagulant effect of naproxen “on [CV] events had not been observed previously in any clinical studies for naproxen.” App. at 765

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Third, two of the three components of the promotional campaign subject to the FDA’s reprimand consisted of statements made to health care professionals in the course of targeted audio conferences and personal conversations. The third component of the promotional campaign targeted by the FDA was the press release, but that press release merely repeated the same information that was first contained in the VIGOR press release.

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Finally, we consider the effect the FDA warning letter had on the market. Merck’s stock price dipped slightly following the disclosure of the FDA warning letter before closing higher than it did before that disclosure just a week and a half later. Although the lack of significant movement in Merck’s stock price following the FDA warning letter is not conclusive, it supports a conclusion that the letter did not constitute a sufficient suggestion of securities fraud to trigger a storm warning of culpable activity under the securities laws. This conclusion is also supported by the fact that more than a half-dozen securities analysts continued to maintain their ratings for Merck stock and/or project increased future revenues for Vioxx after the warning letter was made public.

Merck also emphasizes the three additional lawsuits filed after the FDA warning letter. Of course, none of these lawsuits alleged securities fraud. Rather, they alleged consumer fraud, product liability, and personal injury claims. The claims in those lawsuits alleged that Merck failed to provide publicly available information to Vioxx consumers, rather than to Merck investors.

Finally, we question the District Court’s conclusion that the New York Times article constituted a storm warning. The District Court reasoned that defendant Scolnick’s statements in that article constituted “a significant departure from Merck’s company line as to the explanation for the VIGOR study results.” In re Merck, 483 F. Supp. 2d at 420. But Scolnick did not abandon the naproxen hypothesis; rather, he reiterated that Merck “found no evidence that Vioxx increased the risk of heart attacks” when it looked back at its data comparing Vioxx to other drugs and placebos and “that ‘the likeliest interpretation of the data is that naproxen lowered . . . the thrombotic event rate’ . . . .” App. at 654. Even in the wake of the FDA warning letter, then, Merck continued to reassure the investing public that Merck stood behind the naproxen hypothesis, while acknowledging that another explanation (i.e., that Vioxx causes CV events) remained a possibility. It is also notable there was no “significant movement” of Merck’s stock price following the article’s publication. Thus, we cannot conclude as a matter of law that this article constituted a storm warning.

In summary, we conclude that the District Court acted prematurely in finding as a matter of law that Appellants were on inquiry notice of the alleged fraud before October 9, 2001. As of that date, market analysts, scientists, the press, and even the FDA agreed that the naproxen hypothesis was plausible, at the very least. None suggested that Merck believed otherwise. Accordingly, in April 2002, the FDA approved a labeling change for Vioxx which stated that “[t]he significance of the cardiovascular findings [from the VIGOR
study] is unknown.” App. at 553. Merck continued to reassure the investing public at this time, explaining that the naproxen hypothesis was “a position Merck has always had and now it’s quite clearly laid out in the labeling.” App. at 559. On the record before us, there is no reason to suspect that Merck did not believe the naproxen hypothesis until the Harvard study in 2003 revealed an increased risk of heart attack in patients taking Vioxx compared with patients taking Celebrex and placebo. This study for the first time belied Merck’s repeated assurances that naproxen was responsible for the disparity in CV events in VIGOR and that Vioxx did not have a higher incidence of CVs compared to placebo or comparator NSAIDs, such as Celebrex.

Conclusion

For the reasons set forth, we will REVERSE the judgment of dismissal and remand to the District Court for further proceedings consistent with this opinion.

DISSENT

ROTH, Circuit Judge, dissenting.

I believe “storm warnings” alerting a reasonable investor of possible culpable activity on the part of Merck were evident more than two years prior to the filing of appellants’ complaint. In particular, I believe that the FDA’s September 17, 2001, warning letter, in and of itself, provided sufficient “storm warnings” to put the appellants on inquiry notice of their claims regardless of any significant change in stock price or analysts’ stock ratings or projections at that time. I therefore respectfully dissent.

Under the “inquiry notice” test, the statute of limitations for securities claims “begins to run when the plaintiffs ‘discovered or in the exercise of reasonable diligence should have discovered the basis for their claim’ against the defendant.” Benak v. Alliance Capital Management L.P., 435 F.3d 396, 400 (3d Cir. 2006). In order to establish that plaintiffs were on inquiry notice, a defendant must demonstrate that, as of a particular date, there existed “storm warnings” sufficient to alert “a reasonable investor of ordinary intelligence” to “possible wrongdoing” on the part of defendants. Id.

Furthermore, it is well established that “[t]he existence of storm warnings is a totally objective inquiry[,]” that is based on whether a “reasonable investor of ordinary intelligence would have discovered the information and recognized it as a storm warning[,]” Mathews v. Kidder Peabody & Co., Inc., 260 F.3d 239, 252 (3d Cir. 2001) We do not require that plaintiffs “know all of the details or ‘narrow aspects’ of the alleged fraud to trigger the limitations period[,]” but rather “the period begins to run from the time at which plaintiff should have discovered the general fraudulent scheme.” In re NAHC, 306 F.3d at 1326. Most importantly, we recognize that triggering data for “storm warnings” may include any information that would alert a reasonable investor to the possibility that the defendants engaged in the “general fraudulent scheme” alleged in the complaint. Id. Finally, such triggering data must “relate[] directly to the misrepresentations and omissions alleged.” DeBenedictis, 492 F.3d at 217-18.

In applying the above inquiry notice standard to the instant case, I am reminded of a classic fairytale: The Emperor’s New Clothes, by Danish author and poet, Hans Christian Anderson. As the child in The Emperor’s New Clothes saw—that the
Emperor walked naked down the street—any reasonable investor reading the FDA’s September 17, 2001, warning letter could see the problem with Vioxx—the misrepresentation of its safety profile and the “possibility” that Merck had fraudulently misrepresented the cardiovascular safety of its “blockbuster” product.

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The warning letter [to Merck published on the FDA’s public website] clearly and explicitly reprimanded Merck for its (1) deceptive and misleading conduct in publicly endorsing the naproxen hypothesis as the sole explanation for the higher rate of cardiovascular events in VIGOR study participants taking Vioxx, despite knowing that any purported cardiovascular protective effect of naproxen was unproven, and (2) downplaying of potential safety problems in failing to disclose the possibility that Vioxx increases the risk of heart attack. As the letter explained, this was not the first time the FDA had charged Merck with misrepresenting Vioxx’s safety profile. The language used in the letter was particularly strong and indicated the FDA’s significant concern for the public’s health. Also, the warning letter cannot be said to have constituted mere speculation, but was rather a formal report of “objective wrongdoing.” See Benak, 435 F.3d at 402 (explaining that, in determining whether a plaintiff has inquiry notice, “[s]peculation should not be given the same weight as reports of objective wrongdoing”). Furthermore, the warning letter was published on the FDA’s website where it would have been discovered by a reasonable Merck investor.

Moreover, the charges in the warning letter relate directly to the misrepresentations and omissions alleged in the appellants’ complaint: that the company and certain of its officers and directors intentionally misrepresented the cardiovascular safety of Vioxx and, consequently, the impact that Vioxx would have on Merck’s financial health. Accordingly, I believe that the FDA’s warning letter to Merck sufficiently alerted a reasonable investor to the possibility that Merck fraudulently misrepresented the cardiovascular safety of Vioxx—its “blockbuster” product.

Even assuming that the FDA’s warning letter alone did not sufficiently excite “storm warnings,” the total mix of information in the public realm which followed the warning provided more than adequate “storm warnings” to put appellants on inquiry notice.

In response to the FDA’s warning letter, there was widespread media and financial analyst coverage commenting on the FDA’s charges against Merck, with some reports noting that such warnings are reserved for the more serious offenders.

Furthermore, in addition to the first lawsuit filed before the FDA’s warning letter, three product liability and consumer fraud actions had been filed in September and October 2001, all alleging that Merck had misrepresented the cardiovascular safety of Vioxx. While these law suits did not allege securities fraud, the general allegations contained within these complaints relating to Merck’s intentional misrepresentation with regard to Vioxx’s safety similarly formed the basis of appellants’ complaint.

Moreover, The New York Times article, dated October 9, 2001, quoted defendant Scolnick as explicitly stating that “[n]aproxen lowers the heart attack rate, or Vioxx raises it.” App. at 2367 (emphasis added). Based on my review of the record, this express acknowledgment by a Merck
representative of the possibility that Vioxx actually raises the risk of heart attack appears to be not only the first time such statement had been made by the company, but also in stark contrast to Merck’s prior representations. Therefore, because of what I perceive to be significant media and financial analyst attention directed at the explicit and serious nature of the FDA’s warning letter, the allegations in the multiple lawsuits which followed, and Merck’s change of tone in the October 9, 2001, article, I cannot see how a reasonable investor could not be aware of the possibility that Merck had been fraudulently misrepresenting the cardiovascular safety of Vioxx.

Because the objective evidence indicated the possibility of culpable activity on the part of Merck, a lack of significant stock movement and decreases in analysts’ stock ratings and projections do not negate a finding of “storm warnings” under our inquiry notice standard. Appellants argue that “storm warnings” could not have existed prior to the 2003 Harvard Study because the total mix of public information did not have a negative effect on the price of Merck stock or cause analysts to drop their ratings for Merck or lower their projections for Vioxx sales. It is true, as the majority points out, that our past inquiry notice decisions have taken into consideration the market’s response to disclosures alleged to constitute “storm warnings.” However, I do not believe the law requires that, in order to make a determination that “storm warnings” in fact exist, the total mix of public information (purported to constitute “storm warnings”) must have a negative effect on stock prices or cause analysts to drop their ratings or lower their projections.

* * *

In my view, fluctuations in stock price and analysts’ ratings and projections, although relevant, are not a required consideration in this circuit’s objective “storm warnings” analysis. Here, the lack of a significant response from the market to the FDA’s warning letter does not mean that the Emperor was not walking down the street with no clothes on. It merely means that the analysts saw the emperor’s new clothes as Merck described them—not as reality presented.

Based on the foregoing, I submit there were sufficient “storm warnings” more than two years prior to the filing of appellants’ complaint. At a minimum, I believe the FDA’s September 17, 2001, warning letter constituted more than sufficient “storm warnings” to put appellants on inquiry notice of their claims, particularly since appellants fail to demonstrate either that they conducted a diligent investigation within two years of the accrual of such “storm warnings” or that they were unable to uncover pertinent information during that time period. Accordingly, because appellants waited over two years to bring suit, I conclude that their claims were filed out of time and were properly dismissed by the District Court.
The U.S. Supreme Court agreed to consider Merck & Co.’s bid to stop a shareholder lawsuit over the now-withdrawn Vioxx painkiller in a case that might mean tighter deadlines for investor fraud lawsuits.

A federal appeals court said Merck must defend against a proposed class-action lawsuit that accuses the drugmaker of defrauding investors about the risks posed by Vioxx, which the company pulled from the market in 2004 because of links to heart attacks and strokes. Merck argues that the investors filed suit too late.

The appeal turns on the starting date for the two-year window that investors are given to file some types of federal securities lawsuits. The question for the high court concerns how much notice an investor must have about possible company wrongdoing to cause that window to open.

In the Merck case, the first investor suit was filed in November 2003, more than three years after the drugmaker released the results of a study that showed Vioxx caused five times more heart attacks than a rival painkiller, naproxen. Merck at the time said the results stemmed from naproxen’s protection of the cardiovascular system.

The first Vioxx product-liability suit was filed in May 2001, and in September 2001 federal regulators said company marketing campaigns underplayed potential heart risks associated with Vioxx.

‘Storm Warnings’

The 3rd U.S. Circuit Court of Appeals ruled last year that none of those events amounted to the type of “storm warnings” that triggered the two-year period.

The panel said that, as of October 2001, market analysts, scientists, the press and the Food and Drug Administration all considered Merck’s theory about the cardiovascular benefits of naproxen to be “plausible, at the very least.” The 2-1 ruling overturned the decision of a federal trial judge.

In its appeal, Merck said the investors had enough indications of alleged fraud by 2001 that they should have begun investigating. The company argued that the 3rd Circuit’s approach would prevent the two-year window from opening until “evidence supporting specific elements of fraud claim falls into an investor’s lap.”

The company says other courts of appeals have started the period for lawsuits “when an investor knows, or has reason to know, that a representation on which it relied was false.”

Merck is pleased the high court will review the dispute, Kent Jarrell, a company spokesman, said today. “Merck properly informed the FDA and the scientific community about scientific data as it emerged,” he said in a statement.
‘Wild-Goose Chase’

The investors, led by Richard Reynolds, say their case could proceed under any of the approaches that different appeals courts have laid out. They told the justices that investors shouldn’t have to “launch a wild-goose chase for evidence of securities fraud” simply because a company violated product-safety rules.

The Obama administration said in a brief filed in a different case that the Merck dispute might let the Supreme Court clear up lower court disagreement on the issue. The administration didn’t take a position on the outcome of the Vioxx dispute.

Merck agreed in 2007 to pay $4.85 billion to settle more than 26,000 patient lawsuits. The company, which is buying rival Schering-Plough Corp., is based in Whitehouse Station, New Jersey.

The justices will hear arguments in the nine-month term that starts in October.

The case is Merck v. Reynolds, 08-905.
“Court Revives Merck Class-Action Suit”

The Star-Ledger (Newark, New Jersey)
September 10, 2008
Sophia Pearson

Merck must face a proposed class-action lawsuit saying the company defrauded investors before withdrawing the painkiller Vioxx from the market in September 2004, a federal appeals court ruled. The three-judge panel in Philadelphia reversed a lower court and reinstated the suit in a split decision yesterday, Merck said in a statement. The Whitehouse Station-based company said it may ask the full 3rd U.S. Circuit Court of Appeals or the U.S. Supreme Court to review the decision.

“This allows the case to proceed on behalf of Merck shareholders,” Richard Weiss, an attorney for investors with Milberg in New York, said by telephone. “This is a very significant case with billions of dollars in market losses.”

U.S. District Judge Stanley Chesler in Newark dismissed the class action in April 2007, ruling investors had exceeded a two-year deadline for filing timely cases claiming Merck knew of Vioxx’s risks.

The first investor suit was filed in November 2003, more than three years after a March 2000 study showed Vioxx caused five times more heart attacks than a rival painkiller, naproxen. Merck said the results stemmed from naproxen’s protection of the cardiovascular system.

The appeals court rejected Chesler’s ruling that a September 2001 U.S. Food and Drug Administration letter urging Merck to stop misrepresenting the study served as a “storm warning” that put investors on notice.

“The district court acted prematurely in finding as a matter of law that appellants were on inquiry notice of the alleged fraud before Oct. 9, 2001,” Appellate Judge Dolores Sloviter wrote. “As of that date, market analysts, scientists, the press and even the FDA agreed that the naproxen hypothesis was plausible.”

Senior Judge Jane Roth dissented, arguing the FDA’s warning letter provided “sufficient evidence” of the risks for investors, “regardless of any significant change in stock price or analysts’ stock ratings or projections at the time.”

Chesler only considered timeliness in his ruling and didn’t address alternative grounds for dismissal proposed by Merck. The company plans to renew its request to throw out the suit on those grounds if yesterday’s ruling isn’t reversed. The appeals panel didn’t rule on the suit’s merits, Merck said.

Merck agreed in November to pay $4.9 billion to resolve more than 26,000 product liability lawsuits claiming Vioxx caused heart attacks and strokes. The company spent $1.5 billion out of a $1.9 billion legal reserve to defend the suits.
The main pension fund of New York State filed a federal lawsuit yesterday against Merck & Company, accusing it of misleading shareholders about the safety of its arthritis pain drug Vioxx, which has since been withdrawn.

The suit, brought in United States District Court in Trenton, said that the pension fund lost about $171 million on Sept. 30, when the company, citing increased heart risks in tests of people who had used Vioxx for more than 18 months, withdrew it from the market. On that day, the price of a share of Merck stock plummeted 27 percent, and it has since drifted lower. Merck shares are down almost 40 percent so far this year, though they closed up 35 cents yesterday, at $28.02.

The suit appears to be the first by a pension fund against Merck, which is based in Whitehouse Station, N.J. A company spokeswoman, Joan Wainwright, said that about 15 lawsuits had been filed, contending that Merck misled shareholders. Several hundred personal injury lawsuits have also been filed against Merck by people claiming to have been injured by Vioxx.

The company has denied any wrongdoing.

In a statement issued yesterday, the New York State comptroller, Alan G. Hevesi, who is also the pension fund’s trustee, maintained that Merck knew but failed to disclose that growing evidence indicated that Vioxx users were at increased risk of heart attacks, strokes and death. “Merck must be held legally responsible for its actions,” Mr. Hevesi said. “These actions have put lives at risk and cost shareholders billions of dollars.” Mr. Hevesi’s suit is seeking unspecified damages.

Besides the company, the suit names several individuals, including Merck’s chief executive, Raymond V. Gilmartin.

Merck executives have disputed suggestions that they acted improperly and said they moved promptly to withdraw Vioxx after the patients in the clinical trial—where the drug was being tested as a treatment for colon polyps—experienced increased risks of cardiovascular problems.

“Merck extensively studied Vioxx before seeking regulatory approval to market it,” the spokeswoman, Ms. Wainwright, said. “We promptly disclosed the clinical data about Vioxx. When questions arose, we took additional steps, including conducting further prospective, controlled studies to gain more clinical information.”

She said that Merck had not seen Mr. Hevesi’s lawsuit and so would not comment.

In the suit, Mr. Hevesi cited recent newspaper and broadcast reports and medical journal articles that raised questions about Merck’s handling of safety issues surrounding Vioxx.

Some people raised safety questions after Vioxx’s approval in 1999 by the Food and Drug Administration. In 2000, for instance,
a major clinical trial of the drug found that those taking it had a fivefold greater risk of heart attacks compared with patients in the trial who took another pain reliever, naproxen.

Until recently, Merck executives said that those results did not reflect dangers posed by Vioxx but rather the protective effect of naproxen for cardiac health.

A spokesman for Mr. Hevesi, John Chartier, said that at the end of September, the New York State pension fund owned about 9.4 million shares of Merck.

In the lawsuit filed yesterday, Mr. Hevesi is seeking the court to consolidate all securities-related claims against Merck in connection with Vioxx into a class action and to make him the lead plaintiff. He also filed a separate but related lawsuit yesterday in United States District Court in New Orleans.

The New York State Common Retirement Fund, as the pension fund is formally known, is the second-largest public pension fund in the country, after Calpers. It has some $120.8 billion in assets and more than 970,000 retirees, beneficiaries and members.
Federal prosecutors and the Securities and Exchange Commission are investigating Merck & Company in connection with Vioxx, the painkiller that was withdrawn from the market in late September because it increased the risk of heart attacks in long-term users.

Merck said yesterday that it had received a subpoena from the Justice Department "requesting information related to the company's research, marketing and selling activities with respect to Vioxx." It said the request related to a "federal health care investigation under criminal statutes."

Merck, which disclosed the investigations in its quarterly filing with securities regulators, said the staff of the S.E.C. had told the company that it had begun an informal inquiry.

Merck did not say what the investigations were about and the federal agencies do not as a rule comment on such investigations. But since the Vioxx withdrawal, questions have swirled about whether Merck knew the risks of Vioxx several years ago but had covered them up. For years, even as evidence that the medicine might increase risk of heart attacks mounted, Merck disputed such findings.

A spokeswoman for Merck said yesterday that the company "acted appropriately and responsibly in our development and marketing of Vioxx" and would cooperate with the investigation.

One possibility is that the S.E.C. is looking into whether Merck misled shareholders about the safety of Vioxx. The Justice Department investigation could be looking at that issue as well as whether Merck misled regulators or perhaps caused federal health programs to pay for the prescription drug when its use was not warranted.

The investigations are in addition to hundreds of lawsuits Merck is facing from people claiming to have been injured by Vioxx and lawsuits from shareholders claiming the company misled investors.

Merck said in its filing that it could not predict the outcome of the inquiries, but that "highly unfavorable outcomes" could have a "material adverse effect on the company's financial position." Merck's filing was made public after the close of the markets. The company's stock, which is down about 40 percent from its level before the Vioxx recall, rose 36 cents, to $26.57, in regular trading but then lost 76 cents in after-hours trading.

Shares of Pfizer, meanwhile, dropped 38 cents, to close at $28.41, yesterday after the company said in its quarterly filing late Friday that it would probably add a "black-box" warning—the strongest kind—to the label of Bextra, a pain-relieving medicine in the same class as Vioxx. The warning is about rare but potentially fatal skin reactions to the drug.

Pfizer warned doctors about the skin reactions in a letter last month at the same time as it revealed that Bextra had increased the risk of heart attacks and strokes in two
clinical trials of patients undergoing coronary bypass surgery.

In that letter, the company said it would seek to highlight the risk of skin reactions in bolder text. On Friday it said it was likely to add a stronger warning in a black box.

Tim Anderson, an analyst at Prudential Equity Group, said in a note to clients that such a warning would impair the ability of Pfizer to market Bextra, “which suggests the commercial future of Bextra is at risk.” Dr. Anderson said he might reduce his estimate of $1.7 billion in Bextra sales for 2005 because of the warning and because of the suggestion of cardiovascular risk. (His note mentioned that “the research analyst, a member of the team, or a member of the research analyst’s household has a financial interest” in Pfizer.)

Bextra and Vioxx, as well as Celebrex from Pfizer, are known as COX-2 inhibitors, a new class of painkillers used mainly for arthritis. Regulators in various countries are now investigating whether all drugs in the class may have the same cardiovascular risks as Vioxx. Pfizer has insisted that Celebrex has no increased risk and that Bextra is safe outside of heart bypass surgery.

The skin reactions to Bextra include Stevens-Johnson Syndrome, toxic epidermal necrolysis and erythema multiforme, which are somewhat similar conditions. Jean McCawley, head of the Stevens-Johnson Syndrome Foundation in Westminster, Colo., said the conditions involved severe blistering.

Pfizer said that while such reactions occur with many drugs, the rate for Bextra was higher than for other COX-2 inhibitors, though it did not say what the rate was.

The label of Bextra was amended to mention the reactions in 2002, a year after the medicine was approved, and further amended to mention fatalities last April.

Pfizer also said in its quarterly filing on Friday that the attorneys general of New York and Connecticut were investigating whether the company promoted drugs for uses not approved by the F.D.A.

Pfizer said it received a letter from the New York attorney general’s office seeking information on clinical trials and promotions of certain drugs, which it did not specify. A spokesman for Eliot Spitzer, the attorney general, would not comment.

Attorney General Richard Blumenthal of Connecticut said in a statement that he was seeking information on the children’s use of the antidepressant Zoloft, one of Pfizer’s top sellers. Zoloft, like most antidepressants, is not approved for pediatric use and concerns have grown about suicidal tendencies in children using such drugs.
“Revisiting the Limitations Period for Securities Fraud”

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Sarah S. Gold and Richard L. Spinogatti

In the last several years, the U.S. Supreme Court has addressed several difficult federal securities fraud issues, resolving circuit splits and providing greater certainty and uniformity. Now the Court appears poised to wade into another murky issue—when the statute of limitations applicable to a federal securities fraud claim begins to run. This issue was last addressed by the Court nearly 20 years ago in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991), when it held that the limitations period should be governed by a nationwide uniform standard: one year “after discovery of the facts constituting the violation” or three years after the violation. After Lampf, Congress changed the limitations periods to two and five years, respectively, but retained Lampf’s trigger for the shorter limitations period: “discovery of the facts constituting the violation.” 28 U.S.C. §1658(b).

The Court has now granted certiorari in a case raising the issue of when the statute of limitations begins to run for securities fraud claims under the “inquiry notice” standard. In re Merck & Co. Secs., Deriv. & “ERISA” Litig. The circuit courts agree that a limitations period triggered by “discovery” of an alleged violation commences when a plaintiff either actually or constructively discovers the relevant facts.

Constructive discovery is a two-step analysis: First, when did the plaintiff receive sufficient information of possible wrongdoing such that a reasonable investor would undertake an investigation to determine if a legal claim exists (“inquiry notice”) and second, when thereafter, in the exercise of reasonable diligence, should the plaintiff have discovered the facts constituting the violation. This latter date should trigger the limitations period.

The Merck Case

In Merck, the U.S. Court of Appeals for the Third Circuit, in a split decision, held an investor is not on inquiry notice of a potential fraud claim until the investor has knowledge of a possible fraud, including scienter. The court held that even widely publicized misstatements by Merck about the safety of its drug Vioxx were insufficient to give rise to a duty to investigate without evidence that its misstatements were intentional. The United States Court of Appeals for the Ninth Circuit also recently required evidence of scienter for inquiry notice, in Betz v. Trainer Wortham & Co., 519 F.3d 863 (9th Cir. 2008), and a certiorari petition is pending.

The misstatements in Merck arose after Vioxx studies made public by at least 2000, indicated that Vioxx was associated with a higher incidence of heart attacks than competing drugs using Naproxen. Two possible explanations existed: Vioxx caused more heart attacks or Naproxen prevented them. Merck repeatedly expressed its view that Naproxen lowered the heart attack risks until the FDA warned Merck, in September 2001, that its marketing materials were “false” because no substantial evidence existed supporting that assertion, and Merck failed to provide the other reasonable explanation, that Vioxx caused more heart
attacks. The warning letter received widespread coverage by media and securities analysts, and consumer lawsuits were filed both before and after the FDA letter. An October 2001 New York Times article reported that a Merck scientist admitted Merck had insufficient findings to resolve the issue. An October 2003 Harvard study indicated that Vioxx, as compared with a similar drug, increased heart attacks. In September 2004, Merck withdrew Vioxx from the market.

Securities lawsuits were filed in November 2003. The district court dismissed the claims as time-barred, holding that an “overwhelming collection of information signaling deceit by Merck with respect to the safety of VIOXX” existed at the time of the October 2001 New York Times article and placed plaintiffs on inquiry notice of possible fraud which plaintiffs failed to investigate.

The Third Circuit reversed, finding that misstatements alone were insufficient “storm warnings” of culpable activity under the securities laws where those misstatements related to beliefs or opinions, given the requirement to demonstrate that misstatements of opinion were issued “without a genuine belief or reasonable basis.” The court found there was no reason for an investor to suspect that Merck did not believe Naproxen reduced heart attacks until the November 2003 Harvard study. In rejecting October 2001 inquiry notice, the court also considered the absence of any large stock price movement or changes in analyst ratings. Finding no inquiry notice, Merck never reached the issue of when a reasonable investigation would have provided facts sufficient to file a complaint.

Judge Roth, dissenting, found the FDA warning letter alone, and the total mix of information in the public realm, provided more than adequate “storm warnings” and concluded: “I cannot see how a reasonable investor could not be aware of the possibility that Merck had been fraudulently misrepresenting the cardiovascular safety of Vioxx.” Under Judge Roth’s formulation of inquiry notice, the limitations period begins when information alerts a reasonable investor to the possibility of the general fraudulent scheme alleged in the complaint, “particularly since” the plaintiffs failed to demonstrate either a diligent investigation or that “they were unable to uncover pertinent information during the time period.”

Analysis

Confusion reigns in the circuit courts, compounded by the fact-specific nature of the issues. In some circuits, the statute begins to run as soon as a plaintiff receives storm warnings of possible fraud (Fourth and Eleventh circuits). In some, the statute runs from inquiry notice if a reasonably diligent inquiry could have uncovered the facts underlying the fraud claims within the limitations period (Fifth and Eighth circuits). In others, the statute begins to run only at the time a plaintiff using reasonable diligence could have discovered the facts underlying its claim (First, Sixth and Tenth circuits). In the Second Circuit, a plaintiff on inquiry notice must actually conduct an investigation or the limitations period will be deemed to run from the date the duty to investigate arose. This also is the Third Circuit rule.

The statutory language plainly states a plaintiff has two years “after discovery of the facts constituting the violation” to file suit, from which it appears the limitations period cannot begin to run until a claim that would withstand dismissal may be stated. “Inquiry notice” connotes a point in time
before all the facts are known and thus cannot be the starting date for the limitations period. Thus, no basis exists to start the limitations period upon inquiry notice as some circuit courts have held. As Lampf observed in finding equitable tolling “fundamentally inconsistent” with the limitations structure: “The one-year period, by its terms, begins after discovery of the facts constituting the violation, making tolling unnecessary.”

Thus, whatever triggers inquiry notice, the limitations period should never begin to run until an investor discovers or should have discovered the facts constituting the violation. If the misstatements by Merck had triggered inquiry notice, a reasonable investigation would not have uncovered evidence of scienter, according to the Third Circuit, until the Harvard Study two years later and therefore, assuming an investigation, the action would not have been barred.

The problem in Merck was that Third Circuit precedent required an investigation but none had been conducted, thus making inquiry notice the crucial date. If the Third Circuit had found evidence of falsity, rather than fraud, sufficient for inquiry notice, and then applied its pre-existing rule that inquiry notice triggers the limitations period where no investigation is undertaken, the court might have deemed the suit untimely.

The Solicitor General argued in Betz, as amicus on certiorari, that imputing knowledge as of the inquiry notice date where no investigation is conducted is inconsistent with both the plain text of Section 1658(b) and Lampf’s rejection of equitable tolling. However, the legislative history of Section 1658(b) states that the discovery provision was not intended to change then-existing decisional law and specifically quotes the Second Circuit: “When the circumstances would suggest to an investor of ordinary intelligence that she has been defrauded, a duty to investigate arises, and knowledge will be imputed to the investor who does not make such an inquiry.” Thus, although not in the statutory language, the Court could nonetheless adopt that rule. Indeed, a duty to investigate without such an early imputed knowledge concept would be meaningless.

Regarding the trigger for inquiry notice, the Solicitor General agreed with Betz and Merck that evidence of scienter is required. “Because scienter is an essential element of a securities-fraud claim, there is no logical basis for concluding that a reliably diligent investor would have undertaken further inquiry if the facts before him did not suggest that the defendant had acted with the requisite state of mind.” However, in many cases whether inquiry notice requires scienter “will be utterly irrelevant” because a misstatement concerning a matter exclusively within the knowledge or control of the speaker suggests scienter and thus will automatically constitute inquiry notice.

Indeed most courts have articulated the inquiry notice standard as involving “fraud,” thus necessarily suggesting evidence of scienter, although only Betz and Merck have directly addressed, and expressly required, evidence of scienter. It was the opinion nature of the Merck misstatements which gave rise to specific consideration of scienter. A comparison to the misstatements in Betz is instructive in this regard.

In Betz, a brokerage client was told her investment principal was risk-free. After monthly statements reflected rapid principal decline, upon inquiring she was informed that her principal would return when market conditions improved. Despite the seemingly
obvious fact she had been lied to, Betz found no evidence of scienter. Reviewing these facts one could conclude not only that the plaintiff had information indicating the misstatements were intentional but that she was on actual—not constructive—notice of the fraud.

In Merck, however, because the misstatements involved Merck’s belief, the sincerity of that belief was the relevant issue and misstatements alone arguably did not evidence the scienter necessary to trigger inquiry notice of a fraud claim. While the nature of the misstatement may be relevant to assess the requirements for inquiry notice, the problem appears more to concern how individual judges see the facts.

The Supreme Court’s Task

Resolution of competing policy issues, often the enunciated bases for recent securities fraud decisions, is likely to play a significant role in the outcome here. On one side, an investor must have sufficient time to file a fully formed, sustainable complaint, under the heightened pleading requirements of the Private Securities Litigation Reform Act, which requires class plaintiffs to state with particularity facts giving rise to a strong inference of fraud.

Merck acknowledges such a policy motive, observing: “It is ironic that the dissent, although noting what might be viewed as Merck’s misrepresentations, would apply the Statute of Limitations to deprive plaintiffs of the opportunity to prove a viable case against Merck for such misrepresentations.” Providing time to investigate is important to permit an investor to uncover fraud, but meeting the heightened pleading requirements is equally important to position courts to distinguish between well-founded and frivolous cases at the pleading stage.

On the other side of the policy equation is Congress’ desire “to limit the opportunistic use of federal securities law to protect investors against market risk” by imposing a duty on plaintiffs to take prompt steps to uncover fraud. Merck argues that now in the Third Circuit “a plaintiff is not obligated to ask a single question until it has evidence of scienter, materiality, and loss causation—that is, until it has in hand a nearly fully formed cause of action.” Such a requirement conflicts with the goals of inquiry notice: to encourage investors to investigate possible fraud, to discourage “a wait-and-see” approach, and to ensure fairness to defendants against claims that have been allowed to slumber.

A definition of “discovery of the facts constituting the violation” appears to be easy: when the facts necessary for a sustainable complaint are in hand. Doing away with inquiry notice entirely would solve much, if not all, of the existing confusion. However, the Supreme Court’s view of the competing policy issues is likely to inform its decisions regarding whether to keep inquiry notice and, if so, in what form, and whether to impose upon investors an actual duty to investigate and if so, what consequences follow a failure to do so. Reading the tea leaves, the Court is likely to reaffirm that the limitations period commences only after actual or imputed discovery of the facts, and may well formulate broad guidance for inquiry notice that provides an incentive to investigate fraud at an early stage, and imposes a duty to investigate, failing which imputed knowledge would bar claims.
The exclusive 10-year license that the National Football League teams granted to Reebok International Ltd. to use the teams' intellectual property to manufacture and sell headwear bearing the teams' logos and trademarks does not violate Section 1 of the Sherman Act, which outlaws any "contract, combination . . . or conspiracy, in restraint of trade," because NFL teams share vital economic interests in collectively promoting NFL football in competition with other forms of entertainment and are best described as a single source of economic power when promoting NFL football through licensing the teams' intellectual property.

Questions Presented: (1) Are the NFL and its member teams a single entity that is exempt from rule of reason claims under Section 1 of the Sherman Act simply because they cooperate in joint production of NFL football games, without regard to their competing economic interests, their ability to control their own economic decisions, or their ability to compete with each other and the league? (2) Is the agreement of NFL teams among themselves and with Reebok International, pursuant to which teams agreed not to compete with each other in licensing and sale of consumer headwear and clothing decorated with teams' respective logos and trademarks, and not to permit any licenses to be granted to Reebok's competitors for a period of 10 years, subject to a rule of reason claim under Section 1 of Sherman Act, when teams own and control use of their separate logos and trademarks and, but for their agreement not to, could compete with each other in the licensing and sale of team products?
professional sports league in America today, the NFL needs little introduction. Indeed, the NFL has inspired countless hours of heated and in-depth discussion about the league’s 88 years of professional-football history, including its great players, championship teams, and memorable games. But the only discussion the NFL inspires here involves aspects of the league that are not as well known: the league’s corporate structure, and the nature of its relationships with its member teams and the entities charged with licensing those teams’ intellectual property.

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Realizing that the success of the NFL as a whole was in their best interests, in the early 1960s the individual teams sought to collectively promote the NFL Brand—that is, the intellectual property of the NFL and its member teams—to compete against other forms of entertainment. With this promotional effort in mind, in 1963 the NFL teams formed NFL Properties: a separate corporate entity charged with (1) developing, licensing, and marketing the intellectual property the teams owned, such as their logos, trademarks, and other indicia; and (2) “conduct[ing] and engag[ing] in advertising campaigns and promotional ventures on behalf of the NFL and [its] member [teams].” Among other things, the NFL teams authorized NFL Properties to grant licenses to vendors so the vendors could use the teams’ intellectual property to manufacture and sell various kinds of consumer products that bear the teams’ logos and trademarks—products such as team jerseys, shirts, flags, and, as pertinent here, head-wear, like baseball caps and stocking hats.

For a while after its establishment, NFL Properties granted headwear licenses to a number of different vendors simultaneously; one of those vendors was American Needle, which held an NFL headwear license for over 20 years. But then in 2000, the NFL teams authorized NFL Properties to solicit bids from the vendors for an exclusive headwear license. Reebok won the bidding war, and in 2001 the NFL teams allowed NFL Properties to grant an exclusive license to Reebok for ten years. NFL Properties thus did not renew American Needle’s headwear license, or the licenses of the other headwear vendors.

American Needle responded to the loss of its headwear license by filing an antitrust action against the NFL, NFL Properties, the individual NFL teams, and Reebok. As relevant here, American Needle claimed that the exclusive headwear licensing agreement between NFL Properties and Reebok violated § 1 of the Sherman Antitrust Act, which outlaws any “contract, combination . . . or conspiracy, in restraint of trade.” 15 U.S.C. § 1. As American Needle saw it, because each of the individual teams separately owned their team logos and trademarks, their collective agreement to authorize NFL Properties to award the exclusive headwear license to Reebok was, in fact, a conspiracy to restrict other vendors’ ability to obtain licenses for the teams’ intellectual property. American Needle also contended that, by authorizing NFL Properties to award the license to Reebok, the NFL teams monopolized the NFL team licensing and product wholesale markets in violation of § 2 of the Sherman Antitrust Act.

One year after American Needle brought its suit, the NFL defendants filed a motion for summary judgment on the company’s § 1 claim. The NFL defendants argued that, under the United States Supreme Court’s decision in Copperweld Corp. v.
Independence Tube Corp., and its progeny, they were immune from liability under § 1. In Copperweld, the Supreme Court concluded that a parent corporation and its wholly owned subsidiary are a single entity for antitrust purposes. The Court based its conclusion on its determination that the parent-subsidiary relationship did not yield the anti-competitive risks that the Sherman Antitrust Act was enacted to combat. Specifically, the Court stated that agreements between companies are generally subject to § 1 review because they deprive the market of the independent sources of economic power that competition requires. But because the parent-subsidiary relationship is always “guided or determined not by two separate corporate consciousnesses, but one,” the relationship does not deprive the market of any independent sources of economic power.

Federal courts in later cases extended the single-entity concept beyond the context of a parent-subsidiary relationship, stating that affiliated companies or individuals could also be considered a single entity in certain circumstances. Relying on this gradual extension of Copperweld, the NFL defendants asserted that they functioned as a single entity when collectively promoting NFL football by licensing the NFL teams’ intellectual property, and were thus immune from liability under § 1.

American Needle did not immediately oppose the NFL defendants’ summary-judgment motion. Instead, the company moved for a continuance under Fed. R. Civ. P 56(f) on the ground that it was “unable to present admissible evidence” to dispute the NFL defendants’ single-entity defense. That evidence, American Needle stated, “was in the possession of the defendants.” The company therefore asked the district court for the opportunity to take discovery regarding the NFL defendants’ single-entity defense and “a number of issues generally,” and included a list of 51 discovery requests.

* * *

Shortly after briefing completed, the district court issued an order in which it both denied American Needle’s Rule 56(f) motion, and granted the NFL defendants’ motion for summary judgment on American Needle’s § 1 claim. The district court determined that further discovery on the single-entity issue was unnecessary because “the facts that materially [bore] upon the [court’s] decision [were] undisputed,” and led “to the conclusion that the NFL and the teams act as a single entity in licensing their intellectual property.” The court’s conclusion was based on its determination that the NFL teams’ collective-licensing agreement serves “to promote NFL football.” And by promoting NFL football through collective licensing, the court continued, the NFL teams “act[ ] as an economic unit” in such a manner that “they should be deemed to be a single entity.” The court therefore concluded that American Needle’s § 1 claim failed as a matter of law because, under Copperweld, single entities cannot restrain trade in violation of the Sherman Antitrust Act. The court then sought supplemental briefing on whether its single-entity finding compelled the dismissal of American Needle’s § 2 monopolization claim.

After the parties submitted their briefs addressing American Needle’s § 2 monopolization claim, the court granted summary judgment to the NFL defendants. The court concluded that its earlier single-entity determination doomed American Needle’s § 2 claim because, as a single entity, the NFL and its member teams could collectively license their intellectual property “to one or many without running
afoul of the antitrust laws.” This appeal followed.

II. ANALYSIS

American Needle attacks the district court’s judgment by forwarding two arguments. First, American Needle contends that the district court incorrectly denied its Rule 56(f) motion before granting summary judgment to the NFL defendants on its §1 claim. American Needle further asserts that the district court was wrong to grant the NFL defendants’ motions for summary judgment on both its §1 and §2 monopolization claims. We address these arguments in turn.

A. The district court’s denial of American Needle’s Rule 56(f) motion

[The court determined that the district court did not abuse its discretion by denying American Needle’s Rule 56(f) motion.]

B. The district court’s grant of summary judgment to the NFL defendants

American Needle next challenges the district court’s grant of summary judgment to the NFL defendants. We review the district court’s grant of summary judgment de novo, taking the facts in the light most favorable to American Needle, the non-moving party. And in so viewing the record, we will examine whether there is a genuine issue of material fact that precludes judgment as a matter of law.

American Needle first contends that the district court erred by granting the NFL defendants’ summary judgment on its §1 claim. Specifically, American Needle argues that the district court incorrectly concluded that the NFL teams constitute a single entity under Copperweld when collectively licensing their intellectual property. American Needle’s argument leads us into murky waters. We have yet to render a definitive opinion as to whether the teams of a professional sports league can be considered a single entity in light of Copperweld. The characteristics that sports leagues generally exhibit make the determination difficult; in some contexts, a league seems more aptly described as a single entity immune from antitrust scrutiny, while in others a league appears to be a joint venture between independently owned teams that is subject to review under §1. For instance, from the perspective of fans, a professional sports league can be seen as “a single source” of entertainment that produces “one product,” even though the league’s member teams are distinguishable. Yet at the same time, individuals seeking employment with any of the league’s teams would view the league as a collection of loosely affiliated companies that all have the independent authority to hire and fire employees.

That being said, we have nevertheless embraced the possibility that a professional sports league could be considered a single entity under Copperweld. But because of the many and conflicting characteristics that professional sports leagues generally exhibit, we have expressed skepticism that Copperweld could provide the definitive single-entity determination for all sports leagues alike. This skepticism, in turn, has led us to opine that the question of whether a professional sports league is a single entity should be addressed not only “one league at a time,” but also “one facet of a league at a time.” Thus, in reviewing the district court’s decision, we will limit our review to (1) the actions of the NFL, its members teams, and NFL Properties; and (2) the actions of the NFL and its member teams as they pertain to the teams’ agreement to license their
intellectual property collectively via NFL Properties.

With this compartmentalization of *Copperweld* in mind, we turn to American Needle’s challenge to the district court’s single-entity determination. According to American Needle, the district court applied the wrong legal standard when concluding that the NFL teams were a single entity. As American Needle sees it, the district court concluded “that the NFL teams are a single entity because they ‘act’ as a single entity in licensing their intellectual property.” American Needle asserts that this approach undercuts the Supreme Court’s central teaching in *Copperweld*: that the Sherman Antitrust Act was designed to combat the deprivation of independent sources of economic power in the marketplace.

Therefore, American Needle continues, instead of asking whether the NFL teams merely “act” as a single entity, the district court should have inquired into whether the NFL teams’ agreement to license their intellectual property collectively deprived the market of sources of economic power that control the intellectual property. That question, the company contends, can be answered by looking to whether the teams could compete against one another when licensing and marketing their intellectual property. If so, American Needle posits, then it is the individual teams who actually control their intellectual property, meaning that they cannot be considered a single entity for the purposes of licensing their intellectual property.

We agree with American Needle that the Supreme Court in *Copperweld* was concerned about the anti-competitive effects that collective action might introduce into the market. We further agree that when making a single-entity determination, courts must examine whether the conduct in question deprives the marketplace of the independent sources of economic control that competition assumes.

But we are not convinced that the NFL’s single-entity status in the present context turns entirely on whether the league’s member teams can compete with one another when licensing and marketing their intellectual property. American Needle’s proposed approach is one step removed from saying that the NFL teams can be a single entity only if the teams have “a complete unity of interest”—a legal proposition that we have rejected as “silly.” *Bulls II*, 95 F.3d at 598. As we have explained, “*Copperweld* does not hold that only conflict-free enterprises may be treated as single entities”; “[e]ven a single firm contains many competing interests.” *Id.* At 598. Thus, though the several NFL teams could have competing interests regarding the use of their intellectual property that could conceivably rise to the level of potential intra-league competition, those interests do not necessarily keep the teams from functioning as a single entity. We therefore cannot fault the district court for not considering whether the NFL teams could compete against one another when licensing and marketing their intellectual property.

And with that said, American Needle’s assertion that the NFL teams have deprived the market of independent sources of economic power unravels. Certainly the NFL teams can function only as one source of economic power when collectively producing NFL football. Asserting that a single football team could produce a football game is less of a legal argument than it is a Zen riddle: Who wins when a football team plays itself? It thus follows that only one source of economic power controls the promotion of NFL football; it makes little
sense to assert that each individual team has the authority, if not the responsibility, to promote the jointly produced NFL football. Indeed, the NFL defendants introduced uncontradicted evidence that the NFL teams share a vital economic interest in collectively promoting NFL football. After all, the league competes with other forms of entertainment for an audience of finite (if extremely large) size, and the loss of audience members to alternative forms of entertainment necessarily impacts the individual teams’ success.

But most importantly, the record amply establishes that since 1963, the NFL teams have acted as one source of economic power—under the auspices of NFL Properties—to license their intellectual property collectively and to promote NFL football. Tellingly, American Needle does not dispute that the NFL teams collectively license their intellectual property to promote NFL football; in fact, when opposing the NFL defendants’ motion for summary judgment, American Needle relied on NFL Properties’s Articles of Incorporation, which state that the teams formed NFL Properties “[t]o conduct and engage in advertising campaigns and promotional ventures on behalf of the [NFL] and the member [teams].” And our review of the record reveals no evidence that requires us to question the purpose of the teams’ licensing agreement.

Simply put, nothing in § 1 prohibits the NFL teams from cooperating so the league can compete against other entertainment providers. Indeed, antitrust law encourages cooperation inside a business organization—such as, in this case, a professional sports league—to foster competition between that organization and its competitors. Viewed in this light, the NFL teams are best described as a single source of economic power when promoting NFL football through licensing the teams’ intellectual property, and we thus cannot say that the district court was wrong to so conclude. Moving on, the failure of American Needle’s § 1 claim necessarily dooms its § 2 monopolization claim. As a single entity for the purpose of licensing, the NFL teams are free under § 2 to license their intellectual property on an exclusive basis, even if the teams opt to reduce the number of companies to whom they grant licenses. As such, American Needle has no colorable claim that the NFL teams and NFL Properties created a monopoly by awarding Reebok the exclusive headwear licensing contract. The district court was therefore correct to grant summary judgment to the NFL defendants on American Needle’s § 2 monopolization claim.

III. CONCLUSION

We AFFIRM the district court’s judgment.
In taking a case involving the National Football League’s exclusive licensing deal for sports merchandise, the Supreme Court could go beyond caps and give leagues more leeway in areas such as team relocation, legal scholars said Monday.

“A broad ruling in favor of the NFL could rewrite almost all of sports antitrust law,” said Gabe Feldman, associate law professor and director of the Sports Law Program at Tulane University in New Orleans.

The court will hear an appeal from American Needle Inc., of Buffalo Grove, Ill., which filed an antitrust challenge to an agreement the NFL struck with Reebok International Ltd. American Needle had been one of many firms that manufactured NFL headwear until the league granted an exclusive contract to Reebok in 2001.

The NFL won the case in the federal appeals court in Chicago. But it also asked the Supreme Court to hear the case in a quest for a more sweeping decision that could put an end to what the league considers costly, frivolous antitrust lawsuits.

The court decided to take the case against the advice of the U.S. Solicitor General’s office.

The central question is whether the league is essentially a “single entity” that can act collectively, as the NFL argues, or 32 distinct businesses that must be careful about running afoul of antitrust laws.

Matt Mitten, a law professor and director of the National Sports Law Institute at Marquette University in Milwaukee, called the court’s decision to take the case significant.

“This will be the first time the Supreme Court will consider the merits of the single entity defense,” he said, adding that a favorable court decision could give the league “a lot more room not to have to fear suits” on issues such as relocation and ownership requirements.

In a statement, NFL spokesman Greg Aiello said the league looked forward to explaining why the court should extend, on a national basis, favorable appeals court rulings on how antitrust laws apply “to the unique structure of a sports league.”

American Needle did not respond to telephone messages Monday.

Other than Major League Baseball, which has an antitrust exemption dating to a 1922 Supreme Court decision, the other sports leagues have an intense interest in the case. The National Basketball Association and the National Hockey League both asked the court to rule in favor of the NFL.

“We look forward to the Supreme Court finally resolving what has become an oft-litigated, contentious issue in litigation involving professional sports leagues,” said NHL Deputy Commissioner Bill Daly in a statement.
The NBA declined to comment.

Daniel C. Glazer, a lawyer at the New York-based law firm Patterson Belknap Webb & Tyler, said an NFL victory on the single entity issue would represent a significant change.

“Certain business activities of the NFL would not be subject to antitrust review by the government, and thus be exempt from potential government intervention and oversight,” said Glazer, who has expertise in intellectual property and sports.

Stephen Ross, director of the Penn State Institute for Sports Law, Policy and Research, said he found the court’s decision to take the case “deeply disturbing.”

“This case did not need to be heard by the court unless it had a broad plan from withdrawing the pro-consumer protections of the antitrust laws to sports fans,” said Ross, a former lawyer for the Federal Trade Commission and the Justice Department’s antitrust division.

But Mitten, the Marquette professor, said he wouldn’t make any assumptions about what the court would do based on its acceptance of the case.

Reebok was acquired by Adidas AG in 2006 in a $3.8 billion deal that helped the German company expand in the United States.

The case will be argued late this year or early in 2010.

The case is American Needle v. National Football League, 08-661.
The U.S. Supreme Court will use a case involving the National Football League’s licensing deal with Adidas AG’s Reebok to consider how much of a shield professional sports leagues should have from antitrust suits.

The justices today agreed to hear an appeal by American Needle Inc., which lost its right to sell caps with NFL team logos in 2000 when the league struck an exclusive agreement with Reebok. American Needle is seeking to sue the NFL, its 32 teams and their licensing arm. A federal appeals court threw out the suit.

The NFL, backed by the National Basketball Association and National Hockey League, took the unusual step of joining American Needle in seeking Supreme Court intervention. The leagues are gambling that the nation’s highest court will provide a broader shield from antitrust suits than some lower courts have. Leagues have faced “a cascade of antitrust suits,” the NFL said in a court filing. Those suits have meant “years of litigation and enormous burden and expense.”

The case likely will have its most direct impact on professional sports licensing. Retail sales of NFL-licensed merchandise in the U.S. and Canada topped $3.2 billion in 2007, according to the Licensing Letter’s Sports Licensing Report. Sales of pro football, baseball, basketball, hockey and soccer products combined were more than $9 billion.

The question in the appeal is whether leagues and their teams, at least in some cases, should be considered a single entity for the purposes of federal antitrust law. That finding would limit suits accusing teams of banding together to thwart competition.

**Competing Together**

The Chicago-based 7th U.S. Circuit Court of Appeals concluded in August that the NFL’s teams were entitled to operate collectively in marketing their logos and trademarks “so the league can compete against other entertainment providers.”

American Needle in its appeal said that reasoning would leave “little, if any, aspect of professional sports teams’ businesses” subject to the antitrust laws.

The NFL said leagues should be considered a single entity at least for what it called “core venture functions,” including marketing and sales. The Supreme Court in 2006 ruled that joint ventures have broad power to set prices without violating federal antitrust issues.

The issue doesn’t apply to Major League Baseball, which has an antitrust exemption under a 1972 Supreme Court decision.

The Supreme Court agreed to hear the case against the advice of the Obama administration, which urged the justices to reject the American Needle appeal.

The justices will hear arguments during their 2009-10 term, which starts in October. The case is *American Needle v. National Football League*, 08-661.
During the presidential campaign, when Barack Obama went out for exercise, he was often wearing a ball cap displaying his loyalty to the Chicago White Sox. That hat, though well-worn, apparently was so dear to him that he would not cast it aside when the Sox’s board chairman, Jerry Reinsdorf, offered him a couple of new hats to take its place, the Chicago Tribune has reported.

If the hat is still around, someone should check to see who made it. There is a fair chance it was made by Reebok. And that may be of some legal significance.

One of Reebok’s would-be rivals in the hat business is a company in Obama’s home state, American Needle, Inc., a manufacturer of sports hats, uniforms, and other apparel. It is based in the village of Buffalo Grove, 35 miles north of Chicago. Now that Obama is President, his government lawyers will be weighing in—at the Supreme Court’s invitation—on a case filed at the Court by American Needle, a case that has the major pro sports leagues’ rapt attention.

In fact, the National Football League, the National Basketball Association, and the National Hockey League—all the big-time sports combines except baseball and soccer—have told the Court they want it to hear American Needle’s case, even though it is targeted at one of them, the NFL, with a potential impact on all of them.

On Feb. 23, rather than making up its mind at that time whether to hear the case, the Justices sought first to get advice from the U.S. Solicitor General.

The case raises a core question of antitrust law: What kind of joint ventures, perhaps including pro sports leagues, are immune to the Sherman Act because they may qualify as “single entities”? To American Needle, it is all about whether it is going to be allowed to compete with Reebok International, Ltd., to sell league-sanctioned sports apparel, like hats.

The NFL used to license American Needle to sell hats that bore the logos, the names or other insignia of pro football teams. That was when NFL Properties was allowing various companies the right to produce goods bearing their trademarked imagery. It was all part of an effort to build up the public exposure of pro football as an event on which the public would spend its entertainment dollars.

But, in 2000, the NFL opted to solicit bids for an exclusive license to produce caps and other headwear. Reebok won the bidding, and in 2001 got an exclusive ten-year license. American Needle’s license was not renewed. So it sued the NFL, all of its teams, NFL Properties, and Reebok.

American Needle’s case was thrown out by lower courts. Most of the discussion there focused on the Sherman Act’s Section 1. It outlaws “every contract, combination in the form of trust or otherwise, or conspiracy” that seeks to restrain commercial activity among the states. If an entity sued is considered a single operation, though, there is no one to “combine” or “conspire” with but itself, so the Sherman Act does not apply, as a general rule.
The Seventh Circuit Court, in rejecting American Needle’s Sherman Act claims last August, focused upon a premise that clearly led to its conclusion: that is, the NFL and its 32 teams are just one entity, at least for purposes of licensing their protected images for sale on consumer goods for fans.

“Certainly,” the Circuit Court said, “the NFL teams can function only as one source of economic power when collectively producing NFL football. Asserting that a single football team could produce a football game is less of a legal argument than it is a Zen riddle. Who wins when a football team plays itself?”

Selling identifying goods to build itself up in the entertainment market, the Circuit Court found, is part of selling its single product: pro football games. It concluded: “The NFL teams are best described as a single source of economic power when promoting NFL football through licensing the teams’ intellectual property, and we thus cannot say that the District Court was wrong to so conclude.”

The case, from a sports perspective of law, may turn on what the Supreme Court meant in the 1957 decision in Radovitch v. NFL. There, as American Needle notes in its petition to the Supreme Court, the Justices ruled that the NFL is subject to antitrust liability for violations of Sherman Act Section 1. The Court declined to extend to pro football and other sports leagues the antitrust immunity that Major League Baseball alone has had since an idiosyncratic 1922 Supreme Court ruling.

But, for businesses beyond big-time sports, American Needle’s case may be seen as more important for what it might lead the Court to say about the present meaning of a 1984 ruling, in Copperweld Corp. v. Independence Tube Corp. There, the Court ruled that a parent corporation and its wholly-owned subsidiary can be treated as a single entity for antitrust purposes.

Lower courts have extended this approach to other arrangements, including affiliated companies involved in joint ventures.

American Needle argued that it is time for the Supreme Court to get involved again, at least as to pro sports. It argues that the Seventh Circuit ruling not only conflicts with the Radovitch decision, but with rulings in six other federal Circuit Courts.

“The Court has stated, on more than one occasion,” American Needle asserted, “that application of the Sherman Act to professional sports teams is wholly consistent with Congressional intent.” The Seventh Circuit, it added, “stands alone” in concluding otherwise.

Ordinarily, when everyone involved in a case, plus outsiders, agree that the Court should review it, that is quite persuasive with the Court. But the Justices are looking for some legal advice before they act.

When the Court asks the Solicitor General for the government’s legal views on a case, it often takes months for that office to respond. The Court does not set deadlines for such briefs. The new leaders of the Solicitor General’s office in the Obama Administration will determine what schedule they plan to keep.

With so much else on the President’s calendar, government lawyers may not want to bother to involve him in this case even though Obama is a committed fan of sports—and, of course, is a consumer of some of its merchandise (perhaps with a Reebok label).
Fast forward to a high-definition picture of sports late in 2010. Here is the news of the day, scrawling across the bottom of your TV screen or mobile Web device:

- LeBron James, who had been expecting a free-agency bonanza when his contract with the Cleveland Cavaliers expired after the 2009-2010 season, opens the 2010-11 season with . . . the Cavs, the only team with the right to sign him. Cleveland retains the NBA MVP by slotting his salary into the new league-wide scale.

- Minnesota Vikings defensive coordinator Leslie Frazier, the hottest commodity for every opening in the NFL over the past six months, signs on to be the new head coach of the Dallas Cowboys . . . at a league-determined salary that will pay him far less than he’d have made if the Denver Broncos had chosen him over Josh McDaniels in 2009.

- The Ricketts family, new owner of the Chicago Cubs, scraps plans for its own cable channel because Major League Baseball has barred all such broadcasts, as well as webcasts, by individual teams.

- A young Detroit Red Wings fan who has saved his pennies for months shells out $300 to buy a replica sweater that would have cost him $80 in 2009.

- Lockouts and strikes loom large in all four major team sports as an era of relative peace on the sports labor front ends and owners begin to exercise their new power over player unions.

Unlikely?

Discouraging?

It could happen.

All of those scenarios, in fact, could become realities if the NFL triumphs in a case now under consideration in the U.S. Supreme Court. Experts agree that the case known as **American Needle vs. NFL** could easily be the most significant legal turning point in the history of American sports.

If the high court rules in favor of the NFL, the development will be more important to the sports industry than Curt Flood’s battle against the reserve clause in the 1970s; than baseball’s collusion cases in the mid-’80s; than the NFL players union’s epic fight for free agency in a series of antitrust cases that stretched over a decade; and even than the enactment of the Sports Broadcasting Act in 1961, which is the legislation that is the foundation of the NFL’s television riches.

“There is nothing of more concern to me,” says one veteran union official, asking for anonymity because of the pending case and the significance of the issues. “Our leverage is in the antitrust courts, and a bad decision in this case could tilt the playing field beyond recognition.”

Another union leader, recognizing the significance of a win for the NFL, says wistfully, “We can only hope that the justices somehow decide that their decision to take the case for review was improvident and then decide not to make any decision.”
The news in late June that the Supreme Court had agreed to review the case flashed through the offices of the four player unions, the other three leagues, television networks and corporate sponsors.

The reaction of the unions was swift. Leaders and lawyers for all four unions are now in weekly conferences trying to formulate a coordinated strategy for intervening in the Supreme Court's deliberation. Although the players unions have worked together previously for other common causes, it has rarely happened with this level of urgency.

Legal scholars and experts agree that the case is of enormous significance. Gary Roberts, the dean of the Indiana University School of Law and the author of the leading textbook on sports law, tells ESPN.com that the case "could easily turn out to be the most significant sports law decision ever."

And even as a longtime NFL official who also asked not to be named tries to minimize the importance of the case, he admits that it is the first time the league has approached "so important an issue at so high a level."

The case began innocuously enough in Chicago in December of 2004 when American Needle, Inc. (ANI), filed an antitrust case against the NFL, claiming that the league was using its monopoly powers illegally to deprive the company of its share of the market for caps and hats bearing logos of NFL teams. ANI had made knit caps and baseball hats bearing NFL logos for decades until the NFL ended the relationship in 2000.

Four and a half years ago, the case was nothing unusual. These sorts of legal actions happen all the time, as the NFL is a popular target for antitrust cases large and small. The league's law firm, Covington & Burling in Washington, D.C., has defended similar suits for nearly 60 years—recently, the unsuccessful attempt by Ohio State running back Maurice Clarett to alter the NFL's draft age requirements.

Notable losses for the league came in the antitrust cases filed in Minneapolis by Freeman McNeil and Reggie White in the late '80s and early '90s that established free agency and other important benefits for NFL players.

For a time, the American Needle case seemed on its way to a rapid conclusion. The NFL won as quickly and as conclusively as anyone can win an antitrust lawsuit in the trial court and in an appeals court.

But American Needle didn't give up. It filed a request for review to the U.S. Supreme Court, one of 7,500 or so such requests filed annually. The court takes only 70 or 75 cases for decision each year, and American Needle's quest seemed quixotic at best.

Then, in a stunning development, the NFL told the Supreme Court it endorsed American Needle's request for a hearing and a decision. The league's attorneys announced, in a remarkable understatement, that they "are taking the unusual step of supporting" American Needle's effort to have the case reviewed at the highest level.

The league's action was a legal bombshell. Instead of standing on its lower-court wins over American Needle, the league told the Supreme Court that it wants the justices to consider an issue far beyond the caps-and-hats contract. It wants the court to grant the NFL total immunity from all forms of
antitrust scrutiny, an immunity that would then apply to the NBA, the NHL and MLB, as well.

"It's a strategy of high risk and high reward," says Randal Picker, a professor at the University of Chicago Law School who focuses on antitrust issues in the high court. "The NFL is making a bold bet on a big issue."

The court's first response was to ask the Obama administration for its thoughts on the issue. Sensing the historic possibilities of the case and the magnitude of the ramifications, Elena Kagan, the solicitor general appointed by President Barack Obama, urged caution, telling the justices, "This case would be a particularly unsuitable vehicle to consider the broad rule that the NFL seeks."

But that wasn't enough to keep the Supreme Court from accepting it.

The legal doctrine at the center of the case is known as "single entity." If the NFL manages to persuade the Supreme Court that the league is a single entity competing with other providers of entertainment rather than a group of 32 separate businesses competing with each other, the landscape of the sports industry will be transformed, according to law professors and experts contacted by ESPN.com.

If it is a single unit and not 32 separate, competing teams, any violation of American antitrust law would be impossible to establish. A violation of the Sherman Act begins with a "combination, contract or conspiracy" that restrains competition and hurts consumers. If the NFL is a single unit, it cannot be in combination, contract or conspiracy. It would be immune to the antitrust cases that have allowed player unions to establish and to protect free agency and other benefits.

Under the rule of single entity suggested by the NFL, the league could be vulnerable to antitrust scrutiny only if it were to join with other leagues or other providers of entertainment in setting prices, a highly unlikely development.

The NFL has been trying for decades to sell the idea that it is a single entity and so should be immune to antitrust attacks, with uniformly bad results. At least seven times in federal courts throughout the U.S., judges have been quick to recognize that NFL teams compete with each other for free-agent players, for coaches, for executives, for sponsors, for naming rights money and for fans.

"If the court adopts the NFL's single-entity concept, it would change everything," says Marc Edelman, a law professor at Rutgers who wrote the leading law review article on the issue.

A third antitrust law professor, James Speta of Northwestern, agrees that the NFL's action is a "bold strategy" that is based on the court's trend, under the leadership of John Roberts, the chief justice of the United States, toward rulings that are pro-business.

In other words, as the Supreme Court prepares to hear the single-entity argument at the highest level, the NFL might finally be presenting the idea in the right place at the right time.

"I am sure that the league and the lawyers have gone through a justice-by-justice analysis and have concluded that they have a chance to solve many problems in a single decision," Picker says.
Although handicapping a decision in the high court can be perilous, Supreme Court scholars agree that Roberts, Samuel Alito, Clarence Thomas and Antonin Scalia are likely supporters of the NFL’s position.

Stephen Breyer could easily join the pro-business justices based on his opinion in an NFL case in 1996 in which he hammered the union.

According to most experts, Obama’s choice for the court, Sonia Sotomayor, is likely to side with the players, a conclusion based on her ruling for the MLB players during the work stoppage of 1995. Sotomayor is expected to be confirmed by the time the Supreme Court reviews the case.

If the NFL is successful, then players, maverick owners, networks, paraphernalia manufacturers, fans and others will find themselves conducting business with what would be one of the most powerful cartels ever.

With their new powers and freedom from antitrust concerns, all four leagues would enter a new reality. Owners could attack free agency, using their new bargaining power to restrict player movement from team to team and impose a salary schedule, which is how the Cavaliers’ James conceivably could find his options severely limited after the upcoming NBA season. That could apply to any prospective free agent across the spectrum of pro sports, including stars such as the Boston Red Sox’s Josh Beckett (whose contract expires after this season), the Minnesota Twins’ Joe Mauer (who is scheduled for free agency in 2011) and the Houston Astros’ Lance Berkman (2011) in MLB, as well as the Arizona Cardinals’ Larry Fitzgerald and the San Diego Chargers’ Shawne Merriman (both of whom could be on the market after this season) in the NFL.

Leagues could easily establish a similar salary schedule for coaches and managers, who are considered a part of management and cannot legally form a union. Thus, the Vikings’ Frazier, who has already interviewed for a number of NFL head-coaching openings but has yet to land one of the top jobs, could see his earning power restricted if and when he does.

And leagues could further centralize control over other team operations such as paraphernalia sales, TV programming and web initiatives.

Both the NCAA and the BCS would welcome a decision in favor of the NFL. For the NCAA, the single-entity concept could bring to an end a string of embarrassing and expensive losses in antitrust lawsuits. And the BCS would enjoy new protection against antitrust attacks that have the potential to break up its bowl system.

Although the MLB Players Association has used collective bargaining in its fight to establish significant rights for players under the leadership of Marvin Miller and Donald Fehr, both the football and basketball unions have succeeded for their players primarily by decertifying their unions and then pursuing antitrust lawsuits against leagues and team owners. Even the gains the football and basketball players have made in bargaining have come with the threat of antitrust litigation on the horizon.

If the NFL succeeds in its single-entity gambit in the Supreme Court, the words “decertification” and “class action” will disappear from the vocabulary of sports. Unions will be left to the uncertainties of
bargaining a contract with strikes as their only significant leverage. Instead of resolving bargaining impasses with court cases, the deadlocks will be resolved in strikes and lockouts—the baseball way.

“It is highly significant that the NFL players have never really succeeded in collective bargaining. Their successes have come in antitrust actions,” Edelman says. “Even with their successes in antitrust, they still have no guaranteed contracts; and they have yet to obtain other basic benefits like a neutral arbitrator for player grievances.”

Any doubt about the significance of a ruling for the NFL in the American Needle case is resolved with a look at the all-star team of attorneys the unions are assembling.

Fehr and the MLBPA have hired Virginia Seitz, who graduated Phi Beta Kappa and summa cum laude at Duke, won a Rhodes Scholarship and then finished first in her class at the University at Buffalo Law School. She was a law clerk to former Supreme Court Justice William J. Brennan and works exclusively on cases in the nation’s highest court.

Paul Kelly and the NHL Players’ Association have hired Laurence Gold, a graduate of Princeton University and Harvard Law School who served as general counsel of the AFL-CIO and has argued dozens of cases in the high court.

And Jeff Carey, the attorney for American Needle who filed the lawsuit and handled the case through the U.S. Court of Appeals, has also brought in a heavy hitter, Glen Nager, an honors graduate of the University of Texas and Stanford University Law School who served as a law clerk to Supreme Court Justice Sandra Day O’Connor. Nager argued and won an 8-0 decision in a recent antitrust case. (Justice Samuel Alito did not participate.)

The NBA and NFL unions have not yet retained attorneys to appear in the Supreme Court. These elite lawyers and others to come from the basketball and football players unions will ask the justices to consider their arguments as friends of the court. Experts agree that they will present powerful cases against the revolutionary change in the law sought by the NFL.

Leading the battle for the NFL will be Gregg Levy, another litigation superstar who defeated the union and its attorney, Kenneth Starr, in the 1996 Supreme Court decision in Brown vs. Pro Football, Inc., a case involving a salary scale for taxi squad (now called practice squad) players. Levy also won a powerful opinion from Sotomayor in the Clarett case while Sotomayor was a judge on the Court of Appeals for the 2nd Circuit (New York).

The NBA and the NHL will join the NFL and Levy with friend-of-the-court briefs.

American Needle’s experience offers some evidence of what can happen when the NFL is successful in defending itself against antitrust suits. In court papers, attorneys for American Needle explain that the manufacturer was one of several competing companies licensed to make hats and caps bearing NFL logos. When the league agreed to grant caps-and-hats exclusivity to Reebok in 2000, the prices jumped from $19.99 to $30. Prices of replica jerseys increased by 60 percent, according to Carey, the ANI attorney.

After hearings in 2006, the Senate Judiciary Committee confirmed that it is “well documented” that fans and consumers
suffered “losses from potentially anticompetitive agreements among professional sports clubs” such as the exclusive contract with Reebok.

So the Supreme Court will hear powerful arguments and evidence that contradict the single-entity concept. But experts agree—and the unions fear—that the NFL and the other leagues have a chance for success.

“The court is clearly pro-business and is cutting back on the use of antitrust laws,” Edelman says. “They are relying on economic theories instead of theories of legal regulation. Instead of a violation, they see an efficiency.”

Speta adds, “For a long time, there were no antitrust cases decided in the Supreme Court, and now there are cases with the decisions moving in the direction of business.”

The NFL, clearly reading that trend, made a calculated commercial decision to agree to American Needle’s request for a Supreme Court hearing, and coupled it with a demand to increase the stakes by asking the court to go well beyond the hats-and-caps market into a consideration of a single-entity rule for all leagues in all matters.

Can the NFL and the other leagues succeed?

A decision will come in the spring or early summer of 2010. If the NFL can find five votes for its single-entity concept, it will transform the industry.

Leagues will enjoy unfettered monopoly powers.

Salaries for players and coaches will drop.

Free agency will wither away.

Sponsors will pay more.

Fans will pay more for tickets, television and Internet broadcasts and for paraphernalia.

And owners’ profits will soar.
Plaintiffs owned shares in several mutual funds managed by Harris Associates. Plaintiffs filed suit in district court, arguing that Harris’ fees were too high and violated Section 36(b) of the Investment Company Act of 1940. The district court granted summary judgment in favor of Harris Associates, dismissing the claim. On appeal, the Seventh Circuit affirmed, but did not embrace the reasoning of the district court. Instead of following Gartenberg as the district court did, the Seventh Circuit explicitly declined to follow Gartenberg, concluding that market forces were best able to determine the appropriateness of fees, as opposed to judicial regulation. The circuits are split on this issue.

**Question Presented:** In conflict with the decisions of three other circuits, did the court below erroneously hold that a shareholder’s claim that the fund’s investment adviser charged an excessive fee—more than twice the fee it charged to funds with which it was not affiliated—is not cognizable under §36(b), unless the shareholder can show that the adviser misled the fund’s directors who approved the fee?

Jerry N. JONES, Mary F. Jones, and Arline Winerman, Plaintiffs-Appellants,

v.

HARRIS ASSOCIATES, L.P., Defendant-Appellee.

United States Court of Appeals for the Seventh Circuit

Decided May 19, 2008

[Excerpt: some citations omitted]

EASTERBROOK, Chief Judge

Harris Associates advises the Oakmark complex of mutual funds. These open-end funds (an open-end fund is one that buys back its shares at current asset value) have grown in recent years because their net returns have exceeded the market average, and the investment adviser’s compensation has grown apace. Plaintiffs, who own shares in several of the Oakmark funds, contend that the fees are too high and thus violate § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), a provision added in 1970. The district court concluded that Harris Associates had not violated the Act and granted summary judgment in its favor.

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Now for the main event: plaintiffs’ contention that the adviser’s fees are excessive. They rely on § 36(b), which provides:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect
to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser. . . . With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances. . . .

The district court followed Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), and concluded that Harris Associates must prevail because its fees are ordinary. Gartenberg articulated two variations on a theme:

[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.

694 F.2d at 928. And [t]o be guilty of a violation of § 36(b) . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.

Ibid. Oakmark Fund paid Harris Associates 1% (per year) of the first $2 billion of the fund’s assets, 0.9% of the next $1 billion, 0.8% of the next $2 billion, and 0.75% of anything over $5 billion. The district court’s opinion sets out the fees for the other funds; they are similar. It is undisputed that these fees are roughly the same (in both level and breakpoints) as those that other funds of similar size and investment goals pay their advisers, and that the fee structure is lawful under the Investment Advisers Act. The Oakmark funds have grown more than the norm for comparable pools, which implies that Harris Associates has delivered value for money.

Plaintiffs contend that we should not follow Gartenberg, for two principal reasons: first, that the second circuit relies too much on market prices as the benchmark of reasonable fees, which plaintiffs insist is
inappropriate because fees are set incestuously rather than by competition; second, that if any market should be used as the benchmark, it is the market for advisory services to unaffiliated institutional clients. The first argument stems from the fact that investment advisers create mutual funds, which they dominate notwithstanding the statutory requirement that 40% of trustees be disinterested. Few mutual funds ever change advisers, and plaintiffs conclude from this that the market for advisers is not competitive. The second argument rests on the fact that Harris Associates, like many other investment advisers, has institutional clients (such as pension funds) that pay less. For a client with investment goals similar to Oakmark Fund, Harris Associates charges 0.75% of the first $15 million under management and 0.35% of the amount over $500 million, with intermediate breakpoints. Plaintiffs maintain that a fiduciary may charge its controlled clients no more than its independent clients.

Like the plaintiffs, the second circuit in Gartenberg expressed some skepticism of competition’s power to constrain investment advisers’ fees.

Competition between [mutual] funds for share-holder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces.

694 F.2d at 929. The second circuit did not explain why this is so, however. It was content to rely on the observation that mutual funds rarely advertise the level of their management fees, as distinct from the funds’ total expenses as a percentage of assets (a widely publicized benchmark).

Holding costs down is vital in competition, when investors are seeking maximum return net of expenses—and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment. A difference of 0.1% per annum in total administrative expenses adds up by compounding over time and is enough to induce many investors to change mutual funds. That mutual funds are “captives” of investment advisers does not curtail this competition. An adviser can’t make money from its captive fund if high fees drive investors away.

So just as plaintiffs are skeptical of Gartenberg because it relies too heavily on markets, we are skeptical about Gartenberg because it relies too little on markets. And this is not the first time we have suggested that Gartenberg is wanting. Two courts of appeals (in addition to the second circuit) have addressed claims against the advisers of open-end mutual funds. One circuit has followed Gartenberg. See Midgal v. Rowe Price-Fleming International, Inc., 248 F.3d 321 (4th Cir. 2001). The other has concluded that adherence to the statutory procedures, rather than the level of price, is the right way to understand the “fiduciary” obligation created by § 36(b). Our own Green opinion, though it dealt with the obligations of advisers to closed-end funds, indicated sympathy for the third circuit’s position.

Having had another chance to study this question, we now disapprove the Gartenberg approach. A fiduciary duty differs from rate regulation. A fiduciary
must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.

Section 36(b) does not say that fees must be “reasonable” in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty. That is a familiar word; to use it is to summon up the law of trusts. And the rule in trust law is straightforward: A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay. When the trust instrument is silent about compensation, the trustee may petition a court for an award, and then the court will ask what is “reasonable”; but when the settler or the persons charged with the trust’s administration make a decision, it is conclusive. It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated—for example, if a university’s board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million—but no court would inquire whether a salary normal among similar institutions is excessive.

Things work the same way for business corporations, which though not trusts are managed by persons who owe fiduciary duties of loyalty to investors. This does not prevent them from demanding substantial compensation and bargaining hard to get it. Publicly traded corporations use the same basic procedures as mutual funds: a committee of independent directors sets the top managers’ compensation. No court has held that this procedure implies judicial review for “reasonableness” of the resulting salary, bonus, and stock options. These are constrained by competition in several markets—firms that pay too much to managers have trouble raising money, because net profits available for distribution to investors are lower, and these firms also suffer in product markets because they must charge more and consumers turn elsewhere. Competitive processes are imperfect but remain superior to a “just price” system administered by the judiciary. However weak competition may be at weeding out errors, the judicial process is worse—for judges can’t be turned out of office or have their salaries cut if they display poor business judgment.

Lawyers have fiduciary duties to their clients but are free to negotiate for high hourly wages or compensation from any judgment. Rates over $500 an hour and contingent fees exceeding a third of any recovery are common. The existence of the fiduciary duty does not imply judicial review for reasonableness; the question a court will ask, if the fee is contested, is whether the client made a voluntary choice ex ante with the benefit of adequate information. Competition rather than litigation determines the fee—and, when judges must set fees, they try to follow the market rather than demand that attorneys’ compensation conform to the judges’ preferences. A lawyer cannot deceive his client or take strategic advantage of the dependence that develops once representation begins, but hard bargaining and seemingly steep rates are lawful.

The list could be extended, but the point has been made. Judicial price-setting does not accompany fiduciary duties. Section 36(b) does not call for a departure from this norm. Plaintiffs ask us to look beyond the statute’s
text to its legislative history, but that history, which Gartenberg explores, is like many legislative histories in containing expressions that seem to support every possible position. Some members of Congress equated fiduciary duty with review for reasonableness; others did not (language that would have authorized review of rates for reasonableness was voted down); the Senate committee report disclaimed any link between fiduciary duty and reasonableness of fees.

Statements made during the debates between 1968 and 1970 rest on beliefs about the structure of the mutual-fund market at the time, and plaintiffs say that because many members of Congress deemed competition inadequate (and regulation essential) in 1970, we must act as if competition remains weak today. Why? Congress did not enact its members’ beliefs; it enacted a text. A text authorizing the SEC or the judiciary to set rates would be binding no matter how market conditions change. Section 36(b) does not create a rate-regulation mechanism, and plaintiffs’ proposal to create such a mechanism in 2008 cannot be justified by suppositions about the market conditions of 1970. A lot has happened in the last 38 years.

Today thousands of mutual funds compete. The pages of the Wall Street Journal teem with listings. People can search for and trade funds over the Internet, with negligible transactions costs. “At the end of World War II, there were 73 mutual funds registered with the Securities and Exchange Commission holding $1.2 billion in assets. By the end of 2002, over 8,000 mutual funds held more than $6 trillion in assets.” Paul G. Mahoney, Manager-Investor Conflicts in Mutual Funds, 18 J. Econ. Perspectives 162, 162 (Spring 2004). Some mutual funds, such as those that track market indexes, do not have investment advisers and thus avoid all advisory fees. (Total expenses of the Vanguard 500 Index Fund, for example, are under 0.10% of assets; the same figure for the Oakmark Fund in 2007 was 1.01%.) Mutual funds rarely fire their investment advisers, but investors can and do “fire” advisers cheaply and easily by moving their money elsewhere. Investors do this not when the advisers’ fees are “too high” in the abstract, but when they are excessive in relation to the results—and what is “excessive” depends on the results available from other investment vehicles, rather than any absolute level of compensation.

New entry is common, and funds can attract money only by offering a combination of service and management that investors value, at a price they are willing to pay. Mutual funds come much closer to the model of atomistic competition than do most other markets. Judges would not dream of regulating the price of automobiles, which are produced by roughly a dozen large firms; why then should 8,000 mutual funds seem “too few” to put competitive pressure on advisory fees? A recent, careful study concludes that thousands of mutual funds are plenty, that investors can and do protect their interests by shopping, and that regulating advisory fees through litigation is unlikely to do more good than harm.

It won’t do to reply that most investors are unsophisticated and don’t compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest. As it happens, the most substantial and sophisticated investors choose to pay substantially more for investment advice than advisers subject to § 36(b) receive. A fund that allows only “accredited investors” (i.e., the wealthy) to own non-redeemable shares is exempt from the Investment Company Act. Investment pools that take
advantage of this exemption, commonly called hedge funds, regularly pay their advisers more than 1% of the pool’s asset value, plus a substantial portion of any gains from successful strategies. When persons who have the most to invest, and who act through professional advisers, place their assets in pools whose managers receive more than Harris Associates, it is hard to conclude that Harris’s fees must be excessive.

Harris Associates charges a lower percentage of assets to other clients, but this does not imply that it must be charging too much to the Oakmark funds. Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions. That complicates an adviser’s task. Joint costs likewise make it hard to draw inferences from fee levels. Some tasks in research, valuation, and portfolio design will have benefits for several clients. In competition those joint costs are apportioned among paying customers according to their elasticity of demand, not according to any rule of equal treatment.

Federal securities laws, of which the Investment Company Act is one component, work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices. Plaintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services. The fees are not hidden from investors—and the Oakmark funds’ net return has attracted new investment rather than driving investors away. As § 36(b) does not make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission, the judgment of the district court is affirmed.

AFFIRMED
The Supreme Court on Monday agreed to hear *Jones v. Harris Associates, L.P.*, No. 08-586 (S. Ct. Filed Nov. 3, 2008), which raises a significant question for the mutual fund industry. Specifically, the High Court will consider what shareholders must established when bringing suit under Section 36(b) of the Investment Company Act claiming that the fees paid the investment adviser are excessive. Currently there is a split in the circuits between the standard adopted by the Seventh Circuit in *Jones* and earlier decisions by the Second, Third and Fourth Circuits.

Section 36(b), added to the Act in the 1970 Amendments, provides in pertinent part: “For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature. . . . An action may be brought under this subsection by . . . a security holder. . . . With respect to any such action the following provisions shall apply: (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct . . . (2) In any such action approval by the board of directors . . . of such compensation or payments, or of contracts . . . and ratification or approval of such compensation or payments . . . by the shareholders . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances. . . .”

Prior to the decision in *Jones*, the key decision on this question was the Second Circuit’s ruling in *Gartenberg v. Merrill Lynch*, 694 F.2d 923 (2nd Cir. 1982). There, the Court held that the concept of a fiduciary duty under Section 36(b) reflects the reality of the situation involving an investment company and its adviser. In that context, a breach of fiduciary duty occurs when the adviser charges a fee that is “so disproportionately large” or “excessive” that it “bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” *Gartenberg* has been followed by the Third and Fourth Circuits. *Krantz v. Prudential Investments Fund Management LLC*, 305 F.3d 140 (3rd. Cir. 2002); *Migdal v. Rowe Price-Fleming International, Inc.*, 248 F.3d 321 (4th Cir. 2001).

The Seventh Circuit rejected *Gartenberg* in *Jones*, fashioning a new standard grounded in economics and keyed to deception. In *Jones*, the Petitioners are shareholders in the Oakmark funds. Their complaint challenges as excessive, and a breach of Section 36(b), the fees paid to Respondent Harris, the investment adviser. According to Petitioners, Harris created the funds, manages their daily operations and even furnishes them office space. In short, Petitioners note, they are “captive” mutual funds.

Harris charges Oakmark fees for investment advisory services based on a percentage of each fund’s net assets. Those fees were properly approved. Plaintiffs’ claim that the fees are excessive because they far exceed those charged to independent clients. Respondent counters, noting that the fees charged to Oakmark are comparable to those
paid by similar funds and, in any event, Harris’ performance has been extraordinary.

The district court granted summary judgment in favor of Harris. Following Gartenberg, the court held that the key question is whether the fees charged were “so disproportionately large that they could not have been the result of arm’s-length bargaining.” On the record here, the court concluded that there was no dispute that the fees charged by Harris were comparable to those paid by other similar funds. Accordingly, plaintiffs failed to establish a breach of Section 36(b).

The Seventh Circuit affirmed, but adopted a different rationale. In a panel decision written by Judge Easterbrook, the court began by rejecting Gartenberg as the wrong standard. Rather, the basic economics of the market place suggest that the fees charged reflect competition. Section 36(b), the Court noted, does not put the courts in the rate-setting business: “A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation.” Rather, the federal securities laws rely primarily on disclosure and “then allowing price to be set by competition in which investors make their won choices.” Those investor choices can be made by switching funds.

Here, plaintiffs do not contend that Harris “pulled the wool over the eyes” of the disinterested trustees or otherwise hindered the negotiations to obtain a favorable fee contract. Accordingly, they have not alleged a violation of Section 26(b). Jones v. Harris Associates L.P., 2007 WL 627640 (7th Cir. May 19, 2008). The Seventh Circuit declined to rehear the case en banc, splitting five to five with Judge Posner writing a dissent noting that the economics of the panel decision were ripe for review.

The issue to be resolved by the Supreme Court presents a clear conflict among the circuits. The question is one of importance to funds, their advisers and shareholders. At the same time, the case may hold more significance since it involves the rights of shareholders to bring suits and litigate difficult issues.

The High Court’s decision may also further the recently decided Wyeth v. Levine, No. 06-1249 (Decided March 4, 2009). There, the Court rejected a key argument advanced by business groups, claiming that FDA approval could, in view of the regulatory scheme, effectively immunize complying drug companies from damage suits. In some ways the decision of the Seventh Circuit in Jones invokes a similar notion. Judge Easterbrook’s opinion essentially relies on the approval process for the fees coupled with the notion that shareholder who are unhappy with the results can, absent fraud, follow the Wall Street Rule of “voting with your feet” by leaving. Jones may thus present another version of the arguments advanced but rejected in Wyeth.
On August 8, 2008, the U.S. Court of Appeals for the Seventh Circuit voted against rehearing en banc the panel decision in the *Harris Associates* case. The panel opinion in that case, which was handed down on May 19, 2008, “disapproved” the long-standing *Gartenberg* case, which delineated the factors that most federal courts have applied to determine whether the advisory fees paid by mutual funds violate the fiduciary duty imposed on mutual fund advisers under Section 36(b) of the Investment Company Act of 1940 with respect to their receipt of compensation. The significance of the panel’s decision did not pass unnoticed, however.

In a strongly worded dissent, Judge Richard Posner, joined by four other judges, disputed the panel’s conclusion that courts must only ascertain whether an adviser’s compensation was the product of honest and open bargaining, rather than perform the more detailed analysis applied under *Gartenberg*. He argued that directors and advisers are often too cozy with one another, and that a court would be apt to miss evidence of a breach of fiduciary duty if it were only to assess whether an adviser had misled the board regarding the adviser’s compensation.

**Summary of Dissent**

*Panel’s Analysis Inconsistent with Evidence*

Judge Posner began his criticism of the panel opinion by placing advisory compensation in the broader context of the ongoing controversy surrounding executive compensation. “Mutual funds are a component of the financial services industry, where abuses on compensation matters ‘have been rampant. . . .’” Because directors and advisers “hire each other preferentially based on past interactions,” directors tend to be less skeptical. This, in turn, leads to advisers “captur[ing] more rents” and being “monitored by the board less intensely.”

In this context, Judge Posner reasoned that the standard advocated by the panel—that a court must ascertain only whether an adviser has “ma[d]e full disclosure and play[ed] no tricks”—would be an inadequate tool to determine whether an adviser had breached its fiduciary duty in connection with its receipt of compensation. If directors have “feeble incentives . . . to police compensation,” then, in Judge Posner’s view, it would follow that a court should do more to discern whether Section 36(b) had been violated than assess whether the fee negotiations were open and honest.

*Panel Opinion Ignored Facts, Made Assumptions*

Judge Posner tied his general concern about “less intense” monitoring of advisory fees to the funds at issue in *Harris Associates*. “A particular concern” was that the adviser had charged those “captive funds more than twice what it [had] charge[d] independent funds.” Judge Posner complained that, instead of focusing on evidence, the panel had only “throw[n] out some suggestions on why this difference [in fees] may be justified. . . .” In supporting his assertion as to the captive nature of the funds at issue, Judge Posner observed that the adviser had
set up the funds, had been approved each year since inception to manage the funds, advised the entire fund portfolio, and supplied the funds with office space, equipment, and management personnel.

Judge Posner also challenged the panel’s position that advisory fees paid by captive funds are subject to competition. The panel had asserted that “[a]n adviser can’t make money from its captive fund if high fees drive investors away.” He questioned whether higher fees do, in fact, drive away investors. In this regard, he pointed to academic literature that compared the fees paid to equity pension fund portfolio managers with those paid to equity mutual fund portfolio managers. This comparison indicated, for the period studied, that pension funds paid much lower management fees than did mutual funds.

Judge Posner did not explore whether the additional services that the adviser had provided to the captive funds warranted the larger fee, nor did he address whether any differences between services performed for pension funds and mutual funds could explain the lower management fees paid by pension funds. However, he did observe that “[t]he outcome in this case may be correct,” which might indicate that the higher fee paid by the captive funds could have been justified based on these or other factors.

Panel Set Too High a Floor for Advisory Fees

Judge Posner criticized the panel for concluding that a court could infer a breach of fiduciary duty only from an advisory fee that was “unusual,” which would be “applied solely by comparing the adviser’s fee with the fees charged by other mutual fund advisers.” Because “[t]he governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide,” Judge Posner reasoned that the panel’s “comparability approach” would allow fees that have resulted from less-than-arm’s-length bargaining “to become the industry’s floor.”

Judge Posner contrasted the Harris Associates standard with Gartenberg, under which a court could infer a breach of fiduciary duty from an advisory fee that was “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” He concluded that Gartenberg was a better standard because it was not limited to a simple fee comparison and, as a result, would not set a too-high floor. Judge Posner also suggested that the panel should have forgone creating a new standard and simply compared the fees paid by the captive funds against those paid by the independent funds. In addition, he observed that Gartenberg has been cited and supported by many federal courts over the decades since the Second Circuit’s ruling.

Observations

Advisory Fee Decisions Will Remain under Microscope

One may question whether Judge Posner was on target in his criticism of the mutual fund industry and whether he was correct in including mutual funds in his attack on excessive executive compensation for public companies. As noted above, he even states that the mutual fund “governance structure . . . enables mutual fund advisers to charge exorbitant fees. . . .” Of course, however, that governance structure was established by Congress, and it is not up to the courts to remedy perceived deficiencies in that structure. Still, the dissent in Harris
Associates is a reminder that courts and other observers continue to be skeptical of whether directors are effective watchdogs for mutual fund shareholders. As a result, mutual fund directors should read the dissent as a reminder to ask the hard questions at annual contract reviews.

It Will Remain Important to Compare Advisory Fees

Judge Posner argues that there is more for a court to do in assessing Section 36(b) claims than to compare fees and flag only the “unusual” ones as evidence of a possible breach of fiduciary duty. This is altogether consistent with Gartenberg and its progeny, which call for a fee comparison as one of many factors involved in assessing Section 36(b) claims. We believe that it remains advisable for directors to consider advisory fees paid by comparable funds as part of a broader analysis that encompasses all of the Gartenberg factors.

More than Semantics Distinguishes the Two Decisions

We agree with Judge Posner that there are real differences between the approach taken by the court in Harris Associates and that taken by the courts in the Gartenberg line of cases. The Gartenberg case and its progeny have outlined several factors for boards and courts to consider, and Harris Associates focuses mainly on comparative fees and, to a lesser extent, fund performance.

Referring to our May 27, 2008, article on the panel decision, Judge Posner states that “although one industry commentator has suggested that ‘courts may... conclude that in fact what the court of appeals has done [in Harris Associates] is merely articulate the Gartenberg standard in a different way,’ this misses an important difference between the Gartenberg approach and the panel’s approach.” Indeed, in a previous article we clearly recognized those distinctions and therefore recommended that boards and advisers “stay the course” and continue to apply the Gartenberg factors.

As we observed in May, a standard under which a court evaluates only the probity of an adviser in the negotiation of its fee overlooks some of the statutory language. Congress drafted Section 36(a) to address breaches of fiduciary duty involving personal misconduct, and stated in Section 36(b) that a plaintiff need not prove personal misconduct, so Section 36(b) must mean something more than what the Harris Associates panel opinion suggests.

On the other hand, it could be argued that Gartenberg goes too far the other way by having courts dictate the factors that boards should consider. It remains for the courts to consider the differences between the Gartenberg and Harris Associates approaches and strike a new balance.

Other Courts Will Likely Address Panel Opinion

We think that the dissent has raised the intensity of the debate that the panel opinion initiated over Gartenberg. It is quite clear that Chief Judge Frank H. Easterbrook, who wrote the panel opinion, holds Gartenberg in low esteem, calling it a form of federal rate regulation. As we noted in our earlier article, this is not an accurate characterization of Gartenberg and its progeny. Judge Posner is equally dismissive of his colleague’s opinion, regarding it as an academic exercise that ignores certain inherent problems in the mutual fund industry and misapplies an economics of law analysis. It is striking to us that, while the panel decision in Harris Associates
concludes that competition would prevent an adviser from imposing unduly high fees, Judge Posner is just as convinced that neither competition nor the fund governance structure can be counted on to do so.

The fireworks aside, we think that each opinion highlights legitimate issues that need to be addressed on appeal. First, there is the question, raised by Chief Judge Easterbrook, of whether the far-reaching “reasonableness” test of Gartenberg has a legally sufficient basis in Section 36(b). While Judge Posner endorses Gartenberg, he does not directly address this question (as is his prerogative in dissent). Second, there is the question of what test the courts should apply in hearing Section 36(b) cases. Chief Judge Easterbrook contends that mutual fund investors effectively check advisory compensation by voting with their feet, so that courts no longer need to undertake the Gartenberg analysis. Judge Posner replies, based on a selection of academic literature and lay opinion, that this market is not perfect and therefore merits close judicial supervision of the sort set forth in Gartenberg. His criticism of the fund governance structure, moreover, suggests he would be less likely than other judges have been to give weight to a board’s approval of advisory fees.

These are weighty issues, and ultimately they may need to be resolved by the Supreme Court. We believe the dissent in Harris Associates makes it more likely that, in this or some future case, the U.S. Supreme Court will address Section 36(b).

Conclusion

The dissent in Harris Associates underscores that the panel opinion was out of kilter with the established case law under Section 36(b)—an area in which there otherwise has been general agreement among the circuits for over 25 years. The dissent may therefore lead other courts to continue to adhere to Gartenberg. It will bear watching how other courts—and perhaps the Supreme Court—address the issues the dissent has raised.

In our view, the right answer may be for courts to give full effect to the language used by Congress in the 1940 act, but not to expand that language. Harris Associates arguably failed to give full effect to the statutory language of the 1940 act. Gartenberg and the cases that followed it arguably have gone beyond the statute by mandating that boards consider specific factors, not identified in the statute, in approving an advisory contract. Under Section 15(c) of the 1940 act, it is “the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms” of any advisory agreement. Section 36(b) provides that it shall not be necessary to allege or prove that any defendant engaged in “personal misconduct,” but also states that in any action under Section 36(b) “approval by the board of directors … shall be given such consideration by the court as is deemed appropriate under all the circumstances.” We believe that if a board does its duty carefully and conscientiously under Section 15(c), its decision should carry great weight, whether or not the board has considered all of the factors enumerated in Gartenberg.

But, we hasten to add, no court has yet taken the middle ground we suggest, and it is therefore wise for boards and advisers to continue to apply the Gartenberg factors in connection with review of advisory agreements.
The U.S. Court of Appeals for the Seventh Circuit and the U.S. Supreme Court issued decisions in two important cases impacting mutual funds. In the Seventh Circuit, the court rejected the Gartenberg analysis, holding that Section 36(b) of the Investment Company Act of 1940 does not imply judicial review for reasonableness of fees charged by a fund’s investment adviser. On the same day, the Supreme Court upheld a statute that allows applicable state residents to exclude from their state taxable income interest received from state-issued municipal bonds, thus preserving single state municipal bond funds.

**Jones v. Harris Associates, L.P.—Seventh Circuit Rejects Gartenberg Analysis**

In *Jones v. Harris Associates, L.P.* the Seventh Circuit affirmed the district court’s decision to reject shareholders’ claims that Harris Associates, the adviser to the Oakmark complex of mutual funds, charged excessive management fees under Section 36(b) of the Investment Company Act of 1940.

Section 36(b) states, in relevant part, that “the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.” This section grants the Securities and Exchange Commission, or the security holder, a right to bring an action against an investment adviser for excessive compensation. Section 36(b) further notes that “approval by the board of directors of such investment company of such compensation or payments . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances. . . .”

The current leading case under Section 36(b) is *Gartenberg v. Merrill Lynch Asset Management, Inc.*, in which the Second Circuit stated that the critical test under Section 36(b) is “whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.” Further, the *Gartenberg* court stated that in order to violate Section 36(b), the adviser “must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”

The district court in *Jones*, following *Gartenberg*, concluded that Harris Associates did not violate Section 36(b) because its management fees were ordinary in comparison to the management fees charged by other advisers to funds of similar size and investment goals. In reviewing the district court’s decision, the Seventh Circuit rejected the district court’s concurrence with the *Gartenberg* analysis, but affirmed its decision on different grounds. The Seventh Circuit declined to follow *Gartenberg* because it believed that “[t]he existence of
the fiduciary duty does not imply judicial review for reasonableness.” The court noted that, contrary to Gartenberg, Section 36(b) does not require that fees be reasonable under a judicially created standard; rather, the section provides that the adviser has a fiduciary duty with respect to fees it receives from investment companies or security holders. The Seventh Circuit reasoned: A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.

The existence of a fiduciary duty requires the court to be concerned with “whether the [fund board] made a voluntary choice . . . with the benefit of adequate information.” Under Section 36(b), the adviser is compelled by its fiduciary duty to disclose all information that would be material to the trustees or the investors when considering or negotiating the fees charged. Because the management fees charged by Harris Associates were fully disclosed to the trustees and the investors, the Seventh Circuit found no violation of Section 36(b) and ruled in favor of the adviser.

Jones v. Harris Associates, L.P. further demonstrates a split among the circuit courts that have considered actions against advisers of mutual funds under Section 36(b). The Second Circuit’s Gartenberg analysis, also followed by the Fourth Circuit, advocates a judicially-determined reasonable standard for fees charged, while the Third Circuit and the Seventh Circuit have concluded that the question of whether an adviser has met its fiduciary obligation under Section 36(b) is determined by whether the adviser has made full and candid disclosure regarding fees to fund boards and investors. The impact of the Seventh Circuit’s approach and its rejection of the Gartenberg standard is unclear at this time.

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“Court Rejects Thrust of Investor Suit Against Funds”

*Fund Action*
March 16, 2007

A Chicago federal court has awarded summary judgment to the advisor of Oakmark funds in the first of the post-scandal law suits to go to judgment. Judge Charles Kocoras rejected plaintiffs’ contention in the *Jones v. Harris Associates* case that the fact that the advisor charged retail funds more than institutional ones was proof there was no arms-length bargaining in setting Oakmark fund fees.

The same contention has been made in several other excessive fees cases brought under Section 36b of the Investment Company Act. “Plaintiffs’ counsel did everything they could—deposed fund directors, hired expert witnesses, collected information,” commented *Harris Associates* lead counsel, John Donovan. But the result, summary judgment for the other side, meant the case never went to trial.

In his opinion, Kocoras pointed to the fact that in at least nine other mutual funds investors were paying fees at the same level that Oakmark investors were paying. The fees charged on funds advised by Harris fell within the range of fees charged by rival providers, the judge said, “thus preventing a conclusion that the amount of fees indicates that self-dealing was afoot.”

James Bradley, counsel for plaintiffs in the case and a lawyer at Richardson Patrick Westbrook & Brickman, said, “We believe the court erred. We are planning to file an appeal in the seventh circuit and are hopeful we will win on appeal.”
In a pair of final segments to my series of posts on *Jones v. Harris*, I will speculate separately on the practical and theoretical implications of a Supreme Court ruling. So, let’s start with the practical.

**First, a liminal question: Why did the Supreme Court take the case?**

Just because of a circuit split? Unlikely. The respondents argued in their brief in opposition to certiorari that there is, in fact, no circuit split here because the established *Gartenberg* precedent and the new Easterbrook standard are “substantively identical” and that therefore the petition raises merely “academic issues.” While it’s true that under both standards plaintiffs are probably doomed, it’s difficult to argue that any discrepancies are merely illusory when both Easterbrook and Posner openly discussed the circuit split. It’s even harder when the respondents’ own lawyers issued a “litigation alert” immediately after Easterbrook’s ruling heralding this “new standard” in the title. Also, attempting to dismiss issues as “academic” may not be a terribly effective pejorative when describing the work of two academics, Easterbrook and Posner, to a Supreme Court comprising several former law professors.

Perhaps the more likely reason for granting certiorari was the vigor and prominence of Posner’s dissent. Indeed, the public disagreement between Easterbrook and Posner did a great deal to ensure that the Court would take a case heavily implicating economic analysis.

**So, how will the Court rule?**

Perhaps the Roberts Court will rule in favor of Easterbrook’s call for judicial restraint. But to many experts in this field, Easterbrook’s opinion is anything but restrained: his disregard for the congressional enactment of a fiduciary duty strikes them as an intensely activist overruling of legitimate legislation. Also, denying certiorari would have had the same effect as affirming Easterbrook.

Perhaps the Court will reaffirm and universalize *Gartenberg*. But since that case is still in force in three circuits where large numbers of fund advisers are based (Second, Third, and Fourth), that project also seems an unnecessary use of the Court’s time.

The most likely outcome might therefore be for the Court to follow Posner’s prescription by enacting a “*Gartenberg*-plus” standard that adds additional factors to the *Gartenberg* analysis. For example, the Court might require advisers to provide explanations and data justifying the discrepancy in prices they charge to institutional versus individual investors. Advisers have long argued—and lower courts have long agreed—that advisers have good reasons for charging different fees to different investors in the same fund: *e.g.*, individual investors cost more to serve since they need websites, individual statements, customer support, etc. But in his dissent, Posner argued that it’s a mistake not to compare these two fees since their relationship can reveal whether the entire
industry is tacitly colluding to keep individual fees artificially high. The Court might agree, ruling that if advisers have good reasons for charging different prices, they should disclose those reasons so that investors, trustees, and courts can evaluate how compelling they are.

What effect would such a ruling have?

If the Court were to issue a Gartenberg-plus ruling, it might be hoping to encourage two changes: fund advisers immediately lowering the fees they charge individual investors (since trying to raise fees on institutional clients seems far more difficult) and/or advisers producing internal data that attempt to justify any fee differentials.

Of course, to the extent that the data are unpersuasive, lower courts would be empowered to rule against fund advisers, a prospect that could also exert a downward pressure on fees. (If there weren’t a profit cushion for advisers to give up, requiring more data could in fact lead to higher fees, but this industry is famously profitable.)

But would the Roberts Court ever decide against business and make it easier for plaintiffs to sue?

Many preconceptions about the Court may have been challenged with last week’s ruling in Wyeth v. Levine, when the Court upheld a patient’s right to sue a drug manufacturer in the face of the manufacturer’s arguments of federal preemption. Jones v. Harris arguably presents an even more populist opportunity for the Court to protect individual investors from Bernie Madoffs at a time of economic calamity, if the justices are so inclined.

So individual shareholders will live happily ever after?

With 38 years of defeats under Gartenberg, plaintiffs may need more than just a little tweaking of the standard to mount credible litigation in future, so some commentators would like to see an even more comprehensive overhaul of the standard here. One of the recurring challenges to plaintiffs is that lawyers like to take cases that will pay their expenses; to do so in this area, the defendants must manage large funds with deep pockets; but the highest fees are typically charged by small funds. So the facts aren’t always great for plaintiffs.

Perhaps another solution lies outside the judicial system. If a plaintiff with large legal resources and little economic motivation—i.e., the Securities and Exchange Commission—mounted a case on the strength of egregious facts, things might change. But the SEC has never litigated excessive fees . . . prior to the Obama administration.
Mac's Shell Service v. Shell Oil Products

08-240

Shell Oil Products v. Mac's Shell Service

08-372

Ruling Below: Marcoux v. Shell Oil Products, LLC, 524 F.3d 33 (1st Cir. 2008).

Plaintiffs were 8 franchisees to defendant, Shell Oil Products, operating in Massachusetts. The franchise relationships were governed by the Petroleum Marketing Practices Act ("PMPA"), which holds that franchise relationships may not be terminated or non-renewed except under certain circumstances and with proper notice. The franchise relationship included a Subsidy designed to reduce contract rent through gasoline sales. The Subsidy had a cancellation provision provided that thirty days notice was given, but representations were made to plaintiffs that the Subsidy or something like it would always exist. Defendant, Shell, formed a joint venture with Texaco and Star Enterprises, which was called Motiva. Shell assigned its rights and duties to Motiva. Motiva cancelled the Subsidy after providing the required thirty days notice. The contracts then expired and Motiva offered new leases, which resulted in much higher rent to plaintiffs, which plaintiffs signed, though under protest. Plaintiffs sued claiming defendants violated the Petroleum Marketing Practices Act. The first theory was that Motiva’s cancellation of the Subsidy violated their contract and as such constituted a “constructive termination” in violation of the PMPA. The second theory was that the renewed leases were altered so adversely to plaintiffs that it amounted to a “constructive nonrenewal” of the franchise relationship in violation of the PMPA. The trial court found defendants guilty of both charges among others. The First Circuit affirmed on the “constructive termination” claim, but reversed on the “constructive nonrenewal” claim, citing that plaintiffs signed the new leases, albeit under protest, as the basis of their reasoning.

Questions Presented: (1) Under PMPA, are claims of “constructive nonrenewal” or “constructive termination” valid grounds for claiming violation of PMPA? (2) Did defendants’ elimination of the Subsidy constitute a “constructive termination” in violation of the PMPA? (3) Did defendants’ new leases with plaintiffs, vastly different than those prior to it, constitute a “constructive nonrenewal”?

Francis MARCOUX, et al., Plaintiffs, Mac's Shell Service, Inc.; Cynthia Karol; John A. Sullivan; Akmal, Inc.; Sid Prashad; Ram Corporation, Inc.; J&M Avramidis, Inc.; Three K's, Inc.; Stephen Pisarczyk, Plaintiffs-Appellees,

v.

SHELL OIL PRODUCTS COMPANY LLC; Motiva Enterprises LLC; Shell Oil Company, Inc., Defendant-Appellants.

United States Court of Appeals for the First Circuit

Decided April 18, 2008
Defendants-appellants Shell Oil Company, Shell Oil Products Company (collectively, "Shell"), and Motiva Enterprises appeal jury verdicts against them on several claims relating to their treatment of plaintiffs-appellees (the "Dealers"), franchisees and operators of Shell-branded service stations. Shell and Motiva (together, "the defendants") challenge the legal basis for verdicts against them under a federal statute designed to protect franchisees, as well as the verdicts under Massachusetts state law. Additionally, they appeal the jury's damages determinations as without sufficient basis in the evidence. We affirm in part and reverse in part.

Facts

We recite the facts in the light most favorable to the jury's verdict.

Shell maintained a network of franchisees in Massachusetts. Plaintiffs were eight of these franchisees. In 1998, Shell, Texaco, and Star Enterprises formed defendant Motiva, and Shell transferred the franchise relationships to that entity, assigning its rights and duties under the relevant contracts to Motiva. Shortly thereafter, Motiva replaced the Variable Rent Program ("VRP") with the Special Temporary Incentive Program ("STIP"). Each of these programs (collectively, the "Subsidy") provided for reduction of the contract rent through sales of gasoline; once the specified threshold gallonage was sold in a given month, the contract rent for the next month would be discounted by a certain amount for every gallon sold in excess of that threshold. The threshold amount and the discount amount changed from time to time. The Subsidy had been in effect since 1982; it was renewed in an annual notice to franchisees, although its terms explicitly provided for cancellation with thirty days' notice. Various representations were made to the Dealers to the effect that the Subsidy or something like it would always exist, the contract rent was to be disregarded, and the cancellation provision was only intended to be invoked in a situation like a war or an oil embargo. Nevertheless, having given the required notice, Motiva ended the STIP on January 1, 2000, terminating the Subsidy. Without the Subsidy, the Dealers paid much more rent.

Motiva also offered new leases as the old leases expired. The new leases calculated rent differently than the old leases, resulting in a further increase in rent.

In accordance with their fuel supply contracts, the Dealers were charged a wholesale price for gasoline known as the Dealer Tank Wagon price (the "DTW price"). The fuel supply contracts were open price term contracts: the contracts were silent as to price, and one party set the price unilaterally. This price was set by the defendants, who calculated it by assessing the street prices of other competing gasoline stations in the area, and reducing those prices by the taxes levied on gasoline and an Estimated Industry Margin to approximate the wholesale price of the defendants' competitors.
integrated contracts under Massachusetts law. They claimed the amended contracts were then breached when Motiva eliminated the Subsidy. Under the Dealers’ theory, this breach gave rise to two distinct claims: a state cause of action for breach of contract and a claim under the PMPA that Shell had improperly terminated the franchises when Shell assigned the franchise agreements to Motiva and Motiva terminated the Subsidy. Because no actual termination occurred, the Dealers proceeded under a theory of “constructive termination.” Similarly, they claimed Motiva had “constructively nonrenewed” the franchise relationships in violation of the PMPA (even though the franchises were in fact renewed) because the new contracts changed the rent-calculation method and increased the rent, along with other objectionable changes. Finally, the Dealers argued that Motiva failed to set prices for gasoline in good faith, as required for open price term contracts under Massachusetts law.

The defendants unsuccessfully moved for dismissal on all constructive termination claims and the constructive nonrenewal claims of two plaintiffs on the ground that they were time-barred. They also moved for a judgment as a matter of law on all claims. Following a jury verdict against them on all claims, they properly renewed this motion. They moved as well for a new trial and to set aside the jury’s damages awards. The defendants now appeal the denial of all of these motions.

The PMPA

Congress enacted Title I of the PMPA to “remedy the disparity in bargaining power between franchisors and franchisees.” S. Rep. No. 95-731, 95th Cong., 2d Sess. 18. Because franchisees claimed that this unequal power was often wielded through arbitrary or discriminatory termination or nonrenewal, or threats of termination or nonrenewal, the PMPA aimed to remove this potent weapon from the franchisors’ arsenal.

The PMPA makes a distinction between a “franchise” and the “franchise relationship.” The franchise is a set of definite agreements for 1) lease of the premises, 2) the right to purchase gasoline for resale, and 3) the right to use the franchisor’s trademark. “Franchise relationship” refers to the respective obligations of the franchisor and franchisee created by a franchise. The legislative history of the PMPA makes clear that “franchise” and “franchise relationship” were distinguished to drive home the fact that the franchise relationship survives the expiration of the agreements underlying the franchise. The structure and history of the PMPA emphasize Congress’s view that the franchisees have a reasonable expectation that the franchises would be renewed and that the relationships would continue.

Accordingly, the PMPA forbids termination of a franchise or nonrenewal of a franchise relationship except under enumerated circumstances and with proper notice. The PMPA provides a cause of action to franchisees who suffer termination or nonrenewal in violation of the relevant sections. As long as the action is brought within one year of the termination or nonrenewal complained of, the franchisee may seek preliminary injunctive relief, damages, and “such equitable relief as the court determines is necessary.” The PMPA mandates that preliminary relief “shall” be granted if the plaintiff shows 1) termination or nonrenewal and 2) “sufficiently serious questions going to the merits” that are “a fair ground for litigation,” and the court determines 3) that the balance of hardships tips in favor of granting the injunction. In all
private civil actions for termination or nonrenewal, it is the franchisee’s burden to show termination or lack of renewal.

**Standard of Review**

We review the denial of judgment as a matter of law de novo as to issues of law. As to matters of fact, we view the evidence in the light most favorable to the verdict, asking only whether a rational jury could on the basis of that evidence find as the jury has. We review a denial of a motion for a new trial for “a manifest abuse of discretion.” We “will order a new trial only if the verdict is against the demonstrable weight of the credible evidence or results in a blatant miscarriage of justice.” We will uphold a jury award if it is a result of “any rational appraisal or estimate of the damages that could be based on the evidence before the jury.”

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**Constructive Termination**

The Dealers claimed that when Motiva breached their leases by eliminating the Subsidy, that breach perfected a constructive termination by Shell. The PMPA allows assignment of duties in franchise agreements in accordance with state law. But an assignment that is violative of state law, or one that results in a breach of one of the statutory components of a franchise, gives rise to a claim under the PMPA against the original franchisor/assignor. In the words of the Fourth Circuit, “A franchisor cannot circumvent the protections the [PMPA] affords a franchisee by the simple expedient of assigning the franchisor’s obligation to an assignee who increases the franchisee’s burden. . . .” *Barnes v Gulf Oil Corp.*, 795 F.2d 358, 362 (4th Cir. 1986). In *Chestnut Hill Gulf v. Cumberland Farms, Inc.*, we adopted the test for constructive termination articulated by the Sixth Circuit.

To sustain a claim, under the PMPA, that a franchisor assigned and thereby constructively terminated a franchise agreement, the franchisee must prove either: (1) that by making the assignment, the franchisor breached one of the three statutory components of the franchise agreement, (the contract to use the refiner’s trademark, the contract for the supply of motor fuel, or the lease of the premises), and thus, violated the PMPA; or (2) that the franchisor made the assignment in violation of state law and thus, the PMPA was invoked.

What set *Barnes* apart from both *Chestnut Hill Gulf* and *May-Som Gulf* was that in *Barnes* the assignment of the contract had resulted in gasoline prices above the price specified in the contract; in other words, *Barnes* concerned a breach of one of the statutory elements of the franchise, the agreement for the supply of branded motor fuel. The Fourth Circuit vacated summary judgment for the defendant, holding that the breach of the contract for the supply of gasoline created a constructive termination of the franchise. In *Chestnut Hill Gulf* we held the PMPA was not implicated because there was no evidence that any of the statutory components of a franchise had been breached. “[A]ll thirteen dealers continued to occupy the same service stations under the same leases; they continued to purchase Gulf brand gasoline under the same supply agreements; and they continued to do business under the same Gulf trademark.” In *May-Som Gulf*, the defendants were entitled to summary judgment because the plaintiffs had merely complained of potential breaches to the franchise agreement. In the case before us, the Dealers have proven to the jury’s
satisfaction that Motiva breached the lease component of the franchise agreements. That breach allowed the jury to find that Shell constructively terminated the Dealers’ franchises when it assigned the franchises to Motiva.

The defendants argue that in order to show a constructive termination, the breach must be contemporaneous with the assignment and the breach must amount to a total deprivation of one of the three elements of the franchise. Both contentions misunderstand constructive termination.

First, we agree with the Fourth Circuit that an action for constructive termination lies against the assignor of a franchise when the assignee breaches the franchise. This prevents the assignor/franchisor from shielding itself against liability through the use of another corporation. “The [PMPA] does not contemplate that a franchisee should be relegated to seeking damages from an assignee that might not have the resources to satisfy a judgment.” A delay between the assignment and the breach changes nothing. The reasons for this are even stronger where the assignee is a subsidiary of the franchisor, or a joint venture in which the franchisor is a party.

Second, the breach of the statutory element of the franchise does not have to be a total breach. In *Barnes* the plaintiff was “forced to raise her prices, and her sales and net income . . . declined.” She did not suffer a complete loss of the benefits of the motor fuel supply contract. The defendants’ attempted analogy to constructive termination in employment law or constructive eviction in landlord-tenant law is misleading. Those doctrines require an actual severance of the relationship: The employee must leave the workplace; the tenant must move out. But here, as the Dealers testified, sunk costs, optimism, and the habit of years might lead franchisees to try to make the new arrangements work, even when the terms have changed so materially as to make success impossible. Indeed, some plaintiffs testified they had gone into personal debt, driven themselves into bankruptcy, or enlisted the aid of family members working without pay to make ends meet. To require an actual abandonment of years of work and investment before we recognize a right of action under the PMPA would be unreasonable. The “congressional plan would be frustrated by requiring a franchisee to go out of business before invoking the protections of the PMPA.” *Pro Sales, Inc. v. Texaco, U.S.A.*, 792 F.2d 1394, 1399 (9th Cir. 1986).

We do not here say that any material breach of the lease would necessarily be sufficient to sustain the constructive termination claim. In this case, the district court instructed the jury that it could find constructive termination only if the breach of the lease “was such a material change that it effectively ended the lease, even though the plaintiffs continued to operate the business. . . . It’s not simply was the lease breached, but did that breach amount to . . . effectively the end of the franchise relationship.” In this instruction the district court set an appropriate threshold.

We agree with the district court that an assignor may be liable for even a subsequent breach of the franchise agreement by an assignee, and that a breach of the franchise agreement need not result in complete deprivation of a statutory element of the franchise to support a constructive termination.

Indeed, this case presents a strong argument for the doctrine of constructive termination. At trial the Dealers argued that Shell
assigned the franchise agreements to Motiva, even created Motiva, in order to squeeze them out of their franchises. They presented evidence that this was the reason for the change in the rent formulation, the elimination of the Subsidy, and the dramatic increase in rents they paid. If the jury accepted this as the reason, the case falls within the scope of the PMPA, which is designed not to freeze the franchise agreements exactly where they were, but to prevent franchisors from improperly terminating franchises and thereby to ensure that franchisees benefit from successful investment in their franchises.

This same protection for franchisee expectations underlies the PMPA’s requirement that a franchisor make a bona fide offer, or grant a right of first refusal, to the franchisee when the franchisor contemplates withdrawing from the relevant market, selling the underlying real property, or dedicating the property to another use. This is also why parts of the PMPA place more restrictions on franchisors when the purpose of termination or nonrenewal is to convert the station to direct operation by the franchisor. Were it otherwise, the franchisor could extract any increase in value created by the franchisee’s investment, without sharing that increase with the franchisee. This would dampen the incentive for a franchisee to develop the business. In this case, the Dealers presented evidence that the defendants wanted to convert their stations to direct operation. Where a franchisor has breached its obligations to the franchisee such that the franchisee faces the effective end of the franchise, the PMPA must treat that as a termination of the franchise.

Neither will we contradict the jury’s verdict. When we are satisfied that the law has been faithfully interpreted, we will overturn a jury’s verdict only when no reasonable jury could have come to that verdict on the facts presented. The jury heard ample evidence to conclude that the financial hardship resulting from the loss of the Subsidy meant the end of the relationship. The defendants had opportunity to attack the credibility of that evidence and to put on their own. We will not step into the jury box to provide a second opinion. Nor was the verdict against the demonstrable weight of the evidence or likely to result in a blatant miscarriage of justice. Consequently, there was no manifest abuse of discretion in the district court’s denial of the motion for a new trial.

Constructive Nonrenewal

As each Dealer’s lease expired, Motiva presented a new lease. The new leases changed the way rent was calculated, which had the effect of increasing the rents charged. The Dealers argued that this change and others were not made in good faith, as required by the PMPA, but rather were part of the plan to drive the franchisees out of business. They claimed that inclusion of these terms amounted to a nonrenewal of their agreements, even though each Dealer signed a new agreement (albeit “under protest”). We conclude that the PMPA does not support a claim for nonrenewal under these circumstances. We therefore vacate this portion of the district court’s judgment and remand with instructions to issue judgment on this claim for the defendants.

It is the plaintiffs’ burden to prove that a nonrenewal or a termination has taken place. A notice of nonrenewal issued pursuant to 15 U.S.C. § 2804, while not strictly speaking a nonrenewal, presumably satisfies this burden.

The threshold question is whether to recognize such a “constructive nonrenewal” and thereby bring Motiva’s actions within
the reach of the PMPA. The Ninth Circuit is the only circuit so far to recognize a claim for constructive nonrenewal. In *Pro Sales*, the plaintiff signed a renewal agreement "under protest" and immediately brought suit under the PMPA. The court relied on legislative history to conclude that these facts gave rise to a claim for constructive nonrenewal under PMPA.

*Pro Sales* has been rejected by the other circuits to consider the issue. The PMPA, after all, requires a franchisor to provide a notice of nonrenewal, and then provides a framework for the franchisee to seek preliminary relief on receipt of that notice. Two circuits have held that this notice-and-preliminary-relief structure is evidence that Congress intended to limit the reach of the PMPA to cases where either a notice is given or an actual nonrenewal has taken place. Thus, in *Dersch Energies*, the Seventh Circuit held that a franchisee who had signed a renewal "under protest" did not have a claim for constructive nonrenewal because the franchise had in fact been renewed. "Had Dersch allowed the defendants to issue a formal notice of nonrenewal, its dispute with the defendants would have been transformed from a mere contract dispute into a nonrenewal (within 90 days) of its franchise relationship—thus allowing it to . . . maintain suit" under the PMPA.

The plaintiffs' constructive nonrenewal argument requires the following reasoning. Had the Dealers refused to agree to the new contract terms, Motiva would have issued notices of nonrenewal alleging as a permissible basis for nonrenewal the "failure of [the parties] to agree on changes or additions to the provisions of the franchise."

15 U.S.C. § 2802(b)(3)(A). The Dealers would have asserted that the nonrenewal was improper because the changes were not offered in good faith, or else were offered in order to convert the premises to the franchisor's own control. On those grounds the Dealers could have sought preliminary relief and damages under the PMPA.

The stumbling block that trips up the plaintiffs is that, rather than insist on receiving notices of nonrenewal, the Dealers signed the new agreements "under protest" and continued in operation under the new agreements. We conclude that just as the PMPA requires a clear indication from franchisors that they seek nonrenewal of a franchise relationship, it likewise requires that franchisees faced with objectionable contract terms refrain from ratifying those terms by executing the contracts (even "under protest") and operating under them. Allowing a franchisee to sign "under protest" and then later challenge the renewal would extend the period of uncertainty through the entire first year of a contract that in this case was only three years. Recognizing constructive nonrenewal also would enable a franchisee to sign the contract and simultaneously challenge it. If its claims were rejected by the courts, the franchisee would have lost nothing and could continue to operate the franchise under the agreement with the PMPA-enforced reasonable expectation of continuation and renewal. Absent a claim for constructive nonrenewal, a franchisee must wait for a notice of termination to bring suit under the PMPA. The franchisee therefore risks the end of the franchise if the claim fails and so must carefully weigh the decision to sign or sue. This is the balance Congress has struck, and should we prefer another, we would not be free to impose it. Consequently, we reject application of constructive nonrenewal to these facts.

We note with some concern the limited scope of the PMPA. Two unexpected
consequences of the legislation seem to loom as potential problems. The first is that franchisors will conform their behavior to the letter of the law but still use their position of power to impose their will on franchisees. The statute is of course not a panacea and cannot be faulted for what it fails to do. But some statutory protection is worse than none when it serves as protective cover for the very misdeeds it purports to eliminate. The second unintended consequence is that, to the extent Congress succeeds in leveling the playing field, it makes the franchise arrangement less appealing to franchisors. It is not difficult to imagine protections for franchisees so strong that franchisors abandon the model entirely. Evidence introduced at trial spoke to both of these hazards. However, these are issues for Congress to weigh and remedy, not for the courts.

Because we do not recognize a claim for nonrenewal under the PMPA where the franchisee has signed and operates under the renewal agreement complained of, we vacate this portion of the district court’s judgment and remand with instruction to enter judgment on this count for the defendants.

Unreasonable Gasoline Prices

[The court here discussed the plaintiffs’ claim that defendants set gas prices without good faith in violation of Massachusetts’s adoption of the Uniform Commercial Code.]

Conclusion

The judgment of the district court on the state contract claims, the unreasonable gasoline pricing claims, and the constructive termination claims is AFFIRMED. The judgment on the constructive nonrenewal claims is REVERSED. The jury awards as to the surviving claims are AFFIRMED as rational awards supported by sufficient evidence. The award of attorney’s fees and costs is VACATED and REMANDED for reconsideration in the light of our mixed disposition of the claims under the PMPA. Costs on appeal are awarded to the appellees.
The U.S. Supreme Court will use a case involving Shell Oil Co. to determine how much leverage oil companies have to change their leases with tens of thousands of independent service station owners.

The justices today agreed to consider a bid by Massachusetts gas station owners to sue Shell and Motiva Enterprises LLC. A group of station owners say Shell and Motiva used rent increases to try to end their franchise agreements so the companies could take over operation of the stations.

The station owners at one point won a $3.3 million jury verdict. A federal appeals court upheld part of the award and both sides appealed to the Supreme Court.

The justices agreed to intervene at the suggestion of the Obama administration, which backs Shell and Motiva on the legal issues.

The case centers on the U.S. Petroleum Marketing Practices Act, a 1978 law that gave independent station owners more power in their dealings with oil companies. The station owners are suing under provisions in the law barring improper lease terminations.

Shell and Motiva contend the station owners can’t invoke those provisions because they accepted new lease terms and continued to operate their franchises.

**Joint Venture**

Houston-based Motiva is a refining and marketing joint venture owned by Shell and Saudi Refining Inc. Shell, a unit of Royal Dutch Shell Plc, transferred its franchising rights to Motiva when the venture was created in 1998.

The case before the high court concerns eight of more than 50 Massachusetts station owners pressing lawsuits. The station owners object to Motiva’s decision to phase out a rent subsidy that had been tied to gasoline sales and to begin calculating rent based on the value of the station’s real estate.

The federal appeals court in Boston said the station owners could press claims for “constructive termination” even though they continued to operate their franchises.

The court reached the opposite conclusion on the owners’ allegations of “constructive non-renewal,” saying they forfeited those claims by signing new leases.

The cases are *Mac’s Shell Service v. Shell Oil Products*, 08-240, and *Shell Oil Products v. Mac’s Shell Service*. 08-372.
BOSTON—A recent 1st U.S. Circuit Court of Appeals decision upheld a $4.5 million U.S. District Court in Massachusetts jury verdict for eight gasoline station franchise operators who alleged that Shell Oil Co. and a joint venture partner deliberately overcharged them for rent and wholesale gas.

The franchisees claimed that Shell and Motiva Enterprises, its joint venture with Saudi Refining Inc. to sell oil products to the eastern and southern U.S., charged too much for gasoline and rent for the franchisees to compete in the marketplace. On April 18, the 1st Circuit upheld the Dec. 8, 2004, district court jury verdict. *Marcoux v. Shell Oil Products Co.*, No. 05-2771 (1st Cir.) Jay Farraher, a Boston shareholder at Greenberg Traurig who represented the franchisees, called the decision precedent-setting.

"The 1st Circuit Court of Appeals is one of the only appellate courts in the country to have held that dealers have the right to challenge the wholesale price where dealers feel there is evidence that the oil company may not be acting in good faith," Farraher said.

A 5th Circuit decision upheld a lower court jury verdict that found that Exxon breached its duty of good faith and violated the Texas Uniform Commercial Code in how it set wholesale prices. *Mathis v. Exxon Corp.*, 302 F.3d 448,457-59 (5th Cir. 2002) But a later Texas Supreme Court decision said that when an oil company sets a price there’s a presumption that the price is set in good faith in the absence of discrimination. Farraher said. *Shell Oil v. HRN Inc.*, 144 S.W. 3d 429, 435-38 (Texas 2004). Greenberg Traurig also represents about 50 other franchisees with claims because the district court decided to hear the claims of a small group of franchisees first, Farraher said.

Shell’s attorneys at Goodwin Procter referred questions to the company.

Shell’s joint venture Motiva is considering further court action, said Shell spokeswoman Karyn Leonardi-Cattolica.

"Motiva is considering its options to seek further review of the court of appeals’ decision to correct errors that led the court to affirm, in part, the jury verdict," said Leonardi-Cattolica.

In the ruling, Circuit Judge Jeffrey R. Howard upheld the franchisees’ win on state contract and unreasonable gasoline pricing claims under the Massachusetts Uniform Commercial Code.

"While perhaps more specific and more comprehensive evidence would be preferable, the jury had enough evidence of the defendants’ motives and practices, as well as enough information about competitors’ pricing, to come to the conclusion that the [wholesale prices charged to dealers] were commercially unreasonable," Howard wrote. "Specifically, the use of competing gas stations’ retail prices to draw conclusions about what those stations might be paying for gasoline is not ideal, but it is adequate to the task at hand.” Despite the win on the contract and pricing claims, the franchisees’ collected a mixed
ruling on two claims related to the Petroleum Marketing Practices Act, which governs contracts between gasoline refiners or distributors and retailers.

The 1st Circuit affirmed the jury's award on the constructive termination claim, which alleged that Shell improperly terminated the franchisees' agreements by assigning them to Motiva, which did not continue a subsidy program. Yet the 1st Circuit reversed the lower court's ruling that Motiva's increase of their rent constituted a constructive nonrenewal of the contracts.

Because it issued a mixed decision about Petroleum Marketing Practices claims, the 1st Circuit also vacated and remanded the lower court's award of attorney's fees and costs.
A federal jury awarded more than $3 million to eight Massachusetts gas station operators after finding Shell Oil Co. used unfair tactics that were effectively intended to drive them out of business.

The decision, reached yesterday afternoon in U.S. District Court in Boston, was a victory for the Shell franchise operators, who filed a lawsuit four years ago against Shell and affiliates of the Royal Dutch/Shell Group, arguing the companies raised wholesale prices for gasoline and rents on its station properties to levels that hampered their ability to compete for motorists’ business. The suit said it was part of the company’s plan to convert independent franchises into company-owned stores.

Nine jurors voted unanimously in favor of the gas-station operators, said their attorney, Gary Greenberg of Greenberg Traurig in Boston.

“Our clients feel vindicated. Unfortunately, some of them lost their businesses and have suffered greatly over the last several years,” he said. “A couple of these people worked for years, or took $100 or $200 a week in salary to survive as a neighborhood gas station” under their agreements with Shell.

The case was also important to the world’s third-largest oil company, which has agreements with thousands of franchises nationwide.

Shell attorney Paul Sanson could not be reached at his Connecticut law office.

The jury awarded $3.3 million in compensatory damages; that total does not include interest, attorney’s fees, or possible punitive or other damages that may be awarded by the judge, Greenberg said.

Station franchisees argued in court that the company’s actions reduced the number of independent Shell gas stations in Massachusetts to fewer than 100 in early 2003, from 177 five years earlier.

The dealers took issue with the wholesale prices at which Shell sold its gasoline to them for resale to drivers.

Dealers said the high prices would either squeeze their profits or force them to raise prices to levels that could be undercut by other stations.

The jury voted yes to the question of whether Shell “in bad faith” set wholesale gasoline prices “that were not commercially reasonable,” court documents said.

Lease agreements between franchisees and Shell, which owns the properties upon which the gas pumps sit, were also at issue in the trial which started in mid-November.

Shell in 1999 and 2000 phased out rental subsidies, a decision the jury said was a breach of its lease agreements with station operators.

Jurors decided that the elimination of the subsidies amounts to a “termination of the franchises” under federal marketing laws.
Call this one “The Shell Game.”

A group of Shell gasoline dealers in New England is planning to go to court later this month to stop what the dealers allege is an attempt by Shell Oil Co.’s marketing company to “steal” their franchises.

For nearly two decades, several dealers said recently, Shell had used a “variable rent” program to reward franchises that performed well and thus helped the company to build its distribution network in New England.

The idea was simple: The more gas the dealer sold, the bigger the subsidy he got from Shell to offset his rent.

But in the last few years Motiva Enterprises LLC, Shell’s operator on the East and Gulf coasts, began tinkering with the program to decrease the subsidy.

Dealers said the effect was to raise their rent incrementally and in time squeeze them out of business. In their place would come salaried Shell employees who manage several stations each or dealers willing to sell gas on a less-lucrative commission basis, they said.

Motiva abolished the variable rent program altogether at the end of last year. In response to questions from the Herald last week, it said it could no longer afford the subsidy and that the new rents are designed to reflect the fair market value of the franchises.

But dealers say the new rents have turned what had been a decent way to make a living into a living nightmare.

Profits—modest at best for many of these mom-and-pop operators—have all but disappeared, eaten up by monthly rents of up to $16,000. Unable to cope, some dealers have given up, a few of them in debt.

“We don’t know what else to do,” said Francis Marcoux, owner of a franchise in Webster and president of the United Shell Dealers of New England, the group taking Motiva to court.

“Everything we’ve worked for is here. We’ve built equity here, hoping someday we could sell it if we wanted to. But now Shell wants to take it away,” he said.

Marcoux said he’s better off than many of the estimated 400 Shell dealers in New England. Aside from pumping gas, he has a profitable auto-repair business and a loyal clientele dating to 1964, when his father bought the franchise.

Joseph Inferrera and his son, Joseph Jr., who have run a station on Route 27 in Natick the past 10 years, face a tougher time.

The son said they’re barely making enough to pay their $8,000-a-month rent, manageable in previous years when Shell was giving them up to 4 cents for every gallon they sold under the now-abolished
rent program.

The Inferreras sell about 100,000 gallons a month. The son said that earlier last month, when gas was selling for $1.39 a gallon at the pump, Shell was charging them $1.32 a gallon, leaving them a $7,000 profit.

But that’s not enough to cover the rent. Like most other dealers, the Inferreras have to rely on such sidelines as repairs, inspections, cigarette and other sales to supplement their earnings. Or they can quit.

Inferrera Jr. said that’s what Shell wants.

“They want to make it hurt so much we can’t afford to keep the station,” he said. “They make people hurt so bad they have no choice but to take their offer.”

But quitting is a bitter pill, since it’s unlikely any dealer would be able to sell his franchise without losing money he’d invested.

“We’ve been trying to sell for a year,” said Inferrera Jr. “But every month we’re making less and less. And now we have the final blow, because, who wants to buy?”

Steven Shea took out a $250,000 Small Business Administration loan to help pay for a $400,000 franchise in Lynn two years ago. He could afford his $12,000-a-month rent by selling 150,000 gallons a month and doing repairs.

With his rent jacked up to $16,000 now and the subsidy gone, Shea is looking at the end of the road.

“I can’t sleep, and my stomach’s a mess,” he said. “I take an advance on the credit cards just to keep it going. I can’t even lay off people to save money.”

Shea said Shell offered to buy him out last week—for $60,000. “I may have to take it,” he said.

Robert E. Weiner, a Boston lawyer representing the dealers, wrote to Shell last week seeking “meaningful dialogue” with the company. In the meantime, he’s preparing to file unfair-practice charges against the company.

“The intent seems to be to knock out the small guys and control the industry,” he said. “They want to do that so they can control the market, and it’s only going to hurt the general public if they get away with it.”

Shawn P. Frederick, a spokesman for Motiva, flatly denied his firm is trying to seize the market.

“It’s completely baseless,” he said. “How any one company can corner the market to dictate prices in our opinion is not possible.”

But he admitted Motiva is “updating” and “streamlining” its network, a process that includes shutting some small stations and building larger ones that offer more pumps and such services as a convenience store or even a supermarket.

“The trend nationally has been for fewer stations with higher volumes and more services,” he said. “Unfortunately, station closings are one of the effects of this trend, but it’s not the policy of Motiva to ‘squeeze dealers out of business.’”

Charles Carroll, assistant director of the Massachusetts Office of Consumer Affairs’ division of standards, weights and measures, confirmed the number of stations in the state has decreased steadily in recent years to
around 2,500.

Nationwide, the number of stations reportedly is down 7 percent since 1995 and about 10 percent since 1972.

Carroll said some independent station owners have been forced to close when faced with having to replace expensive underground storage tanks by last year, as mandated by Clean Air regulations.

But others have been squeezed out by bigger stations owned by the major oil companies, some of which have recently merged their operations, such as Exxon-Mobil and Texaco-Shell, he said.

Frederick argued it’s just the law of demand and supply. “Consumers, not companies, decide how the business is run,” he said.

But tell that to Barry Simpson, one of at least nine dealers in Massachusetts who quit the Shell game or had their station shut down in the past year.

“I worked with Shell for 35 years,” said Simpson, who turned in the keys to his station in Danvers five months ago and moved to Maine.

“The rent just kept going up and up and up—until I couldn’t do it anymore,” he said.