June 7, 2014

2nd Circuit Decision in Lotes Clarifies FTAIA's Effect on the Extraterritorial Reach of the Sherman Act, But Leaves Unresolved the Status of Claims Based on Importation of Products Containing Price-Fixed Components

by Orrick, Herrington & Sutcliffe LLP

8

[co-author: Howard Ullman]

Long-simmering issues concerning the applicability of the Sherman Act to foreign conduct under the Foreign Trade Antitrust Improvements Act, 15 U.S.C. § 6a (FTAIA), were addressed in the June 4, 2014 decision of the 2nd U.S. Circuit Court of Appeals in *Lotes Co., Ltd. v Hon Hai Precision Industry, Co., Ltd, et al.*, No. 13-2280 (2d Cir. June 4, 2014). Decisive in tone but offering limited guidance for the future, the decision addresses several issues for which there are inconsistent decisions—or at least a lack of consensus—among the courts of appeals and the district courts. The question of the Sherman Act's extraterritorial reach is of increasing importance as private litigation over international cartel conduct remains very active, and claims of injuries in the U.S. attributable to competitive conditions outside the country become more and more a hallmark of the global supply chain. *Lotes* is the first of three appellate decisions regarding the FTAIA expected this year; the others are from the 9th Circuit in *United States v. Leung*,[1] and from the 7th Circuit in *Motorola Mobility*,[2] where various parties have sought *en banc* reconsideration of an opinion discussed below.

The Holdings in *Lotes*

In *Lotes*, the 2nd Circuit held that (1) the requirements of the FTAIA are substantive and not jurisdictional; (2) foreign anticompetitive conduct can meet the FTAIA's "direct, substantial, and reasonably foreseeable effect" test so long as there is a "reasonably proximate causal nexus between the conduct and the effect"; (3) under the facts pleaded in the case, the FTAIA's test that

the effect "gives rise to a claim under" the Sherman Act was not satisfied; and (4) a private agreement suggesting that the Sherman Act would apply to the parties' relationship did not constitute a "waiver" of elements of the FTAIA.

* * *

Background

Plaintiff Lotes is a Taiwanese corporation that designs and manufactures Universal Serial Bus (USB) connectors that are components in computers, smartphones, computer peripherals and other electronic devices. Defendants are a group of companies that compete with Lotes in the design and manufacture of USBs, but also produce devices (such as personal computers and peripherals) that incorporate USBs. Lotes and the defendants are members of a trade group that produced a technical standard, USB 3.0, for a new generation of USBs. All participants agreed as a condition of their membership in the standard-setting organization to make available to all other members royalty-free, reasonable and nondiscriminatory ("RAND-Zero") license terms for any patents required to satisfy the standard. Lotes alleged that the defendants breached their obligations to provide RAND-Zero licenses and took steps—including marketplace communications and patent infringement suits in China—to marginalize Lotes as a potential competitor and to secure for the defendants a dominant position that would result in higher USB prices worldwide, including in the U.S. Lotes filed suit against the defendants in U.S. district court in New York, and appealed to the 2nd Circuit after its case was dismissed based on the FTAIA.

The FTAIA

The Delphic language of the FTAIA has been construed by the U.S. Supreme Court to place all (non-import) activity involving foreign commerce outside the Sherman's Act reach, but then to make such conduct subject to the Sherman Act provided that the foreign conduct both (1) sufficiently affects American commerce, i.e., it has a "direct, substantial, and reasonably foreseeable effect" on American domestic, import, or (certain) export commerce, and (2) independently "giv[es] rise to" a claim by the plaintiff that is cognizable under the Sherman Act.[3]

The 2nd Circuit's decision addressed these principal questions: (1) whether the FTAIA provisions above are jurisdictional or merely elements that a plaintiff must prove in order to recover; (2) what relationship between conduct and an effect in the U.S. is implied by the term "direct;" (3) whether foreign monopolization conduct that allegedly causes injuries overseas satisfies the "gives rise to" requirement; and (4) whether venue and other agreements made by the defendants as a condition of their participation in the standard-setting trade group constituted a waiver of certain of the statutory requirements. The 2nd Circuit ruled as follows:

1. The FTAIA Is Substantive, Not Jurisdictional

A threshold question addressed by the Court involved the framework under which FTAIA-based challenges to complaints are analyzed. Courts have wrestled for years with the question whether the FTAIA is jurisdictional or merely substantive. While not affecting the meaning of the provisions, the answer to the question may profoundly affect the course of litigation, among other reasons because of the potential availability of motions to dismiss for lack of subject matter jurisdiction under Rule 12(b)(1), and differences in the scope of discovery. The 2nd Circuit had held in 1998 that the FTAIA's requirements are jurisdictional.[4] In light of more recent Supreme Court decisions, however, the *Lotes* panel overruled the circuit law and held that the requirements of the FTAIA are substantive rather than jurisdictional.

2. The "Direct, Substantial, and Reasonably Foreseeable Effect" Test Should Be Given a Flexible Meaning

The Court's decision focused on the meaning of the term "direct" in the statutory requirement that to be actionable in the U.S., foreign anticompetitive conduct must have a "direct, substantial, and reasonably foreseeable effect" on commerce in the U.S. Courts have applied two different tests for assessing whether foreign conduct had a "direct" effect on commerce in the U.S. The 9th Circuit has taken a strict approach, holding that "an effect is 'direct' if it follows as an immediate consequence of the defendant's activity."[5] The 7th Circuit, however, sitting *en banc*, has taken a more functional approach, concluding that "the term 'direct' means only that 'a reasonably proximate causal nexus'" exists between the conduct and the injury in the U.S., whether or not the effect is "immediate."[6] The U.S. Department of Justice and the Federal Trade Commission have advocated using the latter test, seeking rulings that would aid the Government in connection with enforcement efforts against international cartels.

The 2nd Circuit agreed with the 7th Circuit, and the DOJ/FTC, explaining, among other things, that reading "direct" as "immediate" would render the "reasonably foreseeable" language in the statute superfluous: "To demand that any domestic effect must follow as an immediate consequence of a defendant's foreign anticompetitive conduct would all but collapse the FTAIA's domestic effects exception into its separate import exclusion."[7] Accordingly, the Court adopted the "reasonably proximate causal nexus" test, explaining that courts "will have to consider all of the relevant facts, using all of the traditional tools courts have used to analyze questions of proximate causation."[8] Importantly, the Court did not proceed to determine whether the allegations of Lotes's complaint satisfy this standard, leaving its decision technically dictum. Rather, the Court based its decision on the complaint's failure to satisfy a different FTAIA requirement, discussed below.

3. The "Gives Rise to a Claim" Test Should Be Given a Literal Interpretation

The Court ultimately dismissed the complaint based on its failure to satisfy the FTAIA's requirement that the domestic effect "give[] rise to a claim under" the Sherman Act. It explained that the plain meaning of that language is that the FTAIA is not satisfied unless the foreign conduct causes a domestic effect that in turn is the proximate cause of the plaintiff's injury. Lotes did not satisfy the test, because even though it alleged that the defendants' foreign conduct resulted in higher consumer prices in the United States, those prices were not the injury that Lotes allegedly suffered. To the contrary, Lotes complained of injury from being excluded from the market for USB 3.0 connectors, which flowed from the defendants' alleged foreign exclusionary conduct and not from higher consumer prices in the United States.[9] The Court also rejected Lotes's argument that it suffered domestic injury based on its allegation that defendants' refusal to license certain claims of certain U.S. patents foreclosed competition in the U.S., finding the allegations relating to U.S. patents to be trivial in the context of the acts alleged.

4. Private Agreements on Applicability of the Sherman Act Do Not Override the FTAIA

Finally, the Court considered the question whether private agreements that the defendants entered into in connection with global standard-setting activities to comply with the Sherman Act, and to have disputes heard in U.S. courts, operated as a waiver of any argument that the alleged breaches of those agreements were not within the scope of suits that may be brought under the FTAIA. The Court concluded that such provisions merely expressed rules to be followed if the Sherman Act otherwise was applicable and thus that no waiver had occurred. But the Court's broad and at times confusing suggestion that parties' private agreements could be deemed to waive requirements of the FTAIA because it is not jurisdictional may generate its own share of litigation.

* * *

Impact of the 2nd Circuit's *Lotes* Decision

The scope of the FTAIA is being heavily litigated in antitrust cases throughout the United States, most commonly in the many international price-fixing cases pending in district courts around the country. At a high level, the *Lotes* decision will help plaintiffs to the extent it adds to the weight of authority that the FTAIA is not jurisdictional. In other words, while defendants may still move to dismiss complaints that fail to allege the FTAIA elements, plaintiffs will cite *Lotes* to argue that they are unable to do so in the context of challenges to a court's jurisdiction, in which early,

special-purpose discovery may be brought to bear on the question. More complaints may proceed to merits discovery as a result, increasing defense costs and the likelihood of settlements.

On the merits, the 2nd Circuit's construction of the requirement that an effect on U.S. commerce be "direct" also favors plaintiffs. Many claims at issue in FTAIA cases involve U.S. purchases of products that incorporate components that were the subject of alleged price-fixing activity abroad. The *Lotes* decision will likely help plaintiffs' in these cases, because it adds to the weight of authority that the FTAIA does not impose a bright-line rule requiring an "immediate" effect that could be used to dismiss cases involving multi-level production chains. On this point, though, the fact that the *Lotes* case did not involve alleged price fixing of a component, and the 2nd Circuit's decision not to apply the law to the facts of the case, leave open what may be the most significant issue in current FTAIA jurisprudence. In April 2014, Judge Richard Posner wrote an opinion for the 7th Circuit in *Motorola Mobility*[10] holding that the requirement that a U.S. injury be "direct" precluded claims arising from allegedly inflated prices for LCD screens incorporated into cell phones sold in the U.S., because the LCD screens first were purchased by Motorola's overseas subsidiaries. The U.S. government has objected to that decision, arguing that it is inconsistent with the 7th Circuit's decision in *Minn-Chem*, which the 2nd Circuit (in part at the U.S. government's request) adopted in *Lotes*. It is thus clear that many important questions remain unanswered in connection with how the "reasonably proximate causal nexus" test will be applied.

As noted above, the 2nd Circuit's decision in *Lotes* is the first of three anticipated appellate decisions regarding the FTAIA. The United States has filed briefs in the 7th Circuit *Motorola Mobility* case and the 9th Circuit *Leung* case expressing concerns about limiting the scope of the FTAIA. In the *Motorola Mobility* case, the governments of Korea, Japan, and Taiwan have filed briefs expressing concerns about an expansive application of the FTAIA, and the 7th Circuit has asked the United States to submit a brief addressing international comity concerns. Given the importance of the proper interpretation and application of the FTAIA—and the inconsistency in how courts are interpreting and applying it—the issues are well on their way to being teed up for petitions for review by the Supreme Court.

The 2nd Circuit's decision is available here. For more information on recent decisions relating to the extraterritorial application of the antitrust laws, as well as extraterritoriality issues in many other U.S. practice areas, please contact the authors. To visit the homepage of The World in US Courts: Orrick's Quarterly Review of Decisions Applying US Law To Global Business and Cross-Border Activities, click here.

---

1. No. 13-10242 (9th Cir.).

2. *Motorola Mobility LLC v. AU Optronics Corp.*, 2014 WL 1243797 (7th Cir. Mar. 27, 2014).

3. *F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, 542 U.S 155, 162 (2004).

4. *Filetech S.A. v. France Telecom S.A.*, 157 F.3d 922 (2d Cir. 1998).

5. *United States v. LSL Biotechnologies*, 379 F.3d 672, 680 (9th Cir. 2004).

6. *Minn-Chem, Inc. v. Agrium, Inc.*, 683 F.3d 845, 857 (7th Cir. 2012) (en banc).

7. Slip op. at 40.

8. *Id.* at 44.

9. *Cf. Empagran SA v. F. Hoffmann-LaRoche, Ltd.*, 417 F.3d 1267, 1271 (D.C. Cir. 2005) (injury must be proximately caused by the domestic effects).

10. See n.2, *supra*.

RELATED POSTS

- **U.S. District Court Limits the Extraterritorial Application of U.S. Bankruptcy Law but Important Considerations for Foreign Investors Remain**

LATEST POSTS

- **Whistleblowing and Privacy in Italy**
- **Orrick's Financial Industry Week In Review**
- **Build Versus Buy: 5 Ways BigLaw Is Tackling Legal Tech**
- **Annual Reporting Requirements for Incentive Stock Options and Employee Stock Purchase Plans**

WRITTEN BY:

Orrick, Herrington & Sutcliffe LLP

Contact + Follow

 David Goldstein + Follow

 Robert Reznick + Follow

PUBLISHED IN:

Antitrust Litigation + Follow

Extraterritoriality Rules + Follow

FTAIA + Follow

License Agreements + Follow

Price-Fixing + Follow

RAND + Follow

Sherman Act + Follow

Stream of Commerce + Follow

Antitrust & Trade Regulation + Follow

Civil Procedure + Follow

General Business + Follow

International Trade + Follow

more

ORRICK, HERRINGTON & SUTCLIFFE LLP ON: