

The Role of Innovation in Competitive Analysis

The Chair's Showcase Program, ABA Section of Antitrust Law Spring Meeting (March 31, 2005)¹

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(Photo not available)*

RICH WALLIS: This program focuses on antitrust and intellectual property (IP)—where the rules intersect, where they diverge, and perhaps where the two disciplines lead to head-on collisions. We will discuss how to manage the “traffic” inherent in these two systems in an efficiency-enhancing manner to promote innovation and yet allow full and fair competition on the merits. This traffic management is a work in progress. The program will focus on the many ways the IP/antitrust interface manifests itself in our practices and in the real world.

We are very fortunate to have a highly talented and diverse panel to tackle the issues. We will explore the IP/antitrust interface, the role of innovation in merger analysis, standard setting, patent settlements in the pharmaceutical industry, and special issues relating to IP licensing.

Our panelists are: Carl Shapiro, the Transamerica Professor of Business Strategy at the Haas School of Business at the University of California at Berkeley. Carl is a Professor of Economics and the Director of the Institute of Business and Economic Research and a Senior Consultant at Charles River Associates. He is a frequent speaker and writer on IP licensing and standards issues and has testified in a number of cases, some of which we will talk about today. Next is Peter Plompen, Senior Vice President and the Competition Counsel for Royal Phillips Electronics of The Netherlands. Peter has broad antitrust experience in consumer electronics, semi-conductors, telecom, IP licensing, and standards organizations. Panelist Debra Valentine is Vice President,

¹ This program has been edited for publication.

Secretary to the Board of Directors, and Assistant General Counsel for United Technologies. She was previously a Partner and Co-Chair of O'Melveny & Myers' antitrust practice group. She had a highly regarded tenure as General Counsel of the Federal Trade Commission and currently serves as a Commissioner for the Antitrust Modernization Commission. Kent Bernard is Assistant General Counsel for Pfizer Inc. He has the lead responsibility at Pfizer for antitrust and competition issues worldwide, and has a huge job of helping to steer corporate, M&A, licensing, and litigation teams on their respective issues. Finally, we have Tim Muris, a long-time friend of and contributor to the Section. Tim has a distinguished record in public service, including a four-year term as Chairman of the Federal Trade Commission. Tim received uniform bipartisan praise for his work at the Commission. Tim is currently Co-Chair of the antitrust and competition practice group at O'Melveny & Myers.

We'll begin our discussion with the IP and antitrust interface. I'll start with Carl. It's been ten years since the IP Guidelines² were promulgated, and I would like your views on whether those Guidelines struck the right balance. Do those Guidelines reflect current practice at the agencies? Do they reflect current case law? And what has been the experience under the Guidelines?

CARL SHAPIRO: It was April 6, 1995, almost exactly ten years ago, when the IP Guidelines were issued. These Guidelines relate to the licensing of intellectual property. I liked them ten years ago and I still like them today. In fact, there are some principles articulated in the Guidelines that have become so accepted we don't even talk about them anymore, namely: (1) IP is comparable to other forms of property; (2) there is no presumption that intellectual property creates market power in the antitrust context; and (3) the licensing of IP is generally procompetitive and allows firms to combine complementary assets in ways that serve consumers. So we have a good, solid set of principles, including the principle that an owner of an intellectual property is not required to create competition in the use of his or her own property. Again, we rarely even talk about these things anymore because of the consensus that has grown around those principles.

Probably the key element that has generated the most controversy and will continue to do so is the benchmark that is used for evaluating licensing. The Guidelines say antitrust concerns may arise when a licensing arrangement harms competition among entities that would have been actual or likely potential competitors in a relevant market in the absence of the license. So we compare competition given the license between the parties to competition as if there had been no license. Typically, that does not mean picking away, looking at less restrictive alternatives, and analyzing particular restrictions in the license. And that's a very important principle. I don't think the Europeans see it the same way, and I hope we'll have more discussion on that.

If I had to give some criticisms, they would be muted in comparison with my general view that the Guidelines have held up very well. For instance, the innovation market concept that's in the Guidelines does not appear to have been particularly successful in practice—a subject we're going to talk about later. There's nothing in there that says explicitly that the owner of intellectual property is not required to license that property to others, even if a refusal to license will lead to a monopoly. I think Hew Pate, currently the Assistant Attorney General for Antitrust,³ would probably like it if such a statement were included in the Guidelines. That omission has caused some

² U.S. Dep't of Justice & Federal Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property (1995), available at <http://www.usdoj.gov/atr/public/guidelines/ipguide.htm>.

³ *Ed. Note:* R. Hewitt Pate resigned as AAG for Antitrust effective June 30, 2005.

lack of clarity. In addition, and this is not really much of a criticism if you think about conditions ten years ago, but the Guidelines show no real recognition that there are a lot of patents that, as the Federal Trade Commission and many scholars have found, are weak and questionable. The question of how patent weakness affects licensing has become very important. Indeed, this question is key in some of the more current hot topics, such as patent settlements—topics that would have been hard to anticipate ten years ago. Overall, I think that the agencies have followed the Guidelines; I would be curious to hear what the other panelists have to say about that.

Generally, yes, the Guidelines have imposed some discipline at the agencies. However, the case in which I personally felt they departed was the FTC case against Intel back in 1998 or so, in which I did work on behalf of Intel. In that case, I believe that Intel's cross-licensing practices clearly did promote competition in comparison with the lack of such licenses, yet the FTC challenged those licenses. Other people will have their own examples.

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—DEBRA VALENTINE

RICH WALLIS: Tim, reactions? Do you feel as if the Guidelines initially struck the right balance, and are they in the right place now?

TIM MURIS: I think the Guidelines were a very important and sound development. Let me report what the FTC and Justice Department learned about the Guidelines at the hearings that we held on intellectual property. There was very little criticism of the Guidelines, a fact that I think reflects their sound nature. There was concern, however, about issues that were not covered. There was a request for guidance on standards setting and a few additional licensing issues. For industries such as semi-conductors and software, for example, cross-licensing is crucial, given the enormous number of patents that exist. There are some additional issues. We're going to have more to say about the standards and other issues later in this panel. When I left the FTC, the agencies were working on a second IP report, in addition to the one that Carl mentioned that the FTC issued about patents.⁴ A lot of good work has been done there, and I hope they finish that project.

RICH WALLIS: Debra, any thoughts on this?

DEBRA VALENTINE: I think what's interesting is the consistency that you're hearing among the panelists that the Guidelines' three major principles—(1) IP is like other property; (2) licensing is pro-competitive; and (3) patents don't necessarily confer market power—are correct. I agree that the Guidelines got it right.

What's equally interesting is that in many ways the case law hasn't caught up with the Guidelines. There remain cases from the 1980s, such as *SCM v. Xerox*⁵ in the Second Circuit, which held that the patent laws precluded imposing antitrust liability on Xerox for acquiring multiple patents because a relevant market embodying the patented inventions had not yet emerged. In contrast, the Guidelines talk about technology markets and innovation markets where patents can convey market power depending on the facts involved. And while the Guidelines don't apply to merger analysis, certainly the cases that the FTC has been bringing in the pharmaceutical area are not in alignment with the old concept that you can't have a legal violation when there is not yet

⁴ TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW POLICY, A REPORT BY THE FEDERAL TRADE COMM'N (Oct. 2003), available at <http://www.ftc.gov/os/2003/10/innovationrpt.pdf>.

⁵ *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195 (2d Cir. 1981).

a product embodying the technology on the market. Further, one of the issues that we've all agreed on—that IP does not necessarily confer market power, but that it all depends on the context—is something with which the courts still haven't caught up. An example is the recent decision from the Court of Appeals for the Federal Circuit in *Independent Ink*,⁶ which involved the tying of patented ink jet printing systems to the ink, and reflexively accepted that the patented printing systems conferred market power. The decision reads as if the court is begging the Supreme Court to look at this issue of market power in much the same way that Judge Posner begged the Supreme Court to look at maximum resale price maintenance in his *Khan* decision.⁷ To a Guidelines' follower, it is quite extraordinary that we continue to see case law holding that patents automatically confer market power.

One last interesting point is that there are slight differences in the way that the agencies, the federal courts, and the Court of Appeals for the Federal Circuit (CAFC) are developing IP/antitrust principles. For example, in the *CSU v. Xerox*⁸ case—where the government filed a brief after CSU had petitioned for certiorari—one observes the federal agencies resisting the three little rigid categories that the CAFC postulated as the only situations in which an IP holder might have to license. Another example is the recent *Telecom Technical v. Rolm Co.*⁹ case, where the Eleventh Circuit makes clear that the CAFC's *CSU v. Xerox* case is neither binding nor preemptive, but is merely persuasive. So we may be seeing some divergences and disagreements in the courts over the next couple of years.

RICH WALLIS: Peter, let's turn to the EU. We've been talking about U.S. Guidelines for IP, and the EU has its block exemption rules. How do they work and do they differ materially from the U.S. IP Guidelines? What do U.S. practitioners advising clients with European businesses need to know about the block exemption?

PETER PLOMPEN: Any system of law enforcement, and especially one involving intellectual property and antitrust, should be seen against the background of the general regulatory structure in which it is being enforced. Europe, as you may know, is not a federal state, but rather a cooperative effort among many European countries. The European Union's competition laws are virtually the only laws that are more or less federal in nature. This has increasingly been true since the modernization effort that took place last year. It is now well-established that European competition law must be taken in account when applying national competition laws of the individual Member States, perhaps even more than individual states in the United States must take federal antitrust laws into account. European law is applicable in Europe where there is an effect on interstate trade within the European Union. Europe is indeed about integration of the economies of all countries belonging to the European Union, and as a consequence, the integration goal is still one of the goals of European competition law. This still has consequences in the application of competition law. Another important factor, different from the U.S., is that in Europe, patents are still national, and not continental. These factors explain why, for instance, in the area of intellectual

⁶ *Indep. Ink, Inc. v. Illinois Tool Works, Inc.*, 396 F.3d 1342 (Fed. Cir. 2005), cert. granted, 125 S.Ct. 2937 (2005).

⁷ *Khan v. State Oil Co.*, 93 F.3d 1358 (7th Cir. 1996), vacated, 522 U.S. 3 (1997).

⁸ *In re Indep. Serv. Orgs. Antitrust Litig.*, 203 F.3d 1322 (Fed. Cir. 2000), cert. denied sub nom. *CSU, L.L.C. v. Xerox Corp.*, 531 U.S. 1143 (2001).

⁹ *Telecom Tech. Servs. Inc. v. Rolm Co.*, 388 F.3d 820 (11th Cir. 2004).

property, enforcement activities have always been very much focused on combating licensing conditions that would re-erect barriers to intra-European trade. That explains, perhaps, the stronger focus on intra-technology restrictions in comparison to the situation in the U.S.

The new block exemption regulation on transfer of technology (the TTBER) came about in April 2004.¹⁰ In certain ways, it is an enormous improvement over the older regime, but in other ways it is not. It is an improvement in that it now clearly sets forth a limited list of specific contractual provisions referred to as “hardcore restrictions,” the presence of which in an agreement will cause that agreement to fall outside of the protections of the TTBER. Another improvement is that agreements that fall outside of the TTBER may still be covered by an exemption under Article 81(3) of the European Treaty as long as there is no clear situation of “abuse of dominant position.” However, the market share thresholds for the application of the TTBER are problematic in the context of intellectual property and intellectual property licensing, given that parties will be deemed to exceed these thresholds and thereby fall outside the protections of the TTBER. Parties falling within the TTBER are free from harassment in any court in Europe and by any competition authority in Europe. In addition, the new Transfer of Technology Guidelines (the TTG) have a modern economic approach to topics not covered by the TTBER, like patent pools and settlements. Although present, this modern economic approach is not reflected to the same level in the 2000/2001 Guidelines of the Commission relating to vertical and horizontal agreements.

DEBRA VALENTINE: I would like to make one quick comment to put Peter’s observation in context within U.S. law. Much like the Vertical Restraint Guidelines the EC released a while ago, these EU Technology Transfer Guidelines move very far toward a U.S.-like rule of reason, grounded in pro- and anticompetitive balancing, and an economically based approach—a very good move in general. Peter is right that once licensing agreements fall outside the 20 percent safe harbor for competitors, or the 30 percent safe harbor for (vertically related) noncompetitors, you have to worry. But the critical point here is that the agreement is not condemned; instead, the analysis progresses to a balancing test as to whether the procompetitive effects outweigh the anticompetitive effects. Finally, one last interesting provision is the safe harbor for all technology markets involving four or more independently controlled technologies. These guidelines sound very similar to those of the U.S., and have moved a long way.

CARL SHAPIRO: Let me focus on where I think there’s a real difference between the U.S. and EU. Take a field-of-use or a customer-type restriction. Suppose that I have a great patent that I want to license and I have decided to issue a license to Debra that is only for a certain country or only for a certain type of product using my technology. Now in the U.S., at least under our IP Guidelines, I am clearly adding to competition. Debra would not be allowed to compete without this license so there shouldn’t be an issue there. But as I understand the EU Guidelines regarding this restraint, to justify such a restraint—let’s say a territorial restraint—it has to be objectively necessary for the existence of the agreement of this type. Evidently, it is not going to be enough for my documents to say “I really need this restriction in order to make this license work for me as a business matter.” Instead, it seems that the EU will need to be convinced that in this general type of situation (using some comparison set), licenses will not be achieved without these types of

¹⁰ Guidelines on the Application of Article 81 of the EC Treaty to Technology Transfer Agreements, 2004 O.J. (C 101) 2, available at http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_123/l_12320040427en00110017.pdf.

restrictions. That's quite a hurdle as well as a business risk for the patent holder. Am I getting it right? And how do you justify that? Or maybe the European Commission wants to force me to create competition in the use of my own technology? Is that a different principle?

PETER PLOMPEN: Well, the Guidelines are very difficult to read.

Field of use restrictions are normally covered by the TTBER, even if reciprocal between competitors, as long as the restrictions are not a sham cartel as defined by the TTBER. ("Reciprocal license" is European parlance meaning "a license agreement between two parties which cross-license competing technologies.") Only if the cross-license is exclusive or sole, meaning that each licensor is also limited in the exploitation of its own licensed-out technology and not only as to the licensed-in technology, reciprocal fields of use are "hard core" and outside the TTBER. If, on the other hand, there is a field of use restriction in a unilateral licensor/licensee relationship (even if exclusive) or a nonexclusive cross-licensing situation (even if reciprocal), then normally there wouldn't be a problem at all and that arrangement would be covered by the TTBER. Only agreements outside the TTBER require an individual assessment of the license, and a showing that the restriction concerned does not have sufficient negative effects to outweigh the procompetitive effects. In that context, it is important that the Guidelines specifically recognize that anticompetitive effects can only occur regarding competition that would have existed in the absence of the agreement including the restraints concerned. So from our perspective at least, the final outcome of the discussions with respect to field of use was very positive because you're quite right that in earlier drafts of the TTBER, most field of use restrictions fell outside the block exemption.

RICH WALLIS: The complicating issue is that while there is some convergence on Guidelines, the lack of convergence on patent policy creates special problems.

PETER PLOMPEN: Perhaps I can explain that also. In the European Treaty, there is a rule that says there is free circulation of goods within Europe. There is an exemption for patent or IP situations, but through the impact of competition law, there has been a modification of that in the sense that you can only invoke your national intellectual property right against a licensee in another country who is directly putting products in your country's market. If a product has been patented in one country within Europe, as soon as a licensee in another country within Europe has put that product on the market in another European country, the latter country's laws cannot be used anymore to stop the circulation of goods in the country in which the product was patented. Furthermore, because there still is no Europe-wide patent, but only national licenses that could run counter to the economic integration goal of European competition law, there are special rules in European competition law with respect to passive and active imports in other countries by licensees. That's still a typical European situation, although within the Guidelines, there is also a modification: the Commission acknowledges that the European market, to a vast extent, has already been integrated and therefore the consequence of these territorial restrictions on competition may be less than they have been in the past.

RICH WALLIS: Let's shift the discussion to patent pools. Peter, your company was one of the first, if not the first, to create a number of patent pools. How does one deal with the differences between the U.S. and EU models in the treatment of global patent pools, particularly in the way they distinguish between insiders and outsiders. My understanding is that under the EU Guidelines, the treatment of licensees does not depend on whether they are licensors or not. But in the U.S., the

district courts have ruled that differential treatment based on status as a licensor is permissible.

PETER PLOMPEN: Patent pools are the subject of a special chapter in the new TTG, and that is a big benefit because in the past we only had to work on the basis of so-called “comfort letters” in Europe, which were informal messages from the Commission to the parties involved about the way the Commission intended to enforce competition law with respect to a certain project. More often than not, third parties did not have access to the contents of those “comfort letters,” and only saw a summary of the notification of a certain plan to the Commission without any changes made to allow the Commission to issue its comfort letter. This was quite different from the business review letters which have been given in the U.S. where you have a clear exposé of the relevant facts and the reasoning of the authorities involved.

Patent pools are the subject of a special chapter in the new TTG, and that is a big benefit because in the past we only had to work on the basis of so-called “comfort letters” in Europe . . .

Recently, as I already mentioned, a special chapter regarding patent pools has been inserted in the new Guidelines. The way that it is being done, to a large extent, is in conformity with the business review letters over here. Generally speaking, I would say that the rules in Europe and the U.S. are more or less similar with respect to the specific point that you mentioned—the insider/outsider question. I get the feeling that perhaps also this issue originates in the cloudy text of the Guidelines. The TTG explain that if a patent pool includes nonessential patents, the Commission would take into account certain factors when assessing whether such a pool should be allowed or prohibited. One of those factors is whether or not the licensors themselves are also subject to royalty obligations, so that there is not a sort of inner circle of people that does not pay and a circle of outsiders that has to pay. This factor is mentioned only in discussing the situation where the patent pool has a dominant position on the market. I cannot imagine, in view of other language in the Guidelines, that this is meant to exclude cross-licensing agreements as a basis for patent pools. Cross-licensing agreements are recognized in other parts of the Guidelines as sufficient and acceptable in order to allow design freedom to the parties involved. So I would think in Europe the situation is similar to that in the U.S., where one could also act against sham cross-licensing agreements. If there is a real cross-licensing agreement with a real balancing of the interests, I don’t think that there is a different situation in Europe than in the U.S.

—PETER PLOMPEN

RICH WALLIS: That’s a helpful clarification. Tim, let’s talk about the role of innovation in merger analysis and start with a very broad question to you, and maybe get Kent’s view on it as well. What impact should innovation and innovation markets have on the analysis of a merger?

TIM MURIS: One would think that we ought to care about diminution in competition in any dimension where it occurs—and that includes innovation. But with innovation we have to proceed very cautiously. Unlike product markets, the relevant economic literature doesn’t point to a clear resolution. Let me read a conclusion that I think is relevant today from the FTC’s 1996 global competition report on which Debra worked: “economic theory and empirical investigations have not established a general causal relationship between innovation and competition.”¹¹ In fact, the strongest conclusion that they could reach was “[n]o witness maintained that a merger of the only two firms developing a totally new product could *never* have any anticompetitive effects on innovation.”¹² This certainly is a weaker conclusion than we would make on product markets.

¹¹ ANTICIPATING THE 21ST CENTURY: COMPETITION POLICY IN THE NEW HIGH-TECH, GLOBAL MARKETPLACE, A REPORT OF THE FEDERAL TRADE COMM’N STAFF 16 (May 1996), available at http://www.ftc.gov/opp/global/report/gc_v1.pdf [FTC Staff Report]

¹² *Id.* at 16 n.51.

DEBRA VALENTINE: There are also portions of that report that note that virtually all of the business people maintained that competition did drive them to innovate—that they really wanted to be first to market. But I accept your point.

TIM MURIS: My conduct as Chairman indicated that in certain areas there are problems in innovation. That's why we paid attention to pharmaceuticals. Important innovation exists, which I think supports your point. But it also supports the point that there's not a big role for antitrust, in that many innovation situations, probably most, have several players and there is easy entry. Those are cases to which antitrust shouldn't and doesn't pay a lot of attention. In the new drug approval process, however, you have decided differences. There are entry impediments, and in the late stages you often have just a few players. That's the one area that antitrust has focused on, and there it seems highly appropriate to consider reductions in the number of competitors. I don't think you can generalize from that area, however. Finally, even though I think the drug approval area is perfectly appropriate for government intervention, and even though I personally think that the FTC has been appropriately cautious, I understand that the Regulated might have a less sanguine view than the Regulators.

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—KENT BERNARD

RICH WALLIS: Kent, I know you have some passion about this issue.

KENT BERNARD: Speaking on behalf of the oppressed minority, our view (my view) of innovation market analysis is that it doesn't deal with innovation, it doesn't deal with markets, and it's never been really useful. If you look at the history of this, innovation markets were created out of a case from 1993, involving truck transmissions in which you didn't need innovation markets at all to get the conclusion.¹³ The conclusion was the merger of two companies, the only two companies in the world that made these heavy duty truck transmissions, where it cost a lot of money to get the tooling made and everything else was a problem. You don't need any sophisticated analysis for that one.

If there's a market for innovation—and you can read *SCM v. Xerox* as saying that there really shouldn't be for antitrust purposes—it's a little hard to see how you can monopolize it. I mean, with all due respect to my colleagues, unless I go out and hire all the scientists in the world, I don't know how I'm going to monopolize the market for scientific research. I can hire 50 of the best cancer specialists in the world, but there are 500 more that are going to work for somebody else.

So once you get to innovation market analysis, you try to say “where are we?” When you look at it, you see that the supposed “analysis” is completely off the scale in terms of any other market analysis that is done. For example, normally you would look to see how long it will be until a product comes to market—one year, perhaps two years. If you look at what they've done in the pharmaceutical industry, they've gone back 7 or 10 years before a compound would ever be on a market, if indeed it ever got there at all (the attrition rate is very high). We're getting predictions as to what will happen in seven years with \$400 million of research. Based on that, on day one we're saying you have to divest this or some other project will or won't happen. It assumes that you have a better crystal ball than any of the researchers doing the work. That's a little odd. But on “innovation markets,” you're really going back a heck of a ways.

¹³ *United States v. General Motors Corp.*, Civ. No. 93-530 (D. Del. filed Nov. 16, 1993) DOJ Case 4027, 6 Trade Reg. Rep. (CCH) ¶ 45,093.

TIM MURIS: The FTC has studied this industry as much as any. Even in Phase 1 of clinical trials on average there is a quarter probability a drug is going to succeed. Thus, if you have two people pursuing different approaches to a particular problem and you ignore it, in one out of four cases, if it's a 2 to 1, you will have eliminated competition. Given the entry impediments in the FDA process and given small numbers, there is perfect sense in FTC intervention.

KENT BERNARD: I think that Tim's percentages are high, but the problem there is that you define the rabbit into the hat. What we see is the approach to the problem, which gets defined very, very narrowly, so that, instead of saying there are ten different ways you can treat this medical condition, and there are many people and companies working on it, they say, "No, we will define each way as a market for innovation purposes." At which point you have put the rabbit into the hat. You've said, "Well, there are only going to be these three people playing in this field," when the answer is, if in fact this ever works (and one of the reasons you see that much attrition and you see few players is that it's a high risk "generally-you-fail" proposition—the odds in Phases I and II are not favorable at all). And then you go on to say, "Okay, it's only you and somebody else, and furthermore we think this one approach will succeed, and furthermore if it succeeds, patients would be better served having two people competing here." You know, there are a lot of "and ifs" that go into that. We normally don't have the government deciding which independent research initiatives will succeed or fail.

[I]f you look at what happens with successful drugs, it's very hard to find a better example of where you have significant downward-sloping demand that justifies very narrow product markets.

TIM MURIS: Sure. But the question you're raising in an antitrust sense is whether it is appropriate to define markets narrowly. Again, if you look at what happens with successful drugs, it's very hard to find a better example of where you have significant downward-sloping demand that justifies very narrow product markets.

KENT BERNARD: With all due respect, no.

TIM MURIS: But look at what happens when a generic enters.

—TIM MURIS

KENT BERNARD: That's a whole other question, and we'll get to it in a moment. If you're dealing for the moment with somebody who is competing in the field of hypertension, which is a nice broad field, there are about ten different ways to attack that. Once you have products on the market, you can then say, "Okay, these groups compete primarily with these—beta blockers with beta blockers, diuretics with diuretics"—but to say at the start that there is only one way we're going to look at treating hypertension is a little odd.

RICH WALLIS: Tim, you will have the last word on this one.

TIM MURIS: One of the nice things from your perspective is obviously the courts get the last word and we'll talk about that later. I would be surprised—in fact I would be shocked—if there weren't FTC innovation cases in which I might have come out differently. Obviously, there are many close calls in these cases. The reason I made the point about generics is because when a generic enters, the price plummets, which is very strong proof that other drugs, even though they're substitutes, don't have the kind of constraining effect that we would like them to have. Therefore, I think it's appropriate to worry in small number cases the way the government has.

RICH WALLIS: Carl and Debra, I would like your views on that. To what extent do the agencies factor in innovation as part of the analysis of dealing with high market shares? Is it enough that markets are evolving rapidly so that traditional concentration measures are less important?

DEBRA VALENTINE: Let me address that more broadly than just innovation markets. Obviously, parties often come to the agencies and say, “Look, change is happening so rapidly in this market that you shouldn’t worry about this merger.” And it’s very, very true that the agencies and the Guidelines themselves take innovation into account in myriad ways in defining product markets. One can look at whether a buyer shifts purchases based on features like product quality or product features that are important competitive variables in a market undergoing a lot of innovation. The *General Dynamics*¹⁴ principles are captured in Section 1.52 of the Guidelines, pursuant to which the agencies consider whether reasonably predictable or ongoing changes in the market conditions should affect how to interpret market concentration and market share data.

I agree that Debra is posing the key question: “Are there predictable effects in future goods markets.”

—CARL SHAPIRO

I think there are lots of ways that the agencies think about innovation. But at the end of the day you always return to the simple question: “Given what the facts are, given what we know, what is reasonably predictable, what is the reasonably foreseeable effect of this transaction on competition?” It is really a question of reasonable foreseeability. Thus, if an innovation is on the very near horizon and is going to displace and disrupt the relevant market within two years, there’s not a very solid basis for enforcement action in that case. On the other hand, if a party simply claims that there is a brilliant Schumpeterian theory of innovation, demonstrating that all market power will be eroded over time, that’s not a reasonable basis for allowing a merger in a highly concentrated market where no likely entry exists within the foreseeable future. Michael Porter said something very thoughtful in this respect—if one simply relies on Schumpeterian theory then one will dramatically underestimate the time between monopoly displacing occurrences, even in high-tech markets. I think that’s true, and I think you’ve got to be alert to that. On the other hand, if a market is very dynamic, an agency should require increasing certainty as to likely anticompetitive effects before intervening. If you’re uncertain, that’s an appropriate time to hold your hand. The one exception to that would be a tipping market, in which case an agency may well want to intervene early.

CARL SHAPIRO: Instead of focusing on the buzz word of “innovation markets,” I would like to bring the discussion back to potential competition. I think the part we can agree on ultimately is that we care about what’s going to happen in real markets where products are sold. To some extent the innovation market concept is kind of a sleight of hand: We’ll say there’s a market now because people are spending money on R&D, and then if we have concentration there, then the government has a case. Obviously, this is going to make it easier for the government to bring cases. But I agree that Debra is posing the key question: “Are there predictable effects in future goods markets.” Part of your comment asks: “Even if all the people pursuing this line of research were to merge would they have any power to slow down innovation or raise prices, given that they have to compete against other products?” That’s a fair question. But it may be hard to tell, if the future competition is years away and involves products whose attributes are not yet fully defined. It is not a coincidence these issues have come up in the FDA context where we tend to know who the players are years in advance. In many other sectors of the economy there is greater uncertainty

¹⁴ *United States v. Gen. Dynamics Corp.*, 415 U.S. 486 (1974).

about who is currently doing relevant R&D, the likely timing of those projects, or who is going to enter surprisingly from some other market. If we cannot accurately identify the most relevant current lines of innovation and say something about their likely timing and success, it is harder to build a strong case based on loss of innovation and subsequent loss of future product market competition as distinct from the loss of current and imminent product market competition.

RICH WALLIS: So what time horizon is appropriate, Carl?

CARL SHAPIRO: The easy answer is that the time horizon depends on the industry. If we are talking about a weapons system for the Defense Department, DOD is likely to say: "We plan to introduce this weapons system in eight to ten years, and we're trying to make sure that multiple contractors have the necessary capabilities over that time frame." The time horizon can be very long in this setting. In the pharmaceutical case, the horizon may be three to five years depending on which phase of the research process the players are in. More generally, the principle is that you should go as far out in time as the industry participants do in their own planning. If the government can't or won't look as far out as the industry does, the incentive then is for the players to consolidate, and reduce competition, when those effects are within the planning horizon of the companies but not the government.

DEBRA VALENTINE: I'm actually glad you mentioned the DOD. I believe that Kent is right where the activities involve pure innovation, R&D—where it's totally unpredictable what will develop. One might think there are two innovating firms, but there might be 200, and if two parties merged you wouldn't know who was left. In contrast, I think that in pharmaceuticals and defense, where you have government review, government oversight, and government involvement, the agencies know far more about who has capabilities and how many years are required before products are brought to market.

KENT BERNARD: Can I make one suggestion? We don't want to get any closer to government planning of innovation and you're coming awfully close to that when you're suggesting that five or seven years out you can predict which approaches will work. The only problem with looking at the planning cycle of the company is that if you know that you're looking at ten years from "eureka" to what you hope is the end of the product, you're going to plan and you're going to track early. The attrition rate is going to be phenomenal but you're going to do it.

I think the thing that's getting lost here, and it has to just by virtue of the size of the group, is that this analysis will differ depending upon the facts you're actually looking at. If you're looking at something where everybody knows what the condition is and how to cure it and only two people are working on the pill, then maybe you can do these kinds of things. But if you're looking at some of the emerging disease states—various cancers and things—nobody's quite sure how they happen, or how they work. You've got a lot of very informed speculation running around doing different things. That's when it becomes, in my view, dangerous from a competition regulation standpoint to decide five years out which approach is going to work and then make sure that we have various people pursuing that one narrow approach.

TIM MURIS: This is more than informed speculation. You can see in your company and other companies' documents who they think they are competing with, particularly in the later phases.

KENT BERNARD: Different issue. I'm not saying whom I compete with. I'm saying if my approach is to do X to kill cancer, that may not be the best approach to do it. I may think there are three other people doing that approach. I will also know there are seven other people doing these other approaches and they may be right and we may be wrong.

CARL SHAPIRO Ultimately down the road that may be true in some situations. Clearly, it is a relevant issue, depending upon the fact pattern in a given case. For example, consider Phase 3: my understanding is that drugs in Phase 3 have a 70 percent probability of being successfully introduced. I have seen company documents that essentially say, "We're in a race with Company X." If two companies that are racing in Phase 3 seek to merge, I would certainly hope and expect that the government would look at that very carefully. I think you will have to show, using documents from the ordinary course of business, or some other convincing evidence, that within some relevant time period that the government would worry about, that these other seven approaches are going to be relevant. In the Phase 3 case I think that's highly unlikely to be true.

KENT BERNARD: Let me give you the contrary view to that since I'm surrounded by FTC people—or people who at some point in their life were FTC people. And that is this: You're saying that you will know what's going on, where they are coming down to. In fact, in many cases, you will be there saying "I've got a concept," or "I'm putting something in it," but you're working on a slightly different concept toward the same thing. I would just make the point (and then I'll let you explain *Genzyme*¹⁵) that there are times when combining the research programs in fact leads to more resources being put behind them. That's because, if you've got one compound (and I'm going to get fact specific here but not refer to a particular Pfizer compound) and that compound's very effective, but very toxic, in a particular approach, and you've got another compound that is less effective, but less toxic, then if I combine those two research programs, I may find a way around the toxicity problem for mine or a way around the effectiveness of this problem for yours, which I would not have had any chance of finding if you're independent and I'm independent. Combining them may lead to a product which can actually help cure cancer rather than end up with two programs, neither of which will accomplish the goal. That's the only point I was making.

RICH WALLIS: That leads me to the final question in the area, Tim, and it's for you. Are there times that you see a reduction in R&D as an efficiency rather than a competitive effect? If so, in what circumstances do you see that happening?

TIM MURIS: Again, there's no theoretical or empirical consensus on when a reduction in the number of innovators makes a difference. Debra's report,¹⁶ which I've tried to defend, makes that point. A merger can lead to greater efficiency and innovation. Look at pharmaceuticals. The FTC's evidence—there's a caveat I'll get to—suggests that larger firms are more efficient and that larger firms are better at producing successful drugs. The caveat is that this evidence has been developed during a period of mergers, and it's impossible to exclude the explanation (although I think

¹⁵ FTC File No. 0210026, Closing of the Investigation of Genzyme Corp. Acquisition of Novazyme Pharm., Inc., available at <http://www.ftc.gov/opa/2004/01/genzyme>.

¹⁶ See FTC Staff Report, *supra* note 11.

it's probably not the right explanation) that firms are merging to improve their product pipeline. If that's true, then the successful drugs cause large firms and not vice versa. The nature of economic analysis is it's impossible to exclude that explanation. But I think the evidence points much more to the conclusion that large firms are better with innovation. I made this point in front of several senators once and got attacked for it, but there's no other industry where the reality of the good the pharmaceutical industry does for society is at such variance with the public's perception of the industry. Maybe people like to turn on winners, I don't know. Problems can exist, but a government monopsony as some have suggested in the Medicare program would be a disaster for future consumers and for the future health of America. Again, with the drug industry some competitive problems do exist.

RICH WALLIS: Let's shift the discussion to standard setting. Carl, you testified in the *Unocal* case. Can you describe the economic issues in *Rambus*¹⁷ and *Unocal*?¹⁸

CARL SHAPIRO: Let me just give a very quick précis of the *Unocal* case, which is right now awaiting a decision from the Administrative Law Judge. I testified on behalf of complaint counsel. The allegation is that Unocal willfully deceived the California Air Resources Board (CARB) back in the early '90s when they were setting the rules for reformulated gasoline. In particular, complaint counsel alleges that Unocal initially represented that its technology would be available on a nonproprietary basis and then later, after the regulations were in place, and Unocal received a number of patents covering its technology, Unocal sought significant royalties. Hundreds of millions of dollars are at stake, because in the intervening time, the refiners in California spent billions of dollars to invest and comply with these reformulated gasoline regulations.

So the economic issue in the case (there are many other interesting legal issues, including *Noerr Pennington* issues that I will not address) is one of opportunism. Suppose that a company participates in a standard-setting process, misleads others in that process, and then later attempts to enforce intellectual property rights that are essential for that standard. Does that company have market power? Is such behavior anticompetitive? The *Unocal* case, in fact, seems pretty straightforward to me if CARB and the other refiners really were deceived as claimed. There is no business justification for lying, no efficiency associated with deceptive conduct. Plus, refiners made these huge investments to comply with the regulations that clearly put Unocal in a much stronger bargaining position vis à vis the refiners. Therefore, Unocal could be expected to negotiate much higher royalties after the fact, leading ultimately to higher gas prices. Unocal argues that they did not engage in deceptive conduct; and they make a number of other arguments that I will not go into.

The key economic concept in the case involves opportunism, or lock-in as some would call it: initially CARB and the refiners have more flexibility in their choice of technology, but then a standard is set, investments are made, and it becomes much harder to reverse the earlier choice of technology. Therefore, a company that controls technology that is essential to the standard can have quite a lot of market power. If that enhanced market power is achieved through deception, it seems to me extremely hard to defend. If it is achieved through just being quiet, let's say participating in the standard-setting process and not saying anything, then there are questions about

¹⁷ Rambus Inc., FTC Docket No. 9302, available at <http://www.ftc.gov/os/adjpro/d9302>.

¹⁸ Union Oil Co. of Cal., FTC Docket No. 9305, available at <http://ftc.gov/os/adjpro/d9305>.

whether the company took on certain duties by being part of that process and questions about just what the standard-setting organization required in terms of disclosures.

There can be different views about what constitutes “fair, reasonable, and non-discriminatory” royalties. There can be disputes about exactly what participants are required to disclose. Those are some of the issues that came up in *Rambus* and will continue to come up. But the basic economics of opportunism—the shift that leads to a company having greatly enhanced power after the standard is in place, even if there had previously been many good choices for technology, is fundamental to all of these cases. Fortunately, there is a huge literature about opportunism, and the concept is quite well understood by economists. But we will have many different fact patterns in terms of what the challenged conduct was. Is it acceptable to simply participate and stay quiet and then later try to assert your patent? Is it acceptable not to disclose a patent application? Those are the sort of things where there are boundary lines and private standard-setting organizations have not necessarily been clear about exactly what they expect of their participants. That lack of clarity has led to patent disputes and antitrust disputes.

A standard-setting organization should be able to negotiate ex ante detailed provisions regarding licensing for any patented technology that does exist and is disclosed. Per se treatment of such provisions, which some people are afraid may exist, is completely inappropriate unless there's a sham.

—TIM MURIS

RICH WALLIS: Tim, a couple of follow-up questions and then you can talk as broadly on this area as you would like. The follow-ups: Does it make a difference whether specific disclosure is required? Secondly, do you have perspectives on what constitutes a reasonable and non-discriminatory price? How do you get comfortable if you're an agency, how do you get comfortable if you're a party, with what is reasonable and non-discriminatory?

TIM MURIS: Those are crucial questions. Even though I'm not technically under any obligations, I don't want to say any more about *Rambus* and *Unocal* than I said publicly while I was Chairman. There are complex theories in both cases, particularly in *Rambus*. The case involves an alleged disclosure requirement, and the complaint is extremely detailed. Even if you just glance at it, I think you understand that there are many facts that the complaint counsel will have to show to prove the complaint. *Unocal's* not quite so detailed, but it does have the additional complications of *Noerr*. The Commission spoke on those issues in an opinion I authored last summer.¹⁹ If the Commission overrules the ALJ and finds against *Unocal*, that issue is going to a circuit court and ultimately the Supreme Court.

On the second question that you raised, I think that's beyond those cases but it's extremely important. A standard-setting organization should be able to negotiate ex ante detailed provisions regarding licensing for any patented technology that does exist and is disclosed. Per se treatment of such provisions, which some people are afraid may exist, is completely inappropriate unless there's a sham. I hope that the second IP report that I mentioned addresses those issues. That would be a very important statement coming from the government.

PETER PLOMPEN: I just wanted to compare the situation in Europe. In Europe, in the new Guidelines for transfer of technology licensing, there is a specific chapter on patent pooling but there is no specific rule with respect to the situation that you described in *Unocal*. The Commission has only limited experience in this area. Whenever you have participated in a standardization process, there was probably going to be a debate about whether excluding companies from the talks, or

¹⁹ Union Oil Co. of Cal., FTC Docket No. 9305, Opinion of the Commission (Muris, Ch.) (July 7, 2004), available at <http://www.ftc.gov/os/adjpro/d9305/040706commissionopinion.pdf>.

discussing licensing conditions was in itself anticompetitive or not. In the end, the only way to receive a reliable answer was to prompt the Commission to intervene on the basis of competition law, which of course was not always an attractive alternative.

In the area of pools related to standards as such, it would be good if there were an advance agreement on the royalty to be set by the pool. But it is sometimes very difficult to do that because when setting a standard, often the patent rights involved are not yet granted. They are often only patent applications and may only be granted some years later. The other thing is that the TTG provide for a more favorable treatment for patent pools including only so-called essential patents, or only a minority of non-essential patents. The question whether a patented technology is essential or not is also often highly debated. We have had discussions in Europe and in Taiwan about this issue, but it's very difficult in that it also has to do with the availability of alternatives for certain choices that you are making or have made in the standardization process. I would submit that it is important that competition law enforcers focus on the essentiality criteria used for including patents in a pool when setting up the pool and do not intervene ex post when new alternatives for historic choices may have come up.

Second, when you are debating royalties, at least in Europe at the moment, the rule is that you should only have those discussions with licensors and not licensees. And if I recall correctly, in the recent business review letter here in the U.S. with respect to the 3G patent pool²⁰ and also in Europe, the system that has been set up is explicitly such that the combination of licensors and licensees can talk about the general licensing structure, but not as such on the royalties to be set for some of the pool licenses. The royalties are set only by the licensors.

DEBRA VALENTINE: I wanted to throw one more element into the mix. I want us to return to *Dell*,²¹ which was a bellwether in establishing the proposition that a misleading non-disclosure of patents to a standard-setting organization can undermine that patent holder's ability to enforce those patents and could violate the antitrust laws. (And that is a subject you could speak more easily about, Tim.) What you had in *Dell* was as follows: each participant in VESA (the Video Electronic Standard Association) was asked to sign a statement that the proposed standard for the VL-bus did not rely upon any patents that that particular firm held. Dell did not state that the standard read or relied on its patents. Consequently, the FTC (not a court) found that Dell's misleading failure to disclose its patent interests led to liability.

Now, the thing I want to add to the mix here is if we're talking about this kind of behavior as essentially monopolization, we're not talking about profit sacrifice. This isn't costing anybody anything. And I think it's very important to think about, especially for those who might be arguing that profit sacrifice should always be the standard in terms of how we think about exclusionary conduct and monopolies. There's a lot of cheap exclusion. It could be fraud on the patent office, which doesn't cost much, or putting a torch to your competitor's factory, or lying in your standard-setting organization, when there is a duty to disclose. As Carl said, there is generally no legitimate business reason not to disclose, and it's very cheap not to do so. I think that's a problem. I think it probably should be an antitrust violation.

²⁰ Business Review Letter from Assistant Attorney General Charles A. James to Ky P. Ewing, Jr. (Nov. 12, 2002), available at <http://www.usdoj.gov/atr/public/busreview/200455.pdf>.

²¹ See Press Release, FTC (June 17, 1996), available at <http://ftc.gov/opa/1996/06/dell2>.

CARL SHAPIRO: Let me pose these questions from a counseling perspective. Many of you probably work with companies that are participating in standard-setting organizations and which are trying to decide whether to put their weight behind a particular technology. Such companies do not want to find out in two years that another industry participant is coming after them for exorbitant royalties, alleging that they are engaging in patent infringement by complying with the standard. So industry participants have a great desire to know not just that any patents will be licensed on fair, reasonable, and non-discriminatory terms, but also what those nice-sounding words actually mean for a particular technology or patent. Does it mean royalty free? Does it mean 1 percent of revenues? If so, what will be the basis on which revenues are measured? I always advise industry participants who will be licensees to nail down these terms and conditions as best as they can at an early stage, before the standard is set and their bargaining power erodes.

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organizations.

The other related problem is that participants who have intellectual property rights may not disclose them, in part because they would rather negotiate later when their bargaining power is greater. Many standard-setting organizations require disclosure of relevant patents, but the treatment of pending patents varies a great deal across organizations. Indeed, Debra, some participants ask why they should have to disclose patent applications, since under the patent laws most patent applications are not disclosed until 18 months after the application is filed.

I said earlier that lying is hard to defend. But as to non-disclosure, people argue that there are costs to requiring disclosure of pending patents. And I think the standard-setting organizations and individual companies have to design the rules under which they want to operate. I don't see why one size fits all when it comes to rules governing standard-setting organizations. One standard-setting organization may say it's going to require either disclosure of pending patents or a commitment to offer them royalty-free. Under the disclosure requirement, suppose that I say: "I have a pending patent, but the patent application itself is confidential and I am not going to show it to you or describe it to you." At least the other participants in the standard-setting process are on notice, and they might say, "Well you better tell me or I am not going to support this particular specification, because I am not prepared to leave myself at your mercy."

—CARL SHAPIRO

RICH WALLIS: Does anyone have any concerns if a standard-setting organization demands that participants agree to reasonable license fees to have the patents included in the standard? Is everybody comfortable with that approach?

TIM MURIS: To the extent people are concerned about antitrust laws, they shouldn't be; again, with the exception of some sort of sham problem. Obviously, you can have problems with standard-setting organizations. A problem we addressed when I was at the FTC in the '80s, was about the standard being set up purposely to exclude—for example, where the standard has a particular benefit like in a building code and it excludes plastic pipe. That's a different issue and a different problem; but with those caveats I don't have any problem.

RICH WALLIS: Does any of this analysis change depending on the industry?

DEBRA VALENTINE: Hold it. Are we saying that everybody could agree ex ante that the royalty—instead of being between 5 and 10 percent is going to be X dollars. We're going to literally agree on the price?

CARL SHAPIRO: Personally, I think that it is not enough simply to require ex ante that the royalties

be “fair, reasonable, and non-discriminatory.” That language invites subsequent disputes. What company would sign to a licensing agreement under those terms and then make major investments that rely on using the patented technology? Please tell me so I can be sure not to invest in any such companies. The terms “fair, reasonable, and non-discriminatory” can be subject to very different interpretations by different parties based on their subsequent commercial interests. Given the conflicting incentives within the association, I don’t think personally there is a problem with setting a rate.

DEBRA VALENTINE: The moment you have the five largest firms agreeing that the price is going to be X and essentially forcing the three small firms into agreeing to that price, that’s a problem.

TIM MURIS: No, I don’t think that’s the way the normal standard-setting organization works. I agree with Carl that one size doesn’t fit all here. If the standard-setting organization wants to pass a rule that says “we love opportunism”—it seems like a strange rule—and people participate with their eyes open, that’s okay.

CARL SHAPIRO: Or they can do what the World Wide Web Consortium (W3C) has done and adopt a policy directed towards ensuring that patents are licensed on a royalty-free basis. That approach is not going to work in a lot of other contexts, but the W3C has adopted such a policy.

PETER PLOMPEN: Let me quote from the European Technology Licensing Guidelines No. 225: “Undertakings setting up a technology pool that is compatible with Article 81, and any industry standard that it may support, are normally free to negotiate and fix royalties for the technology package and each technology’s share of the royalties either before or after the standard is set. Such an agreement is inherent in the establishment of the standard or pool and cannot in itself be considered restrictive of competition and may in certain circumstances lead to more efficient outcomes. In certain circumstances it may be more efficient if the royalties are agreed before the standard is chosen and not after the standard is decided upon. . . .”²²

TIM MURIS: Debra, it’s also important that Carl and I are not saying that everything is per se illegal.

DEBRA VALENTINE: I agree it should not be per se illegal.

TIM MURIS: And it shouldn’t be per se legal either. I’ll let Carl speak for himself, but I’m not going the extra step to say situations where there is a problem don’t exist.

RICH WALLIS: Does this analysis change in the standard-setting organization if it is a regulated industry or a network industry or an emerging industry as opposed to a mature industry, Tim?

TIM MURIS: Industry context will matter in certain senses. With regulation, you obviously have the *Noerr* issues. You could lack antitrust jurisdiction depending upon the nature of the regulation even at the state level because of the state action issue. The reasons for having a standard can

²² See *supra* note 10.

be greater in a network industry or a nascent industry and so can the opportunity for mischief. There is the problem that we have talked about with exclusion, but I think you can oversell that point. Network effects are ubiquitous. I'm in the network of Diet Coke and Diet Pepsi drinkers and I'm not a Tab drinker. There are definitely increasing returns to scale from the fact that some of those products are ubiquitous.

RICH WALLIS: We're going to talk more about compulsory licenses, generally, later in the program but, Debra, in a standard-setting organization, how do you feel about compulsory licensing? Is it appropriate under any circumstances?

DEBRA VALENTINE: I don't think I know what relief the Commission asked for in *Unocal* and *Rambus*. It's interesting that the relief in *Dell* was not compulsory licensing; it was prohibiting the patent holder from enforcing the patent against others in the standard-setting groups. I think if we agree that when there is misleading conduct within a standard-setting organization—conduct that has no basis other than harming competition and essentially gaining monopoly power—then you have a reason to require licensing. The clever thing about *Dell* was that Dell was allowed to enforce its patents against firms in contexts other than those relating to the standard-setting organization's activities.

CARL SHAPIRO: It seems to me the general principle to apply if somebody has misbehaved in the standard-setting process is to try to restore competitive conditions, which requires trying to determine what the licensing terms would have been *ex ante*, when industry participants had more choices, i.e., when the relevant technology market was more competitive. In *Unocal*, since Unocal had (allegedly) represented that its technology would be nonproprietary, the remedy requested is that they not be able to enforce the patent for California gasoline, but they could still enforce it outside California. In another context, you might well find that the competitive price was not zero, but some other number. In many cases, it is going to be hard to get a good estimate of the *ex ante* competitive royalty rate. That is one of the problems with these cases. At the beginning, industry participants can, in principle, evaluate the different technologies and negotiate and bargain over licensing terms. The outcome of that process is our "competitive benchmark" without the deception or other anticompetitive conduct. To reconstruct that—in the *Unocal* case it is now more than a dozen years—is very hard. I do not know how hard that estimation exercise was in the *Rambus* case, but that would be the principle. I suppose one might use a shortcut and set the royalty rate at zero if a company acted deceptively, not unlike some concepts in the area of patent misuse, but I don't see why the competitive price would always be zero.

DEBRA VALENTINE: In addition, since this is a nascent area, we do all need to be sensitive to encouraging broad-based participation in these standard-setting organizations. It's really a question of how to address the very extreme abuse of these organizations.

KENT BERNARD: The point that I was going to make is we're all antitrust lawyers and we're talking about antitrust. There is the old saying that to a man with a hammer, everything looks like a nail. Antitrust may not be the remedy to a lot of what we're talking about here. Debra gave the example of blowing up somebody's factory. You can bring a Section 2 case about that, but there are probably other laws that are more applicable than that. When we are looking at deliberately lying to set a standard, maybe we shouldn't limit ourselves in terms of remedy to an antitrust remedy

Hatch-Waxman involves difficult issues at the interplay of antitrust and patent law. The courts have split on the appropriate responses to these settlements but I doubt, however, that the Eleventh Circuit has had the last word. First, the opinion is based on an astonishing clear legal error that destroys the premise of much of its argument about Hatch-Waxman.

—TIM MURIS

on these things. You may not be limited to a reasonable royalty. You may be talking about any number of different things, and those of you who deal with the state attorneys general will know that they're extremely creative about coming up with theories which God probably never intended but that can be applied across different contexts. I'm not recommending that, I'm simply stating it because antitrust compulsory licensing—whatever on earth a reasonable royalty might be ex post, and I agree with you, that's almost impossible to figure out—these are kind of blunt instruments and they may not be the best instruments for dealing with this.

RICH WALLIS: One thing that is truly a hot topic right now is patent settlements, in the pharmaceutical industry in particular. I'll ask Tim to talk about what the generic drug cases brought by the FTC entailed and to discuss briefly the *Schering* decision.²³

TIM MURIS: Let me give you the overview, and then make a few points about *Schering*. The Commission has had two generations of cases involving generic competition. The first is like *Schering*, in which there was an agreement, a Section 1 case, where the branded drug maker pays the generic competitor to delay the generic's entry. There were several of these cases brought under Bob Pitofsky's Chairmanship, which, with follow-on class actions, stopped this practice. The second generation, which occurred in my Chairmanship, involved unilateral behavior by the branded drug to exclude generic competition. Probably the best example involved the Commission and the states taking a very tough stance against Bristol-Myers Squibb.²⁴ (Obviously *Mylan*²⁵ involves somewhat similar issues.) Bristol-Myers, for example, went to the PTO and said "X"—it's not worthwhile getting into the details—to get a patent. Then they went to the FDA and they said literally "not X" to get the patent listed in what's called the Orange Book, to be able to exclude generic competition. We thought that that wasn't kosher and Bristol-Myers, after a management change, decided to exit that business. Because there is so much money involved from excluding generics, the tactics have continued to evolve and I think so will the antitrust response.

Now, *Schering*. The case also involves the Hatch-Waxman statute,²⁶ and I'll begin with the only conciliatory note to the Eleventh Circuit that I will provide. Hatch-Waxman involves difficult issues at the interplay of antitrust and patent law. The courts have split on the appropriate responses to these settlements but I doubt, however, that the Eleventh Circuit has had the last word. First, the opinion is based on an astonishing clear legal error that destroys the premise of much of its argument about Hatch-Waxman. In essence, the court assumed that the generic was infringing. That's just wrong. There is an assumption of validity, but the patent holder has to prove infringement. Second, if there's one clear message from Congress in passing Hatch-Waxman, it was to increase the sale of generics. Yet the Eleventh Circuit seems to find an unrestricted right to buy off generic challengers. That conclusion is fundamentally at odds with the congressional Hatch-Waxman purpose. Third, the court attacks the Commission for lacking empirical foundation. That's particularly surprising given the studies the Commission has done in this area. The Commission's Hatch-Waxman study, for example, on which it relies, surveys the universe of generic entry before

²³ *Schering-Plough Corp. v. FTC*, 402 F.3d 1056 (11th Cir. 2005).

²⁴ See, e.g., FTC Analysis to Aid Public Comment, In the Matter of Bristol-Myers Squibb Company, File Nos. 001 0221, 011 0046, and 021 0181, available at <http://www.ftc.gov/os/2003/bristolmyersanalysis.htm>.

²⁵ See, e.g., *FTC v. Mylan Labs, Inc.*, 62 F. Supp. 2d 65 (D.D.C. 1999).

²⁶ 35 U.S.C. §§ 155–56.

patent expiration.²⁷ It's not just a sample, it's the universe. Ironically, the Eleventh Circuit makes an empirical statement itself that is demonstrably false—that the Commission's opinion would stop these settlements. Such settlements now must be reported to the government, and a Commission report shows that many settlements still occur between branded and generics without these payments.

Finally, the Eleventh Circuit stands on its head the well-accepted rule about deferring to agency fact finding. The Eleventh Circuit does defer, but it's to the Administrative Law Judge (ALJ), not to the legal fact finder. The Commission, as the law provides, engaged in an extensive de novo review. The relevant factual analysis in the Commission's opinion takes 40 pages, and it represented months of hard work by a team of lawyers under Tom Leary's able supervision. The court, in 3½ pages, waves its hand at that work largely in deference to the ALJ. I don't think that view will stand, and I don't think much else of the Eleventh Circuit's opinion will ultimately stand, whatever happens to this particular case. I am willing to concede this is a complex area and that, ultimately, Congress may even revisit it.

KENT BERNARD: I'm going to agree with 98 percent of what Tim just said. Perhaps one or two adjectives are different. Clearly the Eleventh Circuit had a different idea of a standard of review, and while I love patents in general, I do agree that the presumption of infringement was kind of gutsy. For those of you who do not live in this particular fish bowl, let me just give you thirty seconds. Hatch-Waxman changed the patent laws—it changed a few things so that a generic could challenge a patent on an innovator drug basically with no risk. They didn't have to try to launch. They didn't have to do anything. They could do all their testing for FDA approval without infringing. Hatch-Waxman set up a different model, and various people have commented on the economics.

The other thing that happened is that most states—and almost all private insurance companies—have mandatory generic substitution. So if a generic of a product comes out on Day 1, almost all of the prescriptions that are written for the branded product automatically are converted by operation of law to prescriptions for the generic. Unless the doctor goes through a lot of hoops, the prescriptions automatically are moved over to the generic without anybody doing anything.

So you sort of have the government rewriting the rules of the marketplace, which governments do all the time. The facts of *Schering*, though, are a little weird in the sense that there was a suit that was settled and *Schering* let the alleged infringer in five years before *Schering*'s patent expired—that concept, by the way, is the norm, you split the difference on patents. Then there was a second set of facts (and I have nothing to do with *Schering*—this is all public record), and that was *Schering* paid money to the alleged infringer—and this is highly disputed, obviously, in the case—got some stuff back, licenses back to things, and the case revolved around the question of how you treated that transaction. I don't think anybody was really worried about the split-the-difference in terms of when your license starts. It was this other chunk and was there a payoff to keep them out—meaning that they would have come in earlier than five years before the patent expired, were they getting value for it, how did it go. There's a very interesting dynamic in a lot of these cases and I'm speaking of this not in a specific case—the economic nature of the system is that when a generic drug comes on the market, the harm to the brand name company is

²⁷ GENERIC DRUG ENTRY PRIOR TO PATENT EXPIRATION: AN FTC STUDY (July 2002), available at <http://www.ftc.gov/os/2002/07/genericdrugstudy.pdf>.

greater than the benefit to the generic company. That's just an artifact of the way that system works after the first 180 days and I'm not going to make that distinction, which is why the first generation of cases looked so attractive to the participants in them until somebody woke up. When you come on the market, I'm going to lose \$100 and you're going to make \$30. So why don't I pay you \$50 to stay off the market and we're both happier? It makes perfect sense until you figure out that it's got to be illegal as heck, and it was. But that generation sort of went away.

With the settlements that are being reported now, and they all have to be, I have to believe that 98 percent of them are pretty vanilla because nobody seems to ask any questions. There's a way of doing it. This case had just weird facts. The question to me is what does it mean now to have the *Schering* decision? Well, it means, obviously, we're going to wait and see what happens if certiorari is petitioned for. But you have the *Schering* case, and you have some of the other cases that found those kinds of agreements were per se antitrust violations. So the question for me as counsel for a company is not how do I deal with an FTC attack. If I have to deal with an FTC attack, the answer is simple: I appeal it to the Eleventh Circuit. But that's not rocket science; everyone in this room could do that one. The question is, what am I going to do with the 35 class actions that are filed not only in the Sixth Circuit, but in 19 different courts, depending upon where the plaintiff has his home office. They're not going to be bound by the Eleventh Circuit. So I think the lesson right now is this thing has seriously unsettled the law of settling, at least temporarily.

My personal view is that at least on the standard of review, this case has got to go up to the Court. What happens after that is an open game. As I said, I tend to agree with Tim on most of this. But the standard of review thing just sort of stopped me the first time I read the case. It's like they went through the whole thing and said, well, the FTC found facts but it wasn't supposed to do that. The Administrative Law Judge found the facts; you were just supposed to sort of see if there was substantial evidence supporting the Administrative Law Judge, which is 180 degrees reversed from the actual legal standard.

RICH WALLIS: Carl, several questions. I'll let you expand on the discussion generally, but when you're talking about reverse payments, the courts are not doing in-depth analysis of the strength of the patents that are involved. Is that an issue from an economic perspective?

CARL SHAPIRO: I think ultimately it has to be. The question is how do you get there. I'll continue to use *Schering* as the vehicle. I've heard from the other end of the table here that there was a presumption of infringement, which is gutsy. There was a standard of review that is unusual. Those are mostly legal issues. On economics, I was taken aback in a completely different dimension, which is the notion that if the agreement stays within the scope of the patent, then it's basically okay. This can include some obviously and blatantly anticompetitive agreements not to compete. Yet it appears that the Eleventh Circuit would consider such agreements to be legal, or at least might find them to be legal, when it is crystal clear that the economics are just like you said—the monopoly profits are a lot bigger than the competitive profits, so there are strong incentives to agree not to compete if this is permitted. Of course, for the very same reason, consumers are benefiting a lot when the generic is offered, so there is money to be had if the incumbent can pay off the potential entrant to go away or come in later. These are very basic arguments in antitrust economics, yet the court seemed unaware of them as they apply to the use of reverse payments.

DEBRA VALENTINE: But the Eleventh Circuit would allow that.

The question to me is what does it mean now to have the Schering decision? Well, it means, obviously, we're going to wait and see what happens if certiorari is petitioned for.

—KENT BERNARD

CARL SHAPIRO: It appears the Eleventh Circuit would allow an incumbent monopolist to pay a potential entrant to stay off the market, so long as the potential entry *might* be infringing a patent held by the incumbent. The economic analysis here is actually pretty straightforward. Aside from the rationale of protecting its monopoly profits, why is the patent holder willing to pay? Because otherwise entry is going to happen either sooner or with greater likelihood. If everyone knew that the patent was absolutely valid, the generic company would never come in until the patent ends, or perhaps the patent holder would obtain a preliminary injunction to stop entry. In neither case would the patent holder pay all that money to the generic supplier.

KENT BERNARD: The only point to make in there is that under normal circumstances that is right, but under Hatch-Waxman, it is different because in that context all that I can do in that suit, basically, is to lose. If I beat the generic, it doesn't cost him anything. When you're looking to settle a case, there's really not the balance of power that you would see in a normal patent infringement suit where the infringer is at risk for damages and I'm at risk for loss. Here, he's at risk for nothing, and other courts have picked up on that. How far it goes, however, I have no clue.

CARL SHAPIRO: There's another discussion about other industries and other situations in which the alleged infringer has already entered the market prior to the settlement. Even defining what is a "reverse payment" is tricky if the alleged infringer has some potential liability for prior patent infringement. We're not going there now. But the *Schering* case is very clean in this sense: the generic supplier is not yet in the market it is threatening to enter, so the incumbent pays the generic to delay or not come in until the patent has expired. That's pretty blatant, and it seems like the Eleventh Circuit would allow those sort of things. That surprised and disappointed me. But there is another whole angle in the *Schering* case: Did Schering in fact make such reverse payments? Because the *Schering* case does not involve a simple cash payment, but rather a more complex side deal involving licensing. From my perspective that leads to a genuine fact question: Did Schering overpay for the licensing rights it obtained so that we effectively have a reverse payment, or not? I have to say, it is rather clever for the companies involved to design the transaction this way. Did they find an ingenious way to settle their dispute by bringing in the gains from trade associated with another licensing transaction? Or did they just design a more complex transaction to hide a reverse payment? On this point, the Commission delved deeply into the facts, which the Eleventh Circuit sees differently. Unlike some of the conceptual points we have been discussing, these factual issues are not of much interest outside the case itself.

DEBRA VALENTINE: One thing that's extraordinary now is how much uncertainty remains. Everyone agrees that the early cases, such as *Hoechst-Andrx*,²⁸ which involved a simple sharing of monopoly profits and then tying up the 180-day exclusivity period, are probably gone. Nobody's going to do that anymore. *Schering* added two interesting complications. One was the additional payment for marketing rights over in Europe, which was and is going to be hard for the fact finders to value going forward. *Schering* also involved—and this has almost gotten lost in the process—a second entrant. How do you figure out whether preventing a second entrant for a few months is anticompetitive and how do you measure what the likely anticompetitive effect of that is? The one

²⁸ See Press Release, FTC, Consent Agreement Resolves Complaint Against Pharmaceutical Companies Hoechst Marion Roussel, Inc. and Andrx Corp. (Apr. 2, 2001), available at <http://www.ftc.gov/opa/2001/04/hoechst>.

last thing about *Schering* that I hope the FTC pays attention to is that the court seized on that bizarre footnote 12 in *California Dental*²⁹ about how you must prove effect—it can't be likely or probable—and raised that to the centerpiece of its analysis. That cannot be something that the agencies are going to like having to do whether it's in cases like *Intel*, or *Microsoft*, or *Schering*.

TIM MURIS: Yes, but the irony here of course is that there's ample evidence of the effect of generic entry.

DEBRA VALENTINE: Yes, but you don't want that as a standard even though you could meet it here.

TIM MURIS: No, but we did think that per se treatment was inappropriate. Particularly when Hatch-Waxman was passed, the essentially bankrupt generic was a real concern. It is less so now because of the generic industry's health. The Commission allows for \$2 million to be paid, essentially for legal fees. Particularly after spending time in O'Melveny, maybe \$2 million is too small. Of course, there's a lot of room between 2 and 60—the payment in *Schering*—and the correct number is much closer to 2. As a matter of doctrine I think it was appropriate, particularly at the beginning, to say this is rule of reason. It turns out that you can show through demonstrable economic evidence the required economic effect. Thus, I understand your point, but even there the court has got it wrong.

CARL SHAPIRO: There is very clear economic evidence: if they were going to come in, we know that would have led to lower prices. But that still leaves the question of whether they really would have come in. If the patent was absolutely valid, then maybe they would never have come in, or at least not until the patent expired, which goes back to your earlier question. If the patent holder—the brand company—is making a large payment, then I think it is very reasonable to infer at least that they were afraid of losing, they were afraid of earlier entry or more likely entry, and thus we can see the anticompetitive effect of the reverse payment. Given that we know entry leads to these price effects, that's how you prove and hopefully meet this condition to establish effect.

TIM MURIS: The Commission's opinion says that delaying entry is not the problem. You can settle, and some appropriate settlements do delay entry. The problem is the payment for delayed entry. I've always thought, and I'm in the minority in this, that the term "reverse" adds nothing to the analysis. But the payment of this large sum to delay entry is the real problem in this context. One should proceed as the Commission did, using a rule of reason analysis. At the end of the day, there is still uncertainty. If the Eleventh Circuit view prevails, and it'll have to be determined by the Supreme Court because of other circuits, then I predict there will be ten bills introduced the next day in Congress to overturn the decision. But before one passes there may be ten bad settlements.

CARL SHAPIRO: Tim, would you be against any settlements that involved these side licensing deals?

TIM MURIS: Absolutely not. The question about side-licensing deals is whether they are legitimate or even look close to being legitimate. You shouldn't second guess them if they appear reason-

²⁹ *California Dental Ass'n v. FTC*, 526 U.S. 756, 775 n.12 (1999).

able. The reason the Commission's opinion goes to such great lengths on the side payment was to prove that it was bogus.

CARL SHAPIRO: As I recall, your predecessor at the FTC said that that was so much work involved that these side deals should not be allowed at all if there was anything of value going from the patent holder to the generic firm. I gather you are not going there.

TIM MURIS: No. In fact the opinion is about doing the hard work. Most of the effort that Tom Leary put in was on that very hard factual question. The ALJ is under a distinct disadvantage compared to the Commission. We could put our best people on that factual record, and we did; that's one of the many reasons why the Commission is the de novo fact finder. It took a lot of hard work by some of our best people. For example, Michael Wroblewski, who received the Chairman's award—it's given annually to someone who does extraordinary work at the Commission—was one of those people, which indicates how important the case was.

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KENT BERNARD: From Schering's position, someone must have looked at the situation and said, "Okay, I want to settle this thing and here are the terms. But the other side is saying that they are not interested in simply settling this, they want another revenue stream, which is why they are pushing me to license this other stuff from them." Now, even if the side transaction is arguably legitimate on its face—the fact is you will always find six memos in the file that say, "Why are we doing this and why are we doing a business deal with them?" The reason we're doing it, and doing it with them, is because it's part of a larger transaction. You have to step back and ask if that's reasonable, if it's not so far beyond the pale, you almost have to let that process happen because the other approach is just to say you can never do it and that doesn't make any sense. The scarier thing to me than the Eleventh Circuit's opinion, assuming that that judgment just gets affirmed and nothing changes, is that the next time I settle a case, the first suit that's brought is going to reexamine the strength of my patent to determine whether my settlement is valid. I cannot for the life of me figure out what the standard would be for that. If you think I had an 80 percent chance of winning the patent case, does that mean I can keep you out for sixteen months? Is it twelve versus twenty? You've got to make it up as you go along. That can't happen. There will be no settlement.

RICH WALLIS: Let's now talk about licensing terms. Debra, talk about compulsory licensing and refusals to deal in *Trinko*³⁰ and how you think that might apply in the broader IP setting.

DEBRA VALENTINE: We have to start with the fact that *Trinko* is a very narrow decision. It involved the rather unique context of substantial regulatory intervention under a telecommunications statute. But we did all agree that the Guidelines got it right that intellectual property is just like other property. Of course, all property has unique features and IP is easily appropriable and many people can use it simultaneously but, for antitrust law purposes it should be treated like other property. Thus, it's fair to ask, "What does *Trinko* tell us about IP licensing?" I think for IP licensors *Trinko* is very good news. It makes it clear that there are very, very few circumstances in which monopolists would ever have any duty to deal with downstream competitors. It states that monopoly pric-

—KENT BERNARD

³⁰ Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, 540 U.S. 398 (2004).

ing, at least for a short period, is an important part of the free market system. Indeed, *Trinko* specifically notes that “to safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless accompanied by . . . anticompetitive conduct.” So I think *Trinko* gives substantial comfort in the context of IP licensing.

We mentioned the profit sacrifice test before, and I’ll raise it again here. I don’t think *Trinko* went so far as to say that the only kind of exclusionary conduct that’s illegal under Section 2 is conduct that’s short-term unprofitable. I think the court used that profit sacrifice inquiry as evidence of anticompetitive intent. But that’s only one type of conduct that might be exclusionary or anticompetitive.

Another beneficial development for IP holders is that *Trinko* effectively sounded the death knell for the essential facilities doctrine. Since there have been some very bizarre cases that have occasionally viewed intellectual property as an essential facility, I think it’s a positive step that “essential facility” is at most a moniker that’s meaningless.

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facilities doctrine.

In addition, the court indicated that if you’ve never had any dealings with a supposedly excluded party, you can refuse to deal and go home and sleep perfectly comfortably at night. Now I think there’s probably one drawback here and I’d be interested in others’ thoughts on this. If a firm knows that if it commences and then stops dealing with another entity, and there is going to be more suspicion placed on its behavior than if it had never dealt at all, what are the incentives as a business matter? Would the firm still refuse to deal when it wanted to refuse to deal because it made business sense, and license when it made sense, or does the general principle that regulators should carefully scrutinize changed conduct warp a firm’s incentives and lead to less licensing?

—DEBRA VALENTINE

KENT BERNARD: Everything warps my incentives. I think you have to be a little fact-specific on this. I’ll give you an example of where there’s a tremendous difference. As some of you know, there’s been a controversy in the scientific community over patenting what are called research tools. These are things that you use to help discover other things—to oversimplify horribly. We have a policy that we prefer that none of them were ever patented and if they are patented, we will license them nonexclusively at a fairly nominal royalty if we have it because we believe as a policy matter that’s the right way to do it. That would be apart from a normal business discovery situation, and yes, honestly, we might act differently if we found something that we felt was an advantage for us and we were going to spend money on it. We don’t have refusal to deal situations very often, at least in the prescription drug business, and so the question doesn’t come up. But generally, our advice has traditionally been, if you don’t want to deal with somebody don’t deal with them. Don’t start dealing with them and then decide twenty minutes later that it was a mistake, because in the normal course of events I’m sure everyone who has counseled a business has seen this. Somebody did something, and it doesn’t have to be price-related. *Colgate*³¹ is the classic on this. They violate your terms, you cut them off, and then they come back and say, “Gee, we made a mistake we’ll never do it again,” and your advice has to be you can’t take them back. Otherwise you’ve done all the bad things that Antitrust 101 says you can’t do. And for a business context that’s bizarre. The idea is that you actually have to cut off your foot because somebody did some of that. So the answer that comes back is “don’t start.” To that extent it does change things.

³¹ *United States v. Colgate & Co.*, 250 U.S. 300 (1919).

RICH WALLIS: Tim, let's talk about compulsory licensing of IP in the United States. When does it happen? Have you seen it used in the remedy setting? What factors would drive using it in the remedy setting?

TIM MURIS: The proposed *Unocal* remedy and others like it deny potential enforcement and thus are the same as compulsory licensing in an indirect sense. A very interesting question here is in what the Department of Justice said. Let me quote its department-wide report on IP. "It is well established under United States law that an intellectual property owner's decision not to license its technology to others cannot violate the antitrust laws." With any one sentence, there can be doubt about what it means. If the statement means that the case law doesn't support antitrust liability for unilateral refusals to deal, there's obviously enormous support. Liability may be the antitrust unicorn. What the statement clearly can't mean is that there is immunity for conditional refusals. The *Colgate* analogy here is a useful one. Professor Hovenkamp has a very nice hypothetical: Chrysler has a patent on a unique windshield wiper blade and it tells the other companies it will lease it only on the condition that Chrysler can set the price for the other companies' automobiles. That is a condition on a license that an antitrust court would not and should not tolerate. The Department of Justice certainly could not have meant the sentence I read to bless conditional refusals.

Under EU law, it is possible, under so-called "exceptional circumstances," that

it is an abuse of a dominant position for a dominant enterprise to refuse to license its intellectual property.

—PETER PLOMPEN

CARL SHAPIRO: *Trinko* is certainly not friendly to imposing a duty to deal, even on monopolists. I think *Trinko* is about unilateral unconditional refusals to license; imposing conditions is a whole different matter. And remedy is a different realm as well, since one is fixing the problem caused by other violations. If somebody has violated the law, you want to restore competitive conditions, whether it's Microsoft having to license certain copyrights or *Unocal* with the patents, or a merger where you have a licensing remedy. All of those involve mandatory licensing. But it is a whole different issue as to how we fix harm to competition caused by other conduct. I hope we can get even more clarity than *Trinko* that there's no duty to license patents even for a monopolist.

RICH WALLIS: We have been talking about how the U.S. agencies treat compulsory licensing. There appears to be a difference in Europe.

PETER PLOMPEN: As to the use of compulsory licenses in the framework of remedying merger situations or remedying abuse situations, I don't think there is a difference between Europe and the U.S. But of course everybody knows there is a difference with respect to the possibility that refusal to license in certain situations may be deemed to be an abuse of a dominant position. That's exactly the issue that has come before the European courts in the *IMS*³² case and also more recently to the President of the Court of First Instance in Europe, in the *Microsoft* case.³³ Under EU law, it is possible, under so-called "exceptional circumstances," that it is an abuse of a dominant position for a dominant enterprise to refuse to license its intellectual property. The criteria until now have been that the refusal to license must prevent the emergence of a new product, a not essen-

³² Case C-418/01, *IMS Health GmbH & Co. OHG v. NDC Health GmbH & Co. KG*, [2004] E.C.R. I-05039 (Apr. 29, 2004), available at <http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:62001J0418:EN:HTML>.

³³ Case T-201/04R, *Microsoft v. Comm'n*, Order of the President of the Court of First Instance (1), 22 Dec. 2004 (proceedings for interim relief under Article 82 EC).

tially duplicative product; that the license be indispensable to carry on business in the particular market, which means that alternative solutions, even if less advantageous, do not exist or cannot be created by an equally efficient party due to economic obstacles, legal reasons, or whatever; and there must also not be an objective justification for the refusal, and the only thing that we know since *Microsoft* is that probably the very fact that you have intellectual property is not an objective justification under European law.

What is, however, interesting in the decision of the President of the Court of First Instance in the *Microsoft* case is that the President agreed that Microsoft had made a serious point when it said that there is a difference between the situations in earlier judgments in *Magill*³⁴ and *IMS* on the one hand, and *Microsoft* on the other hand, in that Microsoft apparently had invested in creating its technology, while the information protected by copyright in *Magill* and in *IMS* was more or less publicly available information. That was a relevant difference.

The other relevant issue according to the President in the *Microsoft* proceedings, was the fact that the old case law criteria for an abusive refusal should not be deemed to require the existence of two different product markets: the product market where you have a dominant position and the market for the product incorporating the input that you need. It is sufficient if you need an input, whether or not it is marketed as a separate product on the market, and it is sufficient that you need a certain input to be able to enter a market with a new non-essentially duplicative product. If there is no objective justification for the refusal, and if indeed the license is indispensable in the way just stated, then a refusal to license such intellectual property may be deemed to be an abuse of a dominant position.

This is very much being debated, not only in the U.S. but also in Europe, also within the framework of a far broader discussion about the application of the rules on abuse of a dominant position generally. The issue should be seen against the background of European competition law. European competition law is something that grew out of the *ordo-liberal* economic approach, which has its basis in Germany in and after the second world war. And it is really based on two pillars. The first is that every restriction in the commercial freedom of another party in itself is anti-competitive unless it is somehow justifiable. The second is that you should not make use of the dependency of somebody else.

You see this basic discussion coming back again nowadays. It has been reflected in the new modernization regulation of last year where there's an explicit exception to the rule (which I described earlier) that European law has pre-eminence over national law for situations that are covered by Article 82. Indeed, the law says that when a national court or a national authority is applying Article 82, it should also take the same approach with respect to national law. But national enforcers are allowed to be stricter than European law would require. And the second important exception is that laws which predominantly have a goal other than competition in the pure sense can also still be applied by national authorities and by national courts. That includes, specifically, unfair competition rules.

This is the basic difficulty we are having at present in Europe. In applying Article 82, our enforcers do more than just act against exclusionary conduct. They also act against exploitative abuses. Furthermore, enforcement is characterized by "type-casting." Certain types of behavior, if done by a company having a dominant position, are *per se* prohibited without having to look at

³⁴ Joined cases C-241/91 P and C-242/91 P, *Radio Telefis Eireann (RTE) and Independent Television Publications Ltd (ITP) v. Comm'n*, [1995] E.C.R. I-00743 (Eur. Ct. Justice Apr. 6, 1995).

actual economic effects. That is of course creating problems particularly in dynamic economic environments. How can you compete in a dynamic environment if certain generally acceptable business models are not acceptable if practiced by a dominant enterprise? Should companies change their business models once they reach a certain level of market power, or even when they reach a certain market share? That is what the debate is about. You can see some of it already in the TTG; that the TTG contain a recognition of the fact that competition laws should take the dynamics of the market into account. On the other hand, the economic approach with respect to Article 82 is still not there; and there was a clear discrepancy among major competition officials of different countries within Europe at a conference in Brussels only a few weeks ago.

DEBRA VALENTINE: You have Member States that can go beyond Article 82. We have states that have all sorts of unfair competition laws, too. So it's sauce for the goose and sauce for the gander. I think Peter is correct that *Microsoft* is going to be very revealing in indicating how close the U.S. and Europe are coming in this area. Thus far, the cases that we Americans are aware of in the EU—whether *Magill* or *IMS*—do not involve any novel, original, or creative intellectual property. For example, in *IMS Health*, the pharmaceutical industry provided the zip codes where firms were selling their products to an entity that packaged these zip codes and manipulated them to provide marketing data for the pharmaceuticals. In essence, Member States were giving IP protection to products that would likely never be granted protection here. So EU-wide competition law was used to overrule unduly protective Member State copyright or patent law.

PETER PLOMPEN: I would like to make a remark about what I think is a positive development in the *IMS* judgment which I have not noticed in comments that I've heard up to now. And that relates to the question whether or not a certain input is indispensable. It is very clear that the court is not allowing an argument that something is indispensable if you need it but getting the input in another way is a little bit more expensive or a little bit more difficult. The Court of Justice explicitly refers to the situation that an alternative would not be available to someone acting on a similar scale. So it's not just a question of something that has developed in the market, and now would require new investments to get a similar structure, and that is impossible in view of the big lead that the other already has in the market. The comparison that the Court says should be made with respect to indispensability, as I read it, is that the party that requests the license for the input should be required to show that even if it were operating at the same level, at the same scale as the incumbent, it would not be economically feasible for it to develop or to create an alternative to the existing one. I think this is a very big limitation on the applicability of what we all call the *IMS* doctrine.

RICH WALLIS: Debra, how do you reconcile U.S. and EU law at this point, particularly when you are advising clients? There are very few licensing situations that stay in one country; they are all worldwide. How do you give advice just looking at the U.S. and EU, and how does the fact that another 90 countries have antitrust regimes complicate matters?

DEBRA VALENTINE: The truth is that you can't say that the EU should not have looked at *Microsoft*, because it did affect their markets, or that the U.S. shouldn't have looked at *Ciba Geigy-Sandoz* (now Novartis). The ideal would be to have, particularly in IP with its worldwide markets, the regulator with the primary interest making the decisions. A system of comity. The trouble with that scenario is that it entails the U.S. making the decision about Microsoft's behavior and the EU making the decision about Airbus' conduct. I fear that this could foster national champions. So for now

In the very area where we should have the greatest convergence, since IP markets tend to be worldwide and technology is easily exported, there is extraordinary diversity. As you say, we have not only 90 countries with different competition laws; we still have many countries without IP laws and with no respect for IP whatsoever.

there is no solution. In the very area where we should have the greatest convergence, since IP markets tend to be worldwide and technology is easily exported, there is extraordinary diversity. As you say, we have not only 90 countries with different competition laws; we still have many countries without IP laws and with no respect for IP whatsoever. We also have countries that grant patents for processes but not for actual products. Unfortunately, you've got to play by all the rules. So while you want to counsel to the highest, most rational law that enables you to pursue legitimate business purposes, there are constant obstacles, like EU pricing laws for dominant firms, that get in the way of sensible behavior.

RICH WALLIS: Tim, you wrote an article, and I'll paraphrase your point, but you talked about "lowest common denominator." When you have so many countries, whether it's fly-specking a merger or looking at a licensing arrangement, how do you counsel clients in a way that makes sense when there's not only the U.S. but also other countries that have some connection to the deal?

TIM MURIS: This is an extraordinarily difficult problem in intellectual property, much more so than in mergers, although I think the focus on international antitrust convergence has been correctly on mergers. Mergers are divisible and, for the most part, countries can take different views and still approve the merger. Divestitures can occur, and the facts can be different between Europe and the U.S., for example. Intellectual property, however, usually involves a worldwide market. There is thus going to be a pressing need for close cooperation. There were very extensive discussions between the U.S. and Brussels about the Technology Transfer Block Exemption. Some of the original proposals would have been by far the most profound divergence. Because of very good work by Commissioner Monti, Philip Lowe, and others, divergence didn't occur. Because of the least common denominator phenomenon, it would be a real problem. In antitrust discussions of convergence, our focus has been on mergers because of the filings in so many countries, but I think our focus will move over time more to intellectual property.

RICH WALLIS: Kent, there is considerable talk about convergence in the antitrust arena. We've got organizations like the ICN and the OECD, that are working on convergence, perhaps first in cartels, perhaps simultaneously in the merger arena. These areas have a head start, but IP is far behind in that discussion. And of course there is not a great deal of discussion or movement towards convergence of IP laws at the moment. How do you navigate these conflicts in a way that does not completely eviscerate IP rights?

KENT BERNARD: It's complicated, but I think if I were to give you a one word or a hyphenated word answer it would be "carve-out." Nowhere is it written that license terms have to be the same in every country in the world. It's a simpler agreement if they are, but if you do business in all the countries in the world, you quickly discover that there are a lot of things that are different among countries. And in many things that you're doing, you are making exceptions or having local agreements for how are you going to handle something in a specific country. With IP what we have tried to do generally is, obviously, there will be something for the U.S.—you already know the rules. There will be something for the EU where there really is a structure you can deal with. And then you're going to take a deep breath and pick which countries you feel you need to carve out or not carve out, for example, and it's not done by legal analysis as much as factual analysis. If you're going to have a major investment in a manufacturing plant in a particular country and it needs the IP license to be valid to do that, then you're going to make sure that you're okay under whatever

—DEBRA VALENTINE

rules, screwy or not, that country has in place. What the big wild card in this is, and I'd like to open this up for discussion, are countries where there is no IP rule. Or, what is almost worse, where there is an IP rule, but there's no enforcement mechanism. We're shortly going to be dealing with some of the countries that are going to be the largest producers of products in the world. You're looking at China; you're looking at India. It's not a matter of how you're going to structure your license, it's a matter of protecting what you have and figuring out how you'll ever enforce it. On that one I think we're all in the same boat of just trying to figure out what the rules can be, and anybody who has got any advice I'd be happy to write it down.

PETER PLOMPEN: I agree with most of what has been said, although I must make one small remark as to the lowest common denominator. I think in making the decision of how to phrase your license agreements it is also very important to do that on the basis of information about where the license agreement is going to have its major effect, because if the market or the product involved is, for instance, to a large extent produced in the U.S., that will be quite important for deciding how to structure your license agreement. On the other hand, even if many of your licensees are producing in the Far East, as nowadays often is the case at least in my industry, then it's also very important that those licensees, when exporting to Europe or exporting to the U.S., have to live by the rules over there. This may provide an extra argument in any debate with them—how to apply intellectual property/antitrust in their own countries because you can clearly show where there is a difference as to the way they benefit from the rules in Europe and the U.S. and the way other parties importing in the licensees' home countries are being treated. But this is of course another area, e.g., that of the TRIPS Agreement of the WTO.

DEBRA VALENTINE: And that's where I wanted to add something which was almost missed. We competition lawyers all love each other and love talking about competition law and principles. But I think with intellectual property, we've got to start dealing with the trade people. The reason that India is enacting an IP law, the reason that China is instituting IP law, is they want to get into the WTO. And it is going to be the WTO and TRIPS and the regimes that grow up around those principles that are going to be the source of your protection or my protection for our IP. This dialogue with trade officials is something we're not great at yet but it's something we're going to have to do.

RICH WALLIS: I hope everyone has enjoyed this discussion as much as I have. Please join me in thanking our panel. ●

Competition, Commerce, and Constitutionality: The Supreme Court's Internet Wine Sales Case

John T. Delacourt

In one of the most closely-watched cases of the 2004–2005 term, the Supreme Court attempted to reconcile pre-Prohibition Era jurisprudence with the demands of a 21st century marketplace. In *Granholm v. Heald*,¹ the growth of the Internet as a rapid and reliable means of distribution compelled the Court to examine anew the constitutionality of state laws prohibiting the direct shipment of wine from out-of-state suppliers. Although the 5–4 decision striking down two such laws as violative of the dormant Commerce Clause was toasted most enthusiastically by wine lovers, a closer examination of the Court's opinion, as well as related competition advocacy efforts by the staff of the Federal Trade Commission, reveals that the case has far broader implications. The growth of e-commerce in wine is not unique, nor is it the only area in which legacy laws and regulations threaten the emergence of online competition. The Internet wine sales controversy, however, demonstrates how two complementary forms of analysis—antitrust enforcement and constitutional scrutiny—can be marshaled in defense of consumer welfare. The seldom litigated Twenty-First Amendment, in contrast, is likely to remain an issue unique to the *Heald* case itself.

State Direct Shipping Laws and the Three-Tier System

The direct shipment of wine, facilitated by use of the Internet, presents an alternative to the traditional, three-tier distribution system through which the vast majority of U.S. wine sales continue to be made. Pursuant to the three-tier system, which developed after passage of the Twenty-First Amendment, producers sell to wholesalers, who in turn sell to retailers, who in turn sell to consumers. Proponents of this system assert that it promotes an appropriate level of regulatory control, commensurate with the social concerns raised by the distribution and sale of a potentially dangerous product like alcoholic beverages. Opponents, however, assert that the three-tier system imposes disproportionate costs, and that its regulatory objectives could be achieved through less restrictive means. Small vineyards, in particular, assert that wholesaler consolidation has made it increasingly difficult for them to obtain distribution for their wares.²

Circumventing the three-tier system by selling to the consumer directly has always presented logistical challenges, but many of these challenges have been significantly diminished by advances in online communications. Using Web-based technology, consumers can locate, price,

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¹ 125 S. Ct. 1885 (2005).

² FTC staff have stated that they are not aware of any systematic data indicating that wholesaler market shares have become so highly concentrated as to threaten competition in any relevant geographic market. See OFFICE OF POLICY PLANNING, FEDERAL TRADE COMMISSION, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE 6 (July 2003) [hereinafter FTC WINE REPORT], available at <http://www.ftc.gov/os/2003/07/winereport2.pdf>.

and purchase a particular vintage as easily as they might purchase a book or compact disc. The product can then be shipped using a standard package delivery service. As a result, Internet wine sales have experienced dramatic growth. From 1994–1999, for example, consumers doubled the amount of money they spent on direct shipments of wine to around \$500 million, or about 3 percent of the total spent on wine.³ According to some estimates, direct shipments could account for as much as 5–10 percent of the market within the next few years.⁴

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Business challenges, however, constitute only one set of obstacles faced by Internet wine sellers. They also face significant legal and regulatory barriers. Just over 20 states permit interstate direct shipping, subject to various restrictions.⁵ For example, some states place limits on the volume of wine that may be shipped annually,⁶ while others impose additional delivery restrictions on shipments from out-of-state.⁷ Approximately 30 states are even more restrictive, and authorize direct shipping only from in-state wineries.⁸ The specific Michigan and New York laws at issue in *Heald* fell into this latter category.

Under Michigan law, producers are generally required to sell through wholesalers. In-state wineries, however, are eligible for “wine maker” licenses that authorize direct shipments to in-state consumers.⁹ Likewise, New York generally requires producers to work through the three-tier system. However, wineries whose vintages are produced from grapes “at least seventy-five percent the volume of which were grown in New York state” may apply for a license that authorizes direct shipment to in-state consumers. An out-of-state winery seeking similar authority must become a licensed New York winery, which requires the establishment of a “branch factory, office or store-room within the state of New York.”¹⁰

Competition

The intensifying conflict between state direct shipping laws and the growth of e-commerce in wine drew the attention of both the FTC and the courts, which—not surprisingly, given their distinct roles in the legal process—viewed the nature of the problem somewhat differently. For its part, the Commission viewed the problem through the lens of competition. Indeed, given the root of this particular restraint of trade in state legislation, the FTC seemed uniquely well-suited to address the Internet wine sales controversy through its competition advocacy program.

Since the agency’s founding more than 90 years ago, the FTC has endeavored to represent consumer interests within the political process, at the federal, state, and local level, by challeng-

³ Alix M. Freedman & John R. Emshwiller, *Vintage System: Big Liquor Wholesaler Finds Change Stalking Its Very Private World*, WALL ST. J., Oct. 4, 1999, at A1. See also Vijay Shanker, *Alcohol Direct Shipment Laws, the Commerce Clause, and the Twenty-First Amendment*, 85 VA. L. REV. 353, 353 n.5 (1999) (discussing other estimates).

⁴ Mark Swartzberg & Jennifer F. Solomon, Salomon Smith Barney, *Clicking on Wine; Will E-Commerce and Other Forces Increase U.S. Consumer Access to Wine?* 18 (Mar. 17, 2000) (equity research report).

⁵ FTC WINE REPORT, *supra* note 2, at 7.

⁶ See, e.g., MO. REV. STAT. § 311.462(1) (2005) (limiting the volume of annual direct shipments to each adult resident of the state to “not more than two cases of wine, each case containing not more than nine liters”).

⁷ See, e.g., IDAHO CODE § 23-1309A(4) (Michie 2004) (“For purposes of out-of-state shipments, the delivery person shall: (a) have the person who receives the wine shipment sign for it, (b) not make deliveries to anyone who is under twenty-one (21) years of age or to anyone who is visibly intoxicated, and (c) keep the signature record for one (1) year.”).

⁸ FTC WINE REPORT, *supra* note 2, at 7.

⁹ *Heald*, 125 S. Ct. at 1893.

¹⁰ *Id.* at 1894.

ing ill-conceived laws and regulations that restrain competition without offering consumers any proportional, corresponding benefit.¹¹ Pursuant to recent practice, the Commission's competition advocacy filings most frequently take the form of a staff letter to an interested state legislator but may also consist of more formal comments, petitions, and reports. Due to the operation of certain exemptions that shield governmental action from antitrust enforcement, and the difficulty and expense associated with addressing governmental action after-the-fact, competition advocacy is often the most efficient—and sometimes the *only*—means of challenging regulatory restraints. In recognition of the strategic benefits of this approach, the FTC's sometimes under-utilized advocacy program has experienced a resurgence under Chairman Deborah Platt Majoras, as well as her predecessor, Chairman Timothy Muris.

As part of this resurgent effort to address overly broad public restraints of trade¹²—carried out not only through competition advocacy efforts, but also through amicus briefs and litigation—the Commission identified legacy barriers to e-commerce as an area of particular concern early on. In October 2002 the Commission convened a public workshop to study a variety of potential barriers to e-commerce but focused primarily on state laws and regulations, enacted in a pre-Internet environment, that disproportionately burden online competitors.¹³ Over three days the Commission heard testimony from a broad spectrum of interested parties, on industries ranging from Internet auto sales to online pharmacies. Commission staff then followed up with a targeted series of com-

¹¹ See Deborah Platt Majoras, A Dose of Our Own Medicine: Applying A Cost/Benefit Analysis to the FTC's Advocacy Program, Address Before the Charles River Associates' Conference on Current Topics in Antitrust Economics and Competition Policy (Feb. 8, 2005), available at <http://www.ftc.gov/speeches/majoras/050208currebtttopics.pdf>; see also James C. Cooper, Paul A. Pautler & Todd J. Zywicki, *Theory and Practice of Competition Advocacy at the FTC*, 72 ANTITRUST L.J. 1091 (2005).

¹² In addition to responding to specific inquiries and complaints, the FTC has sought to address the potential consumer harm resulting from public restraints of trade in a more proactive and systematic manner by, for example, advocating macro-level reforms of particularly problematic governmental processes—see, e.g., John T. Delacourt, *Intellectual Property and "Cheap Exclusion,"* 6 ENGAGE 76, 78 (2005) (describing proposed reforms to the Food and Drug Administration's generic drug approval process and the Patent and Trademark Office's patent prosecution process)—and working to clarify the scope of antitrust exemptions—see, e.g., Timothy J. Muris, *Clarifying the State Action and Noerr Exemptions*, 27 HARV. J.L. & PUB. POL'Y 443 (2004); John T. Delacourt, *The FTC's Noerr-Pennington Task Force: Restoring Rationality to Petitioning Immunity*, ANTITRUST, Summer 2003, at 36; John T. Delacourt, *Protecting Competition by Narrowing Noerr: A Reply*, ANTITRUST, Fall 2003, at 77; but see Lisa Wood, *In Praise of the Noerr-Pennington Doctrine*, ANTITRUST, Fall 2003, at 72.

¹³ See FTC, PUBLIC WORKSHOP, POSSIBLE ANTICOMPETITIVE EFFORTS TO RESTRICT COMPETITION ON THE INTERNET (Oct. 8–10, 2002) (E-COMMERCE WORKSHOP), available at <http://www.ftc.gov/opp/ecommerce/anticompetitive/index.htm>.

petition advocacy filings and amicus briefs, challenging anticompetitive barriers to expanded e-commerce in real estate,¹⁴ contact lenses,¹⁵ legal services,¹⁶ and funeral caskets.¹⁷

The Commission also addressed Internet wine sales. In July 2003 the Commission issued a staff report entitled *Possible Anticompetitive Barriers to E-Commerce: Wine*.¹⁸ The FTC Wine Report was based on testimony received at the workshop, as well as evidence gathered from a variety of public sources, including published court opinions and studies and information received from both package delivery services and the Bureau of Alcohol, Tobacco and Firearms (now the Alcohol and Tobacco Tax and Trade Bureau).¹⁹ Even more significantly, the Report relied on two uniquely probative sources of data: a recent empirical study of wine sales, and a survey of state enforcement officials. The study examined the wine market in McLean, Virginia, and compared the prices and choices available in area stores to the prices and choices that consumers could find

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¹⁴ See, e.g., FTC/DOJ Letter to Missouri Governor re: House Bill 174 (May 23, 2005), available at <http://www.ftc.gov/be/V050010.pdf> (challenging “minimum service” requirements for real estate brokers that prohibit low cost Internet property listings); see also FTC/DOJ Letter to Alabama Senate re: House Bill 156 (May 12, 2005), available at <http://www.ftc.gov/os/2005/05/050512tralabamarealtors.pdf>; FTC/DOJ Letter to Texas Real Estate Comm’n re: 22 Tex. Admin. Code § 535.2 (Apr. 20, 2005), available at <http://www.ftc.gov/os/2005/04/050420ftcdojtexasletter.pdf>.

¹⁵ See, e.g., FTC, OFFICE OF POLICY PLANNING, POSSIBLE ANTITCOMPETITIVE BARRIERS TO E-COMMERCE: CONTACT LENSES (2004), available at <http://www.ftc.gov/os/2004/03/040329clreportfinal.pdf> (challenging restrictions on Internet sales of replacement contact lenses); see also FTC, THE STRENGTH OF COMPETITION IN THE SALES OF CONTACT LENSES: AN FTC STUDY (2005), available at <http://www.ftc.gov/reports/contactlens/050214contactlensrpt.pdf>; FTC Letter to Arkansas House of Representatives re: House Bill 2286 (Oct. 4, 2004), available at <http://www.ftc.gov/os/2004/10/041008matayocomment.pdf>; FTC Staff Comment before the Connecticut Bd. of Examiners for Opticians (Mar. 27, 2002), available at <http://www.ftc.gov/be/v020007.htm>.

¹⁶ See, e.g., FTC/DOJ Letter to Kansas Bar Ass’n re: Proposed Definition of Practice of Law (Feb. 4, 2005), available at <http://www.ftc.gov/be/v050002.pdf> (challenging definition of the practice of law that would prohibit laypersons from providing certain real estate settlement services online); see also FTC/DOJ Letter to Massachusetts Bar Ass’n Task Force re: Proposed Definition of Practice of Law (Dec. 16, 2004), available at <http://www.ftc.gov/os/2004/12/041216massuplitr.pdf>; FTC/DOJ Letter to Massachusetts House of Representatives re: House Bill 180 (Oct. 6, 2004), available at <http://www.ftc.gov/os/2004/10/041008kujawskicomment.pdf>; Cleveland Bar Ass’n v. CompManagement, Inc., No. 04-0817 (Ohio), FTC Amicus Brief (Aug. 2, 2004), available at <http://www.ftc.gov/os/2004/08/040803amicusbriefclevbar.pdf>; McMahon v. Advanced Titles Services Co. of W. Va., No. 31706 (W. Va.), FTC Amicus Brief (May 25, 2004), available at <http://www.ftc.gov/be/V040017.pdf>; FTC/DOJ Letter to Indiana State Bar Ass’n re: Ind. S. Ct. Admissions & Discipline Rule 24 (Oct. 1, 2003), available at <http://www.ftc.gov/os/2003/10/uplindiana.htm>; On Review of UPL Advisory Opinion No. 2003-2, No. S03U1451 (Ga.), FTC/DOJ Amicus Brief (July 28, 2003), available at <http://www.ftc.gov/os/2003/07/georgiabrief.pdf>; FTC/DOJ Letter to Rhode Island House of Representatives re: House Bills 5396 and 5639 (Mar. 28, 2003), available at <http://www.ftc.gov/be/v020013.htm>; FTC/DOJ Letter to State Bar of Georgia re: Potential Unlicensed Practice of Law Opinion (Mar. 20, 2003), available at <http://www.ftc.gov/be/v030007.htm>; FTC/DOJ Letter to American Bar Ass’n re: Model Definition of Practice of Law (Dec. 20, 2002), available at <http://www.ftc.gov/opa/2002/12/lettertoaba.htm>; FTC/DOJ Letter to North Carolina State Bar re: Proposed North Carolina State Bar Opinions (July 11, 2002), available at http://www.ftc.gov/os/2002/07/non-attorney_involment.pdf; FTC/DOJ Letter to Rhode Island House of Representatives re: House Bill 7462 (Mar. 29, 2002), available at <http://www.ftc.gov/be/v020013.pdf>; FTC/DOJ Letter to North Carolina State Bar re: State Bar Opinions (Dec. 14, 2001), available at <http://www.ftc.gov/be/V020006.htm>.

¹⁷ See, e.g., Powers v. Harris, No. CIV-01-445-F (W.D. Okla.), FTC Amicus Brief (Aug. 29, 2002), available at <http://www.ftc.gov/os/2002/09/okamicus.pdf> (challenging restrictions on Internet sales of funeral caskets).

¹⁸ In addition to issuing the FTC Wine Report, Commission staff participated in legislative debates on the Internet wine sales issue at both the state and federal level. See FTC Letter to New York State Assembly and Senate re: Assembly Bill 9560-A and Senate Bills 6060-A and 1192 (Mar. 29, 2004), available at <http://www.ftc.gov/be/v040012.pdf>; *E-Commerce: The Case of Online Wine Sales and Direct Shipment, Hearing before the House Subcomm. on Commerce, Trade, Energy, and Consumer Protection*, 108th Cong. (2003) (statement of Todd Zywicki, Director, Office of Policy Planning, Federal Trade Commission), available at <http://www.ftc.gov/os/2003/10/031030ecommercewine.htm>.

¹⁹ FTC WINE REPORT, *supra* note 2, at 13–14.

online.²⁰ The survey, in turn, consisted of a set of questions regarding tax collection and sales to minors that FTC staff posed to enforcement officials in states that, to one degree or another, permit direct shipping.²¹

The FTC Wine Report concluded that state bans on interstate direct shipping “represent the single largest regulatory barrier to expanded e-commerce in wine.”²² It further observed that, while more than half of the states prohibit or severely restrict the direct shipment of wine from out-of-state, many of these same states permit *intrastate* direct shipping from in-state wineries and retailers. With respect to price, the empirical study demonstrated that, depending on the category of wine and the method of delivery selected,²³ consumer savings attributable to Internet wine purchases are potentially significant. Within the McLean market, for example, consumers using the least expensive shipping method could save 8–13 percent, on average, on wines costing more than \$20 per bottle and 20–21 percent, on average, on wines costing more than \$40 per bottle.²⁴ With respect to consumer choice, the findings were equally dramatic. The study demonstrated that a full 15 percent of a sample of wines available online were not available from retail wine stores within ten miles of McLean.²⁵ This finding was further supported by a substantial quantity of workshop testimony clearly indicating that state level direct shipping bans seriously impede consumer access to thousands of vintages from small wineries. Based on this evidence, FTC staff recommended that “states could enhance consumer welfare by allowing direct shipping from out-of-state wineries and retailers, as well as from in-state suppliers.”²⁶

Commerce

In contrast to the FTC’s approach, which focused on competition issues, the federal courts that have taken up the Internet wine sales controversy have, to date, viewed the problem primarily through the lens of federalism. Thus, rather than focusing on consumer welfare and harm to competition—antitrust issues largely taken off the table by the fact that the interstate direct shipping bans at issue are statutory in nature and therefore exempted from antitrust scrutiny under the state action doctrine of *Parker v. Brown*²⁷—litigation in this area has focused on the so-called dormant Commerce Clause. Pursuant to the Supreme Court’s dormant Commerce Clause case law, if Congress has not specifically permitted some form of interstate barrier to trade, that barrier should be considered unconstitutional, unless some substantial, non-protectionist state interest is

²⁰ *Id.* at App. A.

²¹ *Id.* at App. B.

²² *Id.* at 14.

²³ Because shipping costs do not vary with a wine’s price, consumers buying online can save more money on more expensive wines. In contrast, it may be cheaper to buy less expensive wines in brick-and-mortar stores. *Id.* at 3.

²⁴ *Id.* at 19.

²⁵ *Id.* at 18.

²⁶ *Id.* at 40.

²⁷ 317 U.S. 341 (1943) (exempting from antitrust enforcement the official acts of state governments, regardless of their potential impact on competition). Some commentators have raised concerns that unduly expansive interpretations of the scope of the state action doctrine may result in substantial consumer harm, without necessarily advancing any of the doctrine’s underlying political objectives. See, e.g., FTC, OFFICE OF POLICY PLANNING, REPORT OF THE STATE ACTION TASK FORCE 2–3 (2003), available at <http://www.ftc.gov/os/2003/09/stateactionreport.pdf>; John T. Delacourt & Todd J. Zywicki, *The FTC and State Action: Evolving Views on the Proper Role of Government*, 72 ANTITRUST L.J. 1075 (2005).

involved.²⁸ Although these two approaches overlap in important respects,²⁹ one key distinction is that the antitrust analysis disfavors *all* direct shipping bans, as their adverse impact on price and consumer choice remains constant. In contrast, the dormant Commerce Clause analysis only disfavors *discriminatory* direct shipping bans (i.e., those that treat in-state and out-of-state producers differently). This distinction is most notable when addressing across-the-board direct shipping bans, which prohibit direct-to-consumer sales by both in-state and out-of-state wineries. Although still objectionable from an antitrust perspective, such laws can easily withstand constitutional scrutiny.

As previously mentioned, both the Michigan and New York laws at issue in *Heald* authorized direct shipments by in-state wineries while prohibiting such shipments by out-of-state competitors and, not surprisingly, triggered a dormant Commerce Clause challenge. With respect to the Michigan law, the district court upheld the discriminatory scheme, but the court of appeals reversed. The Sixth Circuit rejected the argument that the Twenty-First Amendment immunizes state liquor laws from Commerce Clause scrutiny, and held that the state had failed to demonstrate that it could not satisfy its proffered regulatory objectives through nondiscriminatory means.³⁰ In contrast, the New York law was invalidated by the district court but upheld by the court of appeals. Unlike the Sixth Circuit, the Second Circuit concluded that an interstate direct-shipping ban fell squarely within the state's police powers, as preserved by the Twenty-First Amendment.³¹ The Supreme Court then granted certiorari in both cases to resolve the split.

Although the Court was closely divided, 5–4, on the ultimate constitutionality of these laws, the Commerce Clause analysis was not a point of particular contention. Writing for the majority, Justice Kennedy observed that “[t]he discriminatory character of the Michigan system is obvious,”³² and that the New York law, by requiring out-of-state wineries to maintain a physical presence in-state, had an identical effect, as demonstrated by the fact that “not a single out-of-state winery has availed itself of New York’s direct-shipping privilege.”³³ Justice Stevens, writing in dissent, did not disagree on this point, but rather observed that “[t]he New York and Michigan laws challenged in these cases would be patently invalid under well settled dormant Commerce Clause principles if they regulated sales of an ordinary article of commerce rather than wine.”³⁴

This seemingly routine dormant Commerce Clause analysis, however, was notable in one significant respect. In addition to establishing that the laws at issue discriminated between in-state

²⁸ The Commerce Clause provides that Congress has the power to “regulate Commerce with foreign Nations, and among the several States.” U.S. CONST., art. I, § 8, cl. 3. From this language the Supreme Court has inferred a “dormant” Commerce Clause, which prohibits undue burdens on interstate commerce. See *Gibbons v. Ogden*, 22 U.S. 1 (1824).

²⁹ For a further discussion of the potential overlap between antitrust scrutiny and dormant Commerce Clause review, see Montgomery N. Kosma, *The Friendly Neighborhood Trade Commission*, 4 ENGAGE 22 (2003).

³⁰ *Heald v. Engler*, 342 F.3d 517 (6th Cir. 2003), *aff’d*, 125 S. Ct. 1885 (2005).

³¹ *Swedenburg v. Kelly*, 358 F.3d 223 (2d Cir. 2004), *rev’d*, 125 S. Ct. 1885 (2005).

³² *Heald*, 125 S. Ct. at 1896.

³³ *Id.* at 1897. Some commentators have asserted that physical presence requirements pose an especially serious threat to competition in the e-commerce context. See, e.g., Asheesh Agarwal, Jerry Ellig & Todd Zywicki, *Wine Wars: Uncorking E-Commerce?*, REGULATION, Winter 2004–2005, at 11 (noting that “[s]tate physical presence laws deprive online suppliers of one of the main efficiency benefits of e-commerce: the ability to provide goods and services over large distances without the need for a substantial, far-flung presence” and that “physical presence requirements could force online companies such as Amazon.com or catalogue retailers such as L.L. Bean to establish offices in all 50 states”).

³⁴ *Heald*, 125 S. Ct. at 1908 (Stevens, J., dissenting).

and out-of-state competitors, the Court's precedents obliged it to consider whether either state regime "advance[d] a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives."³⁵ Interestingly, although the FTC Wine Report expressly declined to take any position on the constitutional issues raised by the Internet wine sales controversy,³⁶ this is the point at which the two modes of analysis converged. The states, along with their *amici*, argued that the discriminatory impact of their direct shipping laws was justified by two countervailing regulatory objectives: (1) ensuring adequate tax collection, and (2) limiting underage drinking. The FTC Wine Report had addressed these same objectives—which, in the course of the Commission's E-Commerce Workshop, had been put forth as justifications for the direct shipping laws' adverse impact on competition—at length, ultimately rejecting them both. Rather than elaborating a separate constitutional analysis, the Supreme Court adopted the reasoning set forth in the FTC Wine Report almost *in toto*, specifically citing the Report over a dozen times. With respect to the issue of tax collection, for example, the Court cited the FTC staff's survey of state enforcement officials for the proposition that tax revenues could be safeguarded by requiring out-of-state producers to obtain a permit as a condition of direct shipping, as "various States use this approach for taxing direct interstate wine shipments . . . and report no problems with tax collection."³⁷ Likewise, with respect to the issue of underage drinking, the Court noted that "[a] recent study by the staff of the FTC found that the 26 States currently allowing direct shipments report no problems with minors' increased access to wine."³⁸

Constitutionality

If the *Heald* case had addressed the Internet distribution of books or compact discs, rather than wine, the Court's analysis would likely have concluded with its discussion of the dormant Commerce Clause. The fact that alcohol sales were at issue, however, compelled the Court to address the impact of the Twenty-First Amendment at length. Specifically, the Court addressed Section 2 of the Amendment, which prohibits "[t]he transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof."³⁹ Michigan and New York argued that this provision insulated their direct shipping laws from Commerce Clause challenge, but the Court ruled otherwise, holding that "Section 2 does not allow States to regulate the direct shipment of wine on terms that discriminate in favor of in-state producers."⁴⁰

³⁵ *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 278 (1988). See also Agarwal et al., *supra* note 33, at 10 (noting that the Supreme Court's dormant Commerce Clause case law "require[s] a state to provide substantial empirical and other evidence demonstrating that it has no alternative but to adopt measures that discriminate against out-of-state merchandise").

³⁶ FTC WINE REPORT, *supra* note 2, at 9 ("Commission staff takes no position on the constitutional issues raised in the lawsuits.").

³⁷ *Heald*, 125 S. Ct. at 1906; FTC WINE REPORT, *supra* note 2, at 38–40. See also Todd Zywicki & Asheesh Agarwal, *Wine, Commerce, and the Constitution*, N.Y.U. J.L. & LIBERTY (forthcoming 2005) (manuscript at 59, on file with author), available at <http://www.law.nyu.edu/journals/liberty/> (concluding that the tax collection argument "appears to be a simple red herring contrived to justify protectionist laws").

³⁸ *Heald*, 125 S. Ct. at 1905; FTC WINE REPORT, *supra* note 2, at 34. See also Zywicki & Agarwal, *supra* note 37 (manuscript at 58, on file with author) (observing that "the concerns of New York and Michigan regarding underage drinking and diversion are undercut by the fact that both states permit intrastate direct shipping").

³⁹ U.S. CONST. amend. XXI, § 2.

⁴⁰ *Heald*, 125 S. Ct. at 1897.

[A]s some commentators have noted, a more expansive construction of the [Twenty-First] Amendment could lead to absurd results.

The reasoning that led to this conclusion entailed detailed consideration of a pair of arcane, pre-Prohibition statutes—the Wilson Act and the Webb-Kenyon Act—which influenced the drafting of Section 2. Late 19th century Supreme Court case law established the original package doctrine, which held that the Commerce Clause immunized goods sold in interstate commerce from state regulation, so long as the goods remained in their original package. The Wilson Act, passed in 1890, was intended to close the “original package” loophole, and thereby re-establish the states’ power to police sales of liquor imported from out-of-state.⁴¹ The majority noted that the Wilson Act did *not* authorize the states to discriminate against out-of-state liquor as, by its own terms, the Act only permitted states to regulate imported liquor “to the same extent and in the same manner” as domestic liquor.⁴² Subsequent Commerce Clause case law, however, opened an additional loophole, which prohibited state regulation of goods sold in interstate commerce that were ultimately intended for personal use. In 1913 Congress acted to close the “personal use” loophole as well, through passage of the Webb-Kenyon Act.⁴³ As the majority explained, the Webb-Kenyon Act was not intended to authorize discrimination against out-of-state liquor sales either, but rather “was enacted simply to extend that which was done by the Wilson Act.”⁴⁴ This framework stood until the passage of Prohibition, via the Eighteenth Amendment, in 1919, but was called into question by the subsequent repeal of Prohibition, via the Twenty-First Amendment, in 1933. In order to resolve these doubts regarding the states’ post-Prohibition power to regulate liquor sales, the drafters of Section 2 of the Twenty-First Amendment closely tracked the language of the Wilson and Webb-Kenyon Acts, thereby “expressing the framers’ clear intention of constitutionalizing the Commerce Clause framework established under those statutes.”⁴⁵

While ancient and obscure in origin, the majority’s construction of Section 2 merely confirms the relatively sensible proposition that the Twenty-First Amendment does not somehow trump other provisions of the Constitution.⁴⁶ As the majority itself explained, “The aim of the Twenty-First Amendment was to allow States to maintain an effective and uniform system for controlling liquor by regulating its transportation, importation, and use. The Amendment did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they had not enjoyed at any earlier time.”⁴⁷ Indeed, as some commentators have noted, a more expansive construction of the Amendment could lead to absurd results. If, as Michigan and New York argued, the Twenty-First Amendment empowered the states to exercise absolute control over liquor sales, “a State could enact a law that prohibited the import of kosher or sacramental wine, or allowed alcohol imports only to a certain race or sex.”⁴⁸ The majority was also careful to note

⁴¹ *Id.* at 1898–99.

⁴² *Id.* at 1899.

⁴³ *Id.* at 1900.

⁴⁴ *Id.* at 1900–01 (quoting *Clark Distilling Co. v. Western Maryland Railway Co.*, 242 U.S. 311, 324 (1917)).

⁴⁵ *Id.* at 1902 (quoting *Craig v. Boren*, 429 U.S. 190, 205–06 (1976)).

⁴⁶ See also Aaron Nielson, *No More “Cherry-Picking”: The Real History of the 21st Amendment’s § 2*, 28 HARV. J.L. & PUB. POL’Y 281, 294 (2004) (“Unfettered interstate commerce is one of the primary reasons for the American union. Common sense dictates that if this fundamental component of the Constitution were being altered, there would be unambiguous declarations explaining that alteration. The context of and debate over § 2 present no such declarations.”).

⁴⁷ *Heald*, 125 S. Ct. at 1902.

⁴⁸ Asheesh Agarwal & Todd Zywicki, *The Original Meaning of the 21st Amendment*, 8 GREEN BAG 135, 140 (2005), at <http://www.greenbag.org/Agarwal%20and%20Zywicki.pdf>.

that its decision invalidating the two states' direct-shipment laws did not call into question the constitutionality of the three-tier system generally but rather required states to extend equal treatment to both in-state and out-of-state producers.⁴⁹

Unlike the majority's dormant Commerce Clause analysis, its construction of the Twenty-First Amendment was fiercely disputed by the four dissenters. The more detailed of the two dissents, authored by Justice Thomas, generally agreed with the notion that Section 2 is best understood as a constitutionalization of the Wilson and Webb-Kenyon Acts.⁵⁰ However, the dissenters sharply disagreed with the majority's construction of the Webb-Kenyon Act, and in particular with the notion that Congress merely intended to extend the approach to the Commerce Clause embodied in the Wilson Act. Looking to the text of the Webb-Kenyon Act, the dissenters noted that it prohibits the shipment or transportation of alcoholic beverages into any state when the beverages in question are "intended, by any person interested therein, to be received, possessed, sold, or in any manner used . . . in violation of any law of such state."⁵¹ While the majority was inclined to read the "any law" language as meaning, essentially, "any otherwise valid (i.e., non-discriminatory) law," the dissenters insisted that "any law of such state" means "any law," including a discriminatory one.⁵² The dissenters also pointed to the text of the Wilson Act, which contains express language prohibiting discrimination, and noted that the absence of any comparable language in the Webb-Kenyon Act "is telling."⁵³ Based on this analysis, the dissenters contended that their construction would not lead to absurd results, as "the text and the history of the Twenty-First Amendment demonstrate that it displaces [only] liquor's negative Commerce Clause immunity, not other constitutional provisions."⁵⁴

Conclusion

One clear, though potentially short-lived, result of the *Heald* decision is that wine consumers in Michigan and New York will now be able to share in the lower prices and wider product selection currently enjoyed by their fellow consumers in less restrictive states. Whether this wine lovers' holiday will be cut short by legislative action, however, remains to be seen, as the decision's grounding in the dormant Commerce Clause leaves both states the option of amending their objectionable laws to prohibit all direct shipments.⁵⁵ Beyond this immediate impact on the citizens of these two states, the Court's opinion is notable in a number of respects:

- **Convergence of Antitrust and Constitutional Analysis.** The Court's repeated and straightforward reliance on the FTC's Wine Report suggests that litigants advancing a dormant

⁴⁹ *Heald*, 125 S. Ct. at 1904–05. See also Agarwal & Zywicki, *supra* note 48, at 136 ("[T]he 21st Amendment enabled dry States to remain dry if they so chose, but it did not empower wet states to engage in economic warfare against the products of other wet states.").

⁵⁰ *Heald*, 125 S. Ct. at 1909–10 (Thomas, J., dissenting).

⁵¹ *Id.* at 1910.

⁵² *Id.* at 1911.

⁵³ *Id.* at 1912.

⁵⁴ *Id.* at 1926–27.

⁵⁵ Legislation that would prohibit direct shipments from both in-state and out-of-state wineries has already been introduced in the Michigan House and Senate, where it has received well-funded support from the state's liquor wholesalers. Eric Arnold, *Direct-Shipping Battle Heats Up in Michigan*, WINE SPECTATOR ONLINE, June 24, 2005, <http://www.winespectator.com/Wine/Features/0,1197,2773,00.html>. New York, in contrast, has moved in the opposite direction, by passing legislation that permits all direct shipments, regardless of the origin. Eric Arnold, *New York to Allow Direct-to-Consumer Shipments of Wine*, WINE SPECTATOR ONLINE, June 27, 2005, <http://www.winespectator.com/Wine/Features/0,1197,2775,00.html>.

Commerce Clause challenge may wish to consider related, industry-specific antitrust case law and policy analysis as a potential source of support. Whether courts will evaluate state regulatory objectives—put forth as either a justification for a restraint of trade or an explanation for economic discrimination—in a uniform manner remains an open question.

- ***Implications for Expanded e-Commerce.*** The Court's willingness to recognize the potential consumer benefits of Internet wine sales, as well as its implicit expectation that state regulators will make reasonable accommodations for online competitors, seems to bode well for expanded e-commerce. The Court's aversion to New York's physical presence requirement is particularly notable, as such requirements may deprive Internet businesses, as well as their customers, of many of the principal advantages of an e-commerce business model.
- ***Resolute Defense of Barrier-Free Interstate Commerce.*** The Court's rejection of the states' justifications for economic discrimination, especially in the context of a product so highly regulated and socially controversial as to merit two constitutional amendments, suggests that at least a narrow majority places an exceptionally high value on unimpeded, national markets. This is particularly reassuring in light of the fact that some states had already endeavored to resolve the direct shipping controversy on their own by negotiating reciprocal trade privileges with their neighbors—a result that the Commerce Clause was specifically enacted to prevent.

Although predominantly positive, the *Held* Court's message on each of these points was less than crystal clear, and could change considerably with the imminent changes in the Court's membership. The importance of the apparent convergence in antitrust and constitutional analysis is also highly dependent on development in the lower courts. For the moment, however, it is likely that wine connoisseurs' message to the Supreme Court can be summarized in single word: *Salud!* ●

The European Competition Network: What It Is and Where It's Going

An ABA Section of Antitrust Law Brown Bag Program (April 19, 2005)*

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JOHN PARISI: This program will focus on the European Competition Network—the ECN. The ECN is the implementing instrument of the modernization of the European Union's antitrust law enforcement—that is, the enforcement of Articles 81 and 82 of the EC Treaty. Modernization radically reformed the enforcement of EU antitrust law. Barry Hawk, whose Fordham Conferences in the mid-to-late-1990s served as an important forum in the evolution of modernization, likened it to the Protestant Reformation: No more would companies trek to the confessional in Brussels with Form A/B in hand. All roads to exemption or other types of indulgence would no longer lead only to Brussels. Instead, companies and their advisors, like their counterparts in the United States, must take responsibility for themselves.

As a consequence of modernization, the enforcement of Articles 81 and 82 now may be carried out by the European Commission or the competition authorities of any of the 25 EU Member States. Each of those authorities is fully empowered to enforce all elements of Articles 81 and 82, including the exemption provisions contained in Article 81(3), a power previously reserved only to the European Commission.

The European Competition Network was created so that the Commission and the Member State authorities could effectively and efficiently enforce EU antitrust law. Rather than 26 authorities that operate oblivious to one another, the ECN provides a mechanism for the notification of cases and the possible referral or allocation of cases to another authority that is best placed to handle them. To facilitate this process, the Commission and the Member State authorities are authorized to share information they obtain in the course of their investigations.

* This program has been edited for publication.

Assessments of the ECN's operation since modernization went into effect on May 1, 2004, have been generally positive. But some questions remain open—for example, the handling of leniency applications in cartel cases.

The International Antitrust and Foreign Competition Law Committee of the ABA Section of Antitrust Law is fortunate to have on this program six people who are certainly among the best placed to describe the operation of the Network and the issues that have arisen during its existence. Our first four speakers come from the enforcement community. They are: Kris Dekeyser, the Chief of the unit in the European Commission's Competition Directorate, DG-COMP, that is responsible for the European Competition Network; Andreas Bardong, a member of the Bundeskartellamt's ECN team for the last couple of years, who, before joining the Bundeskartellamt, worked as a competition lawyer in Brussels; Ray Leonard, Divisional Director of the Cartel Division of Ireland's Competition Authority; and Jozsef Sarai, Head of the International Division of Hungary's Competition Authority, who has been with the Authority since its establishment in 1991.

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Then, commenting on the remarks of those four enforcers will be two well-placed practitioners: Dirk Schroeder, a Partner at Cleary Gottlieb based in Cologne whose practice focuses on EU and competition law, including EC and German merger control, cartels, monopolies, and state aid; and, Hendrik Bourgeois, General Electric's European Competition Counsel, who advises all GE businesses on a wide variety of European competition law matters involving mergers and acquisitions, distribution, R&D activities, and compliance issues.

We begin with Kris Dekeyser. Kris, describe the ECN from your perspective in DG-COMP in Brussels.

KRIS DEKEYSER: The European Competition Network was created in the framework of the new enforcement system for Articles 81 and 82 of the EC Treaty, which was introduced by Regulation 1/2003.¹ It is basically built around the legal framework of that Regulation and serves its principal objectives—namely, to achieve an effective and coherent enforcement of the European antitrust rules in an enlarged Union by both the Commission and the national competition authorities. That is why during the day-to-day work, cooperation in the ECN concentrates on three issues that are crucial to ensuring that the system of parallel competencies introduced by the Regulation functions well: (1) an efficient division of work within the network; (2) a coherent and consistent application of the European antitrust rules by all network members; and (3) an efficient fact-finding through cooperation and assistance among network members. In all three areas, the Network is operating according to plan.

—JOHN PARISI

First of all, as a network, we must avoid having different competition authorities work on one and the same case without there being any need to do so, which is why we try to come to an efficient division of work within the Network. And it is clear that such coordination efforts need to be made in the initial phase of a case, before significant resources are allocated. In that respect, we have an article in the Regulation which is crucial—Article 11(3). That Article results in all members of the Network being informed whenever and wherever a formal investigation is started by another authority in Europe. It is precisely this information which allows us to discover, for instance, the existence of parallel investigations within the Network and to coordinate investigations.

¹ Council Regulation (EC) No. 1/2003 of 16 December 2002 on the Implementation of the Rules on Competition Laid Down in Articles 81 and 82 of the Treaty (Text with EEA relevance), 2001 O.J. (L 1) 1, available at http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_001/l_00120030104en00010025.pdf.

In this context, I would like to stress that the so-called rules on case allocation, which are contained in the Network Notice, are built on the principles of flexibility and efficiency. Though they allow the ECN members to divide the work among themselves in a flexible manner—the objective being to come to efficient enforcement by the Network—these are not rules of competence nor are they rules of jurisdiction, which would take away the flexibility of the system. So the Network does not make formal decisions on case allocation, nor does it act as a clearinghouse. It is only a forum for coordinating enforcement. That is why I prefer, by far, the terminology used in the Notice that refers to work-sharing within the Network. The system is not based on a division of competences, but it is based on efficiency considerations. Of course, there are a number of presumptions for efficient enforcement that are set out in the Network Notice. The main factor is whether an authority is well placed to carry out the investigation, given, for instance, the effects of the behavior, the possibility of bringing it to an end, or having the means to investigate effectively.

The second aspect of formal cooperation within the network relates to the issue of effective enforcement on the basis of the best facts available. Indeed, once a case has started, it is then also important that every authority in the Network is able to base its decision on the best facts available within the Network. That is why we have a number of tools that allow Network members to assist each other during the fact-finding phase of a case. In particular, we have Article 12 of the Regulation, which allows us to exchange information and to use it in evidence. We also have Article 22, which allows one authority to do an inspection in its territory on behalf of the other authority.

The third area of formal cooperation concentrates on the consistent application of Articles 81 and 82. Indeed, the credibility of the reform would be undermined if we were not able as a Network to ensure a coherent application throughout Europe. And as guardian of the EC Treaty, the Commission has a special role in the Network when it comes to guaranteeing consistency. That's why mechanisms are in place to ensure coherent application of the same law by different decision makers, whereby every single case taken by an authority is screened for consistency with established policy and consolidated case law. Indeed, before taking a decision, a national competition authority must send the draft decision to the Commission and to its peers for screening, at the latest, 30 days before taking a decision.

There are, of course, different scenarios as to the outcome of this process. The worst-case scenario is what I would call the “atomic bomb” solution. If there really is a serious problem of major divergence, the Commission can in such a scenario decide to initiate formal proceedings in the case, thereby ending the competence of the national competition authority to deal with the case (mechanism foreseen in Article 11(6) of Regulation 1/2003). But as I say, this is only the “atomic bomb” option and so far there has been no need to use that mechanism. Rather, there have been very, very constructive discussions between the authorities in the Network so that we could ensure a coherent application of the law without having to rely on Article 11(6).

Apart from what I would call this more formal cooperation in the Network in the course of individual case investigations, we have a whole area of less formal cooperation within the ECN, which is also very important because it pursues the objective of promoting a common competition culture. Indeed, the Commission and the national competition authorities can learn a lot from each other, and they are ready to share their experiences. The ECN has proven to be a very good tool in this respect. It is really a broadly functioning framework for discussing all issues of mutual concern and for agreeing on a common approach, which is, indeed, needed to foster the common competition enforcement culture and promote convergence.

We have different fora within the ECN. Two times a year we hold, at the highest level, the meetings of the Directors General of all network members, which is a forum for discussing major poli-

cy issues within the Network. Another central player in the framework is the ECN Plenary, which assembles officials acting as liaisons with the Network from National Competition Authorities (NCAs), as well as from the Commission (the ECN unit of DG Competition). The ECN Plenary is an open forum that may discuss questions of implementation of the Regulation as well as any other horizontal issue of common interest, including, increasingly, substantive questions.

In order to prepare the debate in that plenary, we also have working groups, which are there to explore in full detail some of the more topical issues. For the time being, we have three working groups dealing with horizontal questions relating to procedural issues: we have a group on leniency; we have another group dealing with temporal issues relating to the implementation of Regulation 1; and then we have a third one looking into issues concerning sanctions and procedures. Recently we have also set up a working group on Article 82 (abuse of dominance). This group is closely involved in the process that was launched by the Commission for preparing guidance on this area of enforcement.

And then, finally, there are also a number of sector-specific ECN subgroups that bring together sectoral experts from the different Network members, for instance in the fields of energy, railways, or insurance. These groups are an excellent forum for exchanging experiences and best practices on sector-specific issues where colleagues can discuss possible policy orientations in their fields of expertise.

That is, in a nutshell, what the Network is doing.

JOHN PARISI: Andreas Bardong, of the Bundeskartellamt in Bonn, how does the ECN look from your perspective in Germany, in the center of the European Union?

ANDREAS BARDONG: I would like to focus on a recent case that provides a good example of the Bundeskartellamt's first experiences with leniency, case allocation, and assistance in the ECN context. All these issues came up in a pending case of the Bundeskartellamt that concerns a price-fixing cartel among paper manufacturers, in particular in the German market for the purchase of used paper.² The case also had a European perspective, involving suspicion of hardcore infringements as regards several national markets for the supply of paper. Leniency applications were submitted to the Commission and to national competition authorities, for example to the Bundeskartellamt. I think the case illustrates how the Network works in practice.

With regard to the first issue, leniency, the paper case shows that leniency programs are still working well in the new system. It seems that leniency applicants have realized that they can continue to rely on the leniency programs at the European and the national level within the new context of a network of competition authorities that cooperate closely.

As clearly stated in the Network Notice, information provided by leniency applicants to a national competition authority in the EU or to the European Commission will only be exchanged between the authorities if the leniency applicants are protected. For example, they can be transferred if the applicants have also made an application to the receiving authority. The same applies if the receiving authority has committed not to use the information against the leniency applicant. This is important in practice if the receiving authority does not have a leniency program in place. The receiving authority's commitment will also be supplied in writing to the leniency applicant.

² See http://www.bundeskartellamt.de/wEnglisch/News/Archiv/ArchivNews2004/2004_05_25.shtml.

I should stress that leniency applicants should make sure that they contact all authorities where they are exposed to an investigation and where there is a leniency program in place. I think that is what happened in the paper case.

The paper cartel is also an interesting case from the perspective of case allocation. It shows that the work-sharing principles that you can find in the Network Notice are quite flexible and that they work in practice. The Commission took charge of the aspects of the case that had a European perspective because the price fixing of the selling price of paper concerned more than three Member States. The German Authority handled the part of the case that mainly concerned only one Member State, the price fixing of the purchase price for used paper.

The third issue raised in this case is assistance and exchange of information. From the perspective of the national competition authorities, the enhanced powers for assistance and exchange of information are probably the most important aspect of the new EU Regulation on competition law enforcement. The Bundeskartellamt applied these powers for the first time in the paper case.

In this case, one manufacturer involved in the cartel was located in Austria. Therefore, the Austrian competition authority provided assistance to the Bundeskartellamt by performing a dawn raid on behalf of the Bundeskartellamt. Subsequently, it transferred the documents found during the dawn raid to the Bundeskartellamt. It is an increasingly common situation that one or several participants in a national cartel do not have their management or their sales department located within the jurisdiction of the competition authority that is responsible for the market affected by the cartel. In such situations, it is extremely important for a national competition authority to be able to turn to the respective competition authority in the ECN network to get by with “a little help from my friends.”

In another recent case, the assistance scenario was reversed. The Bundeskartellamt provided assistance to the Italian competition authority which investigated the prices for baby milk in the Italian market. One of the companies involved was located in Germany. Therefore, the Bundeskartellamt performed a dawn raid on behalf of the Italian competition authority and transferred the documents found during the dawn raid to the Italian colleagues.

I think the conclusion that can be drawn from the Bundeskartellamt's first experiences with the new enforcement rules in the paper case and the baby milk case is that the system is working well and that the new assistance rules enhance effective cartel enforcement.

JOHN PARISI: Ray Leonard, sitting out there on the Emerald Isle, how does the ECN look to you?

RAY LEONARD: We are moving from one of the larger Member States at the center of Europe to one of the smaller, peripheral economies of the European Union. For our American colleagues listening, you might think of us as the New Hampshire of the European Union.

In your introduction, you said somebody once described Regulation 1 and modernization as the Protestant Reformation. The Roman Catholics of Ireland take no offense at that, but would rather think of modernization as a form of ecumenism, because the Regulation doesn't seek harmonization—or, indeed, even approximation—at this stage; what it is doing is bringing together a number of diverse faiths and trying to get them to move in the same direction. We all believe in one god, essentially.

Now, Kris accurately described the procedural and legal mechanism by which the Network operates—that is, the Regulation and the various notices. That sounds a little bit dry and anodyne when you leave it just like that. But if you move beyond the Regulation into the Network itself, you

find that it is a bunch of people getting together, as Kris described, at the plenary sessions in Brussels and at various subgroups to deal with the issues that have arisen as a result of modernization.

What has come out of these contacts is a willingness to understand one another, to overcome difficulties, and to reach compromises where compromises are necessary. Generally, there is a “can do” attitude. That to me is the most important thing that has come out of modernization: the way it has been embraced by all of the Member States—this willingness to seek accommodation and to share the information when information sharing is necessary, but at the same time keep the necessary safeguards both from a national and a European point of view.

To give you a practical example of how that has worked for us, I am going to refer to one case, but I am going to try and avoid the specific market because we haven't quite closed the file yet. In this case, a trade association in the Republic of Ireland is alleged to be involved in cartel activity. A number of the members of the trade association are producers and manufacturers in a neighboring Member State.

The case was notified to the Network as an Article 81 infringement possibly affecting trade between Member States. We contacted our colleagues on the neighboring island. Based on the good contacts and goodwill that we had established having met them in Brussels (and within a very short space of time) they were, acting on our information, able to conduct a series of interviews with the persons involved and satisfied us very quickly as to the nature of the activity.

I have a law enforcement background and I have had to do these kinds of exercises before in other agencies, usually by use of a Commission Rogatoire through our Justice and Foreign Affairs Departments. It took months to accomplish and faced bureaucratic obstacles all the way. This Article 81 exercise was done in a matter of weeks; it was done speedily and efficiently and exactly the way that we wanted it done. It is all due to the functioning of the Network.

I want to mention one particular difficulty we have with the Network—it is more the Regulation, I think. And it is not so much a difficulty as a cause for us to take care. Article 12, the Article in the Regulation that governs the exchange of information, has a specific caveat at the end which is designed to ensure that information exchanged cannot be used to impose a prison term on anybody suspected of a hard-core cartel offense. That is important in Ireland because we operate under a criminal regime with respect to cartel offenses. On conviction, a violation can carry a sentence of up to five years in jail. So what it means is that, unlike a lot of the other Member States, we have to be extra careful when we go to the Network for information because most of our cases are criminally prosecuted. If we do take information from the Network that is used in the investigation, then we have to ensure that legally the outcome is not dependent on that information for the purposes of imposing any penalty, particularly a penal one.

JOHN PARISI: Thank you for describing the criminal aspect, because criminal enforcement on the American side of the Atlantic is a challenge to U.S. and European competition authorities in developing further cooperative efforts in cartel enforcement, and we hope that we can make some progress in the future.

Let's move from the far west of the European Union to Central Europe, to Jozsef Sarai of Hungary, a new EU Member State that has had a competition since 1991. How does the European Competition Network operate from your perspective?

JOZSEF SARAI: Hungary has, I believe, far less experience than many large incumbent Member States have in the enforcement of the EC competition law. Nevertheless, since the modernization

package entered into force, we have initiated ten cases under the EC law. This is around 15 percent of our casework compared to the total number of our cases commenced in the categories of anticompetitive agreements and abusive practices.

All the ten cases were initiated in parallel under EC and Hungarian competition laws. I believe that this is a phenomenon that is characteristic mainly for the new Member States, and perhaps it can be also said that it is characteristic for those old Member States which were not authorized for the application of EC competition law prior to May 1, 2004.

The reason for the parallel legal basis is that the practices against which we initiated these proceedings were begun earlier than May 1, 2004. Consequently, we have to apply our national law for that part of the violation which was committed before we acceded to the Union, before the modernization package entered into force; and for that part of the violation which was continued after May 1, 2004, we apply the EC law.

None of these ten cases has arrived at the decision-making phase. This means that we have not communicated our planned decisions to the Commission. As Kris mentioned, to achieve consistency of the EC law application, the national authorities have to report their planned decisions. So we have not had any practice in this respect. This also means, of course, that no decision has been made under EC law by our decision makers in the application of the European competition laws.

As regards case allocation, we have limited experience. We have participated in this exercise on one occasion. In one of our cases, we found that there was a partial overlap with one of the cases started by the Commission. Following consultations with our colleagues from the Commission, the Commission continued the common part of the case and we continued that particular part of the case that was not tackled by the Commission's investigation, which was relevant mainly from the Hungarian perspective.

There are many instruments of ECN cooperation that the Hungarian Competition Authority has not yet tested in practice. Among others, we haven't investigated in parallel with other ECN members; we have not tested information exchange; we haven't been requested to give assistance to the Commission in on-site inspections in the territory of the country; and we haven't been requested to carry out any investigative measure for other ECN members either.

Let me mention another issue specific to new Member States. The entry into force of the modernization package coincided with the accession of new Member States like Hungary. As a result, in addition to the fulfillment of all the tasks stemming from the modernization, we have to learn and put into practice all those exercises for which the old Member States have already become well trained.

We are speaking basically about modernization and about application of Articles 81 and 82. But the accession also brings new responsibilities for the competition authorities of the new Member States into the field of merger control as well as concerning their participation in the work of the two advisory committees, which is not really new for the old Member States. These advisory committees—formed by the Member States' competition authorities—assist the Commission's decision making.

If I try to summarize the experience of these first eleven months, I could say that the workload of the Authority increased very substantially. First of all, when we plan to initiate a new case, we have to consider the legal basis very thoroughly. This means that we have to decide whether we proceed under national law or under the European law. This contemplation has been done not only in the case of the ten ongoing proceedings that have been commenced under the European law, but also in the case of all the other proceedings—around 70, involving both anticompetitive

agreements and abusive practices—that have been commenced at the end, under the national law, because we found that there was no interstate trade effect from the practice.

Furthermore, we rolled out a system which monitors the cases initiated by all the other members of the ECN in order to allow our colleagues to initiate our own case in parallel if we find that the case commenced by other authorities will affect the Hungarian market, too, even if we hadn't had any case of this kind. But we carefully analyze all the new cases reported by other colleagues through the Network and this monitoring has brought considerable additional work for us.

The work is not spectacular, since it cannot be measured by the number of cases started by the Hungarian Authority. So there is not an increase in the number of cases, but the work we find has increased substantially nonetheless. At the same time, the whole exercise is extremely interesting. It provides an enormous and very valuable information source for our experts responsible for casework concerning given industries. Their perspective has widened substantially by having information about cases, even on the continental level.

I have to say some words about the working spirit, which is very informal. It happens regularly that colleagues from other authorities send around email messages to all the other members of the Network asking relevant professional questions about a particular issue—for example, market definition in a particular case. We have also used this opportunity. So during this nearly one-year period my impression is that a real network has begun to develop, and I believe that we are on the right track.

JOHN PARISI: Before turning to Dirk Schroeder and Hendrik Bourgeois for comments, I would like to pose a general question to the four enforcers. Jozsef mentioned some of the kinds of day-to-day things that happen, the communication that takes place among participants in the Network. The question I would like to ask is whether or not there is some aspect of this work that has been surprising to you, either positively or negatively, and whether it is something to be encouraged or something that you think needs some work?

JOZSEF SARAI: When we were involved in the modernization preparation from the very beginning, in the autumn of 2002, we wanted to do things very fast but well, so we focused on the preparation very carefully. We established an internal system here within the Authority. The different units of the office cooperate with each other, for example, when we consider whether trade is affected between the Member States or not. And we also carefully regulated which unit of the office is responsible for which part or parts of the ECN-related work—that is, we tried to foresee and avoid possible surprises. Owing to this thorough preparation, I believe it would be hard to say there is anything which would have surprised us. Perhaps the number of the cases was surprising—we expected fewer cases under EC law; these ten cases seem to be high.

The cooperation is another issue; this working spirit within the Network which is very informal, very helpful, and direct surprised us to some extent. My colleagues in the sectoral divisions who are responsible for the casework say that it is very stimulating. There is much information, although sometimes it is very hard work to follow what happens in other authorities in different industries. But it is very helpful to see the development of competition law on the European level.

JOHN PARISI: Ray, from your perspective in Ireland, have there been any particular surprises?

RAY LEONARD: Perhaps a lack of interaction at the Network has come as some surprise. We supposed in the preparation stages that, given our exposure to the larger UK economy, the common

border with Northern Ireland, and the fact that we are a base for so many American corporations for their expansion into Europe, that we would have a larger number of cases interacting with the Network than we actually have. We have not been overwhelmed at the number of Article 81 and 82 cases—that's an understatement.

JOHN PARISI: That is interesting. Listening to a program just the other night in which someone made a comment about the booming economy of Northern Ireland, I thought about the booming economy of the Republic of Ireland, and wondered: Does this lead automatically to the Commission having responsibility for these kinds of cases? I take it from you that that's not necessarily the case.

RAY LEONARD: No, it's not the case. The Commission is interested where it affects three or more Member States; that's the general guideline. But so far not only haven't we had an effect in two Member States, never mind three, most of the cartel activity that we have detected in our investigations is confined to the domestic market.

JOHN PARISI: Andreas, from your perspective in Germany, have there been any surprises for you and your team?

ANDREAS BARDONG: At the Bundeskartellamt, we had expected that most of our cases would meet the jurisdictional threshold "affectation of trade between Member States" for EU competition law and would therefore come under Article 81/82 EC and not exclusively under national competition law. In the jurisprudence of the European Court of Justice, this criterion is given a very broad reading. On this issue, our expectations were met in practice.

As regards the operation of the case allocation rules in practice, we were quite surprised by our first experiences. At the stage of the discussions that lead to the network notice, we were working on all the details of the case re-allocation procedures and expected there would be more cases in which we would have to enter into case allocation discussions with other national competition authorities. But in practice, it has turned out that in most situations it is quite clear from the start where the cases should be handled; and they stay with the authority that starts the investigation. Many cases have a clear focus on one Member State, so it is obvious that they should normally be pursued by the national competition authority of this Member State. There are also quite a few other cases that the Commission clearly should take up because they affect more than three Member States.

JOHN PARISI: Kris, in Brussels, are there any surprises from your perspective?

KRIS DEKEYSER: I would say that there are two bonuses that I did not expect to happen so quickly and easily. The first has been mentioned by Jozsef and Ray: it is the readiness of all Network members to hear and learn from the observations of others. We have very constructive discussions on issues that arise in daily work, which really help us. This has developed very quickly and very well, I would say.

Second, there has been an important convergence on national procedures. As you know, with modernization, we have had substantive convergence, so Articles 81 and 82 have now become what people call "the law of the land" inside the European Union. What Regulation 1/2003 did not do is harmonize national procedures and sanctions. There is no legal obligation for the Member

States to harmonize procedures, but nevertheless we see that a growing number of Member States are closely aligning their procedures. For instance, we see in a lot of Member States that there has been an abolition of the national notification system. A lot of national competition authorities also have introduced commitment decisions as well as leniency programs. Within the European Union, 17 Member States already have a leniency regime, and this is a big step forward compared to the situation two or three years ago.

Having said this, we are aware that not everything is perfect, in particular with regard to leniency in the EU in a wider sense. Indeed, leniency programs are linked to sanctions and are thus an area in which diversity persists among the Member States' legal systems. The existing programs show a degree of variation, which at the end of the day could dissuade potential applicants from going lenient within the Network. It is also true that the current system requires leniency applicants to file with all concerned authorities, and that such multiple filings are time- and cost-consuming and do constitute a burden. We are aware of this, and that is exactly why, within the Network, we have launched a working group to look into these issues and see how the current system could be improved.

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JOHN PARISI: Let us now turn to Dirk Schroeder. From your perspective in Cologne, could you tell us about your experience so far?

DIRK SCHROEDER: I think Kris has just made an excellent introduction for what I was going to say. I'm not surprised that Ray and Andreas in their introductory statements focused very much on cartel cases, because this seems to be the area where the Network can be most efficient. It is not just an issue of case allocation, but it is also one of cooperation.

These days, cartel cases are very much driven by leniency. We are no longer living in an age where companies would dig in and try to defend on all fronts. Leniency has really changed that. Leniency is a great tool for the agencies, probably more effective than anything else they are doing. Leniency is also an opportunity for the enterprises that find themselves in a situation in which they can use it. So, in practice, this is very much the focus.

The problems in practice for private practitioners and for the enterprises they represent are basically the three issues that Kris just mentioned. The least important of those is probably the lack of a "one-stop shop." You still have to go and apply everywhere, but this is manageable.

What is far more disconcerting is (a) the fact that not every Member State has a leniency program; and (b) that the existing programs are so different from each other. The first one is obvious. There are eight Member States that do not have a program. If there is no program, then you can't apply or, if you do, applying won't get you very far. For the time being, the only solution is to ask and hope for the Commission to take and keep all cases involving Member States that have no program. I understand that four of the remaining Member States are in the process of at least considering adopting a program, but that would still leave four that continue to be a concern.

As far as the differences are concerned, there are a substantial number of differences. An obvious one is that some Member States have criminal sanctions; others don't. That is not a real problem in practice, I think. But, more importantly, some programs cover vertical restraints; others do not.

Another difference is that under the European Commission's 2002 Notice, even ringleaders or instigators can get leniency or amnesty. There are still a number of national programs, however, that follow the earlier 1996 model. Under this format, if an enterprise has been an instigator and a ringleader, then it is not eligible for leniency. I think that is, for example, the case in Ireland.

—**DIRK SCHROEDER**

Then you have programs that give not only leniency to the first applicant but also some reduction to numbers two and three. In other programs—again Ireland, I think—the first in the door gets leniency and further applicants do not.

A very practical issue, which has also become a cross-Atlantic issue, is the question of terminating the infringement. All leniency programs require that at some point the applicant terminate his participation in the infringement. Now, taking a cartel where price discussions or price announcement discussions have taken place at association meetings, the agencies are split as to how one should behave as a leniency applicant. The European Commission takes a rigid position, saying, “Well, you have to stop; that means you cannot go there anymore unless you are prepared to stand up if anyone talks about prices and to say that you are not participating and that you are leaving,” which of course may also have the effect of alerting everyone else as to what is going on.

I understand that some Member States, including Germany and the Netherlands, would like to be a little bit more flexible there, and I know that the DOJ has had discussions with the Commission precisely about this issue. The DOJ thought a radical cutoff in attending association meetings could be counterproductive and make it less likely that dawn raids would be successful.

Then there are differences between the programs in how much evidence one must put forward in order to secure a place in line. In some programs, it is just a marker in the sand—you call up and then you have time to produce the evidence. In others, you have to put the evidence on the table or you will not secure a place in line. Now, this makes leniency strategy for the companies extremely difficult because you always have to weigh the speed of getting there and the difficulty of obtaining the evidence that you need to actually get your place. That may lead to situations where you end up being number one in some countries but not in others. Things could be so much easier if the programs took a uniform approach.

Two more differences and then I will stop.

One is that currently only the Office of Fair Trading—OFT—offers “leniency plus,” which is modeled upon the U.S. “amnesty plus” program, where if you inform the agency about another cartel, you can get leniency in the first cartel. It exists somewhat informally in practice in other countries, but it is only formalized in the United Kingdom.

The last point is that not all European agencies accept oral statements. Parties have an interest in only making oral statements in order to try to protect themselves against discovery in the United States. The Commission is very flexible in that respect; many other countries are, too. But if you make an application in Belgium these days, you have to put it in writing because the law says that it has to be in writing.

Now, it would be largely preferable if these differences between the programs did not exist or if there was just one program. That would be my question to the four agency panelists: What are you doing about it?

JOHN PARISI: They will have an opportunity to answer that question. But first, let us turn to Hendrik Bourgeois and ask him for his comments on the ECN.

HENDRIK BOURGEOIS: Let me start off by making a more general remark. I think it is clear that the goals pursued by the ECN are of key importance for the business community operating in the European Union. Effective enforcement and coherent enforcement, to which Kris Dekeyser referred, are, of course, very worthwhile objectives for companies and for their legal representatives. And harmonization and convergence of European competition law is very beneficial to

commercial organizations with activities spread out within the European Union.

Having said that, from a practical perspective, notwithstanding the apparently great degree of harmonization and convergence that is being brought about by the functioning of the ECN, my sense—and this could be a paradox—is that, today, ensuring compliance with EU competition law in this new environment is perhaps becoming more complex, richer, and more challenging than it was in the past, and not only with respect to the wide variety of leniency programs that exist today to which Dirk was alluding. There are a number of reasons why I think that this may be the case.

First of all, from a general policy perspective, it is clear that EU competition law has gained in awareness and it has gained in visibility and in importance precisely as a result of the increase in the amount of authorities enforcing it. The greater the number of enforcers, the more likely the risk of detection of a particular violation, and therefore, simply, the more significant a set of rules becomes.

First of all, from a general policy perspective, it is clear that EU competition law has gained in awareness and it has gained in visibility and in importance precisely as a result of the increase in the amount of authorities enforcing it.

Secondly—and this relates to my first point—I don't think that practitioners today, whether private practitioners or in-house counsel like myself, can simply stay abreast of EU competition developments by reading up on the main developments brought about by the European Commission. Modernization requires practitioners to follow the trends and developments of two types of authorities, courts and administrations, in 25—including the Commission, 26—jurisdictions. There are, of course, a number of private publications that follow these developments and, as you may be aware, the European Commission is keeping a national court cases database consisting of copies of judgments of national courts deciding on the application of 81/82.³

I am not, by the way, aware of any similar official database containing decisions of the national competition authorities applying 81/82. I don't know whether ECN has even thought about creating such a database. But I think that could be something that would be of great use.

A final reason why I think that ensuring compliance with competition law may be today somewhat more challenging is because harmonization may have undesirable side effects. Dirk already spoke at great length about leniency programs and the fact that now we have 17 Member States having followed the EU example in adopting leniency programs, which may result in negatively impacting the effectiveness of one single leniency program simply because it increases the opportunities for private plaintiffs to obtain access to administrative files. Therefore, it can create a disincentive to apply for leniency in the first place.

Another example, to which I think Kris was alluding, is the fact that as part of the growing tendency of Member States to align their competition procedures to the EU procedures, there are an increasing number of authorities that are also abolishing the ability for companies to notify agreements. And notifying agreements benefits legal certainty. I am not sure that from a business perspective, this is necessarily a positive development.

So these are a few general thoughts that I had on how modernization and the advent of the ECN have changed and are changing the landscape for practitioners. Of course, the ECN is clearly more than a tool to coordinate enforcement activities. It is also used as a discussion platform to improve competition policy issues in general.

I think it is a very worthwhile goal to pursue the elimination of unnecessary or duplicative procedural burdens. In this respect, I agree that setting up a “one-stop shop” leniency facility would be something that would be very useful. I was wondering whether the panelists would give us their

—HENDRIK BOURGEOIS

³ See http://europa.eu.int/comm/competition/antitrust/national_courts/index_en.html.

views on whether they also would regard this as a positive development. I am particularly interested in the views of the representatives of the national competition authorities in this respect.

It is somewhat strange and it seems to be a waste, or at least a bad allocation, of scarce resources to require companies to file a leniency application simultaneously with the European Commission and with a large number of other authorities, each in different languages and focusing on different aspects of their specific leniency programs, only to find out later that the European Commission takes jurisdiction over the case after all.

Finally, I will conclude my remarks with a final suggestion, referred to by Jozsef Sarai when he was talking about the merger area. It is clear that there are other areas where I think there is room for improvement. Today there are a wide variety of procedural differences at the Member State level regarding merger review. The European Competition Network could perhaps follow the example of the International Competition Network and promote the adoption and implementation at the European level of recommended practices for merger notification procedures. These practices could then achieve European convergence in merger review and avoid, again, unnecessary filings and eliminate unnecessary or duplicative procedural burdens.

... as a leniency applicant, you are certainly not worse off in the new system than you were under the old system. I would even say, to the contrary, for those cartel cases where the Commission initiates proceedings, the situation is today more certain and clear than under the old regime.

JOHN PARISI: Let's go back to Kris. Both Dirk Schroeder and Hendrik Bourgeois have talked about the need for a "one-stop shop" for leniency. Commissioner Kroes has mentioned this idea in recent speeches. Could you address that idea, as well as the efforts you are making now, in the absence of a "one-stop shop," to try to make the process work smoothly for all involved?

KRIS DEKEYSER: To start with—and I would like to stress this—as a leniency applicant, you are certainly not worse off in the new system than you were under the old system. I would even say, to the contrary, for those cartel cases where the Commission initiates proceedings, the situation is today more certain and clear than under the old regime. Indeed, before the entry into force of the new Regulation 1, you could even have a scenario where the Commission was dealing with the case and then in addition, on the basis of national law, a national authority was investigating a case (the old "Walt Wilhelm" scenario). The competence of national competition authorities to apply their national law in such a situation has now been removed with Regulation 1.

What has of course changed with Regulation 1 is the increased scope for exchange of information within the ECN. But to ensure that these exchanges do not harm the position of a leniency applicant, we have built in very good guarantees within the Network Notice, and all the Network members have subscribed to these guarantees. First, no member of the network can use information he got through the ECN about a leniency case to initiate its own "ex officio" proceedings against the leniency applicant. Second, information provided by a leniency applicant or collected on the basis of his application may in principle not be exchanged without the consent of the applicant. The only exceptions to that rule are the cases where the exchange takes place between two authorities that have received an application by the same applicant or where the receiving authority commits not to use the information or any information gathered after the transmission to impose sanctions on the applicant. By this mechanism, a company can get immunity in a Member State that doesn't even have a leniency program! So, in fact this is a nice device to expand the benefits of leniency to Member States which even do not have a leniency program.

To cut it short, we have built in all the guarantees which are possible in order to make sure that, as of May 1, 2004, the situation has not become worse for leniency applicants. But having said that, I am aware—we are all aware, I think, within the Network—that there is certainly scope for further improvement. The current system requires leniency applicants to file with all concerned

—KRIS DEKEYSER

authorities within the network and we understand that such multiple filings are time- and cost-consuming. We are also aware of the fact that discrepancies in the various programs might dissuade potential applicants from applying. Therefore, as a Network, we have launched a working group on the leniency issues, where representatives from all authorities meet on a regular basis. The task of this group is to identify possible deficits and problems within the current system and then, indeed, to propose solutions on how such deficits could be overcome.

It is also very much in our interest to listen very carefully to the signals given by the business and legal community and then to tackle the obstacles that might jeopardize the success of all programs. I would not commit myself today to say how the solution should look. We are only at the very beginning of the process and it is far too early to give any indication of if, how, and when a “one-stop shop” for leniency could be introduced. There are also different scenarios. It is clear from a very preliminary analysis that the term “one-stop shop” is a catch-word that covers a number of possible arrangements. As a methodology, we will try first to find solutions within the current framework. If this is not possible, then we will have to see together as a Network what will be the best way forward. But you can be sure that the Commission and the national competition authorities are determined to ensure that there are sufficient incentives for applicants to go lenient and to make the current system more efficient.

JOHN PARISI: Returning to Ray Leonard, since your name and your agency were specifically mentioned, do you have some reaction to the comments that Dirk and Hendrik have made?

RAY LEONARD: Yes. I have somewhat of a schizophrenic attitude. The law enforcer in me smiled wryly when I heard the statement that the price fixers who are getting a lucky break are moaning about the quality of that break and wanting it improved even more. But that said, the pragmatist in me goes with Kris, recognizing that something like the concept of the “one-stop shop” ultimately will be required.

It is not going to happen in the short term. It is still in the discussion phase. It mightn't be actually that, but something different. But it is, I acknowledge, almost unworkable to have a corporation that might have activities in 10 or 15 Member States trying to make multiple applications across various time zones in various languages so as to meet the conditions of each one, with the conditions varying in each one as well.

So as I say, I am somewhat schizophrenic, but the pragmatist in me recognizes the reality of the situation.

JOHN PARISI: Andreas, do you have any reaction?

ANDREAS BARDONG: I think that we should have a little bit of patience regarding the multiple leniency issue. In my opinion, the Network Notice has been successful in providing leniency applicants with sufficient guarantees to maintain the attractiveness of existing leniency programs in the context of the new network of competition authorities in Europe. At the same time, an increasing number of competition authorities that have not operated a leniency program so far are introducing one or are thinking about doing so. In my opinion, before thinking about major changes in the leniency programs' legal basis we should try to make the new enforcement system work as it stands right now and see what room there is for improvement in the handling of leniency applications in practice.

I would also like to address a point that was made by Mr. Bourgeois concerning the abolition

of the notification system in Regulation 1/2003. You regret that companies can no longer notify agreements. I would like to add that the Bundeskartellamt, with the further alignment of German with European competition law, also regrets that it will no longer receive notifications and the information about business practices and developments in the market place that are often contained in them. This is the main reason why the Bundeskartellamt opposed the move to the legal exception system. I do not want to go into the details of a closed debate, but simply want to stress that the Bundeskartellamt continues its open door policy for companies that would like to discuss potential competition issues in advance. If companies are ready to give an accurate description of their plans and of the market situation, officials at the Bundeskartellamt are happy to take the time for an open discussion of the issues. I think that can be a recipe to avoid problems with the Bundeskartellamt in difficult cases.

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JOHN PARISI: Jozsef, do you have a reaction from your perspective in Hungary that you would like to add?

JOZSEF SARAI: Well, as I mentioned, we don't really have too much practice. Concerning the leniency questions, Hungary introduced a leniency policy a year ago, in January 2003. When we were invited to participate in the elaboration of the notices—for example, the details of the Regulation 1/2003—we arrived at these meetings with an associated status. Hungary signed an association agreement with the European Community in the early 1990s. Under this agreement, we undertook to approximate our law to the European law. So we had a commitment to approximate our laws and our by-laws to the European legislation.

As a consequence of this routine, we expected far more centralized rules. Of course, the full Modernization Rule is about decentralization, but originally we expected not only that the substantive rules, Articles 81 and 82, would be the same but also that on the procedural side—concerning the national procedural rules, sanction systems, and those concerning leniency—the whole system would be somehow more centralized.

But having the situation now and having the existing rules, I tend to believe that now first we have to test these present rules and to analyze the lessons and experiences we can get from the operation of the present system. As Kris mentioned, for example, the interpretation of “one-stop shop” in the leniency field can be different. It might mean the same leniency rules on the national level or one common leniency policy in the form of a Council Regulation, for example, or only a central notification point. There are so many questions which this “one-stop shop” idea could raise; we have to learn from the application of the present rules and then to decide about the scope of this new regime very carefully.

JOHN PARISI: I would like to ask Dirk and Hendrik, in that order, if you have some further comments perhaps in rebuttal, or anything further that you would like to add to what has been discussed here.

DIRK SCHROEDER: I have a rebuttal and a question, both for Ray. The rebuttal is that I think it is a bit one-sided to talk about lucky breaks and companies that want leniency improved even more. Leniency is foremost in the interest of the enforcer. Without leniency, you couldn't do the job you are doing. It just happens, though, that the applicants' and the enforcers' interests are aligned. If we are asking for a harmonization of programs, it is not to make it easier for the companies, but to make the whole system better and more efficient.

Now, the question. In Ireland, you have criminal sanctions for cartel infringement. In leniency cases, have you seen companies and their employees arrive with different sets of lawyers because of possible conflicts of interest?

RAY LEONARD: To deal with the latter question first, the question of conflict of interest and employees' representation is currently in litigation in our High Court, so it is not something I am prepared to speak about publicly. The case has finished and we await the Judgment of the Court. There is a difference of opinion between the Competition Authority and the Law Society representing lawyers; our Attorney General has weighed in. There are lots of issues involved. We did issue a Policy Notice on the matter of conflict of interest in representation. That has helped with the subject of challenge. So if you'll let me escape on that one, I'll be most grateful.

On the other matter, the leniency program and your "rebuttal," for want of a better term, I hear where you are coming from. It was a sharp remark on my part. Actually the relationship is not necessarily just for the benefit of the enforcers. It is a symbiotic relationship; both parties get something of significance out of it.

In Ireland, at the very least, we are not dependent on the leniency program. There are a few cases heading towards the courts and they are not dependent in any shape or form on an immunity applicant. We haven't had to depend on one yet. It is possible to present the case without an immunity applicant. That said, it's handy to have one, but it is not vital.

HENDRIK BOURGEOIS: I just very briefly wanted to respond to Andreas, to let him know that the only reason why I mentioned the notification procedures and the lack of legal certainty that is created by the abolition of it results from my reading of the Regulation. The European Commission at least is reserving its right to give advice to undertakings and companies only in cases that give rise to genuine uncertainty because they present novel or unresolved questions. It seems to me to be unnecessarily restrictive for purposes of giving simple informal advice and informal guidance. I am more than happy to hear that the Bundeskartellamt is apparently taking a more relaxed approach to that.

The quick question I had relates to a judgment of the Court of First Instance last week, I believe, concerning the Austrian banks cartel, where the Court of First Instance annulled a Commission decision rejecting a request for access to the administrative file, which was brought about by a consumer organization that was bringing proceedings for civil action in civil court. Apparently, the Court of First Instance annulled the rejection of the Commission on the basis of the European Regulation regarding public access to European Parliament, Council, and Commission documents.

The question I had was whether or not this decision might have an impact on the functioning of the ECN and whether in the future companies wishing to apply for leniency might be interested in or could have an interest in applying for leniency in jurisdictions that would have less strict types of public information guarantees for private litigants?

JOHN PARISI: Kris Dekeyser, would you be willing to respond to that question?

KRIS DEKEYSER: There are two different issues at stake here, a more general one and a more specific one. The more general issue is the interaction between leniency on the one hand and private enforcement on the other hand. Of course, as a competition authority, we are very much interested, as Dirk rightly said, to have good leniency applications because this then allows us to detect the hard-core cartels.

[H]ere in Europe, compared to the United States, private enforcement is rather limited and we are indeed looking at the situation to see how private enforcement could be improved in Europe.

—KRIS DEKEYSER

On the other hand, here in Europe, compared to the United States, private enforcement is rather limited and we are indeed looking at the situation to see how private enforcement could be improved in Europe. One could indeed argue that these are two conflicting interests. I would argue that a balance needs to be struck between the aims of encouraging private enforcement of EC competition law and maintaining incentives for leniency applicants. The Commission and the Member States will need to explore possible means to reduce the civil exposure of successful leniency applicants, so as to preserve the balance between the enforcement instruments of, on the one hand, the leniency program and, on the other, civil damages enforcement. This is exactly one of the issues on which we would like to have a broad debate with all interested parties when we launch our Green Paper on Private Enforcement.

Coming now back to the more specific issue, the Austrian Banks Judgment, this is of course a very recent judgment and we have to analyze it further in order to be able to pronounce on its possible consequences. Therefore, I will give you my very preliminary and strictly personal views. I would like to underline that this is a judgment on the application of the Public Access Regulation and, as such, it does not take position on the substance of the case. It only annuls the decision of the Commission to refuse access to certain documents because we did not respect the procedural requirements of the Regulation. The Court ruled that where an institution receives a request for public access it is required, in principle, to *carry out a concrete, individual assessment* of the content of the documents referred to in the request. The approach chosen by the Commission, to refuse access on the basis of categories of documents, was rejected by the Court. But again, the Court did not express a view on the substance. It did not rule on whether any of the exceptions for access, which are included in the Regulation, had been rightly or wrongly invoked by the Commission. It cannot therefore be assumed that the Austrian Banks Judgment will have the result that the European public at large will now all of a sudden have access to more Commission documents, in particular case files from DG Competition, than in the past. It could well be that, when applying the correct procedure, the result, in terms of access to certain documents, would be exactly the same as before.

But, again, this is really my personal view and subject to further scrutiny of that judgment.

JOHN PARISI: It sounds to us on the American side as though your Court took the same approach to the European Union's Freedom of Information Act that our courts have towards the U.S. FOIA.

And with that, let me thank all of you for your very thoughtful comments about the European Competition Network. This session certainly has given all of us much to think about, both in representing clients and in working in the agencies, as well as cooperation across the Atlantic. ●

Implementation of the ICN's Recommended Merger Practices: A Work-in-(Early)-Progress

J. William Rowley and A. Neil Campbell

Over the course of four years, beginning at the International Competition Network's (ICN) first conference in Naples in 2002, ICN members have embraced a growing set of best practices for the design and operation of merger review regimes.¹ Implementation of these Recommended Practices has now been recognized as the greatest challenge for the ICN's merger work program.² To assess and encourage progress, the Merger Streamlining Group (MSG)³ commissioned two surveys of competition agencies and private law firms in all ICN member jurisdictions. The first, carried out in 2003, found very mixed levels of compliance with the ICN's initial three Recommended Practices for Merger Notification Procedures.⁴ In 2004, a second survey was undertaken to measure implementation of the ICN's next four Recommended Practices relating to Review Periods, Requirements for Initial Notification, Transparency, and Review of Merger Control Provi-

¹ ICN, Recommended Practices for Merger Notification Procedures, <http://www.internationalcompetitionnetwork.org/mnprecpactices.pdf> [hereinafter Recommended Practices].

² Initially, the ICN leadership questioned the appropriateness of the organization taking an active role in seeking the implementation of its Recommended Practices. See, e.g., Konrad von Finckenstein, *International Antitrust Policy and the International Competition Network*, 2002 FORDHAM CORP. L. INST. 37, 46 (B. Hawk ed., 2003). This debate has been resolved squarely in favor of seeking to help the implementation process. Indeed, the Mission Statement that was part of the ICN's conference materials for its 2005 meeting in Bonn makes it clear that the valuable written work product of the organization should be viewed only as an "intermediate step," and that actual achievements for the ICN are to be measured by real world changes for the better in practice. See International Competition Network: A Statement of Mission and Achievements Up Until May 2005, http://www.internationalcompetitionnetwork.org/bonn/Work_Plans/achievements/ICN_Mission_and_Achievements_Statement.pdf.

³ The members of the Group that commissioned the study are Alcan Inc., British Telecom, Charles River Associates, Compaq Computer Corporation, General Electric Company, Goldman Sachs International, NERA, Rio Tinto plc, and Vodafone Group plc. The MSG is assisted by a project team consisting of Janet McDavid (Hogan & Hartson LLP), Phillip Proger (Jones Day), Michael Reynolds (Allen & Overy LLP), and J. William Rowley QC and Neil Campbell (McMillan Binch Mendelsohn LLP). In addition to the *2003 Report*, *infra* note 4, the MSG has previously published the following documents: *Best Practices for the Review of International Mergers*, GLOBAL COMPETITION REV. 27 (Oct./Nov. 2001); Merger Streamlining Group Response to the European Commission's Green Paper on the Review of the Merger Regulation (European Council Regulation 4064/89) (Mar. 2002), http://www.europa.eu.int/comm/competition/mergers/review/comments/ref088_mergerstreamlinegroup.pdf; Best Practices for Merger Review: Analysis and Recommendations for Review Process in the United States and the European Union (November 2002) (on file with authors); Letter from Merger Streamlining Group to Philip Lowe, Director General, DG Competition, European Commission (Apr. 15, 2003) (on file with authors); Comments on Ann III: Draft Form RS Published for Public Consultation by the European Commission (Mar. 11, 2004), http://www.europa.eu.int/comm/competition/mergers/contributions/merger_legislation/029_merger_streamlining_group_en.pdf. All of these documents are available at <http://www.mbmlex.com/streamline>.

⁴ The initial three practices related to Jurisdictional Nexus, Notification Thresholds, and Timing of Notification. See Recommended Practices for Merger Notification Procedures (2002), http://www.internationalcompetitionnetwork.org/2002_RPs.pdf. For the results of the 2003 survey, see J. William Rowley & A. Neil Campbell, *Implementation of the International Competition Network's Recommended Practices for Merger Notification Procedures: Final Report*, 5 BUS. L. INT'L 110 (2004) [hereinafter *2003 Report*].

■
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sions.⁵ This article summarizes and assesses the results of the 2004 survey, which found that much work remains to be done.

Summary of Key Findings

Responses were received from the competition law agencies and/or the private law firms surveyed in 65 (i.e., 88 percent) of the 74 ICN member jurisdictions.⁶ At the aggregate level, a 66 percent compliance with Recommended Practices IV–VII was reported.⁷ There was also relatively little variation between the weakest (Review Periods—60 percent), and strongest (Transparency—73 percent) areas, with Requirements for Initial Notification and Review of Merger Control Provisions falling in the middle (65 percent and 72 percent, respectively).

These averages mask much more extensive variations amongst individual jurisdictions. For example:

At the aggregate level,

a 66 percent

compliance with

Recommended

Practices IV–VII

was reported.

- Germany and Mexico achieved almost complete overall compliance with these four Recommended Practices.
- The European Union, Finland, France, Korea, Lithuania, Mexico, Taiwan, the United Kingdom, the United States, and Zambia also have compliance levels of 90 percent or greater.
- There were 17 jurisdictions (i.e., 27 percent of respondents) with scores below 50 percent, including Indonesia and the Philippines at less than 25 percent.

The most notable findings relating to Recommended Practices IV–VII are summarized below:

Review Periods. 65 percent of responding jurisdictions have procedures for expediting the review of transactions that do not present material competition concerns. While 92 percent of responding jurisdictions have formal time limits or normally complete reviews within the ICN's six-month standard for transactions requiring extended reviews, only 73 percent achieve the benchmark of six-week initial waiting or review periods for transactions not warranting extended review (and 35 percent do not have procedures for expediting the review of non-problematic mergers).

Requirements for Initial Notification. With the exception of translation (where there are approximately equal numbers of fully consistent, partially consistent, and inconsistent jurisdictions), a majority of responding jurisdictions comply with each component of this Recommended Practice. However, there are also a considerable number of non-compliant jurisdictions in each case. For example, 42 percent refuse to accept responsive ordinary course of business information as an alternative to formal filing requirements, 32 percent require personal authentication of the notification by senior officers, and a further 32 percent lack any general flexibility mechanisms relating to the notification requirements for the initial review of a transaction.

⁵ Four additional Recommended Practices were adopted at the 2004 Annual ICN Conference in Seoul (Conduct of Merger Investigations, Procedural Fairness, Confidentiality, and Interagency Coordination). See ICN Subgroup on Merger Notification and Procedures Final Subgroup Draft (2004), <http://www.internationalcompetitionnetwork.org/rps1.pdf>. Two others were adopted at the 2005 Conference in Bonn (Merger Remedies and Agency Powers). An untitled paper setting forth these recommended practices is available at http://www.internationalcompetitionnetwork.org/bonn/Mergers_WG/SG1_Notification_Procedures/RPs_XI_and_XII.pdf. It was decided in Bonn that the ICN's merger work focus going forward will be on implementation of the 13 Recommended Practices adopted to date. At least in the short term, it is not expected that additional Recommended Practices will be adopted.

⁶ Five additional jurisdictions have joined the ICN since the survey was conducted.

⁷ The survey was conducted before a renumbering process for the recommendations. For the purposes of this paper the Recommended Practices will be referred to by their original numbers, IV–VII. After the 2004 additions, the Recommended Practices regarding Transparency and Merger Control Provisions were renumbered (from VI to VIII and from VII to XI respectively).

Transparency. 85 percent of responding ICN members have extensive transparency with respect to the scope of their jurisdiction, and 74 percent make available sufficient information about the major elements of merger review procedure. However, only 46 percent are consistent with the Recommended Practice regarding transparency of substantive principles and criteria, and 42 percent of those utilizing non-competition factors do not transparently indicate how these factors interface with other substantive aspects of the merger review regime.

Review of Merger Control Provisions. As of Spring 2004, 84 percent of responding jurisdictions had either reviewed their merger regime since the initial ICN meeting in Naples (September 2002) or had plans to do so, and 64 percent indicated an intention to pursue reforms that promote convergence with recognized best practices.

Objectives and Process

ICN members indicated after the endorsement of the Guiding Principles for Merger Notification and Review⁸ and the initial three Recommended Practices at their first annual meeting in Naples that implementation issues would be left to the initiative of individual jurisdictions.⁹ While this approach was replaced by an explicit commitment of ICN members at the third and fourth annual meetings in Seoul and Bonn to address implementation as a priority issue,¹⁰ private sector participants have also been encouraged to take an active role in promoting such implementation. The Merger Streamlining Group's 2004 survey was one response to that request.

Following the process established in 2003, surveys were developed to obtain information from both competition law enforcement agencies and private law firms that are regularly involved in merger reviews. The surveys were designed to gather information that is as objective as possible in order to allow an assessment of the level of implementation of each Recommended Practice in each ICN jurisdiction.

The survey was lengthy, primarily because Recommended Practices IV–VI have numerous components and are supplemented by extensive commentaries from the ICN's Merger Working Group. Nevertheless, the response rates were strong: 54 percent of agencies and 73 percent of law firms surveyed provided responses that were substantially complete.¹¹ While it was disappointing not to receive responses from all ICN member agencies and law firms that were contacted, when overlapping agency and private sector responses are consolidated, there were only nine jurisdictions without a response.¹² With the exception of certain relatively subjective questions, responses from the competition agency and law firm for a particular jurisdiction were generally consistent.

⁸ ICN, Guiding Principles for Merger Notification and Review (Sept. 2002), <http://www.internationalcompetitionnetwork.org/icnnpguidingprin.htm> [hereinafter Guiding Principles].

⁹ See, e.g., Konrad Von Finckenstein, Comm'n of Competition, Competition Bureau, Canada, Address to the Conference Board Antitrust Conference: Antitrust Issues in Today's Economy (Mar. 2003).

¹⁰ See, e.g., ICN, Implementation of the ICN Recommended Practices For Merger Notification and Review Procedures (Apr. 2005), http://www.internationalcompetitionnetwork.org/050505Merger_NP_ImplementationRpt.pdf.

¹¹ The higher private sector response rate may reflect resource availability (although efforts were made to keep the survey as simple as possible) and/or possible self-selection biases. Agencies which are not committed to implementation of Recommended Practices may have been less inclined to respond, while private law firms were presumably not subject to the same disincentive and may have welcomed the opportunity for visible participation in the public policy process.

¹² No response was received from the agency or the local counsel contacted in Barbados, Colombia, Costa Rica, Morocco, Panama, Sri Lanka, or Sweden, and no response was received from the Andean Community or the EFTA Surveillance Authority agencies (for which there are no local counsel counterparts).

Each of the Recommended Practices has multiple components. The survey questionnaire attempted to gather information regarding the major elements of each Recommended Practice, as set out in the text of the practice itself and as explained by the accompanying comments of the ICN Notification and Procedures Working Group. In the absence of any objective basis for weighting the relative importance of particular components, an overall measure of compliance with a Recommended Practice was calculated by assigning a score of one for each element where a jurisdiction was fully consistent, a score of zero for areas of clear inconsistency, and, where applicable, a score of one-half for partial consistency. Because not all components of each Reviewable Practice are applicable to every jurisdiction,¹³ the total potential score varied between 14–25 across the four Recommended Practices. Results have been converted to percentages for ease of comparison.

[I]t is troubling that over one-third (35 percent) of responding jurisdictions lack processes for expediting the review of transactions that do not raise significant competitive issues.

Review Periods

The Recommended Practice relating to Review Periods was divided into seven major elements:

Expedited Review Procedures. The survey results indicated that about half (49 percent) of ICN jurisdictions have adopted formal two-phase structures and an additional 16 percent employ other practices for expediting review of non-problematic transactions. However, it is troubling that over one-third (35 percent) of responding jurisdictions lack processes for expediting the review of transactions that do not raise significant competitive issues. This continues to be a major source of unnecessary burden resulting from merger review processes.

Time Frame for Initial Reviews. The ICN recommends a maximum six-week time period for initial waiting/review periods. The results in this area were encouraging, with most suspensive jurisdictions (those that impose a waiting period) (80 percent) and a majority of non-suspensive jurisdictions (56 percent) operating within the recommendation. Unfortunately, there was a considerable disparity between the level of compliance in suspensive versus non-suspensive jurisdictions and it was disconcerting to learn that fully one-third of non-suspensive jurisdictions are lacking any clear rules, policies, or practices with respect to initial review periods.

Time Frame for Extended Reviews. For cases requiring an in-depth review, an encouraging 82 percent of suspensive jurisdictions and 71 percent of non-suspensive jurisdictions have formal time frames which meet the ICN's six-month maximum standard. In addition, 13 percent of suspensive jurisdictions comply with the ICN's alternative standard of a waiting period determinable by the parties and usually capable of completion within six months, and 12 percent of non-suspensive jurisdictions comply with the alternative standard of a non-binding policy of completing reviews within six months. This brings the overall levels of compliance to impressive levels of 96 percent for suspensive and 82 percent for non-suspensive jurisdictions.¹⁴ The only three reporting jurisdictions that reported formal waiting periods or time limits in excess of six months were Croatia, Greece, and the United Kingdom.¹⁵ Chile and Pakistan were the only two jurisdictions

¹³ For example, questions with respect to early termination of waiting periods are not applicable to jurisdictions that do not have a waiting period following notification during which the transaction cannot be consummated (non-suspensive regimes), and questions regarding the transparency of non-competition factors are not applicable in jurisdictions where such factors are not considered.

¹⁴ It is important to note that there are a non-trivial number of cases in some of these jurisdictions (e.g., Canada and the United States) that in practice do extend beyond six months.

¹⁵ Both the agency and private law firm respondents from Greece indicated that, despite the prescribed three-month time limit, the review period usually lasts an additional three to six months.

without clear time limits where, in practice, reviews were reported to be only rarely or sometimes completed within the six-month Recommended Practice.

Early Termination of Suspensive Periods. Most competition agencies (80 percent) are able to terminate suspensive periods ahead of the formal expiration date. However, it is surprising that some agencies only have this power in limited circumstances (11 percent) or cannot do so at all (9 percent). It would seem uncontroversial to allow an agency to terminate a suspensive period as soon as it is satisfied that a transaction is not anticompetitive. This is an area in which simple and non-prejudicial changes could make a significant practical contribution to the streamlining of merger review processes.

Time Limit Extensions on Consent. The survey examined the ability of competition agencies to extend suspensive or review periods with the consent of the merging parties on a limited basis (appropriate) or without consent (inappropriate). The picture which emerges in this area is disappointing. Nearly half (43 percent) of agencies do not have the flexibility to avoid the initiation of Phase II proceedings and/or an adverse enforcement decision where such a result might be obviated by a time-limited extension. Moreover, very few (12 percent) of the agencies that have extension powers are required to obtain the consent of the merging parties, which is an important safeguard against the unwarranted use of extension powers where they do exist.

Tailored Procedures for Take-Over Bid and Financial Distress Transactions. The ICN Working Group recommends that one or more appropriate procedures be identified for facilitating expeditious review of particularly time-sensitive transactions.¹⁶ Roughly half of jurisdictions have taken one or more steps to adapt normal review procedures to the distinctive characteristics of take-over bids (47 percent) and transactions involving financially distressed entities (55 percent), although only about one-third of jurisdictions have adopted special procedures for both categories of transactions. Interestingly, a formal shortening of the waiting or review period is rarely the special procedure of choice, being available in only about 15 percent of jurisdictions for non-consensual transactions and 10 percent of jurisdictions in financial distress cases.

Requirements for Notification

The Recommended Practice relating to Review Periods was segmented into eight major components:

Limiting Initial Notifications to Necessary Information. A subjective, rather than objective, assessment was called for with respect to whether initial notification requirements require only such information as is necessary to determine whether an in-depth review is needed. The vast majority (81 percent) of agencies perceived that their initial notifications did not contain unnecessary information requirements, whereas considerably fewer law firms (67 percent) view filing requirements in this manner. "Necessity" may be in the eye of the beholders, since in seven of the ten cases where the agency and law firm within a jurisdiction differed, it was the agency that perceived that none of the required information was unnecessary. Hopefully, this Recommended Practice will stimulate informed debate regarding the extent to which various specific filing requirements could be reduced without prejudicing effective initial review processes.

Flexibility Mechanisms to Reduce Initial Notification Burdens. Over two-thirds of jurisdictions (68 percent) employ at least one of the four types of mechanisms listed by the ICN Working

The vast majority (81 percent) of agencies perceived that their initial notifications did not contain unnecessary information requirements, whereas considerably fewer law firms (67 percent) view filing requirements in this manner.

¹⁶ Options noted in the commentary to this Recommended Practice include shortened waiting/review periods, requiring the initial filing in take-overs from the acquiror only, discretionary information waivers, and a "failing firm" factor or defense.

Group¹⁷ or some other flexibility mechanism for reducing unnecessary burdens relating to initial notification requirements and/or additional information requests during the initial review period. However, the remaining 32 percent represent a sizeable minority that have not adopted any of these useful burden-reducing techniques.

Willingness to Accept Readily Available Alternatives to Formal Filing Requirements. Two survey questions were designed to probe the ICN Working Group's recommendations concerning acceptance of readily available information in lieu of formal notification requirements where strict compliance with those requirements may be burdensome. Surprisingly, 58 percent of jurisdictions will accept ordinary course of business information, and over two-thirds of jurisdictions will accept substantially responsive information in other formats (e.g., merger filings from other jurisdictions) in all (55 percent) or limited (12 percent) circumstances. It is encouraging that a clear majority of ICN jurisdictions are generally open to "substance over form." However, a significant minority remain unable or unwilling to depart from formal notification requirements in favour of less burdensome substitute forms of information.

Pre-Filing Guidance. The Recommended Practices focus on the availability of confidential pre-notification guidance from competition agencies in two key areas: legal/jurisdictional/factual issues related to notification obligations, and the information requirements in the notification form itself. It is good news that both these useful types of guidance are always available in two-thirds of responding jurisdictions (66 percent each) and sometimes available in half of the remaining jurisdictions (19 percent with respect to notifiability, and 17 percent with respect to information requirements). Because both competition agencies and merging parties benefit from early resolution of notifiability and information requirement issues, it would be desirable and should not be difficult for all jurisdictions to make this type of guidance fully available.

Translation Requirements. There were noticeable differences between agency and law firm responses regarding translation requirements, perhaps because translation of supporting documents is often a matter of agency discretion rather than specific rules. Agencies claimed that full translation of transaction documents is required in 52 percent of jurisdictions and full translation of annual reports and filings is required in 24 percent of jurisdictions. The law firm responses indicated that translations are required in a substantially greater number of jurisdictions—61 percent and 35 percent, respectively. Thus, there appears to be some uncertainty as to when translated summaries of such documents will be sufficient. Given the time and cost of translating large and complex legal documents, summaries are a middle ground that deserves further attention by jurisdictions that are not prepared to proceed without any translation of transaction or other documents.

Personal Officer Authentications. It is gratifying to see that the flexible approaches advocated by the ICN Working Group (such as simple signatures from company personnel or representations by counsel) are more than twice as common as cumbersome formal requirements for personal authentication by senior officers (68 percent versus 32 percent). This is another easy opportunity for improvement in the nearly one-third of responding jurisdictions where personal authentication is still required.

¹⁷ The flexibility mechanisms identified by the ICN Working Group are: (1) advance ruling certificates, (2) short form notifications, (3) other reduced filing requirements (with or without the agency's discretion to seek additional information), (4) discretionary waivers of information requirements; and (5) any other mechanism(s) that allow for flexibility in the context of the initial notification and/or initial phase of the review.

Transparency

The Recommended Practice relating to Transparency was divided into eight major items:

Publicly Available Laws and Related Materials. The survey sought information on the extent to which each of the laws, regulations, policies, case decisions, and other materials relevant to merger review were made readily available to the public in a timely manner. Encouragingly, no jurisdiction reported complete unavailability or lack of timeliness. However, it was disappointing to find that less than half (48 percent) of the responding jurisdictions made such materials fully available on a timely basis. Given the ease with which transparency can be achieved using Internet Web sites, this surely is a priority area where implementation of the ICN Recommended Practices could generate significant benefits quickly and at low cost.

Jurisdictional Scope. The survey examined whether three attributes of jurisdictional scope were readily determinable from publicly available materials.¹⁸ An overwhelming majority of jurisdictions (85 percent) achieved full transparency on all the elements and an additional 10 percent reported partial transparency. Indonesia, Kenya, and the Philippines were the only jurisdictions where public information does not allow for ready determination of the three jurisdictional scope elements.

Merger Review Procedures. The survey also canvassed the transparency of 12 key aspects of merger review procedures.¹⁹ The results in this area are also very positive. Nearly three-quarters of jurisdictions (74 percent) display transparency on all twelve of the listed procedural matters, with another 24 percent reporting partial transparency. The Philippines was the sole jurisdiction not seen as providing readily determinable information about any of the merger review procedure items.

Guidance on Substantive Principles and Criteria. The level of substantive transparency varies dramatically: nearly half of jurisdictions (46 percent) provide extensive information regarding decision-making principles and criteria, but 20 percent offer minimal or no guidance about agency practices on such important matters and 34 percent provide only partial information. While agency guidelines may require considerable effort to develop, competition laws are so open-textured that attempts to provide greater clarity on substantive standards would be very welcome.

Interface Between Competition and Non-Competition Factors. While the Recommended Practices do not object to the consideration of non-competition factors in merger reviews, they urge transparency regarding the manner in which such considerations interact with competition-oriented criteria. Many jurisdictions (39 percent) employ non-competition factors in their merger review processes. A solid majority of these (58 percent) provide transparency that contributes to making the interface between these important decision-making factors understandable. However, eight jurisdictions (Croatia, Iceland, Indonesia, Kenya, Latvia, Pakistan, Slovenia, and Ukraine)

[N]early half of jurisdictions (46 percent) provide extensive information regarding decision-making principles and criteria, but 20 percent offer minimal or no guidance about agency practices on such important matters and 34 percent provide only partial information.

¹⁸ These were: (1) the types of transactions to which the merger control law applies, (2) any exemptions or exclusions from the merger control law; and (3) the precise tests or thresholds that govern whether the parties must notify the transaction or whether the competition agency has jurisdiction over a transaction.

¹⁹ These were: (1) the identity and contact details of the competition agencies, (2) any filing deadlines, (3) notification procedures, including the information to be provided in the initial filing, (4) any filing fees, (5) review periods, (6) suspensive periods and any limits on implementing the transaction prior to clearance, (7) investigative procedures, (8) any deadlines that the merging parties, third parties, or the competition agencies must obey during the review period, (9) procedures and deadlines for appealing adverse decisions or for challenging a merger, (10) procedural rights of merging and third parties, (11) enforcement procedures pertaining to violations of the merger control laws (e.g., failure to notify) or merger review decisions (e.g., breach of conditions or obligations), and (12) measures for protecting confidential information.

have not done so, and two additional jurisdictions (Brazil and New Zealand) have only achieved partial transparency in this area.

Case Decisions. The practice on publication of decisions in key cases (at a minimum, those decisions which set a precedent or represent a shift in policy or practice) is evenly divided between agencies that regularly do and those that do not (44 percent and 40 percent respectively), with a small group (16 percent) varying on a case-by-case basis. This again suggests a significant opportunity to improve the public understanding of how merger review processes are applied in many countries.

Web Sites. The availability of reference materials on agency Web sites is very high: 93 percent of agencies maintain a Web site, and over 80 percent of those sites are reported to be complete and up-to-date. Of the three jurisdictions that do not have a current or planned Web site (Pakistan, Philippines, and Tunisia), at least two can be characterized as relatively new arrivals on the competition law scene. It is hoped that 100 percent of ICN jurisdictions will have comprehensive Web sites in the near future because this greatly facilitates the analysis of potential competition issues for parties involved in international transactions.

English Translations of Basic Materials. Notwithstanding the wide availability of laws, regulations, guidelines, and other reference materials on Web sites, English translations are less common. Only slightly more than half of the jurisdictions (53 percent) have provided such translations for all core materials, with another 31 percent making selected materials available in English. Again, it would be helpful to the international business and legal communities if the remaining jurisdictions were to make progress in this area as soon as resources permit.

Review of Merger Control Provisions

The Recommended Practice relating to Review of Merger Control Provisions contains two standards designed to encourage implementation of improved merger review process:

Periodic Reviews. An exemplary 84 percent of responding jurisdictions reported plans to review their merger regime (or had already done so since the ICN's initial meeting in Naples in September 2002).

Pursuing Convergence with Recommended Practices. A somewhat less impressive, but solid, 64 percent of jurisdictions indicated plans to pursue reforms that will result in increased convergence with recognized best practices (although this figure may be understated due to lack of information underlying the responses of private law firm respondents). It is discouraging that 6 percent have no plans for such improvements, despite having been among the jurisdictions that had adopted the Recommended Practices on a consensus basis.

Government Statements and Actions

The 2004 survey concluded by soliciting information about government statements and actions in relation to implementation of the Guiding Principles as well as the Recommended Practices. Only 13 jurisdictions (21 percent) reported that positive statements have been made by their government regarding the Guiding Principles, with the same number reporting positive statements regarding the Recommended Practices (there was some overlap, but not complete). These numbers are virtually unchanged from similar questions posed in the *2003 Report*.²⁰ Although seven

²⁰ See *2003 Report*, *supra* note 4, at 131–33, noting that 14 jurisdictions had made public statements supporting the Guiding Principles and 13 had made statements regarding the Recommended Practices.

additional jurisdictions reported neutral government statements about the Guiding Principles and six regarding the Recommended Practices, the absence of publicly visible support from over three-quarters of ICN members is alarming.

The responses regarding implementation of the Guiding Principles and Recommended Practices suggest a slightly more positive trend. The *2003 Report* indicated that only 10 percent of responding jurisdictions had or were planning to implement aspects of the Recommended Practices, while a further 20 percent of jurisdictions had such changes under consideration.²¹ These numbers have since increased to 39 percent and 13 percent, respectively, but are still difficult to reconcile with the more positive responses provided on the specific elements of Recommended Practice VII, as discussed above. Similarly, 36 percent of jurisdictions have implemented or are in the midst of implementing elements of the Guiding Principles (as compared with 14 percent in 2003), while the level of jurisdictions merely considering such changes remains relatively constant at 14 percent (16 percent in 2003).²²

Conclusions

The ICN's Recommended Practices are an extremely important initiative for mitigating the spiralling scope, complexity, and costs of international merger review processes. It is hoped that objective assessments will provoke discussion and foster implementation of these unanimously adopted Recommended Practices by identifying areas where substantial progress has already been made and simultaneously highlighting those areas where further improvements could be targeted. The results of this survey, like its 2003 predecessor, indicate that significant opportunities for improvement exist in most jurisdictions.

While it is encouraging to see that some jurisdictions are implementing the Recommended Practices, a clear majority of jurisdictions have not yet made implementation a priority. Indeed, a recent ICN report²³ suggested that some reform efforts in Europe²⁴ and elsewhere, while positive, were motivated by a desire to conform to the EU Merger Regulation or other legislation and that authorities might not be particularly concerned with the Recommended Practices. More positively, the report pointed to a number of practical steps ICN members could take to facilitate implementation,²⁵ and a number of commentators have noted that focusing on a few core Recommended Practices, relating to issues such as Jurisdictional Nexus and Notification Thresholds, for instance, could significantly reduce unnecessarily burdensome filing requirements.²⁶

Even within Europe, where the European Competition Network is well positioned to promote burden-reducing convergence, there continue to be many opportunities to enhance compliance

²¹ *Id.* at 133.

²² *Id.*

²³ See ICN, Implementation of the ICN Recommended Practices for Merger Notification and Review Procedures (Apr. 2005), http://www.internationalcompetitionnetwork.org/050505Merger_NP_ImplementationRpt.pdf.

²⁴ Specifically, in Croatia, Estonia, France, Latvia, Macedonia, the Netherlands, Norway, and Portugal.

²⁵ For example, the Report observed that if some Recommended Practices can be implemented relatively easily through administrative change at the agency level, members should consider making those changes first.

²⁶ See, e.g., Ronald A. Stern, Vice President, Senior Antitrust Counsel, General Electric Co., Address to the Implementation Session, 4th Annual ICN Conference (June 8, 2005), http://www.internationalcompetitionnetwork.org/bonn/2005speeches/Ron_Stern_Slide01.pdf; see also Tony Reeves & Russell Hunter, *European Merger Thresholds vs. the ICN*, GLOBAL COMPETITION REV. 24 (May 2005).

with the Recommended Practices.²⁷ It is clear that achieving implementation will be a significant challenge, notwithstanding the consensus and momentum arising from their development and adoption.²⁸ Bridging this gap must be seen as a critical issue for ICN members and other interested stakeholders. ●

²⁷ J. William Rowley & Neil Campbell, *The Role that the European Competition Network Could Play*, GLOBAL COMPETITION REV. 22 (May 2005).

²⁸ There is a German proverb that may aptly sum up this situation: Kräht der Hahn auf dem Mist, ändert sich's Wetter oder's bleibt wie's ist. [If the cock crows on the muck heap, the weather will change, or it will stay the way it is.] In other words, it will take more than crowing about the Recommended Practices to get them implemented!

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: In this edition we look at papers that analyze familiar issues in new ways. Sunk costs as barriers to entry get a fresh look from Robert Pindyck; and economists do have important insights into the analysis of coordinated effects.

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

—WILLIAM H. PAGE AND JOHN R. WOODBURY

Recent Papers

Robert S. Pindyck, Sunk Costs and Real Options in Antitrust (June 2005), MIT Sloan Working Paper No. 4545-05, <http://ssrn.com/abstract=742505>

In this paper, Robert Pindyck of MIT analyzes the role of sunk costs as barriers to entry, with an interesting new twist. He builds in part on Schmalensee's analysis,¹ which *The Paper Trail* noted in the July 2004 issue of the *Antitrust Source*,² but adds a focus on the role of uncertainty in magnifying sunk costs associated with investment. He adopts Bain's definition of an entry barrier as a cost that an entrant must bear but that the incumbent firm has already incurred, such that the cost deters entry and allows the incumbent firm to raise prices. After distinguishing sunk costs from fixed costs, Pindyck introduces the concept of "real options" to invest in productive facilities or research, and suggests that the exercise of a real option can constitute a sunk cost, in addition to the direct sunk costs of entry. He then relies on the theory of financial options to show how real options might be valued in antitrust analysis.

Pindyck draws a useful distinction between sunk costs and fixed costs. He defines sunk costs as investments, such as advertising expenditures and purchases of specialized equipment, that a firm cannot avoid even by ceasing operations. Even if the firm finances a sunk cost, it must pay the amortization expenses whether or not it remains in the market. Pindyck emphasizes that some sunk expenditures, like advertising expenses, may be specific to the firm. But industry-specific expenditures may also be sunk because, if an investment in new facilities goes south, other firms in the industry will be unwilling to buy them for anything like the original price. Other investments may be sunk if the lemon problem³ depresses the value of the purchased equipment. These sorts of costs, once incurred, do not affect a firm's output decisions; but the prospect of incurring sunk costs can affect a firm's decisions in various ways, including by deterring entry. Fixed costs, as defined by Pindyck, are ongoing expenditures that do not vary with output but that can be avoided if the firm leaves the market. These costs include executive salaries and building maintenance expenditures.

¹ Richard Schmalensee, *Sunk Costs and Antitrust Barriers to Entry*, 94 AM. ECON. REV. 471 (2004).

² <http://www.abanet.org/antitrust/source/Jul04-PaperTrail7=23.pdf>.

³ George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

Although both sunk and fixed costs can function as entry barriers, sunk costs are likely to be more significant in this respect because they involve greater uncertainty and leave the firm with less flexibility. A firm must incur sunk costs in a lump sum and perhaps finance them before receiving any revenues from the investment. Firms in industries like software and mining often incur these sorts of expenses. With high fixed costs, by contrast, if entry turns out in a later time period to have been a mistake, Pindyck writes, “the firm can shut down and avoid the fixed cost in that period.” Industries like air transportation have relatively high fixed costs, such as the lease price of aircraft, and relatively low sunk costs, because the firm can terminate the aircraft leases.

Pindyck shows that one may conceptualize the choice to enter a market as the exercise of an option, analogous to a call option to invest in a stock that pays dividends. Like a financial option, a real option can be valued based up certain variables, especially the volatility of the market. Where the market is highly volatile, exercising the real option, rather than waiting until a later time period, involves a greater opportunity cost.

In the presence of such market uncertainty, there will be some value to waiting because the firm might resolve some of that uncertainty by learning more about underlying market conditions before making the irreversible investments. This consideration could influence the magnitude or timing of sunk investments made in connection with market entry. Thus, when the firm instead invests without waiting, it is exercising the real option of investing today rather than later, forgoing the opportunity of obtaining additional, relevant information and thus incurring an additional sunk (opportunity) cost of entry. In such circumstances, a focus only on the direct sunk costs of investment may underestimate the real sunk costs and hence the barriers to entry. Thus, according to Pindyck, “the full sunk cost that is relevant to an entry decision (and therefore relevant to an analysis of entry barriers) is greater than the direct sunk cost that is typically considered, [and] the magnitude of the full sunk cost depends on the volatility of market conditions.”

Pindyck extends his analysis to a case in which a number of firms can invest but each can gain by waiting for someone else to make the first investment. The first mover thus confers external benefits on the others by showing the cost and feasibility of the investment. In such a situation, no firm may enter because of collective action problems. One antitrust implication of this scenario is that joint ventures or other means of coordinating investment decisions to internalize this externality may be justified.

Pindyck admits that estimating the cost of real options in antitrust analysis may be complex but suggests that it is practical because analysts can use the same methods used to value financial options.

—WHP

Marc Ivaldi, Bruno Jullien, Patrick Rey, Paul Seabright, and Jean Tirole, *The Economics of Tacit Collusion: Final Report for DG Competition, European Commission (2003)*,
http://europa.eu.int/comm/competition/mergers/review/the_economics_of_tacit_collusion_en.pdf

Olivier Compte, Frederic Jenney, and Patrick Rey, *Capacity Constraints, Mergers, and Collusion*,
46 European Economic Review 1–29 (2002)

Kai-Uwe Kuhn, *The Coordinated Effects of Mergers in Differentiated Products Market*,
The John M. Olin Center for Law and Economics Working Paper Series,
University of Michigan Law School Working Paper 34 (Nov. 2004),
<http://law.bepress.com/umichlwps/olin/art34/>

Recently, my colleagues and I introduced a presentation to a government agency by describing how we would address issues regarding both unilateral effects and coordinated effects in a particular matter under consideration. A respected government economist interrupted the presentation to observe that (speaking purely personally) only the unilateral effects discussion would make sense because (of course) economists have little to contribute to any coordinated effects analysis.

Certainly, this position resonates with many antitrust/Industrial Organization economists. In assessing unilateral effects (e.g., in a differentiated products industry), there are concrete models on which economists and policy makers can rely (at least in the first instance). With a few inputs, such as margins, shares, and a measure of aggregate demand elasticity, the economists or policy maker can generate a prediction of the price effects of a merger. Of course, these models can be far more complex in modeling firm interactions and the ultimate price effect as well as in requiring more refined data. And certainly these models must be calibrated against the real-world competitive patterns in the industry.⁴ Moreover, the price effects can be attenuated by factors that the model does not account for, such as entry, (typically) product repositioning, and innovation dynamics. These factors are usually evaluated “after the fact” of the merger simulation itself. Still, the elegance and completeness of the models are hard to resist—the models take account in a seemingly unambiguous way of some of the key market parameters in merger evaluation.

By contrast, the conventional wisdom is that there is no elegance to coordinated effects analysis. As a general matter, we have the Posner checklist, plus other factors that have been highlighted in relatively recent agency decisions.⁵ Economists and lawyers must weigh without any clear scale whether, e.g., product heterogeneity or cost differences are sufficiently great that the merger does not increase the likelihood of coordinated effects. Consequently, there is certainly (or maybe just seemingly) more ambiguity surrounding a coordinated effects analysis than is true for unilateral effects analysis. Even so, one might think that abandoning the coordinated effects beast, as hard as it is to tame, to the economics skills of lawyers might constitute, for economists, professional malpractice.

In any event, the claim that economists have little to offer in coordinated effects analysis led me to do some research. One recent paper I located was co-authored for the European Commission by a number of economists located in Toulouse (Marc Ivaldi, Bruno Jullien, Patrick Rey, Paul Seabright & Jean Tirole, *The Economics of Tacit Collusion: Final Report for DG Competition*, European Commission (2003)). The paper surveys a checklist, and does so within the modern theory of collusion. That is, assuming that the firms can agree on a price or prices, will the firms be able to prevent cheating? As the paper points out, the answer depends both on the size of the “punishment” and the credibility of the commitment to punish other firms. And in this analysis, a key factor is the discount rate of the firms. Punishment is more likely to deter cheating when the firm considering the profitability of cheating attaches a high weight to future profits. For example, if future profits did not matter at all to the firm (if the firm has a high discount rate), then the cheating could not be deterred. This is because the punishment—the loss in future profits—does not matter to the cheating firm. By contrast, firms that place significant weight on future profits (if the

⁴ See, e.g., Gregory J. Werden, David T. Scheffman & Luke Froeb, *A Daubert Discipline for Merger Simulation*, ANTITRUST, Summer 2004, at 89.

⁵ See, e.g., RICHARD A. POSNER, ANTITRUST LAW 69–93 (2001); David T. Scheffman & Mary Coleman, *Quantitative Analyses of Potential Competitive Effects from a Merger*, 12 Geo. Mason L. Rev. 319 (2003), available at <http://www.law.gmu.edu/gmulawreview/issues/12-2/PDF/Pro%20Scheffman-Coleman.pdf>.

firms have a low discount rate) are (other things equal) more likely to successfully collude, because the punishment for cheating—the loss in future profits—matters to such firms.

As suggested above, the paper is still a checklist—there is no single unifying, self-contained theory (or set of such theories) that captures and balances all of the salient features of the checklist that can give rise to tacit collusion and how that balance is affected by a merger. But unlike the usual checklists, this one weighs the conceptual ways in which different industry characteristics and a merger affect collusion by focusing on their impact on the discount rate required to sustain collusion (the “critical” discount rate). Actual discount rates lower than the critical discount rate will support a punishment scheme that is more likely to deter cheating—the weight that firms place on any loss in future profits is high enough to deter cheating. Thus, the higher the critical discount rate, the more likely the actual discount rates are below the critical rate and, therefore, the more likely tacit collusion will be supportable.⁶ So, a merger that increases the critical discount rate is a merger that makes tacit collusion more likely. What the paper does then is to summarize the effects of the checklist factors on (in most cases) one parameter, the critical discount rate. While one can’t simply add up the changes in the critical discount rate for each checklist item to come up with a merger delta, the calculation of those effects can permit the parties and the agencies to better focus their own evidentiary analysis.

An illustration can offer some indication of the flavor of the analysis in this paper: The authors consider a simple punishment scenario, in which the punishment is reversion to competition where no excess profits are earned. The paper then models the effect of a reduction in the number of n symmetric firms producing a homogeneous product on the critical discount rate. If a firm cheats by slightly undercutting the collusive price, it gains the entire market until the market reverts to competition. The fewer the firms, the larger the current share of each, and the smaller the gains from cheating. In addition, with a smaller number of firms, each has a larger share of the collusive profits, which increases the short-term and long-term benefits of collusion. In this model, if the number of firms is reduced from 4 to 3, the paper shows that the critical discount rate increases by about 17 percentage points (i.e., from 33 percent to 50 percent).

As another illustration, the paper considers the effect of industry growth on the critical discount rate. For a given number of firms, higher industry growth fosters collusion because the magnitude of future profits becomes more important relative to current profits. So cheating on the collusive agreement becomes more costly to the cheating firm when the punishment is reversion to zero-profit competition. In the model used by the authors, the critical discount rate in a market with 20 percent growth is at least 20 percent greater than in a market with no growth. For example, if the critical discount rate is equal to 25 percent in a market with zero growth, then in a market with 20 percent growth the critical discount rate is equal to 50 percent (all else equal).

As noted earlier, this paper is not a unified theory of tacit collusion. However, it does provide a way of thinking about the likelihood of tacit collusion that goes beyond vague judgments about whether this or that checklist factor is more or less likely to foster collusion. This is a relatively easy and very useful read.

⁶ This discussion uses the concept of discount rate, while the paper uses the concept of discount factor. The two concepts are closely related. For example, if a firm discounts future profits at a rate of 5% per quarter, then the present value of obtaining \$100 in the next quarter is equal to about \$95.2 (i.e., \$100 divided by 1.05). That is, a discount rate of 5% corresponds to a discount factor of 95.2%. A higher discount rate—say, 10%—means that future profits carry less weight; the present value of \$100 in the next quarter is now equal to about \$90.9 (i.e., \$100 divided by 1.1). In the paper, because the authors use the concept of discount factor, future profits carry less weight when the discount factor is lower (for example, 90.9% instead of 95.2%). This is only a terminology, not a substance, issue.

There are two other papers in this vein that are worth bringing to your attention. One, another Toulouse paper, evaluates the role of firm and industry capacity in fostering collusion. Olivier Compte, Frederic Jenney, and Patrick Rey, Capacity Constraints, Mergers, and Collusion, *European Economic Review* 46 (2002). In the world of the checklist, excess industry capacity can hinder collusion (by giving the firm with the excess capacity an incentive to cheat) or help collusion (by increasing the ability of the colluding firms to punish any cheaters).

This paper considers when capacity can harm or hinder collusion. Using the same general framework as above, the paper asks both how the distribution of capacity affects the likelihood of collusion and how a merger changes that likelihood. For example, the paper finds that when firm capacity shares are asymmetric, collusion can be more difficult to sustain if total industry capacity is limited. This is in part because if total capacity of a firm's rivals is not sufficient to absorb that rival's output, then the firm with larger capacity share will have a greater incentive to defect from the agreement—it knows that even if it charges a higher price, its rivals cannot serve all the customers in the market and so the defecting firm will still have some customers. That is, the ability of the rivals to punish defectors is limited by their capacity.

On the other hand, if the aggregate industry capacity is much larger than the market, larger capacity-share firms still have the greatest incentive to defect, but now, the rivals have the capacity to punish the defector by taking away all of its customers. A merger that reduces the amount of capacity available to rivals to levels that don't allow them to satisfy all demand at competitive prices when punishing the merging firm can reduce the likelihood of collusion. A merger that has no effect on the ability of rivals to absorb all of the customers of the defector (because the total capacity of the rivals exceeds the market size before and after the merger) may have no effect on the likelihood of collusion.

This is only a sampling of results from the paper. The paper compares its results with the use of the HHI as a measure of the likelihood of collusion and finds it lacking. It also applies the theory to the bottled water merger between Nestle and Perrier. While the paper is highly technical (my theory colleague Serge Moresi helped walk me through the logic of the math), it does provide interesting insights into how to resolve the ongoing question of whether excess industry capacity helps or hinders collusion.

One final paper also models coordination, this time within the context of differentiated products where firms are distinguished by the number of brands owned. Kai-Uwe Kuhn, The Coordinated Effects of Mergers in Differentiated Products Market, *The John M. Olin Center for Law and Economics Working Paper Series* (University of Michigan Law School), Working Paper 34 (November 2004). Among other results, the paper shows that the smallest firm has the greatest incentive to deviate from the most collusive price (because, as a result of its few brands and consequently small share, it has the most to gain from cheating), while large firms are more reluctant to engage in punishment strategies (because they have the most to lose from punishment). Therefore, in Kuhn's model, a merger increases the likelihood of coordinated effects when it involves the smallest firm, and it reduces the likelihood of coordinated effects when it involves the largest firm.

The paper also explores the implications of mergers where multimarket contact (e.g., firms A and B compete in market 1 and firms A and C compete in market 2) may be important, as well as (albeit briefly), their effect on innovation and collusion. While the results of this paper are mathematically derived, Kuhn does provide useful and readable intuition in explaining the results. He also provides a useful summary of the coordinated effects literature.

On the whole, these papers should make one feel comfortable in rejecting the claim that economists have little to say about coordinated effects. ●