

# U.S. Antitrust Modernization: A Preview

## Roxane C. Busey

After many months of hearings and deliberations, the Antitrust Modernization Commission is about to issue its long-awaited report to Congress and the President. Although the final report is not yet available, the Commission's proceedings have been open to the public.<sup>1</sup> As a result, it is unlikely that many of the Commission's recommendations will come as a surprise to those who have followed the public hearings.<sup>2</sup> There will, however, likely be some surprises in terms of the details of the Commission's recommendations—how specific they are, to whom they are directed, and the extent to which they are supported by the members of the Commission.<sup>3</sup>

The Commission's report is likely to be comprehensive, covering more than 15 topic areas, with recommendations directed to Congress, state and federal antitrust enforcement agencies, and even the courts. In a nutshell, based on what is publicly available, here is what to expect:

- The Commission is unlikely to recommend any substantive statutory changes, except with respect to the Robinson-Patman Act, where the Commission is likely to recommend repeal.
- The Commission is likely to recommend major statutory changes to overrule *Illinois Brick* to allow indirect purchasers to sue for damages in federal court. The Commission may also recommend limitations to *Hanover Shoe* and the pass-on defense to those cases where only direct purchasers sue in federal court, and to allow removal of all state indirect purchaser actions to federal court to the extent constitutionally permissible.
- The Commission is likely to recommend legislation that would provide for claim reduction before trebling, and a right of contribution among co-conspirators.
- There is likely to be a recommendation from the Commission, possibly including legislation, concerning the clearance process between the Federal Trade Commission and the Department of Justice (collectively, the Agencies), and at least suggestions, if not requirements, for reducing the burden of Second Requests in transactions filed under the Hart-Scott-Rodino Act.

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<sup>1</sup> This article is based on a variety of publicly available materials, including (1) the Potential Recommendations for Review [POTENTIAL RECOMMENDATIONS] made available by the Commission's staff in July 2006, available at <http://www.amc.gov/pdf/meetings/ReportOutline060720circ.pdf>, (2) the American Bar Association (ABA) Antitrust Section's Summary of AMC Meeting, July 25–26 [JULY SUMMARY], available at [http://www.abanet.org/antitrust/at-links/pdf/at-mod/07-25\\_26-06.pdf](http://www.abanet.org/antitrust/at-links/pdf/at-mod/07-25_26-06.pdf), (3) the ABA Antitrust Section's Summary of AMC Meeting, November 14, 2006 [NOVEMBER SUMMARY], available at <http://www.abanet.org/antitrust/at-links/pdf/at-mod/CHIDMS1-2478915-v1-11-14-06.pdf>; (4) the ABA Antitrust Section's Summary of AMC meeting, December 5, 2006 [DECEMBER SUMMARY]; and (5) the public hearings that have been held by the Commission over the past few years and which are available on the Commission's Web site at [http://www.amc.gov/commission\\_hearings.htm](http://www.amc.gov/commission_hearings.htm). The Commission's final report is due in April 2007.

<sup>2</sup> The ABA Antitrust Section contributed approximately 25 submissions to the Commission on a wide variety of topics. The Section also published summaries of all of the Commission's hearings. These materials are available on the Section's Web site at <http://www.abanet.org/antitrust/>.

<sup>3</sup> Although the preliminary views and votes of the Commissioners have been noted, these positions could change, and some may dissent on certain positions advanced by the majority. At least one more hearing has been scheduled in 2007.

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- Although there are likely to be recommendations by the Commission for studies regarding merger enforcement, no major proposed changes to the Horizontal Merger Guidelines are expected, except possibly recognition that the Guidelines more explicitly need to take into account efficiencies, including innovation. There may also be a recommendation that the Agencies revise their vertical merger guidelines.
- Although the Commission is not likely to recommend statutory changes with respect to state antitrust enforcement, there are likely to be recommendations concerning federal and state coordination and cooperation in merger investigations, including convergence on the Horizontal Merger Guidelines and greater consistency in data requests from state and federal agencies and confidentiality agreements from the states.
- There is likely to be a call for legislative review of all antitrust exemptions, with the McCarran Ferguson Act and the Shipping Act as possible starting points.
- Finally, with respect to international matters, the Commission will likely recommend (1) increased coordination, comity, and harmonization through statutory modification to the International Antitrust Enforcement Assistance Act to clarify that non-antitrust uses of information are not required for an Antitrust Mutual Assistance Agreement, (2) increased authority and budgetary assistance to the Agencies to provide technical antitrust assistance, (3) mechanisms to allow respondents to request greater coordination in multijurisdictional investigations, (4) greater deference to jurisdictions where the alleged conduct has a direct and foreseeable effect in such jurisdictions and, possibly, (5) an international centralized, premerger notification system.

Of these recommendations, the most controversial are likely to be any indirect purchaser legislation, claim reduction and the right to contribution, repeal of the Robinson-Patman Act, and Congressional review of statutory exemptions and immunities. There may also be considerable opposition if the Commission recommends an international, centralized premerger notification system. If the Commission were to advocate any limitation upon state enforcement, which appears unlikely, this would also be highly controversial.

### **No Substantive Legislative Reform Except with Respect to the Robinson-Patman Act**

With the exception of the Robinson-Patman Act, the Commission is unlikely to propose any legislative change to substantive U.S. antitrust law. For the most part, the Commissioners agree that it is better to continue to rely on the courts to develop the law on a case-by-case basis rather than propose statutory changes, many of which could be quite complex. This reflects the view that one of the strengths of the U.S. system is the ability of the courts and those who counsel or enforce the U.S. antitrust laws to adapt their rulings or their advice to the particular facts and circumstances.

In the few areas (other than the Robinson-Patman Act) where the Commission sees a need for clarity or reform, the Commission is more likely to recommend Agency involvement through enforcement actions, guidelines, amicus briefs and the like to guide the courts in analyzing the issues. At the top of this list is exclusionary conduct—in particular, bundling—where the Commissioners generally disagree with the holding in *LePage's*,<sup>4</sup> but are unlikely to recommend any statutory fix.<sup>5</sup> Nevertheless, it will be important to see to what extent the Commission considers or comments in its report upon the various tests (such as profit sacrifice, no economic sense,

<sup>4</sup> *Le Page's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004).

<sup>5</sup> POTENTIAL RECOMMENDATIONS at 19–20.

equally efficient competitor, structured rule of reason) that have been advocated and debated in submissions and hearings before the Commission and to see whether the Commission supports the use of any of these tests in any particular factual setting.

Another area where the Commission might have considered recommending substantive legislative reform, but is unlikely to do so, is new technology. One of the reasons the Commission was formed was to address the issues presented by rapidly changing technology. The view of the Commission seems to be that the U.S. antitrust laws are flexible enough to apply even in a rapidly changing marketplace.<sup>6</sup>

### Repeal of the Robinson-Patman Act

The one area where the Commission is likely to recommend substantive legislative change is with respect to the Robinson-Patman Act, and here the Commission's recommendation is likely to be outright repeal.<sup>7</sup> From the Commission's perspective, the purpose of the Robinson-Patman Act, which is to protect competitors rather than competition, is antithetical to all other antitrust laws. In addition, compliance with the Act imposes a regulatory cost—both in terms of legal expense and business strategy—that is indefensible from an antitrust point of view.

Whether total repeal of the Robinson-Patman Act is politically feasible is not known, but the Commission seems less concerned with this practicality and more intent on taking a strong stand against continued compliance with and enforcement of the Act, even though less radical measures were proposed to the Commission.<sup>8</sup> In making this recommendation, the Commission is undoubtedly aware that repeal of this federal law would not prevent states from further enacting “baby” Robinson-Patman Acts, which could create a patchwork of state laws akin to the state indirect purchaser “repealers” that are generally viewed as worse than the problem they were intended to correct. It will be important to see whether the Commission comments on this possibility and whether it advocates any action short of repeal, in the event that repeal becomes politically infeasible.

### Standing to Sue: New Rights of Indirect Purchasers

The Commission considered a number of issues relating to standing to sue. One of the more important is the right of indirect purchasers to sue. Under *Illinois Brick*,<sup>9</sup> an indirect purchaser currently is barred from suing for damages under federal law; however, approximately 30 states allow indirect purchasers to sue under state antitrust laws. Under *Illinois Brick*, these cases are not removable to federal court. The notion that a company could be sued simultaneously by direct purchasers in federal court and by indirect purchasers in as many as 30 state courts led the Commission to consider whether *Illinois Brick* should be overturned by legislation. There appears to be considerable support among the Commissioners for overruling *Illinois Brick*, and by statute (1) allowing indirect purchasers to sue for damages in federal court, (2) permitting removal of any

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<sup>6</sup> *Id.* at 14–16; DECEMBER SUMMARY at 8–10.

<sup>7</sup> POTENTIAL RECOMMENDATIONS at 21. Ten of the twelve Commissioners are likely to advocate total repeal of the Robinson-Patman Act. The remaining two may only advocate repeal of the criminal provisions of the Act.

<sup>8</sup> See, e.g., ABA Antitrust Section, Comments Regarding the Robinson-Patman Act (Apr. 10, 2006), available at <http://www.abanet.org/antitrust/at-comments/2006/04-06/amc-rp.shtml>.

<sup>9</sup> *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1997).

indirect purchaser claims from state court to federal court, and (3) consolidating any indirect claims with any claims by direct purchasers for both discovery and trial in federal court.<sup>10</sup>

Although most of the Commissioners view this as preferable to the current system, the proposed solution is not a magic bullet. There will continue to be issues relating to antitrust injury, class certification, and the passing-on defense. There was also a significant issue with respect to preemption of indirect purchaser suits in state court, but a majority of the Commission does not appear to favor preemption.<sup>11</sup> The Commission has also expressed reservations about entirely overruling *Hanover Shoe*,<sup>12</sup> which bars the use of the pass-on defense (except for preexisting cost-plus contracts), as that might have the unintended effect of defeating class certification, or making it more difficult. This in turn might provide an unintended disincentive for direct purchaser suits. At least some have argued that it may be more difficult to show that common questions of fact predominate where direct and indirect purchasers sue in a single suit. The current recommendation is to modify the rule in *Hanover Shoe* where both direct and indirect purchasers sue, and to limit the amount of the defendants' damages to direct purchasers, which would then be apportioned among all purchaser classes in full satisfaction of their claims. Where only direct purchasers bring claims, *Hanover Shoe* would remain a bar to the pass-on defense.<sup>13</sup> As this bears directly on both private and state enforcement, it will be important to see how the Commission ultimately resolves these issues and whether it actually proposes draft legislation overruling *Illinois Brick* and limiting *Hanover Shoe*.

### **Standing to Sue: Rights of Foreign Parties Under FTAIA**

Standing to sue was also considered by the Commission in the context of the Foreign Trade Antitrust Improvements Act (FTAIA).<sup>14</sup> Here the question was not indirect purchasers but indirect harm. Should a foreign buyer purchasing a product that is the subject of a global conspiracy be allowed to sue a foreign seller for violation of the U.S. antitrust laws in U.S. courts? This question is purportedly answered by the FTAIA, which requires that an antitrust violation have a direct, substantial, and reasonably foreseeable effect on U.S. commerce if it is to be actionable in the United States.

In addition to jurisdictional questions, this also raises issues with respect to restitution. Many in the United States believe that every injured party should be entitled to some form of restitution and redress. But this view is not shared by many other jurisdictions. Private rights of action are rarely found except in the United States, although a number of other jurisdictions are beginning to enact laws authorizing private litigation. In the meantime, the question of standing to sue presents a dilemma. Should we ignore the right of injured parties to sue when to do so may encourage companies to participate in conspiracies on a global basis, with minimal fear of detection or penalty in the rest of the world?

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<sup>10</sup> JULY SUMMARY at 9–10. This may also require some modification to *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26 (1998).

<sup>11</sup> The Commissioners' vote on this was very close, with six Commissioners advocating preemption of indirect purchaser suits in state court.

<sup>12</sup> *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968).

<sup>13</sup> JULY SUMMARY at 9.

<sup>14</sup> 15 U.S.C. § 6a.

The current focus of the law is the Supreme Court's decision in *Empagran*,<sup>15</sup> where a class of foreign purchasers of vitamins brought suit in the United States for damages allegedly suffered outside the United States as a result of a worldwide cartel involving the major vitamin manufacturers. In construing the FTAIA, the court held that the plaintiffs' claim would be barred if based solely on foreign effects that were independent of anticompetitive effects in the United States. On remand, the D.C. Circuit held that the statutory language requires a direct causal relationship that is proximate rather than just a "but for" nexus.<sup>16</sup>

Although most of the Commissioners seem to agree that *Empagran*, or at least decisions interpreting it, are correct, the confusion caused by the FTAIA and the issues presented by it are difficult to ignore. It is unclear at this juncture whether the Commission will recommend that the courts continue to decipher this poorly worded statute or recommend new legislation to replace it.<sup>17</sup> In the meantime, the problem of under-deterrence will remain unresolved so long as other jurisdictions do not prosecute and penalize those who engage in international cartels.

*Although the Commission undertook to consider the entire remedial antitrust scheme, including treble damages, prejudgment interest, and attorneys' fees, it is unlikely to recommend any significant statutory change in these areas.*

### **Civil Remedies: Right to Claim Reduction and Contribution**<sup>18</sup>

Another area where the Commission is likely to propose an important legislative change is with respect to claim reduction in civil cases. The Commission is likely to recommend legislation which provides that the amount claimed against the non-settling defendants will be reduced, before trebling, by the amount of the settling defendant's allocated share of liability based on market share (the preferred measure) or gain from the violation. There also appears to be sufficient support by the Commission for a statutory amendment to allow claims for contribution against other non-settling conspirators. To the extent that these legislative changes to contribution and claim reduction are recommended, each defendant's allocated share of liability should be equal to its market share or gain from the violation. As with the right of indirect purchasers to sue, it will be important to see the Commission's specific proposal and whether any draft legislation is proposed.

Although the Commission undertook to consider the entire remedial antitrust scheme, including treble damages, prejudgment interest, and attorneys' fees, it is unlikely to recommend any significant statutory change in these areas. The Commission may recommend that, in considering an award of attorneys' fees, a court should consider whether, among other factors, the principal development of the underlying evidence was in a government investigation,<sup>19</sup> in which case the award would be reduced.

Although it was considered, the Commission is unlikely to recommend that any additional authority be given to either of the Agencies to obtain civil fines for substantive antitrust violations.<sup>20</sup> The Commission is also likely to endorse the FTC's current policy governing the circumstances under which it will seek equitable monetary relief.<sup>21</sup>

<sup>15</sup> *Hoffmann-La Roche, Ltd v. Empagran S.A.*, 542 U.S. 155 (2004).

<sup>16</sup> *Empagran S.A. v. F. Hoffmann-La Roche Ltd*, 417 F.3d 1267 (D.C. Cir. 2005), *cert. denied*, 126 S. Ct. 1043 (2006). *See also* *Sniado v. Bank Austria AG*, 378 F.3d 210, 213 (2d Cir. 2004) (plaintiffs failed to show injury in Europe was dependent on conspiracy's effect in United States). *But see In re Monosodium Glutamate Antitrust Litig.*, 2005-1 Trade Cas. (CCH) ¶ 74,781 (D. Minn. 2005) (motion to dismiss denied because plaintiff showed causal nexus between domestic effects and foreign injury).

<sup>17</sup> JULY SUMMARY at 23–26; NOVEMBER SUMMARY at 12; DECEMBER SUMMARY at 6–8.

<sup>18</sup> JULY SUMMARY at 15–16.

<sup>19</sup> *Id.* at 12–14.

<sup>20</sup> *Id.* at 7.

<sup>21</sup> *Id.* at 8.

### **Criminal Remedies: Modification to the Sentencing Guidelines' 20 Percent Proxy**

The Commission is unlikely to recommend any changes to the applicability of the alternative fines provision<sup>22</sup> to Sherman Act offenses or to current Sherman Act fines. The Commission is likely to recommend that the U.S. Sentencing Commission explain that gain or loss under the alternative fines provision applies to the entire conspiracy, whereas individual sentences under the Sentencing Guidelines are determined by each defendant's individual sales.<sup>23</sup>

The Commission is also likely to recommend that the Sentencing Commission reevaluate the 20 percent proxy that is used in establishing the harm caused by the violation in the Sentencing Guidelines. Under the existing statutory structure for sentencing of antitrust violations, the base fine is determined by the harm caused by the violation. For antitrust violations, the Sentencing Guidelines simplify the proof required by establishing a proxy for the economic impact of the conduct—20 percent of the volume of commerce attributable to the defendant that was affected by the violation.<sup>24</sup> As a result, the government must prove the affected volume of commerce but not the actual harm resulting from the violation as required in sentencing most other federal economic crimes. Particularly in light of recent Supreme Court cases where the Court has indicated that the government is required to prove harm to a jury beyond a reasonable doubt to establish an alternative maximum fine, the Commission is likely to recommend reconsideration of the presumed harm of 20 percent of the defendant's affected volume of commerce.<sup>25</sup> The Commission is also likely to recommend that the Sentencing Guidelines be amended to make explicit that the 20 percent proxy may be rebutted by proof by a preponderance of the evidence that the overcharge was higher or lower.<sup>26</sup>

*The Commission is considering recommending legislation that would require the Agencies to clear a transaction to one Agency or the other within nine calendar days or face the consequences of a tiebreaker mechanism.*

### **Merger Enforcement: Improvements to Clearance Between the Agencies and Second Requests**

Of the many issues considered with respect to merger enforcement, the two areas that are likely to see recommended changes are the clearance process between the two Agencies<sup>27</sup> and the Second Request issued by either agency.<sup>28</sup> Based upon the occasional report that a transaction has not been cleared between the Agencies within a reasonable time, the Commission is considering recommending legislation that would require the Agencies to clear a transaction to one Agency or the other within nine calendar days or face the consequences of a tiebreaker mechanism. Although the Commission appears unwilling to impose a particular tiebreaker mechanism, two possible approaches considered by the Commission were arbitration or assignment by case number, with even numbers assigned to one Agency and odd numbers to the other. The alternative would be to have the Agencies agree upon a mechanism that will resolve clearance issues once and for all. The Agencies had worked out a clearance procedure in 2002, but Congress intervened to stop it, and the clearance issue has remained unresolved ever since. Thus, it will be

<sup>22</sup> 18 U.S.C. § 3571 (d).

<sup>23</sup> POTENTIAL RECOMMENDATIONS at 3; JULY SUMMARY at 3.

<sup>24</sup> *Id.* at 7. U.S.S.G. § 8C2.4(b) and § 2R1.1 (d). *See also* U.S.S.G. § 2R.1 (individual firms are set at 1–5 percent of the volume of the affected commerce).

<sup>25</sup> *Apprendi v. New Jersey*, 530 U.S. 466 (2000); *United States v. Booker*, 543 U.S. 220 (2005); *Blakely v. Washington*, 542 U.S. 296 (2004).

<sup>26</sup> JULY SUMMARY at 2.

<sup>27</sup> JULY SUMMARY at 17–18.

<sup>28</sup> POTENTIAL RECOMMENDATIONS at 11–13.

important to see whether the Commission's proposed solution is by direction to the Agencies or by statute, and whether a particular tie breaker mechanism is advocated or left to Congress or the Agencies to determine.

With respect to Second Requests, a number of the proposed recommendations merely advocate that the DOJ adopt the procedural reforms that have already been adopted by the FTC, such as limiting back-up tape retention or the time period or number of custodians to be searched. Others relate to reducing the burden of translating foreign language documents or providing the parties' economists with improved access to the Agencies' staff economists' models and data. There is also some support for amending the Hart-Scott-Rodino Act to permit the parties to appeal directly to a federal district court magistrate judge any claims of unreasonable burden caused by a Second Request.

One of the more novel provisions is to recommend that the Agencies adopt a procedure by which the parties and the Agency could agree to terminate a Second Request investigation and proceed directly to litigation in district court. It will be important to see whether this option has sufficient support to be included in the Commission's recommendations.

### **Merger Enforcement: Modification to FTC Act 13(b)<sup>29</sup>**

In response to at least a perceived difference in the legal standard for obtaining a preliminary injunction in merger cases by the FTC and the DOJ, there appears to be majority support among the Commissioners for recommending a statutory modification to Section 13(b) of the FTC Act to ensure that the traditional equitable standard for obtaining such relief is the same for both Agencies. The Commission is also likely to recommend that the Agencies consolidate proceedings for preliminary and permanent relief in merger cases.

The Commission may also recommend statutory modification to 13(b) that would prohibit the FTC from pursuing administrative litigation if it fails to obtain an injunction in a case for which a filing under the Hart-Scott-Rodino Act was required. However, the FTC would not be barred from administrative litigation post-closing based on evidence that a consummated merger has actually had anticompetitive effects.

### **Merger Review: Efficiencies and Innovation and More Studies of the Effects of Mergers**

The Commission is likely to find that the basic framework for analyzing mergers, including the Horizontal Merger Guidelines, as followed by the Agencies and the courts, is sound and will not recommend any statutory change to Section 7 of the Clayton Act or any significant modification to the Guidelines. There is support among the Commissioners for recommending to the Agencies that they continue to consider or give substantial weight to efficiencies, and that they explain the impact of innovation in their competitive analysis.<sup>30</sup> However, it is unclear to what extent the Commission's report will elaborate on these factors.

There is strong support among the Commissioners for further study, including retrospective study or internal review by the Agencies (or others designated by the Agencies), with respect to

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<sup>29</sup> *Id.* at 10.

<sup>30</sup> *Id.* at 14, 16–17.

Agency merger enforcement activity, the economic basis for enforcement decisions, and market performance and concentration.<sup>31</sup>

### **Role of the States: Merger and Non-Merger Enforcement<sup>32</sup>**

After taking a close look at the role of state antitrust enforcement, the Commission is unlikely to recommend any statutory change with respect to civil non-merger or merger antitrust enforcement. Instead, it is likely to recommend increased harmonization between state and federal enforcement and, in the case of merger enforcement, it is likely to recommend substantive convergence on the Horizontal Merger Guidelines and greater consistency in data requests by the federal and state agencies and in confidentiality agreements by the states. The role of state enforcement in merger review was one of the more closely watched and highly contested topics. Although ultimately not endorsed by a majority of the Commissioners, there was considerable support for limiting the states' merger enforcement authority by giving the federal agencies a right of first refusal with respect to merger review.<sup>33</sup>

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### **Statutory Immunities and Exemptions: A Framework for Analysis and Congressional Review<sup>34</sup>**

As one of the first topics identified for study, the Commission's recommendations with respect to statutory immunities and exemptions are likely to demonstrate concern with respect to the growing number of statutory immunities and exemptions and the lack of a disciplined approach to their adoption.

In general, the Commission is likely to express disfavor with antitrust immunities and exemptions, advocate narrow construction of these provisions, and propose a framework for Congress to use in their adoption and review. That approach is likely to provide for a narrow immunity taking into account the immunity's likely impact on consumers and the extent to which a particular social, political, or other goal trumps antitrust goals. It would also require consultation with the FTC and DOJ, and empirical evidence to show that competition is of less value than the justification for the proposed immunity. The Commission is also likely to recommend that Congress direct the FTC to study the competitive effects of, and justifications for, all immunities and exemptions in light of the above framework. A majority of the Commissioners also favor a sunset provision, possibly within seven years, pursuant to which an immunity would terminate unless specifically renewed.

Because the Commission held separate hearings on the McCarran-Ferguson Act and the Shipping Act, it will be interesting to see whether specific recommendations concerning their review or repeal are included in the Commission's report.

### **Regulated Industries: Defining the Role of the Antitrust Agencies**

The Commission has also considered the role of the Agencies in reviewing mergers in regulated industries. Although the final position of the Commission is somewhat unclear, it appears that a majority of Commissioners believe that any competitive analysis should lie principally, if not exclusively, with the Agencies even if another regulatory agency also has an obligation to review a

<sup>31</sup> *Id.* at 15–16.

<sup>32</sup> *Id.* at 7–8; NOVEMBER SUMMARY at 5–6.

<sup>33</sup> NOVEMBER SUMMARY at 6.

<sup>34</sup> POTENTIAL RECOMMENDATIONS at 26–28.

merger to determine if it is in the public interest.<sup>35</sup> Because this is one of the last areas to be considered by the Commission, it will be important to see how the Commissioners' views crystallize in the final report and whether it recommends that the Agencies have exclusive merger enforcement authority.

### **International Issues: Increased Coordination, Comity, and Harmonization<sup>36</sup>**

On the issue of comity, the Commission is likely to recommend that the Agencies continue to pursue additional comity agreements with foreign jurisdictions and make greater use of existing agreements. The Commission is likely to recommend that the International Antitrust Enforcement Assistance Act (IAEAA)<sup>37</sup> be amended to clarify that Section 12(2)(E)(ii) does not require inclusion of a provision allowing for non-antitrust uses of information exchanged in accordance with an Antitrust Mutual Assistance Agreement (AAMA) for an AAMA to be entered into with the United States. Section 12(2) of the IAEAA provides that the United States may enter into AMAAs with foreign jurisdictions "for the purpose of . . . providing antitrust evidence, on a reciprocal basis." However, there is a perception that Section 12(2)(E)(ii) requires that foreign antitrust enforcement authorities grant their U.S. counterparts the authority to use information provided under an AAMA for law enforcement purposes other than antitrust.

Because there is a concern by the Commission that inconsistent and conflicting enforcement by multiple agencies impedes trade, discourages investment, and harms consumers, the Commission is likely to recommend that the Agencies conduct ongoing benchmarking reviews of matters investigated by multiple jurisdictions that impose divergent decrees to ensure that future remedies are consistent across borders. It is also likely to recommend that Congress provide budget authority and appropriations directly to the FTC and DOJ to provide international antitrust technical assistance.

The Commission is also likely to recommend a mechanism to allow any respondent subject to investigation in multiple jurisdictions the right to request, or possibly demand, that the investigating jurisdictions coordinate their investigations and fashion any remedies jointly. Similarly, the Commission is likely to recommend a presumptive deferral to any investigating country by any other country where the alleged conduct does not have a direct and reasonably foreseeable effect on such other country. The Commission has also considered the development of an international, centralized, pre-merger notification system and is likely to recommend that the Agencies pursue this, or study this, and report to Congress. The Commission also strongly endorses the Agencies continuing to pursue procedural and substantive convergence to the extent possible through the International Competition Network and the Organization for Economic Cooperation and Development. It will be important to see the specific language with respect to all of these recommendations and how strong they are in terms of directives to the Agencies.

### **Conclusion**

All indications are that the long-awaited report from the Antitrust Modernization Commission will include specific recommendations to Congress and the federal and state enforcement agencies and will explain the reasons for such recommendations. Some of the recommendations are likely

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<sup>35</sup> NOVEMBER SUMMARY at 9–10; DECEMBER SUMMARY at 1–6.

<sup>36</sup> POTENTIAL RECOMMENDATIONS at 32–34.

<sup>37</sup> 15 U.S.C. 6201 *et seq.*

to be particularly bold and require legislative action. Others will be more suggestive and in the spirit of best practices where the hope is that they will be seriously reviewed and then implemented appropriately.

Regardless of how one feels about the particular recommendations, the Commission's report should be given careful review and due consideration, particularly in light of the openness of the Commission's proceedings, the time and effort of the individuals serving on the Commission, and their intent to improve upon laws that are of such vital importance to our economy. With the theme of "modernization" being heard round the world, this Commission's contribution to U.S. antitrust modernization should be noteworthy and important, both in terms of what it recommends and what it does not. ●

# The Legacy of *Stolt-Nielsen*: A New Approach to The Corporate Leniency Program?

**Donald C. Klawiter and J. Clayton Everett**

Over the past two years, the commentary surrounding the *Stolt-Nielsen* case has become overheated and sensational. Not since Mark Whitacre's "I was a mole for the FBI" stories has the antitrust world experienced anything quite so dramatic. The *Wall Street Journal's* op-ed page has vilified the Antitrust Division for breaking its word and being arbitrary and vindictive.<sup>1</sup> Some commentators have concluded that the *Stolt* case is a fatal self-inflicted wound to the leniency program and that leniency is no longer a viable option for a company because of the inability of the Antitrust Division to keep its word and abide by its promises. A highly regarded mergers and acquisitions lawyer recently opined that any attempt by a company to seek leniency will turn out badly for the company because of *Stolt*.

From the perspective of many who practice in the criminal antitrust area, the simple fact is that *Stolt* is considered an aberrant case that will have little or no direct impact on the continued viability and success of the leniency program. Indeed, the volume of leniency applicants continues to increase at the Antitrust Division. Clearly, leniency agreements are moving ahead without fear of revocation. The important question is not whether the *Stolt* controversy has harmed the leniency program, but how *Stolt* has caused the U.S. leniency program to adapt and evolve. This article will address that post-*Stolt* impact, as well as the nuanced lessons and insights that both the Antitrust Division and defense counsel have learned from the *Stolt* case.

## The Background of the *Stolt-Nielsen* Case

Most of the antitrust world is already familiar with the basic story line. *Stolt-Nielsen, S.A.* applied for leniency under the Antitrust Division's program in late 2002 relating to activities in the parcel shipping industry. *Stolt's* application for leniency followed on the heels of a wrongful termination lawsuit by a former member of its in-house legal department. The former employee alleged that he had been terminated for bringing potential antitrust violations to the attention of management in March 2002.

The Division entered into a conditional leniency agreement with *Stolt* on January 15, 2003. Following the terms of the standard letter used by the Division, the agreement required *Stolt* to have taken "prompt and effective action to terminate its part in the anticompetitive activity being reported upon discovery of the activity."<sup>2</sup> Pursuant to the agreement, *Stolt* provided information that aided the Division's prosecution of other parcel tanker companies and their executives.<sup>3</sup>

■  
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<sup>1</sup> Holman W. Jenkins, Jr., *If Sergio Leone Made a Movie About Antitrust* . . . , WALL ST. J., Oct. 25, 2006, at A15.

<sup>2</sup> *Stolt-Nielsen, S.A. v. United States*, 352 F. Supp. 2d 553, 558 (E.D. Pa. 2005).

<sup>3</sup> *Id.* at 559.

Stolt's cooperation helped the Antitrust Division to collect a total of \$62 million in fines from two co-conspirators and to send three high-ranking executives of those companies to jail.<sup>4</sup>

In April 2003, the Division suspended Stolt's participation in the leniency program, contending that Stolt had breached its obligations under the leniency agreement by failing to terminate its anti-competitive activities when those activities were first brought to the company's attention in March 2002.<sup>5</sup> Under threat of indictment, Stolt filed a complaint on February 6, 2004, seeking enforcement of its rights under the leniency agreement.<sup>6</sup> The suit sought to enjoin the Division from indicting Stolt.

Several authors have discussed the various issues and arguments raised in the district court proceedings,<sup>7</sup> so only a brief summary is needed here. After conducting the preliminary injunction hearing, the district court concluded that (1) Stolt had not breached its obligations under the leniency agreement, and (2) the Division should be enjoined from prosecuting Stolt and its executives.<sup>8</sup> Specifically, the district court held that the Division received the benefit of its bargain by garnering evidence from Stolt's cooperation that enabled the Division to convict other parcel tanker companies and executives. Although the leniency agreement required Stolt to cease its participation in the anticompetitive conduct for which the Division was promising leniency, nothing in the agreement explicitly required Stolt to cease its participation before applying for leniency—or, in this case, to have ceased its participation when senior management was allegedly informed of the conduct by in-house legal counsel. As long as Stolt had ceased the conduct at issue at the time of the agreement—something that the Division did not dispute—that was sufficient for the court to conclude that Stolt satisfied its obligations under the leniency agreement.

Oral discussions between Division staff and Stolt's outside counsel regarding the Division's expectations and concerns with regard to Stolt's conduct could not enlarge or otherwise alter the plain meaning of the written agreement, which did not address Stolt's representations concerning the date that the conduct was "discovered." Because Stolt had abided by its obligations under the agreement, the district court held, the Division was likewise required to abide by its promise not to prosecute Stolt or its executives.

The Division appealed to the Third Circuit, which reversed the district court in an opinion by a two-judge panel.<sup>9</sup> The Third Circuit concluded that the district court lacked jurisdiction to enjoin a criminal prosecution in this case.<sup>10</sup> The district court's power to enjoin a criminal prosecution, the Third Circuit held, was limited to circumstances where "the mere threat of prosecution would inhibit the exercise of constitutional rights."<sup>11</sup> Stolt's constitutional rights were not implicated by the

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<sup>4</sup> *United States v. Odfjell Seachem AS*, Crim. No. 03-654 (E.D. Pa. Sept. 29, 2003) (plea agreement Nov. 3, 2003), available at <http://www.usdoj.gov/atr/cases/f201900/201938.htm>; *United States v. Jo Tankers B.V.*, Crim. No. 04-221 (E.D. Pa. Apr. 19, 2004) (plea agreement June 9, 2004), available at <http://www.usdoj.gov/atr/cases/f204600/204614.htm>.

<sup>5</sup> 352 F. Supp. 2d at 559.

<sup>6</sup> *Id.*

<sup>7</sup> See, e.g., Jim Walden & Kristopher Dawes, *The Curious Case of Stolt Nielsen S.A. v. United States*, ANTITRUST SOURCE, Mar. 2005, <http://www.abanet.org/antitrust/at-source/05/03/02-mar05-walldawe323.pdf>.

<sup>8</sup> 352 F. Supp. 2d at 563.

<sup>9</sup> See *Stolt-Nielsen, S.A. v. United States*, 442 F.3d 177 (3d Cir. 2006). Then Judge, now Justice Samuel A. Alito, Jr., heard oral argument in the case but did not take part in the decision because of his elevation to the U.S. Supreme Court.

<sup>10</sup> *Id.* at 187.

<sup>11</sup> *Id.* at 183.

Division's attempt to indict Stolt and certain of its executives. As the court reasoned, "being indicted and forced to stand trial is not generally an injury for constitutional purposes but is rather 'one of the painful obligations of citizenship.'"<sup>12</sup> Consequently, the Third Circuit reversed and remanded the case to the district court with instructions to dismiss Stolt's complaint with prejudice. The Third Circuit, however, left open the possibility that Stolt could "interpose the Agreement (as a defense to conviction) in a pre-trial motion."<sup>13</sup> Stolt's petition for certiorari to the Supreme Court seeking review of the Third Circuit's decision was denied in October 2006.

In the meantime, Stolt, two subsidiaries and two of its executives were indicted by a grand jury in the Eastern District of Pennsylvania on September 6, 2006.<sup>14</sup> After some procedural wrangling about which judge should preside over the case, the criminal case against Stolt is now proceeding.<sup>15</sup> Stolt filed a motion to dismiss the indictment on the basis of the leniency agreement on November 22, 2006, and an evidentiary hearing is scheduled for March 19, 2007.

Having determined the outcome of the initial appeal based on the threshold separation of powers question, the Third Circuit did not need to address or decide the arguments regarding the contractual obligations of the parties. Those issues, which Stolt and the Division joined in the original district court action, are the focus of the motion to dismiss.

Stolt will be required to prove its breach of contract case all over again. Because the Third Circuit concluded on separation of powers grounds that the district court lacked jurisdiction even to consider Stolt's claims, it effectively annulled the district court's holding that Stolt had not breached the leniency agreement.<sup>16</sup> Thus, the district court's prior opinion regarding the meaning of the leniency agreement and the parties' obligations under that agreement has no preclusive effect for the criminal case.

It remains to be seen how the case will turn out. Stolt will continue to focus on the contractual analysis and support its argument that it fulfilled its part of the bargain by providing cooperation that enabled the Division to convict other parcel shipping companies and executives. The information obtained through that cooperation now will likely be used directly against Stolt.<sup>17</sup> The Division will emphasize the dates that the conspiracy was "discovered" and "terminated," contending both that Stolt lied about the timing of these events to obtain leniency and that the January 15, 2003, conditional leniency agreement allows the Division, in its sole discretion, to void a leniency agreement if it determines that the applicant has not met its obligations.

In deciding whether those indicted are entitled to leniency, the district court is likely to examine and weigh the very information that the Division obtained from Stolt. Regardless of where the district court draws the line, Stolt is likely not a case that will provide bright-line guidance for the

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<sup>12</sup> *Id.* (quoting *Cobbledick v. United States*, 309 U.S. 323, 325 (1940)).

<sup>13</sup> *Id.* at 186.

<sup>14</sup> *United States v. Stolt-Nielsen, SA.*, Case No. 2:06-cr-00466-BWK (E.D. Pa.), available at <http://www.usdoj.gov/atr/cases/f218200/218212.htm>.

<sup>15</sup> Stolt argued unsuccessfully that the criminal case should be assigned to the judge who heard and decided the case Stolt filed to enjoin the Division's prosecution. Under normal Eastern District case assignment, the criminal action would not be assigned as a related case to the judge that handled the injunction case.

<sup>16</sup> 442 F.3d at 187 n.7.

<sup>17</sup> Under the express terms of the leniency letter, the Antitrust Division may use "any documentary or other information provided by ABC, as well as any statements or other information provided by any current [or former] director, officer or employee of ABC to the Antitrust Division pursuant to this agreement . . . against ABC in any such prosecution." Model Corporate Leniency Letter at 3, available at <http://www.ftc.gov/atr/public/speeches/2247.htm>.

antitrust criminal bar; it will provide finality only on the very distinct—and highly unusual—facts before the court.

### The “Common Law” of the Corporate Leniency Policy

Far more important than the ultimate outcome of the *Stolt* case itself, however, is the impact of the *Stolt* case on the corporate leniency program. The *Stolt* controversy has already had a significant impact on the way that the Antitrust Division and the antitrust criminal bar have handled leniency applications since *Stolt* was first expelled from the program, and it will continue to affect how they will handle leniency application in the future. These developments will have far-reaching implications for the future strategy and decisions of leniency applicants.

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The Antitrust Division’s leniency program is constantly evolving.<sup>18</sup> From its creation in 1978, through its major revision in 1993, through the variations now known as “amnesty plus,” “penalty plus,” and “affirmative amnesty,” the leniency program is, first and foremost, an administrative creation of the Antitrust Division. The policy was not born of legislation;<sup>19</sup> it was originally conceived and defined in a series of major speeches by Division leaders.

John Shenefield, then Assistant Attorney General of the Antitrust Division, was greeted with nervous laughter in 1978 when he first explained the new self-reporting and cooperation program to an assembly of corporate general counsel.<sup>20</sup> When AAG Anne Bingaman announced the revised policy in 1993, many believed this amendment would not materially increase the small number of leniency applications up to that time. Since 1993, however, things have changed dramatically. The leniency program is now considered the Division’s most powerful tool for deterring and prosecuting cartels. Thus, over 25 years after the birth of the leniency program, Deputy Assistant Attorney General Scott Hammond was greeted not with nervous laughter, but with respect and careful attention at the ICN Cartel Conference in 2004<sup>21</sup> and at subsequent ICN workshops, which were attended by enforcement officials from many nations that have sought to imitate and replicate the U.S. leniency program.

As with most of the developments in the criminal antitrust area, the leniency policy developed and evolved through the actions of the Antitrust Division and the antitrust criminal bar that represented leniency applicants. In 1993, self-reporting to the Division was still an alien concept. Most defense counsel, accustomed to litigating against the Division, did not trust the government sufficiently to provide sensitive information by proffer to the Division. In leniency’s early years, many Division prosecutors also did not believe in the leniency idea. As a result, the trust essential to the program’s success took time to develop.

<sup>18</sup> For a much more detailed discussion of the U.S. leniency policy and its evolution and development, see Donald C. Klawiter, U.S. Corporate Leniency After the Blockbuster Cartels: Are We Entering A New Era, Proceedings of the 2006 EU Competition Law and Policy Workshop, European University Institute (June 3, 2006) (forthcoming in EUROPEAN COMPETITION LAW ANNUAL 2006: ENFORCEMENT OF PROHIBITION OF CARTELS (Claus-Dieter Ehlermann & Isabela Atanasiu eds., 2006)).

<sup>19</sup> The first and only time the leniency program was mentioned in legislation was in the 2004 Antitrust Criminal Penalty Enhancement and Reform Act of 2004 in which Congress provided for single damages and no joint and several liability for a leniency applicant cooperating with the plaintiffs. See Antitrust Criminal Penalty Enhancement and Reform Act of 2004, Pub. L. No.108-237, Title II, § 201, 118 Stat. 665.

<sup>20</sup> John H. Shenefield, Assistant Attorney General, Antitrust Division, U.S. Dep’t of Justice, Statement Before the 17th Annual Corporate Counsel Institute (Oct. 4, 1978), noted in [Current Comment 1969–1983 Transfer Binder], Trade Reg. Rep. (CCH) ¶ 50,388.

<sup>21</sup> Scott D. Hammond, Director of Criminal Enforcement, Antitrust Division, U.S. Dep’t of Justice, Cornerstones of an Effective Leniency Program, Remarks to the ICN Workshop on Leniency Programs (Nov. 22–23), 2004, available at <http://www.usdoj.gov/atr/public/speeches/206611.htm>.

Beginning in 1996, when the current leniency policy first began to gain acceptance and then to flourish, the rules and practices of leniency have evolved—carefully and delicately. In the last ten years, the Division has worked hard to encourage leniency applications—at first aggressively marketing the policy to the bar (“facing fines of zero”)<sup>22</sup> and then by explaining and interpreting the provisions to achieve transparency and certainty in the program.<sup>23</sup>

From the beginning, the Division has always made clear that its intention is to make leniency as easy as possible for the applicant to obtain. It sought to avoid creating roadblocks. One of the Division’s major objectives was to ensure that a leniency applicant was never put in a worse position than other parties because the applicant had sought leniency. “The Division’s philosophy,” according to Scott Hammond, “has always been that, wherever possible, we will tilt our program in favor of finding ways to make companies eligible for our program rather than looking for ways to keep them out. We maximize the opportunities for companies to report conduct, and we are extremely adverse to practices that may create disincentives.”<sup>24</sup>

The Division has also worked tirelessly to influence its international counterparts by arguing persuasively that roadblocks and obstacles created in one jurisdiction are harmful in all jurisdictions because they deter the filing of leniency applications throughout the world. That seems to be clear evidence that *Stolt* is an aberration, not a policy intention to crack down on leniency, as some detractors suggest.

The reason for keeping the leniency program attractive to potential applicants is self-evident. The program has spawned some of the largest cases—and fines—in history: vitamins, graphite electrodes, rubber chemicals, DRAM, art auctions, and a substantial number of food and feed additives and commodity chemical cases, to name the most obvious. The Division has collected over \$2 billion in criminal fines as a direct result of the leniency program. Observing the success of the Division’s leniency policy, the enforcement officials of the world quickly began to jump on the leniency bandwagon. Consider that Japan’s leniency program only went into effect 11 months ago and has already produced almost 60 leniency applications.<sup>25</sup>

The success of the U.S. leniency program and those around the world modeled on its success is, at bottom, the result of transparency and trust. The program is set up to provide as little discretion as possible—you either qualify or you don’t. Beyond that, the Antitrust Division must trust defense counsel to move the process forward and the defense counsel must trust the good faith of Division staff to honor its obligations. The Division knows that if leniency is granted only grudgingly or made more difficult, there will be fewer leniency applications, with unhappy consequences for the leniency program. That is why the *Stolt* decision is receiving so much notoriety. How the Division and defense counsel react and adapt to future leniency applications will tell the ultimate story of *Stolt*’s impact.

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<sup>22</sup> Gary R. Spratling, Deputy Assistant Attorney General, Antitrust Division, U.S. Dep’t of Justice, Making Companies an Offer They Shouldn’t Refuse, Remarks to the Bar Association of the District of Columbia’s 35th Annual Symposium on Associations and Antitrust (Feb. 16, 1999), available at <http://www.usdoj.gov/atr/public/speeches/2247.htm>.

<sup>23</sup> Gary R. Spratling, Deputy Assistant Attorney General, Antitrust Division, U.S. Dep’t of Justice, The Corporate Leniency Policy: Answers to Recurring Questions, Remarks to the ABA Antitrust Section 1998 Spring Meeting (Apr. 1, 1998), available at <http://www.usdoj.gov/atr/public/speeches/1626.htm>.

<sup>24</sup> Hammond, *supra* note 21.

<sup>25</sup> *Japan’s Leniency Program Silences Critics*, COMPETITION L. 360, Nov. 7, 2006.

### What Is the Antitrust Division Doing Differently Today?

The major outcome of the *Stolt* case—and probably its enduring legacy—is a subtle but clear shift in how the Antitrust Division is operating its leniency program today. Quietly, but consistently, the Division has altered the way in which it is using its “marker” process.

From the outset of the 1993 Revised Leniency Policy, the applicant was given the opportunity to obtain a “marker” from the Division before presenting all of its evidence. The “marker” device was the Division’s way to create a race to the Division. If the applicant started the internal investigation and discovered some bad conduct, counsel could call the Division before completing its investigation and ask for a “marker” to preserve first place in line while counsel continued the internal investigation. The marker would extend for a very short time, usually no more than a few weeks. When counsel was ready, the leniency proffer would be presented and, typically, the applicant would be accepted into the leniency program conditionally and receive the leniency agreement. Then the applicant would provide its full cooperation to the Division.

In earlier times, the parties—and the Division—were very anxious to close the leniency deal quickly and decisively. In many leniency applications, counsel came in, made their presentations, and walked out of the Division offices with the clear understanding that their client was “in the program.” This certainty was what the applicant wanted—especially when it was taking the risky leap of applying for leniency. The Division was equally anxious to close the deal and receive the promise of substantial evidence from the applicant to move its case forward against the co-conspirators. There was a certainty and predictability—and mutual relief—to concluding the first meeting or an early meeting with “the letter” (literally or figuratively).

In looking at the timeline in *Stolt*’s leniency application, the time between the first presentation and the receipt of conditional leniency was very short indeed—with the first approach to the Division in November 2002 and receipt of the “letter” in January 2003. This is consistent with the timing of many pre-*Stolt* applications, where the elapsed time between the first contact with the Division and the agreement to grant conditional leniency was measured in days or weeks. Although no one outside of the Division knows the precise numbers, the anecdotal evidence is strong that because *Stolt* was expelled from the program there has been a subtle shift away from early grants of conditional leniency based exclusively on counsel’s representations to the use of an “extended marker” investigation, which is the model more commonly employed today.

In fairness, three other factors are also at play in lengthening the time between the application and the conditional grant of leniency. First, because of the great value of being “first in” for leniency, there is often a race to the Antitrust Division to obtain leniency. Sometimes the difference between being the leniency applicant and being a criminal defendant is literally a matter of hours. Anxiety about the race has caused counsel to move quickly, usually before the company has conducted anything close to a complete investigation. The process of collecting and producing evidence is, of necessity, protracted, and because the initial information is sketchy and incomplete, the Division considers the applicant to need more time to “perfect” its marker.

Second, the cases for which leniency is sought today are, for the most part, more difficult cases to prove. Much of the “low hanging fruit” was picked in the late 1990s. Fewer of today’s cases involve worldwide allocation meetings attended by senior executives of all the competitors, and few have the trail of documents providing the scorecard of market shares agreed to by the conspirators as were available in, for example, the vitamins and related cases. In today’s cases, the investigative process is necessarily longer and more complex. This trend in leniency applications—with some notable exceptions—has been going on for several years.

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Third, with the advent of the Antitrust Criminal Penalty Enhancement and Reform Act of 2004, which provided, among other things, the possibility of single damages available to the leniency applicant, companies are seeking leniency in less hard-core cases so they may avail themselves of the single damages option in the civil actions that they are defending. This is tempting, especially if the case can be characterized as conduct that the Division may view, even marginally, as criminal conduct. The Division will be wary of many of these applications, and a prudent way to deal with them is to explore the evidence under a marker rather than to grant conditional leniency when it is unclear whether a triable criminal case will ever be made out.

Although these three factors are important, the primary reason for the extension of the marker process is the degree of certainty the Division obtains from being able to develop evidence methodically. The Division appears to be much more comfortable when it sees the actual evidence, as opposed to counsel's proffer, before committing itself to a conditional leniency agreement. By operating for weeks and even many months under the marker, the Division is protected from claims of contractual breach and reliance that the *Stolt* case raised on the public stage. Today's use of the marker system allows the Division to verify first—and trust later. This has replaced the trust—and then verify—system of earlier times. If the Division offers a marker and methodically collects the evidence from the applicant, it does not have to obligate itself to give more than a place in line until it is satisfied that it has verified the evidence by interviewing the witnesses. It can also better define the scope of the leniency it is granting when it has already seen the evidence because it knows definitively the areas where there is evidence and where there is not.

### **Is the New Process Harmful—or Less Helpful—to the Potential Applicants?**

Over the past ten years, the greatest advantage of the leniency program to a company has been the certainty and transparency of the process. If an applicant approached the Division and presented valuable information, the applicant would expect to obtain an agreement that it had conditional leniency. After receiving the agreement, the applicant would then complete the steps of the cooperation process. There was always the concern that the Division would find the evidence untrustworthy, or that the witnesses would not deliver what counsel promised. Until *Stolt*, however, the Division never took any steps to revoke the leniency.

Today's dynamic is very different. The marker recipient is still first in line; no one will take its place in line while it is cooperating. Aside from that, the terminology used by the Division has shifted from "you are in the program" to "you are perfecting the marker." In reality, that means that the applicant will have no assurances of conditional leniency at the front end and, being somewhat anxious, will be motivated to work harder at persuading the Division step by step of its full cooperation.

Does the change of process disadvantage the applicant in any way? This is the ultimate question that may have a lasting effect on the leniency program. Although one view is that the leniency applicant must work hard at each step to persuade the Division to keep it in that position, in most respects this is no different from cooperating in good faith when the applicant already has conditional leniency. Overall, there does not seem to be any real disadvantage.

Can the extended marker process be an advantage to the applicant? Given that many of the leniency applications today will, of necessity, involve evidence that is less decisive and less compelling than the vitamins-style cases, there may be an advantage in presenting the evidence to the Division piece by piece rather than presenting a conclusion that certain conduct amounts to a violation of the criminal law. The Division will be more attentive to helping the applicant establish the details if it is done step by step than it would be if it is first presented in a conclusory statement by counsel. Thus, the marker may provide a viewfinder for the Division to assess and eval-

uate the evidence at an early stage, allowing the Division to make determinations as the case is put together—especially a very hard case. Watching this process unfold, the Division is more likely to determine that the applicant acted responsibly and will work cooperatively with the applicant in good faith, even if it ultimately concludes that there was no violation or no violation that it will seek to prosecute.

In addition, the evidence that the Division would gather under a marker will largely be developed from the testimony of individual executives. This process would generally be governed by a letter to the executive promising not to make direct use of the interview information against the executive. If the Division believes the marker evidence is insufficient to proceed, it can end the process at any time. Because the executive will be questioned under the standard “no direct use” promise, the executive will not face the severe penalty that would occur if conditional leniency were granted and then revoked—the ability to use all the leniency evidence against the leniency applicant and its executives. If a marker is revoked, the direct evidence that the Division can actually use against the executives from the marker process is minimal, or nonexistent. The marker process may, in the difficult case, be a much safer place for the applicant and its executives to remain as this leniency investigation unfolds.

*Despite the most thorough audit and internal investigation, there may always be rogue employees out there who think they are smarter than everyone else.*

### **A Modest Word of Caution to the Division: The Limits of the Corporate Investigation**

The primary cause of sleepless nights for defense counsel representing a leniency applicant is counsel's ultimate ability to assure the Antitrust Division that the client took prompt and effective action to terminate its role in the conspiracy and that company employees have provided complete and truthful evidence to the Division—the seminal issues in the *Stolt* case. While this is especially a concern when dealing with global companies, it is a problem for even the smallest domestic company. Many defense counsel have discovered an executive who is secretly maintaining contact with his friend at a competitor even after the company self-reports. There are always employees who continue to limit their disclosures or shade the information regardless of the heroic efforts of the board, the general counsel, and outside counsel to meet the leniency requirements in good faith. In leniency proceedings and in plea negotiations alike, the absolute confidence of counsel in the certainty of its investigative findings is a matter of great concern. Despite the most thorough audit and internal investigation, there may always be rogue employees out there who think they are smarter than everyone else.

A hypothetical will help illustrate the problem. If a company represents that the conspiracy ended at the time of a particular price increase and the Division later discovers from a competitor that the product manager continued to discuss discounts off the list price with his major competitor for another six months, the leniency applicant is in a precarious place. The company has provided the critical information about its role and the role of competitors to the Division; it has investigated thoroughly and completely, but it has a product manager directly lying to counsel and, perhaps, hiding or destroying documents. It has reviewed the post-lenieny travel and telephone records of every executive but could never discover the 20 calls that the product manager made from the pay phone across the street. Technically, the conspiracy continued for six months, but the issue is whether the *company* took prompt and effective action to terminate its part in the conduct. On facts such as these, should the Division conclude that the company did everything humanly possible to satisfy the Division?

In an age of great sensitivity to corporate governance principles, it is important to remember that the corporation is the party to the leniency application. That is why the decision is—and must be—a board decision. The board must instruct counsel that the investigation must be thorough

and complete, and all employees must know that directly. Despite the need to keep the leniency decision limited to as few people as possible, every employee directly involved in the conduct must be informed of the process and the severe penalties for violating counsel's instructions. Yet, if a rogue employee continues the conspiracy or holds back information from counsel and from the Antitrust Division, what becomes of the applicant's marker or leniency agreement? Isn't the company clearly in non-compliance with the leniency conditions? In the context of the *Stolt* case, isn't the company in breach of the agreement?

This is a very difficult situation, but it must not be a situation where the Antitrust Division adopts a bright-line conclusion that the company did not meet its obligations under the leniency policy. While the burden of proof that it was prompt, effective, and cooperative is on the company, the Antitrust Division has the obligation to evaluate the facts—to look at the good faith of the investigation—and make a reasoned decision about the company's efforts and actions. In some cases, the Division will find that the company was not thorough or careful—and it can expel the company from the program. In many situations, however, the Division will conclude that the company acted as the Division would want it to—and give the company the leniency it earned by its corporate action. A rogue employee, of course, would never be a beneficiary of the leniency program. To ensure the long-term viability of the leniency program, the Division must be able to untangle the corporate act from the independent act of a noncompliant employee.

### Conclusion

The U.S. corporate leniency policy is alive and well. Far from being a harbinger of doom, the *Stolt* case is, at most, *the* single aberration in the 28-year history of the leniency program. The important legacy of the *Stolt* case has been a shift in the application of the program in practice, providing greater scrutiny of the underlying evidence for the safety and security of both parties—the applicant and the Division. Under this evolution of the system, once the leniency marker has been “perfected,” there is no further uncertainty for the leniency applicant or the Division because, by then, the evidence will have been carefully vetted.

Today, the watchwords at both the Antitrust Division and the antitrust criminal bar are caution and care. That is not a bad thing. Potential leniency applicants should find comfort in the process as it has evolved and operates successfully. Future leniency applicants should view the system as a step-by-step process intended to avoid the pitfalls that could lead to a repetition of the strange case of *Stolt-Nielsen*. ●

# Interview with FTC Director of the Bureau of Economics Michael Salinger

**Editor's Note:** In this interview with The Antitrust Source, Dr. Michael Salinger discusses his views on horizontal merger analysis, vertical analyses, the ongoing FTC/DOJ Section 2 hearings, the economics of tying and predatory pricing, consumer protection, and the recent investigations into the petroleum industry. He also provides insights into the structure and staffing of the Bureau of Economics and the interaction with his European counterparts. Dr. Salinger began his job as the Director of the Federal Trade Commission Bureau of Economics in July 2005. He joined the Commission from the Boston University School of Management, where he is a Professor of Economics. The Antitrust Source conducted this interview on November 9, 2006.

—ELIZABETH M. BAILEY



Michael Salinger

**THE ANTITRUST SOURCE:** You joined the FTC as the Director of the Bureau of Economics in the summer of 2005 and have been in that role now for a little over a year. How have you found the transition from academics and consulting to the FTC?

**MICHAEL SALINGER:** It has been great. It is much more interesting than academia. I was also here as a staff economist for about a year in 1985 and 1986 when I took a leave from my position at Columbia Business School.

**ANTITRUST SOURCE:** Will you summarize the role and responsibilities of the Director of the Bureau of Economics?

**SALINGER:** There are a lot of different pieces to the job. The Bureau Director, in a way, is the interface between the Bureau of Economics and the Chairman and Commissioners.

The Bureau Director is responsible for making sure that the economic analysis done in the Bureau of Economics is correct and explained clearly.

Whenever a matter goes before the Chairman and the Commissioners, there is a recommendation from either the Bureau of Competition or the Bureau of Consumer Protection and a separate recommendation from the Bureau of Economics. The Bureau Director ultimately decides what the recommendation of the Bureau of Economics is.

The Bureau Director also has the opportunity to have a public role, giving speeches and attending conferences. That's something I have done quite a bit of.

There are general policy debates within the Commission on a variety of matters, such as amicus briefs to the Supreme Court or advice given to foreign competition agencies or advocacy with respect to regulatory proceedings. The Bureau Director plays a big role in many of those discussions.

And the Bureau Director serves as the chief economic advisor to the Chairman and the other Commissioners.

**ANTITRUST SOURCE:** What is the structure of the Bureau of Economics beneath the Director?

**SALINGER:** Let me start from the bottom and work up.

The staff economists are organized into groups that are headed by an Assistant Director, who is their direct manager. The Assistant Director has Deputy Assistant Directors. Each matter is directly supervised by an Assistant Director or a Deputy Assistant Director.

At headquarters, on the antitrust side, there is a Deputy Director, Mark Frankena, and an Associate Director, Tim Deyak, who are in some sense the interface between the Assistant Directors and me.

On the consumer protection side, the Deputy Director is Paul Pautler, and the Associate Director for Consumer Protection and Special Projects is Pauline Ippolito.

**ANTITRUST SOURCE:** Is it correct that there are economists who work on the antitrust side and other economists who have responsibilities on the consumer protection side?

**SALINGER:** That's correct. On the antitrust side, there are two shops. Mike Vita heads up one of them, Lou Silvia heads up the other. There is also a Division of Consumer Protection. Jesse Leary is the Assistant Director. We have another group that does our policy R&D and our advocacies. Denis Breen heads that up. The Commission also has a group of accountants and financial analysts who are housed in the Bureau of Economics. Gabe Dagen is the Assistant Director of that group.

**ANTITRUST SOURCE:** How do these different groups of economists all relate to each other and how do you manage that interaction?

**SALINGER:** What holds the Bureau together is the common discipline of economics. We have a seminar series that gives people from across the Bureau opportunities to interact professionally. In terms of doing our day-to-day work, people have things that they specialize in, and they are divided into functional areas.

There is some movement between the groups. Some economists have spent part of their career in antitrust and then moved over to consumer protection and vice versa. In a pinch, we move people from one division to the other. It hasn't happened while I have been here, but in the most intense part of the merger wave, there were consumer protection economists working on antitrust matters.

**ANTITRUST SOURCE:** How many economists are there at the FTC?

**SALINGER:** About 70 PhD economists and another 30 people who make up the professional and support staff.

**ANTITRUST SOURCE:** Are the economists about equally split between antitrust and consumer protection?

**SALINGER:** No. It's more heavily weighted toward antitrust.

**ANTITRUST SOURCE:** You've been Director of the Bureau of Economics for about a year now. What

do you consider to be your greatest accomplishment during your tenure?

**SALINGER:** What is more important than any accomplishments of the Bureau Director are the accomplishments of the Bureau. There have been many, but I guess I am most proud of our work on gasoline markets. Given how politically charged the matter is, it was crucial that we get the analysis right, which I think we did.

I have tried to set a tone of cooperation between the Bureau of Economics and the other bureaus. When I was at the Commission 20 years ago, there was quite a bit of animosity between the economists and the lawyers. Of course, matters had improved quite a bit in the meantime, but I came here determined to have none of that. Others will have to judge whether I have been successful, but I think I have. Of course, the other Bureau Directors, Jeff Schmidt, and Susan Creighton before him, in the Bureau of Competition, and Lydia Parnes in the Bureau of Consumer Protection, have been great to work with, and the tone of cooperation is really set at the very top by Chairman Deborah Majoras, as well as the other Commissioners.

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**ANTITRUST SOURCE:** Have there been any surprises so far?

**SALINGER:** The complexity of the place. I, of course, had been warned about it, but until you live it, you don't really understand it. It amazes me how many diverse activities are going on here. It's fascinating.

**ANTITRUST SOURCE:** In one of your first speeches last year, you identified four questions about horizontal merger enforcement. The first question was why efficiencies don't seem to matter in merger enforcement decisions. Your response, to paraphrase, was that most efficiency claims are not well supported by the merging parties and thus do not carry much weight in the enforcement decision process except perhaps around the edges. How have the mergers you have reviewed during the past year confirmed or modified this view on efficiencies?

**SALINGER:** We do take efficiencies seriously. Chairman Majoras has been clear that efficiency claims must be an integral part of merger analysis. I continue to be puzzled why parties do not do more to make efficiency claims than they do.

Part of the reason may be that, at least to my mind, some of the most credible efficiencies are that one of the parties has proprietary knowledge that it can use to improve the operations of the other. That can be hard to communicate. If it were so easy to communicate, then probably you wouldn't need the merger to do it. If there is evidence that one company is much more efficient in its operations than the other and there's some reason to believe that they can transfer that efficiency to the other company, that is something that, in my opinion, we should take quite seriously.

**ANTITRUST SOURCE:** Are there efficiency claims that you consider more or less credible than others?

**SALINGER:** The one that I have been skeptical about concerns claims related to overhead expenses. It's not that I don't think that those can't occur, but sometimes the rationale given is that these costs are fixed, that you only need one CEO and one director of marketing, and so on. I don't think those costs really are fixed in the economic sense of the term. So I am somewhat more skeptical of those, even though sometimes those are the ones that the parties come in with first.

**ANTITRUST SOURCE:** What advice would you give to the merging parties, their lawyers, and their economists that would help them bolster the credibility of their efficiency claims?

**SALINGER:** I would advise them to provide evidence that the realization of the efficiencies was fundamental to the decision made about the terms of the merger.

**ANTITRUST SOURCE:** What advice would you give on presenting efficiencies when the main category of efficiencies relate to reductions in headcount, overhead, and general and administrative expenses?

**SALINGER:** I would be surprised if that was a fundamental motivating force for the merger. And I would ask them probing questions about that. If you are going to have a marketing director for a bigger organization, is that marketing director going to make the same amount of money? Will he or she have the same size staff as before? I think mergers are generally based on broader strategic motivations than cutting out a director of marketing.

**ANTITRUST SOURCE:** The second question you posed in that earlier speech was why are the agencies so reluctant to bring coordinated effects cases, and you answered that shortly and sweetly with: "Because they're hard to win." At this point in your tenure, how would you respond to this same question?

**SALINGER:** I do think they are hard to win. If the legal standard is that you have to prove that the merger makes coordinated effects more likely than not, as a matter of economics, that is very hard to show. We know in oligopolistic situations that there's a mutual incentive to coordinate, that there is an individual incentive to cheat, and we do not know with great precision when the first of those is going to dominate.

**ANTITRUST SOURCE:** In *FTC v. Arch Coal, Inc.*, [329 F. Supp. 2d 109 (D.D.C. 2004)] the court criticized the FTC's reliance on customer complaints. To what extent does the Bureau of Economics staff get involved in interviewing customers and gathering customer information, customer complaints, and customer views?

**SALINGER:** Getting information from customers is a central part of many merger investigations. The challenge is how you use that information in court. A customer complaint is not, by itself, evidence against the merger. You have to take the customer complaints and make economic sense of them.

**ANTITRUST SOURCE:** How has *Arch Coal* changed the way the Bureau of Economics uses information that it gets from customers? How has it changed the type of information that the Bureau of Economics is seeking from customers?

**SALINGER:** Investigations still try to understand initially whether the customers think the deal is good for them or bad for them because that's the central concern of antitrust. We then have to understand why. The lesson that antitrust authorities need to learn from *Arch Coal* is if they find out that the customers are concerned, they need to ask more probing questions so that they can articulate the concerns in ways that the court will accept.

**ANTITRUST SOURCE:** Let's turn to vertical mergers. One of the complaints you have raised about vertical merger analyses is that economists try to fit the case to the model instead of developing the model to fit the case. Can you explain what that means?

**SALINGER:** The general issue of fitting a model to a case is, of course, a very complicated one. Models are necessarily approximations. There will always be something missing in the model, and it's a judgment call as to whether and how a model applies to a case. Some economic models give just really beautiful and deep insight into how to think about cases. It does not necessarily relate directly to vertical cases, but one of my favorite models in economics is the Gilbert-Newberry model of the relative incentives of an incumbent and entrant to develop an innovation. What's beautiful about it is that it stems from the basic insight that the monopoly profits are greater than the sum of duopoly profits. That is a very robust foundation to a model. Once you see it, it helps you think about a whole variety of cases in a way that you otherwise would not have.

The problem that comes up often with vertical issues and in general with a lot of antitrust issues is that the game theoretic models that are used in antitrust analysis can be quite fragile. You change an apparently minor assumption and the results completely change. There are different reactions you might have to that kind of a situation. What some people seem to do is say, "I'll look at a class of models and here is just one assumption that really seems to be key. Maybe it's Bertrand versus Cournot, or it's key whether the company can credibly commit to some particular action. And then I'm going to really focus hard on how this particular assumption comes out."

To my mind, that is a mistake. If the model is so fragile, it means that that framework is not all that helpful in addressing the case.

**ANTITRUST SOURCE:** During the past year, have you tried to develop richer models that depart from some of these traditional models?

**SALINGER:** Well, in some cases, I think it is a mistake to try to come up with *the* right model to apply to a case. Take a particular issue that I have been interested in—tying. One approach is to say, okay, we are going to come up with the right tying model to serve as the foundation for a case. The alternative approach I would take to tying would be to try to come up with a standard that is really akin to what we have with predatory pricing.

Let me explain what I mean by that.

With predatory pricing, there are two key elements to the test—you have to show pricing below the relevant notion of cost (and that relevant notion hasn't necessarily been nailed down yet), and you have to show a dangerous probability of success. Now the first part of that test is different from what you might expect a test to be. You might expect something like a profit-sacrifice test in which anything below the short-run profit maximizing price would be predation. But that's not what is used. Instead, the standard is that you have to show pricing below the relevant measure of cost. The justification for that is that such pricing behavior is qualitatively different from the sort of pricing that you would observe under competition.

With tying, what we would need is not so much the right model of monopolistic or exclusionary tying to justify the case, but we need a standard for what is the sort of tying that we would not expect to observe under competitive circumstances. Of course, that's a challenging thing to do because the tying that we observe under competitive circumstances is really much more subtle than most people acknowledge.

**ANTITRUST SOURCE:** The FTC and DOJ have submitted a joint brief in the *Weyerhaeuser-Ross-Simmons* case on predatory bidding. [<http://www.usdoj.gov/atr/cases/f217900/217988.htm>] Weyerhaeuser is alleged to have engaged in predatory buying of alder logs in order to exclude competitors, including Ross-Simmons. In your view, is there a distinction between predatory bidding and predatory pricing?

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**SALINGER:** In the *Weyerhaeuser* case, the court—I think it was the trial court—said that the output market was perfectly competitive, so the only competition at issue in the case was the competition for the input. There were no possible repercussions of that competition on the output market. In a case like that, there should be a very tough standard for the plaintiff to prevail. Pure predatory buying is probably an even rarer phenomenon than predatory pricing. I think you would have to ask skeptical questions about any case of this nature. For example, if the scheme were successful in driving Ross-Simmons out and the price of lumber dropped after they exited, what would prevent someone from buying up the mills and operating them again now that you could get the input at a reasonable price?

As with predatory pricing, you are looking at the type of behavior that is just part of normal day-to-day decisions that every business has to make. Every business has to decide what inputs to buy and how much they are willing to pay for them. It would really be a big mistake if antitrust policy were to make it easy for someone who is outbid for an input to bring an antitrust action.

**ANTITRUST SOURCE:** Do you think that a recoupment test, which is used in predatory pricing tests, is an important component of a test for predatory bidding?

**SALINGER:** Yes.

**ANTITRUST SOURCE:** One reason predatory pricing cases may be tough to win is that lower prices are an objective of antitrust policy. Do you see that same danger in predatory bidding cases?

**SALINGER:** The antitrust laws protect all forms of competition. Protecting competition among buyers is as important as protecting competition among sellers.

**ANTITRUST SOURCE:** Costs come into play in antitrust analyses in a large number of ways, such as price cost markups, predatory pricing, and even simply identifying which costs are fixed versus variable versus marginal. You have commented that economists need to do a better job of understanding cost. Can you give some examples of situations in which economists do not yet have a good understanding of cost?

**SALINGER:** I can give you an example where I think a court got a basic cost issue wrong. In the Department of Justice's predatory pricing case against American Airlines, I think it was the appeals court that said that the airplanes should have been treated as fixed costs even though American Airlines had expanded the number of airplanes on the route in order to sustain the low prices that they were charging in response to entry. As a matter of economics, that's wrong. Now you might say that wasn't the economists, that was the court that got it wrong; but I think the economics profession bears some of the blame. For the last quarter century, economists have really neglected cost analysis. These sorts of misperceptions on the part of courts are because we have not gotten to a point where we say look, this is the right way to think about this particular set of cost issues.

Another area where cost analysis is really key is in critical loss analysis. One of the critiques you see with the critical loss analysis done in practice is that you need to check whether the estimate of the margin is consistent with some economic equilibrium. If you are starting out with a very high margin then it must be that demand is very inelastic.

At some level that critique is true. But my suspicion is that in a lot of critical loss analyses, the mistake that is made is in computing the high margin by underestimating marginal cost. I think there is a tendency for economists to think that marginal cost is just the average of the cost the accountants treat as variable. That can be a mistake.

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**ANTITRUST SOURCE:** The FTC and DOJ have been conducting hearings on single-firm conduct since June. Several very interesting sessions have taken place. Can you tell us what you are learning from the hearings and what you hope to get out of the hearings?

**SALINGER:** Some of the most interesting sessions are the ones where we were, I think, creative. I particularly liked the business strategy and business history sessions. I think it is important for us to hear and be reminded that there is substantial evidence that, for example, Alcoa's top management had as a central concern that its pricing not be so low as to drive rivals out of business. That sort of evidence makes it clear that the concerns that antitrust can be protecting competitors rather than competition are not mere theoretical concerns but that they are very real.

Last week, I co-moderated the tying session, which I found interesting even though it is a subject that I have thought a lot about. There were perspectives presented that I hadn't thought much about. Mark Popofsky gave, I thought, a really interesting discussion of the distinction between Section 1 and Section 2 tying standards. As an economist, that is a distinction that I had not given a lot of thought to.

I would hope that lawyers listening to the sessions had similar reactions to some of the economic testimony—that they heard perspectives that perhaps they hadn't thought about.

And I thought it was valuable that despite the variety of perspectives that were presented, there was agreement that the per se standard for tying should go.

**ANTITRUST SOURCE:** If you were to use a rule of reason analysis to analyze a tying claim, how would you go about addressing whether there are any competitive concerns?

**SALINGER:** That is an excellent question. It's a question that I typically pose after people say, "We need to move to a rule of a reason." It's challenging. I will repeat what I said before. The standard for tying should be more similar to the standard for predatory pricing than it should be to other kinds of vertical restraints such as exclusive dealing. You should really have to show that tying is somehow qualitatively different from the sort of tying that would be expected under competition.

The difficulty of establishing that is that the essence of a tying claim is that a company sells two goods that in principle could be sold separately, but it chooses not to sell one of the components separately. All companies have to decide what they sell and what they don't sell. Whatever they decide, at the end, you can almost always say well, we could carve that up into components.

**ANTITRUST SOURCE:** In theoretical discussions of Section 2 issues, one issue that comes up is which welfare standard—consumer welfare versus total welfare—to use to evaluate the merits of conduct. What is your view on the correct standard?

**SALINGER:** For most antitrust cases, it's consumer welfare. To some extent, that is a political judgment, not an economic one. Antitrust has populist roots. The public that cares about the antitrust laws, and their elected representatives, expect the antitrust authorities to look out for the "little guy," by which I would mean the individual consumer. If you want to justify it on more formal economic grounds, you might vary the weight given to the surplus of different individuals based on their income. In most cases, the typical consumer is not as well-off as the typical shareholder.

Now, there are cases or classes of cases where I think you have to back off the consumer welfare standard. You asked me before about the *Weyerhaeuser* case, where the exercise of buyer power is what is at issue. Since the antitrust laws protect buyer competition as well as seller competition, they protect the beneficiaries of the competition at issue in each case. In *Weyerhaeuser*, that is the sellers.

*Everyone agrees that childhood obesity is a terrible problem, and one that we need to address. But it is important that when we take action to try to address it that we are addressing the real problem.*

**ANTITRUST SOURCE:** Over the past year, the FTC has been involved in a number of consumer protection areas, including child obesity, mortgage lending, and credit scores. In general, what role do economists play in consumer protection?

**SALINGER:** Our most important role in consumer protection is the big studies that we do. You mentioned a number of the studies that we have ongoing. These are studies where we are able to get evidence, often statistical evidence, but not always statistical evidence. Either way, we bring real facts to bear on issues that are often emotionally charged and where a lot of debate is not supported by facts.

The Bureau of Economics is the part of the Commission that has the technical expertise to do the analysis for those sorts of studies. I think that is where we often do our most good.

**ANTITRUST SOURCE:** As a specific example, let's talk about the child obesity issue. What is the role of the Bureau of Economics in assessing that issue?

**SALINGER:** Pauline Ippolito and Debra Holt are studying how much food advertising children see on television.

Everyone agrees that childhood obesity is a terrible problem, and one that we need to address. But it is important that when we take action to try to address it that we are addressing the real problem. If we think that the root of the problem is television advertising of food products to kids, then I think you would expect that advertising to have increased over the years. But the evidence seems to be that that is not the case. And to the extent that it is not the case, then maybe we need to look at other approaches if we are really going to solve the problem.

**ANTITRUST SOURCE:** Congress has asked the FTC to look at a number of issues related to gasoline price increases. Over the past year, how much of your time has been spent on various reports and investigations into the causes of the gas price increases?

**SALINGER:** A lot.

**ANTITRUST SOURCE:** How many members of the Bureau of Economics staff are involved in ongoing gas price investigations?

**SALINGER:** I don't have an exact count, but it is quite a few. If you look at the number of people who

at some point have been involved in the petroleum investigations, it is really a huge number.

In terms of ongoing activity, we monitor gasoline prices in a pretty large number of cities across the country weekly. That requires effort literally every week.

We often get inquiries from Congress asking about what's going on in the markets in their state or their district. We spend a lot of time responding to them quite carefully.

The last gasoline report was a major effort. The President has asked us to investigate the price increases that we saw after that report was released. That is an ongoing effort.

**ANTITRUST SOURCE:** Is it fair to say that the gas price investigations are an ongoing priority for you and for the Bureau of Economics?

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**SALINGER:** The petroleum industry is one of the FTC's key industries. Petroleum, health care, retailing to some extent. But petroleum and health care are really the two that stand out as being top priorities.

**ANTITRUST SOURCE:** Are there things that you have learned or that you did not expect to find in these gasoline price investigations? Have there been any surprises?

**SALINGER:** From a purely academic standpoint, I thought that what was most surprising about the pricing after the hurricanes was the huge increase in price dispersion. At some level, after you see it, it is not a huge surprise because if every firm's prices moved in lock step, you would be suspicious. The existing economic literature on price dispersion is about so-called equilibrium price dispersion. With the hurricanes, we saw that the dispersion associated with the move from one equilibrium to another was an order of magnitude greater than the equilibrium dispersion.

As I said, that is an interesting phenomenon from an academic standpoint. What to make of it from a public policy standpoint is less clear.

**ANTITRUST SOURCE:** Congress has asked the FTC to comment on possible federal legislation on price gouging. What role has the Bureau of Economics played in responding to that request?

**SALINGER:** Price-gouging legislation would be a mistake. I have said it publicly. I have written it publicly. I don't know any economist who disagrees with me.

**ANTITRUST SOURCE:** Why do you think it is a mistake?

**SALINGER:** Because it is, in effect, a price control and it is an unclear price control. A gas station owner wakes up in the morning and his price is controlled in the sense that if he sets too high a price, he might run into trouble with the law, but he's not exactly sure what price would be too much.

The risk you create is, first of all, if prices are held below the market clearing level, then we are going to run out of gasoline. People seem to think that running out during a disaster is just an abstract possibility. That is really naïve. If we do run out in the midst of a catastrophe, the catastrophe is only going to be worse.

The other related problem is that if gas stations don't know what is within the rules, they are just going to shut down rather than face the risk of violating the rules. Our gasoline report uncovered some gas stations in Florida that shut down rather than face the risk of a price gouging suit.

**ANTITRUST SOURCE:** Let's talk about antitrust outside the United States. How much interaction do you have with the European Commission and with your European Commission counterparts?

**SALINGER:** A lot. Just this week, Damien Neven, the new Chief Economist at the EC, and three members of his team came to Washington. We had a day and a half of presentations from the Justice Department, the FTC, and the EC about economic analysis in cases. It was a very productive set of meetings.

I have participated with the Chairman in our bilateral meetings with the EC in Brussels this year as well as the ones held in Washington last year. I've been over to Brussels on individual issues.

**ANTITRUST SOURCE:** Do you see similarities in the analysis and the models that are being used in Europe and the United States?

**SALINGER:** There are similarities and there are differences. As I said, we had a very good set of meetings with the EC economists. They have a very strong team of economists there and I think they are doing good economic analysis.

**ANTITRUST SOURCE:** We really appreciate your taking the time to talk with us.

**SALINGER:** It has been my pleasure. ●

# Compliance and Ethics in Investigations: Getting It Right

**Ray V. Hartwell, III**

A very aggressive independent investigation of suspected leaks by board members of a major corporation has been widely reported in recent months. The investigation involved the use by investigators of a practice referred to as “pretexting”—obtaining information through deception or false pretenses. The investigators, allegedly at the behest of senior executives and attorneys for the corporation, contacted telephone service providers and misrepresented their true identities in order to obtain board members’ phone records.<sup>1</sup>

Public disclosure of the investigation resulted in extensive fallout, including the resignation of the chair of the board of directors and the general counsel, and fraud-related criminal charges brought by the California Attorney General’s Office against the board chair, the company’s director of ethics, and three individuals associated with the private investigation firms. The company has already paid \$14.5 million to the California state attorney general to settle civil charges.<sup>2</sup> Executives, lawyers, and investigators—not to mention lawmakers—continue to grapple with the ramifications of the investigation.<sup>3</sup>

During the 1990s, investigative reporters for ABC News went “under cover” in order to seek a story on Food Lion’s questionable food handling practices, including the repackaging and sale of spoiled meat. Food Lion did not contest the accuracy of the story, but instead attacked ABC’s investigative techniques in a lawsuit alleging fraud and trespass. The falsification of employment applications and references by the ABC team—a “pretext” that enabled the reporting—became the focus in Food Lion’s litigation against the network.<sup>4</sup>

And, in the antitrust world, the use of covert eavesdropping by the DOJ was at the heart of one of the first major international cartel cases.<sup>5</sup> The Department of Justice’s “lysine video” has since become a staple of compliance programs and seminars on contemporary criminal antitrust enforcement.

Lawyers often supervise investigations in a variety of circumstances, including suspected misconduct by corporate agents or employees, gathering evidence to prepare for litigation, or to supplement pretrial discovery when litigation is pending. Prosecutors may also supervise agents or use informants to elicit (and secretly record) admissions from suspects. In the antitrust context,

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<sup>1</sup> See Peter Waldman & Don Clark, *California Charges Dunn, 4 Others in H-P Scandal*, WALL ST. J., Oct. 5, 2006, at A1.

<sup>2</sup> See Christopher Lawton, *H-P Settles Civil Charges in “Pretexting” Scandal*, WALL ST. J., Dec. 8, 2006 at A3.

<sup>3</sup> See, e.g., Christopher Conkey & David Rogers, *Congress May Soon Make “Pretexting” a Federal Crime*, WALL ST. J., Dec. 6, 2006 at B1.

<sup>4</sup> See *Food Lion, Inc. v. Capital Cities/ABC, Inc.*, 194 F.3d 505 (4th Cir. 1999).

<sup>5</sup> See Scott D. Hammond, *From Hollywood to Hong Kong—Current Antitrust Enforcement Is Coming to a City Near You*, Speech of Nov. 9, 2001, available at <http://www.usdoj.gov/atr/public/speeches/9891.htm>.

lawyers may assist in client investigations of suspected price-fixing activities, compliance with rules against transshipment, deceptive or exclusionary practices, or other competition-related conduct.

In all of these investigations, it can be useful for the investigators, agents, or informants to misrepresent their true identities or purposes. The conduct of any investigation will raise a host of compliance and ethics issues, but the risk of running afoul of ethics rules is heightened by the use of pretexting. Both counsel and clients may be exposed to a range of charges, including witness intimidation, retaliation, or even, as the recent cases indicate, criminal fraud or conspiracy.

Whatever one may think of the practices reported in the press of late, deception has been used successfully, and most would say appropriately, in a number of familiar investigation scenarios. Most of us probably do not consider it shocking, for example, that minority couples have posed as prospective home purchasers in order to gather evidence in housing discrimination cases. We are more grateful than aggrieved when law enforcement agents conduct sting operations that net drug dealers and corrupt politicians. And we understand the need for various types of entrapment strategies in a range of cases, from intellectual property misappropriation and infringement to child pornography.

As lawyers guiding or assisting our clients and their investigators, we need to recognize what separates permissible from impermissible investigative techniques.<sup>6</sup> The starting point, and the focus here, is the ethical rules within which counsel must operate when supervising investigations. Of course, counsel must not only consider the ethics rules and legal framework, but also must be guided by common sense and a healthy wariness about techniques that might fail a “smell test.” Otherwise, the risk that a furor over the investigation itself will get in the way of achieving the inquiry’s proper objectives will be all too real.

### Key Disciplinary and Ethics Rules to Consider in Planning an Investigation

The ethics rules, including the disciplinary ABA Model Rules of Professional Conduct, do not answer all of the questions that may arise in the course of an investigation. Nonetheless, the Model Rules set forth below are instructive and should be considered in planning an investigation.<sup>7</sup>

- Model Rule 8.4(c) states that it is “professional misconduct” for a lawyer to “engage in conduct involving dishonesty, fraud, deceit or misrepresentation.” Although this provision and others literally would preclude all pretexting, interpretations of the rules do allow pretexting in some circumstances.
- Model Rule 4.1(a) provides that, “[i]n the course of representing a client, a lawyer shall not knowingly . . . make a false statement of material fact or law to a third person.”
- Model Rule 4.4(a) prohibits using “methods of obtaining evidence that violate the legal rights” of third parties.
- Model Rule 4.2 states that, “[i]n representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another

<sup>6</sup> As general references on the subject, see David B. Isbell & Lucantonio N. Salvi, *Ethical Responsibility of Lawyers for Deception by Undercover Investigators and Discrimination Testers: An Analysis of the Provisions Prohibiting Misrepresentation Under the Model Rules of Professional Conduct*, 8 GEO. J. LEGAL ETH. 791 (2001); David C. Hricik, *Conflicts and Confidentiality: The Ethical and Procedural Issues Concerning Experts* (2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=917164](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917164).

<sup>7</sup> While the Model Rules (available at <http://www.abanet.org/cpr/mrpc>) have been adopted by most states, interpretations of the rules can vary among the states. Moreover, some states have adopted the Model Rules with modifications, while others, such as New York and California, have not adopted them at all. Even these states, however, have similar restrictions.

*The conduct of any investigation will raise a host of compliance and ethics issues, but the risk of running afoul of ethics rules is heightened by the use of pretexting.*

lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order.” The drafters were aware that this is potentially complicated in the case of organizational clients, and the commentary to the rule addresses this subject by prohibiting contact with managerial employees of a corporate party or any employee who may legally bind the corporation with respect to the matter in question.<sup>8</sup>

- Model Rule 4.3(a) provides that when a lawyer deals with a person who is not represented by counsel, and “knows or reasonably should know that the unrepresented person misunderstands the lawyer’s role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding.”
  - With respect to investigators dealing with persons who are not represented by counsel, there is some leeway not to explain the purpose of an inquiry so long as the investigator does not purport to be acting as, or on behalf of, a lawyer. This is so because Rule 4.3 turns upon the presumed expectations of the third party in dealing with a lawyer, as opposed to nonlawyers.
  - Model Rule 5.3(b) states that “a lawyer having direct supervisory authority over [a] nonlawyer shall make reasonable efforts to ensure that the person’s conduct is compatible with the professional obligations of the lawyer.”
  - Model Rule 5.3(c)(1) provides that a lawyer is responsible for a nonlawyer’s conduct that violates the rules if the lawyer “orders or, with the knowledge of the specific conduct, ratifies the conduct involved.”
  - Model Rule 8.4(a) adds that it is misconduct for a lawyer to “violate or attempt to violate the Rules . . . , knowingly assist or induce another to do so, or do so through the acts of another.”
  - If a lawyer is asked by a judge about the investigative tactics employed to obtain particular information or evidence, Model Rule 3.3 prohibits false statements of law or fact to a tribunal.
- This is a lot to digest, and there is more.

*While navigating safely through the applicable ethical and legal rules may avoid sanctions or prosecution, it will assure neither the admissibility of evidence gathered in the course of an investigation nor the reaction of a court or jury . . .*

### Other Legal and Practical Considerations

The foregoing ethical rules are not the only constraints that may affect the planning of an investigation. As the matters mentioned above underscore, federal and state criminal statutes may be invoked at the discretion of prosecutors.<sup>9</sup> While navigating safely through the applicable ethical and legal rules may avoid sanctions or prosecution, it will assure neither the admissibility of evidence gathered in the course of an investigation nor the reaction of a court or jury—either of which could react negatively to aggressive techniques.

Both the rules and a sense of personal integrity favor honest disclosure of a person’s identity, interest, and role in the course of an investigation whenever possible. However, since disclosure could render the achievement of some legitimate investigative objectives difficult, if not impossible, there is a place for pretext. This has been recognized in ethics opinions and cases to varying degrees in different jurisdictions, with the result that not all pretexting is out of bounds.

<sup>8</sup> See Comment 7 to Model Rule 4.2 (“In the case of a represented organization, this Rule prohibits communications with a constituent of the organization who supervises, directs or regularly consults with the organization’s lawyer concerning the matter or has authority to obligate the organization with respect to the matter or whose act or omission in connection with the matter may be imputed to the organization for purposes of civil or criminal liability.”).

<sup>9</sup> Federal legislation that would complement existing sanctions is also under consideration, and the *Wall Street Journal* reported recently that “[a]bout 12 states have made telephone pretexting a crime.” See Conkey & Rogers, *supra* note 3.

## General Guidance

Ethics opinions and cases provide some general guidance on the legality and ethical propriety of pretexting. The opinions and cases suggest that pretexting is most likely to result in an ethics or statutory violation when used to obtain information legally protected from disclosure, such as financial or telephone records, or information associated with strong privacy interests. For example, the Eighth Circuit recently found that a plaintiff's attorney violated the Fair Credit Reporting Act, 15 U.S.C. § 1681 et seq., by obtaining a potentially adverse party's credit reports in order to determine whether the party was judgment proof.<sup>10</sup>

In addition to the Fair Credit Reporting Act, myriad federal and state statutes may attach civil or criminal liability to pretexting used to obtain non-public information like financial and phone records. According to the Federal Trade Commission, for example, the Gramm-Leach-Bliley Act, 15 U.S.C. § 6821 et seq., makes illegal the use of "false, fictitious or fraudulent statements or documents to get customer information from a financial institution or directly from a customer of a financial institution."<sup>11</sup> The Federal Trade Commission further maintains that the Federal Trade Commission Act, 15 U.S.C. § 41 et seq., generally prohibits pretexting designed to obtain sensitive consumer information. The Commission has filed several complaints alleging that pretexting used to obtain sensitive consumer information violates the Gramm-Leach-Bliley and Federal Trade Commission Acts.<sup>12</sup> The complaints have generally resulted in settlements enjoining the allegedly improper use of pretexting.

The federal wire fraud statute, 18 U.S.C. § 1343, may also be used to prosecute some forms of pretexting, even though it has not yet been applied in the pretexting context. That statute provides criminal penalties for the use of wire communications in interstate commerce to engage in "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent practices."

In addition to federal statutes, state criminal laws may be used to prosecute pretexting under certain circumstances. As noted earlier, prosecutors in California recently filed charges under that state's criminal laws in connection with the heavily publicized company investigation of suspected leaks by board members. The prosecutors filed charges against the company executives and investigators who ordered or used pretexting to obtain the board members' personal telephone records. They alleged violations of several provisions of the California Penal Code, including Section 530.5, which prohibits the use of personal identifying information of another to obtain credit, goods, or services in another's name.

Where neither the techniques used, nor the data obtained, are specifically regulated by statute, authorities become scant, but two general propositions can be drawn from existing court opinions: (1) courts are likely to find that pretexting violates the ethics rules when it is used to intimidate or trick an adverse party or witness into making admissions or statements which that party would not make under normal circumstances, but (2) courts are unlikely to find an ethics or legal violation when pretexting is used to obtain information that is objective or generally shared with the public.

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<sup>10</sup> Bakker v. McKinnon, 152 F.3d 1007 (8th Cir. 1998).

<sup>11</sup> FTC Facts for Consumers, Pretexting: Your Personal Information Revealed, available at <http://www.ftc.gov/bcp/online/pubs/credit/pretext.pdf>.

<sup>12</sup> See, e.g., Complaint for Injunctive and Other Equitable Relief, Federal Trade Commission v. Guzzetta, No. CV-01-2335 (E.D.N.Y.), available at <http://www.ftc.gov/os/2001/04/pretextingsmartdatacomplaint.pdf>.

**Pretexting Designed to Elicit Admissions.** Several courts have condemned the use of pretexting to steer or trick adverse parties or potential witnesses into making damaging admissions. In *Midwest Motor Sports v. Arctic Cat Sales, Inc.*,<sup>13</sup> for example, the Eighth Circuit found that the use of pretexting designed to elicit damaging admissions from an opposing party violated South Dakota's versions of Model Rules 4.2 (prohibiting communications with represented parties absent consent), 4.3 (prohibiting statement or implication of "disinterest"), and 8.4 (prohibiting deceitful conduct).

In *Midwest Motor*, defense counsel instructed an investigator to pose as a customer at the plaintiff's store and attempt to elicit and record "specific" and "damaging" admissions. The admissions were meant to support defendant's theory that the plaintiff was not injured by its inability to sell the defendant's product. Several admissions sought by defense counsel were recorded in the investigator's notes of meetings with counsel predating the investigator's visit to the plaintiff's store. These admissions included inducing plaintiff's store staff to "admit" that products competing with defendant are "the best" and "bad mouth[ing]" another plaintiff.

The court rejected the defense counsel's justification for its conduct, namely that the pretexting investigation was conducted so that defense counsel could become familiar with the plaintiff's product line. The court found that the investigation was designed to "elicit damaging admissions . . . to secure an advantage at trial" and as such could not be countenanced under the rules of professional conduct. The court also stressed that "the obligations and duties of lawyers in our society demand conduct of the highest moral character."<sup>14</sup>

In another case, *Allen v. International Truck and Engine*,<sup>15</sup> a federal district court found that a corporate defendant's attorneys violated Model Rules 4.2, 4.3, 5.3, and 8.4 by directing investigators to pose as employees and question other employees "specifically about the lawsuit" between their client and its employees. The court stressed that "lawyers (and investigators) cannot trick protected employees into doing things or saying things they otherwise would not say or do."<sup>16</sup>

**Pretexting Designed to Collect Objective Information.** *Midwest Motor* and *Allen* stand in stark contrast to cases upholding the use of pretexting to obtain objective information in the absence of questioning or other techniques designed to manufacture or encourage admissions. In *Apple Corps Ltd. v. International Collectors Society*,<sup>17</sup> for example, a federal district court found that the plaintiffs' use of pretexting in a copyright and trademark infringement suit did not violate New Jersey Rules of Professional Conduct 4.2 (prohibiting contact with represented parties absent consent), 4.3 (requiring disclosure to unrepresented parties), and 8.4(c) (prohibiting deceitful conduct).

The *Apple* plaintiffs owned trademarks and copyrights relating to images of the Beatles and had entered into a consent order with the defendants limiting the defendants' ability to sell certain stamps bearing images of the Beatles. In order to test the defendants' compliance with the consent order, the plaintiffs' attorneys (including investigators and staff) called the defendants' sales agents, posing as customers interested in purchasing stamps covered by the protective

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<sup>13</sup> 347 F.3d 693 (8th Cir. 2003).

<sup>14</sup> *Id.* at 699–701.

<sup>15</sup> 2006 U.S. Dist. LEXIS 63720 (S.D. Ind. 2006).

<sup>16</sup> *Id.* at \* 20. See also *In re Ositis*, 333 Or. 366 (2002) (reprimanding attorney for engaging private investigator to pose as journalist in order to obtain information from potential adversary).

<sup>17</sup> 15 F. Supp. 2d 456 (D.N.J. 1998).

order. In many of the plaintiffs' calls, the defendants' sales agents sold stamps in violation of the protective order.

Importantly, the questioning employed by the *Apple* plaintiffs was limited to simple requests to purchase the stamps at issue and did not involve any attempts to trick or intimidate the defendants' sales agents into making admissions or other damaging statements. The court found that "[t]he sales representatives' communications with Plaintiffs' counsel and investigators were limited to recommending which stamps to purchase and accepting an order for [the stamps]. The investigators did not ask any *substantive questions* other than whether they could order the [stamps]." <sup>18</sup>

In finding that the plaintiffs did not violate the ethics rules, the court stressed that the plaintiffs' use of pretexting was not designed to intimidate, or take advantage of, the defendants' sales representatives. The court found that the "Defendants have not produced a scintilla of evidence demonstrating that Plaintiffs' investigators intimidated [defendants'] sales representatives into selling them [the Beatles stamps] or provoked Defendants' breach of the Consent Order." <sup>19</sup> The court also stressed that "Like [Rule] 4.2, [Rule] 4.3 was intended to prevent a lawyer who fails to disclose his role in a matter from taking advantage of an unrepresented party." <sup>20</sup>

The *Apple* decision was echoed by another district court, which upheld the plaintiffs' use of an investigator posing as a customer to detect trademark infringement. In *Gidatex v. Campaniello Imports, Ltd.*,<sup>21</sup> the plaintiffs hired investigators to pose as interior designers and visit the defendants' furniture showroom and warehouse to inquire about the availability of infringing merchandise. The court found that the plaintiffs did not violate New York's analogues to Rules 4.2 and 8.4(c).

Considering the rule against contacting a represented person, the court found that the conduct at issue "technically satisfies" the rules but concluded that the "actions simply do not represent the type of conduct prohibited by the rules." The court concluded that the *Gidatex* investigators did not "interview the sales clerks or trick them into making statements they otherwise would not have made. Rather, the investigators merely recorded the normal business routine in the [defendant's] showroom and warehouse." <sup>22</sup>

Considering the rule against attorney/investigator "misrepresentations," the court stated that "[t]he policy interests behind forbidding misrepresentations by attorneys are to protect parties from being tricked into making statements in the absence of their counsel and to protect clients from misrepresentations by their own attorneys." <sup>23</sup> Again, the court found no evidence that the investigators caused the sales clerks to make statements they otherwise would not have made to a customer.

***Courts Appear Willing to Allow Some (Beneficial) Use of Pretexting.*** A comparison of the *Apple* and *Gidatex* cases with the *Midwest Motor* and *Allen* cases suggests that courts recognize the value that pretexting can serve in investigating wrongful conduct. *Midwest Motor* and *Allen* involve the use of pretexting in conjunction with lines of questioning designed to steer or trick potentially adverse parties or witnesses into making specific admissions or other damaging state-

<sup>18</sup> *Id.* at 474 (emphasis added).

<sup>19</sup> *Id.* at 472.

<sup>20</sup> *Id.* at 476.

<sup>21</sup> 82 F. Supp. 2d 119 (S.D.N.Y. 1999).

<sup>22</sup> *Id.* at 125–26.

<sup>23</sup> *Id.* at 122.

*A comparison of the cases suggests that courts recognize the value that pretexting can serve in investigating wrongful conduct.*

ments. Statements and information elicited under such circumstances are likely to be of questionable veracity, since they are clouded by the questioning and actions that elicited them. As such, the statements have limited value in furthering the courts' truth seeking function.<sup>24</sup>

On the other hand, the pretexting used in the *Apple* and *Gidatex* cases did not create the danger of improperly eliciting admissions of limited veracity. Instead, both *Apple* and *Gidatex* considered the use of pretexting to obtain information without loaded questions or other trickery, which resulted in objective information useful in uncovering wrongdoing and promoting the courts' truth-seeking function. As such, both *Apple* and *Gidatex* stressed the important role of pretexting in uncovering objective evidence of wrongdoing. The *Apple* court, for example, stressed the "prevailing understanding in the legal profession is that a public or private lawyer's use of an undercover investigator to detect ongoing violations of the law is not ethically proscribed, especially where it would be difficult to discover the violations by other means."<sup>25</sup>

### Exclusion of Evidence

As the above discussion illustrates, truth-seeking plays a prominent role in the courts' analysis of the legality and ethical propriety of pretexting investigations. The courts' concern for truth-seeking also plays an important role in the courts' determination of the appropriate sanctions for improper uses of pretexting, such as pretexting designed to elicit admissions unfairly. As a result, courts may punish improper uses of pretexting by excluding evidence. For example, the court in *Midwest Motor* excluded from the evidence the tape recordings made during the pretexting investigation as well as all additional evidence obtained as fruits of the recordings.

The availability of the exclusion sanction can serve as a strong deterrent to attorneys considering the use of pretexting in investigations because it carries the prospect of wholly eliminating the fruits of the investigation. Attorneys should be particularly wary of using pretexting when other avenues for gathering information exist, including formal discovery. For example, in the modern business environment, much of what one might seek through pretexting is recorded in discoverable video and audio surveillance tapes that are made and—at least for a time—retained in the ordinary course of business.

### A Prescription for "Getting It Right"

While the cases discussed above shed helpful light on likely court interpretations of the relevant legal and ethics rules, their value in guiding the use of pretexting is limited, for a number of reasons. First, the cases lack precedential value outside of their respective jurisdictions and can easily be distinguished by subsequent courts because each inquiry into the legality or propriety of pretexting greatly hinges on very specific facts. Moreover, the cases provide little guidance on the various non-legal but very real ramifications of pretexting. Under the appropriate circumstances, pretexting investigations can result in negative publicity. Negative publicity can result in a battered corporate image, corrective advertising expenditures, and lost customers and sales.

In these circumstances, counsel supervising investigations can serve their clients (and themselves) well by considering carefully, in planning any investigation, the objectives and possible

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<sup>24</sup> Similarly, entrapment has limited value in identifying criminal conduct, which would not occur but for the act of entrapment, and is also a prohibited investigative technique.

<sup>25</sup> 15 F. Supp. 2d at 475.

ramifications of the investigation. At the outset there should be candid and careful weighing of the range of means to be employed, the fundamental fairness of the means (both when considered alongside the conduct under investigation, and generally), and the feasibility of an incremental approach that employs less invasive measures, at least initially. Simply because one has the capability to use a given technique does not mean that it is a good idea.

Counsel's checklist of considerations should certainly include the following:

- ***The ethical rules, and opinions and cases interpreting them, in each state or other jurisdiction where the investigation might come under scrutiny.*** Is the conduct being investigated within a jurisdiction where pretexting or similar techniques have been approved or at least tolerated in past cases?
- ***In each relevant jurisdiction, the laws and regulations that may be implicated by the contemplated investigative techniques.*** Legal research is vital on federal and state laws on identity theft, invasion of privacy, tape recordings and other forms of surveillance, and similar topics. Counsel must consider not only the law, but also the enforcement climate, and the likely reaction of those being investigated.
- ***Planned use of the fruits of the investigation, and the impact investigative techniques may have on that use.*** For example, will the manner in which information is obtained jeopardize the admissibility of evidence and potentially provide adversaries a means of "muddying the water"?
- ***The potential impact of, and planned response to, public disclosure of the investigation.*** Will the process you and your client followed in deciding to utilize the means employed stand up to public scrutiny? Does the value of success in the investigation justify the risk to the client that could flow from disclosure?

*Simply because one has the capability to use a given technique does not mean that it is a good idea.*

### Conclusion

Investigations involving pretexting can arise in a number of industries and contexts. Investigation of possible antitrust violations, which may involve secret, conspiratorial communications, is an area where pretexting may potentially serve a valuable function. However, improper use of pretexting can result in significant costs. The planning and supervision of such sensitive investigations is an undertaking in which common sense and sound judgment are essential. And they, in turn, must be strengthened by a solid understanding of the applicable ethical rules, statutes and regulations, and opinions and cases interpreting them. ●

# The Elusive Goal of Convergence and The Inevitability of Uncertainty

**Thomas B. Leary**

One year ago, the European Commission's Directorate-General for Competition published a Discussion Paper on the application of Article 82 to exclusionary practices.<sup>1</sup> The Discussion Paper reflects a significant movement away from formalism and toward a greater reliance on the analysis of economic effects, and it has stimulated extensive discussion and detailed commentary.<sup>2</sup> This commentary is generally appreciative and respectful in tone but—like most commentary—it does tend to focus more on apparent differences than on similarities, and it is rather obvious that the U.S. commentators still think we do things better over here. There is a pervasive suggestion that the economic approach in the United States is more rigorous and better able to discriminate between pro-consumer and anti-consumer outcomes. Maybe so, but some humility is in order.

This article will not offer a point-by-point examination of current U.S. commentary on the EU's Discussion Paper. The article will simply suggest that antitrust analysis in the United States is still evolving; that it is inherently less rigorous and discriminating than many care to admit; and that, in any event, even common agreement by the United States and the European Union on principles or on actual language will not necessarily lead to common outcomes in any particular case. Counselors for global companies will therefore always have to deal with some uncertainty, and this kind of uncertainty is not unlike uncertainties they have faced in the past, even within a single jurisdiction.

At the outset, it is important to acknowledge that so-called Chicago School economics still dominates antitrust analysis in the United States. People tend to forget what the antitrust world was like roughly 30 years ago, when what was then called "The New Learning" first became widely known outside the academy.<sup>3</sup> The idea that antitrust policy should be driven by the economics of consumer welfare was considered heretical by many commentators. Similarly shocking were the ideas that company size could be associated with desirable efficiencies rather than pernicious "competitive advantage," that the intensity of competition is not necessarily correlated inversely with levels of concentration, and that vertical restrictions could be proconsumer.<sup>4</sup>

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<sup>1</sup> DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses (Dec. 2005), available at <http://ec.europa.eu/comm/competition/antitrust/others/discpaper2005.pdf>.

<sup>2</sup> See, e.g., Joint Comments of the ABA Section of Antitrust Law and Section of International Law on the Commission Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses (June 8, 2006), available at <http://www.abanet.org/antitrust/at-comments/2006/06-06/com-article-82.pdf>; Comments of the International Bar Association Antitrust Committee Working Group on Article 82 Enforcement on the DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses (June 2006), available at <http://www.ibanet.org/images/downloads/IBA%2082%20final%20.pdf>.

<sup>3</sup> The publication of INDUSTRIAL CONCENTRATION: THE NEW LEARNING (Harvey J. Goldschmid et al. eds., 1974), introduced these ideas to the broader legal community.

<sup>4</sup> See, e.g., William E. Kovacic, *The Modern Evolution of U.S. Competition Policy Enforcement Norms*, 71 ANTITRUST L.J. 377 (2003).

All of these once revolutionary ideas are now accepted by virtually all antitrust commentators. The big battle is over, and “[w]e play the antitrust game between the forty-yard lines today.”<sup>5</sup> But the game does go on, in the United States and around the world. Even though there may be common agreement on methodology, there still can be serious disagreement about the appropriate disposition of individual cases. The persistence of these differences, despite common agreement on methods, is something that judges and agency heads need to understand and that corporate counselors need to deal with every day. It is important for domestic and international bar groups to promote harmony between the approaches in the United States and the approaches in other jurisdictions, but it is also important to have realistic expectations.

People think in pictures, and therefore it may be helpful to illustrate the intellectual evolution of antitrust in this country by recalling the works of three famous 20th century painters. Before the mid-1970s, a lot of business practices were simply declared per se illegal because no one seemed able to articulate a procompetitive explanation. Outside the per se area, the rule of reason analysis lacked coherent structure. Myriad economic and social factors could be received into the record, without any guidance on how they should be weighed.<sup>6</sup> The finder of fact was somehow supposed to balance the factors in this formless mess. It was rather like the search for a pattern in a painting by Jackson Pollock.

Then came the “New Learning” or “Chicago” revolution. The arguments were compelling and elegant, and it seemed like there was at last a rigorous way to separate procompetitive and anti-competitive behavior. As Robert Bork explained in his famous treatise, a finder of fact must make a binary determination whether particular conduct was explained by “the desire to drive out rivals by improper tactics (which is unlikely) or the desire to create efficiency.”<sup>7</sup> This clear articulation, combined with a structured approach to rule of reason analysis,<sup>8</sup> gave rise to an expectation that it would be possible to distinguish clearly between conduct that is inside the lines or outside. Rather like a painting by Piet Mondrian.

Today, we recognize that things are sometimes not quite so easy. (The problem was not that Chicago theorists promised too much, but rather that we practitioners may have expected too much.) It is true that, in addition to the traditional category of offenses that are per se illegal, there is a recognized category of business practices that are, in effect, per se legal. Antitrust counselors can clear many practices today that once were suspect, and judges or agency heads seldom have to deal with them. The effects of other practices may be genuinely ambiguous, however, and Chicago economics does not always provide a rigorous way to draw the line. In other words there are broad areas of bright clarity with some fuzziness at the edges. Like a painting by Mark Rothko.

This article will explain, first, why we are living in a Rothko world and why there really is no way out of it.

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<sup>5</sup> Thomas B. Leary, *The Bipartisan Legacy*, 80 TUL. L. REV. 605, 606 (2005).

<sup>6</sup> See, e.g., *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962); ROBERT H. BORK, *THE ANTITRUST PARADOX* 201 (1978) (discussing the “nine major ideas” that once underlay merger-law enforcement).

<sup>7</sup> See BORK, *supra* note 6, at 171; see also *id.* at 138.

<sup>8</sup> See, e.g., *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210 (D.C. Cir. 1986) (preliminary screen to test for the existence of market power).

*The Chicago revolution substituted a single lodestar, namely the economic welfare of consumers, for the diffused populist objectives that had previously informed antitrust policy, and it supplied an analytical framework for determining these welfare effects. But this did not mean that cases would necessarily be easier to decide or to handicap. Quite the contrary.*

### Persistent Sources of Uncertainty

The Chicago revolution substituted a single lodestar, namely the economic welfare of consumers, for the diffused populist objectives that had previously informed antitrust policy, and it supplied an analytical framework for determining these welfare effects. But this did not mean that cases would necessarily be easier to decide or to handicap. Quite the contrary. To the extent that Chicago theorists questioned the inverse correlation between industry concentration and competitive vigor, or supplied likely efficiency justifications for restraints that had previously been deemed per se illegal, the outcome of individual cases may actually have become less predictable. The impact of this uncertainty on corporate counseling will be addressed later; the point here is that common agreement on the appropriate logical approach by various antitrust tribunals does not necessarily mean that there will be agreement on the ultimate outcome. To use a crude analogy, even if the appropriate algebraic equations were universally accepted, different experts might still plug in different numbers.

**The Need to Make Predictions.** The first and probably most compelling reason for this state of uncertainty is that virtually all antitrust analysis involves predictions. This is obviously true when it is necessary to evaluate the future competitive effects of a pre-notified merger or of a competitive strategy that has just been announced. Predictions are also required, however, when analyzing the competitive effects of past conduct. In this case, of course, there will be evidence of what has already happened in the market place, but it is still necessary to weigh this outcome against a prediction of what would have occurred in an alternative universe without the conduct. There simply is no rigorous way to make predictions about matters that depend so much on human behavior. Economics is not Newtonian physics.

The economics profession has, of course, developed ever more sophisticated measurements and models to help people make predictions. These models can provide directional signals, but anyone with experience in the business world knows that the most sophisticated models cannot replicate the complexity of a competitive marketplace, or even a single organization in the marketplace. Companies are not going to replace CEOs with supercomputers any time soon, and antitrust enforcers or counselors cannot rely on supercomputers either.

**Factors that Are Hard to Quantify.** The difficulty of making predictions is compounded by the fact that matters of competitive significance often cannot be readily characterized or quantified. For example, antitrust law draws sharp distinctions between unilateral and concerted conduct—and properly so—but it is not always easy to draw the line. In addition, only a relatively small and shrinking segment of U.S. industry deals with fungible products, where comparative prices and output can be fully expressed in numerical terms. A larger and growing segment of U.S. industry deals with combinations of differentiated products, services, and experiences, where comparative prices and outputs cannot be readily captured by statistics.

One short opinion that illustrates both problems was written by one of the most eloquent spokesmen for Chicago economics on the federal bench, in *Chicago Professional Sports Ltd. Partnership v. NBA*.<sup>9</sup> This landmark case involved an antitrust challenge to a league rule that would limit the number of basketball games that TV “superstations” may carry. Judge Easterbrook stripped the case down to two dispositive issues. First, was the league acting as a “single entity” when it established the rule, and hence immune under *Copperweld*?<sup>10</sup> A second critical issue was

<sup>9</sup> 961 F.2d 667 (7th Cir. 1992) (Easterbrook, J.).

<sup>10</sup> *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984).

whether the limitation on the *number* of games on these TV stations could be said to “reduce output.”

On the characterization issue, the court deferred to the district court’s conclusion that the league was acting more like a joint venture than a single entity, but acknowledged that “[c]haracterization is a creative rather than exact endeavor.”<sup>11</sup> In a later opinion in the same case,<sup>12</sup> Judge Easterbrook reiterated that this is a “tough question,” and went on to say that the league might be considered a single entity in some contexts and a joint venture in others.

The “output” issue was similarly ambiguous. How do you quantify the “output” of those enterprises that provide consumers with the experience of viewing a basketball game, both live and on TV? The first Easterbrook opinion in *Chicago Professional Sports* cited Supreme Court precedent for measuring output by the number of games that the league rule permitted to be broadcast. But the opinion also implicitly acknowledged that it would not necessarily be inappropriate to adopt other measures of output, such as the total number of people who will enjoy the experience, either live or on TV, or perhaps the effect on overall revenues.<sup>13</sup> In fact, the enhanced revenues may indicate that various league rules, designed to benefit the weaker teams, have resulted in closer and more exciting contests, which consumers and advertisers deem a superior experience—and hence could be said to increase “output.” Again, however, dedicated supporters of Chicago economics can arrive at different conclusions.<sup>14</sup>

Consider also the example, already cited,<sup>15</sup> of an initial market power test to provide structure for the rule of reason analysis. In many, probably most, cases it is easy to decide that a defendant accused of a restrictive practice does not have market power if it has a relatively low market share. But, in order to determine the market share, it is necessary to say what the “market” is, and this can be a complex and controversial task. The economic test for market definition that is set out in the U.S. Horizontal Merger Guidelines requires a prediction of whether a hypothetical monopolist in the product and geographic space under consideration could profitably impose a “small but significant and nontransitory increase in price”—the so-called SSNIP test,<sup>16</sup> over which serious battles have been fought in the international arena. It probably is the best test currently available, but still involves estimates and predictions. Reasonable Chicago-trained minds can therefore arrive at different conclusions.

***The Attempt to Quantify Efficiencies.*** The same problems arise when it comes to measuring the impact of a transaction on efficiencies. A primary contribution of the Chicago revolution was the recognition that efficiencies are important. This is something that is relatively easy to describe, or even illustrate with examples, but actual measurement can be a complex and controversial exercise. The most important sources of efficiency may not be the savings associated with greater scale and scope, but rather intangible improvements in the morale of an organization that are difficult to quantify and impossible to model. Thus, hard as it is to quantify efficiencies, it is much

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<sup>11</sup> *Chicago Professional Sports*, 961 F.2d at 672.

<sup>12</sup> *Chicago Prof’l Sports Ltd. P’ship v. NBA*, 95 F.3d 593, 599–600 (7th Cir. 1996).

<sup>13</sup> See *Chicago Professional Sports*, 961 F.2d at 673–74.

<sup>14</sup> For a discussion of similar complexities, see Thomas B. Leary, *The Significance of Variety in Antitrust Analysis*, 68 ANTITRUST L.J. 1007 (2001).

<sup>15</sup> See *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210 (D.C. Cir. 1986).

<sup>16</sup> U.S. Dep’t of Justice & Federal Trade Comm’n, Horizontal Merger Guidelines § 1.0 (1992, revised 1997), available at <http://www.ftc.gov/bc/docs/horizmer.htm>.

much harder to predict that efficiencies will actually be realized. A lot of carefully planned mergers and business strategies fail.

Consider the common example of efficiencies associated with extensive local sales efforts, which provide consumers with amenities like convenient locations, pleasant showrooms with a wide variety of choices, and a knowledgeable sales force. These amenities are expensive, and retailers that provide them are vulnerable to “free riding” by discount retailers that can close the sale once consumers have been educated about their choices in comfortable surroundings elsewhere. Identification of the role that vertical restrictions play in the containment of free-riding has been a major contribution of Chicago theory, and it is now almost universally recognized that these restrictions should be judged under the rule of reason. This victory alone will not eliminate all controversy, however, because it would be extraordinarily difficult actually to balance any adverse effects of the restriction against any adverse effects of the free-riding,<sup>17</sup> and most courts do not even try. Market power screens—or simple assertions that intermodal competition is more important than intramodal competition—are commonly applied instead, but the results can still be indeterminate if the market power issue is not clear-cut or the risks of free riding do not appear substantial.

*What all this means is that even a common agreement on the analytic principles of Chicago economics will not ensure that the antitrust authorities in the United States and the European Commission will take the same bottom-line view in any particular situation.*

**The Elusive Goal of Convergence.** What all this means is that even a common agreement on the analytic principles of Chicago economics will not ensure that the antitrust authorities in the United States and the European Commission will take the same bottom-line view in any particular situation. In fact, the authorities could issue a joint set of guidelines that conformed word-for-word, and still draw different ultimate conclusions. In addition to the issues outlined above, one obvious reason is that competitive effects may be different in different jurisdictions.<sup>18</sup> This observation is not intended to denigrate the efforts of the commentators who seek to close perceived gaps between competition law principles applied in the United States and those applied in the European Union. The message simply is that we should not expect too much too soon. Convergence is a laudable goal but will always remain elusive.

Consider just one illustrative example. The International Bar Association’s comments on the Directorate General’s Discussion Paper on Article 82 recommend specific language to make it clear that the conduct of both dominant and non-dominant companies should not be deemed abusive if it “is likely to produce (‘pro-competitive’) consumer welfare enhancing effects that outweigh any (‘anti-competitive’) market distorting effects.”<sup>19</sup> Assume this recommendation were implemented verbatim. There may be near-universal agreement on how to strike the balance in some cases but, for the reasons stated, there will be other cases in which even the most dedicated Chicago economists would disagree.

Identical outcomes are not assured with identical words, even at the government agencies’ level, and possible outcomes are even more variable when the vagaries of private litigation in the United States—and, perhaps, someday in the European Union—are taken into account. This is a big issue, worthy of extended treatment itself, and something that no corporate counselor can ignore. The risk of private litigation before potentially hostile juries means that corporate coun-

<sup>17</sup> See, e.g., *New York v. Anheuser Busch, Inc.*, 811 F. Supp. 848, 872 (E.D.N.Y. 1993) (“the weighing required by the rule of reason is extremely awkward to apply”).

<sup>18</sup> It is also important to remember that for most people in the European Union, the hypothetical joint guidelines would be written in a foreign language, with unfamiliar or varied overtones.

<sup>19</sup> Comments of the International Bar Association, *supra* note 2, § 4.2.4.

selors in the United States have never been able to rely solely on the standards for decisions outlined in U.S. federal cases and the pronouncements of U.S. federal enforcers. They have had to accommodate uncertainty for a long time.

### Some Practical Approaches to Uncertainty

A little history may be instructive. In the early 1980s, the Chicago approach was still highly controversial, the federal agencies were out in front of some courts, and academic opinion was still divided. Some believed that the evolving standards complicated the job of corporate antitrust advisors. I then expressed a contrary view:

Some have complained that rapid evolution, with a possibility of reverter, leads to unpredictability and inhibits antitrust compliance. This is true only if a client is determined to walk close to the cliff edge. The conservative advice of a decade ago is still valid today; in fact, the chances of an antitrust attack against long-standing business practices are considerably reduced. It is therefore easier than ever before for a lawyer to say “yes”; it may sometimes be more difficult to say “no.” This is so, of course, because the “rule of reason” had replaced flat *per se* prohibitions in a number of areas.<sup>20</sup>

The situation today is in many ways similar. Despite some apparent differences between the approaches of U.S. and EU competition authorities, there obviously has been movement toward greater convergence. The recent Discussion Paper on the application of Article 82 to exclusionary abuses is an extraordinarily ambitious attempt to restate the law in this broad area. There are some comments that observers on this side of the water may think are inconsistent or at variance with EU authority, but that is not unusual when agencies are attempting to find their way in a changing environment. For a domestic example, compare the way that concentration has been discussed in successive iterations of the U.S. Merger Guidelines, and consider the still lingering inconsistency in the latest version—which refers to a market share “presumption” in Section 1.51(c) but goes on to state in Section 2.0 that concentration data provide “only the starting point” for the analysis.<sup>21</sup> (Experienced counselors in the U.S. understand that the latter statement is more likely to be operative, unless concentration levels will be very high.)

Perhaps the most significant thing about the Discussion Paper is its extensive reliance on economic reasoning of a kind that is familiar to practitioners in the United States. The paper does not widen gaps, it narrows them. Counselors who advise multinational clients can survive in this evolving environment just as they did in the comparable environment that existed in the United States some 20 years ago. Now, as then, counselors need to be realistic, flexible, and creative.

Those who are not responsible for day-to-day antitrust advice may not appreciate that corporate counselors frequently have to provide a fast response. Assessment of the legal risks involved in aggressive pricing programs, vertical restraints, or even pursuit of an acquisition opportunity usually cannot await a full file search, canvass of customers, and economic analysis of the possible competitive effects. To the extent that these matters are governed by the rule of reason—which is what Chicago analysis is mostly all about—counselors and their clients have to manage uncertainty.

Consider, for example, the factors that the American Bar Association commentary would include in a definition of “substantial market power” or “dominance”:

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<sup>20</sup> Thomas B. Leary, *Antitrust Planning in an Era of Uncertainty*, CCH Business Strategies ¶ 2450, at 15,201 (1984).

<sup>21</sup> For a review of this evolution, see Thomas B. Leary, *The Essential Stability of Merger Policy in the United States*, 70 ANTITRUST L.J. 105, 114–21 (2002).

Many factors in addition to market share may bear on a finding of substantial market power. These include product heterogeneity, entry barriers, the importance and pace of technological innovation, the ability of one competitor to overtake another rapidly through innovation, customer characteristics (sophistication, ability to elicit new supply, etc.) relevant to customer ability to evade or defeat attempted exercises of market power by suppliers, and existence of downstream competition. Some of these factors are identified in paragraph 28 of the Discussion Paper, but the discussion here could usefully be expanded and made more comprehensive.<sup>22</sup>

This list may be unassailable in principle, but clients in a hurry are not likely to find it particularly helpful.

In these circumstances, it is useful—indeed, imperative—for counselors to advise clients on the hierarchy of antitrust risks. This advice requires both a deep understanding of the client's business objectives and the courage to suggest alternative strategies that may carry less antitrust risk. There are many examples of this hierarchy. Joint ventures are usually safer than mergers, and long-term contracts are usually safer than joint ventures. Contracts that specify minimum quantities are safer than exclusive dealing arrangements. Incentive discounts based on relative increases in volume purchased are safer than discounts based on total volume, and volume discounts generally are safer than "loyalty" discounts based on the percentage share of the buyer's purchases. In general, strategies that depend on the "pull through" of customer demand through creation of better value are safer than strategies that depend on a "push through" from dealers. Terminations with a soft landing are safer than terminations that are abrupt. The most practical test to apply up front may be to determine whether the proposed strategy seems primarily designed to do something "for" customers or primarily designed to do something "to" a competitor or a maverick dealer. All of these things are true in the United States as well as in the European Union because—regardless of what the cases hold or the antitrust authorities say—the risks of expensive litigation cannot be ignored.

When alternative strategies are subject to the rule of reason, the decision whether various antitrust risks are tolerable is one for business managers. The lawyers' job is to identify and quantify the relative risks, as best they can, including the likelihood of litigation as well as the likelihood of ultimate victory. This is called creative counseling. In addition to purely legal risks, many prudent managers will also weigh the possible adverse political or public relations consequences of particularly aggressive competitive policies. For them, these political and social facts may have real economic consequences, and less restrictive options may be appealing.

Business managements' caution and willingness to consider alternatives may help to explain why some longstanding anomalies in U.S. antitrust law continue to exist. For example, antitrust commentators almost unanimously disfavor the Robinson-Patman Act in its entirety. But even those businesses most directly affected have never been willing to exert the effort needed to effect a repeal or significant modification of the Act. The matter is simply not all that important for them because they have found practical ways to live with the law, just as they have found practical ways to accommodate uncertainties.

Nervous counselors can draw comfort from the fact that many managers prefer to operate in the broad color fields of the Rothko world, rather than in the fuzzy boundaries. For them, subtle differences between outcomes in the United States and the European Union are less likely to be matters of great concern. ●

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<sup>22</sup> See Comments of the ABA, *supra* note 2, at 5.

## The Current State of Economics Underlying Section 2: Comments of Michael Katz and Michael Salinger

**Editor's Note:** *The Economics and Section 2 Committees of the ABA Section of Antitrust Law presented a Brown Bag program on the current state of economics underlying Section 2 of the Sherman Act on July 24, 2006, in Washington, D.C. Organized by David Scheffman, the Brown Bag was moderated by Susan Creighton and featured Michael Katz of the Haas School of Business at the University of California at Berkeley and Michael Salinger, Director of the Federal Trade Commission Bureau of Economics. In light of the high level of interest in examining Section 2 from many different perspectives, we are publishing in this issue of The Antitrust Source the edited comments of economists Michael Katz and Michael Salinger.*

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**MICHAEL SALINGER:** I haven't done a scientific survey, but I'm confident that the most frequently told economics joke is the one about assuming a can opener. I won't repeat it here. If you don't know it, you can ask an economist.

I suspect, albeit somewhat less confidently, that there are two candidates for runner-up, and they both involve lampposts. There is the one about using data the way a drunk uses the lamppost, more for support than illumination. Then, there is the one about the woman who happens upon a man on his hands and knees under a lamppost outside a tunnel. What is he doing? Looking for his keys? Is that where he lost his keys? No, he lost them inside the tunnel. Why isn't he looking in there? Well, it's dark inside the tunnel; it's light under the lamppost.

I will argue that this last joke comes closest to characterizing the state of the economics literature with respect to unilateral conduct. When I talk about unilateral conduct, I will be a little broader than Section 2, so that when I talk about tying, the lawyers don't point out to me that the per se prohibition is based on Section 1.

Now, for this analogy to hold, I need to embellish the story a bit. Imagine that the man on his hands and knees had a set of keys on a key ring, that the key ring somehow became unattached and that the keys fell off in different spots, some of them inside the tunnel and some of them underneath the lamppost. So, in this extended version of the story, looking under the lamppost is not an entirely useless exercise but it's not sufficient for finding all the keys that we need to formulate sensible antitrust standards for unilateral conduct. Let me add one further embellishment: there might be more than one lamppost outside the tunnel, and the other one might be casting a brighter light.

Enough of speaking cryptically. At a broad level, I don't think there is much controversy about what we would like to know. Of course, as I might be wrong about the lack of controversy, I should stress that this is just my opinion and not necessarily that of the Federal Trade Commission or of any individual Commissioner.

Still, as an economist, I find it both striking and really quite encouraging that there seems to be a wide acceptance of decision theory as a way to organize our thinking about legal standards. Decision theory starts with the premise that mistakes are inevitable. If you think about it, the issues of what needs to be demonstrated and by whom only make sense if you entertain the notion that mistakes will happen. Then, the problem is how do you think about minimizing the damage.

Now, decision theory is pretty clear on the factors that should enter the consideration of legal standards. For any particular practice, there are basically three broad considerations:

1. First, what do we know about the anticompetitive uses of the practice? What's the underlying theory of how the practice can be anticompetitive? When it is anticompetitive, what is the cost to consumers of it being anticompetitive? (Because we need to know the cost in order to know the error cost of permitting anticompetitive instances.) And then, we want to know how often is the practice used anticompetitively.
2. The second thing we want to know about is the procompetitive uses of the practice. Again, what is the nature of the procompetitive benefit? How large is the benefit when it occurs? That tells us about the cost of chilling procompetitive uses of the conduct. And then, how often is the practice used for procompetitive or competitively neutral reasons?
3. And then, the third sort of thing we want to know is, what tests are available to distinguish between the procompetitive and the anticompetitive instances of the practice? And, for any such test, what is the risk that it will mislabel procompetitive behavior as "anticompetitive," and what is the risk that it will do it in reverse?

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No one seriously supposes that we can objectively measure all of these factors. When we talk about the relative frequencies of pro- and anticompetitive instances of particular practices, there is no way to take a random sample. And then, of course, you would have to measure the effects. That is a very hard thing to do. And yet, any standard that we adopt implicitly rests on at least subjective notions of the relative frequency of the pro- and anticompetitive uses of the practice, so we need to try to use evidence as best we can to form those objective assessments.

Now, it seems to me that the silver standard for this general approach to unilateral effects doctrine is predatory pricing. I would not quite call it the gold standard because there remain some issues as to whether we've gotten it entirely right. But, whether or not we've gotten it entirely right, the process by which we arrived at predatory pricing doctrine was to ask the right questions.

To prevail in a predatory pricing case, plaintiff bears a very tough standard of proof to show that pricing was below the relevant notion of cost and that the structural conditions of the industry are such that recoupment is feasible. Now, the rationale for that doctrine is the belief that price cutting for procompetitive reasons is common, that the cost of chilling aggressive price competition is high, and that anticompetitive instances of predatory pricing are quite rare.

If one looks to the literature beyond predatory pricing for related practices, many of the pieces of the puzzle we would need to formulate the right doctrine are just missing. Much of the modern literature starts from the assumption of a monopolist, typically faced with one specific known entrant, and the absence of any valid business justification for the practice. It then works out whether there is a set of assumptions under which the anticompetitive use of the practice is a Nash equilibrium.

As an aside, the lamppost under which many industrial economists seem to look is the Nash equilibrium. In my view, the light emanating from that lamppost is not nearly as bright as many of my colleagues seem to believe. Indeed, sometimes I think economists are attracted to it because they are the only ones with sufficiently keen eyesight to find anything there.

Now, without going into the details of those concerns, this type of analysis, at most, answers the first part of the first question; that is, it tells us what is the theory under which the practice is anticompetitive. It does not tell us the cost of the anticompetitive practice when it occurs, nor does it tell us how common it is for the practice to be used for anticompetitive purposes. The answers to those questions, and in particular the latter, remain inside the dark tunnel.

—MICHAEL SALINGER

The specific area of unilateral conduct that I have worked on the most is tying. As I have recently argued, the literature on tying should be viewed as a complete embarrassment.\* Ask yourself this question: Does the economics literature on tying explain the tying that we observe in practice? Would you take it to business students and say, “If you’re considering tying, these articles explain to you the factors that you need to think about”?

Now, to be sure, the economics literature and the legal literature do acknowledge that there is lots of tying for efficiency purposes. The example that typically gets used to illustrate the point is shoes, that right shoes and left shoes are typically sold as pairs, although as Mark Frankena pointed out to me several months ago, if you go to the Birkenstock Web site, they will sell you separate shoes. But that is the exception, and Birkenstock is a little offbeat anyway.

But this is a completely misleading example because it creates the impression that when tying occurs for efficiency reasons the people buying the tied product want all of the components. That just simply is not true. It happens all the time in competitive markets that people buy tied products and they end up buying a component of the product that they don’t want.

The simple example that I keep talking about is the set of four plug adaptors that you buy when you go to Radio Shack or some electronics store when you’re taking a trip to Europe and you want to use your laptop in Europe. You’ve got to buy along with it the adaptor for Australia and Britain, and also the New York City adaptor, which you don’t need. Until David Evans and I raised this example in an article a couple years ago, I would argue that the economics literature on tying did not contain an explanation for it. Even though that example by itself is economically unimportant, once you look at it, you realize there are tons and tons of examples of everyday tying that are like it. Until we understand the competitive instances of the particular practice in question, we are not going to be able to formulate sensible policies.

Now, like the law on tying, it may be that the economics literature on tying is unusually bad in terms of explaining what we actually observe. If we look at other practices, I think we understand them better. So, for example, I think we understand the efficiency justifications for exclusive dealing reasonably well, and there are a couple of them: exclusive dealing can help solve agency problems when contracts between a manufacturer and a distributor are inherently incomplete; also, I suppose related to contractual incompleteness, it may be that one of the parties in a transaction has to share intellectual property with another party and they want exclusivity because they don’t want the intellectual property to be shared; and finally, some buyers might want exclusive dealing as a way of breaking up what they fear might be cartel behavior, so they may ask parties to bid for exclusivity, and when that happens that is generally efficient. So I think we understand what the procompetitive explanations are. I’m not sure we understand how large they are, nor am I sure that we have a great sense of how frequently they arise.

Take another practice, one that has acquired quite a bit of interest recently, which is “all units” discounts and bundled discounts. Here I think our understanding is more up in the air. This area has the virtue that everyone seems to have a fair amount of humility, acknowledging that we need to understand them better than we do.

Much of the analysis to date has been to understand at a theoretical level the anticompetitive uses of these practices. I’m not sure that we know much about the competitive benefits. When I talk about the practice here, I’m not talking about any bundled or “all units” discount, but the ones

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—MICHAEL SALINGER

\* *Editor’s Note: See, e.g., Alden F. Abbott & Michael Salinger, Learning from the Past: The Lessons of Vietnam, IBM, and Tying, 2 Competition Pol’y Int’l 3 (2006).*

that are puzzling, which are those that entail incremental revenues over a fair range of output that may be negative, or at least well below the relevant notion of cost.

Now, even if we do figure out the procompetitive reasons for this pricing practice, I would like to know how big the benefits are relative to the alternative, because there is a pretty obvious rule to consider with these practices, which is that if a firm has a dominant position, its prices are inherently suspect unless the incremental revenue over substantial portions of business at least covers the avoidable cost associated with that chunk of business. So even if we come up with these procompetitive explanations, I'd like to know how much benefit do they generate compared to other kinds of nonlinear pricing schemes that would have this less-puzzling feature to it.

Now, in my elaboration of the joke about looking for keys under the lamppost, I posited the existence of another lamppost, perhaps one giving off brighter light. What I had in mind there was simple observations of examples of particular practices under sufficiently competitive conditions for which anticompetitive exclusion is not a candidate explanation. In other words, I had in mind ideas like the adaptor example. Now, you might argue that examples like that are subject to the criticism implicit in the other lamppost joke, that examples like that are used more for support than for illumination. There is a danger of that there, but I would argue that, given our current state of knowledge about a bunch of these practices, these kinds of cases are really quite illuminating.

Now, of course, much of what I have said so far has been looking toward the joint FTC and DOJ Section 2 hearings and also discussion about the implementation of Article 82 in Europe, what would we like to know. But, of course, the law can't wait for economists to figure out all that, in principle, we need to know to get the optimal policy. So the question is, what should we do in the meantime?

I find the debate comparing the relative merits of the "no economic sense" test, the "profit sacrifice" test, and the "consumer welfare" test not particularly illuminating. Look at a particular practice—take pricing, for example. You might reject the "profit sacrifice" test in favor of the "no economic sense" test with predatory pricing, and there are good arguments for doing that, but that would reflect a judgment about the risk of false positives and false negatives and their relative likelihood. So I don't think your decision on that issue of prices would necessarily apply to the other practices. I really think that we need to approach these different practices on a practice-by-practice basis, using decision theory as the guide to what the right standard is.

So how do I think it is going to wash out once we do that? I don't want to say too much because, after all, we are going through a set of hearings in which we are trying to learn more, but I'll just hazard some guesses.

I do think that the distinction between overly aggressive behavior and behavior that raises rivals' costs is a useful one. As a rule, dominant firms should not be allowed to pay their customers or suppliers not to deal with their rivals. Saying "not be allowed" is too strong, but I think that kind of behavior is suspect, and policies that have that effect should be treated with suspicion.

In this regard, exclusive dealing strikes me as being a relatively problematic practice among the nonprice practices that come under Section 2 scrutiny. Firms don't get exclusivity for free; they have to pay for it in some way. So exclusive dealing looks to me like paying companies not to deal with your rival. Obviously, we are not at the point where that should be per se illegal, and we are never going to be at that point, but I would treat that practice as being suspicious for firms with sufficiently strong market positions.

The other practice that strikes me as being particularly suspicious is the bundled and "all units" discounts when they have substantial ranges, where, in effect, a company is paying customers to take their product. Again, that doesn't necessarily fit into the raising-rivals'-cost category, but

*Exclusive dealing strikes me as being a relatively problematic practice among the nonprice practices that come under Section 2 scrutiny. Firms don't get exclusivity for free; they have to pay for it in some way.*

—MICHAEL SALINGER

it strikes me as being behavior where the efficiency benefits are not so clear, and so I think that's a practice that at the end of the day will be treated with hostility.

I know we want to leave time for discussion, so I'll end my comments there. Thank you.

**MICHAEL KATZ:** Let me summarize where I think we stand on the economics of unilateral conduct, or at least its implications for legal decision making. I agree that we have a wide range of practices where you have plausible economic theories that say there are consumer and efficiency benefits and there are also plausible theories of consumer and efficiency harm and these include practices, such as those already mentioned—exclusive dealing, pricing below cost, refusals to deal, tying, loyalty discounts. Those are all things where economic theory alone is not going to tell you the practice is always good or it's always bad, and, therefore, you are going to have to do something on a much more case-to-case basis.

One of the things that I think is important here—and it's something I know a lot of non-economists have criticized—is the rise of game theory. I think the problem is not so much game theory itself, but I think what is problematic is that a lot of the theories we have nowadays—and I think correctly so—require somewhat detailed knowledge of how people think and what they think they are doing, so that expectations and beliefs become important.

Consider a concrete example of what is certainly not a concrete concept. In the U.S. case alleging that American Airlines had engaged in predatory pricing, one of the theories put forth for how that could work is that other airlines would see American Airlines successfully beating up on a low-price carrier that tried to establish a hub in Dallas and, seeing that, they would expect the same thing to happen to them later. So the idea was that, even though American was losing money in the short term, and even though other carriers would be able to come in later if they chose to do so, predation could be profitable. There was no need for some hardcore entry barrier that kept rivals out no matter what. The degree of entry barriers was disputed in the case, but for the purposes of this theory, you wouldn't even need other types of entry barriers. What would be critical is that other potential entrants would see that American had beaten up an earlier entrant and they would fear receiving the same treatment. Intuitively American Airlines would be investing in a reputation for toughness.

Now, that I think is a perfectly logical theory, and it's even a common sense one: someone gets a reputation as being a bully and that keeps other people out of his or her way. You don't need a Ph.D. to tell a story like that.

The difficulty, of course, is that the theory depends on what people believe. If the other potential entrants say, "Well, American beat up on those guys, but we don't see any reason to think that they'll beat up on us," then the whole theory unravels. There was evidence that this pattern arose with Southwest, and that American in fact left Southwest alone. So then the question becomes: How does a judge get into the thinking—put him- or herself inside the minds of the parties? Now, of course, that happens in criminal cases all the time, but somehow it is thought to be difficult—and I think it is difficult—in antitrust cases.

So I think where we are is that we have these sophisticated theories that can depend on things that can be very hard to measure. The question is: What do we do about that?

There seem to have been at least three broad responses to this sort of situation, or potential responses. One is we could have courts become economic experts, or expert analysts, and say, "Okay, these theories are hard, but let's just really weigh in, have the courts figure out what is going on, look at all the facts, apply all the theories, and off we go." Now, that one, I think, is one that hasn't been tried. I mean most judges are not economic experts, and, in fact, courts often really mangle the economics.

The Tenth Circuit's opinion, I think, in *United States v. American Airlines* is an example. I think that some of what they said would fail a freshman economics course, at least a well-run course. I am referring, in particular, to some of the discussion about how to measure opportunity costs or determine whether prices are below cost when a company adds capacity, and to their notion that if I sell some units below-cost but then there are some other units that I sell above-cost, that somehow selling below-cost doesn't count. I think that's just flat-out wrong and that their reasoning made no sense at all.

So let's give up on having all judges become economists.

The predominant approach is the second one, which is to adopt rules of thumb that are relatively easy to apply. I want to come back in a couple minutes to say what it means to be easy to apply, or what I think Susan Creighton called a "practical test," because I think that is really important. I think we tend to mix up or conflate several different concepts of what we mean there, and I think it is useful to untangle them a bit. But first, let me give some examples of what I mean by rules of thumb.

*Most judges are not economic experts, and, in fact, courts often really mangle the economics.*

The Supreme Court's two-prong test for predatory pricing in *Brooke Group* is one. There is the first prong, which it seems to me to be rather unfortunate, that says pricing has to be below some measure of cost, and then the Court is deliberately vague about what that cost measure is. Economics actually tells us that whether price is above or below cost isn't even necessarily the right test. In any case, that's one prong.

There is also a second prong that says that there has to be a reasonable probability of recoupment. Now, I think in some ways that test makes sense, but I am not entirely convinced that it makes sense for the reasons the Court may think it does. In particular, at least one reading of what the Court says is that they think that that test is there because, if the firm couldn't recoup, then consumers wouldn't be harmed. That is just false. As a logical matter, you can certainly write down well-specified numerical examples proving that it is false and that there is not a congruence between recoupment and harm to consumers.

—MICHAEL KATZ

Now, the test may make sense, but I think it makes sense for a different reason, which is that you can think of it as a reality check: If there was no reason for the firm that has been alleged to have engaged in predation to expect to be able to recoup, then it raises the question of why the firm would have ever tried to engage in predatory pricing.

But notice the Court here has gotten us into the very thing that a lot of other courts say is something you don't want to do, which is raising the question: What did the defendant in this case believe it was doing, as opposed to what it actually did? If what you are saying is, "No, we don't get into intent; what we care about are actual effects," then you should look at the effects on consumers, and whether or not the firm recouped isn't relevant for that. It is related, it's close, but it is not the right thing. On the other hand, if you think of it as a reality check, then you're saying, "Could the firm have been thinking this?" and you are very much asking, "What were they thinking?"

So we have some rules of thumb, and they are not tightly linked to the underlying economics.

In the case of exclusive dealing, I think the recent *Dentsply* decision gets us closer to having the right economics. For many years, one of the things the courts looked at in exclusive dealing was whether or not there were long-term contracts with the distributors, with the notion that, unless there were long-term contracts, there couldn't be a problem. Well, economics quite clearly shows that that's just incorrect; that you might have no contract at all or have an "at will" contract, yet you could still create the economic pressures and economic incentives that would replicate the effects of long-term contracts. I was pleased to see that the appellate court in the *Dentsply* decision recognized that fact.

So we have a history of adopting rules of thumb, and as I say, I think it is an unfortunate history in some ways because it is not tied closely enough to economics. If someone says, “Okay, well whose fault is that?” I’m not saying it’s the courts’ fault. I think the courts struggle to do what they can and to come up with rules that make sense to them, and I think, as other people have already said, economics has not been overly helpful in coming up with workable, useful rules of thumb.

Now, the third approach—and then I’ll return to rules of thumb—is just to make various practices per se legal or per se illegal. I think that, despite having called it a third approach, it isn’t really, because it often ends up being some variant of the rules of thumb; if you get a good enough lawyer, you can always start defining one practice to look like another and it becomes very hard to know where you are drawing the boundaries, and pretty soon things break down into some sort of rule of thumb.

*Economics has not been overly helpful in coming up with workable, useful rules of thumb.*

Let me give an example to try to clarify this point. Consider the treatment of tying. I think it’s a not entirely unfair caricature of *Jefferson Parish* to say that tying is per se illegal if a rule of reason analysis says so.

The other thing—and this is somewhat controversial—is it is not clear, to me at least, that per se rules ever make sense and can be justified by decision theory or taken as a rational approach to decision making. In particular, one would have to ask the question: If you think a practice is really bad and almost never likely to have pro-consumer or procompetitive benefits, then why not still let the firm have its day in court if it is willing to bear all the expenses? Now, that could be a little tricky because you would have to figure out how they were going to compensate the other parties, but I think that is something one would have to consider before saying, “Oh, this is so unlikely we just have to declare it impossible.”

—MICHAEL KATZ

That last point gets into some issues of decision theory. Michael has already talked about that, so let me say a little bit more about rules of thumb. I’m going to say some things about decision theory, but also some things about what makes something a good rule of thumb generally.

Now, one thing we want is a usable test, something that works outside of the boundaries of an economics journal. Often, people say they want something that is easy, they want something that is predictable. As I said, I think it is important to separate out some different elements of what it means for something to be usable or to provide certainty.

One is that we want theories that are based on data that are actually available. As I already mentioned, that can be a problem, particularly for some of the strategic or game-theoretic theories, because they may depend a lot on expectations and beliefs, and those data may be hard to get. But that is clearly an important element as we move forward, trying to get more refined rules of thumb; we want ones that are based on things that you can potentially see.

The second element to think about is whether or not the rules should require a lack of technical sophistication. I think this one is problematic because people say they want easy rules. On the face of it, it is not clear why it should be easy to apply the rule. We are talking about decisions that involve tens or hundreds of millions of dollars, sometimes billions of dollars. So if it is hard to do, so what? It should be worth spending the money to get the right decision.

Now, I think the problem is, of course, that I don’t see any reason to think that we are going to change the court system and have judges or juries—if we are talking about private cases—who are going to have the technical skills to apply sophisticated theories. I am really at a bit of a loss as to what we should do about it, but I have to say I am disturbed that people don’t worry about these issues more.

Econometrics is, I think, a good example of what I have been talking about. The fact of the matter is that most people cannot understand a sophisticated econometric analysis at all. There is a

real issue, then, of what it means to introduce it into a court proceeding. Now, some people's reaction is, "Well, you shouldn't do it, because if the common man can't understand it, it doesn't count." I think that's ridiculous. It would certainly have interesting implications for the use of technology in society generally if we said that we can only do things that the man on the street can understand. But there is a real question of what we do going forward.

So when we talk about easy, if we mean that it is either cheap to apply or it doesn't require sophisticated technical skills, then I think we really need to think through whether that is something we want to impose.

The final one of these differing characteristics is whether it is easy to predict the outcome. Certainly, people talk about that for business certainty and for investment, and that's fine. But again, that is different than saying it's easy in the everyday sense of the word. What that implies is that we should have rules that say, "Let's take data that the firms can find, or later the courts would have access to, and rules that are relatively unambiguous so that one can apply these rules or apply the algorithm, whatever it may be, and come up with a good prediction of how the court would rule as well." That would be a process that would create certainty. Observe that this approach is consistent with having rules that are extremely sophisticated or complicated or require lots of data, as long as those rules are well-defined and don't rely a lot on opinion and judgment.

That said, lest you think I have taken leave of my senses, I know that in the real world, everything is going to have some degree of opinion and judgment; it's just a question of how much.

So this notion of having rules that are based on data that we can actually get, having rules that a layperson can understand without having a lot of technical skills, and having rules where it is relatively straightforward, where you can with a high degree of accuracy predict the outcome—those are three very different things that often get lumped together when people talk about having practical rules. As I've said, I think it is important to unpack those and think about the implications of each of them. I think the data-availability point should be uncontroversial, but the other two I think raise trickier issues.

Now, I want to say a little bit more on decision theory and this whole thing about weighing the different errors. But I also want to say something else about decision theory. That is, that in my experience—and in talking to others who have been involved in antitrust cases, I think it's their experience as well—the courts do a terrible job of applying decision theory. I don't just mean in the design of rules, but I mean in hearing the evidence and weighing what it means. I think if we want to invest in improving decision theory in antitrust, one of the things we should think about is ways to improve judges' understanding of it.

I'll give one example from my own experience, although I'll fuzz it up a little bit. I was testifying in a case. There was a question about determining the value of a threshold such that an outcome over that number would trigger that harm. The judge said, "What's the answer?" I said: "I know the following: I know that the number is bigger than 90 percent and I know it is certainly less than 100 percent, and that's what I can tell you. I know there's a breakpoint somewhere in there." It became clear that the judge thought that I was somehow trying to mislead her and I was hiding something. The judge wanted "the" number. Had I started my testimony by saying, very confidently, "The number is 93.7 percent," I would have gotten in a lot less trouble than I did by saying, "Look, what economics tells us is it is bigger than 90 and smaller than 100."

And judges are not alone in this. People like point estimates; they hate hearing things about confidence intervals; they hate hearing that things are in ranges. But the fact of the matter is that's how the world is and people have a completely false precision or accuracy when they look at point

*The courts do a terrible job of applying decision theory. I don't just mean in the design of rules, but I mean in hearing the evidence and weighing what it means.*

—MICHAEL KATZ

estimates. But that's what courts like. Almost any expert I have ever talked to will say that, if you go in and start saying, "Look, there are these factors this way and these other factors that way and on balance I think it goes this way and this is my view of the range of possibilities," then you might as well not even go into court. You need to go in and say, "There is this, this, and this that support my case, and here's the number." This is a bit of an overstatement, but the underlying tensions are real.

You can blame experts for not being true enough to economics, but I think there is a fundamental problem that the courts do not do a good job of processing information under uncertainty, and that's what we are always talking about in these cases. I think there could be huge gains to antitrust process if we could have ways for courts to be more sophisticated about the application of decision theory.

Now, the other place decision theory comes up in antitrust—and Michael already mentioned it—is this whole question of designing rules of thumb and trying to minimize the harm that comes from Type 1 and Type 2 errors.

Since Michael has dusted off almost all of the old economist jokes that I know, I guess I will have to use the one I know that's left. As you know, there are Type 1 errors and Type 2 errors. Then there is the Type 3 error: you don't know which is which between Type 1 and Type 2 errors. Unfortunately, I'm always in that category, so I'm always glad for the joke, because somehow if you get people to laugh, it doesn't matter so much that you're ignorant.

Anyway, the idea is that you are worried about false positives and false negatives. Now, the one thing I will say here is I think it is the right way to think about the problem, but it is trickier than I think is commonly recognized. This is so because everything that happens is conditional on the policy that you have. For instance, once the parties observe the rule in place, they are going to decide which conduct to go ahead with and which not, which will influence the mix of conduct that enforcers see.

And what you really want to know is not whether a practice—for example, low pricing—is usually a good thing or is usually bad. What you really want to know is: "If I adopt the following rule for predatory pricing, when I say that something is bad, how often is it actually going to be bad and when I say it is good how likely is it that it is actually going to be good?" That is a very different question than just asking, "If I look across the economy, how often do I see good pricing versus bad pricing?" In fact, if I had a perfectly functioning predatory pricing rule, the answer would be that when I looked out at the economy I would never see predatory pricing; by hypothesis, there is a perfect rule and, hence, no one would ever even try to engage in predation. So you can't conclude from that observation that predatory pricing is not a problem and that we don't need the rule.

People make the claims about the distributions of the different types of errors, and we've got to be careful about what we look at. The Supreme Court is often "quoted" as saying that predatory pricing is unlikely. But what they actually said is that there is a consensus among commentators that predatory pricing schemes are rarely tried and even more rarely successful. I suspect the Supreme Court did not do a systematic search of commentators, and I know that many of the commentators on which the Court based its opinion did not do any sort of empirical study of the extent of predatory pricing.

Now, all of this said, I think it is probably right that we want to be very cautious about challenging predatory pricing because we don't want to chill price competition, and it is all-important. But I think, in fact, we have never made a serious attempt to figure out how likely it is or how likely it would be absent rules. Instead, we rely on some sort of folklore that there is some empirical study done somewhere. But there hasn't been, and we need to have one done.

Let me add a couple of other things to my rambling account, and then I will stop.

There is the issue of what do we do given the state of economics, where experts on each side get up and tell what some people call “Just So” stories. Well, one thing is I think we certainly need it to be the case that the plaintiff—as a minimum requirement—should be able to come up with a “Just So” story because if they can’t even do that, how can you bring a case? Of course, beyond that, I think what is important is that the courts demand that the “Just So” stories plausibly fit the facts of the case.

Now, of course, there is the issue: What if the defendant has a story that says, “Here’s our ‘Just So’ story and here’s why it’s good.” Some people would think that’s enough. I think here, too, it is really important (and that the right way of proceeding is) that the court demand that the story fits the facts of the case.

In the U.S. case against MasterCard and Visa, for example, the defendants’ experts came up with what was clearly a logically coherent theory, and in some ways an elegant theory, of why MasterCard and Visa needed to demand that member banks not issue American Express cards or Discover cards. As I say, it was a perfectly fine *theory*. If you just looked at the logic of it, you’d say it’s a good thing. But there was absolutely no evidence—at least they presented no evidence at trial—that the theory had anything to do with what was going on in this market, that anyone at Visa or MasterCard had ever thought that’s what they were doing with the rule. Now, you might say, “Well, wait a minute. They don’t have to think it. They’re not economists. We care about effects, not intent, anyway.” But I think in some of these things it does matter.

I want to distinguish two points here. Sure, sometimes economists will talk about a practice in very different language than business people will, and the fact that business people did not use the economic terms of art does not, I think, tell us much of anything. But, after one does the translation, if there is still no evidence that the business people thought they were doing anything remotely like what the economic experts claim the practice is doing, it seems to me that should be worrisome to the court. There should be some expectation that business people understand the markets that they are in and know what they are talking about, and that, if they expect the practices to have some effect, that it is likely the practices do have that effect.

I’ll give one more example on this one. It’s in *Dentsply*, where the trial court concluded that the rationale that Dentsply put up for its exclusive distribution requirement was completely pretextual. The court essentially said, “Look, the experts and the business executives came up with this as an ex post rationalization for what was being done.” Yet, the trial court said, “Nonetheless, Dentsply wins” (for other reasons). Now, fortunately, it got overturned on appeal and Dentsply ended up losing the case. It seems to me that, if you have a story and it doesn’t fit the facts, then it should count against you.

I’ll end with one last thing on this point. Maybe I’m ducking the issues, in that, rather than talking about the economics, I’m talking a lot about process, but I do want to make another process point. That is, it seems to me the courts do a really terrible job of telling witnesses or forcing witnesses to give full and complete answers. What a lot of people get away with in depositions is, I think, just ridiculous. It is quite common for experts to try to refuse to answer the questions and just to run the questioners around in circles. Now, of course, some of that the questioners bring on themselves because they love to ask questions like “Have you stopped beating your dog yet?” and they’re playing games as well. But there are some just astounding cases. And the same thing happens with fact witnesses, where they’ll just flat-out refuse to answer the questions, and the courts seem to take no notice of that and not to care.

I'll give one final example of that. Since I'm not the one accusing the person of giving untrue answers, I won't be the one to get sued. *Business Week* described Bill Gates's deposition in the *Microsoft* case. They said it the following way: "Worse, many of the technology chief's denials and pleas of ignorance have been directly refuted by prosecutors with snippets of emails Gates both sent and received." Put another way, I think a lot of people who looked at Gates's testimony thought he was lying through his teeth when he said he didn't know this stuff. Yet, nothing happened because of that. Well, actually what happened is the trial judge got mad, the trial judge then did silly things because he was so mad, and it worked in Microsoft's favor.

I think it's a situation, again, where we could improve the process a lot if the courts would do more to hold fact witnesses' feet to the fire, but also the economic experts', because we do have a situation where there is a lot of "on the one hand, on the other hand," there's a lot of judgment, and I think the courts do a very poor job of getting the experts to identify the underlying sources of the disagreements between them. And I think the courts do a poor job, as I've said, of dealing with uncertainty. I think just those process improvements could make a difference and would be positive changes in dealing with the situation we have in the economics, where it's so much "on the one hand, on the other hand."

One last thing on process. To sound upbeat and positive, I'll make a recommendation, something to think about. In some countries, notably New Zealand and I think also Australia, they have what they refer to as a "hot tub," which is not everybody's idea of a dream hot tub. You get in a room with a bunch of economists, and all the economic experts sit down at once in front of the court, and then they hash out their disagreements and go back and forth and comment on each other. It is, I think, a much more efficient process for at least helping the court narrow down the issues. Also, it is a chance for the economists to point out what they think are the strengths—or, more likely, point out what they think are the weaknesses—of the other economists' theories. I think that is a lot more efficient way than filtering everything through lawyers in cross-examination and not having the back-and-forth.

—Michael Katz

*The courts do a very poor job of getting the experts to identify the underlying sources of the disagreements between them.*

**SALINGER:** Michael said a lot, and I agree with virtually all of it.

On the issue of the rules of thumb and what are good rules of thumb and what are bad rules of thumb, it seems to me that we have a rule of thumb for predatory pricing that's pretty good and we've got a rule of thumb for tying that is awful. So we have a doctrine that says if you have market power in the tying good—and there are a couple of other conditions, which are almost always satisfied—provided you pass the separate product test, that tying is illegal. I don't agree that that really is not a per se standard.

If you go back to the district court's decision in *Jefferson Parish*, there were a lot of compelling efficiency justifications that were given for the exclusive dealing agreement. When people say there really is not a per se standard, the part of the standard they point to is the separate products test. But the court didn't rule that because there were efficiencies, anesthesiology and surgery were a single product. They, in fact, ruled they were distinct products, even though there were lots of efficiencies.

So, with something like tying, I think we are going to need a rule of thumb, but we're just going to need a different rule of thumb, because, in light of the relative frequency and how common it is as an efficient practice, a hostile treatment is problematic.

The other comment I wanted to make . . .

**KATZ:** Michael, could I just say something about that before you make your other comment? That

is, the point I wanted to make on tying is it is not a clean or a pure per se rule and that it has important elements of rule of reason. I agree with you, though, that the rule of reason applies. It's structured, and by forcing the rule of reason analysis, there ends up being all this discussion of separate products. I agree with you that that's not the appropriate full scope of the inquiry, that you could have things that in fact were separate products, in the everyday sense of the word at least, where you would still think tying is okay.

But it is also the case that the separate products clause or rule allows a lot of things we might call ties to get through. So, for example, clearly you could sell automobiles without brakes—brakes are a separate product; as replacement parts they are sold separately from everything else—but no one has successfully brought a tying case saying that the rest of the automobile has been tied with the brakes. So that's why I'm saying there is at least an important element of rule of reason in there, if not necessarily the right one or the best one.

**SALINGER:** It is certainly true that the doctrine has been less harmful than you might expect given the nominal per se illegality.

The other issue I wanted to comment on is who bears the blame when the courts make decisions that are economically wrong. Is it because the courts just can't get it, or is it because economists are not providing the analysis that is needed?

Michael mentioned the *American Airlines* case, and there are a bunch of important issues in that case. One of the issues in the case was what's the right cost standard. One of the things that has happened in industrial economics over the last couple decades is economists have decided that they don't really know how to measure cost; it is really beneath them to do that; that they should leave it to the accountants, who they are sure are going to get it wrong; but that it is not really worth it for us to get it right. And so, having neglected the issue largely for several decades, I don't think it is really fair for us as a profession to criticize the legal community when the decisions don't get it right. I think we would be as a profession much more productive taking a more detailed look at costs than we have been.

**KATZ:** Let me say something about that.

I agree with you completely about looking at more detailed costs. One of the big issues in all of the airline predation cases is trying to figure out how to measure costs, how to deal with the planes and the people on them, and all of the different kinds of tickets—is a business class ticket in the same market as a coach ticket; and if they're not then how do you allocate costs?—and then, the fact that the airlines have very sophisticated algorithms for allocating costs, because they need to look at things like what happens if I have a hub-and-spoke system and this is a flight that is feeding other flights. So I agree that economists need to get into cost issues more deeply. Those are issues that are just flat-out hard.

I thought the United States should have won in *American Airlines*, and I was involved in the appeal. But the fact of the matter is I can see how the court, when it looked at the actual tests that were being done, just said, "I don't find these convincing" or, "It's just so hard, I couldn't tell what was going on." That's one level of dealing with cost.

But if you look at the district court's decision in that case, and also look at what the appellate court said, they also dealt with a little, simple textbook example—so we're talking about what the principle was—and they got that wrong. That example has been around for a lot of years, and it would be the kind of thing you'd have in a Principles of Economics course. I believe it was in Areeda and Turner—maybe it's Areeda and Hovenkamp—it's in there now.

They had the simple example that was in the *Antitrust* text. It said: “Suppose you had bought a whole bunch of gasoline in the past for a dollar”—this is really in the past—“and now the price of gasoline is, say, \$1.50 going forward. But you still have in your gas tank in your gas station, or wherever this is, 1,000 gallons left that you paid \$1.00 for. The question is: Going forward, what is the economically relevant cost of gas? What should I use, for example, if I want to ask the question, is this guy selling the gas for less than he paid for it or less than its economic cost?” I believe any economist I know of would say, “Look, obviously the right answer is \$1.50. That’s the market price. That’s what it is going to cost you to replace that gas after you sell it.”

The court said, “No, no. Obviously, we’ve got to average in that stuff you paid \$1.00 for.” While there is one situation where that would be the right thing to do, I guarantee that’s not what the court was thinking about, and the logic the court put forth to support its averaging was flat-out wrong. That is not a question of economists not having explained it well enough. The textbook explained it very well. It’s just that the court doesn’t know economics. I think that’s a serious problem, because I think if the courts misunderstand the economics at that fundamental a level, it’s really hard to see what you are going to do to get sensible decisions.

**SALINGER:** Michael, do you think economists would be unanimous on whether or not the airplane expense should be included as part of cost?

**KATZ:** As I said, I think there are two levels. This is completely my personal opinion. When I was at DOJ, in terms of appealing the *American Airlines* decision, I said: “Fine, so we lost out on how to treat the aircraft expenses and do those things.” I think the court was wrong on it. “But fine, we’ve lost on that.” It’s incredibly fact-specific and very detailed, and I think it is controversial, and different economists can come up with different answers. But on this fundamental principle, which they got wrong, and unfortunately they state it as a fundamental principle, I don’t think there is disagreement on that one.

But I agree with you, there are a lot of really tricky issues in the *American Airlines* case and the *Northwest v. Spirit* case on how you do the cost allocation. But my point is that we’re worrying about the really tricky issues, where the court can’t even get the first-order issues right.

### Questions and Answers [from the Brown Bag Audience]

**QUESTION:** My question was really suggested by that last comment. That suggests that the Commission should exercise more control over monopolization cases, on the theory that as an expert body we would get it right more often. One way we might do that is by having different proof under Section 5 versus Section 2, which we don’t tend to do.

**KATZ:** Well, I’ll sound like an economist and give an “on the one hand, on the other hand” answer, and I’m also going to sound like an economist who was the Chief Economist at the Antitrust Division. For all the criticism I had of what the courts do, I think that, overall, judicial review is really good, and I think that the process that the Department of Justice goes through is preferable to the process that the Commission goes through. I just think that the DOJ faces a harder time when it goes to court, and I think that’s a good thing. I even thought it was a good thing when I was at the DOJ.

So I think there is a balance there. I think yes, there is more expertise, and I think that’s a good thing, which does suggest moving in the direction you said, but I also think there is something to be said for having to get out there in federal district court.

**QUESTION:** In thinking about the interplay between market structure and conduct, doesn't the fact that we observe a practice adopted by firms in a competitive industry suggest that the practice is efficient? And in the context of predatory pricing, shouldn't we consider the possibility that low prices are designed not to drive rivals out of the market but to discipline those rivals?

**SALINGER:** It is plainly not sufficient to say, "Well, gee, if we observe a practice being common in competitive markets, then it's okay when practiced by a monopolist." The value of looking more carefully at a practice under competitive circumstances is that it might provide some insight into why it occurs and what the efficiency benefits are.

With tying, what has been missed in the economics literature was the notion that companies have a cost for each distinct product offering that they have, so that if you mandate untying, then you are, in principle, forcing a company to have this proliferation of products, which would cause its costs to go up quite a bit. But because there is that efficiency benefit, that doesn't necessarily mean that you would never condemn the behavior when practiced by a firm with market power.

What you should do, and what we should ask, is whether people have instances in which tying occurred in a way that it had an anticompetitive effect. Now, you do run up against the problem that Michael raised, which is that what you observe depends on what the policy is. So we have had, since *International Salt*, a per se prohibition against tying. Maybe if we hadn't had a per se prohibition, we would have all sorts of examples of anticompetitive tying.

With exclusive dealing, again there are efficiency benefits from it. Really, this is going to come down to a judgment call as to when do you think the efficiency benefits just aren't big enough to justify the anticompetitive risk. Can Microsoft or Intel go to Dell and say, "Look, you're going to use just our stuff?" Can Microsoft say, "You're not going to sell Linux machines," and can Intel say, "You're not going to sell AMD machines"? I think we've sort of reached a judgment call that they can't do that. I don't think we can prove as a matter of economics that that's exactly the right thing. I think it does require some judgment.

On the predation question, I haven't completely thought through the oligopoly point. Where I think the predation standard needs to be improved is a more sophisticated understanding of what the right cost standard is. Michael, of course correctly, pointed out that the Court has never said exactly what it is, and that is because we're not sure. But we should be able to know it better than we do.

There are these very complicated problems. Michael mentioned the issues of how do you deal with the hub-and-spoke nature of the network and its implications for cost, and cost allocation. That is very hard. But the question of whether or not you include the airplane, that's not that hard. We ought to be able to get that right.

**KATZ:** That's a good answer. We agree.

**SALINGER:** If they're expanding output, you certainly should be including the cost of the airplane.

**KATZ:** I want the record to show for everyone listening that two economists were asked a question and came up with the same answer. Could I just say one quick thing?

I agree with most, or maybe everything, that Michael was talking about but the oligopoly disciplining of predatory prices. Again, this is going to be one of these "on the one hand, other hand" answers. I think there is a very important point, which is if you are just looking within the confines of an economic journal, or taking the approach of "let me just understand what economic theory

*What you should do, and what we should ask, is whether people have instances in which tying occurred in a way that it had an anticompetitive effect.*

—MICHAEL SALINGER

says about this stuff,” there is nothing special about driving the company literally out of the market. If you have someone enter the market and then you beat up on them, and instead of leaving they meekly follow around and raise their prices and keep to some small percentage of the market and don’t really put competitive pressure on you, that’s a good thing too from the point of view of the firm engaged in predation. Bork said years ago that what you’re doing is using the pricing to discipline rivals.

So I think the theory would tell you yes, that’s right, that that’s just as important, and empirically maybe it’s more important, than literally driving the companies out of business. It’s disciplining them but letting them remain in business. But the real difficulty there is that does get pretty scary. For all I said, and I think it’s right, we don’t have good empirical studies of how often firms really try to engage in predation. But I have to say, in the absence of such empirical studies, I am with everybody else, or certainly the majority of commenters, who say, “We want to be really careful about deterring price competition.” It seems to me if you start letting firms say, “Look, this didn’t drive us out of business but it sent a clear message to us that we should set high prices because otherwise these other guys are going to respond aggressively to us,” if you let companies start bringing that kind of case, it seems to me it would be very worrisome, even though theoretically there certainly could be cases where it is harmful to let a firm respond to its rivals and compete vigorously against them. I think it is very dangerous to go down that road until we have a lot more confidence in our ability to isolate the bad cases from the good ones.

**QUESTION:** Why don’t we bring in evidence that we have from each of our investigations that would bear particularly on predatory pricing, but also more generally other types of Section 2 exclusionary conduct, in making an assessment about how frequently that conduct is likely to occur?

**SALINGER:** Well, it sounds like a pretty good idea to me. I think we all have ways of synthesizing what we generally observe in the world in forming these assessments of what behavior we observe frequently and what behavior we don’t observe very frequently.

I was at a conference at the National Bureau of Economic Research at the end of last week and we were talking about this general issue. I was bemoaning the lack of published evidence to support the proposition that predatory pricing is rare. I said that I thought that way too much weight was given to McGee’s analysis of the Standard Oil Trust, that that settles the matter once and for all. Then, Wally Mullin said, “Well, David Genesove and I are about to come out with a paper in the *RAND Journal* about the sugar trust, and they did do predatory pricing.” That’s nice that we have another observation. Of course, this one comes out the other way. But if that’s the one example, you might say, “Well, gee, it’s still a pretty rare thing.”

We’ve had a pretty long stretch of time where there has been a tough standard for bringing predatory pricing cases. If it were a common practice to try, I think we would be seeing a lot of it. We’d be seeing it in HSR matters and we’d be seeing it in lots of other places. I don’t think we have.

**KATZ:** I would agree with Michael that I think it is unlikely that, if we conducted a survey, we would see a lot of price predation, at least a lot of successful predation. I think Michael mentioned before what would we say to business people. Certainly, teaching in a business school, if an economist got up and started telling a bunch of MBAs, “Oh yeah, predation doesn’t make any sense, it doesn’t work,” they would start laughing or say, “Well, this shows how out of it economists are,” although, frankly, I think economists are probably more right than businesspeople on this one.

But I think Michael is probably right, that if we did do a serious study, if it was somehow possible to construct one, it would probably come out saying that there are not very many instances of successful predation where it's harmful. But I think we are both saying it would be nice to know that with greater certainty.

**QUESTION:** We haven't touched upon the issue of remedy in the event that there was a finding of predatory pricing or exclusive dealing or a refusal to deal, other than, in effect, saying, "Thou shalt not sin any more." That may stretch sort of to the edge of where economics can usefully help us. That may be an area too where we should be giving more thought, since certainly remedy is an issue where I would agree that people have argued that we shouldn't be bringing cases unless we have an effective remedy. So that's an area where we clearly need to be giving a lot of thought. It might be an interesting question whether economics could help us there.

**SALINGER:** You mentioned two kinds of cases in the same breath. I wouldn't mention them in the same breath. I think for the refusal to deal case you have raised exactly the right issue, which is refusal to deal means refusal to deal on what terms. Then, if you are going to go there, you are putting yourself in what looks like an awfully regulatory position. With predatory pricing, I am not sure I see the issue. If the standard is you can't price below the relevant measure of cost, which we have to get right—well, the penalty would be damages and then the threat of a subsequent suit if you keep doing it.

**KATZ:** I guess I would say that they probably belong in the same breath more than Michael is saying. It seems to me that either one of them, either refusal to deal or predatory pricing, both really run into the danger that the remedy is going to end up being regulation.

As Michael and I said at several points earlier today, coming up with these cost measures is really tricky, at least in airlines, and actually in a lot of industries. So to start saying to a firm, "you can't price below cost," of course what you really have to mean is, "you can't price below cost too much when it is going to do bad things" because there are probably good reasons to let them temporarily price below cost, and you've got to allow for them to make mistakes because there is uncertain demand and that might affect what costs are.

I think this question about the remedies is a really important question. I think in predatory pricing it is a problem.

The one thing on refusal to deal is, given that the courts have generally said there is not a duty to deal and the cases we are talking about—go back to *Aspen Ski*, where you say, "What we're requiring is when the guy shows up at the ski lift with a big pile of cash that you agree to sell him the tickets at retail." That is probably not too pervasive an intervention.

So it may be that, because the refusal to deal cases are so extreme, that in practice coming up with a remedy wouldn't be as hard as one might expect it to be. But I think the question is really important, and I think that, in a lot of cases, what the question brought up is a real issue, that you are trying to find liability for something that you are not really convinced you will be able to fix if you do find liability. ●

## Paper Trail: Working Papers and Recent Scholarship

**Editor's Note:** In this edition we note comments by the current chief economist at the FTC, Michael Salinger, and a former chief economist at the Antitrust Division, Michael Katz, on the economic basis of Section 2 of the Sherman Act. We also note a recent paper by Gabaix and Laibson that uses behavioral economics to explain perplexing market phenomena, focusing on the shrouding of high prices of add-on goods and services.

Send suggestions for papers to review, or your comments, to Editors William Page at [page@law.ufl.edu](mailto:page@law.ufl.edu) or John Woodbury at [jwoodbury@crai.com](mailto:jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

### Recent Papers and Speeches

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During the first five years in the life of this publication, there has been much discussion of Section 2 issues in the shadows of the *Trinko*, *American Airlines*, *LePage's*, and *Dentsply* decisions and the exclusionary conduct hearings of the Antitrust Modernization Commission and the Federal Trade Commission and the Department of Justice. It seems fitting that in this 5th anniversary issue, the Paper Trail review the state of the economics policy basis for judicial and agency oversight of exclusionary conduct. And it also coincidentally is one area of particular interest to this editor.

On July 24, 2006, the Section 2 and Economics Committees of the ABA Section of Antitrust Law hosted a "brown bag" program entitled, "The Current State of Economics Underlying Section 2." The key speakers were Michael Katz (a former economist at the Antitrust Division and now at Berkeley) and Michael Salinger (on leave from Boston University and now the FTC's chief economist). In addition to the stature of these two economists provided by their lofty government positions, both are highly respected by their peers (and even lawyers) for their papers on exclusionary activities.

In evaluating claims of exclusionary behavior, one might find some merit in the various tests proposed for identifying that behavior, including "cheap exclusion," "no economic sense," and the "profit sacrifice" and consumer welfare tests. But, of course, one concern in considering the application of any test is the possible chilling effect on the adoption of procompetitive practices.

Can there be a usable, fact-based decision rule identifying exclusionary conduct while reflecting the weighing of the harms and the benefits of the rule itself?

In his brown bag comments,\* Salinger observes that given uncertainty, a good rule would be one that was based on decision-theoretic principles, including an understanding of the anticompetitive costs and procompetitive benefits of the practice, how frequently the practice is used anticompetitively, and how it balances the costs of false positives with those of false negatives. Salinger explains why the predatory pricing test is a "silver standard" for such a rule—pricing below some measure of cost (but no gold here because, among other things, there is still fuzzi-

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\* *Editor's Note:* The comments of Michael Salinger and Michael Katz at the brown bag program are published in this issue of *The Antitrust Source* at <http://www.abanet.org/antitrust/at-source/06/12/Dec06-BrownBag.pdf>.

ness on the right cost standard). While Katz essentially agrees with Salinger on the utility of the predation test, he does note that we should keep in mind its shortcomings in application—e.g., that predation doesn't need to force firms to exit before it becomes harmful to consumers.

Beyond predatory pricing, Salinger's view is that we are far from having any test that is usable for detecting anticompetitive exclusionary conduct. We have game-theoretic stories that tell us when a practice might be anticompetitive, but they don't tell us anything about the costs of the practice or how often that the practice might be used anticompetitively. Katz subsequently notes that notwithstanding the elegance of game-theoretic models of exclusion, those theories are only as good as the underlying beliefs and expectations assumed by the players. And determining what the players (excluders and victims) were thinking at the time of the potentially anticompetitive exclusion can be a substantial barrier to the deployment of rules based on these models.

If the predatory pricing standard is the “the silver standard” for a good decision-theoretic test, Salinger must regard the *Jefferson Parish* test for tying (including the separate products test) as the “fools' gold standard.” He regards the economic literature on tying as a “complete embarrassment.” This is because it explains so little of the tying we observe in practice—the bundling of separate products that no one would likely regard as anticompetitive. So the hostile treatment of tying under the per se illegal standard of *Jefferson Parish* is the antithesis of the decision-theoretic approach. Katz notes that in fact, there is a seeming rule of reason constraint on the per se application of *Jefferson Parish*. No one, e.g., has ever successfully brought a case against a car manufacturer for “tying” the brakes to the sale of the rest of the car.

Salinger closes by noting that he finds that the debate regarding the three tests (profit-sacrifice, no economic sense, and consumer welfare) for anticompetitive exclusion does not shed light on what the “right” answer should be. While he does not have the right answer, he does suggest some rules that could fit. For example, one rule might be that the use of exclusionary practices by “dominant” firms and loyalty discounts that effectively pay the consumer to purchase the product should be suspect.

Katz approaches the “right rules” question from more of a process perspective, although in doing so, he highlights some of the underlying principles discussed by Salinger. There are three policy responses to dealing with testing exclusionary acts. One is to make the courts the experts. But using the decision in *American Airlines* as an example, he concludes that that option is not particularly attractive because the courts can “really mangle” the economics.

The second approach is the dominant one—find rules of thumb that are easy to apply (and therefore predictable), which would then be the basis for a “usable” test. After discussing why even Salinger's “silver standard” of a usable test is flawed, Katz notes that “easy to apply” is not easy to come by. The rule should be linked to the underlying economics and amenable to factual implementation. But applying rules might still require technical sophistication (e.g., the use of econometrics). And if this kind of sophistication is required, then the rule may be predictable, but will not necessarily be easy or cheap to implement. (Even “easy to apply” may not be much of an answer if the courts can't even apply the predation test correctly.)

The third approach is adoption of per se rules, rules that Katz does not believe could ever be justified by a decision-theoretic approach. Katz's view seems to be if a firm is willing to go to court to defend a practice, why not let it do so? After all, it would be impossible to claim that any given practice is never efficient. (However, Katz does not address “cheap exclusion” tactics, e.g., blowing up a rival's factories.)

In the context of decision theory, Katz is particularly critical of the courts' track record in determining and evaluating relevant evidence. He motivates this idea by noting that in his experience

(and mine and probably every other economist who has opined in a courtroom), courts want exact answers, not ranges of possibilities. The courts don't seem to get the fact that ranges are often the best that can be done in an uncertain world.

And Katz thinks it's important for the courts not to be satisfied with a "good" story about why a practice is (or is not) efficient. They need to test the story, and yet this testing is often woefully incomplete. Part of the problem is the inability to compel the experts to tell the whole truth. He suggests as one remedy, the "hot tub" solution. In Australia and New Zealand, all of the experts in a particular matter sit down at a table and "discuss" the issues with each other.

The discussion also addresses whether the FTC has greater expertise than the courts to review complex matters, the extent to which economists have abandoned the field of estimating costs to accountants, and remedies for exclusionary behavior.

In sum, this exchange suggests that when it comes to rules of thumb, we're all thumbs. It is interesting that Salinger is attracted by the dominant firm approach to testing for exclusion. But I suspect that the economics profession is very far removed from finding such an "easy" answer to the identification and remedying of exclusionary practices. As Katz points out, there may not be any truly "easy" answers. That itself may simply be a function of the advances in economics—an awareness that, given the variety of market environments, it may be too costly to force one size to fit all. That doesn't mean that the underlying principles can't be clear, and that may be the best that one can do. On that score, I do think Salinger's dismissal of the ongoing debate surrounding the various exclusionary tests is too sweeping. That debate does in fact force us to focus on how we should think about going about the balancing of harms and benefits.

Click on the link. Take a read. You'll be glad you did.

—JRW

**Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505 (2006), posted online April 28, 2006, <http://www.mitpressjournals.org/doi/abs/10.1162/qjec.2006.121.2.505>. (An earlier version of the paper is available at [http://www.aeaweb.org/annual\\_mtg\\_papers/2005/0109\\_0800\\_1103.pdf](http://www.aeaweb.org/annual_mtg_papers/2005/0109_0800_1103.pdf).)**

Behavioral economics, which models the effects of psychological biases on markets, has begun to influence scholarship on private law, but has just barely begun to affect antitrust.<sup>1</sup> Gabaix and Laibson's article suggests both the promise of the field and its limitations. It offers fascinating insights that explain familiar but perplexing market phenomena in a plausible way. It exposes what appear to be real inefficiencies in the way markets operate. It points the way for future research. But, as the authors concede, it offers little reason to believe that government intervention, particularly by antitrust enforcement, could often remedy these inefficiencies.

It begins with the observation that firms try to profit from consumers' mistakes. In some cases, perhaps most, competition will address this kind of exploitation because rivals have an incentive to show consumers that they are being gouged. But, according to the authors, "competitive debiasing" will not always work. The case they consider is the market (or markets) for "add-ons," or complementary goods and services the seller provides after the sale of the base good. The

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<sup>1</sup> For one effort, see Avishalom Tor, *A Behavioural Approach to Antitrust Law and Economics*, 14 CONS. POL'Y REV., No. 1 (2004), [http://papers.ssrn.com/sol3/Delivery.cfm/SSRN\\_ID906501\\_code606737.pdf?abstractid=906501&mirid=1](http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID906501_code606737.pdf?abstractid=906501&mirid=1). See also Kenneth Hendriks, *Price Discrimination and Irrational Consumers* (Feb. 4, 2006), [http://cemmap.ifs.org.uk/papers/vol2\\_chap6.pdf](http://cemmap.ifs.org.uk/papers/vol2_chap6.pdf).

authors observe that sometimes firms charge low prices for base goods, while “shrouding” (that is, hiding or at least de-emphasizing) the high prices of add-on goods and services. (They also suggest that a sort of functional shrouding can occur where a significant percentage of consumers simply ignore even easily available information about add-on prices.) They cite a number of familiar cases: banks that offer free checking but shroud their fees for bounced checks, hotels that offer bargain rates but shroud the cost of Internet access, printer manufacturers that sell inexpensive printers but shroud the prices of their replacement cartridges.

If consumers were all rational, they would detect the shrouding and think badly of the seller. But, in many cases, studies show that many consumers are simply unaware of these charges at the point of sale of the base good, either because the charges are hard to calculate or because the consumers are oblivious. The authors contrast these myopic consumers with sophisticated consumers who understand the shrouding and take steps to avoid paying the high prices of the add-ons.

In both these circumstances, competition may not work to expose the shrouding. Suppose the shrouding seller charges below marginal cost for the base good and above marginal cost for the add-ons. Myopic consumers (“myopes”) will buy both the base good and the add-ons from such a seller. Sophisticated consumers (“sophisticates”) will buy only the base good and incur a small cost to avoid buying the costly add-ons, but there are not enough of these sophisticates to make shrouding unprofitable. Now suppose that a rival firm tries to charge marginal cost for a package that includes the add-ons “free,” and in its advertising points out that the shrouding seller’s add-ons are overpriced. The rival’s strategy will fail because, once myopes are informed of the high prices of the add-ons, some will continue to buy from the shrouding seller but will behave like sophisticates, substituting other goods and services at some cost in inconvenience. Consumers have no incentive to switch to the marginal cost seller. The authors term this phenomenon “the curse of debiasing.”

The authors suggest that there are two forms of exploitation in this scenario: the shrouding seller’s exploitation of myopes and the sophisticates’ exploitation of the shrouding seller. “[S]ophisticated consumers are subsidized by pricing policies designed for uninformed myopic consumers.” Shrouding, in equilibrium, is also inefficient because sophisticated consumers expend resources to avoid having to pay for the add-ons. It would be efficient for consumers to purchase the package at marginal cost.

From the seller’s perspective, the sophisticates are an unavoidable evil. Once consumers are on to shrouding, firms are stuck with them.<sup>2</sup> Although learning will tend to minimize the benefits of shrouding to sellers, firms may counteract this effect by creating new add-ons. Moreover, advertising can be costly, and it is difficult for nonprofit consumer groups with limited resources to educate consumers in all instances of the problem.

The authors propose a variety of ways regulators or researchers might determine the dimensions of the problem of shrouding. They suggest, for example, observing the prevalence of efforts by firms to shroud certain information and the extent to which groups of consumers with different information behave differently. They are pessimistic, however, about the possibility of regulatory remedies. They cite data suggesting that mandatory disclosure regimes are of limited value, and they counsel against efforts to regulate prices.

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<sup>2</sup> Although the authors do not mention it, some retailers do try to shed sophisticated consumers. Gary McWilliams, *Analyzing Customers, Best Buy Decides Not All Are Welcome: Retailer Aims to Outsmart Dogged Bargain-Hunters and Coddle Big Spenders*, WALL ST. J., Nov. 8, 2004, at 1 (describing Best Buy’s efforts to thwart customers who, e.g., buy only deeply discounted goods and flip them on eBay).

Although the idea of inefficient shrouding may explain some market behavior, it has limited implications for antitrust. It might be relevant in price-fixing cases alleging that add-on prices are being fixed because they are not responsive to competition. For example, a recent case in Israel alleges that a pattern of identical loan fees charged by leading banks is the product of a price-fixing conspiracy.<sup>3</sup> The defense might argue that the present paper explains noncompetitive fees as the product of rational independent choices not to compete on the affected services because of the curse of debiasing.<sup>4</sup> The theory, however, is highly contingent on empirical assumptions.

The authors also mention the 1992 Supreme Court decision in *Eastman Kodak Co. v. Image Technical Services Inc.*<sup>5</sup> The paper supports the idea, accepted by the majority in that case, that buyers may not calculate life-cycle pricing very well and so may be subject to exploitation in the pricing of tied complementary goods and services. But the paper also suggests that myopic consumers may buy costly add-ons even in the absence of a tie, so it is not clear that prohibiting the tie would address the problem.

Most important, as the title of the paper indicates, the problem of shrouding occurs in competitive markets, so the paper does not lend support for the Court's characterization of aftermarket exploitation of myopic buyers as an exercise of market power. Antitrust thus seems to be a poor vehicle for addressing the problem. ●

—WHP

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<sup>3</sup> Anat Roeh, *Banks Sued for Interest Collusion*, HAARETZ, Sept. 17, 2006, <http://www.haaretz.com/hasen/spages/761957.html>.

<sup>4</sup> Cf. John M. Gale, *An Apparent Lack of Price Competition Is Not Proof of Conspiracy*, ECONOMISTS INK (NewsL.), Fall 2006, at 3, [http://ei.com/economists\\_ink.html](http://ei.com/economists_ink.html).

<sup>5</sup> 504 U.S. 451 (1992).

## Book Review

# Reviewing the Antitrust Enterprise

Herbert Hovenkamp

**The Antitrust Enterprise: Principle and Execution**

Harvard University Press • 2005

### Reviewed By Michael Jacobs

Herbert Hovenkamp is one of the preeminent antitrust scholars of his generation. Well-versed in history, economics, psychology, and—of course—antitrust doctrine, Hovenkamp has written widely and well about almost all of antitrust law, its history, its doctrinal development, and its problems large and small. He has assumed responsibility for editing the famous multi-volume treatise started by Phillip Areeda, and, with Tom Sullivan, continues to produce new editions of an excellent antitrust casebook. At this stage of his career, one might imagine, he would be hard-pressed to find something new to say about antitrust as a whole, or any of its important parts. But he has. In *The Antitrust Enterprise*, his latest book, Professor Hovenkamp looks at the “business” of antitrust, and asks whether it operates as efficiently as it might. As the title suggests, he treats the field as an “enterprise,” describes its workings, and suggests a few ways in which its operations might be improved. His stated goal in this endeavor is to make antitrust “a more manageable, effective discipline.”

It seems very useful to examine antitrust as an enterprise and to ask, as Professor Hovenkamp does, whether its administration is cost-effective. Antitrust is a justifiable enterprise, Professor Hovenkamp convincingly argues, “only if court intervention can make markets work better.” *The Antitrust Enterprise* at 7. There is no lack of economic theory that could arguably provide the basis for ever more judicial intervention into controversial business practices. For example, above-cost (limit) pricing by the dominant firm—lawful under current rules—can sometimes achieve anti-competitive outcomes similar to those arising from below-cost predatory pricing,<sup>1</sup> which is unlawful. But the costs of administering a legal rule that might punish certain kinds of above-cost pricing—including the uncertainty such a rule would create—would be much too high, most commentators think, to justify the rule’s adoption.

Professor Hovenkamp’s book subjects many aspects of the “enterprise” to this kind of cost-benefit analysis, systematically, and in a comprehensive way not previously undertaken. In his hands, this analysis is a powerful tool, sometimes explanatory, sometimes critical, but always incisive. Professor Hovenkamp concludes, after reviewing the major developments in antitrust doctrine over the past 40 years, that although “[a]ntitrust has come a long way since its expansionist heyday in the 1960s and 70s. . . . much remains to be done” to improve its efficacy. *Id.* at 305. In particular, antitrust is “too complex,” and “excessively dominated by treble damages,” has “too many per se rules,” and makes cases brought under the rule of reason “too difficult to prove.” He proposes a “handful of modifications” (eight, really; nearly two hands’ worth) which, he claims,

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<sup>1</sup> Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 YALE L.J. 941 (2002).

would “go a long way” towards improving the operation and management of the larger enterprise. Some of these modifications are procedural, and would either reduce or expand (discourage or encourage), as the case might be, access to the judicial system by would-be litigants, or simplify the trial process itself. The others are aimed at rationalizing the doctrinal rules and relevant statutory scheme.

Professor Hovenkamp suggests the following modifications, in order: First, “the use of treble damages actions must be reduced.” *Id.* at 305. Second, “the indirect purchaser rule should be abandoned.” *Id.* at 306. Third, “technical aspects of expert [economic] testimony should not be submitted to juries.” *Id.* at 307. Fourth, “the per se rule should be treated as a method of antitrust analysis rather than a classification of practices.” *Id.* at 308. Fifth, “the rule of reason needs more structure.” *Id.* at 309. Sixth, he argues, “the Supreme Court should overrule *Kodak*,” *id.*, its 1992 opinion dealing with monopoly power in aftermarkets.<sup>2</sup> Seventh, “the Robinson-Patman Act should be repealed; or, failing that, the courts should read in a competitive injury requirement.” *Id.* at 310. And eighth, “the relationship between antitrust and regulation should be simplified.” *Id.* at 311.

Most of the doctrinal recommendations are sensible and incremental. Some are so obviously correct that they are already being implemented, though perhaps not in the form preferred by Professor Hovenkamp. Thus, for example, following the Supreme Court’s opinion in *California Dental Association v. FTC*,<sup>3</sup> the per se approach—to the extent that it remains viable at all in cases other than naked price fixing—seems less categorical and more analytical than ever. Similarly, the Supreme Court’s opinion this past term in *Volvo v. Reeder*<sup>4</sup>—decided too late for inclusion in his book—seems to usher in a new approach to Robinson-Patman Act cases and one with which Professor Hovenkamp might well agree. As to the rule of reason, organized efforts have been afoot for some time—at both the judicial and regulatory levels—to inject more structure into its application. Justice Breyer’s dissenting opinion in *California Dental*, whose approach if not conclusion was much admired by the majority, and the FTC’s opinion in the *Three Tenors* case,<sup>5</sup> both point clearly to the implementation of the kind of structured rule of reason analysis advocated by Professor Hovenkamp.

Professor Hovenkamp’s proposal that the Supreme Court overrule its 1992 *Kodak* decision would find significant support from many other antitrust commentators. Moreover, it fits comfortably with his broader view that the use of treble damage actions be reduced. It seems no coincidence in this regard that the three judicial opinions most heavily criticized in the book—*Kodak*, *Conwood*, and *3M*<sup>6</sup>—were all private actions. Perhaps, though Hovenkamp does not say so, Section 2 doctrine is too easily misapplied, and the line between aggressively competitive and anticompetitive conduct is too thin, to allow dominant firms to be exposed to the risk of treble damage actions at all. Finally, the suggestion that the relationship between antitrust and regulation “should be simplified” sounds more ambitious than it is, since it refers not to the larger question of which kinds of markets might benefit more from regular administrative oversight than from antitrust law’s necessarily sporadic intervention, but deals instead with some house cleaning

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<sup>2</sup> *Eastman Kodak Co. v. Image Technical Servs. Inc.*, 504 U.S. 451 (1992).

<sup>3</sup> 526 U.S. 756 (1999).

<sup>4</sup> *Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc.*, 126 S. Ct. 860 (2006).

<sup>5</sup> *PolyGram Holding, Inc.*, FTC Docket No. 9298, 2003 WL 21770765 (2003), available at <http://www.ftc.gov/os/2003/07/polygramopinion.pdf>.

<sup>6</sup> *Eastman Kodak*, 504 U.S. 451; *Conwood Co. v. United States Tobacco Co.* 290 F.3d 768 (6th Cir. 2002); *LePage’s, Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003).

necessary to tidy up the inconsistencies between three separate bodies of doctrine designed on the one hand to permit governmental regulation to displace antitrust law, and on the other to preserve the important boundary between legitimately petitioning the government for the redress of grievances and colluding to violate the antitrust laws.

His procedural recommendations are sensible but mildly self-contradictory. Reducing the use of treble damages to cases in which the success of the antitrust violation depends on secrecy, such as price-fixing cartels, makes good sense. Firms that act openly must view their conduct as either clearly lawful or not obviously unlawful; sometimes, though not always, their judgments about the legality of that conduct may turn out to be mistaken. But punishing the mistakes with treble damage awards will likely discourage many correct (procompetitive) decisions as well, and thus place a damper on competitive vigor. Abandoning the indirect purchaser rule, whose flawed logic is clearly exposed by Professor Hovenkamp, might also make independent sense. Discarding that rule, however, would significantly increase the numbers of potential plaintiffs in treble damage actions, a result that would conflict with the proposal that treble damage actions be reduced, and would thus create a tension that the book neither identifies nor attempts to resolve. Finally, the suggestion that certain aspects of expert testimony not be submitted to juries is also quite sensible—only those blindly devoted to an idealized notion of juror competence might disagree. But it is also an old suggestion raised by others as well—many have urged antitrust courts to make better use of court-appointed experts to help solve this problem.<sup>7</sup>

As a set of suggestions, Professor Hovenkamp's book is logical and restrained. Nevertheless, it has some important limitations. First, the scope of the book is narrow, too narrow, perhaps. The "antitrust enterprise" that it evaluates is the U.S. system for defining and dealing with problems of competition law. The "competition law" enterprise is much broader, of course, encompassing the growing international network of competition law regimes; and because problems of competition law have become more international in both their scope and potential effects, it is hard to conceive of an "antitrust enterprise" divorced from the larger world of competition law. And it is not only business problems that have become international. At the levels of enforcement and academic theory, legal and economic, the dialogue that animates both the global enterprise and the various national or regional ones has become increasingly international, too. The antitrust enterprise, which was largely self-contained as recently as 20 years ago, no longer functions, or wants to function, in isolation from other competition regimes. Professor Hovenkamp would obviously be well aware of all this, but his book, which focuses entirely on the U.S. system, seems oddly blinkered, failing even to consider how our antitrust enterprise might be affected, positively and negatively, by the competition laws of others.

Second, missing entirely from the analysis of the antitrust enterprise is any discussion of criminal enforcement. This strikes me as an astounding omission, given the growth and success over the past ten years of major efforts—both within the United States and internationally—to find and prosecute criminal cartels. Perhaps, from Professor Hovenkamp's viewpoint, there is not much of interest to be said about criminal cartels, which have been and remain one of the prime focuses of antitrust enforcement worldwide, but whose illegality is not controversial. In my view, though, recent enforcement experience on the criminal side of the enterprise should have, but has not, played an important role in shaping civil enforcement, particularly with respect to merger analy-

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<sup>7</sup> Andrew I. Gavil & Katherine I. Funk, *Daubert Comes to Washington: Managing Expert Economic Testimony in Part III Proceedings at the FTC*, ANTITRUST, Spring 2006, at 21.

sis and Section 1 cases involving circumstantial proof of competitor agreement, two points discussed more fully below. Just as international competition law might exert some significant influence on the U.S. enterprise, criminal antitrust enforcement might inform the rules and presumptions governing certain civil actions. But neither of these topics receives a mention from Professor Hovenkamp.

Third, Professor Hovenkamp's concern with improving the efficacy of the enterprise by examining the cost of its administration is not new. For the past two decades, antitrust commentators have regularly remarked on the fact that the amount of fascinating economic theory available to antitrust enforcers significantly exceeds the amount of economic theory that can be effectively applied to the resolution of actual antitrust controversies. Twenty years ago William Baxter, who headed the Antitrust Division of the Justice Department during the Reagan administration, observed—in discussing theories of strategic behavior—that

A great deal of theoretical work is going on in this area of cost-imposing activities, where you are imposing costs on your rivals. Now, I must say, not much that I regard as administrable as a matter of law has emerged from that yet, but I think that it may well and that this may become a more active area of antitrust.<sup>8</sup>

Four years ago, Commissioner Leary of the FTC noted in the same vein that while work continues in this area (assessing the impact of strategic behavior), “we still have not found an ‘administrable’ body of law.”<sup>9</sup> Professor Hovenkamp's book might well be viewed as the most recent elaboration of this broad and important—but hardly novel—theme.

Fourth, the antitrust enterprise, when it works best, involves not just lawyers, regulators, and judges, but academics as well, all of whom take part in an iterative process of decision making, commentary, and revision that can produce, modify, and refine the views that animate the enterprise. This process is slow-moving, necessarily retrospective, and often frustrating for litigants, but its dialectic quality can significantly improve antitrust doctrine and its enforcement. It cannot keep up with the pace of business, which introduces new forms of behavior—new kinds of transactions, arrangements, products, methods of sale and distribution—much faster than a reflective enterprise like antitrust can make sense of their competitive effects. Over time, though, when it operates well, the antitrust enterprise can develop intelligent methods for analyzing many of these behaviors.

Take the recent *LePage's v. 3M* case.<sup>10</sup> An en banc panel of the Third Circuit Court of Appeals found 3M liable for having harmed its smaller and admittedly less efficient rival by selling large buyers discounted (but above-cost) bundles of office products that included, among other things, Scotch tape and an unbranded transparent adhesive tape, the product of competitive interest. Because its rival sold that one product only and could not match 3M's discounts, which were spread across all of the products in the bundle, and because Scotch tape was seen to confer monopoly power on 3M, the court condemned 3M's discounted bundle as unfairly exclusionary. 3M then petitioned the Supreme Court to take the case on appeal but before deciding whether to do so, the Court asked the Solicitor General (SG) for its opinion on whether certiorari should be

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<sup>8</sup> William F. Baxter, Panel Discussion, *Counseling Your Client on Monopolization, Mergers and Joint Ventures Panel Discussion*, 55 ANTITRUST L.J. 321, 327 (1986).

<sup>9</sup> Thomas B. Leary, *The Essential Stability of Merger Policy in the United States*, 70 ANTITRUST L.J. 105, 114 (2002).

<sup>10</sup> *LePage's, Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003).

granted. The SG took the view that, although the case had been wrongly decided below, the Court should refuse to hear the appeal and should instead wait for the level of economic knowledge about the competitive effects of above-cost bundled discounts to progress from its relatively immature state to a more sophisticated one.<sup>11</sup> The Court accepted this advice, and declined to hear the case; and economists and academics responded by producing a spate of research and commentary about bundled discounts<sup>12</sup> that should lead to more informed decision making in the future. Although 3M might be forgiven for thinking otherwise, the enterprise performed well in this instance. There was a feedback loop at work here, and it operated efficiently. In my view, this feedback loop is a unique and important feature of the antitrust enterprise.

The enterprise, though, does not always work so well, and for reasons other than those discussed by Professor Hovenkamp. In the first place, it lacks a CEO. Or perhaps it has too many: there are two dedicated federal enforcement agencies, several other federal agencies that have occasional enforcement authority, 50 different state enforcers, and innumerable private ones. The size of the enterprise's enforcement community is not necessarily an asset. Sometimes it can create confusion and temporary paralysis.<sup>13</sup> Even within the federal enforcement community narrowly defined (that is, to include only the Antitrust Division of the DOJ and the FTC), there is no manager to ensure that the various components of the enterprise—regulators, judges, lawyers, academics—are working harmoniously towards some agreed-upon set of goals or, more simply, that the agencies are communicating well with one another and not acting at cross purposes.

Finally, because its approach to the perceived problems of the enterprise is at once so incremental and so much more concerned with the costs of the enterprise than with its goals or direction, Professor Hovenkamp's book raises but does not address two other important questions. First, why should the antitrust enterprise set itself such a modest goal? And second, how well has it moved towards achieving that goal? These questions are interrelated in an important sense because if modest goals are the only ones that the enterprise can achieve, then it would be irrational (and inefficient) for it to aspire to loftier ones.

So why such modest goals? In the first place, perhaps, until relatively recently the history of the antitrust enterprise—at least as represented by Supreme Court opinions in the area—has not been one of great accomplishment. Those of us who teach antitrust for a living spend much of our class time criticizing the majority of the cases in the canon, because we regard them—by consensus, I believe—as wrongly decided. Some of those cases, important ones, remain seemingly good precedent despite the nearly universal acknowledgment in the academy that they are simply and dramatically incorrect (*Topco*, *Maricopa*, *Dr. Miles*, *Appalachian Coals*).<sup>14</sup> Perhaps the modest goals of the enterprise represent a reasoned response to past failures.

Indeed, only over the past 25 years or so has the Supreme Court taken to consistently using economics as a basis for deciding antitrust disputes. And, while this increased reliance on eco-

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<sup>11</sup> Brief for the United States as Amicus Curiae, *3M Co. v. LePage's Inc.*, No. 02-1865, 2004 WL 1205191 (U.S. May 28, 2004).

<sup>12</sup> See, e.g., Bruce H. Kobayashi, *Does Economics Provide a Reliable Guide to Regulating Commodity Bundling by Firms? A Survey of the Economic Literature*, 1 J. COMPETITION L. & ECON. 707 (2006); Daniel A. Crane, *Multi-Product Discounting: A Myth of Non-Price Predation*, 72 U. CHI. L. REV. 27 (2005); Andrew I. Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3 (2004); Ronald W. Davis, *LePage's v. 3M: Five Ingredients in Search of a Monopoly Broth*, ANTITRUST SOURCE, Nov. 2004, <http://www.abanet.org/antitrust/source/11-04/Nov04-Davis1129.pdf>.

<sup>13</sup> See *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) (failed effort to mediate an early resolution of the *Microsoft* case).

<sup>14</sup> *United States v. Topco Assocs.*, 405 U.S. 596 (1972); *Arizona v. Maricopa County Med. Soc'y*, 457 U.S. 332 (1982); *Dr. Miles Med. Co. v. John D. Park & Sons*, 220 U.S. 373 (1911); *United States v. Appalachian Coals, Inc.*, 288 U.S. 344, 359–60 (1933).

conomic analysis has led to clearer and more durable decisions, it is hardly a determinate exercise. As Professor Hovenkamp describes, and as I have, too,<sup>15</sup> competing schools of economic thought sometimes disagree about the frequency and durability of certain kinds of business behavior and about the ability of courts to identify and remedy those behaviors if and when they appear harmful. Perhaps the indeterminacy of certain key aspects of industrial organization economics is a second argument for modesty in goal-setting.

Predatory pricing is one of those controversial behaviors. Despite the Supreme Court's pronouncement in *Matsushita* that predatory pricing schemes "are rarely tried and rarely succeed,"<sup>16</sup> certain legal and economic research suggests that the phenomenon is much more common and much more successful than the Court would have us believe. There are others as well. In his review of antitrust doctrine, Professor Hovenkamp usefully notes, among other things, that neither economic theory nor the Supreme Court has been able to devise a useful mechanism for assessing the behavior of the dominant firm—not because there are too few theories, but because there are too many, no one of which seems coherent or practical to apply. Almost as fast as the Justice Department can propose a theory—the so-called "sacrifice" test that it offered to the Supreme Court in *Trinko* is the latest example<sup>17</sup>—economic criticism shoots holes in it.

As Professor Hovenkamp suggests, there is a similar lack of consensus regarding the law of vertical restraints. Because they believe that such restraints are often procompetitive, most members of the antitrust community would remove the per se rules—what remain of them—that apply to vertical agreements to fix minimum prices and to certain tying arrangements, and replace them with full-blown rule of reason analysis. Many in the community think that bundled discounts, which are ubiquitous in our economy, are generally desirable for consumers, even when a dominant firm is the bundler and even when the discounts force a smaller rival to exit the market. But some disagree; and, as noted above, the Solicitor General is so far agnostic on the issue. And there is more. Just this past term, our two federal antitrust enforcement agencies took opposing positions before the Supreme Court about the competitive and economic consequences of so-called "reverse settlement" payments in patent disputes brought under the Hatch-Waxman Act and involving payments made by the branded patent holder to the allegedly infringing generic entrant.<sup>18</sup>

All this is to say that the keen observer of the antitrust enterprise, aware of the Supreme Court's poor track record in building antitrust doctrine, of the seemingly endless array of indeterminate economic theory that can be applied to antitrust cases, and of the large parts of existing doctrine arguably in need of a major overhaul, might plausibly decide that the managers of the enterprise should proceed with considerable caution lest they undertake yet another ill-advised course of decision making. Professor Hovenkamp, as keen an observer as there is, has adopted this view as the theme of his book, urging in effect that the antitrust enforcement community pledge itself to the regulatory equivalent of that part of the Hippocratic Oath that counsels "first, do no harm." On the record, this advice might seem sound.

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<sup>15</sup> See Michael S. Jacobs, *An Essay on the Normative Foundations of Antitrust Economics*, 74 N.C. L. Rev. 219 (1995).

<sup>16</sup> *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986).

<sup>17</sup> *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004).

<sup>18</sup> *Schering-Plough Corp. v. FTC*, 402 F.3d 1056 (11th Cir. 2005), Brief for the Federal Trade Commission as Respondent, *Schering-Plough Corp. v. FTC.*, No. 04-10688-AA, 2004 WL 3557972 (11th Cir. July 23, 2004); *cert. denied*, 126 S. Ct. 2929 (2006); Brief for the United States as Amicus Curiae, *Schering-Plough Corp. v. FTC*, No. 05-273, 2006 WL 1358441 (U.S. May 17, 2006).

But in important respects, it is too cautious. Among other things, it places too much weight on past judicial experience and discounts too heavily more recent developments in economic theory and enforcement experience. Take the matter of conspiracy theory. Collusion is a central—the central—concern of antitrust law, “the supreme evil,” as the Supreme Court termed it in *Trinko*.<sup>19</sup> Per se offenses all result from collusion, whose prevention is the chief goal of Section 1 of the Sherman Act. Proving collusion (agreement) through the use of circumstantial evidence—and the appropriate standards for summary judgment in cases involving such proof—is at once so important and so difficult an endeavor that elaborating the relevant legal rules has occupied a significant amount of judicial time and energy.<sup>20</sup> Moreover, one of merger law’s two main focuses—the more important of the two—aims to prevent mergers that might facilitate collusion between firms in the post-merger market.

With all that emphasis on collusion, one might think that the antitrust enterprise would require a powerful and durable theory to explain collusion’s necessary preconditions. And there has been no shortage of such theories. In the late 1960s, George Stigler theorized that successful collusion was a difficult act to organize and maintain—not impossible because oligopolists selling undifferentiated products could sometimes accomplish it—but very difficult, because the “centripetal” forces behind the universal instinct to cheat on such agreements would cause most conspiracies to break apart. Because firms were rational actors and would understand the enormous difficulties entailed in colluding, Stigler hypothesized, collusion would occur infrequently.<sup>21</sup>

For a decade or so, Stigler’s theory was regarded as the Received Wisdom. Both the 1982 and 1984 versions of the Department of Justice’s Merger Guidelines were based on Stigler’s “oligopoly theory.”<sup>22</sup> But at the same time as those Guidelines were being adopted, game theorists were starting to poke holes in Stigler’s thesis. First, they argued that those firms identified by Stigler as most likely to collude successfully could achieve “collusive” results without actually needing to collude. They could signal, adopt focal points, play follow-the-leader, and thus achieve anticompetitive outcomes (prices higher than those that would prevail in fully competitive markets) without engaging in anti-competitive conduct. That argument created a rather large hole because if those few firms thought capable of colluding by Stigler did not have to collude in order to raise prices, then there was apt to be very little collusion indeed.

But there was another hole as well, which applied to those firms that Stigler had judged unlikely candidates for colluding, firms which—perhaps because they sold differentiated products or could not effectively detect or punish cheating on the part of other cartel members—would not be likely, in Stigler’s view, to form cartels in the first place. As to them, game theory argued that while Stigler might have explained why cartels among such firms might not last forever, cartels did not need to last forever in order to profit their members and harm consumers: they could last for a while, dissolve, re-organize, and so on. From the cartel’s perspective, any period of “success,” no matter how short, was profitable; and from the consumers’, any cartel “success” meant higher prices. In short, imperfect cartels of less than infinite duration could plausibly exist and, while they did, could harm consumers—not as much as perfectly functioning, long-lived cartels, but significantly.

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<sup>19</sup> *Trinko*, 540 U.S. at 408.

<sup>20</sup> See John E. Lopatka & William H. Page, *State Action and the Meaning of Agreement Under the Sherman Act: An Approach to Hybrid Restraints*, 20 YALE J. ON REG. 269 (2003).

<sup>21</sup> See George J. Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44, 45–48 (1964).

<sup>22</sup> See William F. Baxter, *Panel Discussion*, 54 ANTITRUST L.J. 31, 33 (1985).

Game theory's approach, however, seemed to point in two directions at once. While it argued that firms judged by Stigler as "most likely to collude" did not need to do so in order to achieve supracompetitive prices—that is, there would be less collusion than Stigler predicted—it also posited that because those judged "least likely to collude" could often solve the so-called "cartel problems" for some period of time, there would be more collusion than Stigler anticipated. Theories about the preconditions for successful cartel formation can have important consequences for merger analysis. If one believes that cartels are unlikely to form, one can confidently permit mergers in relatively concentrated markets, a policy that U.S. antitrust regulators adopted expressly in the early 1980s and to which they have adhered since. With some simplifying variations, this is also the policy preferred by Professor Hovenkamp.<sup>23</sup> On the other hand, if one believes that cartels form more readily, then mergers should be prohibited—all things being equal—at relatively lower levels of concentration. A durable theory of cartel formation thus makes all the difference to merger analysis.

There is more to this story, however, than assumption and hypothesis. During the last ten years, as criminal prosecutions of price-fixing cartels have become more numerous, more international, and more successful, we have learned something about the nature, frequency, and success of cartel formation that ought to inform both antitrust enforcement and antitrust doctrine. Aided by an unprecedented level of international cooperation and by well-designed leniency programs that have succeeded in inducing participants to inform on their cartels, the Department of Justice has brought scores of successful criminal actions against international and domestic price-fixing cartels. At any one time, there might be 40 or 50 criminal grand juries sitting in the United States alone to determine whether yet another group of price-fixers might have violated the law. Some of the cartels convicted of price fixing lasted for decades before being unraveled.<sup>24</sup> If nothing else, this experience ought to raise serious questions about the general proclivity of rivals to collude.

In addition, it should cause the antitrust enterprise to question a second pillar of current merger policy. Several of the cartels most recently uncovered contained more than the three or four or (sometimes) five firms assumed to be the maximum for successful cartel formation. In May 2005, the Japanese Fair Trade Commission initiated a record number of criminal prosecutions against 26 companies accused of conspiring to rig bids on government construction projects; and a year later it filed criminal complaints against 11 other companies in connection with a separate bid-rigging scheme.<sup>25</sup> In March of this year, following an investigation and referral by the Irish Competition Agency, the Department of Public Prosecutions obtained criminal convictions for price fixing against 24 defendants in the home heating oil industry in western Ireland.<sup>26</sup> And the Israeli Antitrust Authority recently and successfully prosecuted a 14-year old cartel among almost all Israeli makers of floor tiles.

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<sup>23</sup> THE ANTITRUST ENTERPRISE 211 ("a merger can be anticompetitive when it . . . increases a market's propensity toward collusion . . . . But [this] outcome [is] not typical.").

<sup>24</sup> Thomas O. Barnett, Assistant Attorney General, Antitrust Division, U.S. Dep't of Justice, Criminal Enforcement of Antitrust Laws: The U.S. Model, Address Presented at the Fordham Competition Law Institute's Annual Conference on International Law and Policy (Sept. 14, 2006), available at <http://www.usdoj.gov/atr/public/speeches/218336.htm>.

<sup>25</sup> *Id.* at 9.

<sup>26</sup> *Id.* at 10.

The record of recent criminal antitrust enforcement demonstrates, at the simplest level of casual empiricism, that there are many more cartels afoot than oligopoly theory could have imagined. They seem both simpler to form and more durable than theory suggests; and many seem to include larger numbers of conspirators than once thought possible. Although these facts should have important implications for the antitrust enterprise beyond the area of criminal enforcement, they have not. Merger enforcement seems oblivious to them. The apparent impermeability of the merger arm of the antitrust enterprise to the lessons of criminal enforcement is a real shortcoming. If heeded, the lessons from criminal enforcement might suggest that the incremental, low-intervention approach advocated by Professor Hovenkamp for merger enforcement might need some revision.

Those lessons also suggest that summary judgment analysis in Section 1 cases where plaintiffs' claims depend on proof of agreement through circumstantial evidence should be more inclined, all things being equal, to permit those claims to proceed to trial. There is considerable disparity both between and within the circuit courts of appeal regarding how to apply the summary judgment test derived from *Monsanto* and *Matsushita*—compare the majority opinion with the dissent in *Blomkest* and compare *Blomkest* with *In Re Prescription Drugs*<sup>27</sup>—because the test is sufficiently ambiguous to permit either a conservative (in the sense of requiring a high standard of proof from plaintiffs) or a more liberal approach. In an important sense, though, the decision whether to apply one or the other approach must depend on one's view of cartel formation. The conservative approach must draw some strength from oligopoly theory and from the Supreme Court's assertion in *Business Electronics v. Sharp*,<sup>28</sup> that “[c]artels are neither easy to form nor easy to maintain.”<sup>29</sup> But if this assertion is doubtful, as it seems to be, where is the warrant for the conservative approach?

Over the past 25 years, as Professor Hovenkamp correctly acknowledges, economic theory has helped organize antitrust doctrine, rationalize it, and make it much more coherent than it had been before. Theory, however, should be the starting point on the road to sound policy, not the destination. And the policies derived from it should be both informed and shaped by facts gleaned from observation, experience, and research. But in this area—the interplay between cartel theory and antitrust enforcement—the data seem not to have influenced the policy, a lack of influence made more remarkable and more puzzling because the data finders and policy makers reside within the same regulatory agency.

Professor Hovenkamp advocates an even more cautious approach to the analysis of cases brought under Section 2 of the Sherman Act, cases that challenge the legality of conduct by the dominant firm. There seem to be good, and well-known, reasons for adopting this view, and it is hardly remarkable in the antitrust community. The main argument for its adoption rests on a simple, powerful syllogism: consumers benefit most when dominant firms—all firms—compete as vigorously as possible. But a fine line often exists between vigorous, permissible competition, and anticompetitive behavior. Because an overly aggressive application of Section 2 would at the margin chill innovative conduct and discourage dominant firms from competing as vigorously as pos-

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<sup>27</sup> *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *Blomkest Fertilizer, Inc. v. Potash Corp. of Saskatchewan, Inc.*, 203 F.3d 1028, 1042 (8th Cir. 2000); *In re Brand Name Prescription Drugs Antitrust Litig.*, 186 F.3d 781 (7th Cir. 1999).

<sup>28</sup> *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717 (1988).

<sup>29</sup> *Id.* at 727.

sible, and because the “fine line” is often difficult to locate, antitrust enforcers should proceed carefully before bringing a Section 2 case, and antitrust judges should condemn only behavior that is clearly anticompetitive. I agree with the logic of that syllogism.

That syllogism though is buttressed by a second, more controversial presumption, one that Professor Hovenkamp applies to Section 2 analysis generally and to the analysis of predatory pricing claims as well. Like others—including Judge Easterbrook and Justice Scalia<sup>30</sup>—Professor Hovenkamp is concerned with decision-making heuristics, and particularly about the problem of false positives and false negatives. False positives arise when decision makers—asked to determine whether, for instance, certain conduct by a dominant firm is anticompetitive—decide erroneously that the relevant conduct is anticompetitive when in fact it is either benign or procompetitive. False negatives are decisions that mistakenly absolve anticompetitive conduct by incorrectly judging it to be procompetitive or benign.

The cautious approach to the application of Section 2 rests in part on important presumptions about the frequency of each type of error, their relative and absolute costs, and their implications for antitrust enforcement and analysis. In the first place, proponents of the cautious approach assert that false positives are much more harmful than false negatives: the former will absolutely foreclose competitive conduct (until, if ever, the incorrect precedent is overruled), while the latter might be either ameliorated by competitive forces or challenged successfully in court at a later date.<sup>31</sup> Because false positives impose such a high cost on consumers, antitrust enforcers and judges should be reluctant to proscribe conduct—and to intervene—when its possible competitive effects are not well understood. False negatives, since they have a lower cost to consumers, are more tolerable.

The logic of the argument for caution in Section 2 enforcement must ultimately rest on some unspoken and unverified mathematics: that is, although there are both false positives and false negatives in antitrust decision making, at the prevailing ratio of the former to the latter, given their relative costs, we are well-advised to eliminate the former and tolerate the latter. Ergo, caution makes sense. But the mathematics seems contingent on a few important but unknown facts. The first has to do with the relative costs of false positives and false negatives. The antitrust enterprise takes it as given that the former are greater than the latter—maybe they are—but does not suggest how much greater they might be or discuss whether there are effective ways to lower their costs. The error rate for particular enforcement approaches is also unknown, a gap in knowledge that might be thought equally critical. Thus, if a more interventionist approach would yield no more false positives but eliminate some false negatives—by, for example, improving decision makers’ position on the learning curve—then it might be justified on a cost/benefit basis. But this kind of calculation, seemingly so important to the relevant policy choice, has not been, and perhaps cannot be, confidently undertaken. Consequently, it appears as if we know neither the cost nor the rate of the errors that the antitrust enterprise might make.

The second has to do with the possibility of the market’s responding dynamically to false positives. False positives are no doubt harmful; unless and until they are overruled, mistaken judicial decisions foreclose the market from competitive strategies and thus harm consumers. But the number of competitive strategies is almost limitless, I would imagine. And the discussion within antitrust about false positives has always implicitly assumed that a falsely positive ruling fore-

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<sup>30</sup> See Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984); see *Trinko*, 540 U.S. at 407 (Scalia, J.).

<sup>31</sup> See Easterbrook, *supra* note 30.

closed the very best competitive strategy available. Suppose instead that the competitive strategy foreclosed were only the second or third best. In that case, the mistaken opinion might prompt business—much as patents do—successfully to “invent around” the mistake, with the result that the false positive actually improves competition. I am not suggesting that this regularly happens, or even that it happens some particular portion of the time. But it might, and that possibility ought to be part of the discussion regarding false positives, since that discussion—and the underlying belief in The Great Harm of the False Positive—is the capstone for the cautious approach to Section 2 espoused by Professor Hovenkamp and many others within the antitrust enterprise.

### **Conclusion**

Professor Hovenkamp has achieved his preeminent position in the antitrust academy in part because he has mixed his broad understanding of the field with a pragmatic approach to the resolution of its problems and an enviable clarity of expression. His latest book, which is thoughtful, comprehensive, and sensible, should provide additional luster to an already shiny reputation. Its strengths are many: a comprehensive description of the current state of the antitrust enterprise and how it arrived there; an avoidance of strong ideological positions that do little to promote the goals of the enterprise; and an insistence that the antitrust enterprise act entrepreneurially—efficiently, pragmatically, and incrementally. These are real and important benefits. But the book also comes with some costs. Its focus on the U.S. system alone is incomplete in today’s world. Its failure to acknowledge the lessons learned from criminal enforcement and to attempt to incorporate them into the broader workings of the enterprise both elevates and stifles theory at the expense of fact. And its acceptance of the false-positive presumption serves further to embed that questionable presumption into the workings of the enterprise without subjecting it to the intellectual probing that might help either to prove or refute it. ●