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# Stock Prices Aren't Enough For 'Rule Of Reason' Analysis

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The complexities of the rule of reason analysis articulated in the U.S. Supreme Court's 2013 decision in *FTC v. Actavis* have left many practitioners searching for evidence to demonstrate the presence or absence of anti-competitive effects<sup>1</sup>. A recent publication on the use of stock market evidence to evaluate "reverse payment" settlements states that "a jump in the patent holder's stock market price in response to a reverse payment settlement should suffice to show anti-competitive effects<sup>2</sup>." In this article, we explain why stock market evidence should not shortcut the rule of reason analysis required for these settlements in a post-Actavis world, and is far from the "smoking gun" proclaimed by some advocates.

The "stock price approach" stems from the well-established theory in financial economics that the value of a stock at any point in time reflects the present value of expected future cash flows<sup>3</sup>. If the patent holder's stock price increases after a "reverse payment" settlement is announced, it reflects the market's belief that under the settlement, the expected future discounted flow of profits to the patent holder are higher than the market expected prior to the settlement. While stock price and expected profits are typically related, it is incorrect to interpret a stock price increase as evidence that the settlement entry date is anti-competitive or inconsistent with the actual strength of the patent<sup>4</sup>.

To illustrate this, consider a Hatch-Waxman lawsuit between the manufacturer of a brand drug with 10 years of remaining market exclusivity and a potential generic entrant that has asserted the brand's patent as invalid.

The firms agree to settle the case under terms that allow the generic to enter in six years and also include business transactions unrelated to the drug at issue (for example, an agreement for the brand manufacturer to pay the generic firm to undertake development of a potential new therapy). Upon announcement of the settlement, the brand manufacturer's stock price rises 5 percent<sup>5</sup>.

The logic chain that interprets the jump in the stock price as indicating that the stock market expected an earlier entry date and associated lower future cash flows based on patent merits contains a subtle, but important flaw. Specifically, it fails to account for investors' tolerance for risk and, instead, associates the price jump with an unexpected windfall in patent monopoly profits. The increase in present value of expected future cash flows (which was the basis for the incremental 5 percent increase in the stock price), depends on both the magnitude of the expected future cash flows and how those cash flows are discounted. All else equal, riskier cash flows may be less valuable to investors than more certain cash flows<sup>6</sup>. In this particular scenario, the stock price increase may have been driven by a decrease in investors' perceived riskiness of the firm's expected future cash flows holding the amount and timing of those cash flows unchanged. For example, as the patent litigation was unfolding, investors may have viewed the brand manufacturer's future profits and associated future research and development spending as relatively risky because of the uncertainty of the litigation process and of the strength of the patent. Upon settlement, investors gained certainty regarding future cash flow. The 5 percent jump in the stock price is consistent with a higher valuation due to reduced risk.

Determining whether an agreement is anti-competitive using a stock-price approach requires, at a minimum, a rigorous evaluation of the underlying determinants of the stock price change. Is it driven solely by a change in the timing of generic entry and corresponding future cash flows, or a change in underlying risk? In certain cases, it may be possible, with a careful case-specific analysis of the facts, to make such a determination. Alternatively, one could compare stock movements for companies that reached a settlement absent reverse payment and companies that reached a settlement with a reverse payment holding all else equal. However, this method still requires distinguishing between the effect of an earlier than expected entry date and the effects of reduced uncertainty. Further, this analysis is complicated because agreements with reverse payments or contemporaneous business transactions are likely to differ from other agreements along multiple dimensions such as the prominence and other characteristics of the drug, its role within the drug development program of the company, the asymmetry of information between the brand and the generic, the companies involved, the relevant market characteristics and the transactions<sup>7</sup>.

In sum, while the analysis of stock price movements in response to settlement announcements may be informative in certain situations, it offers no "smoking gun" evidence and therefore cannot be a shortcut to the traditional rule of reason analysis of "reverse payment" settlements required by the Supreme Court's Actavis decision.

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## Endnotes

- 1 FTC v. Actavis Inc., 133 S.Ct. 2223 (2013).
- 2 Thomas McGuire, Keith Drake, Einer Elhauge, Raymond Hartman and Martha Starr, "Resolving Reverse Payment Settlements with the Smoking Gun of Stock Price Movements," *Iowa Law Review*, 101(1581), pp. 1581-1599.
- 3 As described, for example, in the paper cited in McGuire et al.: G. William Schwert, "Using Financial Data to Measure Effects of Regulation," *The Journal of Law & Economics*, 24(1), pp. 121-158.
- 4 McGuire et al., p. 1594.
- 5 After controlling for market and industry factors.
- 6 There are a variety of ways to estimate a firm's cost of equity, or the rate at which stock market investors discount a firm's expected cash flow. Some of those approaches explicitly ignore firm-specific risk (e.g., the Capital Asset Pricing Model, or "CAPM"); others account for it (e.g., the Discounted Cash Flow model and its many variants). For pharmaceutical firms, who tend to use current revenue to fund research and development expenditures, and in particular for those that derive a significant amount of revenue from a small number of products, firm-specific risks may play an important role in investors' perception of risk.
- 7 The authors refer to prior work (Keith M. Drake, Martha A. Starr & Thomas G. McGuire (2015) "Do 'Reverse Payment' Settlements Constitute an Anticompetitive Pay-for-Delay?," *International Journal of the Economics of Business*, 22:2, 173-200), which concludes that Hatch-Waxman settlements with indicia of a reverse payment are associated with brand firm stock price returns that exceed those of brand firms associated with settlements lacking indicia of a reverse payment. However, the authors made little effort to control for the relative importance of the drug to the firm's overall revenue. brand firm price increases for settlements with indicia of reverse payments could just as easily be caused by reductions in the discount rate as by changes in expected cash flow.

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