

“When You Don’t Know What to Do, Walk Fast and Look Worried” (Dilbert 2003): Hitting the Section 2 “Refresh” Button for In-House Counsel Following *Trinko*

An ABA Section of Antitrust Law Teleseminar held February 26, 2004

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Editor’s Note: *The Supreme Court decision in Trinko is a significant attempt to clarify the scope of antitrust liability under Section 2 of the Sherman Act. In this ABA Section of Antitrust Law program, four distinguished panelists offer insights on key aspects of the Court’s decision from four distinct perspectives. We are pleased to include this program as the second in a series of published thoughts and insights on the implications of the Trinko decision on Section 2 analysis. We will continue to provide readers with analyses of Trinko in future issues.*

—GARY ZANFAGNA

JEFF CASHDAN: I’d like to introduce our panel for today. My co-moderator is Brian Henry. Brian is Senior Competition Counsel for the Coca-Cola Company, where he is responsible for antitrust and competition law for Coca-Cola North America. He is Chair of the Corporate Counseling Committee of the ABA Section of Antitrust Law.

Our panelists today include Herbert Hovenkamp, who is the Ben V. and Dorothy Willie Professor of Law and History at the University of Iowa, where his principal areas of teaching and scholarship are federal antitrust law and American legal history. He is a prolific writer on antitrust. Included among his work is the standard one-volume textbook, *Federal Antitrust Policy: The Law of Competition and Its Practice*.

We also have with us today Richard Schwartz. Richard serves as Assistant Attorney General in the Antitrust Bureau of the State of New York, where he has litigated numerous cases, including *Kraft General Foods* and *Microsoft*.

We also have with us Mark Whitener. Mark is Antitrust Counsel for General Electric Company, based in Washington, D.C., a position he has held since 1997. He has written and testified before

Congress on a wide range of antitrust issues, and he is soon to become the Editorial Chair of *Antitrust* magazine.

And finally, on our panel today is Greg Werden. He is Senior Economic Counsel in the Antitrust Division of the U.S. Department of Justice, where he has worked since 1977. Greg has worked on a wide range of policy matters, including many Supreme Court amicus briefs. He has over ninety publications on antitrust policy and related matters.

BRIAN HENRY: We thought it would be helpful, in the event that members of the audience have not had the chance to read the opinion recently, to provide a summary of the case to lay a foundation for the discussion to follow.

The issue that the Supreme Court examined in *Trinko* [*Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, 124 S. Ct. 872 (2004), *rev'g* 305 F.3d 89 (2d Cir. 2002)] was whether a complainant that had alleged the breach of an incumbent's duty under the Telecommunications Act of 1996 to share its network stated a claim under Section 2. The answer to that question came in a majority opinion that was written by Justice Scalia and issued on January 13, 2004, and the answer was a resounding "no." The case presented an interesting debate between telecommunications regulation and antitrust policy.

Verizon was the incumbent local exchange carrier in New York. Under the 1996 Act, Verizon was obligated to facilitate the market entry of competitors by providing them with access to its operations and support system to fill orders for new service. The 1996 Act contained a complex regime for regulatory monitoring and enforcement of its provisions. In late 1999, certain competitive local exchange carriers complained to the New York Public Service Commission and to the FCC about Verizon's failure to provide them with proper interconnection access and operations support. As the result of regulatory enforcement proceedings and following the entry of an FCC consent decree, Verizon was placed under new performance measurements and reporting requirements.

The named plaintiff in the *Trinko* case was a New York City law firm that was a local telephone service customer of AT&T. The class action was filed when Verizon entered into the FCC consent decree that had alleged that Verizon completed service orders of its rivals on a discriminatory or delayed basis so as to discourage customers from becoming or remaining customers of competitive LEC's. The claims were brought under Section 2 and the 1996 Act. The Southern District of New York dismissed the complaint. The Second Circuit reinstated the antitrust and certain other claims on the grounds that the plaintiffs had indeed alleged cognizable essential facilities and monopoly leveraging theories.

The Supreme Court's opinion centered around four key issues, and our panelists will address each of them today. The first issue the Court examined is what effect the 1996 Act has on the application of traditional antitrust principles. The Court determined that it had no effect. The Court recognized that while detailed regulatory schemes ordinarily raise the question of whether regulated entities are shielded from antitrust scrutiny by implied immunity, here Congress had included a specific antitrust savings clause in the Act that preserved the application of existing antitrust laws. The Court noted, however, that does not mean that new antitrust standards are thereby created.

The Court next focused on whether the named plaintiff had stated the claim under pre-existing antitrust standards. The first issue the Court examined was whether there was a legitimate claim premised on Verizon's refusal to deal. The Court initially cited standard Section 2 fare, including *Grinnell*, and recognized that both monopoly power and anticompetitive conduct are required for a violation. Recognizing the tension between competing firms to share infrastructure, which gives

them a competitive advantage, and the incentive that firms have to develop such infrastructures in the first place, the Court noted that federal courts need to be careful not to discourage innovation. The Court also recognized that courts generally are not well suited to be central planners of compelled relationships between competitors. Thus, the guiding principle in refusal to deal cases under Section 2 is that of *Colgate*—manufacturers are free to exercise their independent discretion as to whom they will deal. The Court recognized, however, that the right to refuse to deal is not unqualified and that any exceptions need to be approached with great caution. The *Trinko* plaintiffs had cited the 1985 *Aspen* decision to support their refusal to deal allegations. While the Court called that case the “leading case for liability” where a firm refuses to cooperate with a competitor, it also said that that case was “at or near the outer boundary of Section 2 liability.” The key in that case, according to the *Trinko* Court, was *Aspen*’s decision to cease participation in an existing venture, which suggested a willingness to forsake short-term profits to achieve an anticompetitive end and demonstrated an “anticompetitive bent.” The Court, however, distinguished *Aspen*. In *Trinko*, the parties had never previously engaged in a voluntary course of dealing and thus there was no prior conduct to inform the analysis of Verizon’s motivation in refusing to deal, and it was very difficult to assess whether Verizon was acting with competitive zeal or anticompetitive malice. Moreover, the services at issue are not otherwise marketed to the public, as in *Aspen*. The sharing obligation on Verizon results solely from statutory regulations under the Telecommunications Act. Thus, the Court held that the refusal to deal allegation was not a recognized antitrust claim under existing refusal to deal precedents.

The third portion of the Court’s analysis focused on the essential facilities/monopoly leveraging allegations. With respect to the essential facilities allegations, the Court determined that there was no claim. Here, the sharing duties were clearly compelled by statute and there is no need to impose a judicial doctrine of forced access.

A footnote in the opinion (and there are only four footnotes in the entire opinion) handled the monopoly leveraging claim. The Court stated that the Second Circuit was wrong in recognizing the possibility of a monopoly leveraging claim in that the courts are not free to dispense with the “dangerous probability of success” element of Section 2. In doing so, it overruled *Berkey Photo*. This recognition by the Court was consistent with the DOJ’s position in its amicus brief that leveraging is not sustainable as an independent antitrust violation.

Following its determination that the *Trinko* plaintiffs had no cognizable refusal to deal, essential facilities, and monopoly leveraging claims, in the final part of the decision the Court addressed whether the facts in this case warranted the Court’s recognition of a new exception in refusal to deal cases. The Court said “no.” Verizon was subject to a significant regulatory structure designed to deter and remedy anticompetitive harm in the provision of local telephone service. The restrictions were imposed by the FCC and the New York Public Service Commission, and the oversight role that they performed was an antitrust enforcement function. The regulatory process worked in this case. Both the FCC and the NYPSE had found violations and imposed sanctions. The Court stated there was no need to risk “false positives” that can attach under Section 2 due to the difficulty of applying it in various fact patterns. Allegations of violations of sharing duties imposed under the Act are highly technical and difficult for courts to undertake. Moreover, courts are not in a position to exert day-to-day supervision over orders relating to sharing obligations.

Thus, in the *Trinko* decision the Supreme Court held that the class had no Section 2 case to remedy Verizon’s allegedly exclusionary conduct with respect to its rivals.

Herb is going to address the question of where *Trinko* fits within Section 2 lore.

HERB HOVENKAMP: For the record, I was consulted by Verizon in this case.

I'm going to divide up what I have to say into three parts. I'm first going to talk very briefly about monopoly leveraging because that received the least amount of the Court's attention. Then I'll talk at greater length about refusal to deal doctrine and the essential facilities doctrine and I'll conclude with just a few comments about how the regulatory environment was relevant to the outcome in the case.

First of all, in leveraging, this was a very idiosyncratic leveraging claim. The plaintiffs were claiming that the defendant was using its monopoly position in the wholesale market in order to leverage a competitive advantage in the retail market. Historically, leveraging claims, where they've been recognized at all, such as in *Griffith* and *Berkey Photo*, have involved complementary markets, or collateral markets. For example, in *Berkey Photo*, it was the camera and the film. In *Griffith* it was movie theaters in monopoly towns versus movie theaters in competitive towns. Using leveraging in the way that the plaintiffs wanted to use it in *Trinko* really would have been a direct assault on vertical integration because any firm that has a dominant position upstream will necessarily create a dominant position downstream by refusing to deal with rivals. Well, the interesting thing is the Court could easily have distinguished this particular leveraging claim on that basis and said we're simply not going to use leveraging doctrine to require a defendant to retail things that it would prefer to use internally. The Supreme Court chose not to do that. It took the much, much broader route of basically abolishing leveraging claims as *Griffith* and *Berkey Photo* had recognized them, which is to say leveraging claims where there is no threat of monopoly in the secondary market. The Supreme Court referred to its *Spectrum Sports* decision as saying that Section 2 requires either monopolization in a properly defined relevant market, or else a dangerous probability that a monopoly will be created in a properly defined market. And that really means that leveraging theory is nothing more than attempt to monopolize, stated in other words, you have to make out all the elements of an attempt to monopolize offense in order to make out a leveraging claim, which, of course, makes the leveraging doctrine superfluous.

On refusal to deal and the essential facilities doctrine, I think the opening question is what's left of unilateral refusal to deal after *Trinko* and I think the answer is "very little." In fact, one is hard put to find very many essential facilities cases that survive this analysis, although there will be a very few. First, the Court distinguished *Aspen* by noting that in the *Aspen* case the defendant made an immediate sacrifice because it gave up short term profits in anticipation of greater monopoly—of greater profits down the road as a result of creation of a larger market position. The government has styled this the sacrifice test, and the Supreme Court basically adopted it for unilateral refusal to deal actions. Importantly, it did not adopt it for Section 2 violations generally. I'll come back to that point in just a second. But a unilateral refusal to deal will not be actionable under Section 2 according to *Trinko* unless you can show that the defendant gave up short run profits in order to injure or exclude the rival who has requested the dealing. What that means is that a firm that's currently making sales at a profitable retail price, for example, cannot be charged with violating Section 2 simply because it refuses to abandon those sales and wholesale that good to some rival who would prefer to have it. If the more profitable thing for you to do, or even an equally profitable thing for you to do is to make the sales directly to customers yourself, then Section 2 is not going to obligate you to wholesale that product or service to someone else.

Now, on the scope of the sacrifice test, I think where we stand right now is that the sacrifice test applies in two sections of Section 2 doctrine. One is refusal to deal doctrine as *Trinko* defines it, and the other one is predatory pricing. Under prevailing predatory pricing rules, where you have to show prices below a relevant measure of cost, we really have used a kind of sacrifice theory

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there as well. Importantly, we don't require a sacrifice test for other types of Section 2 violations, such as fraudulent patent claims or patent litigation, exclusive dealing and tying, and other kinds of actions that can be held Section 2 violations as well.

Another limit that the Supreme Court put on Section 2 unilateral refusal to deal claims, including essential facilities claims, is that the claims apply only to final goods and not to intermediate goods. As the Court put it, most of the things that plaintiffs are entitled to share under the 1996 Telecommunications Act are intermediate goods, goods that, as Justice Scalia put it, exist within the bowels of Verizon. There's not part of its final product. So, for example, if you're in the business of supplying some input for yourself, if you're a natural gas company and you have built a pipeline only to transport your gas for sale to end users, you're not going to be obligated to share that pipeline unless you're in the general business of renting pipeline space. As a consequence, I think *Trinko* overrules a great many unilateral refusal to deal cases, or at least would require a remand in some of them to see what the facts were. For example, in the typical public utility or pipeline setting, the utility basically deals with end users and it uses its pipelines or other distribution lines mainly to service its own needs. Under *Trinko* that company would no longer have an obligation to share those facilities with others. For example, the Court contrasted *Otter Tail* because *Otter Tail* was in fact in the general business of wholesaling or wheeling power for other utilities. It simply refused to do so in this particular case for a particular group of municipal utilities that needed wheeling. I think the case very likely overrules *MCI v. AT&T*, one of the old standard essential facilities cases from the late 1970s, where the Seventh Circuit applied the essential facilities doctrine to AT&T in order to force it to interconnect with MCI. Well, at the time, AT&T was not interconnecting with anyone voluntarily. It was simply selling telephone services, and what MCI was requesting was access to an intermediate good. I suspect, although I don't know the facts well enough, that *Trinko* overrules the Second Circuit decision in *Delaware and Hudson Railway*, one that the Justice Department objected to, but fifteen years ago, in which it was held that a railroad could have violated the essential facilities doctrine by refusing to rent track, so that a rival carrier could use the track as well. One would have to go back and look at the facts, but what you would now want to know in such a case is was the railroad in the general business of leasing its track to others or was it simply using the track as an input into its own business of shipping freight. And if the latter is the case, then under *Trinko* the essential facilities doctrine would not apply.

Next, the Court refused to apply the essential facilities or refusal to deal doctrine to situations where the defendant would have to create new systems or expand existing facilities in order to serve a rival. Under the 1996 Telecom Act the defendant actually has to create new trunk lines in circumstances. It may have to add billing capacity and so on. What the Court is basically saying is that the essential facilities doctrine will apply where a firm has existing facilities with excess capacity, and those facilities can readily be shared with a rival, but it's not going to be part of Section 2 doctrine that a firm, upon a rival's request, has to add to its facilities or add some kind of transactional or provision power that it did not have previously. In general, the Court refused to repudiate the essential facilities doctrine, but once you throw all of these things into the mix, it's kind of hard for me to see very many situations where the essential facilities doctrine would continue to apply. *Otter Tail* itself is a probable example. *Otter Tail* was in fact in the business of supplying power at wholesale to others, and it refused to do so in this particular case in order to drive some municipal utilities out of business. But that would be the narrow and rather, I think, idiosyncratic situation.

In addition, the Court expressed a great deal of concern about the anticompetitive tendencies that were described as inherent in essential facilities claims. One of them is that a sharing obliga-

tion reduces the incentive upon the plaintiff, or the competitor, to make the investment for itself. That is to say, once you have the right to share, you have a much-reduced incentive to procure or develop that input for yourself because, after all, you can simply share it with someone else. As a result, the Court said that, very important to any unilateral refusal to deal claim, is the plaintiff's absolute inability, or competitor's absolute inability to provide this good for itself. In my view, that conclusion overrules the Ninth Circuit's decision on remand in *Image Tech v. Kodak*. As you may recall, once the *Kodak* case was remanded from a tying theory, it became a general Section 2 refusal to deal case, where the Ninth Circuit assessed liability against Kodak notwithstanding that there was no showing that, with respect to most of the aftermarket parts in that case, the plaintiffs could not procure or produce them for themselves. The Ninth Circuit held that requirement was not necessary. So I don't think the Ninth Circuit's opinion in the *Kodak* case, or at least a substantial portion of it, is good law. Finally, on the Section 2 doctrine, I think it's important to remember this is a refusal to deal case, and it says nothing about other types of Section 2 liability. Things like tying, exclusive dealing, IP abuses, and so on. Nor does it say anything about Section 1 liability. Those things are all preserved, and indeed, the Court made a point of distinguishing its *Terminal Railroad* and *Associated Press* decisions, which involved concerted actions rather than unilateral actions.

I've just got a couple of minutes left; so let me say one thing about the regulatory environment. The Court held that the savings clause meant that there could not be implied immunity in this case. But the Court then applied what has increasingly come to become called "soft immunity," which means rather than finding an implied immunity, you look at the regulatory environment and ask whether the regulatory agencies are doing a good enough job of taking competitive concerns into account in light of the incremental gain that could come about from antitrust enforcement. In this particular case, the Court said, well, the Section 2 claims pushed the bubble with respect to antitrust. They're going to be very difficult to manage. On the other side, the regulatory agency seems to be doing an extremely good job, so we don't need the incremental advantages or offerings of antitrust in this case. Very significantly, in making that assessment, the Supreme Court looked at federal and state agencies more or less interchangeably. It didn't matter; so we don't have this sort of two layers of immunity, one for federal government and one for state government. Finally, the case that the Supreme Court relied on most heavily, *Concord*, assessed this kind of soft immunity. But it did so only after trial. There was a complete trial in the *Concord* case and the Court needed a fairly good record to see how antitrust fit into this overall regulatory scheme. In contrast, *Trinko* is a 12(b)(6) case. This is a motion to dismiss, so I see this not merely as a confirmation of the *Concord* approach, but also as a fairly healthy expansion of that approach signaling the Court's willingness to use it in a more dispositive way at an earlier stage in the litigation in other kinds of cases in regulated industries as well.

BRIAN HENRY: Herb, a quick question. In applying the sacrifice test, do you see a different application in the case where there is a pre-existing relationship between the parties? For example, the pre-existing relationship between the ski operators in *Aspen*.

HERB HOVENKAMP: I do, only for the simple reason that the Court certainly did not purport to overrule *Aspen*. It embraced *Aspen*, assessed it as being at the outer boundary of Section 2 liability. So I think one of the very small group of exceptions to non-liability for unilateral refusals to deal will be in a case like *Aspen*, where there has been an established course of dealing, joint venture, or some other kind of collaborative enterprise, and then the dominant firm repudiates it in a way that does unnecessary harm to the plaintiff.

JEFF CASHDAN: We're now going to move on to Greg Werden, who's going to give us some perspective on *Trinko's* impact on the Department of Justice's interpretation and enforcement of Section 2 and may also have time to say a few words about the implied immunity issue.

GREG WERDEN: The first thing I need to say is I'm speaking on behalf of myself and not on behalf of the Department of Justice, so this is not a statement of what the Department of Justice does or thinks or how it's going to litigate its cases, but rather only a statement of what I think about *Trinko* and the position the Solicitor General took in the case, which is my jumping-off point.

In the merits brief [<http://www.usdoj.gov/osg/briefs/2002/3mer/1ami/2002-0682.mer.ami.pdf>], the Solicitor General argued that "only 'exclusionary' or 'predatory' conduct is proscribed by Section 2," and when "the plaintiff asserts the defendant was under a duty *to assist a rival*, . . . conduct is not exclusionary or predatory *unless* it would make no economic sense for the defendant but for the tendency to eliminate or lessen competition." Because *Trinko* had not alleged exclusionary conduct under this or any other standard the Solicitor General saw as sensible, the brief argued that the Second Circuit should be reversed, which is what happened. The Supreme Court's analysis is consistent with the "no economic sense" standard advocated, but the Court did not expressly adopt that standard.

Most of the criticisms in amicus briefs and scholarly commentary of the position taken by the Solicitor General in this case, and by the Antitrust Division in several other recent cases, are based on an erroneous characterization of the test advocated. The "no economic sense" standard is often mischaracterized as a test for short-run profit sacrifice. In fact, a short-term profit sacrifice is neither a necessary nor a sufficient condition for exclusionary conduct under the "no economic sense" standard.

It is easy to see why a short-term sacrifice isn't sufficient to make conduct exclusionary. All sorts of procompetitive conduct involve the sacrifice of current profits in the effort to make more profits in the future. Giving up current profits in the effort to make greater future profits occurs when buying a capital good, investing in R&D, and doing many of the things that successful businesses do. Obviously, that is not enough to make the conduct exclusionary, and buying capital goods, investing in R&R, and the like, often make perfect economic sense apart from any tendency to eliminate competition.

Conduct that is exclusionary under the "no economic sense" standard also need not entail a short-run profit sacrifice, although there commonly would be such a sacrifice. Critically, no short-run sacrifice was necessary in *Trinko* or in the other Section 2 cases in which the Antitrust Division has advocated the standard, because all were monopoly maintenance cases. If conduct helps to maintain a monopoly and the flow of monopoly profits, it easily can be that, at the time the conduct is engaged in, there is no profit sacrifice; eliminating competition makes the conduct profitable at every point in time. The conduct is nevertheless exclusionary under the "no economic sense" standard if the only reason the conduct makes economic sense is that it eliminates competition.

In the merits brief, the Solicitor advocated the "no economic sense" standard in cases involving an asserted duty to assist rivals, but that is not the only context in which the Antitrust Division has advocated the test. This is essentially the standard advocated in the *Microsoft* and *American Airlines* cases, and now in the *Dentsply* case pending in the Third Circuit [*United States v. Dentsply Int'l, Inc.*, 277 F. Supp. 2d 387 (D. Del. 2003), *appeal pending*, Docket No. 03-4097]. The Antitrust Division has not said that this is the right test for all Section 2 cases, but it has said that it is the right test in a variety of different Section 2 cases, not always involving duties to assist competitors.

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Contrary to a common critique, the “no economic sense” standard works perfectly well in cases in which exclusion may cost very little. Take, for example, a *Walker Process Equipment Inc. v. Food Machinery & Chemical Corp.* (382 U.S. 172 (1965)) type case, involving an attempt to assert an intellectual property right in order to exclude competition. This is a perfect set of facts for applying the “no economic sense” standard. The conduct has no economic payoff at all unless it succeeds to at least some degree in eliminating competition, and the conduct costs something to undertake, even if not much. Eliminating competition, therefore, is the only possible way in which the conduct can generate an economic benefit, and the “no economic sense” standard works perfectly well.

The “no economic sense” standard also works perfectly well in that small class of antitrust cases involving violence rather than economic conduct. Burning down a rival’s factory tends to eliminate competition and pays only because it tends to eliminate competition. Even if it costs no more than the price of a match, it costs something, so this sort of conduct makes no economic sense but for its tendency to eliminate competition. I might add that the “no economic sense” standard anticipates the possibility of pyromania. Setting the fire need not be motivated by desire to eliminate competition, but motivation does not matter under this standard. What matters is the objective economics of the conduct. If it pays in an economic sense only because it eliminates competition, then the conduct is exclusionary under the “no economic sense” standard.

I should add that exclusionary conduct, which is what the “no economic sense” test attempts to define, is not sufficient to make out a Section 2 claim. Some conduct is immune from attack under the Sherman Act, and the courts have crafted some prudential safe harbors. In *Brooke Group* I think the Court was saying that it’s perfectly possible that above-cost pricing can be exclusionary, but there is way too much risk of chilling legitimate price competition if plaintiffs are allowed to attack that conduct. [*Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222 (1993)] It is also theoretically possible that conduct making no economic sense but for a tendency to eliminate competition nevertheless does not eliminate competition. The district court in our *Dentsply* case found no possible motive for the conduct except to exclude competition, but the court nevertheless found that the conduct had no exclusionary effect. [277 F. Supp. 2d at 419–21, 441–53]

The Antitrust Division has a long history of arguing against implied antitrust immunities, often successfully, and I have been asked to comment on what *Trinko* says about implied immunity. On the basis of the Antitrust Savings Clause in the 1996 Act, the Supreme Court found there was no implied immunity, as urged by the Solicitor General. In doing so, however, the Court suggested that, but for the Savings Clause, it might have found implied immunity. The Court indicated that a detailed regulatory scheme, such as that created by the 1996 Act, ordinarily raises the question of whether regulated entities are shielded from antitrust scrutiny altogether. The Court went on to explain that the enforcement scheme set up by the 1996 Act is a good candidate for implied antitrust immunity in order to avoid conflicts between the regulatory scheme and determinations made by, or requirements imposed by, antitrust courts.

One of the few things that I thought the Second Circuit had exactly right in its *Trinko* decision was its attitude toward this issue. The decision quite reasonably held that courts must be mindful of the strong possibility that injunctive relief could disrupt the regulatory scheme, and went on to say: “We have confidence that courts will exercise their discretion with restraint in any case where such relief is appropriate, consistent with the respect for the overarching regulatory regime that Congress has created.” [*Law Offices of Curtis V. Trinko v. Bell Atlantic Corp.*, 305 F.3d 89, 113 (2d Cir. 2002)] I think that’s the right attitude. If district judges are reasonably careful, they will avoid

conflicts. The scheme the Supreme Court developed under the Shipping Act of 1916 basically did just that. [See *Carnation Co. v. Pacific Westbound Conference*, 383 U.S. 213 (1966); *Far East Conference v. United States*, 342 U.S. 570 (1952); *United States Navigation Co. v. Cunard Steamship Co.*, 284 U.S. 474 (1932)] The Court reasoned that there was a potential for a conflict but no implied repeal because conflict could be avoided.

The test the Supreme Court has set out for implied repeal is a convincing showing of clear repugnancy between the antitrust laws and the regulatory scheme, and that cannot often be found. Some courts, however, have found implied repeal even under that standard, as the Second Circuit did last year in the *Stock Exchanges Options Trading Antitrust Litigation* [317 F.3d 134, 149 (2d Cir. 2003)]. Over our strong objection, the court found that the possibility that the agency could allow the conduct, even though in fact it had prohibited the conduct, was sufficient to create the kind of conflict that led to implied repeal. Dicta in the *Trinko* decision will be cited in litigating these implied repeal issues in the future.

To conclude, I offer a few general comments on the *Trinko* decision. First, the Court was not willing to say exactly when refusal to deal claims can be made out under Section 2, but it has made clear that it is not very often. Second, the Court has also made clear that the essential facilities and leveraging doctrines provide no short cuts; all the elements of a Section 2 violation must be established, which means actual monopolization, maintenance of monopoly, or attempted monopoly in some market. Finally, the Court has displayed great reluctance to impose liability for single-firm conduct because of risk of chilling innovation, as emphasized in *Trinko*, and the risk of chilling aggressive pricing, as emphasized in *Brooke Group*.

JEFF CASHDAN: Greg, I wonder if I could ask you one question before we move on to Richard. Do you think that the no-economic-sense test you have articulated should be applied in cases where the theory is raising rivals' costs, where, in the short term, the action being taken by a competitor may make economic sense but is intended to drive a competitor out of business in the long term?

GREG WERDEN: Yes, in most cases that would work. For many ways I can imagine raising a rival's cost, I think the "no economic sense" standard would be the right test to use. It is appropriate if a rival's costs are raised by burning down its factory, by making interface decisions or standard-setting decisions, or by undertaking any number of other actions. As a general rule, it is good test, but in a specific case, it possibly would not be appropriate.

JEFF CASHDAN: We're now going to hear from Richard Schwartz. Richard, who's in the New York Attorney General's Office, was one of the primary drafters of New York's amicus brief, and the states in the *Trinko* case were not all on the same side. There was a split, and New York led the way in submitting an amicus brief on behalf of several states that took a position different from the U.S. Department of Justice. Richard, we're interested in hearing your perspective on contrasting the views of the Department of Justice, the Federal Trade Commission, and the states.

RICHARD SCHWARTZ: Let me begin with the same disclaimer Greg made. I'm speaking only on behalf of myself and not on behalf of the New York State Attorney General's Office.

I'd like to focus my remarks on the debate that occurred between the amicus states on the one hand and the Department of Justice and Verizon on the other, on the proper role of the sacrifice test. I would disagree with what I took to be Herb Hovenkamp's conclusion that the Supreme Court has adopted a sacrifice test with respect to refusals to deal. What Greg said, I think, was a little

different, which was that what the Supreme Court had to say about the subject was consistent with the sacrifice test. Even on that one I would be a little skeptical. Where I would come down is that the Supreme Court clearly did not adopt the sacrifice test for this category of cases, and part of the reason why I think that, is the scope of the debate that took place on in the briefs. I don't think the Supreme Court would have made that kind of decision without more discussion, and let me explain the background to show why.

To set up the issues raised by the test, let me propose the following hypothetical. Suppose the evidence shows that an incumbent monopolist like Verizon, an ILEC, in the jargon, has redesigned the interfaces of its switching equipment. And suppose the evidence shows that its motives for doing so and the effects of it are mixed. On the one hand, it costs the ILEC \$5000 per switch to carry out the work, but it expects to earn more from the switch, or realize some legitimate savings as a result, say, in the amount of \$7000 per switch. On the other hand, the same redesign will cost the ILEC's competitors, who must connect to many of its switches, \$100,000 to make the corresponding design changes. And let's assume that this will be an insurmountable competitive hurdle for them. Now, you would apply the test to these facts by asking whether the profits the ILEC would reap from performing the redesign work exceed those it would obtain from not doing so, apart from any negative effect on competition. And in the hypothetical they clearly would, since the \$5000 expenditure yields a \$7000 return.

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Section 2 analysis

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one-sided.

—RICHARD SCHWARTZ

Under the sacrifice test, the case ends there. The profitability of the conduct to the monopolist forecloses any consideration of the market effects that arise from that conduct. The Court doesn't get to consider the extent to which the conduct may have anticompetitive effects: deter entry, raise prices, or maintain them. New York and the other amicus states argued that this wasn't and couldn't be a prerequisite for Section 2 liability. We agreed that the test is a very useful analytical tool. If conduct flunks the test, it means there's no factual issue as to whether there's a legitimate business justification for the challenged conduct. The conduct is nakedly anticompetitive and so, in that sense, I think of it as a sort of a rough analog to per se Section 1 conduct.

But the test can't replace standard Section 2 analysis either generally—and I was certainly glad to hear Herb agree with that point—or, I would argue, with respect to refusals to deal. And that's because the focus on the monopolist's profitability is one-sided. It doesn't allow the monopolist's conduct to be measured against the principal goals of antitrust: the health of competition and the welfare of consumers. And it's because it leaves these central concerns out of account, that it doesn't fit the more usual situation, where effects and motives are likely to be mixed. So in those circumstances, a fact-based inquiry is necessary and courts have traditionally employed that.

Now let me briefly expand on these points by discussing first the limits within which the sacrifice test is legitimately used and then the extent to which an expansion of the use of the test would be at odds with traditional Section 2 analysis. Finally, I'd like to talk about a challenge to the use of the test that was proposed by the Department of Justice in this case, which came not only from the states, but from some economists who filed a brief, which I thought was quite remarkable.

To begin with legitimate uses of the sacrifice test: as Herb mentioned, and here we would agree, predatory pricing law is a place where you can use it as a prerequisite to liability. But for a host of reasons, predatory pricing isn't a fact pattern that can serve as a model for Section 2 cases generally. There's a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful. The price-cutter endures immediate and ongoing economic loss that's likely to be disproportionate to what its victims are feeling. Its success is highly uncertain; failure is going to be costly. Those conditions don't obtain in the refusal to deal

context and they don't necessarily obtain across the board in Section 2. Certainly in the refusal to deal with rivals cases, the consumer benefits of such conduct are likely to be non-existent, or at least very uncertain. And conduct by dominant firms can raise rivals' costs disproportionately so that that kind of tactic is likely to be attractive, rather than, as in the predatory pricing case, a high-risk strategy.

Now apart from predatory pricing, there are also cases, and indeed refusal to deal cases, where application of the sacrifice test yields the right result. *Lorain Journal* was one. There you had a newspaper whose advertising pages were essential for advertisers. The newspaper refused to deal with advertisers who also patronized the newspaper's rival. There was no countervailing pro-competitive justification for that refusal to deal, so application of the sacrifice test yields the right result. But the simple fact is that many cases are not going to be so simple or so one-sided. And the law, I think, has long taken account of that. Ever since the Supreme Court's landmark decision in *Standard Oil*, it's been clear that the rule of reason, which requires a weighing of anticompetitive effects against procompetitive benefits, underpins Section 2 as well as Section 1. The focus under both sections is on the competitive effects of challenged conduct relative to such alternatives as its abandonment or a less restrictive alternative. And I'm quoting there from the Areeda and Hovenkamp treatise, *Antitrust Law*, vol. VII, ¶ 1500, at 336–37 (2003). Similarly, the Supreme Court in *Aspen* instructed courts to consider the impact of challenged conduct on consumers and whether it has impaired competition in an unnecessarily restrictive way. So on that pattern, courts have condemned conduct by monopolists because of its effects, which would have been lawful, had it been engaged in by a non-dominant firm. And the *United Shoe* case is an example of that. It involved restrictive leasing practices by a monopolist of shoe manufacturing equipment, and although Judge Wyzanski found that the challenged conduct, in part, involved the kind of practices that might have been engaged in by other honorable firms, he held them illegal because when engaged in by a monopolist, they unnecessarily excluded actual and potential competition.

Let me turn now to another aspect of the debate about the sacrifice test. Even if you agree with Greg, for example, that the sacrifice test is in principle the right test to use in the refusal to deal category, or indeed across Section 2, it's nevertheless possible to hold the view that the government's position in the *Trinko* case—namely, that the sacrifice should invariably apply when a monopolist's refusal to deal with a rival is challenged—is wrong. And that was the position taken by four distinguished economists, Professors Ordover, Willig, and Baumol, and Dr. Warren-Boulton, three of whom were themselves former chief economists at DOJ, and two of whom, Professors Ordover and Willig, are largely responsible for at least the recent theoretical articulations of the test in the literature. They felt constrained to point out that by extending the sacrifice test beyond its proper scope, the government was risking far-ranging and deleterious consequences to consumers in particular, and competition in general. Here's the problem they identified. Where a monopolist's refusal to deal with rivals is at issue, the analysis turns on the benchmark for profitability which is employed and against which the sacrifice is measured. In the *Trinko* case, while the government's analysis was not entirely clear (so I'd be interested to hear Greg on this point), it appeared that Verizon and the government asked whether the profits Verizon was currently earning from its sales to its current customers were greater than the profits it would have obtained had it not refused to deal with the rival. Unless the conduct involved a profit sacrifice, the case was over. If Verizon would have lost profits and lost customers by dealing with the rival, its refusal to do so would have been lawful under the proposed test.

I think we all have the intuitive feeling that this can't be the result. The fallacy involved there, the amicus states pointed out in their brief, is essentially a variation of the celebrated *Cellophane*

fallacy, engaged in by a much earlier Supreme Court in the *Du Pont* case, where the Court, in defining a market for flexible wrapping materials, used as its benchmark elasticity of demand at current prices without regard for whether the defendants had already exercised power by pricing at monopoly levels. The flaw in the government's reasoning, the amicus economists pointed out, was that where the benchmark for measuring profits—the monopolist's current pricing structure and customer base—was not itself a product of competitive conditions, you can't simply assume that profit-driven conduct will increase social welfare. What was left out of account, the economists emphasized, was the public interest itself. And let me quote from their brief: "This overarching public interest is not captured in a test of market sacrifice that is based on the regulated monopolist's current market position and profit levels. There is no rational basis on which to presume that the current level of profit constitutes the appropriate benchmark with which to evaluate the incumbent strategy for granting access." That conclusion, I suggest, shouldn't be a surprise to antitrust lawyers. In the *Otter Tail* case, which Herb and Greg have mentioned, the Supreme Court upheld Section 2 liability. The Supreme Court rejected the proffered justification, which was that without the weapons which it used—refusals to deal—more and more municipalities will turn to public power and *Otter Tail* will go downhill. Not surprisingly, retaining customers and monopoly profits, while not themselves unlawful objectives, are also not procompetitive benefits, which can identify a benchmark against which competitive conduct can be judged.

Let me finally say just a word about the decision itself. There obviously isn't any explicit reference in the Court's opinion to the debate I've described which took place on the sacrifice test, nor it seems to me, is there any trace of the debate to be found there. And I think that's worth mentioning in evaluating whether you think the Court, in the face of that kind of briefing, would have taken a position on this issue without discussing the views put forward. So in my view, what the Court said in the few sentences which it devoted to the topic, in its discussion of *Aspen*, for example, was consistent with the traditional view of the sacrifice test which I've defended here. Namely, that it's a sufficient condition for liability, but not a necessary one. And I just quote one sentence from the opinion where the Court said, "Here, the defendant's prior conduct sheds no light upon the motivation of its refusal to deal, upon whether the regulatory lapses were prompted not by competitive zeal, but by anti-competitive malice." So I don't read that as adopting the test urged by the government.

JEFF CASHDAN: We now want to hear from Mark Whitener, who is going to try to make sense of this for many of us who need to take this interesting learning from the case and advise our clients on how to behave.

MARK WHITENER: Let me start with a comment on what I think businesses and their counselors are looking for in terms of antitrust guidance generally, and then I'll try to relate that to the *Trinko* decision.

Business people, of course, want as much flexibility as possible to do what they think makes business sense. But they also want clarity about what they can and cannot do. Uncertainty about the legal rules of the road makes business planning more difficult. Uncertainty is an unavoidable element of antitrust analysis, and of Section 2 rule of reason analysis in particular. It's a fact of life. But it's not a good thing where business planning is concerned.

Antitrust risks can sometimes be broken down into two types—the risk of government investigations, and of private litigation. I don't really have a lot to say about *Trinko*'s effects on government investigations. The U.S. Government brief in *Trinko* was very illuminating and I think it was, gen-

The key risk, both before and after Trinko, was and is private litigation. . . . [T]he real risk equation in this area often focuses on whether a claim is going to be dismissible at an early stage.

—MARK WHITENER

erally speaking, quite well done. But I don't think the Government's position, or the *Trinko* decision itself, will have a major impact on my counseling in this area. This is not an area—speaking now of refusals to deal generally—where there's been a lot of federal enforcement, and I don't think that that's a primary risk factor going forward. The key risk, both before and after *Trinko*, was and is private litigation. And that risk is not, in my view, mainly about how a full trial on the merits would end up in a rule of reason case. If you get to that point, in a sense, you've already lost—if you're before a jury in a rule of reason case, you have already incurred a lot of litigation costs and you are facing a highly uncertain outcome. The uncertainty I talked about a moment ago is escalated, along with the fact that you've already sunk a great deal of cost into defending the case.

So the real risk equation in this area often focuses on whether a claim is going to be dismissible at an early stage. How does *Trinko* affect that particular risk analysis in a refusal to deal case? In my view, although I would like to agree with Herb—and I do agree with a lot of what he said—I don't think this decision is going to have a major impact on how I counsel in this area. It will have some effect on counseling, and I'll talk about that in a moment, but not a major effect. The decision confirmed some things we already thought we knew. It says a couple of things about how to structure the refusal to deal analysis, and it lays out some necessary but not sufficient conditions for a case that weren't perhaps as clear before. It also gives us a good idea of how this Court views these types of claims generally. But *Trinko* still leaves some room, I think, for claims of this type to survive dismissal in the hands of the lower courts.

Let me outline what I see as the major points that *Trinko* did in fact clarify, or at least confirm.

First, as others have noted, the Court sounded the death knell of monopoly leveraging as such. I think the Court confirmed what it said in *Spectrum Sports*—that there's no Section 2 liability absent a dangerous probability of monopolizing a second market. So the sort of simplistic monopoly leveraging theory I think is dead. As for the essential facilities doctrine, I agree with what others have already said. The Court found that theory inapplicable to the facts in *Trinko*, and the decision strongly suggested that a majority of the Court would repudiate the essential facilities theory if and when it needed to. But neither of these theories really factors heavily into antitrust counseling today. Even before *Trinko*, successful monopoly leveraging or essential facilities claims were rare. Monopoly leveraging was unlikely to be a significant part of the antitrust plaintiff's tool kit before, and now it's clearly not; and essential facilities was, and remains, a theory of dubious viability that I think at some point the Supreme Court will address.

What the *Trinko* Court did that is of some significance, I think, was to amplify somewhat the analysis of a Section 2 refusal to deal claim. Overall, this was a very strong statement that a majority of this Court is skeptical of such claims and generally favors business flexibility to deal or not deal with competitors. We see a very skeptical view toward forced dealings, and statements that doing so can undermine incentives to invest and innovate, both by the monopolist and by its rivals. There is also, I believe, the first express statement by the Supreme Court that monopoly pricing is not only lawful, but is an embodiment, if you will, of free-market principles. And the decision makes a strong statement that courts are ill suited to regulate pricing or other commercial terms of private arrangements. It also seems to me the *Trinko* decision signals that if this Court ever confronted a claim that really required that sort of regulatory remedy—as one would think most refusal to deal claims will—the Court is saying that such regulation is not really a suitable judicial role. So all of this is meaningful, but again, as I see it, not a sea change.

The most significant thing the Court did that does affect counseling was to lay out some of the arguably necessary but not sufficient conditions for a refusal to deal case. *Trinko* suggests that there has to be a termination of some ongoing voluntary course of dealing. It would seem that

there has to be an actual course of dealing involving an actual product that's sold to third parties, and that course of dealing must have been voluntarily initiated and then terminated. When these conditions exist, and I'll come back to this in a moment, there is perhaps some inference that the prior dealings were profit-maximizing, and therefore that stopping them may be anticompetitive in some circumstances.

The most significant thing the Court did that does affect counseling was to lay out some of the arguably necessary but not sufficient conditions for a refusal to deal case.

Some of the less than clear aspects of the decision are the questions that are left open. First, the Court cites approvingly an analysis that it may not have called the sacrifice test, but that the Court described in "sacrifice" terms. The Court described as potentially problematic any conduct that sacrifices short-term profits for longer-term anticompetitive gain. The Court returns to this analysis at various parts in the opinion. Whether it was expressly adopting what some refer to as the "sacrifice test" is not a question I can answer, but it certainly seems to be a formulation the Court thought was important and talked about it a fair amount.

Unfortunately, in my view, the Court went on to link that test to a search for anticompetitive intent, asking whether the defendant's actions were prompted by competitive zeal or anticompetitive malice. Now, that's not very Scalia-like language, even though I guess he wrote it. But this and several other portions of the decision suggest that the Court is looking for a malicious purpose of the conduct, for the intent behind the conduct. And bad intent seems to be something that in some cases can be inferred from the fact that there was a prior course of dealing with a competitor that has been terminated.

—MARK WHITENER

When the Court talks about *Aspen Skiing*, even though there is the language that says *Aspen* is at or near the outer boundary of Section 2, the Court suggests that the refusal to sell tickets to a competitor at retail prices implies a calculation that future monopoly prices would be higher. There's a legitimate question whether that's necessarily true, or even usually true. It's also unclear whether the Court intended to imply that any similar refusal by a monopolist to sell to competitors at retail prices creates this inference of anticompetitive purpose. I don't think the Court meant to imply that, but there's language that could be read to suggest that if there is a course of dealing with a competitor at retail prices, it is risky to terminate that course of dealing.

So it's nice to have some necessary conditions for a refusal to deal case clarified. But what's a little troubling is the seeming counter-implication that if you do have a course of dealing with competitors that is ended, there can be an inference of anticompetitive intent. And this leads to what I think is the second less-than-compelling aspect of *Trinko*.

The Court essentially edited the old *Colgate* statement about firms' general freedom to decide with whom they will deal. The Court omitted from its quotation of *Colgate* the part that says this freedom only exists absent monopolistic purpose or intent. Various commentators have looked at this and suggested that this was intentional—that the Court cited *Colgate* but modified it to say that this freedom to deal exists regardless of whether there's monopolistic intent or not. But the Court doesn't explain why this freedom should be limited where there's a change of conduct such as a cessation of a prior course of dealing with a competitor. So I am perplexed, and my counseling will be made more difficult by the Court's reliance on this question of whether there is a change of conduct. It's not clear to me why that should be critical, or even particularly relevant, to the analysis.

I think that at the margin, this sort of analysis will tend to discourage initial decisions to deal with any competitor, because businesses will understand that once they embark on such a course of dealing there is going to be somewhat heightened risk if they stop it. The flexibility to adjust to changed circumstances—to take into account new facts, or simply to come to a different business judgment—would seem to be somewhat impaired, or somewhat called into ques-

tion by this focus in *Trinko* on whether there was a change of practice or a discontinuation of a prior course of dealing.

So in the final analysis, what does this decision mean for counseling? Again, I don't think it's a major change. There's a category of potential claims, such as essential facilities, that were not usually terribly successful before and that will not be very successful going forward either. Before *Trinko*, changes of conduct or cessations of prior courses of dealings with competitors created additional risk; that is certainly still the case after *Trinko*. It now seems arguable that such a cessation is a necessary, but not sufficient, condition to an antitrust claim based on a refusal to deal, and I think that's helpful for counseling. Firms are well advised to have a legitimate business purpose for any refusal to deal, whether it's an initial refusal or, especially, if it's a change in course. That would have been prudent advice before *Trinko*, and I think it's even more prudent advice after *Trinko*. It will sometimes—not always, but sometimes—make sense simply as a risk-avoidance matter to go ahead and deal with competitors if there's a product that's sold at retail and there are competitors who want it. So while I think *Trinko* provides some additional arguments for dismissing a refusal to deal claim in an early stage in some cases, this issue is still on counselors' radar screen going forward.

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JEFF CASHDAN: We're now ready to begin taking questions.

BRIAN HENRY: Can the *Trinko* decision be applied outside its unique telecommunications context? If so, is it going to cause federal courts to be more cautious in condemning conduct of monopolists?

RICHARD SCHWARTZ: May I interject a logically prior question which is, to what extent is *Trinko* going to be dispositive within the telecom area? And I ask that because it seems to me the Court focused on something which, in a sense, I would have thought was an easy question, namely whether a violation of provisions the '96 Telecom Act without more constituted an antitrust violation. I think everyone would have agreed absolutely not, but it seems to me the question is, how much further does the Court's analysis go beyond that? When you have a complaint which is mixed, in the sense that it alleges things which aren't so easily reducible, as this complaint really was to a '96 Act violation, will the Court's reasoning dispose of that? I'm somewhat skeptical.

HERB HOVENKAMP: First of all, in the telecom context, most of the cases, but not all, are some variation of interconnection disputes. There are a few cases—I know of only one, actually—that have alleged a conspiracy among different ILECs. *Trinko* wouldn't do very much with respect to such a case. There are also some claims of tying and exclusive dealing, and I think in all those cases, the upshot is the Court should do roughly what the Supreme Court did in *Trinko*, which is first of all, look at whether this conduct is within the jurisdiction of the agencies and whether they're doing a decent job of supervising it, and then ask how much incremental good can the application of antitrust do, given the nature of the claim. And of course, there, the thing that will tend to favor plaintiffs is that price-fixing cases or concerted refusal to deal cases or even tying and exclusive dealing cases are generally considered to be more manageable than unilateral refusal cases. As a result, this balancing of the effectiveness of the regulatory regime against the nature of the conduct being challenged will work somewhat more in favor of application of the antitrust laws.

GREG WERDEN: I expect *Trinko* to be a watershed in the telecommunications industry. It took only

two weeks for the first district court decision dismissing a telecommunications industry Section 2 claim and citing *Trinko: Levine v. Bellsouth Corp.*, 302 F. Supp. 2d 1358 (S.D. Fla. 2004). The Supreme Court also granted cert., vacated, and remanded *BellSouth Corp. v. Covad Communications Co.* (No. 02-1423) and *Qwest Corp. v. MetroNet Services Corp.* (No. 03-241), in which comparable claims, although by competitors, had been upheld by the Eleventh and Ninth Circuits. I think those two cases are going to come out the other way on remand. [Ed. note: On June 25, the Eleventh Circuit reversed its earlier decision and affirmed the dismissal of refusal to deal and essential facilities claims in “light of *Trinko*.”]

QUESTIONER: It's really a two-part question concerning the concurring opinion. Why did the Justice who joined in that opinion not follow the majority opinion and why did the majority not follow the concurring opinion?

HERB HOVENKAMP: I think the reason the majority didn't follow the concurring opinion is that there are too many disputed issues here with respect to the standing claim. I mean, this was a consumer case. It was a case, which, if the facts were true, would have alleged higher prices, or reduced product quality in the market, and that would be a traditional case for standing. There was this sort of indirect purchaser side show, you know, that Verizon sells to AT&T, and AT&T sells to consumers, but it's not an *Illinois Brick* sort of indirect purchaser case because there's no question of passed-on overcharge damages. The prices are all regulated by the FCC in this case, or most of them are. So it would be a traditional non-*Illinois Brick* standing case and I would assume the plaintiffs had standing, and that's why the majority just chose not to address it. I have no idea why the three concurers did not embrace what the majority said, except that they were following the traditional rule that if you can dispose of the case on standing ground, you don't need to get to the merits.

MARK WHITENER: I don't know why the Justices came out where they did, but in trying to assess going forward what this decision tells us about the antitrust jurisprudence of the Court, I would note that one of the three concurring Justices was Justice Thomas. My guess is that in terms of the Supreme Court's overall approach to refusal to deal issues, you could probably count him as having similar substantive views to those of Justice Scalia and the majority. So I think you can pretty much say that there are at least seven Justices who might be sympathetic to the sentiments expressed in the majority opinion.

GREG WERDEN: There was a lot of questioning at oral argument about the standing issue. The Solicitor General was pushed for a comment, even though the standing issue had not been briefed by the United States, and his comment was the plaintiff probably had standing. That may have had some effect on the Justices who elected not to dispose of the case on standing grounds. The injury belatedly asserted by *Trinko* to support standing was the inability at times to make phone calls. This is not an injury derivative of the injury to AT&T, and seems to me a reasonable basis for standing.

JEFF CASHDAN: Greg, earlier in his discussion, Richard had made reference to a hypothetical, and I expect you might have some reaction to Richard's hypothetical.

GREG WERDEN: My first reaction is I can't believe that could ever happen, and if it did, we have

Section 251(c)(2) of the Telecom Act, which allows the regulators to do something about it. But the hypothesis of the question was that the conduct makes perfect economic sense apart from any tendency to eliminate competition, and I think that should be enough to make it lawful under Section 2 of the Sherman Act. My reading of prior cases suggests that they are consistent with this view. In particular, *In re IBM Peripheral EDP Devices Antitrust Litigation*, 481 F. Supp. 965, 1004–05 (C.D. Cal. 1979), is very much on point. IBM's interface had some ill effects on rivals, but the court said that it didn't violate the antitrust laws because "it was a superior design." That is a lot like the "no economic sense" standard. And the Ninth Circuit held similar things in *California Computer Products, Inc. v. IBM Corp.*, 613 F.2d 727, 744 (9th Cir. 1979). The D.C. Circuit also went down a similar road in the Microsoft case. The court reviewed three specific actions Microsoft took to integrate IE into Windows. It found no liability for one of the three because there was a technical justification for it. [*United States v. Microsoft Corp.*, 253 F.3d 34, 64–67 (D.C. Cir. 2001)] As I would put it, that action made economic sense apart from any tendency to eliminate competition. For the other two integration actions, there was no technical justification; they did not make economic sense but for the tendency to eliminate competition. So I think the test the Solicitor advocated in the *Trinko* case is a good test for Richard's hypothetical, and I think if that sort of thing actually happened, courts would be extremely reluctant to interfere in the interface decisions of single firms.

JEFF CASHDAN: Mark, let me return for a moment to an issue that you raised in your comments. Are you concerned in light of *Trinko's* emphasis on the lack of a change in circumstances in dealing with a competitor, that your client or other clients will make decisions to forgo what might be viewed at the time as efficiency enhancing joint ventures or strategic alliances because of the risk that they might want to change their behavior down the road, and they don't want to be stuck with an antitrust problem?

MARK WHITENER: I think this sort of a decisional rule has to have that tendency in some instances. I can't say that in any particular matter I've counseled that an otherwise sensible business strategy needed to be fundamentally altered because of this issue. But if you look at this continued emphasis on whether a prior course of dealing with a competitor has been changed, in terms of the business incentives such an emphasis creates, I think we can't rule out that even after *Trinko* businesses will have to look more closely at changing their policies than at crafting the policies at the outset. Now again, I'm heartened by the fact that this was articulated more, in my view, as a necessary condition, without which you don't have a case, than as an affirmative indicator of liability. And of course, before *Trinko*, there were already decisions that made a change of course a key factor. But I don't think it's particularly helpful that the Supreme Court also hung its hat on that issue. How can a business not take this into account in making a decision initially whether to deal with a competitor? It might make perfect sense looked at under today's facts and today's business plan to make sales to competitors at retail prices in some instances. But you are placing a bet that down the line there won't be reasons suggesting a different analysis, and some businesses may not then want to face the potential legal risk of making a change, at least if there are other conditions for a Section 2 case present, such as arguable market power.

JEFF CASHDAN: Thank you very much. I want to thank our great panel and my co-moderator, Brian. Thank you again for joining us. ●

Interview with J. Bruce McDonald, Deputy Assistant Attorney General for Regulatory Matters, U.S. Department of Justice

Editor's Note: Bruce McDonald was appointed Deputy Assistant Attorney General for Regulatory Matters in June 2003. In this in-depth interview, he describes the highlights of his first year at the Division. In addition to outlining his role, he discusses the involvement of the Division in recent high-profile antitrust cases and enforcement actions and its priorities going forward.

Prior to his appointment to the Division, McDonald was a partner in the antitrust group of the Houston firm, Baker Botts L.L.P. He has participated as a speaker in numerous seminars on antitrust trade regulation and civil and criminal law compliance and published several antitrust articles. He has also taught Antitrust and Trade Regulation as an adjunct professor at the University of Houston Law Center.

The Antitrust Source conducted this interview on July 1, 2004.



J. Bruce McDonald

ANTITRUST SOURCE: I thought we might start by asking you to tell us about your responsibilities at the Antitrust Division and some of the highlights in your first year there.

BRUCE McDONALD: This is a good time to ask that question. Almost to the day, this is my one-year anniversary working for the Division.

The best thing about this job is that I have a desk full of knotty problems, enough to keep any antitrust enthusiast eager to get up and come to work in the mornings. It has been a real privilege to work with the exceptional lawyers and economists here at the Division. The depth of expertise and dedication of the career staff are impressive. And in the front office, it is a pleasure working with Hew Pate and a collegial team who play well together.

One of the antitrust bar's senior lawyers, who worked at the Division when he was about my age, told me that this still is the best job he ever had. That may be true for me, too, but I'll see what the future holds.

ANTITRUST SOURCE: Are there any cases or projects that you'd like to cite as things you're particularly proud of?

BRUCE McDONALD: It has been working on making hard decisions in complex matters that I've found most gratifying. On the merger side, our work in Air France/KLM, NewsCorp/DirecTV, and of course Oracle/PeopleSoft have made for memorable challenges. Matters that have gone to litigation are the biggest thrill. As you know, right now we are in the last week of the *Oracle* trial in San Francisco, and in September we're going to begin the trial of the challenge to the partial merger of two competing dairy companies in Kentucky and Tennessee, Dairy Farmers of America and Southern Belle Dairy. Both of those matters have highlighted the ability and dedication of the Division career staff, and they are among the most rewarding matters I've been involved in. I should say I have found the aviation work especially interesting, including the Air France merger, our work on United/Mesa/Atlantic Coast, and the US/EU air services negotiations.

ANTITRUST SOURCE: Obviously, you're not on the front lines in the courtroom as you used to be in private practice. Typically, what is your involvement in a litigated matter?

BRUCE McDONALD: It is a change from private practice, because the deputy has so much less of a hands-on role. The deputy will first get involved during the investigation that leads to filing a complaint, meeting periodically with the staff, reviewing some of the evidence, making a recommendation to challenge, and then being very involved in drafting the complaint. Through the litigation, the deputy is like a general counsel or the head of the trial department, not usually appearing as a member of the trial team in the courtroom, but pushing the team with questions and offering an objective perspective. There is some precedent for a front office lawyer to try cases, but today we are working to develop a larger group of career lawyers who have trial skills, which will serve the Division best in the long run. I made a brief appearance early in the *Oracle* case, but the serious campaigning was done by the career staff.

The Division's top

priority is criminal

enforcement against

cartels.

ANTITRUST SOURCE: Could you describe a little bit more broadly your responsibilities and role in the job you now have at the Antitrust Division?

BRUCE McDONALD: I am the so-called Regulatory Deputy. Two deputies are responsible for civil, non-criminal, antitrust enforcement, each overseeing three of the six civil litigating sections. Each of those six sections has expertise in a portfolio of industries, and I have those sections with historically regulated industries. Those are Telecommunications & Media, Transportation, Energy & Agriculture, and Litigation I, which has health care, insurance, and dairy. Debbie Majoras had, and now Tom Barnett has, Networks & Technology and Litigation II and III.

Some of the various management responsibilities are handled by deputies too, which for me include the Promotion Committee and the Attorney General's Honors Program hiring committee.

ANTITRUST SOURCE: Can you tell us something about the Division's priorities going forward?

BRUCE McDONALD: The Division's top priority is criminal enforcement against cartels. Sound merger enforcement continues to be another critical priority, especially as we're seeing an uptick in mergers: we've had about a 40 percent increase in HSR filings over the last fiscal year. In non-merger matters, we have an internal effort working to make our civil investigations more efficient. And we will continue to participate in litigated matters to try to clarify antitrust jurisprudence, as we did in *Trinko*, which addressed Section 2 standards. Most of this takes place at the appellate level, and the Division does not have a master plan to bring enforcement actions in order to change the law. Finally, we will continue to cultivate relationships with antitrust enforcement officials in other countries.

ANTITRUST SOURCE: The Supreme Court is beginning to get back into the business of deciding antitrust cases, and yesterday the Supreme Court denied certiorari in *LePage's*, as the Department had argued it should. The government also filed amicus briefs in *Trinko* and *Empagran*. Do you anticipate that the Department will continue to participate in all or virtually all antitrust cases that surface in the Supreme Court?

BRUCE McDONALD: It is certain that we will. There are few antitrust cases that reach the Supreme Court for which it would not be worth the effort to advocate sound antitrust principles. I think the

amicus briefs filed by the United States and the FTC in *Trinko* were very helpful in bringing about the particular decision that the Court reached. And we obviously had a big influence on the *Empagran* case, in which Hew Pate represented the U.S. before the Court. There we wanted to emphasize not just the importance of reaching the right result under the FTIA statute, but also the importance of the right decision to the Division's criminal enforcement program. Finally, amicus participation seems to have had the right effect in the *LePage's* case since the Court decided it would not take the case, generally for the reasons that the government suggested.

ANTITRUST SOURCE: Let me pick up on that. The government suggested in *LePage's* that certiorari should not be granted essentially because the law hadn't developed sufficiently to have the Supreme Court step in to opine in that area. Do you see a danger that the current lack of clarity in the law means that procompetitive discounting by companies may be discouraged because of confusion over what the law permits?

BRUCE McDONALD: If you take a long-term view, litigants are not going to get to take many shots at bundled discounts before the Supreme Court. If the lower courts and the government were not prepared to present considered ideas to the Court, then what clarity could the Court bring? I can't say the Supreme Court would have developed the "wrong" standard for judging bundled discounts had it been addressed this term, but the likelihood of the Court announcing a workable rule will improve if we wrestle with the issues for a while in the lower courts. Meanwhile, we'll have to suffer some lack of clarity, but for the sake of getting it right in the long run, which is better than rushing to get an authoritative pronouncement, whatever that pronouncement may be.

ANTITRUST SOURCE: Given the Division's interest in driving the development of key areas of antitrust law, is the DOJ doing anything to study bundling and its effects on consumer welfare?

BRUCE McDONALD: We definitely are. This spring the Division's Economic Analysis Group held a conference on bundling and loyalty discounts, where lawyers, economists, judges, and foreign antitrust officials addressed these difficult issues. That was very helpful in outlining the contours of the problem. The Division's economists in particular are spending time thinking about this, and soon you'll see the Economics Deputy, David Sibley, out on the campaign trail talking about his thinking on loyalty discounts as a way to promote further discussion. These efforts and the efforts of the ABA and others who are interested should lead to some workable principles, which then over time should work its way into the case law.

ANTITRUST SOURCE: Let's turn to *Trinko*. Earlier this year at the Spring Meeting of the ABA Antitrust Section, you said you thought the Supreme Court's decision in *Trinko* had made a positive contribution to the search for standards, even if it didn't make a comprehensive statement on monopolization law. Can you expand on that and explain what you believe the contribution was?

BRUCE McDONALD: Certainly the *Trinko* decision does help clarify Section 2 standards. First, what is the standard for defining predatory conduct in the context of refusals to share? In the government's brief, we had proposed a specific standard: In the context of an alleged refusal to assist a rival, "conduct is not exclusionary or predatory unless it would make no economic sense for the defendant but for its tendency to eliminate or lessen competition." The Supreme Court did not explicitly adopt that standard or any other. But its reasoning was consistent with the standard the

government proposed. The Court reasoned that Verizon's conduct was not predatory by analogy to *Aspen Skiing*, which the Court set up as the outer boundary of Section 2 liability. The Court focused on the fact that the *Aspen Skiing* defendant had given up a presumably profitable relationship with the plaintiff solely for the purpose of obtaining the long term benefit of having eliminated a competitor. That couldn't be said about the Verizon conduct that Trinko challenged, not fully complying with its 1996 Telecom Act network sharing obligations to AT&T.

Second, *Trinko* also suggests that the Court is looking to balance antitrust enforcement and government regulation. On one point, the Court made clear that the existence of a regulatory scheme is a reason not to extend the antitrust laws to cover the regulated conduct. The Court used that reasoning to reject Trinko's request that the antitrust laws be expanded to prohibit Verizon's conduct, which allegedly violated the Telecommunications Act but didn't violate existing antitrust rules. On another point, Justice Scalia signaled that the Court might be more receptive to claims of implied immunity, at least where the regulators have some responsibility for competitive concerns. Justice Scalia stated that, if it weren't for the antitrust savings clause in the 1996 Telecom Act, Verizon's conduct might be immune from the antitrust laws, although *Trinko* did not undercut the Court's earlier instructions that antitrust repeals implied by a regulatory statute are strongly disfavored and should be found only when the regulatory scheme otherwise just wouldn't work.

ANTITRUST SOURCE: If it is the case that after *Trinko* it will be easier to find implied immunity against the application of the antitrust laws, is that a good thing or a bad thing in your view?

BRUCE McDONALD: It would depend on the particular situation, but I think easily implied immunity would be a bad thing. In most situations, the Division resists the advance of antitrust immunities. Whether implied or granted by statute or regulation, immunity makes it possible for firms to act without regard for the antitrust consequences. I can think of examples of express immunity being granted without there being a countervailing procompetitive benefit, such as immunity for ocean shipping liner conferences or immunity for the International Air Transport Authority granted by DOT. As for implied immunity, I don't think that consumers are well served if immunity is easily implied, nor does that seem the best way to construe legislation. It seems better to infer immunity only if the regulatory scheme implemented by Congress could not function if the regulated conduct were also governed by existing antitrust rules, that is, to try to reconcile the antitrust and regulatory schemes. This also encourages drafting legislation to be clear on this point; for example, the 1996 Telecom Act has an antitrust savings clause, precluding implied immunity. If immunity is implied even given this high threshold, it may be appropriate for antitrust to give way to a comprehensive regulatory scheme that performs the antitrust function.

ANTITRUST SOURCE: Do you think that the doctrines of monopoly leveraging and essential facilities will have life after *Trinko*, especially in the regulated industries context?

BRUCE McDONALD: Monopoly leveraging as an offense distinct from attempted monopolization does not survive *Trinko*. The essential facilities doctrine as expressed in *MCI*'s four-part test I think also won't stand. Whether the essential facilities doctrine will survive at all is not clear; *Trinko* says that Section 2 will not go further than *Aspen Skiing*, but the Court did not state whether *Aspen Skiing* already went too far.

ANTITRUST SOURCE: Let me change gears and ask you about another topic. In several matters

recently, the Division has issued explanations for decisions that it has made in settings in which it hasn't traditionally offered explanations, such as the reasons for its decision to close a particular investigation. What explains that trend, do you favor it, and do you expect it to continue?

BRUCE McDONALD: Both the Antitrust Division and the FTC today seek out opportunities to publish statements on the reasons they have taken particular decisions. Everyone should think this a good idea. If an agency challenges a merger or conduct, then its reasoning is made clear in the complaint and then through the litigation or, if settled, in Tunney Act materials. But if it does not challenge, no statement is required and our reasoning becomes the subject of guesswork. Contrast that with our European friends who are obliged to explain their reasoning even when they don't challenge. We hope that the statements we have been publishing are helpful to business, the bar, foreign enforcers, and anyone who takes an interest in why we do the things we do.

Transparency is especially important in fast changing industries. Many of the matters in which we have issued closing statements have involved markets that are changing rapidly. The first such statement discussed the Orbitz joint venture among airlines to sell air tickets on the Internet. This was a new kind of business, and there had been considerable public interest in the investigation, so it was valuable publicly to state what were the issues considered and why we had to close the matter. Likewise for the Pressplay and MusicNet joint ventures investigation and the Movielink matter. You can find on the Division Web site (<http://www.usdoj.gov>) the policy on when we may issue closing statements.

ANTITRUST SOURCE: Let me ask you about a couple of other public statements that some observers think are unusual and see if they are being offered in the same spirit. The first is the DOJ's statement following the EU's *Microsoft* decision. There, the Division commented adversely about another jurisdiction's ruling in a particular case, and people took note of it. Why did the Division decide to do that?

BRUCE McDONALD: The Division's statement on the EU's *Microsoft* decision was part of our continuing public dialogue with Europe on what is best for antitrust and competition policy.

Throughout the United States' *Microsoft* case, the government sought a market-oriented solution. Even the proposed break-up remedy, a structural solution, was a way to avoid forward looking regulatory judgments by the government on issues like product design. Likewise, the final judgment, which ordered Microsoft not to prevent PC manufacturers from effectively substituting third-party software products for the Microsoft products sold with the Windows operating system. During the EU's own *Microsoft* investigation, the Division discussed with the EU what we thought was the right way to remedy the *Microsoft* problem.

The European Commission took a different approach than the U.S. The European remedy requires that Microsoft offer for sale in Europe a product that Microsoft did not have before, an operating system sold without the Microsoft media player. It seemed to the Division that this remedy took antitrust down the wrong road. In our view, antitrust enforcers stretch beyond their abilities when they get into the business of redesigning products to obtain a more competitive outcome. Furthermore, this particular remedy had the potential to do harm, as the absence of a media player could complicate third-party software developers' efforts to write middleware to be used with Windows, because third-party programs often rely on the operating system software for certain functions. Finally, the EU remedy was ordered in a case in which there was little evidence of harm to consumers of the kind the U.S. would have to have presented had it pursued a rule of reason case.

With such serious policy and substantive differences between the two agencies, it was important for the Division to discuss them publicly. The approach to single firm conduct is the greatest remaining divergence between the U.S. and Europe. The Division's statement on *Microsoft* was part of a continuing dialogue that has allowed so much convergence so far.

ANTITRUST SOURCE: Let me ask you about another recent public statement by the Antitrust Division that has attracted some interest. That is a June 22, 2004, press release about the *United States v. Oracle* trial, which, as you mentioned earlier, is in progress in San Francisco as we speak. The press release quotes Hew Pate essentially saying that the trial has gone well for the government and although the government is only half-way through, it has already presented enough evidence to show that Oracle's acquisition of PeopleSoft would hurt competition and should be stopped. Why would the government issue a press release like this during the pendency of a litigated matter, and are we going to see more of this kind of thing in the future?

BRUCE McDONALD: Hew Pate's statement was especially appropriate in this case for two reasons. First, his statement emphasized the importance of this case to the government's enforcement priorities. Second, the question of whether Oracle should be allowed to take over PeopleSoft has been discussed non-stop in the press for a year now, mostly by the parties to the proposed transaction and by industry commentators in battalions. It is likely that the continuing uncertainty about PeopleSoft's future has slowed PeopleSoft's growth, to the benefit principally of Oracle. This statement of confidence in the proceeding provided some balance in the public discussion.

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ANTITRUST SOURCE: The Antitrust Modernization Commission is about to start its work and I am curious as to what you think it should focus on. Specifically, do you think the Commission ought to examine the merits of the dual enforcement scheme in the United States where both the DOJ and FTC are responsible at the federal level for enforcement of the antitrust laws?

BRUCE McDONALD: The Antitrust Modernization Commission will have its first meeting on July 15, when it will start to outline the kinds of issues it wants to consider.

None of us know yet what is the full range of what the Commission will consider. I would be surprised if they did not consider everything, from the trivial to the dramatic. Think of the kinds of questions the antitrust bar have been asking themselves for years. Is Clayton Act Section 8 too rigid? Is there any purpose in keeping Clayton Act Section 3 around? Would national antitrust policy benefit from the elimination of overlapping jurisdiction, for example between the federal agencies and the states, between the federal antitrust agencies and the regulatory agencies, between the two federal antitrust agencies?

I would, by the way, be astonished if the Commission recommended the merger of the Antitrust Division and the FTC or the elimination of one. Even though some of the agencies' duties overlap, today each has distinct duties that cannot be taken up by the other, the obvious examples being the Division's authority to bring criminal actions and the Trade Commission's mandate to address consumer protection issues.

I would also be surprised if the core antitrust statutes were changed as a result of the Commission's work. Enforcement actions and court decisions have continued to develop Sections 1 and 2 of the Sherman Act and Section 7 of the Clayton Act as rational, economic-based rules, and this process likely could not be improved with a one-time change of legislation. Certainly I disagree with those who suggest that the basic antitrust statutes or antitrust law in general is not

up to the task of dealing with high-tech markets or industries that are much more complicated and fast-paced than the railroad, oil, coal, and other markets that were in need of antitrust control at the time those acts were passed.

A healthy discussion of the various issues will be beneficial. I am confident that committees and working groups of the ABA Antitrust Section will be marshaled for the task and that the resulting studies, white papers, and testimony will make a significant contribution to the debate, a debate that likely will continue for most of the three years before the Commission is obliged to produce its report.

ANTITRUST SOURCE: What's your view on the current balance between state and federal enforcement regimes?

BRUCE McDONALD: You can imagine a system very different from the one we have. You can imagine a system in which the fifty state governments and the federal government all were able to devote substantial resources to antitrust. Each state would address its own, intrastate problems (as some states do now) without any federal involvement. Perhaps multiple states could join to handle regional cases. The federal agencies alone would take on national and international matters, or with states contributing if local issues were involved.

That's not the system we have. Not all state enforcers have been given the resources to mount large antitrust investigations or litigation. Therefore, the federal agencies take on many matters that implicate only intrastate relevant markets, sometimes with state involvement and sometimes not. And states often join in federal cases of national scope. For example, in our *Southern Belle* dairy merger challenge, Kentucky is a plaintiff, and the involvement of the Kentucky Attorney General's office has been very valuable, because they are especially interested and experienced in the local issues. And ten states joined the United States as plaintiffs in *U.S. v. Oracle*.

Our relationship with the states has improved over the last few years under a system of periodic conferences among teams from the Division, the FTC, and NAAG representatives to discuss issues that have come up in joint enforcement matters.

ANTITRUST SOURCE: In your role as the Deputy who is charged with, among other things, industries that have historically been regulated, to what extent do you interact with other federal regulatory agencies, such as the Department of Energy, FERC, or the Federal Communications Commission?

BRUCE McDONALD: The Division works closely with its sister agencies that have regulatory duties. For example, both the Division and the FCC have authority to review the proposed merger between Cingular and AT&T Wireless. The investigating teams from the two agencies have frequent discussions to share information and theories. The FCC brings its industry expertise to the table, and we bring experience in protecting competitive markets.

We also deal frequently with the FAA and DOT on domestic and international aviation matters. We have periodic meetings with FERC and a regular docket of matters that we work on with our colleagues at USDA. And we have good relationships with components of the Commerce Department, State, and USTR.

ANTITRUST SOURCE: You mentioned the Cingular-AT&T Wireless merger. Do you care to make any predictions about when we can expect to know from the DOJ and FCC whether that merger will go through?

BRUCE McDONALD: This is a pretty complex investigation, and both agencies are working towards the goal of completing our analyses before the FCC's 180-day clock expires in late September.

ANTITRUST SOURCE: There seems to be far greater turnover of senior antitrust officials in the United States government than there is in other jurisdictions (I'm thinking mostly of the EU). First, do you agree with that, and second, what is your view on whether that is a good or a bad thing?

BRUCE McDONALD: We do have very different systems for assigning the senior government officials. The European Union has very little turnover in part because there are very few temporary or political positions. For example, this summer Mario Monti may leave the European Commission, but you would expect Philip Lowe and everyone who reports up to him to stay. The EU has attracted a highly qualified group of career officials, and working for the Commission is considered a pretty great job. It has been expressed to me that it would be startling for a high Commission official to leave for private law practice or industry, and it is much more likely that one would return to a Member State government or go to a university.

The U.S. system is completely different. With political parties competing for the right to control the executive branch, an administration makes about 2500 full-time political appointments for the purpose of implementing its policies. At the Division, the appearance of a new set of appointees upon the turnover of the executive branch makes less policy difference than in other areas, because there is strong bipartisan support for sound antitrust enforcement. Nevertheless, I believe that the regular turnover is valuable. Antitrust policy in the U.S. is developed primarily by antitrust enforcement. Contrast this to Europe's more regulatory approach. The U.S. antitrust enforcement effort benefits from the introduction of new ideas brought by lawyers and economists who have been representing private clients or working in academia.

The average political appointee's tenure throughout the government is only 18–24 months. The Division has a better record on average. And in this administration, although there have been empty deputy slots at times, the long tenure of Hew Pate and Debbie Majoras provided continuity. If there is a change of administration in January—which certainly I would regret—it will be incumbent on those of us here now to continue moving the ball down the field, to continue developing new cases, until the clock runs out.

ANTITRUST SOURCE: Do you think the resources that the Antitrust Division has currently are sufficient for you to carry out the mission of the organization, and if you had more, what would you do with them?

BRUCE McDONALD: Our budget is being considered on Capitol Hill right now. The current budget is about \$133 million, and an additional \$3 million is proposed. If we had more, I expect it would be used in large part to hire more professionals.

ANTITRUST SOURCE: Are there any areas that you think new or revised written guidelines should be issued by the agencies, in particular, in areas like vertical mergers or gun jumping?

BRUCE McDONALD: We do not have any current plans to revise any existing guidelines or to issue new ones. At the merger workshop the Division and FTC held earlier this year, the presentations from inside and outside the agencies did not suggest a consensus that the Merger Guidelines should be changed. And I do not believe you will see new guidelines in other areas.

Certainly for gun jumping, the rules are pretty clear, and we have brought enforcement actions to punish Section 7A violations and deter future gun jumping. I don't think there's any need for guidelines in that area.

ANTITRUST SOURCE: What about intellectual property? Will the intellectual property hearings produce revisions to the IP guidelines?

BRUCE McDONALD: I don't know of any revisions that are being considered.

ANTITRUST SOURCE: When can we expect the agencies' much-anticipated intellectual property report to be issued?

BRUCE McDONALD: I would look forward to it this Fall.

ANTITRUST SOURCE: Are there any partially regulated industry sectors that you see as special candidates for further deregulation, and why?

BRUCE McDONALD: One of the biggest deregulation successes we've had in the last few years is the deregulation of the air travel computer reservation systems, now almost completely deregulated. That became possible because of changes in the ownership of the CRSs (now almost no airline ownership), the expansion of Internet distribution of air tickets, and the entry of online travel companies, such as Orbitz and Travelocity.

As for future deregulation, some other transportation areas definitely should be deregulated. The Federal Maritime Commission still oversees a system of tariff filing requirements that does not promote price competition. And the flying public would benefit if international aviation were liberalized, for example if European and U.S. restrictions on flights within and beyond the other's national boundaries were lifted; unfortunately, we have hit an impasse in negotiations, because some EU member states rejected the agreement that we had reached with the EU.

In the long run, we should see deregulation in telecommunications markets. The 1996 Telecom Act and its Section 271 process are good steps towards relying more on competition and less on regulation.

ANTITRUST SOURCE: Finally, how do you compare private practice with your experience at the Division? Are there any aspects of private practice that you would like to see imported into government service?

BRUCE McDONALD: One of the ways the deputies can make a contribution is to use lessons learned from being on the front lines to help inform policy development. Having represented clients in private practice, most of us in the front office are familiar with the perspective of the firms that are the subjects of antitrust investigations and sometimes the beneficiaries of antitrust enforcement. Where antitrust enforcement is necessary to protect competitive markets, it is government involvement in the economy that even conservatives should applaud. Where it is not, the government should as quickly as possible stand down to let the market work.

Those of us who come from private practice appreciate the urgency with which matters should be brought to a conclusion, in part because private clients demand quick results. One of the Division's priorities has been to make its investigations more efficient. You have seen that in the

merger review process initiative that Charles James put in place and now in our attempt to advance civil investigations more quickly and efficiently.

ANTITRUST SOURCE: Thank you very much, Bruce, for what has been a fascinating interview. ●

Antitrust Implications of Category Management: Resolving the Horizontal/Vertical Characterization Debate

Kenneth Glazer, Brian R. Henry, and Jonathan Jacobson

Category management is evil. It enables a dominant supplier to eliminate all of its rivals across an entire category of products and impose its will on weak and helpless retailers. It puts all competing suppliers at a huge competitive disadvantage by letting the “knighted” supplier roam freely over all of their sensitive business data and make decisions about which products will be on the shelves, in what quantities and at what prices. It also enables retailers to coordinate pricing with each other through a common supplier serving the role of category manager for multiple retailers at the same time. It destroys competition and should be banned from U.S. commerce.

Category management is wonderful. It enables the retailer to take a holistic approach to an entire category of products rather than determining profits and margins on an item-by-item basis. It makes great business sense for the retailer to get expert advice from a leading supplier about the overall category. The retailer does not have the financial or personnel resources to develop expertise in dozens, if not hundreds, of separate categories. Huge efficiencies flow from that transfer of knowledge—efficiencies that redound greatly to the retailer’s, and ultimately the consumer’s, benefit. Category management should be applauded, not condemned, and recognized as one of the greatest business innovations since the invention of the steam engine.

Category management has led to strong reactions, pro and con. The concept of category management covers a broad range of commercial relationships and practices, and asking whether it is good or bad is therefore like asking the blind men in the parable whether the elephant is a tree or a snake: it depends on which part of the elephant they are touching. The debate over whether category management is on balance anticompetitive or procompetitive will no doubt rage for many years to come.

There is, however, one aspect of the current antitrust debate about category management that can and should be resolved, and soon. A few prominent antitrust commentators—who might usefully be called “horizontalists”—have recently suggested that, in the context of category management, discussions between a supplier and a retailer regarding the products of other suppliers should be treated as “horizontal” for purposes of determining antitrust liability. The distinction is of course critical because vertical practices (other than minimum resale price maintenance and tying) are subject to analysis under the rule of reason. Horizontal restraints, in contrast, are more readily condemned as unlawful per se. As this article will demonstrate, the characterization of category management relationships as horizontal does not withstand scrutiny. It is at odds with clear Supreme Court precedent and the weight of modern antitrust thinking on vertical distribution practices. By precluding rule-of-reason treatment for practices that may, in many cases, yield benefits for consumers, the horizontalist approach would result in bad policy.

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What Is Category Management?

Category management practices have become increasingly prevalent and important in retailing over the past ten years. The specifics can vary widely from retailer to retailer, but the term essentially describes a system in which all the products in a given product category are dealt with as a whole rather than on a brand-by-brand, package-by-package, or SKU-by-SKU basis. The FTC explained in its *Report on Slotting Allowances* that, “[a]s the name suggests, category management is an organizational approach in which the management of a retail establishment is broken down into categories of like products. Under category management, decisions about product selection, placement, promotion and pricing are made on a category-by-category basis with an eye to maximizing the profit of the category as a whole.” FEDERAL TRADE COMM’N, STAFF REPORT ON THE FTC WORKSHOP ON SLOTTING ALLOWANCES (Feb. 2001), available at <http://www.ftc.gov/bc/slotting/index.htm> (FTC Report).

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A retailer will typically select one supplier in that category—sometimes called the “category captain”—to take the lead role in helping the retailer implement a product management program. The captain then assumes some level of responsibility, subject to the retailer’s approval, for the merchandising of that aisle or portion of the store. The captain provides the retailer with overall sales and trend data, usually from Nielsen or IRI, expert planning, and merchandising advice, and suggests retail shelf space allotments through a “plan-o-gram.” It will also typically provide recommendations on packaging assortments, product additions or deletions, promotion types, promotion schedules, and possibly also retail prices. The retailer’s goal is to get the best, most experienced advice available on how to compete most effectively and how to satisfy its consumers. These recommendations will necessarily cover not just the captain’s own products but those of competitors as well. But the captain only recommends. The ultimate decision rests with the retailer. No retailer is going to delegate its operational control, profit mandates, or competitive market position to a third party. And, as the FTC summarized, “[t]he exact function performed by category captains varies widely across firms and product categories.” *FTC Report* at 48.

Potential cost savings and informational advantages for retailers are considerable. One of the main advantages from the retailer’s point of view is that “[t]he manufacturer may know things like the times of year when a product will sell best, the kinds of promotions that are most effective in moving the product, or the kinds of complementary goods that might be advantageously displayed in adjacent space.” *Id.* As the leading business book on category management explains: “Retailers . . . rely on [the manufacturer] partner for information, expertise and resources in the development of plans.” 3 R. BLATTBERG & E. FOX, *CATEGORY MANAGEMENT: THE CATEGORY PLAN* 15 (1995).

In its report, the FTC noted, “Category management can provide significant benefits to manufacturers, retailers, and consumers.” *FTC Report* at 48. Among other things, it reduces retail costs by shifting part of the merchandising costs back to the supplier; it provides the retailer with more and better access to information; and ultimately it helps the retailer generate more sales and profits per square foot of space. Category management can also generate healthy competition among suppliers by adding another dimension on which that competition takes place—that is, the competition to be the category manager.

The FTC added, however, that category management “can also provide an opportunity for ‘mischievous,’ particularly when it is practiced with a heavy reliance on a category captain.” *Id.* at 49. The *FTC Report* identified four possible ways in which category management could lessen competition: (1) by placing in the hands of the category captain confidential information about rivals’ plans; (2) by hindering the expansion of rivals; (3) by promoting collusion among retailers; and (4) by facilitating collusion among manufacturers. *Id.* at 50. The *Conwood* decision focused on a

particular instance of the second type of mischief: the use of the captain to provide false data on competitor's sales. *Conwood Co. v. U.S. Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002), *cert. denied*, 123 S. Ct. 876 (2003).

Category management is ubiquitous in retailing, affecting most product categories and, by some estimates, 75 percent of supermarkets and over 50 percent of drug and department stores. CHAIN STORE AGE/KPMG NINTH ANNUAL SURVEY OF INVENTORY MANAGEMENT (Dec. 2001). But the heart of any category management relationship is the relationship between a single supplier and a single retailer. From an antitrust point of view, therefore, it is critical to resolve the question of how that relationship should be treated.

Should Discussions Between a Supplier and a Retailer Be Considered Horizontal?

As noted above, a few commentators have recently argued that when a supplier and a customer discuss competing products, those discussions should be viewed as horizontal under the antitrust laws. Thus, for example, in a recent speech, Federal Trade Commissioner Thomas Leary said that, while it may not be inappropriate for a supplier and retailer to discuss the supplier's own products, discussions between them regarding the products of *other* suppliers are problematic and in fact should be viewed as horizontal. As he explained:

Some insist that category management should be analyzed as a vertical restraint, presumably because category managers are primarily suppliers to, not competitors of, the retail customers they advise. I believe the matter is more complex. In my view, the nature and context of the communications should control, not the formal relationship between the parties. In short, advice on the resale of the manufacturer's own product should be viewed as vertical; advice on the resale of a competitor's product should be viewed as horizontal.

Thomas Leary, A Second Look at Category Management 2–3 (May 17, 2004), *available at* <http://www.ftc.gov/speeches/leary/040519categorymgmt.pdf>. At least two other prominent commentators have warned against such communications—a warning that seems to suggest a belief that the relationship is horizontal. See Antitrust and Category Captains Roundtable Discussion, a Report by Gabrielle Herderschee-Hunter, *available at* <http://www.antitrustinstitute.org/recent2/270.pdf> (June 23, 2003) at 35 (remarks of Chris MacAvoy); and at 44 (remarks of Irving Scher) (*Roundtable Report*).

Commissioner Leary articulates the rationale for this position by reasoning that, while a manufacturer has a legitimate interest in the distribution of its own product, it lacks a legitimate interest with respect to competitive products. Thus, he states, “[a]ny advice that the captain gives to a customer about the appropriate ways to distribute a competitor's product is not likely to serve a legitimate interest, but rather affects horizontal competition and serves a horizontal interest. It should be viewed as a horizontal communication.” Leary, *supra*, at 3. In support, he states that he is drawing on the so-called dual distribution cases, which he characterizes as “emphasiz[ing] whether the restraint in question serves a vertical or a horizontal interest.” *Id.* As Commissioner Leary recognizes, the initial characterization as horizontal or vertical is often outcome-determinative. *Id.* at 2, 5 It therefore is a matter of no small moment whether his characterization is right or wrong.

Antitrust Case Law and Policy

The horizontalist approach is hard to square with the modern cases. If it is correct, literally thousands of daily discussions between suppliers and retailers would be cast into the horizontal net. Commissioner Leary invokes the post-*Sylvania* law of vertical restraints in support of his position.

But that body of cases, from *Sylvania* and *Monsanto* through *Sharp* and *NYNEX*, far from supporting his position, demonstrates precisely why supplier-retailer communications should not be treated as horizontal, even if the subject of those communications is other suppliers.

Antitrust law has long recognized the critical difference between horizontal and vertical arrangements. See generally *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977). It runs through antitrust law like a major fault line (along with, for example, the distinction between unilateral and concerted conduct). The distinction is critical because, while we have reason to be generally suspicious of competitors working and communicating with each other (except in a very narrowly circumscribed set of circumstances, such as legitimate joint ventures and petitioning conduct), we have no such concerns about interactions between firms in a vertical relationship with each other. See, e.g., *Business Electronics Corp. v. Sharp Electronics*, 485 U.S. 717, 724–30 (1988). These interactions are and ought to be ubiquitous, and are fundamental to legitimate commerce. Vertical agreements thus cannot be viewed with the same jaundiced eye as are horizontal agreements.

The horizontalist position is that an agreement between a manufacturer and a retailer with regard to other people's products is horizontal. This is wrong.

But what is “vertical” and what is “horizontal”? The horizontalist position is that an agreement between a manufacturer and a retailer with regard to other people’s products is horizontal. This is wrong. The Supreme Court has been clear that the horizontal/vertical distinction depends on the relationship between the parties reaching the agreement, not on the subject of the agreement being reached or its effects in the marketplace. “Restraints imposed by agreements between competitors have traditionally been denominated as horizontal restraints, and those imposed by agreement between firms at different levels of distribution as vertical restraints.” *Sharp*, 485 U.S. at 730. Discussion between a supplier and a retailer is discussion between firms at different levels of the marketplace, and therefore any agreements relating to the relationship between them are necessarily vertical under the *Sharp* definition.

The distinction is not just a matter of labels. Antitrust policy rightly is suspicious of communications among competitors, and treats agreements among them harshly absent some demonstrable integration or other efficiency. Communications among firms whose primary relationship is one of customer and supplier, however, are fundamentally different. As the post-*Sylvania* cases recognize, manufacturers and their distributors must be in constant communication with each other as a matter of business necessity, and a rule of law that attached negative consequences to those communications would inevitably involve large losses in economic efficiency.

As the Court put it in *Monsanto*: “A manufacturer and its distributors have legitimate reasons to exchange information about the prices and the reception of their products in the market.” *Monsanto Co. vs. Spray-Rite Service Corp.*, 465 U.S. 752, 762 (1984). A rule under which certain types of discussions between a manufacturer and a retailer are treated as horizontal would have an undesirable chilling effect on such communications. The business objectives of these parties are fundamentally complementary, and not adversarial. The retailer competes in a relevant market distinct from that in which the supplier competes. Its objective is to meet its consumers’ needs by creating the best product array at the best prices; if it does not, it will lose customers to competing retailers. Whatever the supplier’s interests, the retailer must do what is necessary to meet its customer’s desires to remain competitive at its level of the market. All of its decisions—pricing and otherwise—must take that competition into account.

Commissioner Leary’s assertion that the horizontal-vertical distinction should turn on the “nature and context of the communications” and whether there is an “effect on horizontal competition” is the precise argument advanced by Justice Stevens’s *Sharp* dissent. The *Sharp* majority, however, specifically rejected the argument, holding that the distinction was between “agreement[s]

between competitors” as horizontal, and “agreement[s] between firms at different levels of distribution” as vertical. 485 U.S. at 730. Every antitrust issue of consequence involves horizontal competition. If horizontal competition is not affected, no further analysis need be done.¹

Interbrand vs. Intra-brand Competition

Commissioner Leary argues that the “permissiveness [of *Sylvania*], extends only to activities that are designed to rationalize *intra-brand* competition at the retail level. To the extent that the manufacturer attempts to rationalize *interbrand* competition at that level, it is directly affecting horizontal competition and the activity should be analyzed as a horizontal restraint.” Not so.

The distinction between interbrand and intra-brand competition is of course an important one in antitrust law, but it is not the same as the horizontal/vertical distinction. Just because an agreement affects interbrand competition does not mean that the agreement is horizontal. If it did, then every exclusive dealing agreement would suddenly be horizontal—a troublesome proposition given the ubiquity of such agreements in our economy. In fact, such agreements are vertical even though they directly affect interbrand competition. This is the spirit if not the express holding of *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128 (1998), where the Court ruled that an agreement between a customer and a supplier restricting the customer’s freedom to deal with a competing supplier should not be treated as a horizontal group boycott. If the rule were otherwise, every exclusive dealing agreement in which a retailer agrees to devote its sales efforts to a particular brand or manufacturer would be *per se* unlawful. The rule of reason is the proper method for analyzing such agreements, but that would change if Commissioner Leary’s horizontal characterization were adopted.

Even when a retailer does something that adversely affects one of its suppliers, it is doing so to better compete at the retail level. After all, every retailer but the rarest is constrained by competition at its level of the market.

It appears that some of the hostility to category management may be based on the notion that such arrangements represent a sharp break from the past. Thus, for example, one of the speakers at the American Antitrust Institute Roundtable is reported to have said: “Never before in retail history have manufacturers advised retailers on what to do with their rivals’ products.” *Roundtable Report, supra*, at 28. But that can’t be right. While some new concepts and business techniques may be at work in category management, the basic business relationship is not fundamentally new. Manufacturers have been telling retailers what they should do with their rivals’ products (sometimes in colorful language!) from time immemorial. There is nothing new about a supplier and a retailer discussing whether the retailer should carry the products of other manufacturers and to what extent. Indeed, a salesperson would only be doing half of his job if he ignored his competition in a sales call. Again, think of exclusive dealing agreements, which are simply agreements

¹ Nor is accurate to say, as Commissioner Leary appears to be suggesting, that the dual-distribution cases lend the horizontalists any support. In cases decided after *Sylvania*, the courts have held consistently either that the relationship between a self-distributing manufacturer and its other distributors is vertical or that such relationships should be judged under the rule of reason, which amounts to the same thing. See, e.g., *Electronics Communications Corp. v. Toshiba Am.*, 129 F.3d 240, 244 (2d Cir. 1997); *Illinois Corporate Travel v. American Airlines*, 889 F.2d 751, 753 (7th Cir. 1989); *Krehl v. Baskin Robbins Ice Cream Co.*, 664 F.2d 1348, 1354–47 (9th Cir. 1982); *Beyer Farms v. Elmhurst Dairy, Inc.*, 142 F. Supp. 2d 296, 302 (E.D.N.Y. 2001); 8 PHILLIP AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* ¶ 1605 (1989); 12 *id.* ¶ 2033 (1999); ABA ANTITRUST SECTION, *ANTITRUST LAW DEVELOPMENTS* 160–61 & nn. 896–97 (5th ed. 2002); see also *Sewell Plastics v. Coca-Cola Co.*, 720 F. Supp. 1186, 1192 (W.D.N.C. 1988) (*per se* rule applicable only where firms are competitors for all relevant purposes), *summary judgment entered*, 720 F. Supp. 1196 (W.D.N.C. 1989), *aff’d*, 1990-2 Trade Cas. (CCH) ¶ 69,165 (4th Cir. 1990).

between a supplier and a customer regarding other products. Exclusive dealing is not a recent phenomenon. *See, e.g., Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346 (1922).

To subject category management to blanket condemnation would be to require retailers to operate in isolation from their potentially best advisors. It is essential that retailers have full access to such expert advice in order for them to compete against their fellow retailers.

The horizontalist position appears to be based on the premise that decisions are made by the supplier, as if the retailer has no role in its own market success. But that is not the reality. The retailer has its own principals and constituencies that it must satisfy on a daily basis—shareholders, employees, customers—that are entirely independent of the supplier and its desires to compete against its competitors. The retailer ignores these at its own peril.

What about a situation in which a retailer owns a supplier (i.e., has a private label which it sells on its shelves). In that case, should discussions between a supplier and retailer regarding that retailer's private label product be considered "horizontal"? At least one commentator has suggested so.² The answer is still no. Unless the retailer is actually marketing that private label to other retailers—an unusual if not non-existent circumstance—then that retailer is no more a competitor of the supplier than a retailer without a private label. Yes, in some sense the private label product competes with the supplier's branded product on the store's shelves, but the price of both is set by the same retailer (perhaps with advice sought from the category expert supplier). There is no more competition between the supplier's brand and the private label product than there is between that brand and a third supplier's brand, or between two brands owned by the same supplier.

Obviously if two suppliers (or two retailers) are misusing a category management relationship to coordinate with each other, that should be treated as horizontal. But that is not the horizontalists' point. Those are real horizontal relationships and deserve to be treated as such. The horizontalists are trying to convert what is properly viewed as a vertical one into a horizontal one.

Conclusion

While category management practices have been in use for a decade, the debate over the application of the Sherman Act to such practices appears to be gaining momentum. There should be no debate, however, about whether the relationship between a retailer and a supplier is horizontal. The business reality is that this is a vertical relationship, the terms of which will be properly constrained by competitive forces in the distinct markets in which the parties independently compete. ●

² See Robert A. Skitol, *Consolidation and the Private Label Sector: Antitrust Enforcement Policy Developments* 20 (Oct. 1, 2002), available at <http://www.antitrustinstitute.org/recent2/207.pdf> ("To the extent that a brand manufacturer in its role as category captain persuades its retail partners to abandon their plans to price or promote private label goods aggressively against the branded products, or there is any coordination of the plans in these areas, the parties could easily be found to be engaged in illegal collusion.").

Antitrust Issues Raised by Product Bundling in Communications Markets

Mark Del Bianco

Communications firms with large residual market shares, such as incumbent local telephone exchange carriers (ILECs) and incumbent cable companies (both often referred to as “incumbent monopolists”), face growing competition in their core communications markets. To stem the hemorrhaging of their residential and small business customers, they have begun to adopt a strategy of bundling the core product with other telecommunications services.¹

This article identifies and examines some of the antitrust risks posed by this bundling strategy in light of recent case law developments in the area of distribution restraints and the ongoing technological developments in the telecommunications arena. It also identifies factors—some of which are within a company’s control—that may influence the antitrust risk.

Bundling by Incumbents

The Telecommunications Act of 1996 sought to open all communications markets, and particularly local telephone and cable television markets, to competition. As competition has developed, Congress’s intent has, to at least a limited extent, been fulfilled—ILECs and cable companies have begun to lose market share in their core markets.

Given the decline in their core markets, it is no surprise that incumbents have begun adopting a strategy of bundling telecommunications and non-telecommunications services, including long distance services, broadband Internet access (cable modem or digital subscriber line (DSL) service), mobile phone service, voice over Internet protocol (VOIP), video on demand (VOD), multi-player online gaming, and personal video recording technology (PVRs). The rationales for these bundles are both defensive and offensive. The offensive goal of bundling is to increase the per-customer revenues, and possibly to raise rivals’ costs. A key defensive purpose is to slow erosion of market share in the core market by making it more difficult, expensive, and time-consuming for the end user to switch services to one or more other providers. Attaining customer “stickiness” is another way to describe this goal. There are various other possible motivations, including responding to consumer demand, reducing churn, and price discrimination.

Incumbents have created a variety of bundled packages. The four remaining regional Bell operating companies (RBOCs)—Verizon, SBC, BellSouth, and Qwest—have introduced various combinations of local, long distance, wireless, and/or Internet Service Provider (ISP) service (both dial-up and broadband).² Most of the major incumbent cable operators, including Cox, Comcast,

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¹ I use the term “bundling” in its common (and most generic) form to mean sales of two or more products made together and made more attractive because the purchaser receives an additional feature (e.g., a single monthly bill for multiple services) or a discount or rebate on one or more of the bundled products or services.

Charter, and Cablevision, offer bundles that combine cable television service with other services, including cable modem, local and long distance voice and, in limited areas, circuit-switched resale and wireless.³ The major differences between incumbent telephone companies and incumbent cable companies today are the lack of a competitive video product in the RBOC bundles (although recently announced deals with direct broadcast satellite firms may serve as an interim solution) and the lack of a viable wireless component (and in some cases, any telephone component at all) in the cable offerings.⁴

Opposition to Bundling

The cable companies' bundled offerings have already generated opposition. In March 2003, the Consumer Federation of America and Consumers' Union filed a letter with the Antitrust Division and the FTC asking for an investigation of whether the bundled offerings of cable companies, particularly Comcast, constituted either predatory pricing or illegal tying arrangements.⁵ Neither agency has publicly responded to the letter or indicated that it has initiated any investigation.

The incumbent telcos' bundling practices are also beginning to come under attack. For example, a group of customers has brought an antitrust action in New York challenging as anticompetitive Verizon's practice of tying DSL and local phone service.⁶ In addition, at least four state public utilities commissions have ruled that incumbents must unbundle their voice and DSL services and so cannot refuse to sell DSL services to customers unless those customers also buy voice service. In an attempt to preempt this state trend, BellSouth filed an emergency petition at the FCC in December 2003 seeking a ruling that its refusal to sell unbundled DSL is legal, and preempting state public utility commissions from ordering unbundling.⁷ The proceeding is still pending.

Antitrust Bundling

The will to attack these new bundling practices is obviously present, at least in private parties and the states, and antitrust provides a fearsome, if not wholly reliable, weapon. At present, the antitrust law on distributional restraints is fluid and chaotic. There is no consensus among the circuits as to either permissible or impermissible behavior by firms found to be dominant or to have significant market power in a properly defined antitrust market.⁸ The situation is complicated by the fact that most distributional restraints can be challenged under at least two and up to five separate statutory provisions,⁹ each with disparate elements of proof and precedent. In addition, there is no consensus on terminology in the realm of product co-marketing and cross-product dis-

The will to attack these new bundling practices is obviously present, at least in private parties and the states, and antitrust provides a fearsome, if not wholly reliable, weapon.

² See, e.g., Washington Telecom & Media Insider, *SBC, BellSouth Launch Bundle Offers* (Apr. 4, 2003); Washington Telecom & Media Insider, *The World According to Chairman Notebaert: Qwest Focused on Broadband and Bundling* (May 16, 2003); Legg Mason Equity Research, *Battle of the Bundles, Appendix: Breakdown of Current Bundling Efforts 15-17* (June 2003), available at <http://www.theinternetanalyst.com/download.asp?docid=27277324>.

³ See Legg Mason Equity Research, *supra* note 2, at 17-20; Precursor Group, *Cox Lengthens Bundle Lead over Rivals* (June 23, 2003).

⁴ Cable companies are moving quickly to adopt VOIP technology for voice services to fill this gap.

⁵ See, e.g., Washington Telecom & Media Insider, *Groups Seek Antitrust Scrutiny of Cable Company Bundling Practices 4-5* (Mar. 23, 2003).

⁶ *Greco v. Verizon Communications, Inc.*, 03 Civ. 0718 (KMW) (S.D.N.Y.). A motion to dismiss is pending in the case.

⁷ *In re BellSouth Telecommunications, Inc.*, WC Docket No. 03-251.

⁸ Showing that a defendant has market power is a threshold requirement for any plaintiff claiming harm to competition through distributional restraints, such as tying, bundling, and various loyalty discount programs. Market share is usually a first-stage proxy for market power. To rebut the inference that a significant market share equates to significant market power requires a complex, costly, and time-consuming economic analysis of the relevant market. Such analysis has not been done in most telecommunications product or geographic markets.

counts. Many practices are now labeled under the rubric of “bundling,” a term relatively new to the law, having migrated there from business jargon and recent economic theory. The outcome of a lawsuit can turn on whether bundling is characterized as “tying,” “predatory pricing,” or an “exclusionary practice.” Tying and predatory pricing analyses are notoriously defendant-friendly. Exclusionary practice analysis is just as notoriously plaintiff-friendly.

Since 1995, seven circuits have been called upon to address the issue of bundling. Four of the outcomes have favored plaintiffs; defendants have clearly prevailed only twice.¹⁰ The unlucky defendant in a recent pro-plaintiff case, *LePage’s Inc. v. 3M*,¹¹ petitioned for certiorari. Many in the antitrust community were hoping that the Supreme Court would grant the petition and provide some guidance. On June 30, 2004, however, the Court, following the suggestion of a strongly worded brief from the U.S. Solicitor General, denied certiorari, leaving the case law and academic analysis to develop further.

In this atmosphere of “Let a Thousand Flowers Bloom,” potential plaintiffs will see a gold mine of theories and fact patterns from which they can pick and choose the precedent that is most helpful to their case. Potential defendants will see a minefield where an attractive business model can explode in their faces. Whether a firm is crafting a defensive or an offensive strategy, the following distillation of case law serves as a useful starting point. In particular, it identifies specific factors that may affect the application of antitrust law to bundling by communications incumbents.

Bundling Paradigms

A close reading of these seven circuit court decisions leads to the conclusion that firms whose bundling activities may be most vulnerable to antitrust challenge are those that:

1. have significant market share, especially if built upon an installed base;
2. are in a market characterized by high entry barriers and/or high switching costs;
3. have a larger portfolio of products than most or all of their competitors;
4. bundle a new product with an established product;
5. start bundling in a market where the practice is not common; and
6. market the bundled products via steep discounts, generous volume or market share rebates, or exclusive dealing provisions.

In addition, a plus factor that resonates through some of the cases is the sense that the challenged bundling is a strategic move necessary for the incumbent to defend the continued existence of its core market. Where regulatory, business, or technological developments are causing a dramatic change to the market—a paradigm shift—an incumbent may feel that if it does not make a fundamental change in its distribution model, it risks not just a loss in market share, but

⁹ Those provisions are: Sherman Act Section 1 (agreements in restraint of trade); Sherman Act Section 2 (single firm conduct that creates or maintains a monopoly); Clayton Act Section 3 (tying arrangements); and the Federal Trade Commission Act (unfair acts and practices; note that this statute is not available to private plaintiffs). In addition, most states have a “Little FTC Act” which allows the state attorney general to sue on behalf of the state’s citizenry.

¹⁰ In chronological order, the plaintiff-friendly circuit court decisions are *Multistate Legal Studies, Inc. v. Harcourt Brace Jovanovich Legal and Prof’l Publ’ns, Inc.*, 63 F.3d 1540 (10th Cir. 1995); *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), *cert. denied* (June 30, 2004); and *Metronet Servs. Corp. v. USWest Communs.*, 325 F.3d 1095 (9th Cir. 2003), *reh. den.*, 329 F.3d 986 (9th Cir. 2003). The defendant-friendly circuit court decisions are *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000); and *Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.3d 256 (2d Cir. 2001). The seventh case, *U.S. v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001), might best be characterized as a draw, since the appellate court’s directions for treatment of bundling, which could have been harmful to defendant if followed on remand, were mooted by settlement of the case.

¹¹ 324 F.3d 141 (3d Cir. 2003), *cert. denied* (June 30, 2004).

total obsolescence. That perception, especially if memorialized in documents or admitted in testimony,¹² tends to persuade courts and juries that innovative bundling practices employed by the incumbent are fundamentally unfair because they are not intended merely to compete in an existing market, but to prevent the development of a competing market, or at least to impede its growth until the incumbent can shift its resources to become dominant in that market also. In short, the incumbent is perceived as unfairly tilting the new competitive playing field in its favor. This suggests that judges and juries may be intuitively applying a different set of rules when firms are engaged in competition *for the market*, as opposed to the traditional antitrust analysis applied to competition *in an existing market*.

Only one of the seven decisions arose in the traditional communications industry. However, most if not all of the paradigm conditions for bundling vulnerability exist for incumbents in the cable television and local phone markets. The incumbents' still-high market shares in their local service areas would likely satisfy a plaintiff's initial burden of demonstrating significant, perhaps even dominant or monopolistic, market power.¹³ In addition, most of these local markets are characterized by high barriers to entry in the form of facilities and branding costs.¹⁴ The switching costs are low in the local wireline and the wireless markets because of mandated number portability, but they are not low in many local cable TV service areas (and in fact switching may not be possible since in most markets there is only one local cable provider).

Bundling in its current incarnation is new to the communications industry. Until very recently, cable television was a stand-alone product and cable systems were not designed to provide even simple two-way communications services. Bundling of local, long distance, and equipment was long the norm in the AT&T-dominated wireline telephone market, but it came under attack from government agencies and competitors beginning in the 1960s.¹⁵ For the last thirty years, bundling has been on the decline in the wireline market (except in the medium to large corporate market, which was dominated by firms, such as MCI and AT&T, that did not have bottleneck local facilities), and bundling has never, until very recently, been a common practice in other communications markets. However, the incumbents are now bundling their established core products with a variety of new products, and they can offer more attractive bundles than most competitors because they have a larger portfolio of products. On some of these bundles, the discounts are in the order of 5–10 percent or more, well above the levels that led the Third Circuit to find liability in a case that provided the precedent for its analysis and outcome in *LePage's*.¹⁶

¹² See, e.g., *Microsoft*, 253 F.3d at 96–97; *Conwood*, 290 F.3d at 787; *Smithkline Corp. v. Eli Lilly & Co.*, 427 F. Supp. 1089, 1151–52 (E.D. Pa. 1976), *aff'd*, 575 F.2d 1056 (3d Cir. 1978).

¹³ To rebut the inference would require complex, costly, and time-consuming economic analysis of each relevant market. Such analysis has not been done in most communications product or geographic markets.

¹⁴ See, e.g., *Metronet Servs. Corp. v. USWest Comm.*, 325 F.3d at 1102–04 (discussing plaintiff's expert's identification of structural barriers to entry into the market for small business local telephone service in the Seattle/Tacoma area).

¹⁵ FCC decisions running back through the *Computer Inquiries* to the *Carterfone* order required or encouraged unbundling. The MFJ, of course, represented an extreme form of unbundling, because AT&T's long distance and local operations were split and the RBOCs were prevented from providing long distance and many enhanced (information) services. Modification of Final Judgment, *reprinted in* U.S. v. AT&T, 552 F. Supp. 131 (D.D.C. 1982). In recent years, there has been a trend towards permissive bundling by incumbents. Judge Greene lifted the MFJ prohibition on RBOC provision of information services in the early 1990s, and the Telecommunications Act of 1996 provided a mechanism—Section 271—under which RBOCs could gain the ability to enter the long distance market, with no restrictions on the bundling of local and long distance services. The FCC has also become more tolerant of bundling. For example, in 2000, in its order approving the Section 271 application of SBC for long distance authority in Texas, it for the first time permitted RBOC bundling of local telephone and DSL services. See *In the Matter of SBC Communications Inc.*, FCC 00-238, released June 30, 2000.

The danger for incumbents is that at trial the finder of fact, whether judge or jury, will focus on the imbalance of power, and find it likely that bundling could be used anticompetitively regardless of actual pricing levels.

In light of the structure of the market, it seems inevitable that some plaintiffs will bring communications bundling cases that survive summary judgment and reach the trial stage. Moreover, the “plus” factor discussed above—the struggle for survival in a rapidly evolving market—would seem to apply in spades. Technological change and deregulatory initiatives at the state and federal levels are reinforcing each other and causing fundamental structural changes in communications markets. Incumbents are facing drastic and accelerating loss of market share in their core markets, and those markets are either stagnant or declining in size. The danger for incumbents is that at trial the finder of fact, whether judge or jury, will focus on the imbalance of power, and find it likely that bundling could be used anticompetitively regardless of actual pricing levels.¹⁷

Surviving Antitrust Scrutiny

The justification for the bundling program will no doubt be crucial at the fact-finding stage of a case.¹⁸ The justification will have to be visible in the initial documentation for the development of the bundling program. Valid justifications might include improved products or any other benefits to the consumer, response to customer demand, distributional efficiencies,¹⁹ and possibly responding to competition.²⁰ If one of the incumbent’s major multi-product competitors initiates a bundling program, then the incumbent may be able to justify its own bundling as a simple competitive response, just so long as its bundled price is not predatory.²¹ The goals of preserving mar-

¹⁶ *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978). The term “bundled rebates” was not used in the opinion: the court spoke of “linked” sales and “volume rebates.” However, when the Third Circuit revisited this precedent in *LePage’s*, it stated that SmithKline had addressed the practice of bundled rebates. Defendant Eli Lilly had, through lawful patents, created the market for cephalosporins, a type of antibiotic. By the time competition appeared, Lilly was marketing five cephalosporins, two of which were still on patent and therefore reaping (lawful) monopoly profits. SmithKline’s competitive product was the generic equivalent of Lilly’s third (unpatented) product. Moreover, SmithKline’s product could also compete against Lilly’s premium (patented) product, as the therapeutic features were identical, but the generic had a more comfortable and less expensive delivery mode. To fend off this competition, Lilly offered a 3% “bonus rebate” to hospital pharmacies that purchased any three of Lilly’s five cephalosporins. The court found that the “practical effect” of this offer was to force SmithKline, a single product competitor, to compete “three-on-one.” *Id.* at 1061–62. It found the marketing plan to be monopoly maintenance in violation of Section 2 of the Sherman Act, and issued a permanent injunction against the illegal marketing practices.

¹⁷ *Multistate Legal Studies*, 63 F.3d 1540. Defendant started bundling multistate bar review workshops with its Colorado state bar review courses when faced with competition from a new entrant into the Colorado market, which was offering only multistate programs. Despite the fact that the new entrant was a relatively strong competitor to defendant, both being national providers of both local and multistate bar review, the court focused on the imbalance of power in the state locality.

¹⁸ Any justification created by lawyers after the bundling is challenged will carry almost no weight. See *United States v. Dentsply Int’l, Inc.* 2003 U.S. Dist. LEXIS 14139, *191 (D.C. Del. Aug. 8, 2003).

¹⁹ Such efficiencies can include lower distribution and consumer transaction costs. PHILLIP E. AREEDA, *ANTITRUST LAW* ¶ 1703g2 at 51–52 (1991); *Microsoft Corp.*, 253 F.3d at 87–88; see generally *Virgin Atlantic Airways, Ltd. v. British Airways PLC*, 257 F.3d at 256; *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000).

²⁰ The fact that Brunswick’s market share discounts were a common distribution practice among boat engine manufacturers helped convince the court that Brunswick was acting within the confines of fair competition, despite its 75% market share (a dominant position by most standards). *Concord Boat*, 207 F.3d at 1044, 1063–64. The tone of documents referring to the competition can be important. Merely copying a rival’s successful marketing approach is benign; but documents suggesting that the bundle was designed to target a specific, weaker competitor could be dangerous. Less obvious as to anticompetitive intent, but still helpful to plaintiffs, are documents which boast of the incumbent’s “market power.” These documents can be used to suggest that the bundling program is a device to leverage installed base market power into other, still developing communications markets.

²¹ See AREEDA, *supra* note 19, ¶ 1744c4 at 200; *Microsoft*, 253 F.3d at 87–88; *Concord Boat*, 207 F.3d 1039; *Virgin Atlantic Airways*, 257 F.3d at 261, 266–69. Query whether, if the initiating competitor was the other incumbent, a plaintiff could bring a dual monopoly maintenance action against both incumbents, perhaps on some novel coordinated interaction theory.

ket power or leveraging power in one market into another market would be viewed as decidedly anticompetitive.²²

A bundle that provides product integration, new services, or other benefits to consumers is more likely to survive antitrust scrutiny than a bundle that involves the mere “electronic stapling” of multiple bills into one bill or a price discount on one or more services.²³ Customer demand and customer reaction will also likely be key determinants at trial of the legitimacy of any incumbent’s bundle. To the extent that a firm can demonstrate customer demand predating its bundled offerings, it will be in a more defensible position.²⁴

A court may, of course, look at the incumbent’s pricing. The Supreme Court has endorsed an average variable cost test for predatory pricing, but other tests for measuring the price/cost variable may be used.²⁵ If internal documents suggest or demonstrate that the bundled price is a money-losing proposition for any significant period of time, red flags may be raised. For example, a special introductory offer which lasts only up to three months would probably be safe, but an open-ended commitment to maintain a low price for DSL or cable modem service, regardless of cost or profitability might be read as evidence of predatory intent.

Another consideration is likely to be whether the components of the bundle are available separately at competitive prices.²⁶ For incumbents electing to sell pieces of the bundle, such as DSL or cable modem service, as stand alone products with attractive discounts, *Concord Boat* is a helpful template.²⁷ Moreover, the availability of certain pieces of the telephone network as unbundled network elements under the FCC’s regulations and the Telecommunications Act of 1996 may also reduce the antitrust risk for ILECs, although not for cable incumbents. Even without true predatory pricing, a package may be so economically coercive that consumers will feel compelled to buy it, rather than mix and match the components from various producers. Consumer options may also be constrained by any technological ties between the large installed base of basic cable TV service or local telephone service and the bundled products.²⁸

²² “Desire to maintain a monopoly market share or thwart the entry of competitors” does not constitute the type of business justification that is an acceptable defense to monopolization. *LePage’s Inc.*, 324 F.3d at 163 (quoting *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1183 (1st Cir. 1994)).

²³ See J. Gregory Sidak, *An Antitrust Rule for Software Integration*, 18 YALE J. ON REG. 1, 29–31, 33 (2001). Examples of the former type of bundle might be a “follow-me” platform that automatically transferred wireline calls to a subscriber’s wireless phone after a set number of rings, or an interactive TV application that allowed a customer to participate in audience polling or shop online using her associated wireless service.

²⁴ See discussion in *Microsoft Corp.*, 253 F.3d at 88–89, 96–97 (2001). Evidence that consumers did not want the bundled product (calling it “horrible,” “a waste of time,” and “a joke”) helped the court conclude that defendant’s alleged business rationale for bundling was specious in *Multistate Legal Studies, Inc. v. Harcourt Brace Jovanovich Legal and Professional Publications, Inc.*, 63 F.3d 1540, 1552 (10th Cir. 1995).

²⁵ *Brooke Group Ltd., v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993); *United States v. AMR Corp.*, 353 F.3d 1109 (10th Cir. 2003); *aff’g* 140 F. Supp. 2d 1141 (D. Kan. 2001).

²⁶ *Microsoft Corp.*, 253 F.3d at 97.

²⁷ Brunswick’s reprieve rested upon several factors. First, although the industry was highly concentrated at times, there were no significant entry barriers; in fact, during the relevant time period several firms entered or exited the boat engine market. Brunswick’s market share fluctuated around 75% during the time it offered volume discounts, but the gains were due to market events unrelated to the discount program. Second, customers were not coerced into buying Brunswick’s engines. The engines were not tied to any other product, the discounts were reasonable, and the agreements were not exclusive (i.e., Brunswick did not require that a customer buy 100% of its engines from Brunswick). Third, the discounted prices were above Brunswick’s costs. Fourth, when Brunswick started its “market share discount” program, several of its competitors already had similar programs in place. See 207 F.3d at 1042 *et seq.*

²⁸ *Microsoft Corp.*, 253 F.3d at 64–67.

In a rule of reason case, however, the nature of the relationship between the incumbent's price and cost may not be the governing factor. Rather, the result may turn on the judge's or jury's categorization of the defendant's entire course of conduct. If a plaintiff can get the case out of the predatory pricing box and into a non-price predation box (e.g., strategic behavior aimed at defending, maintaining, or extending a monopoly), then it has a much better chance of prevailing.²⁹ The Second Circuit (*Virgin Atlantic*) seems to have as clear a preference for the pricing box as the Third Circuit (*LePage's*) has for the conduct box.³⁰ Other circuits can be placed somewhere between the two extremes. The key issue in communications bundling cases will be this categorization battle, especially since the Supreme Court declined to cut the Gordian knot by addressing the issue in *LePage's*.

Conclusion

In late May, the Solicitor General filed an amicus brief advising the Supreme Court not to accept the *LePage's* case on certiorari because there was a dearth of practical experience with and academic analysis of the competitive effects of the practice of bundling products and rebates.³¹ The government recognized that bundling of rebates was widespread and in many cases likely to be procompetitive, but that under certain circumstances it could in theory (and perhaps in practice) be anticompetitive. The brief concluded:

While bundled rebates may be a common business practice, it is not clear that monopolists commonly bundle rebates for products over which they have monopolies with products over which they do not. The United States submits that, at this juncture, it would be preferable to allow the case law and economic analysis to develop further and to await a case with a record better adapted to development of an appropriate standard.³²

The communications industry may well be unique because it clearly is an area where incumbents now commonly bundle rebates for products over which they have monopolies with products over which they do not. Given the Supreme Court's denial of certiorari in *LePage's*, the bundling of products in communications markets will be a key area of antitrust activity in the next few years. In fact, the communications industry will likely be the laboratory for the development of theoretical and analytical models of the economic desirability of bundling practices. Both incumbents and plaintiffs will be better prepared for the conflict if they keep the complex chain of antitrust precedent in mind. ●

²⁹ See Andrew I. Gavil, *Dominant Firm Distribution: Striking a Better Balance*, 72 ANTITRUST L.J. (forthcoming 2004); see also Barry Nalebuff, *Bundling as an Entry Barrier*, 119 Q.J. ECON. 159 (2004).

³⁰ The European Commission has adopted variations of the conduct box in its decisions in the *GE/Honeywell* and *Microsoft* cases. See *General Electric/Honeywell*, Case No. COMP/M.2220 (July 3, 2001); *Microsoft*, Case No. COMP/C-3/37.792 (Mar. 24, 2004). At press time, there are reports that the EU is also forcing The Coca-Cola Company to cease its practice of offering discounts across bundles of soda products, and to base discounts on the retailer's sales of the specific product on which the discount is offered. *Coke European Accord Seen*, N.Y. TIMES, July 16, 2004, available at <http://www.nytimes.com/2004/07/16/business/worldbusiness/16coke.html>.

³¹ Brief for the United States as Amicus Curiae, 3M Company v. LePage's Inc., No. 02-1865 at 12-14 and 18, available at <http://www.usdoj.gov/osg/briefs/2003/2pet/6invit/2002-1865.pet.ami.inv.html>.

³² *Id.* at 19.

Merger Enforcement in Innovation Markets: The Latest Chapter—Genzyme/Novazyme

Douglas L. Wald and Deborah L. Feinstein

The Federal Trade Commission has been challenging pharmaceutical mergers for a decade based upon their impact on “innovation markets.” Until this year, all of these challenges have been resolved by consent decree with little explanation of the economic rationale for concern over loss of “innovation” competition. The Commissioners have now provided new insights into their views on the proper approach to merger enforcement in innovation markets.

On January 13, 2004, by a vote of 3–1–1, the Commission closed its investigation of Genzyme’s previously completed acquisition of Novazyme. Three Commissioners issued separate statements explaining their respective views. In this article, we summarize the rationale for the Commission’s decision and provide additional information we believe may have been important to the Commission’s decision not to take action against the transaction.

Past Merger Enforcement in “Innovation Markets”

Over the past decade, the Commission has obtained consent orders in nearly a dozen matters based on the view that the merger would have eliminated competition to develop a new pharmaceutical product.¹ Yet the Commission has never given formal guidance as to its enforcement philosophy concerning mergers that involve “innovation markets.” The 1992 Horizontal Merger Guidelines² do not speak to innovation markets.³ The Antitrust Guidelines for Collaborations Among Competitors do set forth a simple, “number of competitors” approach as an initial screen in considering whether to challenge joint ventures that may cause the loss of innovation competition.⁴ These Collaboration Guidelines, however, make clear that the “antitrust safety zone does not apply to . . . competitor collaborations to which a merger analysis is applied.”⁵ Further, because there had been no previous Commission decisions on merger innovation cases, other than by consent, the Commission had never formally set forth its views.

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¹ While innovation concerns were mentioned in other FTC, and DOJ, cases, those allegations seemed primarily aimed at buttressing concerns in existing product markets, rather than referring to specific products whose development might be inhibited as a result of the merger.

² U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (1992; revised 1997) [Merger Guidelines], available at <http://www.ftc.gov/bc/docs/horizmer.htm>.

³ The Merger Guidelines talk about “products” or “groups of products.” See, e.g., *id.* § 1.0.

⁴ “Absent extraordinary circumstances, the Agencies do not challenge a competitor collaboration on the basis of effects on competition in an innovation market where three or more independently controlled research efforts in addition to those of the collaboration possess the required specialized assets or characteristics and the incentive to engage in R&D that is a close substitute for the R&D activity of the collaboration.” Federal Trade Commission and U.S. Department of Justice, Antitrust Guidelines for Collaborations Among Competitors § 4.3 (2000) [Collaboration Guidelines], available at <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf> (footnotes omitted).

⁵ *Id.*

Examining the Commission's previous merger enforcement actions in innovation markets, we believe that the Commission's decisions to bring those actions rested on two premises: (1) competition in future goods markets would be harmed by the merger; and (2) development of new products would be harmed by a reduction in the competition to innovate. The Commission's first premise—harm to future product markets—is based on traditional merger enforcement principles applied to existing product markets and, at least initially, seems reasonable.⁶ If two firms with the only products in development for a particular disease were to merge only days before they both receive FDA approval, should that merger escape scrutiny simply because no products are yet on the market?

It was the competition to innovate, in addition to competition in the ultimate end-goods market, that the Commission has viewed as worthy of protection.

The Commission's enforcement activities, however, have ventured far beyond that fact pattern, reaching potential products that were years away from coming to market, if ever. For instance, in the Commission's 1997 decision in *Ciba-Geigy, Ltd.*⁷ the Commission challenged the merger of Ciba-Geigy and Sandoz, both of which had gene therapy R&D programs. The Commission speculated that the first gene therapy products would not be available until the year 2000 but that the market for gene therapy products could grow to \$45 billion by the year 2010.⁸ As of 2004, there is still no human gene therapy product approved for sale.⁹

The Commission's second basis for enforcement action offered a rationale for reaching early-stage R&D efforts, where any product was years away from reaching the market. The Commission reasoned that absent competition to innovate, competitors would be less likely to expend the resources and energy to do so, or would undertake innovation at a much slower pace. Thus, it was the competition to innovate, in addition to competition in the ultimate end-goods market, that the Commission has viewed as worthy of protection.

Genzyme

Against this backdrop of past enforcement, the Commission was faced with Genzyme's completed acquisition of Novazyme.¹⁰ Genzyme is a large biotech company with thousands of employees and sales of nearly \$1 billion at the time of the acquisition. Novazyme, in contrast, was a small privately held research company. Novazyme had no products on the market, no products in clinical trials, and no clinical-scale or commercial-scale manufacturing facilities. Genzyme was the only company with an approved product for lysosomal storage disorders (LSDs), a group of forty-one diseases. The science involved in developing drugs to treat LSDs is complex. Genzyme's first LSD product took over ten years to develop.

Pompe, the LSD disease at issue in this matter, is a painful and debilitating disease that is always fatal; many of its victims are infants who die before their first birthday and children who die before adolescence after spending most of their lives dependent upon ventilators and wheelchairs. Pompe is an extremely rare disease, affecting fewer than five to ten thousand people worldwide. Although it has been more than sixty years since Pompe disease was first identified, there are still no approved drugs to treat Pompe on the market.

⁶ But see *infra* pp. 6–7 (discussing whether, as a matter of statutory interpretation, Clayton Act § 7 even applies to mergers that occur prior to the existence of a relevant market in the goods being developed).

⁷ 123 F.T.C. 842 (1997).

⁸ *Id.* at 845.

⁹ See <http://www.fda.gov/cber/gene.htm>.

¹⁰ The transaction was not reportable under the Hart-Scott-Rodino Act.

Because Pompe is such a rare disease, efforts to develop pharmaceutical products for its treatment are covered by the Orphan Drug Act.¹¹ An “orphan drug” is a pharmaceutical product that treats a disease affecting fewer than 200,000 patients in the United States. To provide incentives for pharmaceutical companies to develop products to treat such rare diseases, the Orphan Drug Act was enacted in 1983. The most important incentive that Congress provided is marketing “exclusivity.” A company that obtains FDA approval of an orphan drug is given the assurance that FDA will not approve another company’s application for the “same drug” for seven years from the date of FDA approval.¹² In short, Congress grants a seven-year monopoly to orphan drugs that obtain FDA approval. The overriding purpose of the Orphan Drug Act is to bring drugs to market that otherwise would never be developed and marketed because the costs of developing such drugs could never be recouped without such exclusivity. Congress provided a set of narrow circumstances in which marketing exclusivity for an orphan drug could be broken by another drug considered “the same drug” under the Orphan Drug Act.¹³

At the time of the acquisition in September 2001, Genzyme and Novazyme were the only two companies attempting to develop a treatment for Pompe. The merger left Genzyme as the only entity performing R&D to develop Pompe treatments.

After a lengthy investigation, the Commission voted to close its investigation of Genzyme’s acquisition of Novazyme.¹⁴ Chairman Muris issued a detailed statement explaining his views as to why the investigation should be closed.¹⁵ Although Commissioners Leary and Swindell joined in the vote to close the investigation, they did not join in the Chairman’s statement or issue their own statements. Commissioner Thompson voted against closing the investigation and issued a statement explaining why he believed the Commission should have pursued an enforcement action against Genzyme.¹⁶ Finally, although Commissioner Harbour did not vote on the matter because she had only recently joined the Commission, she issued a statement setting forth her general views on “innovation markets.”¹⁷

¹¹ 21 U.S.C. §§ 360aa–ee.

¹² *Id.* § 360cc.

¹³ First, if a subsequent product is clinically superior to the original orphan drug, it can be brought to market during the exclusivity period. Second, a subsequent product can be brought to market if the orphan drug manufacturer either consents to “shared” exclusivity with the new product or is unable to supply sufficient quantities of the product to meet the patient demand for the orphan drug. The exclusivity is inapplicable where the second product is not the “same drug.” The Orphan Drug Act provides a fairly broad definition of the “same drug” for macromolecules (such as proteins). *See* 21 C.F.R. § 316.3(b)(13)(ii). Finally, a subsequent product may be marketed to treat a different disease than the disease for which the orphan drug was approved. In all other circumstances, the marketing exclusivity granted to the first orphan drug is absolute.

¹⁴ FTC Press Release, *FTC Closes Its Investigation of Genzyme Corporation’s 2001 Acquisition of Novazyme Pharmaceuticals*, available at <http://www.ftc.gov/opa/2004/01/genzyme.htm>.

¹⁵ Statement of Chairman Timothy J. Muris in the Matter of Genzyme Corporation/Novazyme Pharmaceuticals, Inc., available at <http://www.ftc.gov/os/murisgenzymestmt.pdf>.

¹⁶ Dissenting Statement of Commissioner Mozelle W. Thompson, *Genzyme Corporation’s Acquisition of Novazyme Pharmaceuticals Inc.*, available at <http://www.ftc.gov/os/2004/01/thompsongenzymestmt.pdf>.

¹⁷ Statement of Commissioner Pamela Jones Harbour, *Genzyme Corporation’s Acquisition of Novazyme Pharmaceuticals Inc.*, available at <http://www.ftc.gov/os/2004/01/harbourgenzymestmt.pdf>.

There Is No Basis for Presuming Anticompetitive Effects in Innovation Markets

The Views of the Commissioners. Perhaps the most fundamental disagreement among the Commissioners was the appropriate analytical framework to use in assessing the merger, in particular, whether there should be any presumptions concerning “anticompetitive effects.” Chairman Muris advocated a fact-based approach to considering innovation mergers. The Chairman relied heavily upon a 1996 report of the Commission staff,¹⁸ which, he noted, acknowledged that “economic theory and empirical investigations have not established a general causal relationship between innovation and competition.”¹⁹

The Chairman summarized his views as follows:

[N]either economic theory nor empirical research supports an inference regarding the merger's likely effect on innovation (and hence patient welfare) based simply on observing how the merger changed the number of independent R&D programs. Rather, one must examine whether the merged firm was likely to have a reduced incentive to invest in R&D, and also whether it was likely to have the ability to conduct R&D more successfully.²⁰

In contrast, Commissioner Thompson suggested that innovation mergers, like other mergers, should be subject to a “rebuttable presumption of competitive effects for mergers if the change in, and resulting level of, market concentration is significant.”²¹ Commissioner Thompson pointed to the Antitrust Guidelines for Collaborations Among Competitors as support for his position. Although Commissioner Thompson did not refer to empirical support for the presumption in innovation cases, he stated that he saw “no compelling reason why innovation mergers should be exempt from the Horizontal Merger Guidelines or the presumption of anticompetitive effects for mergers to monopoly and other mergers as discussed therein.”²² Moreover, Commissioner Thompson pointed to testimony of business witnesses in the investigation that competition had affected other companies' innovation efforts.²³

Commissioner Harbour struck a middle ground. She noted that “[a]lthough one may question whether we have yet reached the point where a general presumption of anticompetitive effects in highly concentrated innovation markets is applicable, in the extreme case of a merger to monopoly that eliminates all competition and diversity in the innovation market, such a presumption seems appropriate.”²⁴

Economics Literature. Unlike traditional oligopoly theory as applied to markets for existing products, there is no firm grounding in economic doctrine for presuming an anticompetitive reduction in innovation from a reduction in the number of competitors attempting to innovate. The 1996 Global Marketing Report cited by Chairman Muris noted the lack of economic consensus that

¹⁸ FTC Staff Report, *Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace* (May 1996) [Global Marketplace Report].

¹⁹ Muris Statement, *supra* note 15, at 2–3.

²⁰ *Id.* at 5–6.

²¹ Thompson Statement, *supra* note 16, at 3.

²² *Id.*

²³ *Id.* at 9 n.21 and accompanying text.

²⁴ Harbour Statement, *supra* note 17, at 3 (citations omitted).

*Economic theory—
as well as empirical
evidence—supports the
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furthering innovation.*

reduced competition leads to less R&D or to fewer new products.²⁵ In a 2001 article, Richard Gilbert and Willard Tom concluded that the basis for a belief that competition enhances R&D efforts is “largely anecdotal,”²⁶ and that “[e]conomic theory does not provide that more competition is better for R&D and [that] statistical studies do not support that conclusion either.”²⁷ Indeed, economic theory—as well as empirical evidence—supports the view that collaboration may be preferable to competition in terms of furthering innovation. As Dennis Carlton & Robert Gertner noted in a 2003 paper, “[s]ince competing R&D expenditures may be duplicative, a merger that eliminates redundancy may lead to the same knowledge produced at lower costs, or even greater knowledge at lower costs.”²⁸ Another efficiency that can result from combined R&D efforts is “an enhanced interchange of ideas and sharing of resources.”²⁹ As Carlton & Gertner explain, “It is incorrect to conclude that any reduction in R&D is necessarily bad for consumers.”³⁰ Their view, therefore, is that “neither theory nor empirical work provides any general justification for an antitrust merger policy aimed at preserving competition in R&D markets.”³¹

The Views of the Courts. It is of interest that all the Commissioners’ Statements appeared to assume that the antitrust laws could bar a merger that adversely affected an “innovation” market, even if no market for the sale of goods existed yet, despite the fact that no court has ever held a transaction unlawful solely because of effects solely on “innovation,” in the absence of an existing product market. Indeed, since Section 7 Clayton Act requires a lessening of competition “in any line of commerce,”³² there are significant questions whether Section 7 is implicated at all when no product is being sold and thus no commerce is currently affected, as prior cases have recognized. Yet the several Statements of the Commissioners did not address that case law.

The most directly relevant case authority is *SCM Corp. v. Xerox Corp.*,³³ in which the plaintiff alleged that Xerox had violated the antitrust laws by buying up patents for plain-paper copier technology. However, the acquisitions occurred several years before Xerox marketed the first plain-paper copier. In short (as in the *Genzyme* case), the relevant product market did not exist at the time of the acquisitions. The court ruled that acquisitions of patents could not violate the antitrust laws if the relevant product market did not exist at the time of the acquisitions, even though the “probable effect” of the patent acquisitions was to substantially lessen competition once the relevant market did exist.³⁴ Rather, the court construed the “line of commerce” requirement to mean that an acquisition (at the time it occurs) must have probable anticompetitive effects in an “existing” line of commerce.³⁵

²⁵ See Dennis W. Carlton & Robert H. Gertner, *Intellectual Property, Antitrust and Strategic Behavior*, UNIVERSITY OF CHICAGO, NATIONAL BUREAU OF ECONOMIC RESEARCH (Abstract, May 2002) at 13, reprinted in ADAM JAFFE & JOSHUA LERNER, 3 INNOVATION POLICY AND THE ECONOMY 13 (2003).

²⁶ Richard Gilbert & Willard Tom, *Is Innovation King at the Antitrust Agencies? The Intellectual Property Guidelines Five Years Later*, 69 ANTITRUST L.J. 43, 83 (2001).

²⁷ *Id.*

²⁸ Carlton & Gertner, *supra* note 25, at 10.

²⁹ *Id.* at 11.

³⁰ *Id.*

³¹ *Id.* at 14.

³² 15 U.S.C. § 18.

³³ 645 F.2d 1195 (2d Cir. 1981).

³⁴ *Id.* at 1210.

³⁵ *Id.* at 1211.

The court in *Crucible, Inc. v. Stora Kopparbergs Bergslags AB*³⁶ reached a similar result. As in *SCM*, the court ruled that “the absence of a relevant [product] market . . . at the time of patent acquisition precludes the applicability of Section 7.”³⁷

Thus, Genzyme argued to the Commission that there is no economic or legal foundation for a presumption that a merger of two innovators, even if they are the only ones, is anticompetitive. To state simply that the merger is a “merger to monopoly” in some area of R&D says nothing about what the merger means for the pace, amount, quality, or—most importantly—likely outcome of the innovation efforts. Only a detailed examination of the facts can answer those questions. In the case of Genzyme’s acquisition of Novazyme, Genzyme pointed to facts that indicated that no harm to innovation was likely, thus demonstrating that any presumptions would be inappropriate.

The Commission Neither Found (Nor Discussed) Risks of Harm in Future Product Markets

As noted above, one premise of prior enforcement actions was the possible effect of a merger on future product markets. For there to be an adverse effect on actual competition, however, the Commission would have had to demonstrate that there would in fact have been competition between Genzyme and Novazyme in a future product market absent the transaction. Genzyme pointed to an absence of any basis for believing that both products were likely to be successfully developed, especially in light of the legal impediments established by the Orphan Drug Act.

Successful development of a treatment for LSDs is exceedingly difficult. There are more than forty such diseases, and to date in the United States there are only four products for three LSD diseases, all made by Genzyme. Even though Orphan Drug exclusivity ended over two years ago for Genzyme’s Gaucher products, Genzyme faces no competition. A theoretical concern that additional patients might have benefited from the development of different products misses the point that patients can only be helped if effective and approved products actually emerge. It would have been highly speculative to predict that both Genzyme and Novazyme would have developed products, and received FDA approval, particularly in light of the Orphan Drug Act. Perhaps for this reason, the Commission statements do not discuss the theory of potential harm in a future products market from the transaction.

Procompetitive Benefits of the Combination Outweighed the Speculative Harm of a Reduction in Innovation Competition

The second premise underlying prior enforcement actions has been potential adverse effects on “competition to innovate.” The Statements of Chairman Muris and Commissioner Thompson considered various potential effects of the Genzyme/Novazyme transaction on such competition and reflect mainly a divergence of views as to whether any adverse effects were likely to arise from the transaction.

³⁶ 701 F. Supp. 1157 (W.D. Pa. 1988).

³⁷ *Id.* at 1162–63. *See also* *Fraser v. Major League Soccer, L.L.C.*, 97 F. Supp. 2d 130, 140–41 (D. Mass. 2000) (“Where there is no existing market, there can be no reduction in the level of competition. . . . Competition that does not exist cannot be decreased”), *aff’d*, 284 F.3d 47, 71 (1st Cir. 2002) (“Even advocates of a broader reading of section 7 concede that striking down a combination that does not threaten present competition could be justified . . . only in already concentrated markets.”).

A “Race” to Innovate? The first theory of anticompetitive harm Chairman Muris considered was “whether Genzyme and Novazyme would have engaged in a ‘race to market’ absent the merger.”³⁸ He said that for such a race to exist “at least one of them would have had to believe that altering its expenditures on R&D would significantly change its probability of beating the other company to the market with a therapy for Pompe.”³⁹ The Chairman concluded that the evidence showed that Genzyme and Novazyme did not view themselves as being in a “race” to innovate. Novazyme believed it was developing a better drug, not a drug that would come to market first. “Under these circumstances,” the Chairman stated, “the competition between Genzyme and Novazyme would not have had a substantial effect on the amount or timing of Genzyme’s or Novazyme’s R&D spending on Pompe, or on when the first Pompe therapy would reach the market.”⁴⁰ He explained that “regardless of Novazyme’s program, Genzyme’s incentive was to get a Pompe therapy to market sooner rather than later to earn profits on sales of its enzyme.”⁴¹ The same was true for Novazyme. Thus, absent the merger, “there would not likely have been a ‘race to market.’”⁴² Commissioner Thompson, however, believed the evidence indicated that a race existed between Genzyme and Novazyme to develop a Pompe product and that the race increased the pace of innovation.

Genzyme contended that the facts supported a finding that the parties’ innovation efforts would have been no different whether or not they perceived themselves to be in a race. Both Genzyme and Novazyme each stated, both publicly and privately, that they were pushing their programs as quickly as possible. Moreover, the incentive to speed up—rather than withdraw from an unwinnable race to market—will occur only when the competing innovators’ programs are close to each other in development progress. Yet there was no evidence that Genzyme and Novazyme were close to each other in development progress. Nor was there evidence that Genzyme and Novazyme were close in the race to develop a Pompe product. Finally, and perhaps critically, the Commission apparently concluded that the actual benefits of the Genzyme-Novazyme collaboration—providing better products to patients—outweighed the minimal and highly speculative risk that Genzyme might develop a drug a few months later than it would have if R&D competition had existed.

Incentives to Delay Novazyme’s Development Program?

Chairman Muris also considered whether the merger might lead Genzyme to delay the Novazyme program.⁴³ He noted that such a concern was problematic only if the Genzyme product succeeded.⁴⁴ If the Genzyme program failed, Genzyme’s incentives would be to push the development of the Novazyme product.⁴⁵

³⁸ Muris Statement, *supra* note 15, at 11.

³⁹ *Id.*

⁴⁰ *Id.* at 12.

⁴¹ *Id.*

⁴² *Id.* at 12–13.

⁴³ *Id.* at 13.

⁴⁴ *Id.* at 14.

⁴⁵ The Chairman pointed to other facts suggesting that Genzyme was not planning to delay the program, including putting the Novazyme CEO, whose two children had Pompe disease, in charge of the merged company’s Pompe program, and entering into a merger agreement which provided significant milestone payments for stages of the Pompe program that substantial Novazyme shareholders headed up.

Genzyme raised a number of reasons why its incentives to continue R&D on the Novazyme technology are far greater than the incentives of a third party. First, Genzyme noted that it believes that the Novazyme technology, in conjunction with the existing Genzyme CHO product,⁴⁶ might be useful in the development of an improved second-generation Pompe product. No other company would have access to the Genzyme CHO product.

Second, if Genzyme succeeded with its internal CHO product, it would have market exclusivity under the Orphan Drug Act. In the hands of a third party, any product developed with Novazyme technology would have to be demonstrably better and would have to prove superior efficacy in head-to-head clinical trials. The need to break Orphan Drug exclusivity is a significant disincentive for a third party to develop the Novazyme Pompe preparation in light of the problems that have been uncovered. In contrast, Genzyme can bring a product with the Novazyme technology to market if (1) the product is only marginally better than the Genzyme product, (2) Genzyme believes the product is better but that fact would be very difficult to demonstrate or (3) the product is no better but results in cost savings.

Third, Genzyme believes that the Novazyme technology may have potential use in products for the treatments of other LSDs. A third party would not be able to apply the technology to those products.⁴⁷ For these reasons, Genzyme argued that it has greater incentives and is more likely to develop the Novazyme technology than a third party.

Commissioner Thompson, in contrast, believed that Genzyme's incentives to develop the programs aggressively could be adversely affected and that business incentives motivating Genzyme to develop a Pompe product were not a substitute for competition.⁴⁸ He suggested that Genzyme could develop a product that was not as good in the absence of a race to develop a product that would not lose Orphan Drug exclusivity. Yet the economic incentive to develop a better drug effective for more patients always existed. Moreover, Genzyme pointed to evidence that showed that, in other cases where Genzyme had market exclusivity, it has continued to improve its products.⁴⁹

Beyond the issue of incentives, Chairman Muris also concluded that "there is no evidence that the merger reduced R&D spending on either the Genzyme or the Novazyme program or slowed progress along either of the R&D paths."⁵⁰ To Commissioner Thompson's suggestion that the programs had been delayed, the Chairman countered that "there is no evidence . . . that the merger caused those delays. Rather, they appear attributable to overly optimistic early projections and subsequent unexpected problems."⁵¹ Indeed, Novazyme's documents repeatedly made the erroneous prediction that it was only months away from the beginning of clinical trials for Pompe and was within reach of the clinic for its other products. In an atmosphere of a start-up biotech company that had to convince investors to provide funding, such aggressive projections are commonplace. Nor is it surprising that Novazyme's CEO, trying desperately to find a cure for his

⁴⁶ "CHO" refers to Chinese Hamster Ovary cells, the cell line on which the Genzyme product is based.

⁴⁷ Finally, Section 4.23 of the Agreement and Plan of Merger between Genzyme and Novazyme requires Genzyme to use "commercially reasonable and diligent efforts" to determine the development plan for the Novazyme programs.

⁴⁸ See Thompson Statement, *supra* note 16, at 9.

⁴⁹ Indeed, Genzyme introduced a second generation Gaucher product during the Orphan Drug exclusivity period for its first generation product.

⁵⁰ Muris Statement, *supra* note 15, at 17.

⁵¹ *Id.* at 23.

children's illness, used these timelines as aspirational documents to motivate his colleagues to find a cure.

Genzyme pointed out that Novazyme's aggressive timelines could never be met, for several reasons. First, Novazyme's projections were based on having the money it needed to do the R&D work, conduct clinical trials, and obtain FDA approval. Yet there was great uncertainty as to whether that money would ever materialize. Second, Novazyme was having difficulty making its preparation. Third, Novazyme simply had no plan for how to manufacture its preparation. It had no bioreactors, and such capacity is in short supply. It is important to realize that at the time of the acquisition only one animal trial had been conducted—with a drug that because of toxicity issues could never be used in humans.⁵²

Commissioner Thompson viewed with skepticism “post-acquisition evidence” regarding delays. He reasoned that because the merged firm controls its own behavior, any reduction or delay of innovation would be “inherently difficult to detect.”⁵³ Yet Genzyme pointed to the absence of any evidence that Genzyme was delaying the Novazyme program and the fact that for two years after the acquisition, Genzyme was diligently continuing R&D and having extensive collaboration between the Genzyme and Novazyme programs. In his response to Commissioner Thompson's statement, Chairman Muris underscored that “[a]nticompetitive behavior . . . depends on incentives as well as ability. . . . When those incentives are evaluated, the specific facts of this case do not indicate any likely effect on Genzyme's effort to bring a second Pompe therapy to market.”⁵⁴

Procompetitive Benefits. Chairman Muris next considered “whether the merger has made it more likely that the Genzyme program or the Novazyme program will produce a successful therapy, or will do so sooner.”⁵⁵ He pointed to several benefits arising from the merger, such as allowing comparative experiments and information that “enabled the Novazyme program to avoid drilling dry holes.”⁵⁶ Indeed, there were numerous examples presented to the Commission of merger-specific benefits to the Novazyme development program that in fact had been realized by the transaction. As Chairman Muris wrote, “We are not dealing with vague claims about uncertain benefits some time in the future.”⁵⁷ These benefits included allowing the Novazyme product to use cell lines previously developed by Genzyme that were scalable for a Pompe enzyme; access to a Genzyme assay; knowledge of how different patients reacted to previous Pompe products; and technology for measuring the clearance of glycogen. These benefits could not have been brought to the Novazyme development program by any party other than Genzyme, given Genzyme's unique history with development of Pompe treatment. No other company had a Pompe cell line. No other company had experience measuring glycogen reduction. No other company had a patient database of Pompe patient's reactions to different Pompe products. In sum, to the suggestion that other possible means of achieving efficiencies might exist, Chairman Muris said there was

⁵² Genzyme explained that the value of Novazyme to Genzyme was always in the promise of its technology, rather than the specific product it was trying to develop.

⁵³ Thompson Statement, *supra* note 16, at 8.

⁵⁴ Muris Statement, *supra* note 15, at 24.

⁵⁵ *Id.* at 17.

⁵⁶ *Id.*

⁵⁷ *Id.*

no reason to weigh equally the merger's actual benefits with the potential benefits of a joint venture that never occurred. Any number of factors . . . render the benefits in the hypothesized "but for" world more conjectural. These speculative gains cannot offset concrete gains that will translate into immense benefits for patients if the Genzyme internal Pompe program fails and the Novazyme program succeeds. Many lives would be saved and much suffering prevented.⁵⁸

While Commissioner Thompson suggested that the parties might have collaborated in a narrower R&D joint venture, he pointed to no evidence in support of the view that they might ever have done so. Nor did he provide any explanation as to why the parties would have had any incentive to do so if, as he alleged, the parties were in a race to innovate.

The Effect of a Challenge. Finally, Chairman Muris noted that "[n]either litigation nor a remedial order would likely benefit Pompe patients. To the contrary, litigation could adversely affect Genzyme's incentives to spend on R&D, and could disrupt the Novazyme research program" by diverting the attention of key scientists from research to courtroom testimony.⁵⁹

Chairman Muris also determined that finding an appropriate remedy "appears problematic. . . . unwinding the merger of preclinical research efforts on the particular facts of this case raises numerous issues."⁶⁰ For instance, a nonexclusive license to the Novazyme product would be unlikely to spur competition. Any value in the Novazyme product lay in its potential to break Orphan Drug Act exclusivity as a "superior" product; yet, if another competitor had a license to that product as well, there would be little incentive for either party to expend the money and effort to break Orphan Drug exclusivity. A forced divestiture would destroy the beneficial synergies that had already resulted from the combination. Because the Novazyme development program was using a Genzyme cell line, divestiture would mean going back to the drawing board in search of an effective cell line.

Commissioner Thompson rejected that argument as a basis for exercising prosecutorial discretion not to challenge the transaction. He contended that companies routinely litigate and engage in R&D simultaneously and that the costs, distractions, and other adverse effects of litigation can be avoided through settlement.⁶¹ While acknowledging that developing and implementing remedies for consummated mergers can provide challenges, he noted that "imprecise or otherwise imperfect remedies for consummated mergers may still be able to replace some or all of the meaningful competition lost due to the merger."⁶²

Lessons from Genzyme

In some respects, Genzyme's acquisition of Novazyme presented a unique fact situation. The early-stage nature of the drug programs at the time of the acquisition raised significant questions as to whether both products would ever reach the market. As a result, concerns that might otherwise have existed with respect to competition in the future goods market were lessened. There were significant factual questions as to whether the parties were really in any "race" to innovate given Genzyme's further advanced R&D program. Finally, because this was a consummated

Muris noted that

"[n]either litigation

nor a remedial order

would likely benefit

Pompe patients."

⁵⁸ *Id.* at 18.

⁵⁹ *Id.* at 20.

⁶⁰ *Id.* at 21.

⁶¹ Thompson Statement, *supra* note 16, at 12–13.

⁶² *Id.* at 13.

transaction, the Commission had post-acquisition evidence from which to judge the merger's effects.

Nevertheless, there are important lessons to be taken from the Commissioners' statements in connection with the termination of the investigation of the Genzyme/Novazyme merger. First, despite prior court rulings requiring an existing product market for an antitrust violation to be found and economic literature stating no clear effects of mergers on innovation or R&D, the absence of an "existing" goods market appears to be no impediment, in the Commission's view, to a challenge to mergers affecting innovation efforts. Such challenges are likely to continue.

Second, a majority of the Commissioners appear to believe that no "presumptions" of anti-competitive effect should govern "innovation market" mergers. Rather, mergers involving innovation markets should be subject to very specific factual analysis, and require a focused examination into whether innovation is likely to be adversely impacted (or enhanced) by consolidation. This was clearly illustrated in Genzyme, where evidence as to the likelihood of competition between the parties, R&D efficiencies, and alternatives to the merger were considered by both Chairman Muris and Commissioner Thompson.

Finally, evidence of procompetitive benefits will likely play an important role in the Commission's decision on whether to challenge mergers in innovation markets. Indeed, Chairman Muris underscored his view that the Genzyme/Novazyme transaction was more likely to benefit consumers than to harm them. ●

FTC/DOJ Organization Charts and Photos

Editor's Note: In response to several recent changes in antitrust enforcement leadership at the federal agencies, we are updating the organization charts and photos published in our September 2003 issue (<http://www.abanet.org/antitrust/source/sep03.html>). These updates include organization charts, with photos, for enforcers at the U.S. Department of Justice Antitrust Division and the Federal Trade Commission Bureau of Competition. In addition, links to speeches by agency leadership are provided below. As always, we encourage our readers to click the appropriate link to obtain access to these speeches.

We owe special thanks to Jayme Sawyer, and to the Department of Justice and FTC staff, who assisted us in organizing this feature.

—GARY ZANFAGNA

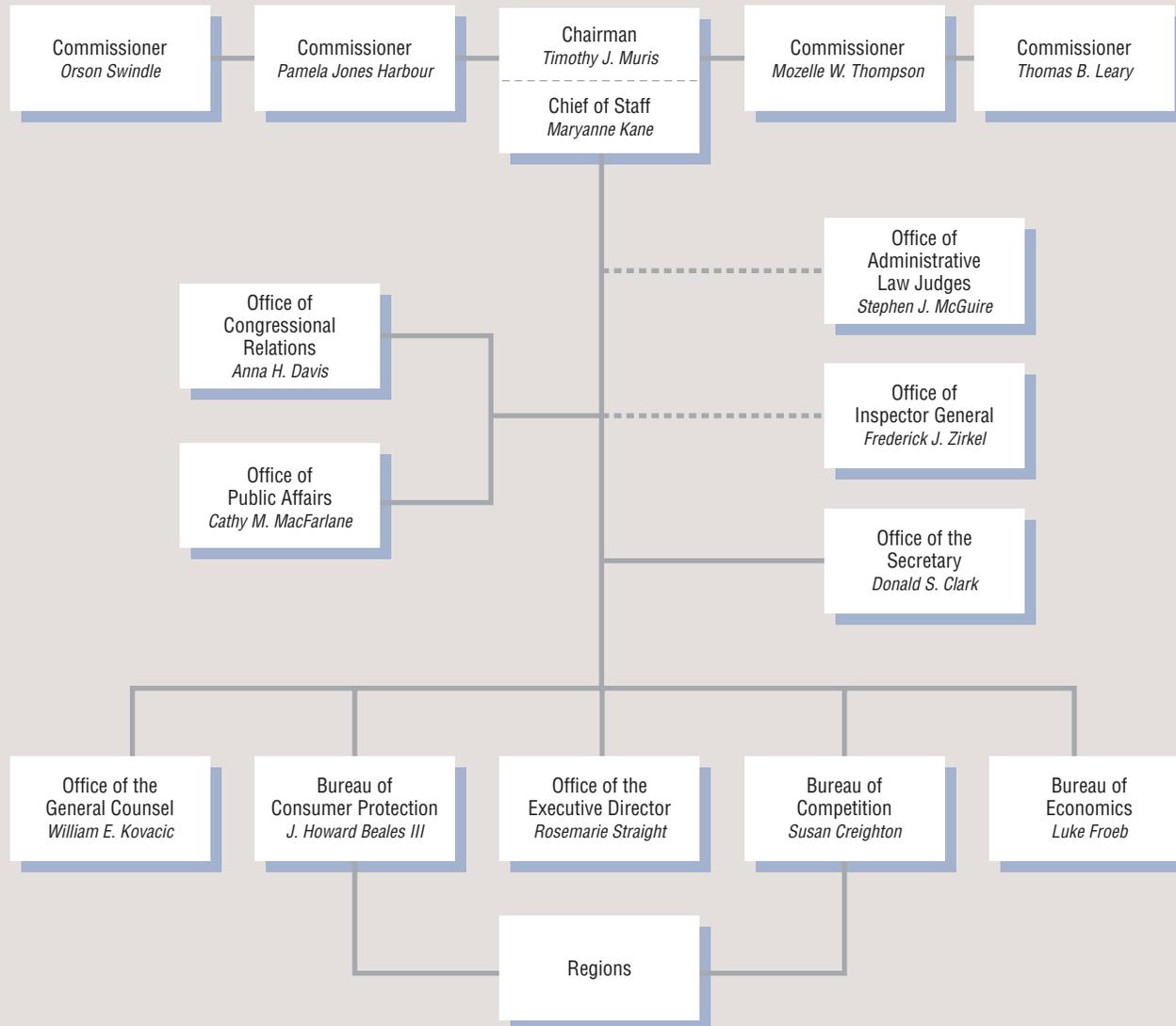
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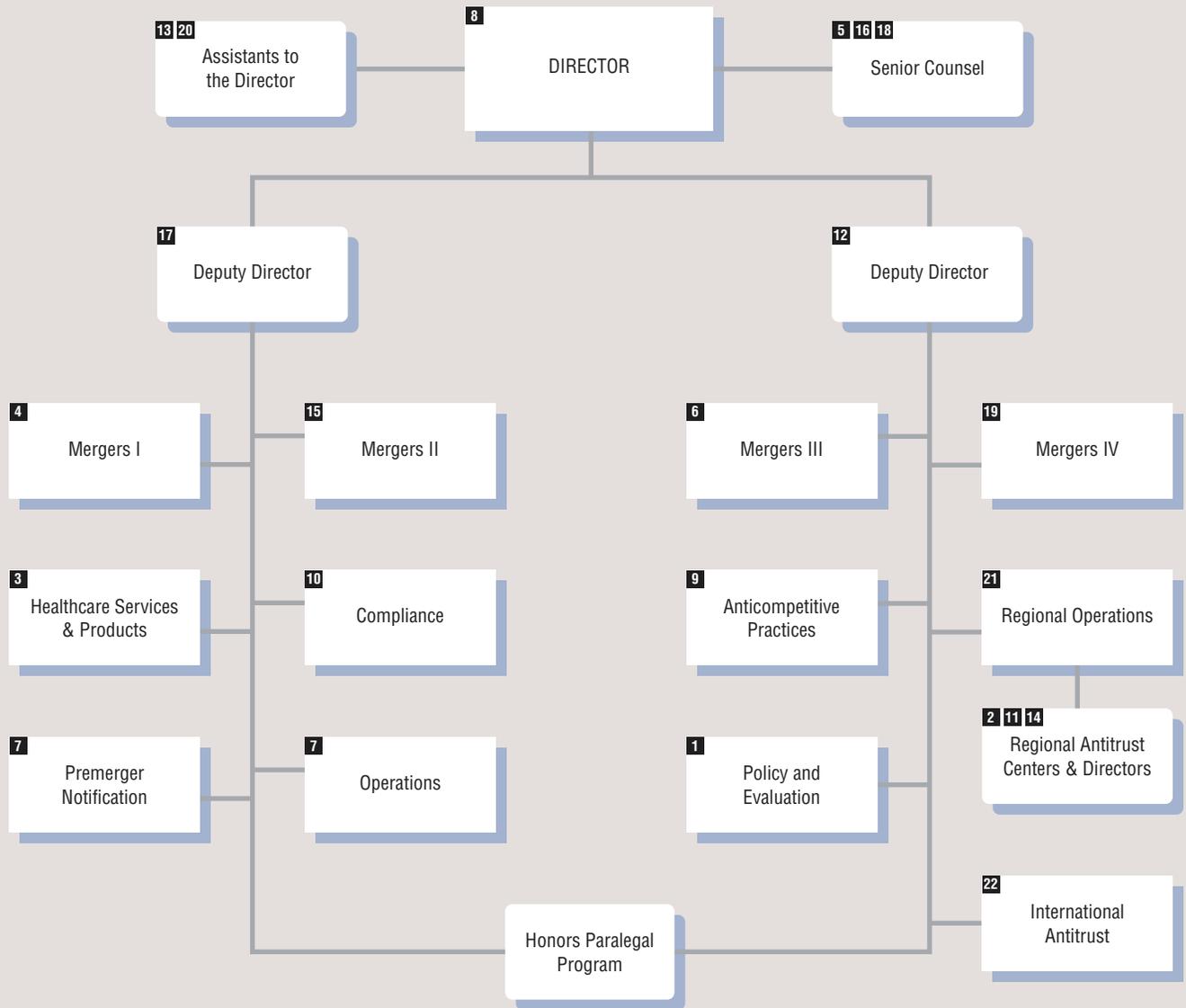
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- **Robert J. Kramer II**, Director, Office of Operations:
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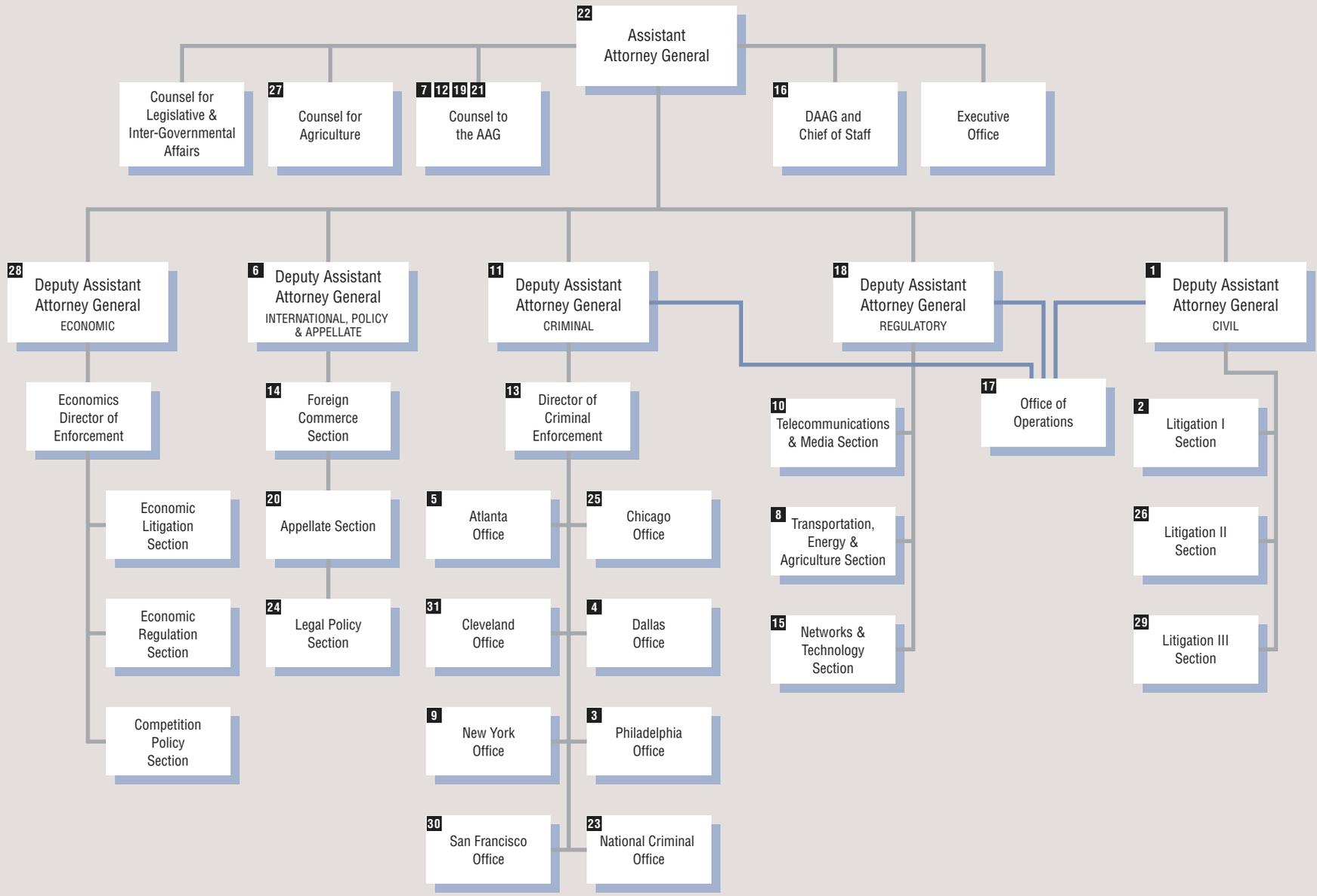


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Paper Trail: Working Papers and Recent Scholarship

Editor's Note: In this edition, we note a recent article on entry barriers by Richard Schmalensee, the Dean of the MIT Sloan School of Management and frequent expert witness in antitrust cases, most notably *United States v. Microsoft*. We also look at an in-progress paper by three FTC economists, exploring ground that is usually avoided by economists—does common ownership of media outlets change the ideological tilt of the media?

Send comments and suggestions for papers to review to: page@law.ufl.edu or jwoodbury@crai.com.

—WHP & JRW

Papers and Summaries

Richard Schmalensee, Sunk Costs and Antitrust Barriers to Entry,
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=486944

Antitrust law requires the identification and measurement of entry barriers whenever market power is at issue. Unfortunately, economists disagree about what market characteristics constitute true barriers to entry. Joe S. Bain measured entry barriers by the extent to which incumbent firms can raise prices above minimum average costs without attracting entry; George Stigler measured entry barriers by the extent to which potential entrants' long-run average costs exceed those of incumbent firms. Both views have contemporary adherents—Tirole and the DOJ/FTC Merger Guidelines favor Bain, while Carlton and Perloff (as well as Posner) favor Stigler. In this short paper (nine pages), Schmalensee argues that the Bainian definition of entry barriers is preferable to the Stiglerian definition for antitrust purposes, if antitrust is about enhancing "consumer welfare" as opposed to total welfare. Under the total welfare standard, both definitions can lead to anomalous results. Because of the paper's extreme brevity, however, we are left largely on our own to consider the many implications of the paper's strong conclusions.

According to Schmalensee, when antitrust scholars and policy makers use the term "consumer welfare," they usually mean only consumers' surplus; economists, in contrast, typically consider both consumers' surplus and producers' profits and rents. Thus, an economist might endorse Oliver Williamson's famous demonstration that a merger is welfare enhancing if the cost savings it makes possible exceed any deadweight welfare loss from reduced competition, but antitrust authorities would only consider the cost savings relevant if the savings benefit consumers. The choice of the goal of antitrust enforcement has implications for what should count as an entry barrier in antitrust analysis. If antitrust policy is aimed at promoting only consumer welfare in the sense of consumers' surplus, then whether an entry barrier exists should depend upon whether potential entrants can "undo" a reduction in competition in the market—essentially the question posed by the Bain definition. Schmalensee formulates "simple" mathematical models to consider whether entry barriers exist in this sense if (1) all costs are variable, with no fixed or sunk costs; (2) all costs are fixed and sunk (i.e., there are significant economies of scale); and (3) some costs are sunk, but there are no economies of scale.

(1) Where all costs are variable and constant with changes in output and there are no fixed or sunk costs, then there are no economies of scale. In this case, both Stigler and Bain would say an entry barrier exists to the extent the incumbents' unit cost is lower than the potential entrants' unit cost. Schmalensee argues that his characterization for antitrust purposes is consistent with the consumer welfare goal because the higher the entrants' cost relative to the incumbents' cost, the less effective entry will be in limiting an incumbents' pricing discretion, and the lower consumer welfare will be. But this definition of entry barriers is inconsistent with a total welfare standard: if entry occurs at a cost higher than the incumbent's, it could reduce total welfare, even if consumers benefit from a lower price.

(2) Where no costs are variable, and entry requires incurring a fixed and sunk cost, the definitions of what constitutes an entry barrier diverge. (A fixed cost is one that does not vary with output; a sunk cost is one that cannot be avoided by exiting the market, e.g., if it involves purchasing specialized equipment that cannot be resold.) Stigler would say an entry barrier only exists to the extent the potential entrants' sunk cost exceeds the incumbents'; Bain would say an entry barrier exists to the extent the potential entrants' sunk cost is greater than zero. Schmalensee argues that the Bain definition is preferable for a goal of consumer welfare, because it "captures the importance of the potential entrants' scale economies relative to the market," rather than focusing on the incumbent's costs. In a Cournot model, whether entry occurs in these circumstances depends only the *entrants'* sunk costs, and thus their economies of scale, not on the incumbent's sunk costs, and the lower the entrant's sunk costs, the lower the post-entry equilibrium price.

Schmalensee cites (without explanation) *Alcoa* and *Microsoft* as examples of courts focusing on the incumbent's costs or "absolute efficiency" rather than on "what would be required for an entrant to compete effectively." This last point may be a reference to his testimony in *Microsoft* that the "applications barrier to entry" is not a relevant barrier to entry because it is not "a cost or obstacle that deters more efficient entry." Here is what he said in his direct testimony:

The mere fact that a new software platform does not have a pre-existing stock of applications does not mean that consumers would be better off if this entrant succeeded, or that consumers are worse off because they have applications available to them for the incumbent software platform. For entry to be efficient, the software platform entrant has to convince consumers and ISVs to write applications for its platform and reduce the cost to consumers of switching from their existing applications. The fact that a software platform entrant does not have a pre-existing stock of applications also does not mean the entrant faces higher costs than the incumbent. Successful software platform providers, like Microsoft, have spent and continue to spend significant resources to persuade ISVs to write new and improved applications for their constantly evolving platforms. They did not find a pre-existing stock of applications awaiting their entry either. (Schmalensee Direct Testimony, ¶ 115).

Thus, Schmalensee asserted, the applications barrier to entry does not deter entry that would benefit consumers.

(3) Where entry requires incurring sunk costs but there are no economies of scale (i.e., there is "price-taking entry"), entry may also be deterred because the potential entrants face lower expected profits. But Schmalensee argues that, under a "static model," there is no antitrust barrier to entry because entry would occur and drive the market price to the same equilibrium level regardless of competitive conditions in the market.

Schmalensee is right to focus his definition of entry barriers on antitrust policy rather than on economists' conventions. But it is probably unwise to adopt a single definition of entry barriers for all markets and all legal issues. Courts will always examine how entry actually occurs in the market at issue in resolving whether barriers exist. Moreover, if the question is not simply whether there

are entry barriers (as in a merger case), but whether the defendant has monopolized by artificially creating entry barriers (as in the *United Shoe Machinery* case), the definition of barriers should change accordingly.

—WHP

David J. Balan, Patrick DeGraba, and Abraham Wickelgren, Media Mergers and the Ideological Content of Programming, <http://www.gwu.edu/%7Eindustry/workshop/ioworkshop.html>

Ever since the dawn of broadcasting, the Federal Communications Commission has applied its “public interest” standard in evaluating numerous media-related policy issues, including media mergers. Historically, key components of this standard have been diversity of ownership, “viewpoint” or “editorial” diversity, and “localism” (i.e., that programming should be informative about or reflect local tastes). These issues have been highlighted in recent months by the renewed interest of the FCC and Congress in regulating “indecentcy” on the airwaves, always with the risk that fines for indecentcy might deter “legitimate” policy discourse. And in recent years, the FCC’s ownership rules have come under increased scrutiny both by the courts and by third parties. Indeed, largely on the basis of diversity concerns (namely, local news availability), the Third Circuit on June 24, 2004, in *Prometheus Radio Project v. FCC*, overturned many of the FCC’s recently adopted rules that had substantially relaxed the regulatory constraints on the common ownership of multiple media outlets in the same locale. See <http://www.ca3.uscourts.gov/opinarch/033388p.pdf>.

To many economists (and, in my experience, to many attorneys), the diversity standard has been so slippery and vague that addressing the validity of FCC (or FCC staff) concerns about diversity has inevitably been frustrating. How do you measure diversity? How do consumers value diversity? Will common ownership of media outlets really reduce diversity or could it increase diversity? Some economists (including this editor) have opined that policies that do not hinder competition will best serve the interests of diversity, a viewpoint that Coase articulated more generally in his classic paper, *The Market for Goods and the Market for Ideas*, 64 *Am. Econ. Rev.* 384 (1974). If consumers demand diversity—whether it be “editorial” diversity or “localism,” one might predict that in general, competition among profit-maximizing media outlets will generate that diversity. To be sure, if one thinks about diversity in terms of product differentiation for which production is subject to scale economies—a reasonable characterization of the production of a viewpoint or a program, i.e., high fixed costs but low marginal costs for providing the “viewpoint” to another consumer—then in a free-entry equilibrium, there is the usual welfare tension between greater viewpoint variety and higher prices on the one hand, and less variety and lower prices on the other. (The “price” in this case can be viewed as either the price that consumers must pay to watch an ad-free program or the number of ads consumers must watch if the program is advertiser supported.) Indeed, in these kinds of models, the profit-maximizing amount of diversity may be excessive because of that tension.

But economists have never been able to (nor should they) rule out non-profit-maximizing behavior either empirically or as a matter of theory (in fact, principal-agent issues have always provided theoretical scope for such behavior). With respect to media ownership in particular, one cannot with certainty reject the possibility that an individual or group of individuals controlling multiple media outlets would excessively tilt the programming on those outlets towards a preferred point of view. Certainly this is a fear that has girded both Congressional and in part FCC concern with media concentration. And notwithstanding arguments that with respect to the media as else-

where, the FCC should nonetheless assume that profit-maximization is the best presumptive description of firm motivation even with respect to diversity, the FCC's diversity policies have been partially driven by a concern about the impact of the outliers, i.e., about the possibility that the media will be hijacked by a non-profit-maximizing ideologue.

Against that background, this novel paper authored by a trio of FTC economists addresses head-on the question of how media mergers might affect diversity. It does so by assuming that in acquiring media outlets, the owners do not maximize the profits of the outlet but instead obtain utility from being able to use the outlet as a device to persuade viewers of the "truth" of their ideology. The paper then evaluates the circumstances under which ownership diversity and the amount of "persuasion" might be affected by mergers. While the authors note that persuasion might be used to increase the profits of the owner in other markets by, say, promoting favorable regulatory or congressional outcomes (in which case, the behavior would be profit-maximizing), the authors evaluate their results more in terms of an owner who simply obtains more utility from convincing others of its view even if it means a profit sacrifice.

The model used in the paper is highly stylized—there are two advertiser-supported product-differentiated media outlets and two ideologies. Diversity is defined in terms of whether each outlet is in the hands of an owner with a different ideology. But the authors don't stop there—they also focus on the amount of "persuasion" that is produced as a result of ideological ownership. And (in my view, importantly) the paper assumes that the consumers do not value ideological "persuasion": More ideological persuasion on one outlet will lead some consumers to switch to the other outlet.

Even with the highly stylized model, the results provide some interesting insights. In the equilibrium in which common ownership of the outlets is prohibited, the authors find that there are two countervailing forces that affect whether the ownership will be diverse and how much persuasion is produced. On the one hand (and roughly speaking), if the two ideologies are not too different, then the marginal persuasion benefits to the members of one ideology of having each outlet controlled by owners subscribing to that ideology may be viewed as (relatively) small. Other things equal, that characteristic will tend to result in the ownership of the second outlet falling into the hands of an owner with a different—but not "too" different—ideology, and in that sense, diversity is maximized. On the other hand, if the ideologies are too different in that the persuasion that would be produced by an owner with one ideology greatly reduces the utility experienced by possible owners sharing the other ideology, then the owners of the two outlets will tend to be of the same ideology, a less diverse outcome.

If common ownership is now permitted and a merger then occurs, diversity is obviously reduced—the owner of one ideology controls both media outlets. In that case, the paper assesses the extent to which the common ownership may increase or decrease the amount of ideological content, i.e., persuasion. In particular, the paper demonstrates that a merger will unambiguously increase the amount of persuasion output, thereby reinforcing what the authors refer to as a "dominant" ideology. But the paper also suggests that in fact, if mergers are permitted, it may still be true that an owner of an opposing ideology will win the bidding contest for one of the outlets. Echoing the result in the previous paragraph, the increase in the amount of persuasion associated with one ideology that would follow from the merger could so reduce the utility of would-be owners sharing the other ideology that they outbid the incumbent media owner for the second outlet.

This paper formally goes where few economists have gone before, which makes the paper interesting reading even in this incomplete stage. While there is a fair amount of mathematical

modeling in the paper, the authors go out of their way to provide the intuition behind their results—and they do a very good job.

But where one (which is to say, I) might take issue with the paper is the idea that the results at this stage of model development could be of use to the FCC in formulating its ownership policy. Among the problematic issues are the following.

First, there are the questions summarized at the beginning of this note. How do you measure differences in ideology? How do you measure the value that an owner would place on using the outlet as a bully pulpit? How do you decide what is a “dominant” ideology? If there are in fact numerous media outlets in a market, some of which are commonly owned and some of which are not, how does one decide that a merger would result in a significant reduction in diversity? Has the dramatic growth in the Internet rendered all of these concerns moot? (Not according to the Third Circuit.)

Second, the results assume that consumers don’t like “persuasion.” The authors note that even if consumers instead “like” persuasion (i.e., they are willing to pay for ideologically tilted programming), then the paper’s results regarding the amount of persuasion would still hold—the non-profit-maximizing owners would produce more persuasion than would otherwise be the case. Yet, given that consumers demand this kind of programming (and that profit-maximizing firms are responding to that demand), the additional amount of merger-induced persuasion may be quantitatively insignificant and therefore an unimportant merger motive.

Third, does an individual controlling a media outlet have the ability to engage in this kind of obvious non-profit-maximizing behavior? Most significant owners of the media are publicly owned. Even if there is a single controlling stockholder, its ability to pursue ideological goals with the other stockholders bearing the costs is likely limited by the threat of stockholder suits, among other possible deterrents.

But most importantly, inviting the FCC to become more active in mergers or programming decisions based on diversity/persuasion concerns can’t help but be disquieting. The history of the FCC is replete with examples of its using that rationale to adopt rules that harmed consumers (although many of those rules are no longer on the books). When television broadcasting was in its infancy, the FCC deliberately chose a model of spectrum allocation that all but guaranteed that individual viewers would have access to fewer VHF stations (the most powerful stations), all in the name of protecting localism. The FCC used a similar rationale to restrict the kinds of programs that nascent cable operators could offer their subscribers. And for years, FCC limits on the amount of prime time programming by television networks was undertaken in the name of advancing diversity. Put simply, the FCC’s use of the diversity goal has historically had the effect of harming consumers, not advancing their interests.

In short, this paper is certainly worth the read because of the unexplored territory (for economists) that it examines. But its implications for media ownership policy need to be more carefully considered by the authors as they refine the paper. ●

—JRW