Session 4: Market Power: Natural Monopoly and Standards Businesses

In our last session, we discussed the antitrust/competition policy approach to market power. In this session, we will look at situations where antitrust proper may not work very well given that the underlying production technology may give rise to just a few producers or even one. This is the case of natural monopoly and is historically the domain of regulated industries laws, such as those operating in railroads, telecommunications, electricity and natural gas. We continue to have statutes and regulations in those areas, but over the last twenty years, standard setting and platforms have become an important part of the regulatory conversation. Our reading will start with DVD patent pools and then we will look at the issue of network neutrality. The third reading is the press release issued on July 17, 2019 by the European Commission in which it announced a new investigation of Amazon. Finally, the fourth reading is the English summary issued by the German Cartel Office in February 2019 on its investigation into Facebook.

DVD Joint Licensing of Patents Request Letter

July 29, 1998

Honorable Joel I. Klein, Esq.,
Assistant Attorney General,
Antitrust Division,
United States Department of Justice,
10th Street and Constitution Avenue, N.W.,
Washington, D.C. 20530.
Re: Request for Business Review Letter Regarding the Licensing of Patents Essential to DVD-Video and DVD-ROM

Dear Mr. Klein:

On behalf of Koninklijke Philips Electronics, N.V. (“Philips”), Sony Corporation of Japan (“Sony”), and Pioneer Electronic Corporation of Japan (“Pioneer”) (and their affiliates which are involved in the patent licensing program described below) we submit this request for a Business Review pursuant to 28 C.F.R. § 50.6 regarding the proposed arrangement under which certain patents essential to the manufacture and use of DVD-Video and DVD-ROM will be licensed on reasonable and non-discriminating terms (the “Proposed Licensing Program”).

DVD (or Digital Versatile Discs) refers to a high density CD-sized optical disc in which signals are encoded and stored in digital form and are then read and reproduced by players using an optical read out beam. Relying on basic CD technology, the DVD discs and players allow for an increase of approximately sixty times the storage capacity of a typical CD or CD-ROM. DVD-Video and DVD-ROM are two formats relating to high density optical discs which have been described by Philips, Sony, Pioneer and several other companies in the DVD-Specification for Read Only Disc version 1.0 dated August 1996 and in several updates thereto (a copy of the specification is set forth in Exhibit A hereto).
A single DVD format for video and ROM was defined in an open process by participating companies over the course of several years at the request of various industries—particularly the computer industry—which asserted that multiple DVD formats would delay introduction of this new and beneficial product, increase costs, and much like the incompatible BETA and VHS formats, result in losses to consumers who purchased products based on a format which quickly became obsolete. In defining the DVD-Video and DVD-ROM formats, input was solicited and received from a variety of industries and an even wider variety of companies throughout the world.

As the format was developed and refined, it became clear that numerous independent companies had been granted patents which were relevant to DVD-Video and DVD-ROM. The three companies submitting this request actively sought to join the licensing of their patents with the patents of other companies which also claimed to have patents which are essential to DVD-Video and DVD-ROM. To date, those efforts have not resulted in any other companies joining the Proposed Licensing Program. Philips, Sony and Pioneer, however, remain willing to include others having essential patents in the licensing program described below.

The companies submitting this request firmly believe that, in the near future, DVD products will be widely marketed by a wide variety of companies. We are also convinced that, once these products are manufactured and distributed in volume, there will be great consumer demand for them. We anticipate that the producers and sellers of DVD discs and players will largely be the companies that currently manufacture and sell CDs and the equipment that plays CDs and CD ROMs. Thus, prospective licensees include manufacturers of consumer audio equipment and computer disc drives. Typically, licensees to manufacture DVD discs will be replicators, as is the case with CDs. In sum, the DVD licenses will be offered to the same classes of sophisticated licensees as are CD licenses, and there is every reason to expect that the transfer of this valuable DVD technology will have the same beneficial effects upon the relevant industries that CD licenses had upon the recorded music industry 15 years ago.

In one respect, licensors of DVD technology face risks and uncertainties that were not faced 15 years ago by the creators of CD technology. During the past year, several different formats have been announced that will compete with various applications of DVD for the favor of consumers. For example, Circuit City and others have developed Digital Video Express (DIVX), a pay-per-play system that allows consumers who have purchased a DIVX-compliant player to purchase a disc at a lower price and to play that disc for a limited period of time without having to return the disc when finished. The disc may later be “re-activated” for additional plays upon payment of additional fees. Various companies have announced that they will offer DIVX discs, including Twentieth Century Fox, the Walt Disney Company, Paramount Pictures, Universal Studios and Dream Works. It is our understanding that DIVX discs will not play on non-DIVX DVD players. In addition, NEC, one of Japan’s largest electronics manufacturers, has announced its intention to introduce Multimedia Video File (MMDF), an optical disc format which is expected to compete directly with certain applications of DVD technology. Other new announced products include TeraStor’s Near Field Recording (NFR) technology and Advanced Storage Magneto-Optical (ASMO). In short, this is an area in which several well-financed suppliers
are prepared to compete aggressively with DVD products. Obviously, there also will be competition among those selling DVD products.

Offering a patent license for all essential patents of the three companies under the Proposed Licensing Program will provide several pro-competitive benefits, including (1) reducing the uncertainty of the availability of patent licenses so that those who require a license to manufacture or use a DVD-Video or DVD-ROM product are aware that a license from the three companies easily can be obtained; (2) reducing the royalties that likely would be payable if the three companies licensed their essential patents on their own; (3) reducing the cost for each prospective licensee of determining on its own the identities of owners of essential patents and the entities from which licenses which must be obtained; (4) reducing other transaction costs of licensees having to negotiate and execute separate licenses; (5) reducing the transaction costs of essential patent holders offering separate licenses thereby allowing for a reduction in the price of the license; and (6) offering the same royalty rate and other conditions to all interested licensees so that no entity manufacturing or selling a DVD-Video or DVD-ROM product will have a price advantage over any other such entity as a result of entering into a license for the essential patents of Philips, Sony and Pioneer.

The Proposed Licensing Program will be structured to avoid any countervailing aspects that may be deemed anticompetitive. For example, each patent holder will retain the right to license its patents outside the Proposed Licensing Program under whatever terms and conditions it reaches with any prospective licensee, and each prospective licensee will be informed in writing of its option to negotiate such an individual license under reasonable terms and conditions. The Philips personnel who are responsible for the Proposed Licensing Program will play no role in the marketing of DVD products. An independent expert in the art has been retained to insure that the portfolio of patents that will be licensed under the Program includes only those patents which are essential to DVD-Video and DVD-ROM products. Although Philips, Sony and Pioneer have not been successful in having other companies join their licensing program, they remain willing to include any others having essential patents who wish to join. There will be no royalty payable by the licensee unless a licensed patent would be infringed but for the license, information which the licensee may be required to disclose to monitor infringement and royalty payments will not be disclosed to any of the licensors, but only to a third party expert retained by the licensors, patents included in the licenses will be specifically identified in appendices to the license, and Philips, Sony and Pioneer will commit to licensing to any licensee any essential patent rights they may acquire subsequent to the date specified in the license.

Set forth below is a fuller description of the proposed licensing terms and the agreements among the licensors.

The Proposed Patent License

Two licenses (Appended hereto as Exhibits B and C) will be offered, both in substantially the same form. One is for DVD players, the other for DVD discs. A three page “Agreement” sets forth a few basic terms of the license and also specifically incorporates the “Conditions” of the license which are appended to the Agreement.
On the first page of the Agreement, it is specifically noted that Philips, Sony and Pioneer are each willing to license their respective patent rights for optical disc or player manufacturing whether within or outside the standard DVD specifications on reasonable terms and conditions. Thus, any prospective licensee who is dissatisfied with the terms of the Proposed Licensing Program is assured of this alternative.

Article 2 of the Conditions sets forth the terms of the license grant, and provides for a license under Licensed Patents which are defined in Article 1.07 as all patent rights pertinent to DVD discs or players which Philips has acquired the right to license, which have or are entitled to a priority date prior to January 1, 1997, and which are essential to DVD discs or players. Article 1.07 goes on to define as “essential” those patents which are necessary as a practical matter for compliance with the DVD-Video or DVD-ROM specifications. The license, therefore, includes not only all patents technically necessary to manufacture a product to the standard specifications, but also those which a typical licensee is likely to require. For example, it may be theoretically possible to design around a particular patent at significant additional cost (and without additional benefit), but few, if any, licensees who pay the standard royalty rate for other essential patents would want such patent excluded from the license. Indeed, it is fair to say that most, if not all, licensees would want such patents included.

Article 2.07 describes the method by which patents are selected for the portfolio license. The prospective licensee is specifically informed that Philips has appointed an independent patent expert to evaluate the patents of the three licensors for “essentiality” and that the portfolio included in the license may be amended from time to time based on the results of that evaluation.\(^1\)

In Article 2.03, each licensor agrees to grant a license to each licensee under any essential patent which Philips, Sony or Pioneer acquire the right to license in the future. Thus, to the extent any of the licensors are issued essential patents in the future or other companies join the proposed licensing program, all licensees are guaranteed a license under any such essential patent.

Articles 2.05 and 2.06 set forth the terms of the licensees’ grant of patent rights. For the identical term of the license granted by Philips, Sony and Pioneer, the licensee agrees to grant to the licensors and other licensees (who also agree to the terms of the grant back) a royalty bearing license on essential patents. Thus, the scope of the grant back is virtually identical to the scope of the license itself. The grant back would not create any disincentive to innovate as it specifically allows the licensee to charge a royalty for its grant of a license and would only prevent a particular patent holder from deciding to use its after-acquired patent position to completely block others from competing in a business in which they already have invested substantial resources.

Article 4 sets forth the royalty payments to be made by licensees. The license provides for a $10,000 payment upon execution of the license ($5,000 of which may be credited to

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\(^1\) Philips has appointed Kenneth Rubenstein, a member of Proskauer Rose LLP of New York, to determine which patents are essential and should be included in the license. Dr. Rubenstein received his Ph.D in plasma physics from the Massachusetts Institute of Technology in 1975 and his J.D. cum laude from New York Law School in 1982. Dr. Rubenstein previously performed a similar function for the licensing of patents essential to MPEG-2 technology and he continues this work.
royalty payments) and a running royalty of $.05 per disc or 3.5% of the net selling price of a player, with a minimum player payment of $7.00 until January 1, 2000 and a minimum of $5.00 thereafter.\(^2\)

Article 4 makes plain that no royalties are due unless “a Licensed Patent is utilized” and, therefore, there are no royalty paying obligations regardless of whether the 10-year license is in effect if the licensee has adopted new or different technology that does not utilize any of the patents in the portfolio.

Articles 4.09 and 4.10 provide that licensees must maintain and furnish certain information relevant to issues of infringement and appropriate royalty payments, but specify that such information shall be provided to independent experts rather than to any licensor itself.

The licenses provide for “most favorable nations” terms under which each licensee is assured of receiving the most favorable royalty rate granted any other portfolio licensee under the conditions specified in Article 5. Thus, no similarly situated licensee is given a competitive advantage by the license over any other such licensee.

Article 10.05 gives each licensor the right to withdraw its own patents from the portfolio license with respect to any licensee which both (1) brings a lawsuit against the licensor for infringement of an essential DVD patent and (2) refuses to license such patents to the licensor on fair and reasonable terms. This provision is necessary to prevent portfolio licensees from taking unreasonable and unfair advantage of the fact that each portfolio licensor already has agreed to license its patent on the open, fair and non-discriminatory terms provided in the portfolio license at royalty rates that are likely considerably lower than what would be payable if patents were licensed individually outside the portfolio license.

Without the provisions of Article 10.05, a portfolio licensee could, while enjoying the considerable benefits of the portfolio license, attempt to extract unreasonable terms for licensing its patents as a result of already being licensed under the portfolio license. Article 10.05 merely “evens the playing field,” returns the parties to the bargaining position each would have been in but for the portfolio license, and creates no competitive issues. This is particularly so in light of each portfolio licensors’ undertaking to license its patents outside the portfolio license. Thus, a licensee who subjects itself to the provision of Article 10.05 by filing suit and refusing to grant a license on fair and reasonable terms is not denied the right to a license for essential patents, just to a license for essential patents on the favorable terms of the portfolio license.

Finally, Article 11.04 provides that any disputes involving the license shall be submitted to arbitration in New York and resolved under New York law. This provides for a certain and cost effective method to resolve disputes.

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\(^2\) Widespread public reports have suggested that the typical disc will retail for approximately $20-25. The per disc royalty thus amounts to approximately .22% of the retail price of discs, although the royalty typically will be payable by the disc replicator.
Agreement Among Licensors
The agreements among Philips, Sony and Pioneer relating to the Proposed Licensing Program are set forth in two bilateral Agreements and Amendment No. 1 thereto, one between Sony and Philips and one identical agreement between Pioneer and Philips. The Agreements and Amendments are appended hereto as Exhibit D.

The Agreements basically set forth the terms under which Philips shall license the three companies’ essential patents and set out many of the same terms which are incorporated in the licenses itself and are discussed above. The Agreements make plain that the Proposed Licensing Program does not in any way impede the companies’ ability to license their patents on their own under any conditions they may negotiate.

Article 2.01 of the Agreement provides that Philips shall offer the portfolio license to “all interested third parties.” Article 5 of Amendment No. 1 further specifies that Philips shall grant licenses “to all interested parties and shall not discriminate against or among potential licensees” although Philips is entitled to seek financial guarantees on royalty payments when required. The Agreements also set out various terms for the collection and distribution of royalties. Although Article 4.03 provides that each party may consult with the others in the event of a good faith belief that an act of infringement has occurred, Article 4.04 provides that each party retains the right to enforce its patents as it sees fit.

Article 7 of Amendment No. 1 sets forth the details of the procedure by which Philips shall retain an independent expert to assure that all patents in the portfolio are essential, and provides the procedure under which patents may be added to the Proposed Licensing Program.

Conclusion
It is anticipated that DVD-Video and DVD-ROM applications will gain widespread acceptance among consumers in the United States and throughout the world. Intellectual property rights granted by the United States and other sovereign nations to numerous unrelated entities could seriously delay if not block the introduction of this new and significant technology. The Proposed Licensing Program described above eliminates one potential impediment to the implementation of DVD-Video and DVD-ROM by allowing all essential patents of Philips, Sony and Pioneer to be offered in a single, non-discriminatory, fair and cost effective licensing program. The Proposed Licensing Program has been carefully crafted in an effort to avoid any competition concerns which may arise from the combining of patents belonging to independent entities within a single license. We respectfully submit that the Proposed Licensing Program has successfully addressed any competition concerns, and that the pro-competitive aspects of the program far outweigh any potential competition issues which may remain.

We will be available at your convenience to provide any further information you may require. We very much appreciate the Division’s attention to this matter.

Respectfully,
Garrard R. Beeney
for Koninklijke Philips Electronics, N.V.; Sony Corporation of Japan and Pioneer Electronic Corporation of Japan
DVD Business Review Letter Response

December 16, 1998

VIA FAX
Garrard R. Beeney, Esq.
Sullivan & Cromwell
125 Broad Street
New York, New York 10004-2498

Dear Mr. Beeney:

This letter is in response to your request on behalf of Koninklijke Philips Electronics, N.V. (“Philips”), Sony Corporation of Japan (“Sony”) and Pioneer Electronic Corporation of Japan (“Pioneer”) for the issuance of a business review letter pursuant to the Department of Justice’s Business Review Procedure, 28 C.F.R. ¶ 50.6. You have requested a statement of the Department of Justice’s antitrust enforcement intentions with respect to a proposed arrangement pursuant to which Philips will assemble and offer a package license under the patents of Philips, Sony and Pioneer (collectively, the “Licensors”) that are “essential,” as defined below, to manufacturing Digital Versatile Discs (DVDs) and players in compliance with the DVD-ROM and DVD-Video formats, and will distribute royalty income among the Licensors.

I. The DVD-ROM and DVD-Video Formats

The Standard Specifications for the DVD-ROM and DVD-Video formats describe the physical and technical parameters for DVDs for read-only-memory and video applications, respectively, and “rules, conditions and mechanisms” for player units for the two formats. In either format, the DVD offers storage capacity more than seven times that of a compact disc; a single-layer, single-sided DVD, for example, can store 4.7 billion bytes (4.38 GB) of information including audio, video, text, and data. Employing compression technology, a DVD-Video disc can hold a 135-minute feature film on a single side.

The Licensors, along with a number of other producers of consumer electronics hardware, software, or both, established the Standard Specifications. These Standard Specifications appear to implicate the intellectual property rights of numerous firms.

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1 DVD Specifications for Read-Only Disc (the “Standard Specifications”), Part 3: Video Specifications, Version 1.1 (December 1997), § 3.3.1. You have attached the Standard Specifications as Exhibit A to your letter. DVD-Video, which is described in Part 3 of the Standard Specifications, appears to be a subunit of the DVD-ROM format. The DVD-Video specifications indicate that DVD-Video discs shall comply with Parts 1 and 2 of the Standard Specifications, which describe the disc’s physical and file-system characteristics, respectively. Id., § 1.1.

2 In addition to the Licensors, the publishers of the DVD-ROM Specifications are: Hitachi, Ltd.; Matsushita Electric Industrial Co., Ltd.; Mitsubishi Electric Corporation; Thomson Multimedia; Time Warner Inc.; Toshiba Corp.; and Victor Company of Japan, Ltd. While your letter includes information concerning the process by which these formats were established, you have not requested, and this letter does not offer, an opinion on any competitive issues presented by the development of these formats or any other DVD-related format.
II. The Proposed Arrangement

The proposed arrangement is embodied in two pairs of licenses: two separate but substantially identical licenses to Philips from Sony and Pioneer (the “DVD-Video and DVD-ROM Agreement”); and a pair of standard licenses from Philips to DVD makers (the “Disc License”) and player manufacturers (the “Player License”). Through these two sets of licenses, Philips aggregates the Licensor’s patents and will disseminate them to users of the DVD-ROM and DVD-Video formats.

A. The patents to be licensed

Under the proposed arrangement, Philips is licensing from the other Licensor those patents that: (i) they owned or controlled as of specific dates in 1997; (ii) are entitled to a priority date before December 31, 1996; and (iii) are “essential,” which is defined as “necessary (as a practical matter) for compliance with the DVD Video or DVD-ROM Standard Specifications.” In turn, Philips will sublicense those patents, along with its own patents that meet the same criteria, in the Portfolio Licenses for use in making discs or players, respectively, that comply with either of those formats.

Initially, each Licensor has designated its “essential” patents for inclusion in the Portfolio Licenses; there are 115 patents in all for the manufacture of DVD players, and 95 for the manufacture of the discs themselves. However, the Licensor has retained a patent expert to review the designated United States patents and make an independent determination as to their “essentiality.” His determination, reflecting his “best independent judgment,” is to be based on information he obtains from the Licensor, others in the industry, and the advice of technical experts he may retain. The review, which is already underway, will not entail an examination of validity. Should the expert determine that a patent initially designated as “essential” is not, Philips will exclude it from the Portfolio Licenses. However, licensees that have already taken the Disc or Player License shall have the option to retain their licenses to the newly excluded patent.

While one of the license documents indicates that the patent expert is to be “appointed” by Philips, the letters that the Licensor will send to the expert state that all of them are retaining him. Further, the letters state that the expert’s conclusions will have no bearing on either his compensation or any Licensor’s future retention of him or his law firm.

As noted above, the DVD-Video and DVD-ROM Agreements ensure only that the Licensor’s “essential” patents with filing dates before December 31, 1996, and which were owned or controlled by the Licensor as of November 24, 1997 (or, in Pioneer’s case, October 1, 1997) will be part of the Portfolio Licenses. You have stated to us that, as of

5 You have attached the Player License as Exhibit B to your letter, and the Disc License as Exhibit C. I will refer to the Disc and Player Licenses collectively as the “Portfolio Licenses.”

7 DVD-Video and DVD-ROM Agreement, Arts. 1.06-1.07. You have confirmed that the term “priority date” means, for any given patent in the Portfolio License, the first date on which the application for that patent, or for a patent on the same invention in another country, was filed. See 35 U.S.C. § 119.

8 We understand this definition to encompass patents which are technically essential—i.e., inevitably infringed by compliance with the specifications—and those for which existing alternatives are economically unfeasible. As discussed below, a less concrete definition of the term “as a practical matter” could give rise to difficult competitive issues. Neither Sony’s and Pioneer’s licenses to Philips nor the Portfolio Licenses convey rights to patents that are “essential” by virtue of the DVD formats’ incorporation of MPEG-2 video compression technology.
December 1, 1998, no Licensor has indicated that it owns or controls an “essential” patent that falls outside these bounds. Should such a patent emerge, however, the DVD-Video and DVD-ROM Agreements commit the Licensors to licensing it, “at fair and reasonable conditions,” to any licensee under the Portfolio Licenses, either through Philips or individually.

B. The joint licensing arrangement

1. The licenses from Sony and Pioneer to Philips

Sony and Pioneer have granted Philips nonexclusive, sublicensable licenses on their “essential” patents to enable Philips to grant licenses “to all interested parties . . . to manufacture, have made, have manufactured components of, use and sell or otherwise dispose of” discs and players that conform to the Standard Specifications. The licenses obligate Philips to grant licenses on the “essential” patents for use in conformity with the specifications nondiscriminatorily to all interested third-parties. All three Licensors, however, remain free to license their “essential” patents independently of the Portfolio Licenses, including for uses outside the DVD-ROM and DVD-Video formats.

The licenses from Sony and Pioneer also establish the Portfolio Licenses’ royalty rates. The Player License per-unit royalty is to be 3.5% of the net selling price for each player sold, subject to a minimum fee of $7 per unit, which drops to $5 as of January 1, 2000. The Disc License royalty is to be $.042 per disc sold. In addition, each Portfolio License requires a $10,000 initial payment, half of which is creditable against the per-unit royalties. Philips’ licenses from Sony and Pioneer separately set the latter two firms’ share of these royalties, again on a per-unit basis. The allocation of royalties among the Licensors is not a function of the number of patents contributed to the pool. To ensure the receipt of their agreed royalties, Sony’s and Pioneer’s independent auditors may audit Philips’ books and records up to once a year.

While each of the Licensors retains sole discretion to pursue infringers, the licenses from Sony and Pioneer require each Licensor to notify the others before initiating any enforcement action and provide for sharing of joint infringement litigation expenses.

2. The Portfolio Licenses

As authorized by its licenses from Sony and Pioneer, Philips’ licenses to disc and player manufacturers will be for use in conformity with the Standard Specifications. However, the Portfolio Licenses will notify potential licensees that all the Licensors are “willing to license their respective patent rights for optical disc manufacturing, whether within or outside of the DVD-Video and DVD-ROM Standard Specifications . . . on reasonable terms and conditions.” They will warn potential licensees that licenses from other intellectual property owners may be necessary for compliance with the formats. A “Most Favourable Conditions” clause will entitle the licensee to the benefit of any lower royalty rate Philips grants to another licensee under “otherwise similar and substantially the same conditions.”

Each Portfolio License will have a term of ten years from the license’s effective date, subject to termination for a limited number of reasons.37 To verify royalties owed and paid,

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37 Philips or its licensee may terminate the license on 30 days’ notice for the other party’s default. Philips also
Philips may appoint an independent accountant to audit its licensees’ books and records up to once a year and may require licensees to provide the accountant with additional information for that purpose. The Portfolio Licenses also require licensees to provide, on request, information for review by a patent expert to determine whether a particular product infringes any of the licensed patents and, thus, triggers royalty obligations. The licensees’ obligation to provide information to the independent accountant and patent expert extends only to the information necessary to determine the amount of royalties owed or whether they are owed at all.

One of the grounds on which Philips may terminate a license relates to the licensees’ grantback obligation: Portfolio licensees must grant the Licensors and fellow licensees a license, “on reasonable, non-discriminatory conditions comparable to those set forth herein,” on any patents they own or control that are “essential” to either disc or player manufacture in conformity with the Standard Specifications. As noted above, this obligation is reinforced by Philips’ right to terminate without notice the license of any licensee that, after having refused to grant a Licensor a license on an “essential” patent it owns, sues that Licensor for infringement of that patent.

III. Analysis

As with any aggregation of patent rights for the purpose of joint package licensing, commonly known as a patent pool, an antitrust analysis of this proposed licensing program must examine both the pool’s expected competitive benefits and its potential competitive hazards. In particular, one expects that a patent pool “may provide competitive benefits by integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation.” At the same time, “some patent pools can restrict competition, whether among intellectual property rights within the pool or downstream products incorporating the pooled patents or in innovation among parties to the pool.” Accordingly, the following analysis addresses (i) whether the proposed licensing program is likely to integrate complementary patent rights and (ii), if so, whether the resulting competitive benefits are likely to be outweighed by competitive harm posed by other aspects of the program.

A fundamental premise of the following analysis is that the patents to be licensed are valid. This is a legitimate presumption with any patent. On the other hand, persuasive evidence to the contrary would undermine virtually any licensing arrangement: “A licensing scheme premised on invalid or expired intellectual property rights will not withstand antitrust scrutiny.” Unaccompanied by legitimate intellectual property rights, restrictions on licensors or licensees are highly likely to be anticompetitive. None of the information

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that you have provided us warrants abandonment of the presumption of validity as to any of the patents to be licensed. Should the Department subsequently receive information that undercuts this presumption, its enforcement intentions as to the proposed arrangement might be very different.

A. Integration of Complementary Patent Rights

If the Licensors owned patent rights that could be licensed and used in competition with each other, they might have an economic incentive to utilize a patent pool to eliminate competition among them. A pool that served that purpose “would raise serious competitive concerns.” In combining such substitute patents, the pool could serve as a price-fixing mechanism, ultimately raising the price of products and services that utilize the pooled patents. If, on the other hand, the pool were to bring together complementary patent rights, it could be “an efficient and procompetitive method of disseminating those rights to would-be users.” By reducing what would otherwise be three licensing transactions to one, the pool would reduce transactions costs for Licensors and licensees alike. By ensuring that each Licensor’s patents will not be blocked by those of the other two, the pool would enhance the value of all three Licensors’ patents.

One way to ensure that the proposed pool will integrate only complementary patent rights is to limit the pool to patents that are essential to compliance with the Standard Specifications. Essential patents by definition have no substitutes; one needs licenses to each of them in order to comply with the standard. At the same time, they are complementary to each other; a license to one essential patent is more valuable if the licensee also has licenses to use other essential patents.

A broader inclusion criterion than essentiality carries with it two anticompetitive risks, both arising from the possibility that there may be substitutes for patents included in the pool. Consider, for example, a situation where there are several patented methods for placing DVD-ROMs into packaging—each a useful complement to DVD-ROM manufacturing technology, but not essential to the standard. A DVD-ROM maker needs to license only one of them; they are substitutes for each other. Inclusion in the pool of two or more of those patents would risk turning the pool into a price-fixing mechanism. Inclusion in the pool of one of the patents, which the pool would convey along with the essential patents, could in certain cases unreasonably foreclose the competing patents from use by manufacturers; because the manufacturers would obtain a license to the one patent with the pool, they might choose not to license any of the competing patents, even if they otherwise would regard the competitive patents as superior. Limiting a pool to essential patents ensures that neither of these concerns will arise; rivalry is foreclosed neither among patents within the pool nor between patents in the pool and patents outside it.

If our understanding of the criterion “necessary (as a practical matter)” is correct, then it appears that the Licensors intend to license through the pool only complementary patents for which there are no substitutes for the purposes of compliance with the Standard Specifications. Some uncertainty arises from this definition’s imprecision: Unlike the

50 Id.
MPEG-2 pool, which required actual technical essentiality for eligibility, this pool introduces the concept of necessity “as a practical matter.” On its face, this latter standard is inherently more susceptible to subjective interpretation. An excessively liberal interpretation of it could lead to the inclusion of patent rights for which there were viable substitutes. In that event, the pool could injure competition by foreclosing such substitutes.

Based on what you have told us, however, the definition of “necessary (as a practical matter)” that the expert will be employing is sufficiently clear and demanding that the portfolio is unlikely to contain patents for which there are economically viable substitutes. Thus, so long as the patent expert applies this criterion scrupulously and independently, it is reasonable to expect that the Portfolio will combine complementary patent rights while not limiting competition between them and other patent rights for purposes of the licensed applications.

The structure of this pool, however, creates some concern about the expert’s ability to apply this criterion entirely independent of the Licensor. While you have stated that the patent expert will be “independent” and demonstrated that his independence is a term of the licenses from Sony and Pioneer to Philips, the expert is being retained directly by the Licensor, who have an incentive to combine in the pool any of their competing DVD-related patents and to foreclose others’ competing patents. Without more, there would be justifiable skepticism that this structure would ensure a disinterested review of the “essentiality” of the patent rights put forward.

However, in furtherance of the provision for independence in the license agreements, each Licensor has assured the U.S. expert in writing that the expert’s compensation and future retention will not be affected by his determinations as to essentiality; the same assurance will go to the Japanese patent expert as well. These assurances, of course, are no guarantee. Their continuing fulfillment is necessary to the expert’s independence and, consequently, to the likelihood that the portfolio will contain only complementary patents without foreclosing competition. Whether they will be sufficient as well as necessary remains to be seen.

Although the patent-expert mechanism is flawed, the Department is willing to base its present enforcement intentions on your representation that the combination of the Licensor’s contractual commitment to independence and their written assurances to the expert will insulate him from their interests sufficiently to ensure that the Portfolio Licenses will contain only those patent rights of the Licensor that all DVD-Video and DVD-ROM licensees will need. In that case, the proposed arrangement would serve the procompetitive purpose of combining complementary technologies into a package that will be likely to lower costs to makers of DVD-Video and DVD-ROM discs and players. If, nevertheless, these assurances prove insufficient either to ensure the expert’s ability to function independently and objectively or to ensure that the pool will contain only essential patents, the

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56 Because the royalty allocation is unaffected by each Licensor’s share of the patents in the Portfolio License, the Licensor have no financial incentive to exclude each other’s non-essential patents. In the MPEG-2 pool, in contrast, the joint licensor, which retained the expert, was an entity separate from the patent owners with no intellectual property of its own at stake. Moreover, the pool members themselves had a strong incentive to exclude non-essential patents, since their share of the royalties was a direct function of the number of essential patents they held.
Department’s enforcement intentions as to the proposed arrangement might be very different.

B. Foreclosure of Competition in Related Markets
As mentioned above, the Licensors are competitors in markets vertically related to the licensed technology—not only in “downstream” markets such as the manufacture of DVD discs and players, but also in the creation of content, such as feature-length films, that is incorporated in DVD discs. Consequently, the question arises whether this pool is likely to impede competition in any of those markets, not only between any given Licensor and licensees, but also among the Licensors themselves.

Based upon what you have told us, the proposed licensing program does not appear to have any such anticompetitive potential in the markets in which the licensed technology will be used. First, the agreed royalty is sufficiently small relative to the total costs of manufacture that it is unlikely to enable collusion among sellers of DVD players or discs. Second, the proposed program should enhance rather than limit access to the Licensors’ “essential” patents. Because Philips must license on a non-discriminatory basis to all interested parties, it cannot impose disadvantageous terms on competitors, let alone refuse to license them altogether. Should the agreed pool royalty prove economically unrealistic, each Licensor’s ability to grant licenses on its own to users of the Standard Specifications provides a backstop. Third, the extent of Philips’ ability to audit licensees, through independent accountants, is unlikely to afford it anticompetitive access to competitively sensitive proprietary information, such as cost data. Sony’s and Pioneer’s similarly limited right to an annual audit of Philips’ conduct as joint licensor should not create any greater likelihood of collusion. Nor does there seem to be any facet of the proposed program that would facilitate collusion or dampen competition among the Licensors in the creation of content for software.

C. Effect on Innovation
Because only already-filed “essential” patents and patent applications are required for inclusion in the Portfolio, the program does not discourage the Licensors from continuing research and development that may relate to the standard. Further, the Licensors are free to license their “essential” patents for purposes that compete with the DVD-Video and DVD-ROM standards.

Ordinarily, patent license grantback provisions might be expected to raise the question whether, by reducing licensees’ incentives to innovate, they threaten competitive harm that outweighs their procompetitive effects. Here, however, the proposed grantback provisions are so narrow that they are unlikely to raise significant issues. Their scope is commensurate with that of the Licenses: They cover only “essential” patents. A licensee’s non-“essential” improvements remain its own and may be licensed or not, as the licensee wishes. Thus, the grantback obligation seems unlikely to apply to further innovation within the DVD-ROM and DVD-Video formats. Instead, it is far more likely to force cross-licenses, on “reasonable, non-discriminatory conditions comparable to those” of the Portfolio Licenses, from owners of already extant “essential” patents. In requiring licensees to offer the Licensors and fellow licensees access, on reasonable terms, to whatever “essential”
patents they own or control, the Portfolio Licenses ensure that no licensee may take advantage of the benefits of the pool while exploiting its own market power over users of the Standard Specifications. The grantback provision is likely simply to bring other “essential” patents into the Portfolio, thereby limiting holdouts’ ability to exact a supracompetitive toll from Portfolio licensees and further lowering licensees’ costs in assembling the patent rights essential to their compliance with the Standard Specifications. While easing, though not altogether eliminating, the holdout problem, the grantback should not create any disincentive among licensees to innovate.

In the current circumstances, the proposed ten-year term of the license does not pose significant concerns. The Portfolio Licenses authorize only a limited field of use for the licensed technology—the manufacture and sale of products that comply with the Standard Specifications; they do not limit licensees’ other options. Licensees may seek presently unknown methods of complying with these standards, or they may support altogether different product standards. The absence of any renewal clause puts potential licensees on notice that they will be facing a new market-based negotiation for access to the technology on the expiration of the Portfolio Licenses ten years hence. The uncertainty of market conditions at that time makes it impossible to speculate on the degree of power, if any, the Licensors will hold over any future technology licensing market.

IV. Conclusion

Based on the information and assurances that you have provided us, it appears that the proposed arrangement is likely to combine complementary patent rights, thereby lowering the costs of manufacturers that need access to them in order to produce discs and players in conformity with the DVD-Video and DVD-ROM formats. Your assurances and information indicate that the proposed arrangement is not likely to impede competition, either in the licensing or development of technology for use in making DVDs, players, or products that conform to alternative formats, or in the markets in which DVDs and players compete.

For these reasons, the Department is not presently inclined to initiate antitrust enforcement action against the conduct you have described. This letter, however, expresses the Department’s current enforcement intention. In accordance with our normal practices, the Department reserves the right to bring an enforcement action in the future if the actual operation of the proposed conduct proves to be anticompetitive in purpose or effect.

This statement is made in accordance with the Department’s Business Review Procedure, 28 C.F.R. ¶ 50.6. Pursuant to its terms, your business review request and this letter will be made publicly available immediately, and any supporting data will be made publicly available within 30 days of the date of this letter, unless you request that part of the material be withheld in accordance with Paragraph 10(c) of the Business Review Procedure.

Sincerely,

/ s / Joel I. Klein
For Immediate Release

FCC ACTS TO RESTORE INTERNET FREEDOM

Reverses Title II Framework, Increases Transparency to Protect Consumers, Spur Investment, Innovation, and Competition

WASHINGTON, December 14, 2017—The Federal Communications Commission today voted to restore the longstanding, bipartisan light-touch regulatory framework that has fostered rapid Internet growth, openness, and freedom for nearly 20 years.

Following detailed legal and economic analysis, as well as extensive examination of comments from consumers and stakeholders, the Commission reversed the FCC’s 2015 heavy-handed utility-style regulation of broadband Internet access service, which imposed substantial costs on the entire Internet ecosystem.

In place of that heavy-handed framework, the FCC is returning to the traditional light-touch framework that was in place until 2015. Moreover, the FCC today also adopted robust transparency requirements that will empower consumers as well as facilitate effective government oversight of broadband providers’ conduct. In particular, the FCC’s action today has restored the jurisdiction of the Federal Trade Commission to act when broadband providers engage in anticompetitive, unfair, or deceptive acts or practices.

The framework adopted by the Commission today will protect consumers at far less cost to investment than the prior rigid and wide-ranging utility rules. And restoring a favorable climate for network investment is key to closing the digital divide, spurring competition and innovation that benefits consumers. The Declaratory Ruling, Report and Order, and Order adopted by the Commission takes the following steps to achieve these goals:

Declaratory Ruling

- Restores the classification of broadband Internet access service as an “information service” under Title I of the Communications Act—the classification affirmed by the Supreme Court in the 2005 Brand X case.
- Reinstates the classification of mobile broadband Internet access service as a private mobile service.
- Finds that the regulatory uncertainty created by utility-style Title II regulation has reduced Internet service provider (ISP) investment in networks, as well as hampered innovation, particularly among small ISPs serving rural consumers.
- Finds that public policy, in addition to legal analysis, supports the information service classification, because it is more likely to encourage broadband investment and innovation, thereby furthering the goal of closing the digital divide and benefitting the entire Internet ecosystem.
• Restores broadband consumer protection authority to the Federal Trade Commission (FTC), enabling it to apply its extensive expertise to provide uniform online protections against unfair, deceptive, and anticompetitive practices.

**Report and Order**

• Requires that ISPs disclose information about their practices to consumers, entrepreneurs, and the Commission, including any blocking, throttling, paid prioritization, or affiliated prioritization.
• Finds that transparency, combined with market forces as well as antitrust and consumer protection laws, achieve benefits comparable to those of the 2015 “bright line” rules at lower cost.
• Eliminates the vague and expansive Internet Conduct Standard, under which the FCC could micromanage innovative business models.

**Order**

• Finds that the public interest is not served by adding to the already-voluminous record in this proceeding additional materials, including confidential materials submitted in other proceedings.

The item takes effect upon approval by the Office of Management and Budget of the new transparency rule that requires the collection of additional information from industry.


WC Docket No. 17-108

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This is an unofficial announcement of Commission action. Release of the full text of a Commission order constitutes official action. See MCI v. FCC, 515 F.2d 385 (D.C. Cir. 1974).
STATEMENT OF
CHAIRMAN AJIT PAI

Re: Restoring Internet Freedom, WC Docket No. 17-108.

The Internet is the greatest free-market innovation in history. It has changed the way we live, play, work, learn, and speak. During my time at the FCC, I’ve met with entrepreneurs who have started businesses, doctors who have helped care for patients, teachers who have educated their students, and farmers who increased their crop yields, all because of the Internet. And the Internet has enriched my life immeasurably. In the past few days alone, I’ve downloaded interesting podcasts about blockchain technology, ordered a burrito, managed my playoff-bound fantasy football team, and—as you may have seen—tweeted.

What is responsible for the phenomenal development of the Internet? It certainly wasn’t heavy-handed government regulation. Quite to the contrary: At the dawn of the commercial Internet, President Clinton and a Republican Congress agreed that it would be the policy of the United States “to preserve the vibrant and competitive free market that presently exists for the Internet . . . unfettered by Federal or State regulation.”

This bipartisan policy worked. Encouraged by light-touch regulation, the private sector invested over $1.5 trillion to build out fixed and mobile networks throughout the United States. 28.8k modems gave way to gigabit fiber connections. Innovators and entrepreneurs grew startups into global giants. America’s Internet economy became the envy of the world.

And this light-touch approach was good for consumers, too. In a free market full of permissionless innovation, online services blossomed. Within a generation, we’ve gone from email as the killer app to high-definition video streaming. Entrepreneurs and innovators guided the Internet far better than the clumsy hand of government ever could have.

But then, in early 2015, the FCC jettisoned this successful, bipartisan approach to the Internet. On express orders from the previous White House, the FCC scrapped the tried-and-true, light touch regulation of the Internet and replaced it with heavy-handed micromanagement. It decided to subject the Internet to utility-style regulation designed in the 1930s to govern Ma Bell.

This decision was a mistake. For one thing, there was no problem to solve. The Internet wasn’t broken in 2015. We weren’t living in a digital dystopia. To the contrary, the Internet is perhaps the one thing in American society we can all agree has been a stunning success.

Not only was there no problem, this “solution” hasn’t worked. The main complaint consumers have about the Internet is not and has never been that their Internet service provider is blocking access to content. It’s that they don’t have access at all or enough competition. These regulations have taken us in the opposite direction from these consumer preferences. Under Title II, investment in high-speed networks has declined by billions of dollars. Notably, this is the first time that such investment has declined outside of a recession in the Internet era. When there’s less investment, that means fewer next-generation networks are built. That means less competition. That means fewer jobs for Americans building those networks. And that means more Americans are left on the wrong side of the digital divide.

The impact has been particularly serious for smaller Internet service providers. They don’t have the time, money, or lawyers to navigate a thicket of complex rules. I have personally visited some of them, from Spencer Municipal Utilities in Spencer, Iowa to Wave Wireless in Parsons, Kansas. I have personally spoken with many more, from Amplex Internet in Ohio to AirLink Services in Oklahoma. So it’s no surprise that the Wireless Internet Service Providers Association, which represents small fixed wireless companies that typically operate in rural America, surveyed its members and found that over 80% “incurred additional expense in complying with the Title II rules, had delayed or reduced network expansion, had delayed or reduced services and had allocated budget to comply with the rules.” Other
small companies, too, have told the FCC that these regulations have forced them to cancel, delay, or curtail fiber network upgrades. And nearly two dozen small providers submitted a letter saying the FCC’s heavy-handed rules “affect our ability to find financing.” Remember, these are the kinds of companies that are critical to providing a more competitive marketplace.

These rules have also impeded innovation. One major company, for instance, reported that it put on hold a project to build out its out-of-home Wi-Fi network due to uncertainty about the FCC’s regulatory stance. And a coalition of 19 municipal Internet service providers—that is, city-owned nonprofits—have told the FCC that they “often delay or hold off from rolling out a new feature or service because [they] cannot afford to deal with a potential complaint and enforcement action.”

None of this is good for consumers. We need to empower all Americans with digital opportunity, not deny them the benefits of greater access and competition.

And consider too that these are just the effects these rules have had on the Internet of today. Think about how they’ll affect the Internet we need ten, twenty years from now. The digital world bears no resemblance to a water pipe or electric line or sewer. Use of those pipes will be roughly constant over time, and very few would say that there’s dramatic innovation in these areas. By contrast, online traffic is exploding, and we consume exponentially more data over time. With the dawn of the Internet of Things, with the development of high bit-rate applications like virtual reality, with new activities like high-volume bitcoin mining that we can’t yet fully grasp, we are imposing ever more demands on the network. Over time, that means our networks themselves will need to scale, too.

But they don’t have to. If our rules deter the massive infrastructure investment that we need, eventually we’ll pay the price in terms of less innovation. Consider these words from Ben Thompson, a highly-respected technology analyst, from a post on his blog Stratechery supporting my proposal:

The question that must be grappled with . . . is whether or not the Internet is ‘done.’ By that I mean that today’s bandwidth is all we [will] need, which means we can risk chilling investment through prophylactic regulation and the elimination of price signals that may spur infrastructure build-out . . .

If we are “done”, then the potential harm of a Title II reclassification is much lower; sure, ISPs will have to do more paperwork, but honestly, they’re just a bunch of mean monopolists anyways, right? Best to get laws in place to preserve what we have.

But what if we aren’t done? What if virtual reality with dual 8k displays actually becomes something meaningful? What if those imagined remote medicine applications are actually developed? What if the Internet of Things moves beyond this messy experimentation phase and into real-time value generation, not just in the home but in all kinds of unimagined commercial applications? I certainly hope we will have the bandwidth to support all of that!

I do too. And as Thompson put it in another Stratechery post: “The fact of the matter is there is no evidence that harm exists in the sort of systematic way that justifies heavily regulating ISPs; the evidence that does exist suggests that current regulatory structures handle bad actors perfectly well. The only future to fear is the one we never discover because we gave up on the approach that has already brought us so far.”

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Remember: networks don’t have to be built. Risks don’t have to be taken. Capital doesn’t have to be raised. The costs of Title II today may appear, at least to some, to be hidden. But the consumers and innovators of tomorrow will pay a severe price.

* * *

So what is the FCC doing today? Quite simply, we are restoring the light-touch framework that has governed the Internet for most of its existence. We’re moving from Title II to Title I. Wonkier it cannot be.

It’s difficult to match that mundane reality to the apocalyptic rhetoric that we’ve heard from Title II supporters. And as the debate has gone on, their claims have gotten more and more outlandish. So let’s be clear. Returning to the legal framework that governed the Internet from President Clinton’s pronouncement in 1996 until 2015 is not going to destroy the Internet. It is not going to end the Internet as we know it. It is not going to kill democracy. It is not going to stifle free expression online. If stating these propositions alone doesn’t demonstrate their absurdity, our Internet experience before 2015, and our experience tomorrow, once this order passes, will prove them so.

Simply put, by returning to the light-touch Title I framework, we are helping consumers and promoting competition. Broadband providers will have stronger incentives to build networks, especially in unserved areas, and to upgrade networks to gigabit speeds and 5G. This means there will be more competition among broadband providers. It also means more ways that startups and tech giants alike can deliver applications and content to more users. In short, it’s a freer and more open Internet.

We also promote much more robust transparency among ISPs than existed three years ago. We require ISPs to disclose a variety of business practices, and the failure to do so subjects them to enforcement action. This transparency rule will ensure that consumers know what they’re buying and startups get information they need as they develop new products and services.

Moreover, we empower the Federal Trade Commission to ensure that consumers and competition are protected. Two years ago, the Title II Order stripped the FTC of its jurisdiction over broadband providers. But today, we are putting our nation’s premier consumer protection cop back on the beat. The FTC will once again have the authority to take action against Internet service providers that engage in anticompetitive, unfair, or deceptive acts. As FTC Chairman Maureen Ohlhausen recently said, “The FTC’s ability to protect consumers and promote competition in the broadband industry isn’t something new and far-fetched. We have a long-established role in preserving the values that consumers care about online.” Or as President Obama’s first FTC Chairman put it just yesterday, “the plan to restore FTC jurisdiction is good for consumers. . . . [T]he sky isn’t falling. Consumers will remain protected, and the Internet will continue to thrive.”

So let’s be absolutely clear. Following today’s vote, Americans will still be able to access the websites they want to visit. They will still be able to enjoy the services they want to enjoy. There will still be cops on the beat guarding a free and open Internet. This is the way things were prior to 2015, and this is the way they will be once again.

Our decision today will also return regulatory parity to the Internet economy. Some giant Silicon Valley platforms favor imposing heavy-handed regulations on other parts of the Internet ecosystem. But all too often, they don’t practice what they preach. Edge providers regularly block content that they don’t like. They regularly decide what news, search results, and products you see—and perhaps more importantly, what you don’t. And many thrive on the business model of charging to place content in front of eyeballs. What else is “Accelerated Mobile Pages” or promoted tweets but prioritization?

What is worse, there is no transparency into how decisions that appear inconsistent with an open Internet are made. How does a company decide to restrict a Senate candidate’s campaign announcement video because her views on a public policy issue are too “inflammatory”? How does a company decide to
demonetize videos from political advocates without notice? How does a company expressly block access to websites on rival devices or prevent dissidents’ content from appearing on its platform? How does a company decide to block from its app store a cigar aficionado app, apparently because the company perceives that the app promotes tobacco use? You don’t have any insight into any of these decisions, and neither do I. Yet these are very real, actual threats to an open Internet—coming from the very entities that claim to support it.

Look—perhaps certain companies support saddling broadband providers with heavy-handed regulations because those rules work to their economic advantage. I don’t blame them for taking that position. And I’m not saying that these same rules should be slapped on them too. What I am saying is that the government shouldn’t be in the business of picking winners and losers in the Internet economy. We should have a level playing field and let consumers decide who prevails.

* * *

Many words have been spoken during this debate but the time has come for action. It is time for the Internet once again to be driven by engineers and entrepreneurs and consumers, rather than lawyers and accountants and bureaucrats. It is time for us to act to bring faster, better, and cheaper Internet access to all Americans. It is time for us to return to the bipartisan regulatory framework under which the Internet flourished prior to 2015. It is time for us to restore Internet freedom.

I want to extend my deepest gratitude to the staff who have worked so many long hours on this item. From the Wireline Competition Bureau: Annick Banoun, Joseph Calascione, Megan Capasso, Paula Cech, Ben Childers, Nathan Eagan, Madeleine Findley, Doug Galbi, Dan Kahn, Melissa Kirkel, Gail Krutov, Susan Lee, Ken Lynch, Pam Megna, Kris Monteith, Ramesh Nagarajan, Eric Ralph, Deborah Salons, Shane Taylor. From the Office of General Counsel: Ashley Boizelle, Jim Carr, Kristine Fargotstein, Tom Johnson, Doug Klein, Marcus Maher, Scott Noveck, Linda Oliver, and Bill Richardson. From the Wireless Telecommunications Bureau: Stacy Ferraro, Nese Guendelsberger, Garnet Hanly, Betsy McIntyre, Jennifer Salhus, Paroma Sanyal, Jamiing “Jimmy” Shang, Don Stockdale, and Peter Trachtenberg. From the Office of Strategic Planning and Policy Analysis: Eric Burger, Mark Bykowsky, and Jerry Ellig. From the Consumer and Governmental Affairs Bureau: Jerusha Burnett. From the Public Safety and Homeland Security Bureau: Ken Carlberg. And from the Media Bureau: Tracy Waldon.
Antitrust: Commission opens investigation into possible anti-competitive conduct of Amazon

Brussels, 17 July 2019

The European Commission has opened a formal antitrust investigation to assess whether Amazon's use of sensitive data from independent retailers who sell on its marketplace is in breach of EU competition rules.

Commissioner Margrethe Vestager, in charge of competition policy, said: "European consumers are increasingly shopping online. E-commerce has boosted retail competition and brought more choice and better prices. We need to ensure that large online platforms don't eliminate these benefits through anti-competitive behaviour. I have therefore decided to take a very close look at Amazon's business practices and its dual role as marketplace and retailer, to assess its compliance with EU competition rules."

Amazon has a dual role as a platform: (i) it sells products on its website as a retailer; and (ii) it provides a marketplace where independent sellers can sell products directly to consumers.

When providing a marketplace for independent sellers, Amazon continuously collects data about the activity on its platform. Based on the Commission's preliminary fact-finding, Amazon appears to use competitively sensitive information - about marketplace sellers, their products and transactions on the marketplace.

As part of its in-depth investigation the Commission will look into:

- the standard agreements between Amazon and marketplace sellers, which allow Amazon's retail business to analyse and use third party seller data. In particular, the Commission will focus on whether and how the use of accumulated marketplace seller data by Amazon as a retailer affects competition.

- the role of data in the selection of the winners of the “Buy Box” and the impact of Amazon's potential use of competitively sensitive marketplace seller information on that selection. The "Buy Box" is displayed prominently on Amazon and allows customers to add items from a specific retailer directly into their shopping carts. Winning the "Buy Box" seems key for marketplace sellers as a vast majority of transactions are done through it.

If proven, the practices under investigation may breach EU competition rules on anticompetitive agreements between companies (Article 101 of the Treaty on the Functioning of the European Union (TFEU)) and/or on the abuse of a dominant position (Articles 102 TFEU).

The Commission will now carry out its in-depth investigation as a matter of priority. The opening of a formal investigation does not preclude its outcome.

Background

Article 101 of the TFEU prohibits anticompetitive agreements and decisions of associations of undertakings that prevent, restrict or distort competition within the EU's Single Market. Article 102 of the TFEU prohibits the abuse of a dominant position. The implementation of these provisions is defined in the Antitrust Regulation (Council Regulation No 1/2003), which can also be applied by the national competition authorities.

Article 11(6) of the Antitrust Regulation provides that the opening of proceedings by the Commission relieves the competition authorities of the Member States of their competence to apply EU competition rules to the practices concerned. Article 16(1) further provides that national courts must avoid adopting decisions that would conflict with a decision contemplated by the Commission in proceedings it has initiated.

The Commission has informed Amazon and the competition authorities of the Member States that it has opened proceedings in this case.

There is no legal deadline for bringing an antitrust investigation to an end. The duration of an antitrust investigation depends on a number of factors, including the complexity of the case, the extent to which
the undertakings concerned cooperate with the Commission and the exercise of the rights of defence. More information on the investigation will be available on the Commission's competition website, in the public case register under case number AT.40462.

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Case Summary

Facebook, Exploitative business terms pursuant to Section 19(1) GWB for inadequate data processing

Sector: Social networks
Ref: B6-22/16
Date of Decision: 6 February 2019

In its decision of 6 February 2019 the Bundeskartellamt prohibited Facebook Inc., Menlo Park, USA, Facebook Ireland Ltd., Dublin, Ireland, and Facebook Germany GmbH, Hamburg, Germany (hereinafter: “Facebook”) from making the use of the Facebook social network (hereinafter: “Facebook.com”) by private users residing in Germany, who also use its corporate services WhatsApp, Oculus, Masquerade and Instagram, conditional on the collection of user and device-related data by Facebook and combining that information with the Facebook.com user accounts without the users’ consent. The prohibition is based on Section 19(1) of the German Competition Act (GWB). The same applies to terms making the private use of Facebook.com conditional on Facebook being able to combine information saved on the “Facebook account” without the users’ consent with information collected on websites visited or third-party mobile apps used via programming interfaces (“Facebook Business Tools”) and use this data. There is no effective consent to the users’ information being collected if their consent is a prerequisite for using the Facebook.com service in the first place.

The proceeding was initiated in March 2016 and aimed at user and device-related data which Facebook collects when other corporate services or third-party websites and apps are used and which it then combined with user data from the social network. The proceeding did not deal with the issue of information processed on the use of the social network that is generated after users have registered. The Bundeskartellamt saw no reason to intervene on the grounds of the prohibition of abusive practices under competition law. It is taken into account that an advertising-funded social network generally needs to process a large amount of personal data. However, the Bundeskartellamt holds that the efficiencies in a business model based on personalised advertising do not outweigh the interests of the users when it comes to processing data from sources outside of the social network. This applies in particular where users have insufficient control over the processing of their data and its allocation to their Facebook accounts. As far as this part of data processing is concerned, it was necessary to intervene from a competition law

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perspective because the data protection boundaries set forth in the GDPR were clearly overstepped, also in view of Facebook’s dominant position.

1. Statement of facts

Facebook develops and operates various digital products, online services and applications for smartphones (apps). Facebook's core product is the social network Facebook.com, which has been offered in Germany since 2008. Its user base has been increasing continuously worldwide. In 2018 the number of daily active users in Germany was 23 million, while 32 million users were classified as monthly active users.

Private users can access Facebook.com via the websites www.facebook.com, www.facebook.de or via a mobile app. Facebook offers private users a range of functions to connect with their friends and acquaintances and share contents with them. Private Facebook.com use is conditional upon registration by creating a user profile. Using their real names, users can enter information on themselves and their personal situation and set a profile picture. Based on this information, a personalised site is created for each user, which is subdivided into three subsites: the “profile”, “home” and the “find friends” pages. Users can see the latest news (“posts”) of other private and commercial users in the “Newsfeed” on their start pages. The order of appearance is based on an algorithm to match the user's interests. Facebook Messenger is integrated into the social network and serves for real-time bilateral or group communication. In the social network, Facebook.com offers a variety of further functionalities, e.g. a job board, an app center or event organisation.

Not only private users but also businesses, associations or business individuals can use Facebook.com to publish content in the social network to increase their reach. Publishers can create their own pages to publish content and connect with private users, e.g. via subscriptions or likes. Facebook funds its social network through online advertising offered to publishers and other businesses. The ads match a social network user's individual profile. The aim is to present users with ads that are potentially interesting to them based on their personal commercial behaviour, their interests, purchasing power and living conditions (“targeting” or “targeted advertising”).

In addition, the Facebook group offers “Facebook Business Tools”, a selection of free tools and products for website operators, developers, advertisers and other businesses to integrate into their own websites, apps and online offers via programming interfaces (Application Programming Interfaces, API) pre-defined by Facebook. The selection includes social plugins (“Like” or “Share”
buttons), Facebook login and other analytics services (Facebook Analytics) implemented through “Facebook Pixel” or mobile “software development kits” (SDKs).

Besides Facebook.com, Facebook also offers Instagram, a service for sharing photos and short video clips which is often referred to as a “photo network” or “photo blogging” service. The service has been growing considerably over the last few years and is also funded through advertising. Private users have to register via the mobile app. To register, they have to enter an email address, a user name and, as an optional piece of information, a phone number. They can also upload a profile picture. They can use the Instagram camera to take pictures or record videos and edit them using filters, texts, drawings or special effects before sharing them with other users.

WhatsApp Inc. is also part of the Facebook group. In Europe it offers the mobile app WhatsApp via its Irish subsidiary WhatsApp Ltd. WhatsApp is a free service which was originally developed as a free internet-based alternative to short message services (SMS). Using the service, users can send and receive a multitude of media like text messages, photos, videos, documents, locations, voice messages and voice calls. While WhatsApp has not been monetised through advertising so far, the company announced that it was going to launch advertising in the “status” function in 2019.

Masquerade is another product used for editing and sharing pictures with filters and masks. Facebook also offers virtual reality headsets and software via its Oculus business.

Using the social network Facebook.com is conditional on the user’s agreement to Facebook’s terms of service upon registration, i.e. they have to agree to the terms of service to conclude the contract. The terms of service stipulate that Facebook processes personal data as specified in particular in the data and cookie policies. Pursuant to these policies, Facebook also collects data on users and their devices outside of Facebook-related activities via Facebook Business Tools integrated by advertisers, app developers and publishers. Facebook also processes user data across other Facebook companies and products and collects user and device-related data from its corporate services. As a legal basis for data processing, Facebook claims that the data are required to provide the service and to fulfil Facebook’s legitimate interests.

2. Legal assessment

1. Market definition

Based on the concept of demand-side substitutability, the Bundeskartellamt defines the product market as a private social network market with private users as the relevant opposite market side. The relevant geographic market is Germany.
In defining the market and considering the new provisions of Section 18(2a) and (3a) of the German Competition Act (GWB), the Bundeskartellamt first of all examined Facebook’s business model and its special characteristics as a multi-sided network market with free services. With its service Facebook.com Facebook offers an intermediary product, which, according to the content of its services, is a combination of a network and a multi-sided market pursuant to Section 18(3a) GWB. Essentially the product is a network financed through targeted advertising, which forms a multi-sided market precisely because of this form of financing. Key user groups are private users using Facebook.com without monetary compensation on the one hand, and advertisers running targeted advertisements on the other. Indirect network effects exist between the two user groups. Facebook added further market sides to its core product. One of these market sides is publishers using Facebook.com to promote their businesses with their own Facebook pages on which they publish editorial content and connect with users. Developers represent another side of the market. They can integrate Facebook into their own websites or apps by using “Application Programming Interfaces” (APIs) to integrate Facebook Products like social plugins (e.g. “Like” button), Facebook Login or the Facebook Analytics analysis service. Indirect network effects also exist between private users and the latter two sides:

As none of the above groups of Facebook users have demands similar to the group of private users, they have to be attributed to other markets. The network has to be considered a market service pursuant to Section 18(2a) GWB despite the fact that its use is not subject to fees for private users.
The product market definition also requires an analysis of the various online services commonly referred to as “social media” and their competitive relationships. Key criteria for defining the market are the high degree of product differentiation of social media and the various overlaps of their functionalities. When defining the market, strong direct network effects are also important. The Bundeskartellamt’s investigations, which included an examination of a large number of social media as well as a survey among users and competitors, and decisions by the European Commission in the Facebook/WhatsApp and Microsoft/LinkedIn cases have shown that a national market exists for social networks which essentially meet specific requirements that differ from other social media. With Google+ having disappeared from the market, this market now includes, besides Facebook, some smaller German providers of social networks. Networks like LinkedIn and Xing are designed to meet professional requirements and thus constitute a separate product market. Like the Commission in the Facebook/WhatsApp case, the Bundeskartellamt considers messaging services like WhatsApp as a separate market due to their technical characteristics and applications. The investigations have shown that although YouTube’s business model has some overlaps with those of social networks, the service is not sufficiently comparable to a social network. Snapchat, whose central function is a camera that opens automatically for taking “snaps” that are deleted after a short while, is not part of the product market either. The same applies to Twitter, Pinterest and Instagram. The latter is part of the Facebook group. When defining the market the Bundeskartellamt also looks at the extent to which internet companies shaped by network effects can show flexibility in adapting the products they offer. At least as far as the services affected in this case are concerned, it is not sufficient to have a “critical mass” of users or technical, financial and personal expertise in order to be able to enter neighbouring markets and be as successful as on the original market. As the example of Google+ has shown, a service cannot expect to have the same reach when providing a different type of service, due to strong direct network effects.

The geographic market was defined as Germany-wide as a result of the investigations, based on the fact that the service was found to be used predominantly to connect with people in the users’ own country, special national user habits and the lack of opportunities for supply-side substitution.

2. Market dominance

Facebook is the dominant company in the national market for social networks for private users pursuant to Section 18(1) in conjunction with (3) and (3a) GWB as, based on an overall assessment of all factors of market power, the company has a scope of action in this market that is not sufficiently controlled by competition.
First the Bundeskartellamt examined the user-based market share of Facebook on the relevant market. Facebook's user-based market share is very high, especially among daily active users, where Facebook has a market share exceeding 95%. Facebook's market share among monthly active users is above 80% and above 50% among registered users. The Bundeskartellamt considers the number of daily active users as the key indicator and relevant measurand for assessing the network's competitive significance and market success as a social network's success is measured by the intensity of use. Users use social networks as a virtual social space. When assessing the market share, the amount of time spent intensively using the network is an important indicator of the competitors' actual market position. The services of the Facebook group would have a combined market share far beyond the market dominance threshold pursuant to Section 18(4) GWB, even if YouTube, Snapchat, Twitter, WhatsApp, and Instagram were included in the relevant market.

A key element of the market dominance test are the strong direct network effects of Facebook’s business model and the difficulties associated with switching to another social network. Facebook users connect with selected people in the social network, and it is difficult to motivate them to switch to another service as well. Competitors in the area of social networks have been experiencing a continuous decrease in user-based market shares in recent years; some of them have already left the market. Examples include StudiVZ and SchülerVZ, services which were temporarily operated by the Holtzbrinck publishing group and which were market leaders before Facebook entered the German market. Their operating company went into insolvency in 2017. The Lokalisten network, which was operated by ProSiebenSat.1, was discontinued in the autumn of 2016. Google+, the social network operated by the Google group, announced in the spring of 2018 that it would discontinue its service for private users and offer a payable service for internal business communications. In contrast to its competitors, Facebook’s user figures keep rising or at least stagnate at a high level. The facts that competitors can be seen to exit the market and that there is a downward trend in the user-based market shares of the remaining competitors strongly indicate a market tipping process which will result in Facebook.com becoming a monopolist. This assessment is supported by the fact that the strong identity-based network effects lead to a lock-in effect which makes it difficult for users or prevents them from switching to another social network. Existing functionalities and interfaces do not alleviate the consequences of Facebook’s incompatibility with other social networks.

Another important aspect of the examination are the indirect network effects encountered with Facebook as an advertising-funded service, which increase the barriers to market entry. Other advertising-financed platforms will find it difficult to enter the market and be successful in the long-
term as all competitors would have to enter both the user market for social networks and the online advertising market.

Facebook also has excellent access to competitively relevant data. Facebook’s comprehensive data sources are highly relevant for competition as a social network is driven by such personal data. In addition, these specific data facilitate highly personalised advertising. Combined with the direct and indirect network effects, this access to data constitutes another barrier to market entry for a competitor’s product that can be monetised.

In its overall assessment, the Bundeskartellamt took a close look at the internet’s innovative power and its significance for assessing market power. The internet’s innovative power cannot be taken as a general argument against an internet company’s market power. Instead, specific indications of a dynamic or disruptive process are required in each individual case. This applies in particular to the control of abuse of dominant positions which focuses on the current market situation. Against this background the Bundeskartellamt examined the recent innovations which Facebook referred to. The authority’s opinion is that these developments do not go beyond responses to competition from substitutes in the case of some individual functionalities. In particular in the context of pronounced direct network effects, its responses have rather shown that Facebook has been capable of successfully fighting off competitors’ innovations. As a result, there is no trend towards users withdrawing from Facebook or Facebook losing market shares to a relevant extent despite the internet’s high innovative power.

3. Abusive data policy

Using and actually implementing Facebook’s data policy, which allows Facebook to collect user and device-related data from sources outside of Facebook and to merge it with data collected on Facebook, constitutes an abuse of a dominant position on the social network market in the form of exploitative business terms pursuant to the general clause of Section 19(1) GWB. Taking into account the assessments under data protection law pursuant to the General Data Protection Regulation (GDPR), these are inappropriate terms to the detriment of both private users and competitors.

a) Data protection and competition law

The Bundeskartellamt holds that, being a manifestation of market power, the terms violate the stipulations of the GDPR and are abusive within the meaning of Section 19(1) GWB.

The authority bases its assessment on the case-law of the German Federal Court of Justice, which established an abuse of business terms in the VBL-Gegenwert and Pechstein cases based
on the general clause of Section 19(1) GWB. In its decisions taken in the VBL-\textit{Gegenwert} cases the Federal Court of Justice considers the agreement of contract terms abusive if terms and conditions violating Sections 307ff. of the German Civil Code are applied, in particular if the fact that such terms and conditions are applied is a manifestation of market power or superior power of the party using these terms. The Federal Court of Justice held that it was necessary to balance all interests including constitutional rights in the \textit{Pechstein} case. Accordingly, to protect constitutional rights, Section 19 GWB must be applied in cases where one contractual party is so powerful that it is practically able to dictate the terms of the contract and the contractual autonomy of the other party is abolished. If, the Court held, in such a case a dominant company handles constitutional rights of its contractual partners, the law had to intervene to uphold the protection of such rights. Relevant legal provisions in this regard were, according to the Court, the general clauses under civil law, one of which is Section 19 GWB. The Court held that these clauses should be applied with a view to balancing the conflicting positions of the contractual parties in such a way that the constitutional rights of all parties were, as far as possible, maintained.

The Bundeskartellamt holds that as far as the appropriateness of conditions agreed in an unbalanced negotiation is concerned, these decisions of the highest court apply to all other areas of the law as well. The same applies to data protection law, the purpose of which is to counter asymmetries of power between organisations and individuals and ensure an appropriate balancing of interests between data controllers and data subjects. In order to protect the fundamental right to informational self-determination, data protection law provides the individual with the right to decide freely and without coercion on the processing of his or her personal data.

The Bundeskartellamt closely examined the relation between the competition law provisions under Section 19(1) GWB and the harmonised European data protection principles of the GDPR which are mainly enforced by data protection authorities. The authority holds that it appears to be indispensable to examine the conduct of dominant companies under competition law also in terms of their data processing procedures, as especially the conduct of online businesses is highly relevant from a competition law perspective. It is the authority’s view that the European data protection regulations, which are based on constitutional rights, can or, considering the case-law of the highest German court specified above, must be considered when assessing whether data processing terms are appropriate under competition law.

The responsibility and consistency regulations in the GDPR do not rule out that the Bundeskartellamt can assess whether data processing terms infringe the GDPR. The GDPR has been in force in the Member States since May 2018. It governs the responsibility of data protection authorities and is set out to ensure a uniform level of protection and application by the national
data protection authorities. For this purpose a data protection board has been set up by the Member States to decide on data protection matters in the event of disputes. The board can also instruct the national authorities accordingly. These regulations, however, do not rule out that substantive data protection law can also be applied by authorities other than the national data protection authorities. The GDPR explicitly states that data protection law can also be enforced under civil law, i.e. full consistency is not aspired to. This applies in particular to consumer protection organisations and competitors and their associations. These entities can enforce data protection based on stipulations of the Act Against Unfair Competition (UWG) or regulations on business terms linked to data protection and also based on Section 19 GWB. A large part of the ECJ’s case law which data protection authorities and the data protection board have to consider has been obtained from civil law proceedings. Civil law proceedings promote rather than threaten the consistent implementation of data protection law, especially as the ECJ can be involved at an early stage as part of the preliminary ruling procedure. It is not evident that the consistency mechanism would rule out that the competition authority considers and interprets data protection law under Section 19 GWB and, at the same time, would allow a civil law enforcement of Section 19 GWB with regard to data protection law.

Also, data protection regulations do not suspend abuse control which is more specific. These regulations do not include final provisions regarding dominant companies, i.e. they only allow data processing by dominant companies to be examined by data protection authorities based on the direct data protection regulations, or the existing enforcement options under civil law (UWG or legislation on business terms). However, they do not include the prohibition of abusive practices which applies in particular to dominant companies. The GDPR does not explicitly state that its provisions are final, so it cannot be assumed that it leaves no further scope for examination by other authorities and under other aspects.

In the course of the proceeding the Bundeskartellamt maintained regular contact with data protection authorities none of which considered they had exclusive competence. The Conference of independent data protection authorities of the German Federal Government and the Länder (Konferenz der unabhängigen Datenschutzbehörden des Bundes und der Länder) expressly stated that the enforcement of data protection law must not be the sole response to violations of data protection requirements. Competition and antitrust law can, according to the conference, also be enforced. Even divestiture is mentioned as an option to punish the systematic circumvention of data protection. The Data Protection Officer for the city state of Hamburg explicitly supports the Bundeskartellamt’s proceeding. The Bundeskartellamt also briefed the Irish data protection authority IDPC about the proceedings.
b) Consideration of data protection aspects

In a first step, the Bundeskartellamt examined whether the data policy is appropriate based on the data protection assessments of the GDPR. It came to the conclusion that Facebook’s comprehensive processing of personal data from other corporate services and Facebook Business Tools, which enable, among other things, profiling and “device fingerprinting”, violates European data protection requirements pursuant to the GDPR and is subject to the affected users’ consent pursuant to data protection requirements. Facebook, which is responsible for the processing of these data, presented or substantiated hardly any justifications in the course of the proceeding. The determined facts of the case do not indicate a sufficient legal justification for the extent of data collected and merged.

There is no effective consent pursuant to Art. 6(1a) of the GDPR. The reasons for this include the fact that, in view of Facebook’s dominant position in the market, users consent to Facebook’s terms and conditions for the sole purpose of concluding the contract, which cannot be assessed as their free consent within the meaning of the GDPR.

Facebook does not have to process data to fulfil its contract pursuant to Art. 6(1b) GDPR. This reason for justification has to be narrowly interpreted, i.e. it has to be considered whether the unilateral determination of the contract details has to be taken into account. Particularly, it cannot be substantiated that the service has to process data to the extent that has been determined in the course of the examination for reasons of efficiency and advantages of a personalised service. If this view is taken, the company would be entitled to unlimited data processing solely on the grounds of its business model and product properties as well as the company’s concept of product quality. Any kind of data processing would then have to be deemed necessary for fulfilling the contract as all data carry some information on the individual user. Processing data from third-party sources to the extent determined by Facebook in its terms and conditions is neither required for offering the social network as such nor for monetising the network through personalised advertising, as a personalised network could also be based to a large extent on the user data processed in the context of operating the social network. The latter is not a subject of the proceeding at hand. None of the stipulations of Art. 6(1c-e) GDPR apply to justify data processing for special purposes.

Even a comprehensive assessment of interests did ultimately not lead to the conclusion that Facebook’s interest in processing data according to the terms and conditions it set outweighs other interests (Art. 6(1f) GDPR). This assessment is based on an evaluation of the legitimate interests Facebook brought forward, third-party interests and user interests. Criteria considered were the consequences for the affected users, taking into account the data type and the way in
which it is processed, reasonable expectations of users and the respective positions of Facebook and its users. What also had to be considered pursuant to the guidelines of the data protection board was that Facebook as a dominant company has bargaining power over its users and is in a position to impose far-reaching data processing conditions, which users cannot prevent as they have no additional control mechanisms. Data processing to the extent at hand cannot be justified without the users’ voluntary consent. Voluntary consent to their information being processed cannot be assumed if their consent is a prerequisite for using the Facebook.com service in the first place.

c) Manifestation of market power

The violation of data protection requirements found is a manifestation of Facebook’s market power. According to the case-law it is not necessary to determine that the conduct, i.e. the violation, was only possible in the first place because of market dominance and that other market participants did not have a chance to behave in a similar way. Instead, it is sufficient to determine that the two aspects are linked by a causality which is either based on normative aspects or the outcome. Both aspects can be assumed to be fulfilled in this case.

Normative causality with regard to the violation of data protection rules exists as the restriction of the private users’ right to self-determination is clearly linked to Facebook's dominant position. Data protection law considers corporate circumstances like market dominance, the concrete purpose and the amount of data processed in its justifications, i.e. Facebook’s market position is significant when assessing the violation.

In addition to that there is a causality in terms of the outcome as Facebook’s conduct linked to its market dominance, which was the subject of the proceedings at hand, impedes competitors because Facebook gains access to a large number of further sources by its inappropriate processing of data and their combination with Facebook accounts. It has thus gained a competitive edge over its competitors in an unlawful way and increased market entry barriers, which in turn secures Facebook’s market power towards end customers.

Both data protection law and competition law consider the aspect of an unbalanced negotiation position, i.e. a weighing up of interests under competition law which could be required in addition to the examination under data protection law, and reach the same conclusions due to the largely identical considerations including market dominance. In addition, pursuant to the Pechstein case-law, assessments with regard to constitutional rights have to be included in assessments of interests under competition law. Again, these assessments are largely identical with the assessments under data protection law.
As Facebook is a dominant company users cannot protect their data from being processed from a large number of sources, i.e. they cannot decide autonomously on the disclosure of their data. However, it must be ensured that the interests of the opposite market side are sufficiently considered if a provider is a dominant company which is not subject to sufficient competitive control. The terms and conditions under review have a considerable reach as Facebook’s market power extends beyond its social network and consumers’ data are collected whenever they use the internet. While the efficiencies of a data-driven business model for consumers are generally acknowledged, the outlined extent of data processing is to be deemed inappropriate and hence abusive.

4. Decision

Based on the above and in exercising due discretion, the Bundeskartellamt has prohibited the data processing policy Facebook imposes on its users and its corresponding implementation pursuant to Sections 19(1), 32 GWB and ordered the termination of this conduct. The prohibition refers to the terms of processing personal data as expressly stated in the terms of service and detailed in the data and cookie policies as far as they involve the collection of user and device-related data from other corporate services and Facebook Business Tools without the users’ consent and their combination with Facebook data for purposes related to the social network. The Bundeskartellamt also prohibited the implementation of these terms and conditions in actual data processing procedures which Facebook performs based on its data and cookie policies. In the order to terminate the infringement Facebook is ordered to implement the necessary changes and to adapt its data and cookie policies accordingly within a period of twelve months. In addition to that Facebook has been given a deadline of four months to present an implementation road map for the adjustments. The time limits can be suspended by an emergency appeal to the Düsseldorf Higher Regional Court. Facebook has already appealed against this decision to the Düsseldorf Higher Regional Court and requested that the suspensive effect of the appeal be restored.
Session 5: Entity Law and the Duties of Officers and Directors
We will spend a session talking through issues that arise in the choice of legal entities as well as the duties of directors and officers. We will start with a business law class, Smith v. Van Gorkom, which gives one example of how boards exercise their authority. We will then turn to broader questions. Should corporations operate in the sole interest of shareholders or should they have broader obligations? We will look at the Business Roundtable statement on these issues and will pair that with a draft bill from Senator Elizabeth Warren, the Accountable Capitalism Act.

Smith v. Van Gorkom
488 A.2d 858 (Del. 1985)
HORSEY, Justice (for the majority): This appeal from the Court of Chancery involves a class action brought by shareholders of the defendant Trans Union Corporation (“Trans Union” or “the Company”), originally seeking rescission of a cash-out merger of Trans Union into the defendant New T Company (“New T”), a wholly-owned subsidiary of the defendant, Marmon Group, Inc. (“Marmon”). Alternate relief in the form of damages is sought against the defendant members of the Board of Directors of Trans Union, New T, and Jay A. Pritzker and Robert A. Pritzker, owners of Marmon.

Following trial, the former Chancellor granted judgment for the defendant directors by unreported letter opinion dated July 6, 1982. Judgment was based on two findings: (1) that the Board of Directors had acted in an informed manner so as to be entitled to protection of the business judgment rule in approving the cash-out merger; and (2) that the shareholder vote approving the merger should not be set aside because the stockholders had been “fairly informed” by the Board of Directors before voting thereon. The plaintiffs appeal.

Speaking for the majority of the Court, we conclude that both rulings of the Court of Chancery are clearly erroneous. Therefore, we reverse and direct that judgment be entered in favor of the plaintiffs and against the defendant directors for the fair value of the plaintiffs’ stockholdings in Trans Union, in accordance with Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701 (1983).

We hold: (1) that the Board’s decision, reached September 20, 1980, to approve the proposed cash-out merger was not the product of an informed business judgment; (2) that the Board’s subsequent efforts to amend the Merger Agreement and take other curative action were ineffectual, both legally and factually; and (3) that the Board did not deal with complete candor with the stockholders by failing to disclose all material facts, which they knew or should have known, before securing the stockholders’ approval of the merger.

I.
The nature of this case requires a detailed factual statement. The following facts are essentially uncontradicted:

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Trans Union was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. During the period here involved, the
Company had a cash flow of hundreds of millions of dollars annually. However, the Company had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs). ***

On August 27, 1980, Van Gorkom met with Senior Management of Trans Union. Van Gorkom reported on his lobbying efforts in Washington and his desire to find a solution to the tax credit problem more permanent than a continued program of acquisitions. Various alternatives were suggested and discussed preliminarily, including the sale of Trans Union to a company with a large amount of taxable income.

Donald Romans, Chief Financial Officer of Trans Union, stated that his department had done a “very brief bit of work on the possibility of a leveraged buy-out.” This work had been prompted by a media article which Romans had seen regarding a leveraged buy-out by management. The work consisted of a “preliminary study” of the cash which could be generated by the Company if it participated in a leveraged buy-out. As Romans stated, this analysis “was very first and rough cut at seeing whether a cash flow would support what might be considered a high price for this type of transaction.”

On September 5, at another Senior Management meeting which Van Gorkom attended, Romans again brought up the idea of a leveraged buy-out as a “possible strategic alternative” to the Company’s acquisition program. Romans and Bruce S. Chelberg, President and Chief Operating Officer of Trans Union, had been working on the matter in preparation for the meeting. According to Romans: They did not “come up” with a price for the Company. They merely “ran the numbers” at $50 a share and at $60 a share with the “rough form” of their cash figures at the time. Their “figures indicated that $50 would be very easy to do but $60 would be very difficult to do under those figures.” This work did not purport to establish a fair price for either the Company or 100% of the stock. It was intended to determine the cash flow needed to service the debt that would “probably” be incurred in a leveraged buy-out, based on “rough calculations” without “any benefit of experts to identify what the limits were to that, and so forth.” These computations were not considered extensive and no conclusion was reached.

At this meeting, Van Gorkom stated that he would be willing to take $55 per share for his own 75,000 shares. He vetoed the suggestion of a leveraged buy-out by Management, however, as involving a potential conflict of interest for Management. Van Gorkom, a certified public accountant and lawyer, had been an officer of Trans Union for 24 years, its Chief Executive Officer for more than 17 years, and Chairman of its Board for 2 years. It is noteworthy in this connection that he was then approaching 65 years of age and mandatory retirement.

For several days following the September 5 meeting, Van Gorkom pondered the idea of a sale. He had participated in many acquisitions as a manager and director of Trans Union and as a director of other companies. He was familiar with acquisition procedures, valuation methods, and negotiations; and he privately considered the pros and cons of whether Trans Union should seek a privately or publicly-held purchaser.

Van Gorkom decided to meet with Jay A. Pritzker, a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the
sale. Van Gorkom did so without consulting either his Board or any members of Senior Management except one: Carl Peterson, Trans Union’s Controller. Telling Peterson that he wanted no other person on his staff to know what he was doing, but without telling him why, Van Gorkom directed Peterson to calculate the feasibility of a leveraged buy-out at an assumed price per share of $55. Apart from the Company’s historic stock market price,⁵ and Van Gorkom’s long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company.

Having thus chosen the $55 figure, based solely on the availability of a leveraged buy-out, Van Gorkom multiplied the price per share by the number of shares outstanding to reach a total value of the Company of $690 million. Van Gorkom told Peterson to use this $690 million figure and to assume a $200 million equity contribution by the buyer. Based on these assumptions, Van Gorkom directed Peterson to determine whether the debt portion of the purchase price could be paid off in five years or less if financed by Trans Union’s cash flow as projected in the Five Year Forecast, and by the sale of certain weaker divisions identified in a study done for Trans Union by the Boston Consulting Group (“BCG study”). Peterson reported that, of the purchase price, approximately $50-80 million would remain outstanding after five years. Van Gorkom was disappointed, but decided to meet with Pritzker nevertheless.

Van Gorkom arranged a meeting with Pritzker at the latter’s home on Saturday, September 13, 1980. Van Gorkom prefaced his presentation by stating to Pritzker: “Now as far as you are concerned, I can, I think, show how you can pay a substantial premium over the present stock price and pay off most of the loan in the first five years. * * * If you could pay $55 for this Company, here is a way in which I think it can be financed.”

Van Gorkom then reviewed with Pritzker his calculations based upon his proposed price of $55 per share. Although Pritzker mentioned $50 as a more attractive figure, no other price was mentioned. However, Van Gorkom stated that to be sure that $55 was the best price obtainable, Trans Union should be free to accept any better offer. Pritzker demurred, stating that his organization would serve as a “stalking horse” for an “auction contest” only if Trans Union would permit Pritzker to buy 1,750,000 shares of Trans Union stock at market price which Pritzker could then sell to any higher bidder. After further discussion on this point, Pritzker told Van Gorkom that he would give him a more definite reaction soon.

On Monday, September 15, Pritzker advised Van Gorkom that he was interested in the $55 cash-out merger proposal and requested more information on Trans Union. Van Gorkom agreed to meet privately with Pritzker, accompanied by Peterson, Chelberg, and Michael Carpenter, Trans Union’s consultant from the Boston Consulting Group. The meetings took place on September 16 and 17. Van Gorkom was “astounded that events were moving with such amazing rapidity.”

On Thursday, September 18, Van Gorkom met again with Pritzker. At that time, Van Gorkom knew that Pritzker intended to make a cash-out merger offer at Van Gorkom’s

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⁵ The common stock of Trans Union was traded on the New York Stock Exchange. Over the five year period from 1975 through 1979, Trans Union’s stock had traded within a range of a high of $39 1/2 and a low of $24 1/4. Its high and low range for 1980 through September 19 (the last trading day before announcement of the merger) was $38 1/4 - $29 1/2.
proposed $55 per share. Pritzker instructed his attorney, a merger and acquisition specialist, to begin drafting merger documents. There was no further discussion of the $55 price. However, the number of shares of Trans Union’s treasury stock to be offered to Pritzker was negotiated down to one million shares; the price was set at $38—75 cents above the per share price at the close of the market on September 19. At this point, Pritzker insisted that the Trans Union Board act on his merger proposal within the next three days, stating to Van Gorkom: “We have to have a decision by no later than Sunday [evening, September 21] before the opening of the English stock exchange on Monday morning.” Pritzker’s lawyer was then instructed to draft the merger documents, to be reviewed by Van Gorkom’s lawyer, “sometimes with discussion and sometimes not, in the haste to get it finished.”

On Friday, September 19, Van Gorkom, Chelberg, and Pritzker consulted with Trans Union’s lead bank regarding the financing of Pritzker’s purchase of Trans Union. The bank indicated that it could form a syndicate of banks that would finance the transaction. On the same day, Van Gorkom retained James Brennan, Esquire, to advise Trans Union on the legal aspects of the merger. Van Gorkom did not consult with William Browder, a Vice-President and director of Trans Union and former head of its legal department, or with William Moore, then the head of Trans Union’s legal staff.

On Friday, September 19, Van Gorkom called a special meeting of the Trans Union Board for noon the following day. He also called a meeting of the Company’s Senior Management to convene at 11:00 a.m., prior to the meeting of the Board. No one, except Chelberg and Peterson, was told the purpose of the meetings. Van Gorkom did not invite Trans Union’s investment banker, Salomon Brothers or its Chicago-based partner, to attend.

Of those present at the Senior Management meeting on September 20, only Chelberg and Peterson had prior knowledge of Pritzker’s offer. Van Gorkom disclosed the offer and described its terms, but he furnished no copies of the proposed Merger Agreement. Romans announced that his department had done a second study which showed that, for a leveraged buy-out, the price range for Trans Union stock was between $55 and $65 per share. Van Gorkom neither saw the study nor asked Romans to make it available for the Board meeting.

Senior Management’s reaction to the Pritzker proposal was completely negative. No member of Management, except Chelberg and Peterson, supported the proposal. Romans objected to the price as being too low; he was critical of the timing and suggested that consideration should be given to the adverse tax consequences of an all-cash deal for low-basis shareholders; and he took the position that the agreement to sell Pritzker one million newly-issued shares at market price would inhibit other offers, as would the prohibitions against soliciting bids and furnishing inside information to other bidders. Romans argued that the Pritzker proposal was a “lock up” and amounted to “an agreed merger as opposed to an offer.” Nevertheless, Van Gorkom proceeded to the Board meeting as scheduled without further delay.

Ten directors served on the Trans Union Board, five inside (defendants Bonser, O’Boyle, Browder, Chelberg, and Van Gorkom) and five outside (defendants Wallis, Johnson, Lanterman, Morgan and Reneker). All directors were present at the meeting, except O’Boyle who was ill. Of the outside directors, four were corporate chief executive officers and one
was the former Dean of the University of Chicago Business School. None was an investment banker or trained financial analyst. All members of the Board were well informed about the Company and its operations as a going concern. They were familiar with the current financial condition of the Company, as well as operating and earnings projections reported in the recent Five Year Forecast. The Board generally received regular and detailed reports and was kept abreast of the accumulated investment tax credit and accelerated depreciation problem.

Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting. He reviewed the Company’s ITC and depreciation problems and the efforts theretofore made to solve them. He discussed his initial meeting with Pritzker and his motivation in arranging that meeting. Van Gorkom did not disclose to the Board, however, the methodology by which he alone had arrived at the $55 figure, or the fact that he first proposed the $55 price in his negotiations with Pritzker.

Van Gorkom outlined the terms of the Pritzker offer as follows: Pritzker would pay $55 in cash for all outstanding shares of Trans Union stock upon completion of which Trans Union would be merged into New T Company, a subsidiary wholly-owned by Pritzker and formed to implement the merger; for a period of 90 days, Trans Union could receive, but could not actively solicit, competing offers; the offer had to be acted on by the next evening, Sunday, September 21; Trans Union could only furnish to competing bidders published information, and not proprietary information; the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one million newly-issued shares of Trans Union at $38 per share.

Van Gorkom took the position that putting Trans Union “up for auction” through a 90-day market test would validate a decision by the Board that $55 was a fair price. He told the Board that the “free market will have an opportunity to judge whether $55 is a fair price.” Van Gorkom framed the decision before the Board not as whether $55 per share was the highest price that could be obtained, but as whether the $55 price was a fair price that the stockholders should be given the opportunity to accept or reject.

Attorney Brennan advised the members of the Board that they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law.

Romans attended the meeting as chief financial officer of the Company. He told the Board that he had not been involved in the negotiations with Pritzker and knew nothing about the merger proposal until the morning of the meeting; that his studies did not indicate either a fair price for the stock or a valuation of the Company; that he did not see his role as directly addressing the fairness issue; and that he and his people “were trying to search for ways to justify a price in connection with such a [leveraged buy-out] transaction, rather than to say what the shares are worth.” Romans testified:

I told the Board that the study ran the numbers at 50 and 60, and then the subsequent study at 55 and 65, and that was not the same thing as saying that I have a valuation of the company at X dollars. But it was a way—a first step towards reaching that conclusion.

Romans told the Board that, in his opinion, $55 was “in the range of a fair price,” but “at the beginning of the range.”
Chelberg, Trans Union’s President, supported Van Gorkom’s presentation and representations. He testified that he “participated to make sure that the Board members collectively were clear on the details of the agreement or offer from Pritzker;” that he “participated in the discussion with Mr. Brennan, inquiring of him about the necessity for valuation opinions in spite of the way in which this particular offer was couched;” and that he was otherwise actively involved in supporting the positions being taken by Van Gorkom before the Board about “the necessity to act immediately on this offer,” and about “the adequacy of the $55 and the question of how that would be tested.”

The Board meeting of September 20 lasted about two hours. Based solely upon Van Gorkom’s oral presentation, Chelberg’s supporting representations, Romans’ oral statement, Brennan’s legal advice, and their knowledge of the market history of the Company’s stock, the directors approved the proposed Merger Agreement. However, the Board later claimed to have attached two conditions to its acceptance: (1) that Trans Union reserved the right to accept any better offer that was made during the market test period; and (2) that Trans Union could share its proprietary information with any other potential bidders. While the Board now claims to have reserved the right to accept any better offer received after the announcement of the Pritzker agreement (even though the minutes of the meeting do not reflect this), it is undisputed that the Board did not reserve the right to actively solicit alternate offers.

The Merger Agreement was executed by Van Gorkom during the evening of September 20 at a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery to Pritzker.

** On Monday, September 22, the Company issued a press release announcing that Trans Union had entered into a “definitive” Merger Agreement with an affiliate of the Marmon Group, Inc., a Pritzker holding company. Within 10 days of the public announcement, dissent among Senior Management over the merger had become widespread. Faced with threatened resignations of key officers, Van Gorkom met with Pritzker who agreed to several modifications of the Agreement. Pritzker was willing to do so provided that Van Gorkom could persuade the dissidents to remain on the Company payroll for at least six months after consummation of the merger.

Van Gorkom reconvened the Board on October 8 and secured the directors’ approval of the proposed amendments—sight unseen. The Board also authorized the employment of Salomon Brothers, its investment banker, to solicit other offers for Trans Union during the proposed “market test” period.

The next day, October 9, Trans Union issued a press release announcing: (1) that Pritzker had obtained “the financing commitments necessary to consummate” the merger with Trans Union; (2) that Pritzker had acquired one million shares of Trans Union common

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9 The Trial Court stated the premium relationship of the $55 price to the market history of the Company’s stock as follows: *** the merger price offered to the stockholders of Trans Union represented a premium of 62% over the average of the high and low prices at which Trans Union stock had traded in 1980, a premium of 48% over the last closing price, and a premium of 39% over the highest price at which the stock of Trans Union had traded any time during the prior six years.
stock at $38 per share; (3) that Trans Union was now permitted to actively seek other offers and had retained Salomon Brothers for that purpose; and (4) that if a more favorable offer were not received before February 1, 1981, Trans Union’s shareholders would thereafter meet to vote on the Pritzker proposal.

It was not until the following day, October 10, that the actual amendments to the Merger Agreement were prepared by Pritzker and delivered to Van Gorkom for execution. As will be seen, the amendments were considerably at variance with Van Gorkom’s representations of the amendments to the Board on October 8; and the amendments placed serious constraints on Trans Union’s ability to negotiate a better deal and withdraw from the Pritzker agreement. Nevertheless, Van Gorkom proceeded to execute what became the October 10 amendments to the Merger Agreement without conferring further with the Board members and apparently without comprehending the actual implications of the amendments.

* * *

Salomon Brothers’ efforts over a three-month period from October 21 to January 21 produced only one serious suitor for Trans Union—General Electric Credit Corporation (“GE Credit”), a subsidiary of the General Electric Company. However, GE Credit was unwilling to make an offer for Trans Union unless Trans Union first rescinded its Merger Agreement with Pritzker. When Pritzker refused, GE Credit terminated further discussions with Trans Union in early January.

In the meantime, in early December, the investment firm of Kohlberg, Kravis, Roberts & Co. (“KKR”), the only other concern to make a firm offer for Trans Union, withdrew its offer under circumstances hereinafter detailed.

On December 19, this litigation was commenced and, within four weeks, the plaintiffs had deposed eight of the ten directors of Trans Union, including Van Gorkom, Chelberg and Romans, its Chief Financial Officer. On January 21, Management’s Proxy Statement for the February 10 shareholder meeting was mailed to Trans Union’s stockholders. On January 26, Trans Union’s Board met and, after a lengthy meeting, voted to proceed with the Pritzker merger. The Board also approved for mailing, “on or about January 27,” a Supplement to its Proxy Statement. The Supplement purportedly set forth all information relevant to the Pritzker Merger Agreement, which had not been divulged in the first Proxy Statement.

* * *

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. Of the outstanding shares, 69.9% were voted in favor of the merger; 7.25% were voted against the merger; and 22.85% were not voted.

II.

We turn to the issue of the application of the business judgment rule to the September 20 meeting of the Board.

The Court of Chancery concluded from the evidence that the Board of Directors’ approval of the Pritzker merger proposal fell within the protection of the business judgment rule. *** [W]e conclude that the Court’s ultimate finding that the Board’s conduct was not “reckless or imprudent” is contrary to the record and not the product of a logical and deductive reasoning process.
* * * Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del.C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.11 Aronson v. Lewis, Del. Supr., 473 A.2d 805, 811 (1984). In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself “is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Aronson, supra at 812. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves “prior to making a business decision, of all material information reasonably available to them.” Id.

Under the business judgment rule there is no protection for directors who have made “an unintelligent or unadvised judgment.” Mitchell v. Highland-Western Glass, Del. Ch., 167 A. 831, 833 (1933). A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Thus, a director’s duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof. Hence, it is presumed that the directors reached their business judgment in good faith and considerations of motive are irrelevant to the issue before us.

The standard of care applicable to a director’s duty of care has also been recently restated by this Court. In Aronson, supra, we stated:

While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence. (footnote omitted)

473 A.2d at 812.

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11 8 Del.C. § 141 provides, in pertinent part: (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.
We again confirm that view. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

In the specific context of a proposed merger of domestic corporations, a director has a duty under 8 Del.C. § 251(b), along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement. Only an agreement of merger satisfying the requirements of 8 Del.C. § 251(b) may be submitted to the shareholders under § 251(c).

It is against those standards that the conduct of the directors of Trans Union must be tested, as a matter of law and as a matter of fact, regarding their exercise of an informed business judgment in voting to approve the Pritzker merger proposal.

III.

*** On the record before us, we must conclude that the Board of Directors did not reach an informed business judgment on September 20, 1980 in voting to “sell” the Company for $55 per share pursuant to the Pritzker cash-out merger proposal. Our reasons, in summary, are as follows:

The directors (1) did not adequately inform themselves as to Van Gorkom’s role in forcing the “sale” of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the “sale” of the Company upon two hours’ consideration, without prior notice, and without the exigency of a crisis or emergency.

As has been noted, the Board based its September 20 decision to approve the cash-out merger primarily on Van Gorkom’s representations. None of the directors, other than Van Gorkom and Chelberg, had any prior knowledge that the purpose of the meeting was to propose a cash-out merger of Trans Union. No members of Senior Management were present, other than Chelberg, Romans and Peterson; and the latter two had only learned of the proposed sale an hour earlier. Both general counsel Moore and former general counsel Browder attended the meeting, but were equally uninformed as to the purpose of the meeting and the documents to be acted upon.

14 8 Del.C. § 251(b) provides in pertinent part: (b) The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation. The agreement shall state: (1) the terms and conditions of the merger or consolidation; (2) the mode of carrying the same into effect; (3) such amendments or changes in the certificate of incorporation of the surviving corporation as are desired to be effected by the merger or consolidation, or, if no such amendments or changes are desired, a statement that the certificate of incorporation of one of the constituent corporations shall be the certificate of incorporation of the surviving or resulting corporation; (4) the manner of converting the shares of each of the constituent corporations ... and (5) such other details or provisions as are deemed desirable.... The agreement so adopted shall be executed in accordance with section 103 of this title. Any of the terms of the agreement of merger or consolidation may be made dependent upon facts ascertainable outside of such agreement, provided that the manner in which such facts shall operate upon the terms of the agreement is clearly and expressly set forth in the agreement of merger or consolidation. (underlining added for emphasis)
Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom’s 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom’s statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.

Under 8 Del.C. § 141(e), “directors are fully protected in relying in good faith on reports made by officers.” Michelson v. Duncan, Del. Ch., 386 A.2d 1144, 1156 (1978); aff’d in part and rev’d in part on other grounds, Del. Supr., 407 A.2d 211 (1979). The term “report” has been liberally construed to include reports of informal personal investigations by corporate officers, Cheff v. Mathes, Del. Supr., 199 A.2d 548, 556 (1964). However, there is no evidence that any “report,” as defined under § 141(e), concerning the Pritzker proposal, was presented to the Board on September 20. Van Gorkom’s oral presentation of his understanding of the terms of the proposed Merger Agreement, which he had not seen, and Romans’ brief oral statement of his preliminary study regarding the feasibility of a leveraged buy-out of Trans Union do not qualify as § 141(e) “reports” for these reasons: The former lacked substance because Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking. Romans’ statement was irrelevant to the issues before the Board since it did not purport to be a valuation study.

The defendants rely on the following factors to sustain the Trial Court’s finding that the Board’s decision was an informed one: (1) the magnitude of the premium or spread between the $55 Pritzker offering price and Trans Union’s current market price of $38 per share; (2) the amendment of the Agreement as submitted on September 20 to permit the Board to accept any better offer during the “market test” period; (3) the collective experience and expertise of the Board’s “inside” and “outside” directors; and (4) their reliance on Brennan’s legal advice that the directors might be sued if they rejected the Pritzker proposal. We discuss each of these grounds seriatim:

(1)
A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price. Here, the judgment reached as to the adequacy of the premium was based on a comparison between the historically depressed Trans Union market price and the amount of the Pritzker offer. Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise, as the defendants’ own evidence demonstrates.

The record is clear that before September 20, Van Gorkom and other members of Trans Union’s Board knew that the market had consistently undervalued the worth of Trans

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15 Section 141(e) provides in pertinent part: A member of the board of directors ... shall, in the performance of his duties, be fully protected in relying in good faith upon the books of accounts or reports made to the corporation by any of its officers, or by an independent certified public accountant, or by an appraiser selected with reasonable care by the board of directors ..., or in relying in good faith upon other records of the corporation.
Union’s stock, despite steady increases in the Company’s operating income in the seven years preceding the merger. The Board related this occurrence in large part to Trans Union’s inability to use its ITCs as previously noted. Van Gorkom testified that he did not believe the market price accurately reflected Trans Union’s true worth; and several of the directors testified that, as a general rule, most chief executives think that the market undervalues their companies’ stock. Yet, on September 20, Trans Union’s Board apparently believed that the market stock price accurately reflected the value of the Company for the purpose of determining the adequacy of the premium for its sale.

In the Proxy Statement, however, the directors reversed their position. There, they stated that, although the earnings prospects for Trans Union were “excellent,” they found no basis for believing that this would be reflected in future stock prices. With regard to past trading, the Board stated that the prices at which the Company’s common stock had traded in recent years did not reflect the “inherent” value of the Company. But having referred to the “inherent” value of Trans Union, the directors ascribed no number to it. Moreover, nowhere did they disclose that they had no basis on which to fix “inherent” worth beyond an impressionistic reaction to the premium over market and an unsubstantiated belief that the value of the assets was “significantly greater” than book value. By their own admission they could not rely on the stock price as an accurate measure of value. Yet, also by their own admission, the Board members assumed that Trans Union’s market price was adequate to serve as a basis upon which to assess the adequacy of the premium for purposes of the September 20 meeting.

The parties do not dispute that a publicly-traded stock price is solely a measure of the value of a minority position and, thus, market price represents only the value of a single share. Nevertheless, on September 20, the Board assessed the adequacy of the premium over market, offered by Pritzker, solely by comparing it with Trans Union’s current and historical stock price.

Indeed, as of September 20, the Board had no other information on which to base a determination of the intrinsic value of Trans Union as a going concern. As of September 20, the Board had made no evaluation of the Company designed to value the entire enterprise, nor had the Board ever previously considered selling the Company or consenting to a buy-out merger. Thus, the adequacy of a premium is indeterminate unless it is assessed in terms of other competent and sound valuation information that reflects the value of the particular business.

Despite the foregoing facts and circumstances, there was no call by the Board, either on September 20 or thereafter, for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context. It is undisputed that the major asset of Trans Union was its cash flow. Yet, at no time did the Board call for a valuation study taking into account that highly significant element of the Company’s assets.

We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.
Here, the record establishes that the Board did not request its Chief Financial Officer, Romans, to make any valuation study or review of the proposal to determine the adequacy of $55 per share for sale of the Company. On the record before us: The Board rested on Romans’ elicited response that the $55 figure was within a “fair price range” within the context of a leveraged buy-out. No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. ***

The record also establishes that the Board accepted without scrutiny Van Gorkom’s representation as to the fairness of the $55 price per share for sale of the Company—a subject that the Board had never previously considered. The Board thereby failed to discover that Van Gorkom had suggested the $55 price to Pritzker and, most crucially, that Van Gorkom had arrived at the $55 figure based on calculations designed solely to determine the feasibility of a leveraged buy-out. No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

We do not say that the Board of Directors was not entitled to give some credence to Van Gorkom’s representation that $55 was an adequate or fair price. Under § 141(e), the directors were entitled to rely upon their chairman’s opinion of value and adequacy, provided that such opinion was reached on a sound basis. Here, the issue is whether the directors informed themselves as to all information that was reasonably available to them. Had they done so, they would have learned of the source and derivation of the $55 price and could not reasonably have relied thereupon in good faith.

None of the directors, Management or outside, were investment bankers or financial analysts. Yet the Board did not consider recessing the meeting until a later hour that day (or requesting an extension of Pritzker’s Sunday evening deadline) to give it time to elicit more information as to the sufficiency of the offer, either from inside Management (in particular Romans) or from Trans Union’s own investment banker, Salomon Brothers, whose Chicago specialist in merger and acquisitions was known to the Board and familiar with Trans Union’s affairs.

Thus, the record compels the conclusion that on September 20 the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of $55 per share for sale of the Company.

(2)

This brings us to the post-September 20 “market test” upon which the defendants ultimately rely to confirm the reasonableness of their September 20 decision to accept the Pritzker proposal. In this connection, the directors present a two-part argument: (a) that by making a “market test” of Pritzker’s $55 per share offer a condition of their September 20 decision to accept his offer, they cannot be found to have acted impulsively or in an

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19 As of September 20 the directors did not know: that Van Gorkom had arrived at the $55 figure alone, and subjectively, as the figure to be used by Controller Peterson in creating a feasible structure for a leveraged buy-out by a prospective purchaser; that Van Gorkom had not sought advice, information or assistance from either inside or outside Trans Union directors as to the value of the Company as an entity or the fair price per share for 100% of its stock; that Van Gorkom had not consulted with the Company’s investment bankers or other financial analysts; that Van Gorkom had not consulted with or confided in any officer or director of the Company except Chelberg; and that Van Gorkom had deliberately chosen to ignore the advice and opinion of the members of his Senior Management group regarding the adequacy of the $55 price.
uninformed manner on September 20; and (b) that the adequacy of the $17 premium for sale of the Company was conclusively established over the following 90 to 120 days by the most reliable evidence available—the marketplace. Thus, the defendants impliedly contend that the “market test” eliminated the need for the Board to perform any other form of fairness test either on September 20, or thereafter.

Again, the facts of record do not support the defendants’ argument. There is no evidence: (a) that the Merger Agreement was effectively amended to give the Board freedom to put Trans Union up for auction sale to the highest bidder; or (b) that a public auction was in fact permitted to occur. The minutes of the Board meeting make no reference to any of this. Indeed, the record compels the conclusion that the directors had no rational basis for expecting that a market test was attainable, given the terms of the Agreement as executed during the evening of September 20. We rely upon the following facts which are essentially uncontradicted:

The Merger Agreement, specifically identified as that originally presented to the Board on September 20, has never been produced by the defendants, notwithstanding the plaintiffs’ several demands for production before as well as during trial. No acceptable explanation of this failure to produce documents has been given to either the Trial Court or this Court. Significantly, neither the defendants nor their counsel have made the affirmative representation that this critical document has been produced. Thus, the Court is deprived of the best evidence on which to judge the merits of the defendants’ position as to the care and attention which they gave to the terms of the Agreement on September 20.

Van Gorkom states that the Agreement as submitted incorporated the ingredients for a market test by authorizing Trans Union to receive competing offers over the next 90-day period. However, he concedes that the Agreement barred Trans Union from actively soliciting such offers and from furnishing to interested parties any information about the Company other than that already in the public domain. Whether the original Agreement of September 20 went so far as to authorize Trans Union to receive competitive proposals is arguable. The defendants’ unexplained failure to produce and identify the original Merger Agreement permits the logical inference that the instrument would not support their assertions in this regard. It is a well established principle that the production of weak evidence when strong is, or should have been, available can lead only to the conclusion that the strong would have been adverse. Van Gorkom, conceding that he never read the Agreement, stated that he was relying upon his understanding that, under corporate law, directors always have an inherent right, as well as a fiduciary duty, to accept a better offer notwithstanding an existing contractual commitment by the Board.

The defendant directors assert that they “insisted” upon including two amendments to the Agreement, thereby permitting a market test: (1) to give Trans Union the right to accept a better offer; and (2) to reserve to Trans Union the right to distribute proprietary information on the Company to alternative bidders. Yet, the defendants concede that they did not seek to amend the Agreement to permit Trans Union to solicit competing offers.

Thus, notwithstanding what several of the outside directors later claimed to have “thought” occurred at the meeting, the record compels the conclusion that Trans Union’s Board had no rational basis to conclude on September 20 or in the days immediately following, that the Board’s acceptance of Pritzker’s offer was conditioned on (1) a “market
test” of the offer; and (2) the Board’s right to withdraw from the Pritzker Agreement and accept any higher offer received before the shareholder meeting. ***

(4)
Part of the defense is based on a claim that the directors relied on legal advice rendered at the September 20 meeting by James Brennan, Esquire, who was present at Van Gorkom’s request. Unfortunately, Brennan did not appear and testify at trial even though his firm participated in the defense of this action. *** Several defendants testified that Brennan advised them that Delaware law did not require a fairness opinion or an outside valuation of the Company before the Board could act on the Pritzker proposal. If given, the advice was correct. However, that did not end the matter. Unless the directors had before them adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could be made, mere advice of this type is meaningless; and, given this record of the defendants’ failures, it constitutes no defense here. 22

* * *

We conclude that Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal on September 20; and we further conclude that the Trial Court erred as a matter of law in failing to address that question before determining whether the directors’ later conduct was sufficient to cure its initial error. * * *

-B-

We now examine the Board’s post-September 20 conduct for the purpose of determining first, whether it was informed and not grossly negligent; and second, if informed, whether it was sufficient to legally rectify and cure the Board’s derelictions of September 20.

(1)
First, as to the Board meeting of October 8: Its purpose arose in the aftermath of the September 20 meeting: (1) the September 22 press release announcing that Trans Union “had entered into definitive agreements to merge with an affiliate of Marmon Group, Inc.” and (2) Senior Management’s ensuing revolt.

Trans Union’s press release stated:

FOR IMMEDIATE RELEASE:

CHICAGO, IL—Trans Union Corporation announced today that it had entered into definitive agreements to merge with an affiliate of The Marmon Group, Inc. in a transaction whereby Trans Union stockholders would receive $55 per share in cash for each Trans Union share held. The Marmon Group, Inc. is controlled by the Pritzker family of Chicago.

The merger is subject to approval by the stockholders of Trans Union at a special meeting expected to be held sometime during December or early January.

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22 Nonetheless, we are satisfied that in an appropriate factual context a proper exercise of business judgment may include, as one of its aspects, reasonable reliance upon the advice of counsel. This is wholly outside the statutory protections of 8 Del.C. § 141(e) involving reliance upon reports of officers, certain experts and books and records of the company.
Until October 10, 1980, the purchaser has the right to terminate the merger if financing that is satisfactory to the purchaser has not been obtained, but after that date there is no such right.

In a related transaction, Trans Union has agreed to sell to a designee of the purchaser one million newly-issued shares of Trans Union common stock at a cash price of $38 per share. Such shares will be issued only if the merger financing has been committed for no later than October 10, 1980, or if the purchaser elects to waive the merger financing condition. In addition, the New York Stock Exchange will be asked to approve the listing of the new shares pursuant to a listing application which Trans Union intends to file shortly.

Completing of the transaction is also subject to the preparation of a definitive proxy statement and making various filings and obtaining the approvals or consents of government agencies.

The press release made no reference to provisions allegedly reserving to the Board the rights to perform a “market test” and to withdraw from the Pritzker Agreement if Trans Union received a better offer before the shareholder meeting. The defendants also concede that Trans Union never made a subsequent public announcement stating that it had in fact reserved the right to accept alternate offers, the Agreement notwithstanding.

The public announcement of the Pritzker merger resulted in an “en masse” revolt of Trans Union’s Senior Management. The head of Trans Union’s tank car operations (its most profitable division) informed Van Gorkom that unless the merger were called off, fifteen key personnel would resign.

Instead of reconvening the Board, Van Gorkom again privately met with Pritzker, informed him of the developments, and sought his advice. Pritzker then made the following suggestions for overcoming Management’s dissatisfaction: (1) that the Agreement be amended to permit Trans Union to solicit, as well as receive, higher offers; and (2) that the shareholder meeting be postponed from early January to February 10, 1981. In return, Pritzker asked Van Gorkom to obtain a commitment from Senior Management to remain at Trans Union for at least six months after the merger was consummated.

Van Gorkom then advised Senior Management that the Agreement would be amended to give Trans Union the right to solicit competing offers through January, 1981, if they would agree to remain with Trans Union. Senior Management was temporarily mollified; and Van Gorkom then called a special meeting of Trans Union’s Board for October 8.

Thus, the primary purpose of the October 8 Board meeting was to amend the Merger Agreement, in a manner agreeable to Pritzker, to permit Trans Union to conduct a “market test.” Van Gorkom understood that the proposed amendments were intended to give the Company an unfettered “right to openly solicit offers down through January 31.” Van Gorkom presumably so represented the amendments to Trans Union’s Board members on October 8. In a brief session, the directors approved Van Gorkom’s oral presentation of the substance of the proposed amendments, the terms of which were not reduced to writing until October 10. But rather than waiting to review the amendments, the Board
again approved them sight unseen and adjourned, giving Van Gorkom authority to execute the papers when he received them.\textsuperscript{25}

Thus, the Court of Chancery’s finding that the October 8 Board meeting was convened to \textit{reconsider} the Pritzker “proposal” is clearly erroneous. Further, the consequence of the Board’s faulty conduct on October 8, in approving amendments to the Agreement which had not even been drafted, will become apparent when the actual amendments to the Agreement are hereafter examined.

The next day, October 9, and before the Agreement was amended, Pritzker moved swiftly to off-set the proposed market test amendment. First, Pritzker informed Trans Union that he had completed arrangements for financing its acquisition and that the parties were thereby mutually bound to a firm purchase and sale arrangement. Second, Pritzker announced the exercise of his option to purchase one million shares of Trans Union’s treasury stock at $38 per share—75 cents above the current market price. Trans Union’s Management responded the same day by issuing a press release announcing: (1) that all financing arrangements for Pritzker’s acquisition of Trans Union had been completed; and (2) Pritzker’s purchase of one million shares of Trans Union’s treasury stock at $38 per share.

The next day, October 10, Pritzker delivered to Trans Union the proposed amendments to the September 20 Merger Agreement. Van Gorkom promptly proceeded to countersign all the instruments on behalf of Trans Union without reviewing the instruments to determine if they were consistent with the authority previously granted him by the Board. The amending documents were apparently not approved by Trans Union’s Board until a much later date, December 2. The record does not affirmatively establish that Trans Union’s directors ever read the October 10 amendments.

The October 10 amendments to the Merger Agreement did authorize Trans Union to solicit competing offers, but the amendments had more far-reaching effects. The most significant change was in the definition of the third-party “offer” available to Trans Union as a possible basis for withdrawal from its Merger Agreement with Pritzker. Under the October 10 amendments, a better offer was no longer sufficient to permit Trans Union’s withdrawal. Trans Union was now permitted to terminate the Pritzker Agreement and abandon the merger only if, prior to February 10, 1981, Trans Union had either consummated a merger (or sale of assets) with a third party or had entered into a “definitive” merger agreement more favorable than Pritzker’s and for a greater consideration—subject only to stockholder approval. Further, the “extension” of the market test period to February 10, 1981 was circumscribed by other amendments which required Trans Union to file its preliminary proxy statement on the Pritzker merger proposal by December 5, 1980 and use its best efforts to mail the statement to its shareholders by January 5, 1981. Thus, the market test period was effectively reduced, not extended.

In our view, the record compels the conclusion that the directors’ conduct on October 8 exhibited the same deficiencies as did their conduct on September 20. \textit{***}

\textsuperscript{25} We do not suggest that a board must read \textit{in haece verba} every contract or legal document which it approves, but if it is to successfully absolve itself from charges of the type made here, there must be some credible contemporary evidence demonstrating that the directors knew what they were doing, and ensured that their purported action was given effect. That is the consistent failure which cast this Board upon its unredeemable course.
We conclude that the Board acted in a grossly negligent manner on October 8; and that Van Gorkom’s representations on which the Board based its actions do not constitute “reports” under § 141(e) on which the directors could reasonably have relied. Further, the amended Merger Agreement imposed on Trans Union’s acceptance of a third party offer conditions more onerous than those imposed on Trans Union’s acceptance of Pritzker’s offer on September 20. After October 10, Trans Union could accept from a third party a better offer only if it were incorporated in a definitive agreement between the parties, and not conditioned on financing or on any other contingency.

The October 9 press release, coupled with the October 10 amendments, had the clear effect of locking Trans Union’s Board into the Pritzker Agreement. Pritzker had thereby foreclosed Trans Union’s Board from negotiating any better “definitive” agreement over the remaining eight weeks before Trans Union was required to clear the Proxy Statement submitting the Pritzker proposal to its shareholders.

(2)

Next, as to the “curative” effects of the Board’s post-September 20 conduct, we review in more detail the reaction of Van Gorkom to the KKR proposal and the results of the Board-sponsored “market test.”

The KKR proposal was the first and only offer received subsequent to the Pritzker Merger Agreement. The offer resulted primarily from the efforts of Romans and other senior officers to propose an alternative to Pritzker’s acquisition of Trans Union. In late September, Romans’ group contacted KKR about the possibility of a leveraged buy-out by all members of Management, except Van Gorkom. By early October, Henry R. Kravis of KKR gave Romans written notice of KKR’s “interest in making an offer to purchase 100%” of Trans Union’s common stock.

Thereafter, and until early December, Romans’ group worked with KKR to develop a proposal. It did so with Van Gorkom’s knowledge and apparently grudging consent. On December 2, Kravis and Romans hand-delivered to Van Gorkom a formal letter-offer to purchase all of Trans Union’s assets and to assume all of its liabilities for an aggregate cash consideration equivalent to $60 per share. The offer was contingent upon completing equity and bank financing of $650 million, which Kravis represented as 80% complete. The KKR letter made reference to discussions with major banks regarding the loan portion of the buy-out cost and stated that KKR was “confident that commitments for the bank financing * * * can be obtained within two or three weeks.” The purchasing group was to include certain named key members of Trans Union’s Senior Management, excluding Van Gorkom, and a major Canadian company. Kravis stated that they were willing to enter into a “definitive agreement” under terms and conditions “substantially the same” as those contained in Trans Union’s agreement with Pritzker. The offer was addressed to Trans Union’s Board of Directors and a meeting with the Board, scheduled for that afternoon, was requested.

Van Gorkom’s reaction to the KKR proposal was completely negative; he did not view the offer as being firm because of its financing condition. It was pointed out, to no avail, that Pritzker’s offer had not only been similarly conditioned, but accepted on an expedited basis. Van Gorkom refused Kravis’ request that Trans Union issue a press release announcing KKR’s offer, on the ground that it might “chill” any other offer. Romans and
Kravis left with the understanding that their proposal would be presented to Trans Union’s Board that afternoon.

Within a matter of hours and shortly before the scheduled Board meeting, Kravis withdrew his letter-offer. He gave as his reason a sudden decision by the Chief Officer of Trans Union’s rail car leasing operation to withdraw from the KKR purchasing group. Van Gorkom had spoken to that officer about his participation in the KKR proposal immediately after his meeting with Romans and Kravis. However, Van Gorkom denied any responsibility for the officer’s change of mind.

At the Board meeting later that afternoon, Van Gorkom did not inform the directors of the KKR proposal because he considered it “dead.” Van Gorkom did not contact KKR again until January 20, when faced with the realities of this lawsuit, he then attempted to reopen negotiations. KKR declined due to the imminence of the February 10 stockholder meeting.

GE Credit Corporation’s interest in Trans Union did not develop until November; and it made no written proposal until mid-January. Even then, its proposal was not in the form of an offer. Had there been time to do so, GE Credit was prepared to offer between $2 and $5 per share above the $55 per share price which Pritzker offered. But GE Credit needed an additional 60 to 90 days; and it was unwilling to make a formal offer without a concession from Pritzker extending the February 10 “deadline” for Trans Union’s stockholder meeting. As previously stated, Pritzker refused to grant such extension; and on January 21, GE Credit terminated further negotiations with Trans Union. Its stated reasons, among others, were its “unwillingness to become involved in a bidding contest with Pritzker in the absence of the willingness of [the Pritzker interests] to terminate the proposed $55 cash merger.”

* * *

In the absence of any explicit finding by the Trial Court as to the reasonableness of Trans Union’s directors’ reliance on a market test and its feasibility, we may make our own findings based on the record. Our review of the record compels a finding that confirmation of the appropriateness of the Pritzker offer by an unfettered or free market test was virtually meaningless in the face of the terms and time limitations of Trans Union’s Merger Agreement with Pritzker as amended October 10, 1980.

(3)

Finally, we turn to the Board’s meeting of January 26, 1981. The defendant directors rely upon the action there taken to refute the contention that they did not reach an informed business judgment in approving the Pritzker merger. The defendants contend that the Trial Court correctly concluded that Trans Union’s directors were, in effect, as “free to turn down the Pritzker proposal” on January 26, as they were on September 20.

** * [W]e conclude that the Trial Court’s finding in this regard is neither supported by the record nor the product of an orderly and logical deductive process. Without disagreeing with the principle that a business decision by an originally uninformed board of directors may, under appropriate circumstances, be timely cured so as to become informed and deliberate, we find that the record does not permit the defendants to invoke that principle in this case. ** * We find the Trial Court to have erred, both as a matter of fact and as a
matter of law, in relying on the action on January 26 to bring the defendants’ conduct within the protection of the business judgment rule.

Johnson’s testimony and the Board Minutes of January 26 are remarkably consistent. Both clearly indicate recognition that the question of the alternative courses of action, available to the Board on January 26 with respect to the Pritzker merger, was a legal question, presenting to the Board (after its review of the full record developed through pre-trial discovery) three options: (1) to “continue to recommend” the Pritzker merger; (2) to “recommend that the stockholders vote against” the Pritzker merger; or (3) to take a non-committal position on the merger and “simply leave the decision to [the] shareholders.”

We must conclude from the foregoing that the Board was mistaken as a matter of law regarding its available courses of action on January 26, 1981. Options (2) and (3) were not viable or legally available to the Board under 8 Del.C. §251(b). The Board could not remain committed to the Pritzker merger and yet recommend that its stockholders vote it down; nor could it take a neutral position and delegate to the stockholders the unadvised decision as to whether to accept or reject the merger. Under §251(b), the Board had but two options: (1) to proceed with the merger and the stockholder meeting, with the Board’s recommendation of approval; or (2) to rescind its agreement with Pritzker, withdraw its approval of the merger, and notify its stockholders that the proposed shareholder meeting was cancelled. There is no evidence that the Board gave any consideration to these, its only legally viable alternative courses of action.

But the second course of action would have clearly involved a substantial risk—that the Board would be faced with suit by Pritzker for breach of contract based on its September 20 agreement as amended October 10. As previously noted, under the terms of the October 10 amendment, the Board’s only ground for release from its agreement with Pritzker was its entry into a more favorable definitive agreement to sell the Company to a third party. Thus, in reality, the Board was not “free to turn down the Pritzker proposal” as the Trial Court found. Indeed, short of negotiating a better agreement with a third party, the Board’s only basis for release from the Pritzker Agreement without liability would have been to establish fundamental wrongdoing by Pritzker. Clearly, the Board was not “free” to withdraw from its agreement with Pritzker on January 26 by simply relying on its self-induced failure to have reached an informed business judgment at the time of its original agreement.

Therefore, the Trial Court’s conclusion that the Board reached an informed business judgment on January 26 in determining whether to turn down the Pritzker “proposal” on that day cannot be sustained. The Court’s conclusion is not supported by the record; it is contrary to the provisions of §251(b) and basic principles of contract law; and it is not the product of a logical and deductive reasoning process.

* * *

Upon the basis of the foregoing, we hold that the defendants’ post-September conduct did not cure the deficiencies of their September 20 conduct; and that, accordingly, the Trial Court erred in according to the defendants the benefits of the business judgment rule.
The defendants ultimately rely on the stockholder vote of February 10 for exoneration. The defendants contend that the stockholders’ “overwhelming” vote approving the Pritzker Merger Agreement had the legal effect of curing any failure of the Board to reach an informed business judgment in its approval of the merger. ***

The settled rule in Delaware is that “where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail.” Gerlach v. Gillam, Del. Ch., 139 A.2d 591, 593 (1958). The question of whether shareholders have been fully informed such that their vote can be said to ratify director action, “turns on the fairness and completeness of the proxy materials submitted by the management to the … shareholders.” Michelson v. Duncan, supra at 220. ***

Applying this standard to the record before us, we find that Trans Union’s stockholders were not fully informed of all facts material to their vote on the Pritzker Merger and that the Trial Court’s ruling to the contrary is clearly erroneous. We list the material deficiencies in the proxy materials:

(1) The fact that the Board had no reasonably adequate information indicative of the intrinsic value of the Company, other than a concededly depressed market price, was without question material to the shareholders voting on the merger.

Accordingly, the Board’s lack of valuation information should have been disclosed. Instead, the directors cloaked the absence of such information in both the Proxy Statement and the Supplemental Proxy Statement. Through artful drafting, noticeably absent at the September 20 meeting, both documents create the impression that the Board knew the intrinsic worth of the Company. In particular, the Original Proxy Statement contained the following:

[although the Board of Directors regards the intrinsic value of the Company’s assets to be significantly greater than their book value ..., systematic liquidation of such a large and complex entity as Trans Union is simply not regarded as a feasible method of realizing its inherent value. Therefore, a business combination such as the merger would seem to be the only practicable way in which the stockholders could realize the value of the Company.]

The Proxy stated further that “[i]n the view of the Board of Directors ..., the prices at which the Company’s common stock has traded in recent years have not reflected the inherent value of the Company.” What the Board failed to disclose to its stockholders was that the Board had not made any study of the intrinsic or inherent worth of the Company; nor had the Board even discussed the inherent value of the Company prior to approving the merger on September 20, or at either of the subsequent meetings on October 8 or January 26. ***

We find misleading the Board’s references to the “substantial” premium offered. The Board gave as their primary reason in support of the merger the “substantial premium” shareholders would receive. But the Board did not disclose its failure to assess the premium offered in terms of other relevant valuation techniques, thereby rendering questionable its determination as to the substantiability of the premium over an admittedly depressed stock market price. ***
(5) The Board’s Supplemental Proxy Statement, mailed on or after January 27, added significant new matter, material to the proposal to be voted on February 10, which was not contained in the Original Proxy Statement. Some of this new matter was information which had only been disclosed to the Board on January 26; much was information known or reasonably available before January 21 but not revealed in the Original Proxy Statement. Yet, the stockholders were not informed of these facts.

*** In this case, the Board’s ultimate disclosure as contained in the Supplemental Proxy Statement related either to information readily accessible to all of the directors if they had asked the right questions, or was information already at their disposal. In short, the information disclosed by the Supplemental Proxy Statement was information which the defendant directors knew or should have known at the time the first Proxy Statement was issued. The defendants simply failed in their original duty of knowing, sharing, and disclosing information that was material and reasonably available for their discovery. They compounded that failure by their continued lack of candor in the Supplemental Proxy Statement. While we need not decide the issue here, we are satisfied that, in an appropriate case, a completely candid but belated disclosure of information long known or readily available to a board could raise serious issues of inequitable conduct.

The burden must fall on defendants who claim ratification based on shareholder vote to establish that the shareholder approval resulted from a fully informed electorate. On the record before us, it is clear that the Board failed to meet that burden.

***

For the foregoing reasons, we conclude that the director defendants breached their fiduciary duty of candor by their failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval.

VI.

To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

We hold, therefore, that the Trial Court committed reversible error in applying the business judgment rule in favor of the director defendants in this case.

On remand, the Court of Chancery shall conduct an evidentiary hearing to determine the fair value of the shares represented by the plaintiffs’ class, based on the intrinsic value of Trans Union on September 20, 1980. *** Thereafter, an award of damages may be entered to the extent that the fair value of Trans Union exceeds $55 per share.

***

REVERSED and REMANDED for proceedings consistent herewith.
Statement on the Purpose of a Corporation

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.

- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.

- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.

- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

Released: August 19, 2019
Updated with New Signatures: September 6, 2019
To establish the obligations of certain large business entities in the United States, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 15, 2018

Ms. WARREN introduced the following bill; which was read twice and referred to the Committee on Commerce, Science, and Transportation

A BILL

To establish the obligations of certain large business entities in the United States, and for other purposes.

Be it enacted by the Senate and House of Representa-

tives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the “Accountable Capital-italism Act”.

SEC. 2. DEFINITIONS.

In this Act:

(1) DIRECTOR.—The term “Director” means

the Director of the Office.

(2) LARGE ENTITY.—
(A) IN GENERAL.—The term “large entity” means an entity that—

(i) is organized under the laws of a State as a corporation, body corporate, body politic, joint stock company, or limited liability company;

(ii) engages in interstate commerce;

and

(iii) in a taxable year, according to information provided by the entity to the Internal Revenue Service, has more than $1,000,000,000 in gross receipts.

(B) AGGREGATION RULES.—All entities treated as a single employer under subsection (a) or (b) of section 52 of the Internal Revenue Code of 1986, or subsection (m) or (o) of section 414 of such Code, shall be treated as 1 entity for the purposes of subparagraph (A).

(3) OFFICE.—The term “Office” means the Office of United States Corporations established under section 3.

(4) OFFICER.—The term “officer” means, with respect to a United States corporation—

(A) the president of the United States corporation;
(B) the principal operating officer of the United States corporation;

(C) the principal accounting officer of the United States corporation or, if the United States corporation does not have such an accounting officer, the controller of the United States corporation; and

(D) any vice president in charge of a principal business unit, division, or function of the United States corporation.

(5) STATE.—The term “State” means—

(A) each of the several States of the United States;

(B) the District of Columbia;

(C) the Commonwealth of Puerto Rico;

(D) Guam;

(E) the United States Virgin Islands;

(F) American Samoa; and

(G) the Commonwealth of the Northern Mariana Islands.

(6) UNITED STATES CORPORATION.—The term “United States corporation” means a large entity with respect to which the Office has granted a charter under section 3.
SEC. 3. OFFICE OF UNITED STATES CORPORATIONS.

(a) Establishment.—There is established within the Department of Commerce the Office of United States Corporations.

(b) Director.—

(1) Establishment of position.—There is established the position of Director of the Office, who shall be the head of the Office.

(2) Appointment; term.—

(A) Appointment.—Except as provided in subparagraph (E), the Director shall be appointed by the President, by and with the advice and consent of the Senate, from among individuals who are citizens of the United States.

(B) Term.—The Director shall be appointed for a term of 4 years, unless removed before the end of that term by the President.

(C) Vacancy.—A vacancy in the position of Director that occurs before the expiration of the term for which a Director was appointed shall be filled in the manner established under subparagraph (A), and the Director appointed to fill that vacancy shall be appointed only for the remainder of that term.

(D) Service after end of term.—An individual may serve as the Director after the
expiration of the term for which the individual
was appointed until a successor has been ap-
pointed.

(E) INITIAL DIRECTOR.—The Secretary of
Commerce shall appoint an individual to serve
as the Director until an individual is appointed
to serve as the Director in accordance with sub-
paragraph (A).

(e) DUTIES.—The Office shall—

(1) review and grant charter applications for
large entities;

(2) monitor whether large entities have ob-
tained a charter in accordance with this Act;

(3) except as provided in paragraph (4)(B),
refer any violation of this Act to the appropriate
Federal agency for enforcement with respect to that
violation; and

(4) when appropriate—

(A) rescind the charters of United States
corporations under section 4(b);

(B) revoke the charters of United States
corporations under sections 6(c)(2)(B)(ii),
8(e)(2), and 9; and
(C) issue rules to prevent entities from taking action to intentionally avoid qualifying as large entities.

(d) Disclosure of Taxpayer Identity Information for Use by Office.—

(1) In general.—Section 6103(m) of the Internal Revenue Code of 1986 is amended by adding at the end the following:

“(8) Office of United States Corporations.—Upon written request by the Director of the Office of United States Corporations, the Secretary shall disclose taxpayer identity information to officers and employees of the Office of United States Corporations solely for purposes of identifying any taxpayer that satisfies the requirement under section 2(2)(A)(iii) or 4(b) of the Accountable Capitalism Act for the most recent taxable year for which information is available.”.

(2) Effective date.—The amendment made by this subsection shall take effect on the date of enactment of this Act.

SEC. 4. REQUIREMENT FOR LARGE ENTITIES TO OBTAIN CHARTERS.

(a) Large Entities.—
(1) IN GENERAL.—An entity that is organized as a corporation, body corporate, body politic, joint stock company, or limited liability company in a State shall obtain a charter from the Office as follows:

(A) If the entity is a large entity with respect to the most recently completed taxable year of the entity before the date of enactment of this Act, the entity shall obtain the charter not later than 2 years after the date of enactment of this Act.

(B) If the entity is a large entity with respect to any taxable year of the entity that begins after the date of enactment of this Act, the entity shall obtain the charter not later than 1 year after the last day of that taxable year.

(2) FAILURE TO OBTAIN CHARTER.—An entity to which paragraph (1) applies and that fails to obtain a charter from the Office as required under that paragraph shall not be treated as a corporation, body corporate, body politic, joint-stock company, or limited liability company, as applicable, for the purposes of Federal law during the period beginning on the date on which the entity is required to obtain a
charter under that paragraph and ending on the
date on which the entity obtains the charter.

(b) Rescissions.—

(1) In General.—An entity that has obtained
a charter as a United States corporation and, with
respect to a subsequent taxable year of the entity,
is not a large entity may file a petition with the Of-

cie to rescind the charter of the United States cor-

poration.

(2) Determination.—Not later than 180 days
after the date on which the Office receives a petition
that an entity files under paragraph (1), the Office
shall grant the petition if the Office determines that
the entity, with respect to the most recently com-
pleted taxable year of the entity preceding the date
on which the petition was filed, was not a large enti-
ty.

SEC. 5. RESPONSIBILITIES OF UNITED STATES CORPORATIONS.

(a) Definitions.—In this section:

(1) General Public Benefit.—The term
“general public benefit” means a material positive
impact on society resulting from the business and
operations of a United States corporation, when
taken as a whole.
(2) **Subsidiary.**—The term “subsidiary” means, with respect to a person, an entity in which the person owns beneficially or of record not less than 50 percent of the outstanding equity interests of the entity, calculated as if all outstanding rights to acquire equity interests in the entity had been exercised.

(b) **Charter Requirements.**—

(1) **In general.**—The charter of a large entity that is filed with the Office shall state that the entity is a United States corporation.

(2) **Corporate purposes.**—A United States corporation shall have the purpose of creating a general public benefit, which shall be—

(A) identified in the charter of the United States corporation; and

(B) in addition to the purpose of the United States corporation under the articles of incorporation in the State in which the United States corporation is incorporated, if applicable.

c) **Standard of Conduct for Directors and Officers.**—

(1) **Consideration of interests.**—In discharging the duties of their respective positions, and in considering the best interests of a United States
corporation, the board of directors, committees of
the board of directors, and individual directors of a
United States corporation—

(A) shall manage or direct the business
and affairs of the United States corporation in
a manner that—

(i) seeks to create a general public
benefit; and

(ii) balances the pecuniary interests of
the shareholders of the United States cor-
poration with the best interests of persons
that are materially affected by the conduct
of the United States corporation; and

(B) in carrying out subparagraph (A)—

(i) shall consider the effects of any ac-
tion or inaction on—

(I) the shareholders of the
United States corporation;

(II) the employees and workforce
of—

(aa) the United States cor-
poration;

(bb) the subsidiaries of the
United States corporation; and
(ee) the suppliers of the United States corporation;

(III) the interests of customers and subsidiaries of the United States corporation as beneficiaries of the general public benefit purpose of the United States corporation;

(IV) community and societal factors, including those of each community in which offices or facilities of the United States corporation, subsidiaries of the United States corporation, or suppliers of the United States corporation are located;

(V) the local and global environment;

(VI) the short-term and long-term interests of the United States corporation, including—

(aa) benefits that may accrue to the United States corporation from the long-term plans of the United States corporation; and
(bb) the possibility that those interests may be best served by the continued independence of the United States corporation; and

(VII) the ability of the United States corporation to accomplish the general public benefit purpose of the United States corporation;

(ii) may consider—

(I) other pertinent factors; or

(II) the interests of any other group that are identified in the articles of incorporation in the State in which the United States corporation is incorporated, if applicable; and

(iii) shall not be required to give priority to a particular interest or factor described in clause (i) or (ii) over any other interest or factor.

(2) Standard of Conduct for Officers.—

Each officer of a United States corporation shall balance and consider the interests and factors described in paragraph (1)(B)(i) in the manner described in paragraph (1)(B)(iii) if—
(A) the officer has discretion to act with respect to a matter; and

(B) it reasonably appears to the officer that the matter may have a material effect on the creation by the United States corporation of a general public benefit identified in the charter of the United States corporation.

(3) Exoneration from Personal Liability.—Except as provided in the charter of a United States corporation, neither a director nor an officer of a United States corporation may be held personally liable for monetary damages for—

(A) any action or inaction in the course of performing the duties of a director under paragraph (1) or an officer under paragraph (2), as applicable, if the director or officer was not interested with respect to the action or inaction; or

(B) the failure of the United States corporation to pursue or create a general public benefit.

(4) Limitation on Standing.—Neither a director nor an officer of a United States corporation shall have any duty to a person that is a beneficiary of the general public benefit purpose of the United
States corporation because of the status of the person as such a beneficiary.

(5) Business judgments.—A director or an officer of a United States corporation who makes a business judgment in good faith shall be deemed to have fulfilled the duty of the director under paragraph (1) or the officer under paragraph (2), as applicable, if the director or officer—

(A) is not interested in the subject of the business judgment;

(B) is informed with respect to the subject of the business judgment to an extent that the director reasonably believes to be appropriate under the circumstances; and

(C) rationally believes that the business judgment is in the best interests of the United States corporation.

(d) Right of action.—

(1) Limitation on liability of corporation.—A United States corporation shall not be liable for monetary damages under this section for any failure of the United States corporation to pursue or create a general public benefit.
(2) STANDING.—A proceeding to enforce the requirements of this section may be commenced or maintained only—

(A) directly by the United States corporation to which the proceeding applies; or

(B) derivatively, under the laws of the State in which the United States corporation is organized, by a person, or a group of persons, that own—

(i) beneficially or of record not less than 2 percent of the total number of shares of a class or series outstanding at the time of the act or omission that is the subject of the proceeding; or

(ii) beneficially or of record not less than 5 percent of the outstanding equity interests in an entity of which the United States corporation is a subsidiary at the time of the act or omission that is the subject of the proceeding.

(3) RULE OF CONSTRUCTION REGARDING BENEFICIAL OWNERSHIP.—For the purposes of this subsection, a person shall be construed to be the beneficial owner of shares or equity interests if the
shares or equity interests are held in a voting trust
or by a nominee on behalf of the person.
(c) Application.—

(1) Rule of construction regarding general corporate law.—Nothing in this section
may be construed to affect any provision of law that
is applicable to a corporation, body corporate, body
politic, joint stock company, or limited liability com-
pany, as applicable, that is not a United States cor-
poration.

(2) Applicability of other laws.—

(A) State law.—Except as otherwise pro-
vided in this section, the law of the State in
which a United States corporation is organized
shall apply with respect to the United States
corporation.

(B) Federal law.—If any provision of
Federal law is inconsistent with the require-
ments of this section with respect to a United
States corporation, the requirements of this sec-
tion shall supersede that provision.

(3) Organic records.—A provision of the ar-
ticles of incorporation in the State in which a United
States corporation is incorporated, if applicable, or
in the bylaws of a United States corporation may
not limit, be inconsistent with, or supersede a provision of this section.

**SEC. 6. BOARD REPRESENTATION.**

(a) **RULEMAKING.**—Not later than 1 year after the date of enactment of this Act, the Securities and Exchange Commission, in consultation with the National Labor Relations Board, shall issue rules to ensure that director elections at United States corporations are fair and democratic.

(b) **UNITED STATES CORPORATION ELECTIONS.**—

(1) **IN GENERAL.**—Not less than 2/5 of the directors of a United States corporation shall be elected by the employees of the United States corporation using an election process that complies with the requirements of the rules issued under subsection (a).

(2) **EFFECTIVE DATE.**—Paragraph (1) shall take effect on the date that is 1 year after the date on which the Securities and Exchange Commission issues the rules required under subsection (a).

(c) **ENFORCEMENT.**—

(1) **SECURITIES AND EXCHANGE COMMISSION.**—The Securities and Exchange Commission, in consultation with the National Labor Relations Board, shall ensure that the elections described in
subsection (b)(1) comply with the requirements of
the rules issued by the Commission under subsection
(a).

(2) Department of Labor.—

(A) In general.—The Secretary of Labor
shall coordinate with the Office to ensure that
the representation of the boards of directors of
United States corporations comply with the re-
quirements under subsection (b).

(B) Penalties.—If the representation
with respect to the board of directors of a
United States corporation fails to comply with
the requirements under subsection (b) for a pe-
riod that is not less than 180 consecutive
days—

(i) the Secretary of Labor—

(I) shall assess a civil money pen-
alty against the United States cor-
poration in an amount that is not less
than $50,000 and not more than
$100,000 for each day that such rep-
resentation is not in compliance with
those requirements, including for each
day during that 180-day period; and
(II) may collect the penalty described in subclause (I) beginning on the day after the date on which that 180-day period ends; and

(ii) the Office may revoke the charter of the United States corporation.

SEC. 7. EXECUTIVE COMPENSATION.

(a) DEFINITIONS.—In this section:

(1) COVERED PERSON.—The term "covered person" means an officer or a director of a United States corporation.

(2) EQUITY SECURITY.—The term "equity security" has the meaning given the term in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

(3) RULE 10B–18 PURCHASE.—The term "Rule 10b–18 purchase" has the meaning given the term in section 240.10b–18(a) of title 17, Code of Federal Regulations, as in effect on the date of enactment of this Act.

(4) SUBJECT SECURITY.—The term "subject security" means any—

(A) equity security of a United States cor-
(B) security, the value of which is derived from, or that otherwise relates to, an equity security described in subparagraph (A).

(b) Sale of Subject Securities.—

(1) Prohibitions.—Subject to paragraph (2), no covered person with respect to a United States corporation may—

(A) during the 5-year period that begins on the date on which the covered person first owns or beneficially owns a subject security with respect to that United States corporation (or an affiliate of that United States corporation), sell, transfer, pledge, assign, alienate, or hypothecate, in exchange for value, that subject security, other than—

(i) in connection with the sale of the United States corporation or the affiliate, as applicable; or

(ii) through—

(I) a will; or

(II) the laws of descent or distribution; or

(B) during the 3-year period that begins on the date on which that United States corporation, or an affiliate of that United States
corporation, effects a Rule 10b–18 purchase,
sell any subject security with respect to that
United States corporation.

(2) APPLICATION.—The prohibition under para-
graph (1) shall not apply with respect to any subject
security that a covered person owns or beneficially
owns on the day before the date of enactment of this
Act.

(e) ENFORCEMENT.—The Securities and Exchange
Commission may impose on any covered person that vio-
lates subsection (b) a civil penalty in an amount that is—

(1) not less than the fair market value of the
subject securities of which the covered person dis-
poses in violation of that subsection, as measured on
the date on which the covered person makes the dis-
position; and

(2) not more than the amount that is 3 times
the fair market value of the subject securities of
which the covered person disposes in violation of
that subsection, as measured on the date on which
the covered person makes the disposition.

(d) RULE OF CONSTRUCTION.—For the purposes of
this section, a subject security is beneficially owned by a
covered person if—
(1) the subject security is held in the name of a bank, broker, or nominee for the account of the covered person;

(2) the subject security is held as a joint tenant, tenant in common, or tenant by the entirety or as community property by the covered person; or

(3) the covered person has a pecuniary interest, by reason of any contract, understanding, or relationship, including an immediate family relationship or arrangement, in subject securities held in the name of another person.

SEC. 8. POLITICAL SPENDING.

(a) DEFINITIONS.—In this section:

(1) ELECTIONEERING COMMUNICATION.—The term “electioneering communication” has the meaning given the term in section 304(f)(3) of the Federal Election Campaign Act of 1971 (52 U.S.C. 30104(f)(3)), except that the term “any public communication” shall be substituted for “any broadcast, cable, or satellite communication” in the matter preceding subclause (I) of subparagraph (A)(i) of such section 304(f)(3).

(2) INDEPENDENT EXPENDITURE.—The term “independent expenditure” means an expenditure, as that term is defined in section 301 of the Federal
Election Campaign Act of 1971 (52 U.S.C. 30101),
by a person that expressly advocates the election or
defeat of a clearly identified candidate, or is the
functional equivalent of express advocacy because,
when taken as a whole, the expenditure can be inter-
preted by a reasonable person only as advocating the
election or defeat of a candidate, taking into account
whether the communication involved—

(A) mentions a candidacy, a political party,
or a challenger to a candidate; or

(B) takes a position on character, quali-
fications, or fitness for office of a candidate.

(3) Political expenditure in support of
or in opposition to any candidate for fed-
eral, state, or local public office.—The term
“political expenditure in support of or in opposition
to any candidate for Federal, State, or local public
office” means an expenditure or series of expendi-
tures totaling more than $10,000 for any single can-
didate during any single election that—

(A)(i) is an independent expenditure; or

(ii) with respect to a candidate for State or
local public office, would be treated as an inde-
dependent expenditure if the candidate were a
candidate for Federal public office;
(B)(i) is an electioneering communication;

or

(ii) with respect to a candidate for State or local public office, would be treated as an electioneering communication if the candidate were a candidate for Federal public office; or

(C) are dues or other payments, disbursements, or transfers to any other person that—

(i) are, or could reasonably be anticipated to be, used or transferred to another association or organization for the purposes described in subparagraph (A) or (B); and

(ii) are not investments or payments, disbursements, or transfers made in commercial transactions in the ordinary course of any trade or business.

(b) SHAREHOLDER AND DIRECTOR APPROVAL.—A United States corporation may not make a political expenditure in support of or in opposition to any candidate for Federal, State, or local public office unless—

(1) not less than 75 percent of the shareholders of the corporation and not less than 75 percent of the directors of the corporation approve of the expenditure; and
(2) the approvals required under paragraph (1) occur—

(A) before the date on which the expenditure is made or obligated; and

(B) after the date on which the shareholders and directors described in that paragraph have been informed regarding the precise nature of the proposed expenditure, including—

(i) the amount of the proposed expenditure; and

(ii) the candidate and election to which the proposed expenditure relates.

(e) Enforcement.—

(1) Shareholder suit.—A shareholder of a United States corporation may bring a civil action in an appropriate district court of the United States to enjoin a United States corporation from making a political expenditure in support of or in opposition to any candidate for Federal, State, or local public office that violates the requirements under subsection (b).

(2) Revocation of charter.—The Office may revoke the charter of a United States corporation that knowingly or repeatedly violates the requirements under subsection (b).
SEC. 9. PETITION FOR REVOCATION OF CHARTER.

(a) FILING OF REVOCATION PETITION.—The attorney general of a State may file a petition with the Office to revoke the charter of a United States corporation that is organized in that State or that does business in that State.

(b) TIMING OF RESPONSE AND DECISION.—If a revocation petition is filed under subsection (a) with respect to a United States corporation—

(1) not later than 180 days after the date on which the petition is filed, the United States corporation may file a response that explains why revoking the charter of the United States corporation is not justified in consideration of the factors described in subsection (c)(2); and

(2) the Director shall issue a ruling with respect to the petition not later than 180 days after the earlier of the date that is—

(A) 180 days after the date on which the petition is filed; or

(B) the date on which the corporation files a response under paragraph (1).

(c) GRANTING REVOCATION PETITION.—

(1) IN GENERAL.—The Director, with the approval of the Secretary of Commerce, and after consideration of the factors described in paragraph (2),
may grant a revocation petition that is filed under subsection (a).

(2) FACTORS.—In determining whether to grant a revocation petition under paragraph (1) with respect to a United States corporation, the Director shall consider whether the United States corporation—

(A) has engaged in repeated, egregious, and illegal misconduct that has caused significant harm to—

(i) the customers, employees, shareholders, or business partners of the United States corporation; or

(ii) the communities in which the United States corporation operates; and

(B) has not undertaken measures to address the causes of the misconduct described in subparagraph (A), such as terminating the employment of any officer or executive of the United States corporation who oversaw that misconduct.

(3) REVIEW OF GRANTING OF PETITION.—A decision by the Director to grant a revocation petition under this subsection—
(A) shall be subject to judicial review under section 706 of title 5, United States Code; and

(B) shall not be subject to the procedure for congressional disapproval under section 802 of title 5, United States Code.

(d) Revocation of Charter.—If the Director grants a revocation petition under subsection (c) with respect to a United States corporation, the Office shall revoke the charter of that corporation, which shall be effective beginning on the date that is 1 year after the date on which the Director grants the petition.

(e) Rulemaking.—The Director may issue any rules that are necessary to carry out this section.

SEC. 10. SEVERABILITY.

If any provision of this Act, or any application of that provision to any person or circumstance, is held to be invalid, the remainder of the provisions of this Act and the application of any such provision to any other person or circumstance shall not be affected.
Session 6: Structuring Transactions and Bankruptcy

We will start with some background material on debt and priority and then turn to how those issues are dealt with in bankruptcy.

Bank of America National Trust and Savings Ass’n v. 203 N. LaSalle Street Partnership

526 U.S. 434 (1999)

Justice SOUTER delivered the opinion of the Court: The issue in this Chapter 11 reorganization case is whether a debtor’s prebankruptcy equity holders may, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. We hold that old equity holders are disqualified from participating in such a “new value” transaction by the terms of 11 U.S.C. § 1129(b)(2)(B)(ii), which in such circumstances bars a junior interest holder’s receipt of any property on account of his prior interest.

1

Petitioner, Bank of America National Trust and Savings Association (Bank), is the major creditor of respondent, 203 North LaSalle Street Partnership (Debtor or Partnership), an Illinois real estate limited partnership. The Bank lent the Debtor some $93 million, secured by a nonrecourse first mortgage on the Debtor’s principal asset, 15 floors of an office building in downtown Chicago. In January 1995, the Debtor defaulted, and the Bank began foreclosure in a state court.

In March, the Debtor responded with a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101 et seq., which automatically stayed the foreclosure proceedings, see § 362(a). The Debtor’s principal objective was to ensure that its partners retained title to the property so as to avoid roughly $20 million in personal tax liabilities, which would fall due if the Bank foreclosed. The Debtor proceeded to propose a reorganization plan during the 120-day period when it alone had the right to do so, see 11 U.S.C. § 1121(b); see also § 1121(c) (exclusivity period extends to 180 days if the debtor files plan within the initial 120 days). The Bankruptcy Court rejected the Bank’s motion to terminate the period of exclusivity to make way for a plan of its own to liquidate the property, and instead extended the exclusivity period for cause shown, under § 1121(d).

The value of the mortgaged property was less than the balance due the Bank, which elected to divide its undersecured claim into secured and unsecured deficiency claims under § 506(a) and § 1111(b). Under the plan, the Debtor separately classified the Bank’s secured claim, its unsecured deficiency claim, and unsecured trade debt owed to other creditors. See § 1122(a).7 The Bankruptcy Court found that the Debtor’s available assets

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7 Indeed, the Seventh Circuit apparently requires separate classification of the deficiency claim of an undersecured creditor from other general unsecured claims. See In re Woodbrook Associates, 19 F.3d 312, 319 (1994). Nonetheless, the Bank argued that if its deficiency claim had been included in the class of general unsecured creditors, its vote against confirmation would have resulted in the plan’s rejection by that class. The Bankruptcy Court and the District Court rejected the contention that the classifications were gerrymandered to obtain requisite approval by a single class, and the Court of Appeals agreed. The Bank sought no review of that issue, which
were prepetition rents in a cash account of $3.1 million and the 15 floors of rental property worth $54.5 million. The secured claim was valued at the latter figure, leaving the Bank with an unsecured deficiency of $38.5 million.

So far as we need be concerned here, the Debtor’s plan had these further features:

1. The Bank’s $54.5 million secured claim would be paid in full between 7 and 10 years after the original 1995 repayment date.\(^8\)

2. The Bank’s $38.5 million unsecured deficiency claim would be discharged for an estimated 16% of its present value.\(^9\)

3. The remaining unsecured claims of $90,000, held by the outside trade creditors, would be paid in full, without interest, on the effective date of the plan.\(^{10}\)

4. Certain former partners of the Debtor would contribute $6.125 million in new capital over the course of five years (the contribution being worth some $4.1 million in present value), in exchange for the Partnership’s entire ownership of the reorganized debtor.

The last condition was an exclusive eligibility provision: the old equity holders were the only ones who could contribute new capital.\(^{11}\)

The Bank objected and, being the sole member of an impaired class of creditors, thereby blocked confirmation of the plan on a consensual basis. See §1129(a)(8).\(^{12}\) The Debtor, however, took the alternate route to confirmation of a reorganization plan, forthrightly known as the judicial “cramdown” process for imposing a plan on a dissenting class. §1129(b).

There are two conditions for a cramdown. First, all requirements of §1129(a) must be met (save for the plan’s acceptance by each impaired class of claims or interests, see §1129(a)(8)). Critical among them are the conditions that the plan be accepted by at least one class of impaired creditors, see §1129(a)(10), and satisfy the “best-interests-of-creditors” test, see §1129(a)(7).\(^{13}\) Here, the class of trade creditors with impaired unsecured claims voted for the plan,\(^{14}\) and there was no issue of best interest. Second, the objection is thus not before us.

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\(^8\) Payment consisted of a prompt cash payment of $1,149,500 and a secured, 7-year note, extendable at the Debtor’s option.

\(^9\) This expected yield was based upon the Bankruptcy Court’s projection that a sale or refinancing of the property on the 10th anniversary of the plan confirmation would produce a $19-million distribution to the Bank.

\(^{10}\) The Debtor originally owed $160,000 in unsecured trade debt. After filing for bankruptcy, the general partners purchased some of the trade claims. Upon confirmation, the insiders would waive all general unsecured claims they held.

\(^{11}\) The plan eliminated the interests of noncontributing partners. More than 60% of the Partnership interests would change hands on confirmation of the plan. The new Partnership, however, would consist solely of former partners, a feature critical to the preservation of the Partnership’s tax shelter.

\(^{12}\) A class of creditors accepts if a majority of the creditors and those holding two-thirds of the total dollar amount of the claims within that class vote to approve the plan. §1126(c).

\(^{13}\) Section 1129(a)(7) provides that if the holder of a claim impaired under a plan of reorganization has not accepted the plan, then such holder must “receive ... on account of such claim ... property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive ... if the debtor were liquidated under chapter 7 ... on such date.” The “best interests” test applies to individual creditors holding impaired claims, even if the class as a whole votes to accept the plan.

\(^{14}\) Claims are unimpaired if they retain all of their prepetition legal, equitable, and contractual rights against the debtor. §1124.
of an impaired creditor class may be overridden only if “the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.” § 1129(b)(1). As to a dissenting class of impaired unsecured creditors, such a plan may be found to be “fair and equitable” only if the allowed value of the claim is to be paid in full, § 1129(b)(2)(B)(i), or, in the alternative, if “the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property,” § 1129(b)(2)(B)(ii). That latter condition is the core of what is known as the “absolute priority rule.”

The absolute priority rule was the basis for the Bank’s position that the plan could not be confirmed as a cramdown. As the Bank read the rule, the plan was open to objection simply because certain old equity holders in the Debtor Partnership would receive property even though the Bank’s unsecured deficiency claim would not be paid in full. The Bankruptcy Court approved the plan nonetheless, and accordingly denied the Bank’s pending motion to convert the case to Chapter 7 liquidation, or to dismiss the case. The District Court affirmed, as did the Court of Appeals. ***

II

The terms “absolute priority rule” and “new value corollary” (or “exception”) are creatures of law antedating the current Bankruptcy Code, and to understand both those terms and the related but inexact language of the Code some history is helpful. The Bankruptcy Act preceding the Code contained no such provision as subsection (b)(2)(B)(ii), its subject having been addressed by two interpretive rules. The first was a specific gloss on the requirement of § 77B (and its successor, Chapter X) of the old Act, that any reorganization plan be “fair and equitable.” 11 U.S.C. § 205(e) (repealed 1938) (§ 77B); 11 U.S.C. § 621(2) (repealed 1979) (Chapter X). The reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor’s owners. Hence the pre-Code judicial response known as the absolute priority rule, that fairness and equity required that “the creditors ... be paid before the stockholders could retain [equity interests] for any purpose whatever.” Northern Pacific R. Co. v. Boyd, 228 U.S. 482, 508 (1913).

The second interpretive rule addressed the first. Its classic formulation occurred in Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939), in which the Court spoke through Justice Douglas in this dictum:

“It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor.... Where th[e] necessity [for new capital] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made....

“[W]e believe that to accord ‘the creditor his full right of priority against the corporate assets’ where the debtor is insolvent, the stockholder’s participation must be based on a contribution in money or in money’s worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.”

308 U.S., at 121-122.
*** Enactment of the Bankruptcy Code in place of the prior Act might have resolved the status of new value by a provision bearing its name or at least unmistakably couched in its terms, but the Congress chose not to avail itself of that opportunity. *** The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to “new value” in the phrase “on account of such junior claim,” the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.

III

Three basic interpretations have been suggested for the “on account of” modifier. The first reading is proposed by the Partnership, that “on account of” harks back to accounting practice and means something like “in exchange for,” or “in satisfaction of.” On this view, a plan would not violate the absolute priority rule unless the old equity holders received or retained property in exchange for the prior interest, without any significant new contribution; if substantial money passed from them as part of the deal, the prohibition of subsection (b)(2)(B)(ii) would not stand in the way, and whatever issues of fairness and equity there might otherwise be would not implicate the “on account of” modifier.

This position is beset with troubles, the first one being textual. Subsection (b)(2)(B)(ii) forbids not only receipt of property on account of the prior interest but its retention as well. See also §§ 1129(a)(7)(A)(ii), (a)(7)(B), (b)(2)(B)(i), (b)(2)(C)(i), (b)(2)(C)(ii). A common instance of the latter would be a debtor’s retention of an interest in the insolvent business reorganized under the plan. Yet it would be exceedingly odd to speak of “retain[ing]” property in exchange for the same property interest, and the eccentricity of such a reading is underscored by the fact that elsewhere in the Code the drafters chose to use the very phrase “in exchange for,” § 1123(a)(5)(J) (a plan shall provide adequate means for implementation, including “issuance of securities of the debtor ... for cash, for property, for existing securities, or in exchange for claims or interests”). It is unlikely that the drafters of legislation so long and minutely contemplated as the 1978 Bankruptcy Code would have used two distinctly different forms of words for the same purpose.

The second difficulty is practical: the unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if “on account of” meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds but permit one whenever substantial funds changed hands. “Substantial” or “significant” or “considerable” or like characterizations of a monetary contribution would measure it by the Lord Chancellor’s foot, and an absolute priority rule so variable would not be much of an absolute. Of course it is true (as already noted) that, even if old equity holders could displace the rule by adding some significant amount of cash to the deal, it would not follow that their plan would be entitled to adoption; a contested plan would still need to satisfy the overriding condition of fairness and equity. But that general fairness and equity criterion would apply in any event, and one comes back to the question why Congress would have bothered to add a separate priority rule without a sharper edge.

Since the “in exchange for “reading merits rejection, the way is open to recognize the more common understanding of “on account of “ to mean “because of.” This is certainly
the usage meant for the phrase at other places in the statute, see § 1111(b)(1)(A) (treat-
certain claims as if the holder of the claim “had recourse against the debtor on account of
such claim’’); § 522(d)(10)(E) (permitting debtors to exempt payments under certain ben-
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or be realizable money’s worth, just as Ahlers required for application of Case’s new value rule.

IV

Which of these positions is ultimately entitled to prevail is not to be decided here, however, for even on the latter view the Bank’s objection would require rejection of the plan at issue in this case. It is doomed, we can say without necessarily exhausting its flaws, by its provision for vesting equity in the reorganized business in the Debtor’s partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan. Although the Debtor’s exclusive opportunity to propose a plan under § 1121(b) is not itself “property” within the meaning of subsection (b)(2)(B)(ii), the respondent partnership in this case has taken advantage of this opportunity by proposing a plan under which the benefit of equity ownership may be obtained by no one but old equity partners. Upon the court’s approval of that plan, the partners were in the same position that they would have enjoyed had they exercised an exclusive option under the plan to buy the equity in the reorganized entity, or contracted to purchase it from a seller who had first agreed to deal with no one else. It is quite true that the escrow of the partners’ proposed investment eliminated any formal need to set out an express option or exclusive dealing provision in the plan itself, since the court’s approval that created the opportunity and the partners’ action to obtain its advantage were simultaneous. But before the Debtor’s plan was accepted no one else could propose an alternative one, and after its acceptance no one else could obtain equity in the reorganized entity. At the moment of the plan’s approval the Debtor’s partners necessarily enjoyed an exclusive opportunity that was in no economic sense distinguishable from the advantage of the exclusively entitled offeror or option holder. This opportunity should, first of all, be treated as an item of property in its own right. While it may be argued that the opportunity has no market value, being significant only to old equity holders owing to their potential tax liability, such an argument avails the Debtor nothing, for several reasons. It is to avoid just such arguments that the law is settled that any otherwise cognizable property interest must be treated as sufficiently valuable to be recognized under the Bankruptcy Code. Even aside from that rule, the assumption that no one but the Debtor’s partners might pay for such an opportunity would obviously support no inference that it is valueless, let alone that it should not be treated as property. And, finally, the source in the tax law of the opportunity’s value to the partners implies in no way that it lacks value to others. It might, indeed, be valuable to another precisely as a way to keep the Debtor from implementing a plan that would avoid a Chapter 7 liquidation.

Given that the opportunity is property of some value, the question arises why old equity alone should obtain it, not to mention at no cost whatever. The closest thing to an answer favorable to the Debtor is that the old equity partners would be given the opportunity in the expectation that in taking advantage of it they would add the stated purchase price to the estate. But this just begs the question why the opportunity should be exclusive to the old equity holders. If the price to be paid for the equity interest is the best obtainable, old equity does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain. There is no reason, that is, unless the very purpose of the whole transaction is, at
least in part, to do old equity a favor. And that, of course, is to say that old equity would obtain its opportunity, and the resulting benefit, because of old equity’s prior interest within the meaning of subsection (b)(2)(B)(ii). Hence it is that the exclusiveness of the opportunity, with its protection against the market’s scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners’ right a property interest extended “on account of” the old equity position and therefore subject to an unpaid senior creditor class’s objection.

It is no answer to this to say that the exclusive opportunity should be treated merely as a detail of the broader transaction that would follow its exercise, and that in this wider perspective no favoritism may be inferred, since the old equity partners would pay something, whereas no one else would pay anything. If this argument were to carry the day, of course, old equity could obtain a new property interest for a dime without being seen to receive anything on account of its old position. But even if we assume that old equity’s plan would not be confirmed without satisfying the judge that the purchase price was top dollar, there is a further reason here not to treat property consisting of an exclusive opportunity as subsumed within the total transaction proposed. On the interpretation assumed here, it would, of course, be a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar, but this it could not satisfactorily do when it would receive or retain its property under a plan giving it exclusive rights and in the absence of a competing plan of any sort. Under a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market. This is a point of some significance, since it was, after all, one of the Code’s innovations to narrow the occasions for courts to make valuation judgments, as shown by its preference for the supramajoritarian class creditor voting scheme in §1126(c). In the interest of statutory coherence, a like disfavor for decisions untested by competitive choice ought to extend to valuations in administering subsection (b)(2)(B)(ii) when some form of market valuation may be available to test the adequacy of an old equity holder’s proposed contribution.

Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of §1129(b)(2)(B)(ii).

The judgment of the Court of Appeals, accordingly, is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

In re Chrysler LLC
576 F.3d 108 (2nd Cir. 2009)
DENNIS JACOBS, Chief Judge: The Indiana State Police Pension Trust, the Indiana State Teachers Retirement Fund, and the Indiana Major Moves Construction Fund (collectively,
the “Indiana Pensioners” or “Pensioners”), along with various tort claimants and others, appeal from an order entered in the United States Bankruptcy Court for the Southern District of New York, Arthur J. Gonzalez, Bankruptcy Judge, dated June 1, 2009 (the “Sale Order”), authorizing the sale of substantially all of the debtor’s assets to New CarCo Acquisition LLC (“New Chrysler”). On June 2, 2009 we granted the Indiana Pensioners’ motion for a stay and for expedited appeal directly to this Court, pursuant to 28 U.S.C. § 158(d)(2). On June 5, 2009 we heard oral argument, and ruled from the bench and by written order, affirming the Sale Order “for the reasons stated in the opinions of Bankruptcy Judge Gonzalez,” stating that an opinion or opinions would follow. This is the opinion.

In a nutshell, Chrysler LLC and its related companies (hereinafter “Chrysler” or “debtor” or “Old Chrysler”) filed a pre-packaged bankruptcy petition under Chapter 11 on April 30, 2009. The filing followed months in which Chrysler experienced deepening losses, received billions in bailout funds from the Federal Government, searched for a merger partner, unsuccessfully sought additional government bailout funds for a stand-alone restructuring, and ultimately settled on an asset-sale transaction pursuant to 11 U.S.C. § 363 (the “Sale”), which was approved by the Sale Order. The key elements of the Sale were set forth in a Master Transaction Agreement dated as of April 30, 2009: substantially all of Chrysler’s operating assets (including manufacturing plants, brand names, certain dealer and supplier relationships, and much else) would be transferred to New Chrysler in exchange for New Chrysler’s assumption of certain liabilities and $2 billion in cash. Fiat S.p.A agreed to provide New Chrysler with certain fuel-efficient vehicle platforms, access to its worldwide distribution system, and new management that is experienced in turning around a failing auto company. Financing for the sale transaction—$6 billion in senior secured financing, and debtor-in-possession financing for 60 days in the amount of $4.96 billion—would come from the United States Treasury and from Export Development Canada. The agreement describing the United States Treasury’s commitment does not specify the source of the funds, but it is undisputed that prior funding came from the Troubled Asset Relief Program (“TARP”), 12 U.S.C. § 5211(a)(1), and that the parties expected the Sale to be financed through the use of TARP funds. Ownership of New Chrysler was to be distributed by membership interests, 55% of which go to an employee benefit entity created by the United Auto Workers union, 8% to the United States Treasury and 2% to Export Development Canada. Fiat, for its contributions, would immediately own 20% of the equity with rights to acquire more (up to 51%), contingent on payment in full of the debts owed to the United States Treasury and Export Development Canada.

At a hearing on May 5, 2009, the bankruptcy court approved the debtor’s proposed bidding procedures. No other bids were forthcoming. From May 27 to May 29, the bankruptcy court held hearings on whether to approve the Sale. Upon extensive findings of fact and conclusions of law, the bankruptcy court approved the Sale by order dated June 1, 2009.

After briefing and oral argument, we affirmed the bankruptcy court’s order on June 5, but we entered a short stay pending Supreme Court review. The Supreme Court, after an extension of the stay, declined a further extension. The Sale closed on June 10, 2009.

The factual and procedural background is set out in useful detail in the opinions of Bankruptcy Judge Gonzalez. This opinion is confined to a discussion of the arguments made
for vacatur or reversal. The Sale Order is challenged essentially on four grounds. First, it is contended that the sale of Chrysler’s auto-manufacturing assets, considered together with the associated intellectual property and (selected) dealership contractual rights, so closely approximates a final plan of reorganization that it constitutes an impermissible “sub rosa plan,” and therefore cannot be accomplished under § 363(b). We consider this question first, because a determination adverse to Chrysler would have required reversal. Second, we consider the argument by the Indiana Pensioners that the Sale impermissibly subordinates their interests as secured lenders and allows assets on which they have a lien to pass free of liens to other creditors and parties, in violation of § 363(f). We reject this argument on the ground that the secured lenders have consented to the Sale, as per § 363(f)(2). Third, the Indiana Pensioners challenge the constitutionality of the use of TARP funds to finance the Sale on a number of grounds, chiefly that the Secretary of the Treasury is using funds appropriated for relief of “financial institutions” to effect a bailout of an auto-manufacturer, and that this causes a constitutional injury to the Indiana Pensioners because the loss of their priorities in bankruptcy amounts to an economic injury that was caused or underwritten by TARP money. We conclude that the Indiana Pensioners lack standing to raise this challenge. Finally, we consider and reject the arguments advanced by present and future tort claimants. ***

I

The Indiana Pensioners characterize the Sale as an impermissible, sub rosa plan of reorganization. See Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983). As the Indiana Pensioners characterize it, the Sale transaction “is a ‘Sale’ in name only; upon consummation, new Chrysler will be old Chrysler in essentially every respect. It will be called ‘Chrysler.’... Its employees, including most management, will be retained.... It will manufacture and sell Chrysler and Dodge cars and minivans, Jeeps and Dodge Trucks.... The real substance of the transaction is the underlying reorganization it implements.” Indiana Pensioners’ Br. at 46 (citation omitted).

Section 363(b) of the Bankruptcy Code authorizes a Chapter 11 debtor-in-possession to use, sell, or lease estate property outside the ordinary course of business, requiring in most circumstances only that a movant provide notice and a hearing. 11 U.S.C. § 363(b).2 We have identified an “apparent conflict” between the expedient of a § 363(b) sale and the otherwise applicable features and safeguards of Chapter 11. Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983).

In Lionel, we consulted the history and purpose of § 363(b) to situate § 363(b) transactions within the overall structure of Chapter 11. The origin of § 363(b) is the Bankruptcy Act of 1867, which permitted a sale of a debtor’s assets when the estate or any part thereof was “of a perishable nature or liable to deteriorate in value.” Lionel, 722 F.2d at 1066 (citing Section 25 of the Bankruptcy Act of 1867, Act of March 2, 1867, 14 Stat. 517) (emphasis omitted). Typically, courts have approved § 363(b) sales to preserve “wasting asset[s].” Id. at 1068 (quoting Mintzer v. Joseph (In re Sire Plan, Inc.), 332 F.2d 497, 499 (2d Cir. 1964)). Most early transactions concerned perishable commodities; but the same practical necessity has been recognized in contexts other than fruits and vegetables. ***

2 The section provides: “The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate ....” 11 U.S.C. § 363(b)(1).
In the twenty-five years since *Lionel*, § 363(b) asset sales have become common practice in large-scale corporate bankruptcies. In the current economic crisis of 2008-09, § 363(b) sales have become even more useful and customary. 6

Resort to § 363(b) has been driven by efficiency, from the perspectives of sellers and buyers alike. The speed of the process can maximize asset value by sale of the debtor’s business as a going concern. Moreover, the assets are typically burnished (or “cleansed”) because (with certain limited exceptions) they are sold free and clear of liens, claims and liabilities. See infra (discussing § 363(f) and tort issues) A § 363 sale can often yield the highest price for the assets because the buyer can select the liabilities it will assume and purchase a business with cash flow (or the near prospect of it). Often, a secured creditor can “credit bid,” or take an ownership interest in the company by bidding a reduction in the debt the company owes. See 11 U.S.C. § 363(k) (allowing a secured creditor to credit bid at a § 363(b) sale).

This tendency has its critics. The objections are not to the quantity or percentage of assets being sold: it has long been understood *** that § 363(b) sales may encompass all or substantially all of a debtor’s assets. Rather, the thrust of criticism remains what it was in *Lionel*: fear that one class of creditors may strong-arm the debtor-in-possession, and bypass the requirements of Chapter 11 to cash out quickly at the expense of other stakeholders, in a proceeding that amounts to a reorganization in all but name, achieved by stealth and momentum.

As § 363(b) sales proliferate, the competing concerns identified in *Lionel* have become harder to manage. Debtors need flexibility and speed to preserve going concern value; yet one or more classes of creditors should not be able to nullify Chapter 11’s requirements. A balance is not easy to achieve, and is not aided by rigid rules and prescriptions. Lionel’s multi-factor analysis remains the proper, most comprehensive framework for judging the validity of § 363(b) transactions.

Adopting the Fifth Circuit’s wording in Braniff, 700 F.2d at 940, commentators and courts-including ours-have sometimes referred to improper § 363(b) transactions as “sub rosa plans of reorganization.” *** The term “sub rosa” is something of a misnomer. It bespeaks a covert or secret activity, whereas secrecy has nothing to do with a § 363 transaction. Transactions blessed by the bankruptcy courts are openly presented, considered, approved, and implemented. *Braniff* seems to have used “sub rosa” to describe transactions that treat the requirements of the Bankruptcy Code as something to be evaded or subverted. But even in that sense, the term is unhelpful. The sale of assets is permissible under § 363(b); and it is elementary that the more assets sold that way, the less will be left for a plan of reorganization, or for liquidation. But the size of the transaction, and the residuum of corporate assets, is, under our precedent, just one consideration for the exercise of discretion by the bankruptcy judge(s), along with an open-ended list of other salient factors.

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6 For instance, Lehman Brothers sold substantially all its assets to Barclays Capital within five days of filing for bankruptcy. Lehman Brothers filed for bankruptcy in the early morning hours of September 15, 2008. On September 20, 2008, the bankruptcy court approved the sale to Barclays of Lehman’s investment banking and capital markets operations, as well as supporting infrastructure including the Lehman headquarters in midtown Manhattan for $1.7 billion. See Bay Harbour Mgmt., L.C. v. Lehman Bros. Holdings Inc. (In re Lehman Bros. Holdings Inc.), No. 08-cv-8869(DLC), 2009 WL 667301, at *8 (2009) (affirming the § 363(b) sale order).
Braniff’s holding did not support the argument that a § 363(b) asset sale must be rejected simply because it is a sale of all or substantially all of a debtor’s assets. Thus a § 363(b) sale may well be a reorganization in effect without being the kind of plan rejected in Braniff. Although Lionel did not involve a contention that the proposed sale was a sub rosa or de facto reorganization, a bankruptcy court confronted with that allegation may approve or disapprove a § 363(b) transfer that is a sale of all or substantially all of a debtor’s assets, using the analysis set forth in Lionel in order to determine whether there was a good business reason for the sale.

The Indiana Pensioners argue that the Sale is a sub rosa plan chiefly because it gives value to unsecured creditors (i.e., in the form of the ownership interest in New Chrysler provided to the union benefit funds) without paying off secured debt in full, and without complying with the procedural requirements of Chapter 11. However, Bankruptcy Judge Gonzalez demonstrated proper solicitude for the priority between creditors and deemed it essential that the Sale in no way upset that priority. The lien holders’ security interests would attach to all proceeds of the Sale: “Not one penny of value of the Debtors’ assets is going to anyone other than the First-Lien Lenders.” Opinion Granting Debtor’s Motion Seeking Authority to Sell, May 31, 2009, (“Sale Opinion”) at 18. As Bankruptcy Judge Gonzalez found, all the equity stakes in New Chrysler were entirely attributable to new value—including governmental loans, new technology, and new management—which were not assets of the debtor’s estate.

The Indiana Pensioners’ arguments boil down to the complaint that the Sale does not pass the discretionary, multifarious Lionel test. The bankruptcy court’s findings constitute an adequate rebuttal. Applying the Lionel factors, Bankruptcy Judge Gonzalez found good business reasons for the Sale. The linchpin of his analysis was that the only possible alternative to the Sale was an immediate liquidation that would yield far less for the estate—and for the objectors. The court found that, notwithstanding Chrysler’s prolonged and well-publicized efforts to find a strategic partner or buyer, no other proposals were forthcoming. In the months leading up to Chrysler’s bankruptcy filing, and during the bankruptcy process itself, Chrysler executives circled the globe in search of a deal. But the Fiat transaction was the only offer available.

The Sale would yield $2 billion. According to expert testimony—not refuted by the objectors—an immediate liquidation of Chrysler as of May 20, 2009 would yield in the range of nothing to $800 million. The expert’s earlier estimates of liquidation value had been higher. For example, in early May 2009, the same expert opined that a liquidation might yield between nothing and $1.2 billion. But, from the beginning of May until the end, Chrysler expended $400 million in cash collateral.

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9 The transaction at hand is as good an illustration as any. “Old Chrysler” will simply transfer the $2 billion in proceeds to the first lien lenders, and then liquidate. The first lien lenders themselves will suffer a deficiency of some $4.9 billion, and everyone else will likely receive nothing from the liquidation. Thus the Sale has inevitable and enormous influence on any eventual plan of reorganization or liquidation. But it is not a “sub rosa plan” in the Braniff sense because it does not specifically “dictate,” or “arrange” ex ante, by contract, the terms of any subsequent plan.

12 The expert’s earlier estimates of liquidation value had been higher. For example, in early May 2009, the same expert opined that a liquidation might yield between nothing and $1.2 billion. But, from the beginning of May until the end, Chrysler expended $400 million in cash collateral.
had been shuttered, and the business was hemorrhaging cash. According to the bankruptcy court, Chrysler was losing going concern value of nearly $100 million each day.

On this record, and in light of the arguments made by the parties, the bankruptcy court’s approval of the Sale was no abuse of discretion. With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the melting ice cube. Going concern value was being reduced each passing day that it produced no cars, yet was obliged to pay rents, overhead, and salaries. Consistent with an underlying purpose of the Bankruptcy Code—maximizing the value of the bankrupt estate—it was no abuse of discretion to determine that the Sale prevented further, unnecessary losses.

The Indiana Pensioners exaggerate the extent to which New Chrysler will emerge from the Sale as the twin of Old Chrysler. New Chrysler may manufacture the same lines of cars but it will also make newer, smaller vehicles using Fiat technology that will become available as a result of the Sale—moreover, at the time of the proceedings, Old Chrysler was manufacturing no cars at all. New Chrysler will be run by a new Chief Executive Officer, who has experience in turning around failing auto companies. It may retain many of the same employees, but they will be working under new union contracts that contain a six-year no-strike provision. New Chrysler will still sell cars in some of its old dealerships in the United States, but it will also have new access to Fiat dealerships in the European market. Such transformative use of old and new assets is precisely what one would expect from the § 363(b) sale of a going concern.

II

The Indiana Pensioners next challenge the Sale Order’s release of all liens on Chrysler’s assets. In general, under § 363(f), assets sold pursuant to § 363(b) may be sold “free and clear of any interest” in the assets when, inter alia, the entity holding the interest consents to the sale. 11 U.S.C. § 363(f)(2). The bankruptcy court ruled that, although the Indiana Pensioners did not themselves consent to the release, consent was validly provided by the collateral trustee, who had authority to act on behalf of all first-lien credit holders.

We agree. Through a series of agreements, the Pensioners effectively ceded to an agent the power to consent to such a sale; the agent gave consent; and the Pensioners are bound. Accordingly, questions as to the status or preference of Chrysler’s secured debt are simply not presented in this case. ***

III

The Indiana Pensioners argue that the Secretary of the Treasury (“Secretary”) exceeded his statutory authority and violated the Constitution by using TARP money to finance the sale of Chrysler’s assets. Pensioners raise interesting and unresolved constitutional issues concerning the scope of the Secretary’s authority under TARP and the use of TARP money to bail out an automobile manufacturer. However, federal courts are constrained by our own constitutional limitations, including the non-waivable Article III requirement that we have jurisdiction over the case or controversy before us. We do not decide whether the Secretary’s actions were constitutional or permitted by statute, because we conclude that the Indiana Pensioners lack standing to raise the TARP issue, and that we lack jurisdiction in this case to entertain that challenge. ***
Finally, several objectors appeal from that portion of the Sale Order extinguishing all existing and future claims against New Chrysler, that “(a) arose prior to the Closing Date, (b) relate[ ] to the production of vehicles prior to the Closing Date or (c) otherwise [are] assertable against the Debtors or [are] related to the Purchased Assets prior to the closing date.” Sale Order at 40. The objectors can be divided into three groups: (1) plaintiffs with existing product liability claims against Chrysler; (2) plaintiffs with existing asbestos-related claims against Chrysler; and (3) lawyers undertaking to act on behalf of claimants who, although presently unknown and unidentified, might have claims in the future arising from Old Chrysler’s production of vehicles. We consider each group’s arguments in turn.

A. Existing Product Liability Claims

The Ad Hoc Committee of Consumer-Victims of Chrysler LLC and William Lovitz et al. challenge the foreclosing of New Chrysler’s liability for product defects in vehicles produced by Old Chrysler. Section 363(f) provides, in relevant part, that a “trustee may sell property ... free and clear of any interest in such property,” under certain circumstances. 11 U.S.C. § 363(f) (emphasis added). The objectors argue that personal injury claims are not “interests in property,” and that the district court’s reliance on In re Trans World Airlines, Inc., 322 F.3d 283 (3d Cir. 2003) (“TWA”), which advances a broad reading of “interests in property,” was misplaced.

We have never addressed the scope of the language “any interest in such property,” and the statute does not define the term. In TWA, the Third Circuit considered whether (1) employment discrimination claims and (2) a voucher program awarded to flight attendants in settlement of a class action constituted “interests” in property for purposes of § 363(f).

*** After surveying its own precedents and the Fourth Circuit’s decision in United Mine Workers of Am.1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.), 99 F.3d 573 (4th Cir. 1996), the TWA court held that “[w]hile the interests of the [plaintiffs] in the assets of TWA’s bankruptcy estate are not interests in property in the sense that they are not in rem interests, ... they are interests in property within the meaning of section 363(f) in the sense that they arise from the property being sold.” 322 F.3d at 290 (emphasis added).

Appellants argue that these decisions broadly construing the phrase “any interest in such property” fail to account for the language of 11 U.S.C. § 1141(c), a provision involving confirmed plans of reorganization. Section 1141(c) provides that “except as otherwise provided in the [reorganization] plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.” 11 U.S.C. § 1141(c) (emphasis added). Appellants argue that Congress must have intentionally included the word “claims”18 in § 1141(c), and omitted the word from § 363(f), because it was willing to extinguish tort claims in the reorganization context, but unwilling to do so

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18 The Bankruptcy Code defines “claim” as: (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured. 11 U.S.C. § 101(5).
in the § 363 sale context. Appellants account for this discrepancy on the basis that reorganization provides unsecured creditors procedural rights that are not assured in a § 363(b) sale.

We do not place such weight on the absence of the word “claims” in § 363(f). The language and structure of § 1141(c) and § 363(f) differ in many respects. Section 1141(c), for example, applies to all reorganization plans; § 363(f), in contrast, applies only to classes of property that satisfy one of five criteria. Thus, while § 363 sales do not afford many of the procedural safeguards of a reorganization, § 363(f) is limited to specific classes of property.

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We agree with TWA and Leckie that the term “any interest in property” encompasses those claims that “arise from the property being sold.” See TWA, 322 F.3d at 290. By analogy to Leckie (in which the relevant business was coal mining), “[appellants’] rights are grounded, at least in part, in the fact that [Old Chrysler’s] very assets have been employed for [automotive production] purposes: if Appellees had never elected to put their assets to use in the [automotive] industry, and had taken up business in an altogether different area, [appellants] would have no right to seek [damages].” Leckie, 99 F.3d at 582.

“To allow the claimants to assert successor liability claims against [the purchaser] while limiting other creditors’ recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code’s priority scheme.” TWA, 322 F.3d at 292. Appellants ignore this overarching principle and assume that tort claimants faced a choice between the Sale and an alternative arrangement that would have assured funding for their claims. But had appellants successfully blocked the Sale, they would have been unsecured creditors fighting for a share of extremely limited liquidation proceeds. Given the billions of dollars of outstanding secured claims against Old Chrysler, appellants would have fared no better had they prevailed.

The possibility of transferring assets free and clear of existing tort liability was a critical inducement to the Sale. As in TWA, “a sale of the assets of [Old Chrysler] at the expense of preserving successor liability claims was necessary in order to preserve some [55,000] jobs, ... and to provide funding for employee-related liabilities, including retirement benefits [for more than 106,000 retirees].” TWA, 322 F.3d at 293; see also Sale Opinion at 3.

It is the transfer of Old Chrysler’s tangible and intellectual property to New Chrysler that could lead to successor liability (where applicable under state law) in the absence of the Sale Order’s liability provisions. Because appellants’ claims arose from Old Chrysler’s property, § 363(f) permitted the bankruptcy court to authorize the Sale free and clear of appellants’ interest in the property.

B. Asbestos Claims

On behalf of herself and others with outstanding or potential claims against Old Chrysler resulting from exposure to asbestos, Patricia Pascale argues that the Sale Order improperly grants New Chrysler immunity without assuring compliance with 11 U.S.C. § 524(g).

Section 524(g) *** authorizes the court “to enjoin entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any [asbestos-related] claim or demand.” 11 U.S.C. § 524(g)(1)(B). To obtain relief under § 524(g), a debtor must “[c]hannel [ ] asbestos-related claims to a personal injury trust [to] relieve[ ] the debtor of the uncertainty of future asbestos liabilities.”
In re Combustion Eng’g, Inc., 391 F.3d 190, 234 (3d Cir. 2004). Injunctions granting relief under this provision are subject to numerous requirements and conditions. See 11 U.S.C. § 524(g)(2)(B); Combustion Eng’g, 391 F.3d at 234 & n. 45.

By its terms, however, § 524(g) applies only to “a court that enters an order confirming a plan of reorganization under chapter 11.” 11 U.S.C. § 524(g)(1)(A). Sections I and II of this opinion conclude that the Sale was proper under § 363. That determination forecloses the application of § 524(g) because there is no plan of reorganization as yet. Moreover, the bankruptcy court in this case did not issue an injunction, as is permitted by § 524(g)(1)(B), and the debtor did not establish a trust subsuming its asbestos liability. Accordingly, there is no merit to Pascale’s argument that the Sale Order violates § 524(g).

C. Future Claims
The Sale Order extinguished the right to pursue claims “on any theory of successor or transferee liability, whether known or unknown as of the Closing, now existing or hereafter arising, asserted or unasserted, fixed or contingent, liquidated or unliquidated.” Sale Order at 40-41. This provision is challenged on the grounds that: (1) the Sale Order violates the due process rights of future claimants by extinguishing claims without providing notice; (2) a bankruptcy court is not empowered to trump state successor liability law; (3) future, unidentified claimants with unquantifiable interests could not be compelled “to accept a money satisfaction,” 11 U.S.C. § 363(f)(5); and (4) future causes of action by unidentified plaintiffs based on unknown events cannot be classified as “claims” under the Bankruptcy Code.

We affirm this aspect of the bankruptcy court’s decision insofar as it constituted a valid exercise of authority under the Bankruptcy Code. However, we decline to delineate the scope of the bankruptcy court’s authority to extinguish future claims, until such time as we are presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the Sale, and that is cognizable under state successor liability law.

CONCLUSION

We have considered all of the objectors-appellants’ contentions on these appeals and have found them to be without merit. For the foregoing reasons, we affirm the June 1, 2009 order of the bankruptcy court authorizing the Sale.