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FTC's Challenge to Altria-JUUL Transaction: Antitrust and Constitutional Issues Hiding in Plain Sight

by Steven Cernak

Antitrust and the constitutional aspects of administrative law have been much in the news lately. When the FTC challenges a merger or the Supreme Court rules on the powers of an executive branch agency, these issues are in the headlines. But too often, these cases and the important issues they raise fade from attention with changes in the news cycle as we focus on the next outrage.

Such is the case with the FTC's challenge of Altria Group's proposed minority investment in JUUL Labs, Inc. (JLI). When the FTC first challenged the transaction in April 2020, the matter made plenty of headlines in both the mainstream media and the competition law press. Since then, a few reports have covered the latest developments but have missed the important, sometimes unusual, issues the matter has ended up raising: When can an anticompetitive agreement be reached before the official merger documents have been signed? Non-compete agreements have been pilloried lately but are they anticompetitive even in a partial merger situation like this one? And, not to bury the lede, but are the structure and processes of the FTC even constitutional?

This LEGAL BACKGROUNDER summarizes those issues and more as the September 12, 2022 oral arguments in front of the Commissioners loom.

The Parties and the Transaction

Altria, together with its subsidiaries, is the largest and one of the oldest cigarette companies in the U.S. During the relevant time, its products included e-cigarettes. JLI is a smaller, newer company focused only on e-cigarettes.

As with most antitrust matters, especially merger investigations, market definition was contentious. Generally, e-cigarettes are electronic devices that, as the consumer puffs, aerosolize nicotine-containing liquid using heat generated by a battery. Open system e-cigarettes contain a reservoir that a consumer can refill with a nicotine-containing liquid of their choosing. Closed system e-cigarettes have a container that already contains that liquid. Closed systems include cig-a-likes, which mimic the shape and look of a traditional cigarette, as well as pod products that have various shapes, including a shape like a USB thumb drive.

The e-cigarette category started to grow rapidly about ten years ago as a handful of competitors offered different varieties. Altria offered cig-a-like products and then pod products. JLI offered only pod products. By the time of the challenged transaction, pods had become the dominant choice of consumers and JLI's product was the market leader.

While sales of pods, especially JLI's pods, were growing considerably at the end of 2017, Altria was only selling cig-a-likes and their sales were cratering. For regulatory reasons, Altria could not develop its own pod product in a reasonable timeframe and so looked to acquire an existing pod product. In late 2017, it licensed the rights to a Chinese pod product and rushed it to market in early 2018. Unfortunately, the initial sales results were bad, perhaps because of early quality issues. Later that year, Altria also determined that none of its e-cigarette

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products had the right amount of nicotine salts in them to provide consumers with the desired cigarette-like effect. Again, development of a new formula and receipt of necessary regulatory approval would take years, at best.

In early 2018, Altria approached JLI about an acquisition. The initial negotiations were difficult, but the parties began to explore a transaction in which Altria purchased only a part of JLI. As early as April 2018, the parties agreed that their respective antitrust counsel would need to develop a plan to obtain approval, "including the treatment of any competitive products owned by Altria."

By the end of July, the up-and-down negotiations were starting to coalesce around a multi-billion dollar investment by Altria in exchange for a minority interest in JLI, perhaps initially a non-voting interest convertible to voting after antitrust clearance. (An acquisition of non-voting securities does not require Hart-Scott-Rodino approval; conversion of such securities does.) While the parties remained far apart on the economic terms of a deal, they began to discuss two other items that would lead to the FTC's challenge of the eventual transaction.

The first, ironically, was the steps the parties would need to take to obtain antitrust clearance for the entire transaction. The term sheet negotiated by the parties envisioned cooperation with the FTC and agreement to any "concessionary requirements of the FTC" related to Altria's e-cigarette business. Specifically, the parties agreed that Altria would "divest (or if divestiture is not reasonably practicable, contribute at no cost to [JLI] and if such contribution is not reasonably practicable, then cease to operate") Altria's e-cigarette business. Because Altria would be privy to important JLI information as a major shareholder, JLI did not want Altria to be competing with it. Later, JLI's executives testified that they expected the FTC to oversee this process.

Second, in exchange for Altria aiding JLI in regulatory matters, Altria would agree to not compete with JLI's e-cigarette products. Again, JLI was concerned that Altria's access to sensitive JLI information while performing these services would allow Altria to improve its current e-cigarette products (before divestiture) or develop better new ones.

While haggling over financial considerations and Altria's voting rights, the parties continued to refine these two items. In subsequent term sheets, the requirement that Altria "cease to operate" its e-cigarette assets disappeared while the requirement that Altria either contribute those assets to JLI or divest them remained. According to the term sheets and later testimony, those moves by Altria were supposed to happen as part of antitrust clearance. The key point seemed to be that once Altria had rights to confidential JLI competitive information, it would not compete with JLI.

In early September, negotiations broke down. At that same time, the parties and other e-cigarette suppliers received a letter from the FDA complaining about use of their products by youth and asking them to take "bold action" to stop it. Later that month, Altria decided to discontinue selling its underperforming pod products and the cig-a-likes that appealed to youth. By October, it had re-engaged with JLI and was pursuing a transaction and development of new products on parallel paths.

Negotiations in October went much more smoothly as Altria came around to terms much closer to JLI's proposals. Simultaneously, Altria told the FDA, then the public, about its earlier decision to partially withdraw from the e-cigarette market. JLI was not happy to hear that announcement, thinking that it implicitly condemned JLI's products as contributing to youth use of pod products and complicated any antitrust review of the transaction. Still, the parties continued negotiating and started due diligence and document drafting. In early December, Altria announced that it was pulling its remaining e-cigarette products from the market, allegedly to conserve costs for product development or to invest in JLI. Later in December, the parties reached an agreement. Later, Altria ceased its other e-cigarette development efforts.

The Challenge and Initial Decision

On April 20, 2020, the FTC issued a two-count administrative complaint against the parties. Count I alleged an unreasonable agreement by which Altria agreed not to compete with JLI in the e-cigarette market "now or in the future" in exchange for the ownership interest in JLI. Specifically, that agreement took the form of the non-compete provisions of the written agreement as well as an agreement to exit the market reached during

negotiations as a "condition for any deal." Count II alleged that the transaction, including the agreed upon market exit by Altria and the written non-compete provisions, violated Clayton Act Section 7's prohibition of mergers that "substantially lessen competition" in the relevant market.

As per the FTC's usual procedures, the administrative complaint was first heard by an FTC administrative law judge. After substantial pre- and post-trial briefing and thirteen days of hearing in June 2021, the ALJ dismissed the complaint in an initial decision issued in February 2022. The FTC's complaint counsel immediately appealed to the Commissioners.

In the Initial Decision, the ALJ went through the usual market definition analysis and agreed with the FTC complaint counsel that the appropriate product market was the closed system e-cigarettes, both cig-a-likes and pod-based products. That was about the last time the ALJ agreed with complaint counsel.

The ALJ dismissed the Sherman Act Section 1 count, finding insufficient evidence of an agreement between the parties to have Altria exit the e-cigarette market in return for entering the transaction. The ALJ found complaint counsel's focus on some, but not all, of the draft term sheet language to be "highly circumstantial." The parties rebutted any negative inferences with alternative explanations for the removal of the products supported by "substantial, credible evidence, including contemporaneous documents."

Similarly, the ALJ dismissed both the Sherman Act Section 1 claim and Clayton Act Section 7 claim by finding that the non-compete provision did not unreasonably restrain competition and the minority investment was not reasonably likely to substantially harm competition in the e-cigarette market. The ALJ accepted complaint counsel's expert's calculation of Altria's share of the market just before it exited the market; however, he found that that share had been dropping and so overstated Altria's likely competitive significance in the market going forward. The ALJ also rejected that expert's estimate of the disposition of Altria's customers after it left the market, instead crediting the actual diversion that occurred. As a result, the ALJ estimated that the change in concentration after the transaction was small. Because Altria was not likely to be an effective actual or potential competitor even if the transaction did not occur, the ALJ found that the transaction did not substantially harm competition.

Antitrust Issues on Appeal

The case tees up several interesting antitrust issues for the FTC Commissioners to consider. As in any Section 1 case, the question of agreement is key: Does this combination of communication followed by action add up to an agreement? Unusual here is the context for the communications — negotiations specifically designed to reach an agreement that ultimately were successful. Even more important, some of the communications that complaint counsel most suspects are the preparations for FTC review of potential anticompetitive aspects of the deal and remedies for them. Enforcers have explicitly told parties to prepare such remedies in such situations. If such discussions can lead to successful allegations of illegal agreements, merger negotiators will need some guidance on how to safely do their jobs.

The Commissioners also must opine on a couple issues that have been in the antitrust news lately. In merger cases, how strong is the structural presumption? Here, the market shares as measured by complaint counsel's expert were high enough to trigger a presumption that would block the deal. The initial decision had some issues with the timing of those measurements, but its bigger objection was that those backward-looking shares said very little about future competition. Will Commissioners who have championed the strength of such presumptions agree?

Non-compete agreements have come under increasing scrutiny recently. But the history of such agreements being found reasonable in the merger context, if narrowly tailored, predates the Clayton Act. Can enforcers dead-set against them in other contexts accept them in a merger context? In *this* merger context?

Of course, the biggest antitrust issue is a most basic one for the FTC, one that the parties made sure to put in the opening sentence of their answering brief to the Commissioners: In the past 25 years, the Commission has not ruled against a complaint it voted to authorize. That enviable winning streak has generated complaints,

even legal challenges, insisting that the FTC's processes are not fair to parties. So here, after a 250+ page opinion and finding of facts by a respected ALJ based on 20 witnesses, 2400 exhibits, and extensive briefing, will the Commission affirm the initial decision to demonstrate that it has not "rigged the rules" to always win? Or will they overturn it and keep the winning streak alive?

Constitutional and Administrative Law Issues on Appeal

That final antitrust issue dovetails with multiple constitutional issues. The parties raised them in their initial arguments. The ALJ noted but otherwise ignored them. In their briefing to the Commissioners, the parties again raise them, completely though succinctly. Depending on the timing of decisions in this case and others, these are the arguments that might make even non-antitrust lawyers remember this case.

The parties challenge the entire FTC enforcement regime by raising issues of separation of powers and due process. First, the parties point out that Commissioners are removable only for "inefficiency, neglect of duty, or malfeasance." That restriction allegedly violates Article II of the Constitution, which vests all executive power in the President and requires that he or she be able to remove any executive officers. Decades-old precedent grants an exception to multi-member agency heads that do not exercise executive powers, as the FTC was described years ago. The parties assert that the precedent might no longer be good law and, in any event, the FTC clearly exercises executive power now.

Second, the U.S. dual agency enforcement of antitrust law violates the parties' due process rights. DOJ-led matters go directly to federal courts and are judged under one standard. FTC-led matters could go to federal courts or the FTC's ALJ at the FTC's choice. Any FTC matters that directly or eventually reach federal courts are judged under a slightly different standard. And the government's choice of FTC or DOJ as the lead agency is an arbitrary black box, in extreme cases coming down to a coin toss. That arbitrary choice of process and standard allegedly violates a defendant's due process rights.

Finally, the FTC serves as prosecutor, judge, and jury for any FTC case, from initiating the case to prosecuting and ultimately deciding it before any appeal to a federal court. The Commissioners do not even have to defer to any factfinding by the ALJ who conducted the trial. All these steps lead to concerns about actual bias and prejudgment of the merits. The FTC's 25-year record of ultimately supporting every case it initiated seems to support the parties' assertion of impermissible bias.

The parties here are not the first to raise these types of issues about independent agencies in general or the FTC in particular. For instance, Axon Enterprise was about to be challenged by the FTC in an administrative proceeding when it raised similar issues in its own federal court case. Both the lower court and Ninth Circuit dismissed Axon's claims on the basis that the legislation creating the FTC gave federal courts jurisdiction only to review matters and only after the FTC had reached a decision on the merits. Axon successfully sought Supreme Court review and in early November the Court will hear arguments about if, and, if so, when Axon can raise these constitutional issues about the FTC.

The upshot is that it is conceivable that the substance of any constitutional challenge to the FTC's structure and processes might be heard first by a federal court in the JLI/Altria matter, not the Axon matter. The Commission will hear oral argument in the JLI/Altria case in September and would be scheduled to issue an opinion by around year-end. If they overturn the initial decision, the parties can immediately appeal to any appellate circuit court and start the briefing process shortly thereafter. The Court, on the other hand, will hear oral argument in the Axon case two months later in early November. Because any opinion from the Court likely will not be issued until early to mid-2023, any ruling and remand for Axon likely will put it well behind any appeal of the JLI/Altria case. So those interested in these constitutional challenges need to pay attention to the JLI/Altria case as well as Axon. Some of the most interested observers of that November Axon argument could be the Commissioners themselves.

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Whether you are interested in antitrust or administrative law, now is the time to anticipate the headlines and again pay attention to e-cigarettes and this case.

