



American University Washington College of Law

From the Selected Works of Jonathan B. Baker

November 15, 2013

Procaps S.A. v. Patheon Inc.: Expert report

Jonathan B. Baker



Available at: https://works.bepress.com/jonathan_baker/196/

EXHIBIT B

Exhibit to Deposition of Jonathan Baker

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
MIAMI DIVISION

PROCAPS S.A.,

Plaintiff,

V.

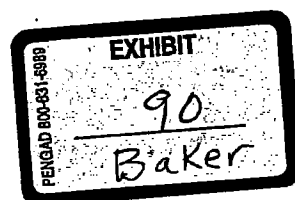
PATHEON INC., et al.,

Defendants.

Case No. 1:12-cv-24356-DLG

EXPERT REPORT OF JONATHAN BAKER.

NOVEMBER 15, 2013



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II. Summary of Conclusions

15. I conclude that Procaps was not harmed by virtue of any aspect of Patheon's conduct that Procaps alleges harmed competition. As explained below, under Procaps' theory of how competition in the softgel marketplace was harmed, the competitive problem stems from the removal of Banner as an independent bidder. But under Procaps' theory explaining why Procaps itself was injured, its injury comes from the cessation of the collaboration between Procaps and Patheon. The injuries that Procaps claims to have suffered do not flow from the mechanism by which Procaps claims competition was harmed.
16. I also conclude that the collaboration between Patheon and Procaps had the potential to promote competition, and that its exclusivity provisions were likely to promote competition by giving the parties to the collaboration incentives to work together.
17. I further conclude that Patheon's conduct in acquiring Banner, against the backdrop of its collaboration with Procaps (as memorialized in the collaboration agreement) could not plausibly harm competition in either of the markets in which I analyzed its likely effects: contract development and manufacturing of prescription softgels for sale in the U.S., and contract development and manufacturing of non-prescription softgels for sale in the U.S. by the ten buyers specified in an amendment to the collaboration agreement.
18. The collaboration's trivial market share in both markets means that it is implausible that a hypothetical acquisition of Banner by the collaboration as a whole would harm competition, and thus unlikely that the acquisition by one member of the collaboration alone (Patheon) would do so. Banner's low market share or limited competitive significance in those markets further suggests that harm to competition was highly unlikely.
19. Even if market participants could somehow overcome the nearly insurmountable problems to coordinating, including identifying consensus terms of coordination and deterring cheating, the collaboration's limited market presence makes it implausible that Patheon's acquisition of Banner would make a difference to the ability of market participants to coordinate. The collaboration's trivial market share and pre-

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softgel development and manufacturing business geographically included its substantial softgel manufacturing capability in South America; its regulatory experience from obtaining FDA approval for one proprietary prescription pharmaceutical product;³² its technological expertise in formulating and manufacturing softgel products, including for food supplement clients in the U.S.;³³ and its intellectual property in softgel technologies.³⁴ Procaps also was marketing proprietary nutritional softgels in the U.S.

45. Procaps' efforts to compete in pharmaceutical development and contract manufacturing in the U.S. before its collaboration with Patheon were not successful.³⁵ Procaps' ability to succeed was circumscribed because its U.S. sales force was small and its prescription drug business with U.S. pharmaceutical firms focused on their South American operations.³⁶ It had no experience with the development and commercial manufacturing of softgel prescription products for sale in the U.S.³⁷ In addition, its manufacturing location, in Colombia, was unattractive for some U.S.-based customers.³⁸
46. Patheon and Procaps entered into a collaboration agreement on January 10, 2012.³⁹ They amended the agreement twice, the first time within a month and the second four months after the collaboration began.⁴⁰ The collaboration was established "for the development and marketing of a branded soft gel capsule service for pharmaceutical products," including "outsourced pharmaceutical development,

³² Deposition of Alvaro Franco (Nov. 6, 2013) at 39, 88, 325. See Procaps Group (PAT00071221) at 1226, 1228.

³³ Deposition of Ruben Minski (Nov. 4, 2013) at 129, 158.

³⁴ See Email from Michael Lyttton (June 18, 2011) (PAT00001135) (describing reasons that Patheon saw "the potential for a 'win win' collaboration"); Procaps SWOT (July 22, 2011) (PAT00071620 at 2) (Procaps' strengths include, among others, vertical integration into gelatin production, intellectual property in product formulation and manufacturing, development and regulatory expertise, and manufacturing facilities).

³⁵ Deposition of Alvaro Franco (Nov. 6, 2013) at 21, 25, 186.

³⁶ See Procaps Visit, 11/21-11/23/11 (PAT00071460) ("despite a US facility in Miami, Procaps has no direct sales capability in the US, Europe or Asia"); cf. Deposition of Alvaro Franco (Nov. 6, 2013) at 21 (noting lack of connections with the pharmaceutical industry in the U.S.).

³⁷ See Deposition of Ruben Minski (Nov. 4, 2013) at 136-37 (attributing Procaps' lack of success in the U.S. in part to customer lack of knowledge of the firm).

³⁸ Deposition of Ruben Minski (Nov. 4, 2013) at 114, 136; Deposition of Alvaro Franco (Nov. 6, 2013) at 73.

³⁹ Collaboration Agreement (Jan. 10, 2012) (PAT00050169)

⁴⁰ Addendum to Collaboration Agreement (Feb. 1, 2012) (PROCAPS-00001692); Addendum No. 2 to Collaboration Agreement (May 7, 2012) (PAT00129139).

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clinical supply and commercial production of soft gel capsules and related services” (i.e. contract development and manufacturing of softgels).⁴¹

47. The collaboration was formed to develop and manufacture of softgel capsules for pharmaceutical products. It was initially limited to pharmaceutical development and contract manufacturing for prescription softgels; prescription pharmaceuticals were termed the collaboration’s “field.”⁴² The field was later expanded by amendment to include non-prescription softgels for ten specific pharmaceutical companies.⁴³ Over-the-counter and nutritional softgel products for other customers, as well as internal development projects, were excluded.⁴⁴

48. The collaboration agreement assigned commercial manufacturing activities to Procaps, marketing efforts to Patheon (with cooperation from Procaps required), and development and clinical supply activities to both (divided between the collaborators project-by-project by mutual agreement).⁴⁵ The agreement required Patheon to obtain Procaps’ approval before expanding its existing capacity to manufacture softgel capsules for products that would be covered by the agreement, but did not limit Patheon’s ability to expand capacity to produce softgel capsules for outside the agreement’s field and territory.⁴⁶ In addition, the agreement included limitations on the use and disclosure of confidential information shared by the collaborators.⁴⁷

49. While the collaboration agreement contemplated that Patheon and Procaps would generally pursue softgel development and manufacturing in the field and territory of the collaboration only through the collaboration,⁴⁸ it carved out several types of products and activities. The agreement allowed Patheon and Procaps, each “in its

⁴¹ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§2.1, 1.19 (defining soft gel branded services), 1.10 (defining field).

⁴² Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§1.10 (defining field).

⁴³ Addendum No. 2 to Collaboration Agreement (May 7, 2012) (PAT00129139) (expanding field for Abbott Laboratories, Bayer, Boehringer Ingelheim, Johnson & Johnson, Takeda, Pfizer, Watson, Mylan, Actavis, and Endo); see P-Gels Joint Steering Committee Meeting (March 1, 2012) (PAT00001886) (deciding to include in the collaboration the over-the-counter businesses for key prescription drug customers).

⁴⁴ See Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§1.8, 1.11, 1.19, 1.20.

⁴⁵ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§2.3, 3.1, 3.2.

⁴⁶ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §10.3. See also Deposition of Ruben Minski (Nov. 4, 2013) at 191-92 (provision concerning Patheon’s capacity expansion was sought by Procaps and intended to prevent Patheon from competing with Procaps).

⁴⁷ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§7.1-7.6.

⁴⁸ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§10.1, 10.2.

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sole discretion,” to pursue softgel product development for its own proprietary pharmaceutical products that that the firm would submit for regulatory approval, after notice to the other firm.⁴⁹ The agreement also excluded certain specified products of each firm from the “field” of the collaboration, including some specifically sold in the United States,⁵⁰ and it excluded certain countries from the “territory” of the collaboration, mainly in Central and South America where Procaps had a large presence.⁵¹

50. The parties agreed to meet periodically and to renegotiate certain provisions of the collaboration if specified performance objectives were not met.⁵² They also agreed that if a party acquired a company that competed with the collaboration in its field and territory, that party would, within six months, divest the portion of the acquired firm that competed with the collaboration or bring the overlapping business into the collaboration.⁵³

51. The parties agreed to split collaboration revenues. For example, if a new project within the collaboration’s field and territory was marketed by Patheon and if Procaps undertook both product development and manufacturing, the collaboration agreement provided that Patheon would receive 18% of project revenues (less returns, refunds, freight charges, and other similar customary deductions), and Procaps would receive the remainder.⁵⁴ Patheon and Procaps would jointly approve the price at which the collaboration would offer its services to each such customer.⁵⁵ In practice this meant that the collaboration would often approach pricing by starting with a figure from Procaps, which Procaps typically computed by marking up its estimated costs. Initially, Procaps often marked up its costs by 40% before

⁴⁹ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§1.11 (definition of internal development project), 3.5 (co-development projects).

⁵⁰ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) Exhibits 1.7 & 1.8.

⁵¹ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §1.9 & Exhibit 1.9.

⁵² Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §2.8 (b).

⁵³ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §10.4 (b).

⁵⁴ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§1.4 (credits), 1.14 (net revenue), 5.1(a) (net revenue sharing for development and clinical supply), 5.1(b) (net revenue sharing for commercial manufacturing).

⁵⁵ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§2.4 (a), 2.4 (b).

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B. Market Participants and Market Concentration

75. In 2011, the year before the collaboration began, at least nine firms participated in the market for contract development and manufacturing of prescription softgels in the U.S.: Accucaps, Aenova, Banner, Capsugel, Catalent, International Vitamin, Patheon, Pharmaceuticals International, Inc. (Pii), and Procaps. All of these firms had FDA approval for some product and were earning revenues in the market or were soliciting business.⁹⁰ Other firms may also have participated in this market, given that in 2010, Patheon identified 23 that had received regulatory approval to produce some softgel product from the FDA or any European Union regulatory body.⁹¹
76. The estimates of market shares, set forth in Table 1 below, are based on the number of prescription softgels (in units) manufactured for sale in the U.S. during 2011. Sales for Patheon and Banner were supplied by Patheon based on internal business records.⁹² (The Banner figures exclude prescription softgels manufactured by Banner for proprietary distribution.) Sales for the other firms are derived primarily from information presented by McKinsey when advising Patheon on the Banner acquisition.⁹³
77. I understand that the underlying data, from Phast, came from sampling retail outlets for prescription drugs in the U.S.⁹⁴ The McKinsey information implies a higher unit sales figure for Banner than Banner reported, in part because it does not exclude prescription softgels manufactured by Banner for proprietary distribution. Although the shares in Table 1 are based on the best quantitative information available, they likely understate Catalent's share and overstate the shares for all other firms insofar

⁹⁰ See Soft Gel Commercial Evaluation Implications for Patheon (May 27, 2010) (PAT00126617) at 19-81 (discussing the business of various firms other than Catalent, Capsugel and Patheon). Cf. U.S. Department of Justice & Federal Trade Commission, Horizontal Merger Guidelines §5.2 (2010) (market participants include firms earning revenues, vertically integrated firms to the extent their inclusion accurately reflects their competitive significances, and rapid entrants able to supply in the market quickly and with little additional sunk expenditures).

⁹¹ See Soft Gel Commercial Evaluation Implications for Patheon (May 27, 2010) (PAT00126617) at 7 (identifying firms).

⁹² See Banner's historical sales 2010-2013 July YTD (PAT00194434).

⁹³ See Project Audi: Products and Market Analysis (PAT00057721) at 12.

⁹⁴ I did not rely upon the revenue data available from the same sources because the Phast data set reports retail revenues, which are not a reliable indicator of revenues from the contract development and manufacturing of softgel products.

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collaboration, when entered into, meant that only one entity would be seeking softgel contract development and manufacturing work where formerly there were two, the limited prospects of each firm on its own meant that their combination did not threaten to harm competition in either market.

82. I conclude that the collaboration had the potential to enhance competition, including with Catalent (the leading firm).¹⁰⁰ Procaps and Patheon each had strong capabilities for softgel development and manufacturing in areas where its collaborator was weak,¹⁰¹ making it possible that the firms could work more effectively together than either firm would be able to on its own.¹⁰² Although the collaboration had little success when operating, its creation enhanced competition.¹⁰³

83. The collaboration agreement incorporated exclusivity provisions to provide incentives for the parties to work together in order to make the collaboration work. These included the provisions preventing Patheon and Procaps from pursuing opportunities that would fall within the collaboration's field and territory on their own, outside the collaboration;¹⁰⁴ the provision requiring Patheon to obtain Procaps' approval before expanding its existing manufacturing capacity; and the provision requiring that a party must bring the competitive portion of an acquisition within the collaboration, or divest it, within six months.¹⁰⁵ Exclusivity provisions are routinely found in joint venture agreements and are often necessary for joint ventures to work,

¹⁰⁰ See Email from Eric McCafferty (Jan. 19, 2012) (PAT00001055) ("Since I heard about this from the start, I thought [the collaboration] was a good idea and will fill a core capability gap in our offering. . . I truly believe that this can be very disruptive to Catalent for which this represents a major portion of their revenue stream. . . We might also think about going head to head in marketing against Catalent once we have some customer case examples on why Patheon soft gel is just as good, but cheaper!").

¹⁰¹ BCX—4161 Softgels: Development → Commercialization (PAT00028001) at 4 (the partnership between Patheon and Procaps "Combines Patheon's depth and breadth of development services, and customer access, with Procap's world-class softgel expertise"); Procaps/Patheon Soft Gel Collaboration (June 17, 2011) (PAT00001136) at 8-9 (collaboration combines Patheon's customer relationships and marketing organization, and development expertise, with Procaps's commercial softgel manufacturing expertise and experience); Collaboration Agreement (Jan. 10, 2012) (PAT00050169) (Recitals) (collaboration combines Patheon's "substantial resources and expertise in outsourced pharmaceutical development services and commercial manufacturing services and relationships with pharmaceutical companies" with Procaps' "substantial resources and expertise in the development and manufacture of soft gel capsules, including ownership of manufacturing facilities with capability and capacity in South America for the production of soft gel capsules for prescription pharmaceutical products"). See also *supra* ¶¶ 43, 45.

¹⁰² See Email from Michael Lyton (June 18, 2011) (PAT00001135) (describing Procaps' proprietary technologies, commercial manufacturing capability, and network in Latin America).

¹⁰³ See Complaint at ¶7.

¹⁰⁴ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §§10.1, 10.2.

¹⁰⁵ Collaboration Agreement (Jan. 10, 2012) (PAT00050169) §10.4 (b).

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because they help align the incentives of the parties to a collaboration in order to promote its goals and help prevent free riding, which could undermine the collaboration. As a consequence, they commonly foster competition despite appearing, on their face, to limit competition. In this case, Patheon and Procaps would not have a strong incentive to make the collaboration work unless it was the sole vehicle by which each competed within the collaboration's field and territory.¹⁰⁶ For that reason, the exclusivity provisions in the collaboration agreement were likely needed for the collaboration to be effective and likely promoted competition in both markets.

84. Procaps and Patheon agreed under the collaboration to share business information, including confidential information subject to limitations on its use and disclosure, and did share some information about customers, costs and prices. Information exchange of this sort is also typically necessary for a collaboration to work. Exchange of competitively sensitive information among rivals in the absence of a collaboration may facilitate coordination, but that is a concern only in concentrated markets which are susceptible to coordination, and that is not the case here.

B. Patheon's Banner Acquisition and the Post-Acquisition Collaboration

85. The collaboration when formed was an agreement between two horizontal rivals: Patheon (which had begun to compete) and Procaps (which was at least a potential competitor). For the reasons just discussed, that agreement between rivals promoted competition in both markets even though it reduced the number of firms competing in them. That conclusion did not require complex economic analysis; it is based, most importantly, on the fact that concentration did not increase in either market, and on the procompetitive benefits the collaboration likely would generate.
86. In its complaint, Procaps alleges that Patheon's acquisition of Banners transformed the collaboration into an agreement between two horizontal rivals: Patheon (as the

¹⁰⁶ Cf. Deposition of Ruben Minski (Nov. 4, 2013) at 191-92 (an exclusivity provision was negotiated by Procaps to further the "spirit of the agreement" that Patheon would come to Procaps "for all manufacturing of commercial products"); Procaps/Patheon Soft Gel Collaboration (June 17, 2011) (PAT00001136) at 7 (Guiding principles for a collaboration include "a deal structure that aligns incentives").

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Loss of Direct Competition

97. Higher prices can also result from the loss of direct competition between sellers of close substitutes. In particular, in a market where customers make purchases through formal or informal bidding, competitive harm could arise from a merger if the merging parties are the first and second choice suppliers for many customers. In this situation, after the merger, customers may be unable to play off the two against each other, or credibly threaten to switch to their second choice supplier. As a result, the merged firm may be able to raise price (at least to a level where it would be constrained by the customer's third choice supplier).¹¹³
98. This problem would arise from Patheon's acquisition of Banner only if some customers in the market view Banner and the collaboration as their first and second choice suppliers (regardless of which of the two was the first choice).¹¹⁴ (The relevant customers are the pharmaceutical firms that contract for the development and manufacturing of prescription softgels for sale in the U.S., or the ten specified pharmaceutical firms when contracting for the development and manufacturing of non-prescription softgels for sale in the U.S.) I have not seen any information suggesting that customers in either market are or would find themselves in this position, however.¹¹⁵
99. At the time of Patheon's acquisition of Banner, it is likely that Catalent and Banner in the U.S. were the second choice for the other's customers. Moreover, the collaboration's small presence and pre-acquisition Banner's small presence made it implausible that the collaboration was the first choice for many customers, and made it implausible that many customers would view the collaboration and pre-acquisition Banner as their first and second choices (in either order). For this reason, it is

¹¹³ See generally U.S. Department of Justice and Federal Trade Commission, 2010 Horizontal Merger Guidelines §6.2 ("Anticompetitive unilateral effects in these settings are likely in proportion to the frequency or probability with which, prior to the merger, one of the merging sellers had been the runner-up when the other won the business. These effects also are likely to be greater, the greater advantage the runner-up merging firm has over other suppliers in meeting customers' needs.")

¹¹⁴ See U.S. Department of Justice and Federal Trade Commission, 2010 Horizontal Merger Guidelines §6.2 ("Anticompetitive unilateral effects in these settings are likely in proportion to the frequency or probability with which, prior to the merger, one of the merging sellers had been the runner-up when the other won the business.").

¹¹⁵ E.g. Deposition of Ruben Minski (Nov. 4, 2013) at 180-181 (no competition between pre-acquisition Banner and Procaps in the U.S.).