

Product Bundling in Communications Markets

An ABA Section of Antitrust Law Brown Bag Program (September 20, 2004)

MODERATOR



Mark Del Bianco

Member of the D.C. and Maryland Bars, practicing communications and antitrust law

PARTICIPANTS



Barry Nalebuff

Professor of Economics, Yale School of Management



Robert Zastrow

Assistant General Counsel for Antitrust, Verizon Communications



Marc Lawrence-Apfelbaum

Executive Vice President and General Counsel, Time Warner Cable

Editor's Note: Bundling is a hot-button issue in the telecommunications industry, particularly in the wake of the Third Circuit's en banc opinion in *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003), cert. denied, 124 S. Ct. 2932 (2004), which held that bundled rebate programs can constitute monopolization even if the monopolist's prices are above its costs. In this ABA Section of Antitrust Law program, one academic and two business telecommunications experts offer practical and theoretical insights into why bundling, in the context of the telecommunications industry, may be the best of all outcomes for consumers. The discussion below is useful in considering bundling not only in the telecommunications industry, but generally in other industries as well.

—ANNE RODGERS

MARK DEL BIANCO: The issue of product bundling in communication markets is a very hot topic these days. It's not often you get a brown bag lunch co-sponsored by three separate committees of the Antitrust Section, but that is what we have today. This program is brought to you by the Committee on Computers and Internet (of which I am Co-Chair), the Communications Committee, and the Sherman Act Section Two Committee.

The trade press and business analysts, such as Legg Mason and The Precursor Group, have been writing about this trend for a long time. Just last Monday, the *Wall Street Journal* had a special section full of articles about changes in the communications market and the business reasons for and dangers around communication bundling.

The regulatory agencies are also taking an interest in this issue. In a speech last month in Aspen, Hew Pate, Assistant Attorney General for Antitrust, raised the issue of bundling in communications markets and discussed in some detail how changes in communications markets might affect the Antitrust Division's analysis of mergers or the way it conducts investigations. We have heard informally that the Federal Trade Commission has staffers examining communications, particularly cable bundling issues. The FCC has been considering communications product bundling

issues since at least the beginning of this year and has had outside experts, including Professor Nalebuff, who you are going to hear from in a minute, in to talk to their lawyers and economists about bundling issues. In its recent information request to the other wireless carriers in the Cingular/AT&T wireless case, the FCC asked for information about bundled offerings combining wireless and other communication services.

Our topic today is very timely, and we've assembled a panel of experts to help us sort things out. Our first speaker is Barry Nalebuff, the Milton Steinbach Professor of Economics and Management at the Yale School of Management. He has probably contributed as much as anyone to the academic and theoretical analysis of bundling issues in the past few years. He is an expert in game theory, and he has written extensively on its application to business strategy. He is co-author of *Thinking Strategically*, *Co-Opetition*, and most recently, *Why Not?* His current research focuses on the strategic and antitrust aspects of product bundling. His monograph on bundling prepared for the UK DTI is available on its Web site, <http://www.dti.gov.uk/economics/>. He was an expert for GE and Honeywell in the EU's investigation of the GE/Honeywell merger, as well as for the Australian Competition Commission in its case against Baxter. Barry is on the boards of Trader Classified Media and Bear Sterns Financial Products and is the Chairman and co-founder of Honest Tea, tea that tastes like tea.

In its recent information request to the other wireless carriers in the Cingular/AT&T wireless case, the FCC asked for information about bundled offerings combining wireless and other communication services.

Our second speaker will be Robert Zastrow, the Assistant General Counsel for Antitrust at Verizon Communications. His work has included civil jury trials, counseling, particularly in the high-speed data markets, and advocacy of the company's position on mergers and acquisitions before the DOJ. Before joining Verizon he was an Assistant Chief of the Civil Task Force at the Antitrust Division where his cases included *Microsoft I* and an analysis of the *LePage's v. 3M* case when it was in the district court. Before that he was a litigation partner at Stroock & Stroock & Lavan in New York.

Our third speaker is Marc Lawrence-Apfelbaum. Marc is the Executive Vice President and General Counsel of Time Warner Cable, the nation's second largest cable systems operator. He joined TWC in 1989 as Assistant General Counsel, became Senior Vice President and General Counsel in 1996 and an Executive Vice President in January 2003. In addition to its basic cable operations, TWC has been at the forefront of developing new broadband technologies and programming, including the Road Runner cable modem service and various local news channels, including New York One News and seven other 24-hour local news channels around the country. Marc has been active in dealing with legal issues arising from new ventures as well as with the issues relating to TWC's general cable operations.

I expect that our speakers will explore the business and strategic reasons, both competitive and potentially anticompetitive, for bundling in the communications industry. I am particularly hoping that they will talk about whether there are reasons for bundling in telecom markets that are not obvious to people who aren't familiar with those specific markets or to antitrust lawyers who are not steeped in communications jargon.

Barry will begin with a presentation about the theoretical aspects of the issues.

BARRY NALEBUFF: Given the ad hoc nature of the recent cases that we've seen (e.g., *LePage's*), I hope to convince this room of practitioners that there is nothing so practical as a good theory. What you really need in terms of guidance in this world is to understand the motivations for bundling and have a model for it. I will give you a few models. When it comes to bundling, it's "different horses for different courses." There is no single explanation of why you bundle. It depends on the specific circumstance. I'm going to focus on three motivations:

—MARK DEL BIANCO

(1) The ability to actually leverage monopoly. The notion here is that if you have a monopoly, it is in fact possible to earn more money and to extend that monopoly into a competitive market. In other words, I'm going to show you why the sort of Chicago School argument that you've known and loved isn't really right for most of the world.

(2) I'm going to explain why bundling is different than predatory pricing. Bundling leads to the same outcome in terms of exclusion and foreclosure, but it does so much more neatly than predatory pricing in the sense that it can do so at no cost. And, in this sense, the plaintiff's arguments in *LePage's* were correct, in theory. That is, plaintiffs claimed that 3M could exclude them from the market without selling below cost. While I think the idea of no-cost predation is correct in theory, I'm not convinced that *LePage's* showed that this theory actually applied to the facts of their case.

(3) Last, I'm going to talk about how variety bundles actually provide a competitive advantage.

*If the market ends up
with bundle vs. bundle
competition, that is the
most procompetitive
outcome of all.*

I want to start with a caveat. While bundling is relevant to many industries and antitrust cases, I'm not so sure it's relevant to communications. That's because the anticompetitive issues associated with bundling generally require: (a) a monopoly, and it's not clear where there's a monopoly in the communications world today; (b) variable consumption (that is, consumption that is not just one or zero, but one or zero seems to be the typical case in communications); and, (c) only one firm that can bundle, which doesn't seem to describe the telecom world.

Indeed, one of the results we'll talk about is the fact that while a firm that bundles has an advantage against firms that don't, if the market ends up with bundle vs. bundle competition, that is the most procompetitive outcome of all. If what we see in telecom is bundle vs. bundle, we have every reason to think that that's going to be the best outcome for consumers.

—BARRY NALEBUFF

Monopoly Leveraging. Let me first explain how it is that you go about leveraging monopoly. Our simple model is that there's a monopoly in "A" and a competitive market in "B." The Chicago School story says leverage is not possible in a world where you only consume exactly one unit of "A" and one unit of "B." So, let's leave that world and focus on the case where consumption is variable. If the firm cuts the price of "A" you'll consume a good bit more of it, and the same thing for "B."

Furthermore, I want to create a bundle that's optional. That is, I'm not going to force the person to buy the bundle. I'm going to keep the old price of "A" and the old price of "B" available in the market. The monopolist in A is going to make a deal for the customers, which is the following: I'll give you a discount on A if you agree to buy my B at a slight price premium. If the monopolist has priced A optimally, giving a slight discount on A doesn't hurt because its profits have been maximized at its monopoly price "m." So, if it charges $m-1$ vs. m , it's going to make about the same amount of money.

On the other hand, consumers are really much happier. They like the fact that they've been offered a dollar discount. That's not a little effect to them, that's a big effect. In return for giving them the dollar off A, they are happy to give the monopolist 10 cents more on B. And so, the monopolist makes a little extra money on B, consumers are happier with the discount A, even with the slight offset on B. The end result is that the monopolist has made more money, consumers are better off, but—and here's the key issue—the monopolist in A has foreclosed all the other players in the B market.

In a static sense, this is a Pareto improvement in that everyone's better off. But you may worry in a dynamic sense—if you think that firms in the B market were going to be potential entrants into the A market, or that the A monopolist can now create a monopoly in the B market. Both of those are concerns to a dynamic perspective in that the monopoly in A has leveraged itself into B.

Let me give you some numbers here, just so you can get a sense of the effect. If you had a linear demand curve where quantity is 100 minus price and there's no cost for A, then the monopoly price is 50. If the monopolist charges 50 it makes 50 times 50 or 2500. (Remember, there are no costs here.) If it lowers its price to 45, it gets 55 sales. 55 times 45 is almost the same as 50 times 50; in fact it's only \$25 less. Customers are much better off because they've saved, in this particular case, \$5 on each of their prior 50 units purchased. They've saved a huge amount (\$250) and the monopolist has hardly given up anything (\$25). The customer savings are ten times its lost profits.

Because customers saved \$5 on A they're happy to give the monopolist back a dollar on B. If they give it back a dollar on B, the monopolist makes an extra \$50. If the monopolist makes \$50 on B and it has given up only \$25 on A, then on net, it is \$25 better off. Customers are essentially \$4 better off because they've saved \$5 on A and given back \$1 on B.

The reason why the result is working is that customers buy more A from the monopolist when it cuts its price and that means the price cut doesn't cost it a dollar per dollar. If existing customers are only going to buy one unit, then using that good to give a discount costs the firm a dollar for each dollar it cuts price. But if cutting price leads customers to increase their demand, then the firm is okay. (For a formal proof, see Barry Nalebuff, *Bundling as a Way to Leverage Monopoly Power* (2004), available at www.ssrn.com.)

Monopoly is inefficient, and that explains what's going on here in terms of Bork's one monopoly profit. It's true that if you take the inefficient monopoly profit, there's only that amount to go around. But, what we've done is to expand the pie by reducing the monopoly inefficiency. In essence, the firm is saying: I don't really want to charge you the monopoly price. I'd like to charge you less but I don't have any way of making that back. I know it's inefficient to charge you that much, so, if you help me out on the B market, I'll charge you less on the A market. That's how it is that the firm is leveraging its monopoly.

The end result is that everyone is better off, at least in the short run. However, we have foreclosure because the other B firms can't compete with this. They would have to price below cost, to make up for the fact that the monopolist has given \$5 off the A market and its rivals in the B market don't have that \$5 to come up with.

Bundling Distinguished from Predatory Pricing. Now, let me give you another way of thinking about how exclusion occurs, one which shows how bundling leads to a different outcome than ordinary price competition. The first example is an extreme version. The monopoly in A facing competition in B says to its customers, "If you want to buy my A you have to buy my B."

Well, customers don't care whose B they buy. They're happy to buy the monopolist's version of B, so they do. Other firms are foreclosed. It doesn't cost the monopolist anything.

That works. The only problem is that it is pretty much a per se antitrust violation. So, the trick is the monopolist can achieve just about the same thing at no cost. Instead of saying, "you have to buy my B in order to buy my A," the monopolist says "if you don't buy my B, I'm going to charge you a boatload for my A. I will raise the price of A if you just buy it à la carte. I'll charge you the right price for A only if you also buy my B." In effect the monopolist message is, "You'll only be able to buy my A at an economic price if you also buy my B."

Because the threat works, the monopolist ultimately charges the right price for A and customers all buy its B. In the end, there's no loss to the firm and there's no loss to customers either. The big difference between this and predatory pricing is that with predatory pricing the monopolist actually has to charge below cost on B. Here, all the monopolist has to do is *threaten* to raise the price of A if a customer doesn't go along with it. If the threat works, the monopolist doesn't have to carry

it out and hence there was no cost to it. The outcome is the same with respect to foreclosure, but exclusion comes at no cost, and hence there's no issue of recoupment.

There are a couple of other ways the exclusion can be created. For example, instead of saying I'm going to lower the price of A if you buy my B, the monopolist can say I'll lower the price of B and take it back on A. Imagine that the price of B is the competitive amount c , and the monopolist offers to sell B at a price of $c-1$ while at the same time raising the price of the monopoly good A to $m+1$.

Old price of A & B: $m+c$

New price of A & B: $(m+1) + (c-1) = m+c$

At the end of the day, the total price of A and B comes up to the same amount. Everyone is going to buy the monopolist's B. Why? Because it's the cheapest B on the market. Nobody else can compete with a $c-1$ price. It's a dollar below cost. On the other hand, how does the monopolist recoup? Well, it is recouping right now. It's recouping by charging an extra dollar on A. Because customers only care about the combined price of A plus B, customers are no worse off but rivals can't match. (Here there's an assumption that A and B are complements and that all customers buy one unit of each.)

One approach is that the monopolist can lower the price of A and raise the price of B. Another approach is that the monopolist can lower the price of B and raise the price of A. It can do it either way. When it lowers the price of B and raises the price of A, it doesn't even need a contract because it's the only one customers can go to for A, and its B is the cheapest one in the market. The A monopolist is going to win both markets.

I think this is a reasonable example in terms of numbers for Netscape or for media players. If you thought of A selling at a hundred, think of that as the operating system. Good B is a media player that customers value at between \$1 and \$2, and the rival is charging a dollar for it. If the monopolist in A comes in and offers B for free, the rival can't match that. Customers were willing to pay \$100 for A and \$1 for B before; now they are getting B for free, so the monopolist can raise the price of A to \$101. In essence, the monopolist has the ability to recoup simultaneously by real-locating the prices. That's one key reason why bundling is different than a standard predatory pricing case.

You can also work it out the other way, where the monopolist in A offers to lower the price of the monopoly product under the condition that the customer buys its competitive product at a price premium. This works even in the case where the quantities are fixed (so there's no advantage in terms of getting increased demand). But, in order to do that, the monopolist has to have a contract because the deal is: "I'm going to give you a discount on A provided you buy my B." It can either threaten to raise A above its regular price or it could offer to discount it below its regular price in return for which the customer must buy its B product at the price premium.

Under that second way of doing it, the monopolist threatens: the regular price of the monopoly product is m , but, I'm going to charge $m+1$ if you only buy A by itself. From the customer's perspective, that extra dollar they're going to have to pay for A if they buy it by itself really means that somebody selling B has to undercut B by a dollar in order for them to buy B on an à la carte basis. And, of course, rivals can't afford to do that. But if the customer goes and buys the monopolist's product along with B, that extra dollar disappears. So the customer only has to pay the extra dollar if it buys A on an à la carte basis. If the customer buys A as part of a package, and if it agrees to buy all of its B from the monopolist, then it won't be charged the inefficient extra dollar price. Hence, as things play out, the monopolist maximizes its profits. It charges m . It suffers no loss

because it charges the optimal price to customers that go along with its deal. And that leads to exclusion because equally efficient rivals can't discount B enough in order to displace the threat.

Let's look at some numbers to put this in context. The monopoly price is \$50. The firm threatens to go up to \$55. Rivals can't afford to give customers that \$5 back in order to get them to buy their à la carte products.

One interesting thing about this is that normally when a firm makes a threat, it's very expensive for it to carry out the threat. Here, if the customer ends up forcing the firm to carry the threat out, it makes almost as much money (selling 45 units at \$55) as it does selling 50 units at \$50. Because \$50 was its optimal price, it hardly hurts the firm to go up to \$55. It hardly hurts the firm to go down to \$45. Customers care a lot between \$45 and \$55. In essence, the monopolist threatens its customers: I can hurt you a lot by going up to \$55 if you don't buy my B. I can reward you a lot by going down to \$45 if you do buy my B. All of these prices are about the same to me, but they matter a lot to you.

All of this leads me to what I would like to see used as the definition for exclusionary bundling. Take the price of an A-B bundle and look at what the incremental price of that A-B bundle is over A alone. See how much more you are paying to get the bundle than just A, and compare that incremental price to the cost of producing B. (And by the cost, I mean the monopolist's cost of producing B.) If that incremental price is less than the cost, then we have exclusionary bundling and an antitrust issue. If it isn't, then we have a safe harbor.

Exclusionary Bundling

Firm with market power in A also sells good B and faces competition in B.

Firm prices A-B bundle such that *incremental* price of A-B over A alone is less than long-run average variable cost of B.

Result: Equally efficient rivals selling only B are foreclosed. This is the horizontal parallel to vertical price squeeze.

The reason for this test is that if an incremental price is less than the cost, then equally efficient firms to the monopolist will be excluded—they will be foreclosed from the B market. I think this is pretty much the natural extension of the predatory pricing test to a bundle. What I'm really doing is calculating the implied price correctly and I'm calculating cost correctly. But it's not the same as a predatory pricing test because of two issues. One is that the monopolist doesn't necessarily lose money, and recoupment, therefore, is going to be a different issue. (The reason is because the monopolist was never expecting to sell A alone. If the monopolist charges too high a price for A à la carte, nobody's going to buy it. And hence, the monopolist is not sacrificing that revenue because it was a threat, not an actual market transaction price.)

The second reason why it is different from predatory pricing is that prices are difficult to calculate in the bundle. If one firm offers \$397 and another firm offers \$412, you know that \$397 is cheaper than \$412. But if the monopolist offers a complicated A-B bundle, and somebody else just has an A, you have to figure out how much A you're buying, how much B you're buying in order to really figure out the incremental prices. And, if you're uncertain about the quantities of A and B, then you can easily make mistakes. All the uncertainties about quantities make exclusionary bundling a much more complicated calculation for buyers. In the case of *LePage's*, the nature of 3M's bundle discounts made it hard to figure out what the buyers expected to pay for

3M's generic tape, which made it hard to figure out how much discount LePage's needed to offer to be competitive.

Exclusionary bundling by itself is not necessarily a violation. It doesn't say anything about the size of the market that is foreclosed. If all B customers also buy A, then the entire B market will be foreclosed and the effect will be significant. Exclusionary bundling doesn't say anything about purpose. The purpose could be something anticompetitive, such as the monopolist wants to deter rivals from using B as a platform to enter A, or that it's intending to monopolize the B market. I don't need to show recoupment here, but I do want some evidence of anticompetitive purpose. I also want the firm to have reasonably understood that it engaged in exclusionary bundling. (Exclusionary bundling could be unintentional if the seller had a very different expectation about the relative future sales of A and B.)

If you're worried about a safe harbor (because these defenses might be hard for a firm to establish), the safe harbor is simple—don't engage in exclusionary bundling. In particular, if your bundled discounts are large because your à la carte price is artificially high, you are in danger. If you want to know that you're okay, don't engage in exclusionary bundling and you'll be fine.

Let me conclude by taking you through some actual cases. In Australia, the exclusionary bundling case against Baxter Healthcare involved prices for various sterile fluids primarily used with peritoneal dialysis patients.¹ Offer 1 was on an à la carte basis and Offer 2 was on a bundled basis.

South Australia²

	Offer 1 Price	Offer 2 Price	Savings
LVP, IS, and PN Products	\$4,714,867		
PD Products	\$1,201,611		
Total	\$5,916,478	\$4,329,136	\$1,587,342

Baxter had a monopoly over the first three products (LVP, IS, and PN), but faced competition for the peritoneal dialysis (PD) products.³ If you examine the à la carte prices, what you'll see is that it was actually cheaper to buy the entire bundle (at \$4.3 million) than it was to buy the first three products (at \$4.7 million) on an à la carte basis. The implied incremental price of PD products in the bundle was a negative price \$385,731. Thus, a rival would have had to pay the State Purchasing Authority in order to sell its PD products.

A negative price is always below production cost, however it is measured. As you might imagine, it was hard for rivals to compete. Or, was Baxter just nuts? Should the pricing people be shot? No—because they never expected to sell anything at the à la carte price.

Nobody was going to pay that amount. Given that no one was going to take it, it wasn't that they were giving that up. Moreover, the à la carte prices were about 50 percent above what the previous prices were in this market.

¹ Australian Competition and Consumer Commission v. Baxter Healthcare Pty. Ltd., Federal Court Proceedings No. N1153 of 2002.

² These figures are taken from the public opening statement of Stephen Rushton, pp. 93–95 of ACCC and Baxter Healthcare Pty Ltd. & Others, Sydney, 10:00 AM, May 19, 2004.

³ LVP are large volume products, such as saline bags. IS are irrigating solutions. PN are peritoneal nutrition solutions.

Similarly, in *LePage's*, 3M said that its entire bundle was above cost. But I think that's an irrelevant argument. The issue is not whether all of its tapes (Scotch™ and "generic" transparent tape) were above cost, but whether or not the incremental price for the generic transparent tape was above the incremental cost for the generic transparent tape. And there is some question about that. 3M argues in one of its footnotes that its pricing was above cost, however costs are calculated. However, in the text it actually says it never priced its "transparent tape" below its cost. Well, does "transparent tape" include Scotch Tape™ in the definition, since Scotch Tape™ is transparent? Why doesn't 3M ever calculate the implied incremental price of its generic tape? And why are they making this argument in a footnote? To me, this is the central issue of the whole case.

LePage's never showed that the incremental price was below cost. It never tried to do that. And 3M never showed that it wasn't. And so, both of them are responsible for this controversial decision in that the central issue was not addressed.

In *SmithKline v. Lilly*,⁴ you had the same sort of thing going on in the cephalosporin market. The incremental price of Kefzol was sufficiently low that the rival SmithKline couldn't compete. (The one caveat is that the courts used average cost rather than variable cost to reach this conclusion.) Contrast this with *Ortho v. Abbott*,⁵ where the experts calculated incremental prices and discovered that the incremental price was not below cost. As a result, the courts didn't find Ortho guilty. What's good about the exclusionary bundling test is that it works both ways. If you violated the test, as in *Lilly*, you're found guilty. If you don't violate the test, as in *Ortho*, you're okay.

Bundle v. Bundle Competition. Finally, a word on bundle-versus-bundle competition. You can sell a bundle against rivals that are selling individual components. Alternatively, you can be in the bundle-versus-bundle competition situation.⁶ To compare these two cases, I've created a baseline with no bundling, just component-versus-component competition. This baseline is set so that all the prices are 1 and the two firms are splitting the market evenly. With a model of linear demand and some other simplifying assumptions, you find that a firm that can bundle (which in this case is A) wins when selling against a firm that doesn't bundle. It gains market share and its single-good rivals really have trouble.

The advantage comes from solving the coordination issue. When one of the single-good rivals lowers the price of its part of the bundle, that improves its demand. It also improves the other firm's demand and it doesn't take that into account. And so therefore, a single-good firm doesn't have proper incentive to cut price.

In contrast, if you go to bundle-versus-bundle competition what you discover is that prices fall by 50 percent in the market. That is, the bundle goes from \$2, one dollar for each component, all the way down to \$1. Bundle-versus-bundle competition drives prices down in half compared to our baseline. The reason is that if either firm cuts its price, not only does it make one more sale, it actually make two more sales. It sells A_1 and A_2 . That's why rivals have twice the incentive to cut the price. And so prices and profits have to be half as big. That extra incentive to be price competitive works to customers' advantage when all firms in the market can bundle—which I think is typically the case in the telecom world.

LePage's never showed that the incremental price was below cost. It never tried to do that. And 3M never showed that it wasn't.

—BARRY NALEBUFF

⁴ *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978).

⁵ *Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc.*, 920 F. Supp. 455 (S.D.N.Y. 1996).

⁶ This argument is based on the more formal treatment found in Barry Nalebuff, *Competing Against Bundles*, in *INCENTIVES, ORGANIZATION, AND PUBLIC ECONOMICS* (Peter Hammond & Gareth Myles eds., 2000).

In conclusion, I think that the Chicago School distracted our understanding of bundling by focusing on a special case where products are consumed one or zero. While this applies to some circumstances, it is not the general case. When consumption is variable, I have shown how bundling and tying create the ability to leverage market power.

A key starting point is that you need market power to leverage, and that's often lacking in telecom. Moreover, telecom bundling creates efficiencies, which are important in terms of marketing, customer acquisition, and billing—all of which are legitimate reasons to bundle. And if the market has bundle-versus-bundle competition, the results will be very competitive.

There is no one simple story about bundling. That's all the more reason why I hope to have convinced you that there's is nothing so practical as good theory.

BOB ZASTROW: I have copies of the amicus brief in *LePage's* filed by Verizon and a number of other companies that have engaged in some form of bundled pricing.⁷ I'm here to discuss whether theories of anticompetitive bundling may be sensibly applied to the telecom industry. We all know that there are some misguided souls out there who think that local service is a monopoly, but I'm not going to get into that debate. I'm going to call local service the "A" product and I'm going to call the other things that a telecom company might want to bundle with local service the "B" product.

The first thing that struck me when I started delving into the literature this summer, is how different, even assuming the A product is a monopoly, telecom bundling is from the typical bundling precedents and economists' hypotheticals. In the typical case, as Professor Nalebuff has said, the monopolist discounts prices on product A to manipulate sales of product B. Here, the local phone service, product A, is a regulated service that is frequently sold below cost due to state regulation. So there's really no margin on A to play with. The bundle, at least in the telecom industry, works very much in reverse: we'll give you a discount on the B product, whether that's DSL or long distance, if you also keep our A product (local phone service). I haven't fully thought through whether that distinction is dispositive, but it struck me when I first started looking at it that this is very different.

Second, while we can disagree on whether you have to show predation as part of your analysis—in part of our *LePage's* brief there is an argument as to why you should—you would still have to prove monopoly maintenance or monopoly extension, which is going to be very difficult to show in the telecom industry. The B products are sold in a very competitive market. Take DSL for example. People have occasionally alleged that DSL is itself a product market, which the telephone companies are in danger of monopolizing. But the reality is that the cable industry still has the majority of broadband customers, although we're gaining on them. It is hard to tell a credible story that the Baby Bells are in danger of monopolizing the high speed data markets. Monopoly maintenance, I think, falls for a separate reason. When you look at a lot of these cases where the plaintiffs have won on a monopoly maintenance theory, product B is a partial substitute or potential replacement for product A, and A's whole strategy is to forestall B's entry into A's market. In telecom the component parts of the package tend to be complements rather than substitutes.

Another reason I think plaintiffs are going to have a hard time in this industry is that products tend to be sold in fixed quantities. In those circumstances, Professor Nalebuff agrees that the one monopoly rent story does apply. A customer normally needs one local line and one DSL service.

The first thing that struck me . . . is how different . . . telecom bundling is from the typical bundling precedents and economists' hypotheticals.

—ROBERT ZASTROW

⁷ 2003 WL 22428381.

You can't even put two DSL lines on a single phone line. Long distance was different in the past. Long distance was consumed variably, for the most part, four or five years ago. That is becoming a lot less true today. In fact, those of you who read last Monday's *Wall Street Journal* article, all of the packages that they were talking about were all-you-can-use packages.

As for why bundling occurs in the communications sector, I think the answers are obvious. There are very significant efficiencies for both the cable industry and telephone companies. Both of us already have a line into the customer's residence. We already sell that person something. We bill them monthly anyway. From the customer's point of view, sending us one less check in a month is a very good idea. If you have a summer house, think of the number of utility bills you pay maintaining two houses. The convenience of one bill for several services is not just for the service provider—it's for the customer too.

In terms of where are we going politically with this, those of you who are real telecom junkies and have read the latest FCC decisions know that the FCC has adopted a fairly unique set of rules in the high-speed data industry, to encourage bundling. In its recent line-sharing decision, the FCC has eliminated, prospectively, some of those obligations to share a line with competitors. In other words, where we provide the voice service, we used to be required to let someone else provide the DSL service. They have, however, left intact the obligations to configure our network to permit others share the line together so that a CLEC and AT&T could partner to provide voice and data services. The underlying rationale is that a more lenient policy will encourage competitors to produce their own services.

The other thing I think you see is a lot of bundle-versus-bundle competition emerging in this industry. That was the subject of the *Wall Street Journal* article last Monday. It's forcing competition into new areas. The fact that Time Warner Cable has a video offering and Verizon has only a resale offering with DirecTV is forcing us to spend billions of dollars to provide an equivalent video offering on our own network. Many of you have heard the public announcement that Verizon is actually building fiber to the home, and will get to about a million homes within the first year or so. Similarly, Time Warner's prior lack of a voice offering is forcing it and others to implement VOIP and cable telephony.

We could use more empirical research on the actual benefits of bundling to consumers. I know, anecdotally, that I pay less for the package than we used to pay our long distance provider alone for long distance service. We pay \$12 less in our house for video and so I think there is at least an anecdotal story that bundle-versus-bundle competition is very good for consumers. And, lest you think that this area is becoming a two-firm monopoly, read the analysts' articles about wireless, and about where wireless is going with data. For example, take the O'Hare Red Carpet Club, where I was recently in a four hour meeting. There used to be hundreds of phone and data lines so people could plug in their computers, but now everyone is using wireless devices to check their messages. It's a new world out there and I think a relatively lenient regulatory position will in the end be very good for consumers, at least in this industry.

MARK DEL BIANCO: I have to say that there's been less disagreement among our first two speakers than I'd anticipated. Lets hope our next speaker, Marc Lawrence-Apfelbaum, will have something a little more provocative to say.

MARC LAWRENCE-APFELBAUM: First, I just wanted to be clear that I'm not bundling today. I'm speaking only for myself and not also for my company, as the government lawyers like to say. In terms of the *LePage's* case, I really don't think it's a very controversial decision. It's not very well rea-

soned and it's hard to tell exactly what the facts were and what the practices were. But, I think it's clear that defendant 3M was arguing that bundling can never be an antitrust violation unless it involves pricing below cost. And to me the decision pretty much said: well no, there can be antitrust violations by a monopolist for other things besides pricing below cost, which I think is certainly true. It's true going back to John D. Rockefeller buying up all of the wooden barrels so that none of his rivals would have any place to put their oil. There are plenty of cases and learned treatises on antitrust law about monopolists doing things that are exclusionary other than pricing below cost. In *LePage's*, as I said, I think it's a little hard to follow exactly what was going on, but it does seem that there was some exclusive dealing in addition to bundling.

For our discussion today, it is important to note that the bundling in *LePage's* was something quite different from what goes on in the communications world. It wasn't just, if you buy these two products from me at the same time, I'll give you a discount. Instead, it applied to purchases from 3M that were spaced out over the course of a year, and if the buyer didn't buy from the plaintiff, it would get a lot better discount than if it bought anything at all from the plaintiff. It seems to me that what 3M's conduct was designed to say was: don't buy anything at all from my rival. To me that is more exclusionary than just somebody who says if you buy A and B from me I'll give you a discount, especially at the retail level. If so, it would be similar to the Netscape case with Microsoft, where the defendant saw a new phenomenon as something that could threaten its monopoly status in the long-term. There was testimony from executives at 3M that they saw private label tape as a threat to their branded tape, and although they weren't interested in being in the private label business, they were very interested in making sure that private label tape didn't catch on.

On the communications side, currently it's very hard to say of anything cable operators sell, that there's market power associated with the cable operator. If you look at the core video business, the largest multichannel seller is Comcast. The second largest is DirecTV (satellite). Time Warner Cable is the third largest, and then DishTV is a very close number four. When you look in terms of where new customers are going, I think that DBS is getting most of the new customers. So, I think in these circumstances it's very hard to say that there's any market power on behalf of the cable operators—and it's even more true when you look at everything else that we are selling. High speed data is certainly very, very competitive. And on the phone side, we are the brand new entrant. It's just inconceivable that someone could say that cable operators have market power. I think the only explanation for why cable operators are bundling is to respond to competitors who are offering bundles. There are efficiencies in bundling. I think it's the very definition of positive competition to be offering bundles in the market circumstances that characterize our business. And, that's pretty much all I have, so I guess we're up to the questions.

The only explanation for why cable operators are bundling is to respond to competitors who are offering bundles. There are efficiencies in bundling.

—MARC LAWRENCE-
APFELBAUM

Questions and Answers

QUESTIONER: I want to bring this back to communications markets. Right now as a consumer, I seem to have two bundles to choose from at home. I have a bundle of long distance and local service and they're trying to get me to buy broadband service. And then I have a bundle of cable service where they're trying to get me to buy their broadband service. But, I really don't have two equal bundles to choose from—to play off each other—and get the best price. And I was wondering from a policy perspective, is there anything that regulators ought to be doing to try to encourage consolidation in such a way that as a consumer, I have two more equal bundles to choose from and to play off each other?

MARK DEL BIANCO: What I'd like to do is have the business guys answer that first and then have the academic answer the strategic reasons why, if you were a competitor, you may not want to have bundles that overlap and are coherent enough for the consumer to figure out which one is in fact the better deal.

MARC LAWRENCE-APFELBAUM: Well, I think it's fair to say that bundles are becoming more similar. But, I think even if they weren't, I don't see that there's any strong government action saying you need to consolidate more to have more similar bundles. If the market place is working and there is lots of competition between different providers and some have two products and some have three, I think consumers can still do the math and figure out for themselves what's the best way to go without setting up some government-mandated further consolidation or other regulation.

BOB ZASTROW: I may not have been making myself totally clear, but I think that is what the government was doing in a series of decisions on line sharing and line splitting. It was very explicitly imposing obligations on us to make it possible for others to come in and offer bundled voice and data services on our network. I would just argue that given the history of telecom regulation, more harm than good can result. If you look at the past ten years, I'd say, the dual mistakes of not allowing spectrum to be traded, when combined with network sharing rules that drew investment capital away from the wireless business and into the hands of people who resold our networks, have done a lot of harm. And so, if the government wants to get active again, just think of whether you can adequately predict the consequences of what you are doing.

BARRY NALEBUFF: I think what you pointed out is that it's not just A and B, it's ABC. Let's assume for a moment, the local phone service (A) is a monopoly and that cable (C) is a monopoly. Let B be DSL/broadband service. In some sense, then, you have an AB bundle competing against a BC bundle. And so you have some parts that are overlapping and some not. Alas, the theory is not well enough developed to truly answer your question. The good news is that the world seems to be heading towards an ABC against ABC, which I'd bet is going to be good for consumers.

QUESTIONER: If you have an ABC vs. ABC bundle, would you expect prices to be closer to cost than an A vs. A?

BARRY NALEBUFF: One of the things that's true is the more items you have in a bundle, in a bundle-to-bundle competition, the lower prices are. The simple intuition for this is that when you cut the price of one component, in essence, you are getting increased A, B, and C sales, because when the person buys more A, they're getting the B and the C too. Therefore, there's more at stake, and because there's more at stake, you're willing to be more aggressive. That suggests why you may get a much more competitive market with bundle vs. bundle competition.

The theory is pretty unambiguous. The larger the bundle, assuming the bundles are comparable, the more competitive it becomes. So AB vs. AB is more competitive than A vs. A. And ABC vs. ABC is more competitive than AB vs. AB.

QUESTIONER: Just to follow up on the evolution of "ABC vs. ABC," I'd like to tag on to both Bob and Marc having mentioned the race on the video component of the bundle. What happens if you have perfect ABC bundle vs. ABC bundle offerings, but one of the participants in that competition has a key element that can also be offered outside of the ABC bundle? To make the explicit example:

if you have a Time Warner movie offering that can be offered theatrically by DVD, broadcast television, paid TV, those kinds of things where there's a licensing scheme, even if the owner of the intellectual property in the movie offers that particular license to the competitors in the ABC bundles at the same price, doesn't the ability to offer it outside the bundle through different competitive channels alter the competitive posture vis-à-vis the bundles? In other words, whoever is offering C outside of the ABC channel can choose to increase their margins outside of the channel such that the C component becomes the least profitable of the three, or the most profitable depending upon whether the margins appear to be favored as part of an ABC bundle or whether the margins are favored by keeping the higher revenues of product C outside of the ABC bundle.

MARC LAWRENCE-APFELBAUM: I'm not sure I'm following you. I think other sellers out there are free to sell or not sell products from other parts of Time Warner as they wish. Getting back to first principles, I think we face competition in each and every one of the products we sell and if we're going to put something else in the bundle or not put it in it's really responding to what we think customers want. I don't think that we can game the system whether or not Warner Brothers chooses to do anything in particular with its movies.

BARRY NALEBUFF: I think that you are correct in saying that there is some content that is a monopoly product. In that sense, it's not a straight ABC versus ABC competition. If one player has all the movies, then it can engage in either a horizontal or vertical price squeeze as part of that. In that sense, whether or not other people are selling the C or not selling it, it's not as if they are producing it. The question is: what are the prices, and is exclusionary bundling taking place where we have monopoly?

In fact, one of the ironies is that there's been a lot of talk about consumers trying to get cable operators to debundle content. Actually, the cable operators themselves are being sold bundled content. Which is why, if you want Disney, you have to buy ESPN. It seems to me that's another place where we have some potential issues associated with bundling. ●

LePage's v. 3M: Five Ingredients in Search of a Monopoly Broth

Ronald W. Davis

By accepting the government's recommendation to deny certiorari¹ in *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004), the Supreme Court let stand an en banc Third Circuit back-to-the-future opinion endorsing an expansive and controversial view of the law of monopolization. The appellate court's analytical errors—errors as much of omission as of commission—have given us a precedent that has much potential for mischief.

To illustrate why the decision in *LePage's* creates practical problems, this article explores a not-so-hypothetical hypothetical. First, however, some clarifying thoughts about what this article is and is not about; then, a hard look at those missing ingredients in the Third Circuit's monopoly broth.

Let Me Be Clear

Flawed as it is, *LePage's* has its strong defenders—who tend to praise what they see as the justice of the outcome as between the two litigants, rather than the acuteness of the court's legal analysis.² Thus, in discussing *LePage's* it is important to be clear about whether one is defending the legality of 3M's conduct or defending the court's analysis. So let me make several points, just to be clear.

As an outside observer—I have no dog in this fight—3M's business strategy against *LePage's* seems to have been imprudent. 3M, moreover, should not have assumed that the mere fact that it sold above cost would carry the day in litigation. (That was their story, and they were sticking to it). A litigation victory for the plaintiff should have come as no big surprise. This article does not attempt to prove that the wrong side won the case. Conceivably, the appellate court might have written an analytically sound opinion upholding the jury verdict for *LePage's*. Whether or not that is so is beyond the scope of this article.

This article tells no "narrative" of efficient monopolists engaged in hard, manly competition against inefficient, whiny, smaller competitors.³ One will find no argument here in favor of a simple—or simplistic, if one prefers that word—rule of thumb for deciding bundling cases, such as that bundled discounts and rebates are per se lawful if they are above cost, or if the injured competitor is less efficient, or if the monopolist's plan involves no sacrifice of profits in the short term, or if the monopolist's customers are not "coerced." And no argument is advanced that the legal system owes a duty toward monopolists to create unambiguous rules of per se legality to afford a safe harbor for bundled discount programs or other arguably exclusionary strategies.

■ **Ronald W. Davis**

is a solo antitrust practitioner in Atlanta, Georgia, and Developments Editor of Antitrust magazine.

¹ Brief for the United States as Amicus Curiae, available at <http://www.usdoj.gov/atr/cases/f203900/203900.pdf>. Denial of certiorari followed soon after the agencies filed their amicus brief recommending that the Court not take the case.

² See PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 749 (Supp. 2004); Andrew I. Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3 (2004).

³ See Gavil, *supra* note 2, at 34.

It is not my purpose to dispute that strategies employed by monopolists that create, preserve, or extend monopoly power merit careful antitrust scrutiny. No fault is found with those who argue that Supreme Court dicta in cases like *Brooke Group*⁴ and *Trinko*⁵ is too friendly in tone toward monopolists.

All those things said, the en banc Third Circuit court in *LePage's* has served up a monopoly broth with almost no ingredients. And that is a big problem. The Supreme Court's decision to deny certiorari was problematic, but my point is not to quarrel with that decision. It is to illustrate how *LePage's* can create adverse real world effects.

3M's Strategy

In 1992, concerned about the success of LePage's in the private label transparent tape business, 3M adopted an aggressive stance, entering into a series of deals with large buyers like Wal-Mart and Staples. The terms varied from deal to deal, but generally involved bundled rebate programs, where 3M set a customer-specific target growth rate for each of six product lines—including Scotch™ transparent tape and PostIt™ repositionable notes, two strong 3M brands. In these deals customers had to achieve the target growth in *each* line in order to get a rebate. Sometimes the only practical way in which a customer could meet 3M's target was to drop LePage's tape. Very few of these arrangements involved any contractual commitment to exclusivity, and the jury found for the defendant on LePage's claim of unlawful exclusive dealing under Clayton Act Section 3. 324 F.3d at 145.

The en banc Third Circuit court in LePage's has served up a monopoly broth with almost no ingredients.

There was no suggestion that 3M priced below cost. LePage's problem was that if a customer bought any substantial amount of LePage's private label tape, the customer would not meet its 3M "target" in one product line—and the failure to meet the target in one line would, in turn, result in loss of the rebate on *all six* 3M product lines.

The bundled rebates were modest in percentage terms, but significant in dollars, representing up to \$1 million or more per year for large customers.

To meet or beat 3M's bundled discounting, LePage's would have had to cut its price substantially, and this it was unwilling to do. Following the adoption of 3M's new strategy, LePage's share of the overall transparent tape business decreased from 14.4 percent to 9.35 percent. At the time of trial LePage's had been in the red for three years, but it still had two thirds of U.S. private label transparent tape sales. 324 F.3d at 161–62, 170.

The jury found 3M liable for monopolization, with single damages of \$23 million based on lost profits. Reversing an earlier three-judge panel decision, 277 F.3d 365 (3d Cir. 2002), in 2003 the Third Circuit, sitting en banc, affirmed the verdict.

Throughout the litigation 3M clung tenaciously to the position that there is no legal distinction between an above-cost bundled discount and an above-cost unbundled discount—and that, based on *Brooke Group*, no price above cost, bundled or not, can support liability under Sherman Act Section 2. It did not matter, said 3M, that its documents showed an intent to drive LePage's from the market, and perhaps thereafter to raise prices. Nor did it matter whether 3M's scheme was likely to succeed. It did not matter whether barriers to entry were high, and it did not matter if LePage's ultimate demise would leave 3M with 100 percent of a relevant market. Pricing above cost is per se legal. That was 3M's position.

⁴ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

⁵ *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398 (2004).

Rising to the bait, the en banc court identified the validity of 3M's per se legality argument as “the most significant legal issue in this case,” 324 F.3d at 147, and rejected it root and branch. The court took inspiration from the spirit of *Alcoa*⁶ and other classic monopolization authorities. *Id.* at 147–51. It found a host of reasons to distinguish—and to dismiss—the Supreme Court's decision in *Brooke Group*: the case was an aberration, *id.* at 151–52; it dealt with simple price cutting, not bundling, *id.* at 151; and, most remarkably—despite Justice Kennedy's high dictum in *Brooke Group* indicating that this Robinson-Patman decision should apply, as well, to the law of monopolization—the Third Circuit allowed as how “nothing in [*Brooke*] suggests that its discussion of the issue is applicable to a monopolist with its unrestrained market power.” *Id.*⁷

The court found that 3M's bundled rebate program illegally denied market share to the plaintiff. *Id.* at 155. Invoking the “monopoly broth” tradition of antitrust jurisprudence, the Third Circuit observed:

The effect of 3M's conduct in strengthening its monopoly position by destroying competition by LePage's in second-tier tape is most apparent when 3M's various activities are considered as a whole. The anti-competitive effect of 3M's exclusive dealing arrangements, whether explicit or inferred, cannot be separated from the effect of its bundled rebates. 3M's bundling of its products via its rebate programs reinforced the exclusionary effect of those programs.

Id. at 162.

Some look kindly on the Third Circuit's approach, believing it to be well within the mainstream of antitrust's traditionally strict scrutiny of the aggressive business practices of monopolists. Others, including myself, view it with alarm.⁸

A Flavorless Monopoly Broth

In *MCI v. AT&T*, 708 F.2d 1081, 1177 (7th Cir. 1983), the court said that “[i]f you really wanted to know what caused the unsavory flavor of the monopoly broth, you would not just audit the chef's books of account; you would also take a look at his recipe.” The Third Circuit's recipe in *LePage's* for Monopoly Broth lacks five key ingredients.

1. Foreclosure by Exclusive Dealing Contracts. A classic monopolist's ploy is to foreclose substantial market share, for a substantial period of time, using a series of parallel exclusive dealing contracts—contracts that put the buyer in breach if it chooses to do business on the merits with a competing seller. But 3M did not do that. Its two exclusive dealing contracts were not material to the case, see 324 F.3d at 157, and the jury found for 3M on the claim of illegal exclusive dealing. *Id.*

Some have argued that the antitrust concept of exclusive dealing should extend to “partial exclusive dealing” arrangements where, for example, a buyer promises to buy a significant percentage (though less than all) of its requirements from a specific seller. Maybe, even, stretching

⁶ *United States v. Aluminum Co. of Am.*, 148 F.2d 416 (2d Cir. 1945).

⁷ This sweeping assertion came as a shock to the antitrust bar, including the federal agencies, see Brief for the United States, *supra* note 1, at 14–15 n.11, not to mention the authors of the chapter on monopolization in both the fourth and fifth editions of ABA ANTITRUST SECTION, ANTITRUST LAW DEVELOPMENTS (4th ed. 1997 & 5th ed. 2002), who relied heavily on *Brooke Group* in describing the black letter law of predation as a Sherman Act Section 2 violation.

⁸ See David L. Meyer, *LePage's II: The Third Circuit Revisits 3M's Bundled Discounts and Sees Unlawful “Exclusion” Instead of Below-Cost Pricing*, ANTITRUST SOURCE, July 2003, available at <http://www.abanet.org/antitrust/source/july03/meyer.pdf>; Joanna Warren, *Comment, LePage's v. 3M: An Antitrust Analysis of Loyalty Rebates*, 79 N.Y.U. L. REV. 1605 (2004); Ronald W. Davis, *LePage's v. 3M: What Will Stick from the Tape Case?*, Discussion Paper Prepared for ABA Antitrust Section Teleseminar on “Buying Loyalty” (June 10, 2003).

a little further, antitrust might label as “exclusive dealing” a situation where the buyer promises nothing, but the seller provides a discount *conditioned* on the buyer’s purchasing, say, 60 percent of its requirements from the discounting seller.⁹

Significantly, however, the en banc majority in *LePage’s* did not seem to think that “exclusive dealing” requires a legally binding promise of exclusivity or a discount conditioned on exclusivity. According to *LePage’s*, all that is needed is an offer that is too good to refuse—an offer so attractive that a buyer chooses to buy from the party making the offer, to the exclusion of other sellers, whose offers are less attractive. The court seemed to ground liability not on a promise elicited from the buyer, or on a condition imposed by the seller, but simply in the seller’s *intent* to make an offer so attractive that it would “exclude” others—as the court put it, “payments to many of the larger customers that were designed to achieve sole-source supplier status.” 324 F.3d at 157.¹⁰

That is what the court said. Did it really *mean* that neither a promise nor a condition is necessary to invoke “exclusive dealing,” only a really, really attractive offer? Enquiring minds want to know. They will not find out by reading the opinion. In a decision that is analytically weak overall, the discussion of exclusivity is the very weakest point.

2. Foreclosure by Tying and De Facto Tying. Like true exclusive dealing, refusal to sell a desired product unless the customer also takes an undesired product—a product it would not otherwise choose on the basis of price, quality, and service alone—is a kind of foreclosure: it artificially interferes with competition on the merits of price and quality. This kind of foreclosure is called tying. 3M did not do that.

A bundled offer that is so much more attractive than the unbundled alternative as to make the unbundled option illusory—in other words, *de facto* tying—may have the same adverse effect on customer freedom of choice as literal tying.¹¹ But *LePage’s* elected not to pursue any claim of literal or *de facto* tying.¹²

I make ice cream. I use the secret Davis family formula, and my ice cream is unusually good. Also, I have learned to produce my ice cream very efficiently and thus I can sell my product at a low price and still make money. But I make and sell only one flavor, vanilla. My competitor down the street sells average tasting ice cream and charges more than I charge. But she sells three flavors, vanilla, strawberry, and chocolate, and she gives a 5 percent discount to customers who buy

⁹ See Willard K. Tom, David A. Balto, & Neal W. Averitt, *Anticompetitive Aspects of Market Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615 (2000); see also Richard M. Steuer, *Discounts and Exclusive Dealing*, ANTITRUST, Spring 1993, at 28.

¹⁰ See also *id.* at 158: “*LePage’s* introduced powerful evidence that could have led the jury to believe that rebates and discounts to Kmart, Staples, Sam’s Club, National Office Buyers and ‘UDI’ were designed to induce them to award business to 3M to the exclusion of *LePage’s*.” Again, the court focused on 3M’s intent to gain all the business, not on any contractual promise it may have elicited, or on any gentlemen’s agreement, or even on any specific condition that 3M may have imposed.

¹¹ See generally 1 ABA ANTITRUST SECTION, ANTITRUST LAW DEVELOPMENTS 190–94 (5th ed. 2002). Kenneth Glazer and Brian Henry have argued that liability in a *LePage’s* type of scenario should turn on whether customers were coerced to enter rebate deals. Kenneth L. Glazer & Brian Henry, *Coercive v. Incentivizing Conduct: A Way out of the Section 2 Impasse?* ANTITRUST, Fall 2003, at 45. Compare Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 339 (2002) (buyer consent should not matter). Whatever may be the merits of distinguishing between coerced and willing customers in this context, this is not the distinction I am drawing. Even a customer that willingly and freely binds itself to buy exclusively from a particular seller for a substantial period of time is foreclosed, i.e., may not choose to buy from some other supplier “on the merits” of price and quality, as long as the contractual obligation remains in effect. Simply choosing to buy everything from supplier A on the merits, without such legal foreclosure, is a horse of a very different color.

¹² The narrative portion of the complaint characterized 3M’s bundled rebates as “tying” or “*de facto* tying,” but, inasmuch as 3M never refused to sell any product on an unbundled basis, *LePage’s* dropped the charge of “*per se* illegal” tying, and hung its hat, instead, on the argument that bundling is *analogous* to tying, a position the court accepted. 324 F.3d at 155.

all three as a bundle. She wins some sales from me because some customers prefer one-stop shopping and some like the bundled price. I win some sales from her because some customers only like vanilla, enjoy my secret family recipe, and like my price.

Could I say that I am “foreclosed” from selling to customers who want all three flavors? Could my competitor say that she is “foreclosed” from selling to customers who prefer vanilla ice cream made with my secret formula? Yes to both questions, but only if we speak in a misleadingly imprecise way. In the hypothetical, no one has interfered with a customer’s freedom to choose on the merits. My competitor and I are simply relying on our respective competitive strengths to win sales by making our offerings as attractive as possible.

3. Inability to Compete Effectively. Because its product line was much smaller in scope than 3M’s, LePage’s was literally unable to compete by offering a similar bundled rebate program. At least theoretically, however, LePage’s could have offered an economically equivalent (or superior) counteroffer by cutting the price of its tape by some large amount.¹³ Whether it “could” have done so and made enough money to stay in business is a different question. Justice Greenberg, dissenting from the majority opinion in *LePage’s*, contrasted LePage’s case with that of *SmithKline*¹⁴ in a 1978 bundled discount case:

SmithKline *showed* that it could not compete by explaining how much it would have had to lower prices for both small and big customers to do so. SmithKline ascertained the rebates that Lilly was giving to customers on all three products and calculated how much it would have had to lower the price of its product if the rebates were all attributed to the one competitive product. In contrast, LePage’s did not even attempt to show that it could not compete by calculating the discount that it would have had to provide in order to match the discounts offered by 3M through its bundled rebates, and thus its brief does not point to evidence along such lines. . . . [I]t is critically important to recognize that LePage’s had 67% of the private label business at the time of the trial. Thus, notwithstanding 3M’s rebates, LePage’s was able to retain most of the private label business. In the circumstances, it is ironic that LePage’s complains of 3M’s use of monopoly power as the undisputed fact is that LePage’s, not 3M, was the dominant supplier of private label tape both before and after 3M initiated its rebate programs. Indeed, the record suggests that inasmuch as LePage’s could not make a profit with a 67% share of the private label sales, it must have needed to be essentially the exclusive supplier of such tape for its business to be profitable as it in fact was when it had an 88% share of the private label tape sales business.

324 F.3d at 175–76.

In contrast, the *LePage’s* majority cited *SmithKline* with approval, 324 F.3d at 155–56, but failed to mention that the plaintiff in that case was rendered unable to compete by the defendant’s bundled discount program, or to address the distinction drawn by Judge Greenberg in dissent. The *LePage’s* majority likewise did not deal with another key case, *Ortho Diagnostic Systems, Inc. v. Abbott Laboratories, Inc.*, 920 F. Supp. 455 (S.D.N.Y. 1996), in which

[t]he district court stated that to prevail on a monopolization claim in “a case in which a monopolist (1) faces competition on only part of a complementary group of products, (2) offers the products both as a package and individually, and (3) effectively forces its competitors to absorb the differential between the

¹³ Cutting price would have increased LePage’s sales volume but lowered its profit on each unit. The net result of such a low price strategy *might* have driven LePage’s hopelessly into the red—making a low price strategy totally unrealistic. On the other hand, selling a greater volume of tape at reduced unit profit *might* have been an entirely feasible response for LePage’s. Which of these two different scenarios—a potentially successful low price, high volume strategy, or a low price strategy foredoomed to failure—actually describes the choices LePage’s faced? Based on the information given in the opinion, no one can say.

¹⁴ *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978).

bundled and unbundled prices of the product in which the monopolist has market power,” the plaintiff must allege and prove “either that (a) the monopolist has priced below its average variable cost or (b) the plaintiff is at least as efficient a producer of the competitive product as the defendant, but that *the defendant’s pricing makes it unprofitable for the plaintiff to continue to produce.*”¹⁵

The majority in *LePage’s* did, however, cite (with approval) the 2002 Hovenkamp *Supplement* to the *Antitrust Law* treatise.¹⁶ The current (2004) *Supplement* to the treatise discusses the en banc decision in *LePage’s*, straining to reconcile the opinion with Professor Hovenkamp’s own, more restrictive view. Hovenkamp paraphrases the court as concluding, “although without offering specific numbers, that an equally efficient rival offering only a single product, tape, could not profitably match the defendant’s discounts.” However, as discussed further below, the discussion in the 2004 *Supplement* advocates a more precise, limited, and nuanced antitrust rule on strategic bundling than any to be derived from the Third Circuit’s decision.¹⁷

To sum up: Would *LePage’s* actually have been able to make an economically attractive counter offer to 3M’s bundled rebate program and still operate profitably? It is unclear.

Did the majority care one way or the other? Clearly it did not. (Otherwise, why would the majority ignore the issue of the plaintiff’s ability or inability to compete, of which the dissent made such a big deal?)

Would it be fair for a future plaintiff to cite *LePage’s* for the proposition that, contrary to *Ortho* and *SmithKline*, it is irrelevant whether or not the plaintiff can match the bundled offer made by the monopolist defendant? Yes, it would.

4. Past Consumer Injury. Often, illegally exclusionary conduct harms both competitors or potential competitors and consumers. Direct purchasers who pay a monopoly overcharge as a result of the exclusion of potential competitors suffer “antitrust injury” and have a claim for damages.¹⁸ A competitor forced to exit a market by illegally predatory or exclusionary means likewise suffers antitrust injury in the form of lost profits.¹⁹ By contrast, unilateral “exclusionary” conduct that has not harmed consumers in the past, and does not threaten (to a legally sufficient degree of probability) to harm them in the future cannot be a basis for liability to a competitor under Sherman Act Section 2. As the Supreme Court said in *Aspen Skiing*,²⁰ “The question *whether Ski Co.’s conduct may properly be characterized as exclusionary cannot be answered by simply considering its effect on [the plaintiff].* In addition, it is relevant to consider its impact on consumers and whether it has impaired competition in an unnecessarily restrictive way.” 472 U.S. at 605 (emphasis added). In *Aspen Skiing*, liability was based on the plaintiff’s having been “crippled” competitively, in a case where the source of the crippling—the defendant’s deprivation of the plaintiff’s

¹⁵ 324 F.3d at 177 (dissent) (citing 920 F. Supp. at 469) (emphasis added).

¹⁶ 324 F.3d at 155 (citing PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 749 at 83 (Supp. 2002)).

¹⁷ AREEDA & HOVENKAMP, *supra* note 2, at 182–84. Despite its inability to advocate a black letter rule on bundled rebates, the Antitrust Division likewise seems to attribute significance to the ability or inability of a plaintiff to match the offer. In its amicus brief opposing certiorari it wrote that

a bundled rebate or discount can—under certain theoretical assumptions—exclude an equally efficient competitor, if the competitor competes with respect to but one component of the bundle and cannot profitably match the discount aggregated over the other products, even if the post-discount prices for both the bundle as a whole and each of its components are above cost.

Brief for the United States, *supra* note 1, at 13.

¹⁸ See *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968).

¹⁹ See, e.g., *Midwest Gas Servs., Inc. v. Indiana Gas Co.*, 317 F.3d 703 (7th Cir. 2003).

²⁰ *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985).

ability to offer a package of skiing experiences—was, at one and the same time, the source of injury to consumers. *Id.* at 606.²¹

In *LePage's* the court found Sherman Act liability without any past consumer injury.²² It neither referred nor alluded to any overcharge paid by a direct or indirect purchaser from 3M, nor did it mention, directly or indirectly, any other way in which purchasers had been deprived of the benefits of competition or suffered any economic loss, as a result of 3M's strategy.²³

5. Future Consumer Injury. Where exclusionary conduct threatens consumer injury and has already injured a competitor, the competitor may seek damages for its past economic injury even though consumers have not yet suffered loss. The leading case is *Brunswick*, which said, “[C]ompetitors may be able to prove antitrust injury before they actually are driven from the market and competition is thereby lessened. Of course, the case for relief will be strongest where competition has been diminished.”²⁴ Thus, a competitor likely to be excluded from a market as a consequence of illegally predatory or exclusionary conduct by a monopolist suffers antitrust injury and may sue for lost profits, where its impending exclusion will likely cause consumer injury. (No one disputes that *LePage's* demise, which would have changed the market from a duopoly to a pure monopoly, would probably have caused consumer injury.)

Even where a competitor is not literally excluded from—compelled to exit—a market, consumer injury may sometimes occur if a smaller competitor is “crippled.” The “wounding” of a competitor might, for example, deprive consumers of innovative new products or increased output that would have occurred, but for the illegal “crippling” behavior. But caution is in order, because “injury” to a competitor occurs whenever a sale is taken away, yet taking sales away is the essence of competition. In *Aspen Skiing* the Supreme Court was careful to link the “crippling” of a competitor with injury to consumers. 472 U.S. at 606. That linkage seems essential in order to prevent smaller competitors from obtaining damages for aggressive competition that benefits consumers—in the short run *and* in the long run.

²¹ See generally 3 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 651d (2d ed. 2002) (urging that “[e]xclusionary conduct requires actual or prospective consumer harm”).

²² Part V of the opinion, headed “Anticompetitive Effect,” expatiated on how much 3M's program hurt *LePage's*, and on evidence of *intent* to earn future monopoly profits. There was no reference to any past injury to competition—only injury to a competitor, the plaintiff. The court did allude several times to the market exit of a third competitor, *Tesa Tuck*. See, e.g., 324 F.2d at 162. The reasons for *Tesa's* exit were not explored, but it is no huge leap to assume that 3M's strategy may have contributed to *Tesa's* market withdrawal. When a market changes from three firms to two firms, it may be easier for the remaining duopolists to coordinate pricing with one another, to the detriment of consumers. If that happened—and there is no suggestion that it did happen—it would have resulted in economic benefit to *LePage's*, not economic loss. In follow-on litigation arising out of the same facts, a class of retail purchasers does claim past damages. *Bradburn Parent/Teacher Stores, Inc. v. 3M*, No. Civ. A. 02-7676, 2004 WL 1842987 (E.D. Pa. Aug. 18, 2004). According to an Associated Press report, Publix Super Markets has filed a similar case. See http://biz.yahoo.com/ap/040917/tape_fight_2.html. The claim seems implausible, but time will tell whether these plaintiffs can prove their case.

²³ The Third Circuit majority found it significant that the lump sum rebate payments in 3M's program were unlikely to be passed on to tape consumers, because the payments did not appear on the invoice. 324 F.3d at 163. That may be right. But economic theory holds that, if the market in which the retailers operate is competitive, then the retailers will compete away these payments in ways that are potentially beneficial to consumers, such as expanding their stores. In *FTC v. H.J. Heinz Co.*, 246 F.3d 708 (D.C. Cir. 2001), the Federal Trade Commission persuaded the D.C. Circuit that competition in offering slotting allowances to retailers is competition protected by the antitrust laws, regardless of the form in which such allowances are passed on. The salient question, in any event, is not whether 3M affirmatively proved that its conduct benefited consumers. Rather, the key issue is whether the plaintiff showed that its lost profits were associated with past, or likely future, consumer injury.

²⁴ *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 489 n.14 (1977).

What lessons may we learn from *LePage's* about the showing of likely future consumer injury that a plaintiff in a bundled rebate case must make in order to demonstrate antitrust injury? In answering this question, we have a choice. On the one hand, we may choose to answer based on what we think the court in *LePage's* woulda, shoulda, coulda said—fashioning our answer with a view toward the parties' claims, our intuition as to what the facts really were, and our sense of what the law ought to be. On the other hand, we may answer based on what the court actually said. The former alternative may be described as the mature choice: like the sophisticated courtiers at the emperor's court, we may praise the emperor's new fashions and overlook his nakedness.

Let us begin, however, with the immature alternative, and consider the words that the court used. Two points stand out. First, in the court's exact words: "Had 3M continued with its program it *could* have *eventually* forced *LePage's* out of the market." 324 F.3d at 162 (emphasis added). "Could" and "eventually" do not, however, cut the mustard. If sixteen improbable things happen in the right order, I "could" "eventually" fly to the moon. And any aggressive tactic by a dominant firm "could" "eventually" threaten a smaller rival.

Second, the court was exercised by strong evidence of 3M's intent that its bundling strategy would drive competitors from the market and permit it to recoup monopoly profits. The court alluded to "evidence from which the jury could have determined that 3M intended to force *LePage's* from the market, and then cease or severely curtail its own private-label and second-tier tape lines," which it juxtaposed with snippets of evidence showing "3M's interest in raising prices"—as if a profit-making enterprise's interest in earning profits were surprising or legally relevant—along with evidence that the rebates would generally not be passed along to customers,²⁵ to support its overall conclusion that "there was sufficient evidence for the jury to conclude the long-term effects of 3M's conduct were anticompetitive." 324 F.3d at 163.

It is uncontroversial that intent underlying a business strategy may assist the trier of fact in predicting the likely actual effect of that strategy. By like token, it is uncontroversial that business people often intend to injure their competitors more severely than objective circumstances will permit. For that reason and others, recent case law²⁶ and commentary²⁷ generally recognize that antitrust outcomes should not turn on "bad intent" unaccompanied by likely bad effect.

Nevertheless, based on the words the court employed, a future plaintiff challenging a monopolist's bundled rebate program may fairly cite *LePage's* for the proposition that a smaller and less diverse competitor that loses sales as the result of such a program may recover all its lost profits as single damages where there is a possibility that the plaintiff could eventually be driven from the market, at least where there is evidence of the defendant's intent to achieve such a result and thus to recoup monopoly profits. The hypothetical future plaintiff may legitimately argue that it should win even though there has been no past consumer injury and the probability of future consumer injury is low.

²⁵ Even if rebates are not passed on in the form of lower prices, economic theory dictates that, insofar as the rebate recipients operate in competitive markets, competition will result in their "passing on" the rebates indirectly, in the form of increased advertising, bigger stores, and so forth. Accordingly, while the point remains controversial, the stronger argument is that antitrust protects competition in the provision of rebates and other lump sum payments to commercial intermediaries. See *supra* note 23.

²⁶ *E.g.*, *A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc.*, 881 F.2d 1396 (7th Cir. 1989).

²⁷ *E.g.*, 3 AREEDA & HOVENKAMP, *supra* note 21, ¶ 601.

Did the court intend for its opinion to be read this way? Who can say? I suspect the court knew it was on shaky ground in respect of consumer injury, and intentionally employed language vague enough so that finding its holding is like nailing Jell-O® to the wall.

Now to what the court woulda, shoulda, coulda said on future consumer injury. In its brief to the Third Circuit LePage's predicted its own "imminent demise."²⁸ Its Supreme Court brief asserted that "[a]t the time of trial, LePage's was barely surviving as a going concern."²⁹ Moreover, the court was aware that LePage's was making a stronger claim than that it might eventually exit the market. The court said, "LePage's claims that it barely was surviving at the time of trial and that it suffered large operating losses from 1996 through 1999." 324 F.3d at 144–45. Thus, one would suppose, the court might properly have written something like this:

Based on the evidence, the jury might reasonably have concluded that LePage's exit from the relevant market was imminent; that 3M's bundled rebate program was a material cause of the plaintiff's likely demise; and that, in light of the high barriers to entry into the relevant market [see 324 F.3d at 162–63], consumers were likely to pay monopoly overcharges as a consequence of LePage's prospective disappearance.

Such a hypothetical finding would have taken care of the future consumer loss/antitrust injury side of the case—and we would have been left to argue only about whether we wish to call 3M's program "exclusionary" or whether we regard it as a legitimate form of competition. As to the latter point, the court might have added language along these lines:

In defense of the strategies that are about to lead to total monopoly on 3M's part, and resulting injury to consumers, 3M has offered wholly unpersuasive—barely colorable, even—purported "business justifications. [See 324 F.3d at 163–64.] Accordingly, we hold that whenever a firm with monopoly power in one or more legally relevant markets employs a bundled rebate or discount program including products over which it has monopoly power, and such a program has led, or is likely to lead, to consumer injury, the firm employing such practices has violated Section 2 of the Sherman Act.

Such a rule would have been controversial on a number of grounds, but it would have been a far cry from a rule permitting liability with no past consumer injury and only the merest possibility that consumer injury "could eventually" result.³⁰

Certiorari Denied

The Antitrust Division and the FTC successfully urged the Supreme Court to deny certiorari. The government had no more success than anyone else in divining the court's holding: it cogently observed that the "court of appeals was unclear as to what aspect of bundled rebates constituted exclusionary conduct," Brief for the United States as Amicus Curiae at 8, and that the court did not explain "what precisely rendered 3M's conduct unlawful." *Id.* at 16. The government recognized that bundled rebates can be procompetitive, *id.* at 12, and that it would be really nice if businesses had some notion about what the rules are. *Id.* at 18. But the Division and the Commission did not buy into 3M's bright line test of per se legality where prices are above cost, *id.* at 14–15,

²⁸ Brief for Appellees/Cross-Appellants, 2002 WL 32157026.

²⁹ Brief for the Respondents in Opposition at 7.

³⁰ Professor Andrew Gavil, who likes *LePage's*, has written "Although LePage's ultimately prevailed as a litigant, it was driven out of the market by 3M, and consumers will continue to suffer the uncompensated consequences of less competition." Gavil, *supra* note 2, at 40. But this report of the firm's death is exaggerated. Its current Web site, http://www.lepages.com/about_us.htm, declares that it is a leading tape producer, and promises a "New Security Tape to Combat Terrorism," thereby illustrating that it is an ill wind indeed that blows nobody good.

nor did it view bundled rebates as invariably procompetitive or benign. *Id.* at 8. And in a case where, in the government's view, both sides were wrong on the legal analysis, the Supreme Court, with little aid from counsel for the parties, was not well positioned to step in and craft its own test. *Id.* at 15–19.

A Not-So-Hypothetical Hypothetical

Some commentators have spoken eloquently of the absence of an identifiable holding by the Third Circuit, and have identified a variety of conflicting specific rules that are consistent with the court's discussion and result³¹ or that might arguably be used to decide the case.³² Others have argued over whether some or all of the bundled rebate should be "allocated" to the tape that competed directly with LePage's, for purposes of a possible predatory pricing analysis³³ (though the plaintiff and the court disclaimed reliance on such a theory). These are good and valid points, and they require no repetition here. Instead, I want to focus on the breathtakingly minimalist nature of the Third Circuit's opinion.

Consider the following hypothetical. It shares some features with the facts in *LePage's* but is different in other respects. (Whether those differences do or do not make legal distinctions is, naturally, the point of the hypothetical.)

Consolidated Gigantic (the company), a large and diversified firm with many high-tech products, asks for an evaluation of the antitrust risks (Robinson-Patman aside) of the following proposed program. The company proposes to negotiate deals with its 20 largest customers (who together account for about 50 percent of its sales and about 50 percent of the buying side of the market in the broad industry in which the company operates). The deals will be negotiated individually and will differ in their details, but will generally be as follows. For each of 15 different "strategic products," the deals will specify an "annual target" for each customer, based, roughly, on the amount purchased by that customer in the preceding year. If the customer buys 10 percent more than its target, it will receive a one percent rebate; for 20 percent growth, a 2 percent rebate; and for 30 percent growth, a 3 percent rebate. (In some cases, adjustments will be necessary. If, for example, 30 percent growth over the prior year would be more than the customer's reasonable requirements, either the "target" will be adjusted downward, or some other modification will be made in the deal.)

Rebates will be payable at the end of the one year contract period. They will be bundled, but the details of the bundling will vary. The company will try to get its large customers to agree that no rebate will be paid unless there is at least 10 percent growth in all 15 categories, but is prepared to modify the requirement through individual negotiation. For example, a deal might provide no rebate unless there is growth of at least 30 percent in one category, 20 percent in two categories, and 10 percent in seven others. It is planned, however, that each of the 20 deals will involve substantial bundling.

In each case the maximum possible rebate will be 3 percent. The company enjoys substantial profits; even if the entire discount were "allocated" to a single category, the price paid would, in almost every possible permutation, be well above variable cost, and, indeed, well above total cost.

Customers that sign these deals will not undertake a contractual commitment to buy any amount at all. In fact, the contracts will recite that no restriction is placed on the customer's ability to buy from any

³¹ *E.g.*, W. Dennis Cross, *What's Up with Section 2?* ANTITRUST, Fall 2003, at 8.

³² Gregory C. Wrobel, *New Clothes for the Emperor: Tailoring Section 2 Standards for Predatory and Exclusionary Conduct*, ANTITRUST, Fall 2003, at 28.

³³ *E.g.*, *Roundtable: Recent Developments in Section 2*, ANTITRUST, Fall 2003, at 15; *see also* Mark R. Patterson, *The Sacrifice of Profits in Non-Price Predation*, ANTITRUST, Fall 2003, at 37; Glazer & Henry, *supra* note 11.

source, without breaching the contract. If a competitor makes a better offer, the customer is entirely free to take it; the only downside is the loss of some or all of the rebate, per the terms of the arrangement. The company anticipates, however, that most customers will increase the amount they buy from the company in many of the 15 categories. In some of them, for some customers, the company may become the sole source of supply.

Of the 15 “strategic products” the company plans to include in its bundled deals, it enjoys, as to two of the categories, a market share higher than 75 percent in a clearly defined relevant product market. In three other categories it also has a greater than 75 percent share, but there is substantial doubt as to whether the market definition should be broadened. Of the remaining ten product lines, it has a high share of market (33–60 percent) in three, while it is one of many competitors in the remaining seven lines. Most or all of the 15 products are “high-tech,” and, generally speaking, barriers to entry may be said to be high in all 15 product lines, though some are perhaps more difficult to enter than others.

Some of the company’s competitors are equally large and diversified; they, for the most part, are offering similar bundled rebate programs. None, however, has exactly the same product lineup as the company, and the company thinks its bundled offer will be seen as attractive by its largest customers. Consequently, it anticipates that the bundled rebate program will result in an increase of some 5–10 percent in sales and profits. It anticipates modest, single digit increases in market share in most categories, including the categories in which it already enjoys a monopolistic share of market. In one or two of the 15 categories, its share is on the decline, but the bundling program, it is hoped, will slow the decline.

The company does not believe that any of its customers will feel “coerced” by its program or will otherwise take offense. On the contrary, a number of the large customers expect, or even demand, that programs such as this should be made available.

The company’s large competitors are mostly doing the same thing, and are unlikely to sue or complain to a government agency. Some of the company’s competitors, however, are smaller or less diversified. The intent of the program is not to “target” any particular competitor or competitors. The company believes that none will be forced to exit from any market or be “competitively crippled” in any meaningful sense, as a consequence of the bundling program.

Relevant business people at the company have not thought deeply about how their smaller competitors are likely to respond, or considered in any detail what degree of difficulty they might have in fighting back by offering economically equivalent alternatives. However, in view of the relatively small percentage size of the discounts, the company’s general understanding is that less diversified competitors can compete effectively by lowering their price, emphasizing the quality of their offerings, or taking other measures. The company thinks the plan will increase its sales and profits regardless of how any particular competitor reacts. Its success is not conditioned on the demise or crippling of any competitors. Nor does the company believe itself to be “investing” in low profits today for the sake of achieving high profits at some future time.

Finally, in response to an inquiry, the company can point to no “efficiency” accruing from its bundled rebate program. There is no saving in production or distribution, and no significant saving in the cost of negotiation, to be had from the program. Its motivation is not to achieve “efficiency” but rather to meet competitive offers, satisfy the needs and expectations of customers, and gain some competitive advantage from the diversity and strength of its product line.

A Plethora of Tests

The hypothetical is complex, but so is life. And I believe the hypothetical describes a much more common scenario than that of *LePage’s*, where the program was “targeted” on a specific competitor, whose demise (if and when it ever occurred) would lead to recoupment of monopoly profits.

Should the program outlined in the hypothetical be condemned as a violation of the Sherman Act? No, it should not, in my opinion. First, there is little, if any, prospect of consumer injury, and some possibility of consumer benefit (as Consolidated Gigantic's customers compete away their lump sum rebates in ways that may indirectly benefit consumers). Indeed, the Antitrust Division's amicus brief in *LePage's* recognized that some bundled discount programs may be procompetitive, and this could well be such a case: there is a good chance that the program is undertaken as a way of competing on price in concentrated markets and is intended to avoid the kind of competitive retaliation that might ensue from simply dropping prices across the board. Second, judicial intervention in such complex and competitively ambiguous circumstances would lead, I am persuaded, not only to indefensible outcomes but to random and completely unpredictable outcomes.

But would Consolidated Gigantic be vulnerable to attack under *LePage's* by a smaller and less diversified competitor that lost a dollar of profit as a consequence of the program? Arguably, it would. Monopoly power and (modest) enhancement of monopoly power are built into the hypothetical. Establishing those elements is a big head start in winning a monopolization case. Consumer injury, present or prospective, is also an essential element, in the view of most cases and commentators—but not, based on the discussion above, in the mind of the Third Circuit.

And what is left? Unlike the facts in *LePage's*, my hypothetical involves no hot documents showing bad intent. But does that really help the defendant? Surely, the plaintiff would argue that absence of hot documents proves only that the defendant was well counseled and clever about what it chose not to write down—and should derive no benefit from its cleverness.

What of “business justification”? Assuming the Third Circuit buys the explanation that the bundled rebate program was, in large measure, an attempt to “cheat” on Consolidated's fellow oligopolists, would that be regarded as a legally sufficient excuse for “exclusionary” conduct? I would not bet the mortgage money on it.

Putting aside “monopoly” and “enhancement of monopoly share” (built into the hypothetical), consumer injury (irrelevant), intent (only counts against the defendant, never for the defendant), and business justification (not accepted as valid), what does that leave? One thing and one thing only: whether to label the business strategy “exclusionary” within the meaning of the Section 2 jurisprudence. For the reasons set forth at some length above, I would not describe the hypothetical program as involving either “exclusive dealing” or “foreclosure.” But the Third Circuit evidently would disagree.³⁴

Fortunately, there is hope because the Third Circuit's position, as I understand it, is an outlier. Space and time do not permit an exhaustive review of the case law and commentary that might have some bearing on the bundled rebate issue, but consider these four alternative approaches.

1. The Ortho Test. This 1996 Southern District of New York opinion set forth a specific test that seems to apply to the hypothetical: Consolidated Gigantic enjoys monopoly power in some markets; it offers products in which it has monopoly power and products in which it does not have monopoly power, both as a package and individually—there is no “tying” in the hypothetical—and it “effectively forces its competitors [with less diverse product lines] to absorb the differential between the bundled and unbundled prices of the product in which [it] has market power.” 920

³⁴ Those who like the *LePage's* approach would have a fallback argument as well: even if the Third Circuit was loose in its “exclusive dealing” and “foreclosure” language, that should not matter, because bundling is inherently unfair to less diverse competitors no matter what name we give it.

F. Supp. at 469. In such a case, under *Ortho* there is liability if “(a) the monopolist has priced below its average variable cost or (b) the plaintiff is at least as efficient a producer of the competitive product as the defendant, but that the defendant’s pricing makes it unprofitable for the plaintiff to continue to produce.” *Id.* In the hypothetical the first test is not met, because price exceeds average variable cost. In the hypothetical, as is typically the case in real life, it is not known whether a specific potential plaintiff “is at least as efficient a producer as the competitor.” But that doesn’t matter, because, as far as one knows, there is no potential plaintiff that will find it unprofitable to continue to produce any of the products in the package.

In the hypothetical the defendant is a monopolist, it has adopted a form of strategic pricing that produces no efficiency, and is intended to, and likely will, gain market share from less diversified competitors, increasing its share of market in properly defined relevant markets in which it enjoys monopoly power—and perhaps in others where the likelihood of increased market share support a dangerous probability of achieving monopoly power. Yet, under *Ortho*, the defendant escapes liability.

2. The SmithKline Test. Although its holding was somewhat more loosely phrased than that of the *Ortho* court, the Third Circuit in *SmithKline* summarized its finding of liability by pointing to the following key factors:

- a defendant with monopoly power in some products and no monopoly power in others,
- linkage of the two categories of products through package pricing so that its competitor in the non-monopoly products is forced to pay rebates equal to the rebates the monopolist gives on its entire package,
- with the result that the less diverse competitor has “poor prospects” for continuing to compete in the non-monopolized product market,
- in a situation with high barriers to entry.

575 F.2d at 1065. Each of these factors is met in the hypothetical except the third—“poor prospects” for continuing in the business—but as Judge Greenberg read *SmithKline*, and as I read it also, failure by the plaintiff to show likely future exit should be enough to defeat recovery. Otherwise, there is no consumer injury, and a competitor should not be able to recover for conduct that lowers prices in the absence of present or prospective consumer injury.

3. The Concord Boat Test. *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000), addressed the legality of a structured rebate program where the amount of the rebate was based on “market share,” i.e., percent of a customer’s requirements. The court rejected an argument, similar to 3M’s, that under *Brooke Group* pricing above cost may never be illegal under the Sherman Act. But on the other hand, it said, “If a firm has discounted prices to a level that remains above the firm’s average variable cost, ‘the plaintiff must overcome a strong presumption of legality by showing other factors indicating that the price charged is anticompetitive.’” *Id.* at 1061 (citation omitted). In the hypothetical, it is hard to see how a potential plaintiff might overcome such a “strong presumption of legality.”³⁵

³⁵ The case is not directly on point, inasmuch as the court distinguished (without explaining the rationale for the distinction) cases like *LePage’s*, involving multi-product rebates rather than rebates based on a single product line. It is, however, at least a second cousin to the facts in *LePage’s* and the scenario involved in our hypothetical.

4. The Hovenkamp Test. Addressing *LePage's* in the 2004 *Supplement*, Hovenkamp asserts that the majority's treatment seems consistent with our definition of exclusionary conduct as acts that:

- (1) are reasonably capable of creating, enlarging, or prolonging monopoly power by impairing the opportunities of rivals, and
- (2) that either (2a) do not benefit consumers at all, or (2b) are unnecessary for the particular consumer benefits that the acts produce, or (2c) produce harms disproportionate to the resulting benefits.

¶ 749 at 183. In the hypothetical it is assumed that the rebate program will enlarge or prolong monopoly power, by at least some non-trivial amount. Whether that result is accomplished “by impairing the opportunities of rivals” is a matter of semantics, but, from the context of his discussion, presumably Hovenkamp would think the facts in the hypothetical meet his first test. The application of each of the three alternatives set forth in the second part of the test is likewise open to question. A potential plaintiff would perhaps have the easiest shot at proving the second of the three alternatives: that the rebate program is “unnecessary” to produce “the particular consumer benefit.” Read literally, however, such a test would outlaw any and all bundled pricing by monopolists, because the monopolist could always, at least in theory, have simply lowered the price without bundling. But this cannot be what Hovenkamp intends because he goes on to urge caution in extending *LePage's*, observing, “Indeed, . . . we would be reluctant to extend the doctrine to any situation in which there was at least one competing firm able to match the defendant's discount across all product lines.” *Id.* at 184. Here, the hypothetical assumes that others could match the general scope of the discount program, though no one could duplicate the exact items that Consolidated Gigantic proposes to include in its program. In sum, then, it is doubtful that the company in the hypothetical would be found liable under the Hovenkamp analysis.

Conclusion

Bundled discount and rebate programs are common—increasingly common, I believe. As the Antitrust Division recognized in its brief to the Supreme Court, many are procompetitive. In other cases, the intent and likely effects of the programs seem benign or, at worst, highly ambiguous. Although the outcome in *LePage's* may have been right, the court's analysis was objectionable in several important ways but chiefly in its failure to keep its eye on consumer injury. If future courts avoid that one signal error, most cases will, I believe, be rightly decided.

In his recent article on exclusionary distribution strategies Professor Gavil said that “[t]he real challenge—and the focal point over disagreements about standards under Section 2—are the closer cases, which involve conduct that yields both significant inefficiencies *and* significant efficiencies.”³⁶ Situations of that nature may indeed present challenges to the antitrust court, but I see few of them. Much more often I see scenarios like that in the hypothetical, where there are *insignificant* efficiencies and *insignificant* likelihood of harm, yet there is arguable monopoly power, enhancement of market power, and a business strategy that could, with good lawyering, be made to appear “exclusionary.” To deal with situations of that nature, keep your eye on the consumer injury. ●

³⁶ Gavil, *supra* note 2, at 77.

LePage's v. 3M: A Reality Check

Gary P. Zanfagna

The year 2004 was a big one for antitrust at the Supreme Court. *Trinko*,¹ *Empagran*,² *Intel*³—three antitrust cases in one term. A Supreme Court antitrust renaissance. But the Court also decided not to hear a fourth antitrust case, *3M v. LePage's*.⁴ Unfortunately, *LePage's* was at least as important a case for the Court to hear as any of the other three.

The Third Circuit en banc decision in *LePage's* is a giant step backwards in Section 2 jurisprudence. In an almost visceral reaction to 3M's insistence that the case should be resolved as a matter of law under *Brooke Group*,⁵ the Third Circuit literally rejected the relevance of price in assessing 3M's bundled rebates. Far from applying below-cost pricing analysis as 3M advocated, the en banc court said that the appropriate inquiry is whether 3M's bundled rebates constituted exclusionary conduct. That, of course, begs the question of *how* to determine whether or not a bundled rebate is simply a form of price competition or is exclusionary. According to the en banc court, a bundled rebate is exclusionary whenever a rival simply can't match the rebate because it doesn't offer a comparable breadth of products. That view, with no further analytical guidance by the court, appears fundamentally to turn back the antitrust clock to the days of protecting competitors rather than competition.

In deciding whether to grant cert. in *LePage's*, the Supreme Court was presented with three very different perspectives on bundled rebates: 3M focused on *Brooke Group* and below-cost pricing; the Third Circuit centered its inquiry on exclusionary bundling conduct; and finally, the United States' amicus brief found merit in both arguments, but recommended that the Court wait for another day and another case to consider bundled rebates after judges and scholars gave the matter more thought. The Court accepted the government's recommendation.

This article reviews the three different perspectives on bundled rebates and offers a reality check in the wake of the Court's denial of cert. In particular, the article suggests that there is a right test for reviewing bundled rebates like those in *LePage's*.

Background

3M, with its Scotch brand tape, is a conceded monopolist in the transparent tape market. Until the early '90s, 3M had over 90 percent of the market. 3M's share of the tape market began to erode in the early '90s with the advent of office superstores and mass merchandisers, which were fond of the lower-priced private label tape. By 1992, 3M's main competitor, LePage's, had nearly 88 per-

■ **Gary P. Zanfagna** is Chief Antitrust Counsel, Honeywell International Inc., and Editorial Chair of The Antitrust Source. The views expressed in this article are the author's and not necessarily those of Honeywell.

¹ Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, 124 S. Ct. 872 (2004).

² F. Hoffmann-La Roche Ltd v. Empagran, S.A., 124 S. Ct. 2359 (2004).

³ Intel Corp v. Advanced Micro Devices Inc., 124 S. Ct. 2466 (2004).

⁴ LePage's Inc. v. 3M, 324 F.3d 141 (3d Cir. 2003), cert. denied, 124 S. Ct. 2932 (2004).

⁵ Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

cent of the private label segment of transparent tape, but still only about 14 percent of the overall tape market.

3M responded to the changing marketplace in two ways. 3M introduced its own private label product as well as offered a second less expensive brand, “Highland,” to compete with LePage’s cheaper private label offering. 3M also initiated pricing programs, including a bundled rebate program, aimed at the large superstores. The rebate program offered higher discounts when customers purchased products across a number of 3M’s different product lines. The bundled rebate program linked products across six of 3M’s product lines and set customer specific target growth rates in each product line. The size of the discount was linked to the number of product lines in which targets were met.

LePage’s competes against 3M in only one product—transparent tape. Specifically, only in lower-priced private label tape. LePage’s alleged that it couldn’t possibly match 3M’s multiple discounts on multiple products. LePage’s cried foul and filed an antitrust suit.

Three Different Perspectives

3M Position. 3M unwaveringly maintained that the case was only about price and contended that it should prevail because its price for transparent tape was always above any measure of cost (e.g., average variable cost).⁶ *Brooke Group, Brooke Group, Brooke Group*. According to 3M, there was nothing more to be said because Brooke Group’s bright line above-cost test for predatory pricing in the single-product context was an equally appropriate test for bundled rebates in the context of multi-product offerings. Because LePage’s claim did not satisfy the *Brooke Group* standard, 3M argued that it should win as a matter of law.⁷

Admittedly, I am partial to 3M’s argument to extend *Brooke Group* into the context of multi-product bundled rebates. It is important to recognize, however, that 3M offers at least two different tape products, Scotch Brand tape and private label tape. These tapes are sold at very different prices. 3M’s monopoly is in branded tape. LePage’s offers only one type of tape, private label tape, and thus competes against 3M only in private label tape. Private label tape, not all transparent tape, is the relevant product on which the analysis of above-cost pricing should focus.

Third Circuit En Banc Decision. The Third Circuit completely disagreed with 3M. The en banc court said the case is not about pricing at all. Rather, it’s about exclusionary conduct—bundling conduct.⁸ Specifically, the case is about multi-product bundled discounts that had the effect of excluding a smaller rival, LePage’s, which couldn’t offer the same breadth of products. According to the Third Circuit, LePage’s was competitively disadvantaged because it didn’t have a similar breadth of products on which to offer discounts.⁹ It just couldn’t match 3M’s bundled rebates with its one product—private label tape.

The Third Circuit observed that Section 2 addressed exclusionary conduct much broader than simply predatory pricing.¹⁰ In fact, the Third Circuit said *Brooke Group* isn’t even relevant to this case, pointing out that LePage’s didn’t allege predatory pricing.¹¹ It alleged exclusionary conduct.

⁶ Petitioner’s Brief at 14–21, *3M Co. v. LePage’s Inc.*, 124 S. Ct. 2932 (2004) (No. 02-1865).

⁷ *Id.*

⁸ *LePage’s Inc. v. 3M*, 324 F.3d 141, 154–55 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004).

⁹ *Id.* at 162.

¹⁰ *Id.* at 152.

¹¹ *Id.* at 151–52.

The Third Circuit also concluded that 3M was without a legitimate business justification for its exclusionary bundling conduct, a conclusion easily reached after the court rejected lower prices to consumers as a justification.¹²

The Government Position. In its amicus brief, the United States took the position that both 3M and the Third Circuit decision were partially right. *LePage's*, the government argued, is about both price discounts and bundling conduct—it's about multi-product bundled rebates.¹³ The case is more complicated than single product above-cost pricing—straight *Brooke Group*.¹⁴ It's about rebates that give customers an incentive to buy multiple products.

The government was generally critical of the court's assessment of 3M's bundled rebates, observing that the court had failed to explain “what precisely rendered 3M's conduct unlawful.”¹⁵ The government also disagreed with the Third Circuit's conclusion that *Brooke Group* and price-cost analysis couldn't apply to a monopolist.¹⁶ Overall, the government said that the en banc decision provided “few useful landmarks” on how Section 2 should be applied to bundled rebates.¹⁷

But the government concluded that the case does not provide a “suitable vehicle” for the Court to provide guidance on bundled rebates.¹⁸ The government argued that the record below was spotty relating to potentially important facts in the case. In addition, there was no split in the circuits, and the case law and academic literature was not well-developed. Moreover, there was no demonstrated business urgency. Consequently, the government recommended that the Court deny cert.¹⁹

The Court accepted the government's recommendation. *LePage's* stands as good law in the Third Circuit.

A Reality Check—Life After *LePage's*

Not-So-Subtle Reminder. One legacy of *LePage's* is the not-so-subtle reminder of the practical significance of “bad” documents. Setting aside the obvious questions about Section 2 jurisprudence and sophisticated economic bundling theories, one simple lesson from *LePage's* is that bad documents can color the jury's and even the judge's view on what is “really going on.”

The en banc court, for example, noted that “[t]here is considerable evidence in the record that 3M entered the private-label market only to ‘kill it.’”²⁰ The court went on: “That's precisely what Section 2 of the Sherman Act prohibits by covering conduct that maintains a monopoly.”²¹ A business document that says “kill” unbranded is just not helpful to a conceded monopolist. It leaves the unmistakable impression that the monopolist is doing something malicious to take out a smaller competitor, which must be “wrong.”

¹² *Id.* at 163–64.

¹³ Amicus Brief of the United States at 12, *3M Co. v. LePage's Inc.*, 124 S. Ct. 2932 (2004) (No. 02-1865) [United States Amicus Brief].

¹⁴ *Id.*

¹⁵ *Id.* at 16.

¹⁶ *Id.* at 14 n.11.

¹⁷ *Id.* at 16.

¹⁸ *Id.* at 8.

¹⁹ *Id.*

²⁰ *LePage's Inc.* 324 F.3d at 164.

²¹ *Id.* at 164.

But on another level, it evidences absolutely nothing. Of course 3M would prefer not to face lower-priced, unbranded tape in the market. 3M enjoys higher margins on its Scotch Brand tape, and obviously would want to and should maximize sales of its highest margin products. That's not anticompetitive. But once the jury and even the judge believe they understand what's "really going on" through the lens of a business person's puffery, the case law, and the economic theory that help us understand the conduct's competitive significance, mean much less.

We, of course, can debate and even disagree on the relevance of "intent" in Section 2 analysis. But that's precisely the point. Once out in the open before judge and jury, it's out to stay. And it will have an effect, as *LePage's* reminds us.

Unequivocal Message. The unequivocal message of *LePage's*: Bundle at your own risk! If you are a multi-product firm with a significant position in one or more products, and engage in bundled rebates, you face treble damages if your smaller rival can't keep up—period. *LePage's* can be read to stand for the proposition that Section 2 will protect the smaller rival. That's a terribly unfortunate step backwards for Section 2 jurisprudence.

LePage's can be read to stand for the proposition that Section 2 will protect the smaller rival.

Some might argue that it's not that bad, suggesting that *LePage's* can be distinguished on various grounds. The government in its amicus brief, in fact, did not so much argue that the Third Circuit's decision was right as it explained that it wasn't necessarily wrong. The government plainly was uncomfortable with the Third Circuit's sweeping condemnation of 3M's bundled rebates without explaining what exactly was anticompetitive about them.²² And the government noted that bundled rebates no doubt often are procompetitive.²³

The government, in large part, recommended denying cert. because of the insufficient record on which to properly assess the competitive effects of the bundled rebates.²⁴ In addition, the government suggested that there was no business urgency, no split in the circuits and limited scholarly scrutiny to understand bundled rebates.²⁵

But regardless of whether *LePage's* can be legally distinguished, the decision will have a real impact on business conduct. Bundled rebates are a common form of price competition. After *LePage's*, any firm with a significant position in one or more products likely will avoid offering bundled rebates rather than risk treble damage liability. Consumers will not receive the benefit of lower prices through these programs.

A Right Test. In its amicus brief, the government lamented the absence of sufficient experience with bundled rebates to be able to derive a bright line test for bundled rebates.²⁶ The Court would benefit, the government maintained, from further development of the case law and academic scholarship on bundled rebates.²⁷ No doubt that is true, but we do have significant understanding and experience to guide us in assessing at least the type of bundled rebates involved in *LePage's*. And that experience tells us that the test actually doesn't have to be that complicated.

²² United States Amicus Brief at 16.

²³ *Id.* at 12.

²⁴ *Id.* at 8.

²⁵ *Id.*

²⁶ *Id.* at 14.

²⁷ *Id.* at 19.

Two cases, *SmithKline*²⁸ and *Ortho*,²⁹ both applied a similar test for assessing the competitive effect of bundled rebates that are comparable to those in *LePage's*. Both cases, in the pharmaceutical industry, involved rebates earned through the purchase of bundled pharmaceuticals. The bundler had monopoly power on certain of the bundled drugs, and the rival competed on certain other products in the bundle. As in *LePage's*, the rival alleged that it couldn't match the bundled rebate with its limited offering.

In both cases, the courts used an "attribution" test to assess whether the smaller rival was unfairly disadvantaged by the bundled rebates. The attribution test, in simplest form, takes the entire bundled rebate and attributes it to the relevant product on which the rival competes. The test then asks whether the rival can still profitably compete in the relevant product after the discount is attributed. In *SmithKline* the answer was no.³⁰ For *Ortho*, the answer was yes.³¹

Applying the same test to *LePage's*, 3M's entire bundled rebate would be attributed to the relevant product on which *LePage's* competes with 3M, and ask if *LePage's* could still profitably compete in the relevant product. Two important clarifications are necessary.

Equally Efficient Competitor. The attribution test doesn't actually look at whether the rival could profitably compete based on its own cost position. Rather, the test is focused generally on a rival of equal efficiency as the bundler for the relevant product. There are at least two reasons for this. First, the test would be of little guidance to the bundler were it based on the rival's costs. How would the bundler know its rival's costs on the relevant product? Second, the judgment, consistent with the test in *Brooke Group*, is that the antitrust laws are not intended to protect a less efficient rival.

Relevant Product. The relevant product is the product on which the rival competes. So in *LePage's*, the relevant product is not all transparent tape, but rather private label tape. That's the single product on which *LePage's* competes with 3M.³²

In sum, the attribution test would ask the following: Can an equally efficient competitor in private label tape profitably compete if the entire bundled rebate were attributed to that product? Put differently, would the equally efficient competitor's price for private label tape be above some measure of cost (e.g., average variable cost) if the entire bundled rebate were attributed to that product? Still slightly differently, would 3M's price for private label tape be above some measure of its cost (e.g., average variable cost) if the entire bundled rebate were attributed to that product?

LePage's may or may not have come out differently if the Third Circuit had used this test. But we at least would have precedent that would be consistent with *SmithKline* and *Ortho* and that could be relied upon for guidance. The attribution test, of course, may not work for all types of bundling practices. But that doesn't mean it shouldn't be used in situations where it does. ●

²⁸ *SmithKline Corp. v. Eli Lilly & Co.*, 427 F. Supp. 1089 (E.D. Pa. 1976), *aff'd*, 575 F.2d. 1056 (3d Cir. 1978).

²⁹ *Ortho Diagnostics Sys., Inc. v. Abbott Lab.s, Inc.*, 920 F. Supp. 455 (S.D.N.Y. 1996).

³⁰ *SmithKline Corp.*, 427 F. Supp at 1125.

³¹ *Ortho Diagnostics*, 920 F. Supp at 471.

32 Barry Nalebuff, *Comments, Product Bundling in Communications Markets*, ANTITRUST SOURCE, November 2004, at 7-8, at www.antitrustsource.com.

Paper Trail: Working Papers and Recent Scholarship

Editor's Note: In this edition we note a recent paper by Barry Nalebuff that relies on the envelope theorem to show that a monopolist can increase its profits by bundling the monopolized product with a competitively supplied product, even when the monopolist continues to offer the products separately.

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

—William H. Page and John R. Woodbury

Papers and Summaries

Barry Nalebuff, Bundling as a Way to Leverage Monopoly,
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586648

In this paper, Professor Barry Nalebuff, of the Yale School of Management, argues that a monopolist can *usually* increase profits by offering consumers a monopolized product at a discount in return for their agreement to purchase a second, competitively supplied product at a premium. He points out that the famous Chicago School refutation of simple leveraging (i.e., that the monopolist can gain no more than the full monopoly profit on the monopolized product, because consumers will pay no more than the unbundled price for both) depends on the products being used in fixed proportions. He thus characterizes the Chicago argument as addressing only a special case. In the more general case of variable proportions, the monopolist can increase profits by what he calls “mixed tying.”¹

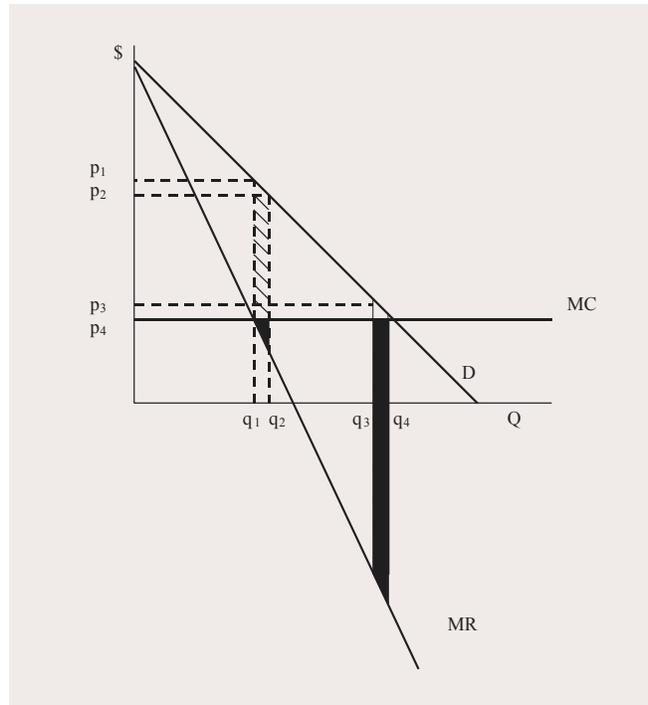
Others writers, of course, have shown that *forced* tying can increase monopoly profits. The best-known example is Bowman's demonstration that tying with variable proportions can be used to discriminate in price by metering the intensity of various buyers' demands, and extracting more of the inelastic demanders' consumer surplus. Nalebuff goes beyond this literature to show that a form of bundling can increase monopoly profits, even if the monopolist continues to offer the products separately at the original prices.

The key to understanding Nalebuff's argument is the envelope theorem, which points out an important implication of ordinary price theory: if a monopolist is charging the full monopoly price for a product, a small reduction in price will cause only a trivial reduction in monopoly profits, but a much larger increase in consumers' surplus and in allocative efficiency. When the price is at that region of the demand curve, marginal revenue is high and positive. Consequently, the reduction in revenue attributable to the sale of inframarginal units at a slightly lower price is almost completely offset by

¹ In note 3, Nalebuff offers this term as a compromise between “bundling” or “tying.” Bundling usually means a package sale in fixed proportions, typically at a single price. Nalebuff's model, in contrast, requires that the products be sold *both* (1) tied, but in variable proportions, with the tying product sold at below the full monopoly price and the tied product sold at above the competitive price, and (2) separately, with the monopolized product sold at the full monopoly price and the competitively supplied product sold at the competitive price.

the increased revenue attributable to the sale of marginal units. Moreover, because consumers represented at that region of the demand curve value the product highly, the sale of the additional units together with the price reduction on inframarginal units causes a substantial increase in consumer surplus. If, in contrast, the monopolist is only charging a small increment above the competitive price, then a reduction to the competitive price will sacrifice all monopoly profits, but will cause only a trivial gain in total welfare.

Those who find diagrams helpful may wish to consider the following one from *Letter from William Page to Ian Ayres*, 17 MISS. COLL. L. REV. 92 (1996):



The monopolist maximizes profit at the price and output combination, here (p_1, q_1) , that corresponds to the point at which marginal cost (MC) is equal to marginal revenue (MR). For a small price reduction from the profit maximizing monopoly price p_1 to p_2 , output expands from q_1 to q_2 . The value of those additional units to consumers is given by the area under the demand curve (D) between q_1 and q_2 ; the cost of producing those units is given by the area under MC. Consequently, the deadweight welfare loss from monopoly decreases by the shaded area between D and MC and between q_1 and q_2 . Consumers gain an amount equal to the area between p_1 and p_2 , and to the left of D.² But the sacrifice in monopoly profit is only the small darkened triangle between MC and MR between those levels of output.³ This disparity between the loss to the monopolist and the gains to consumers and to overall social wealth is the central insight of the envelope theorem.

² This amount is larger than the increase in allocative efficiency by the area of the small darkened triangle. Thus, the gain to consumers is equal to the sum of the shaded area below D and the darkened triangle, although it is actually the inframarginal consumers who receive most of the gain.

³ The area under MR between q_1 and q_2 is the addition to total revenue attributable to the new units of output, while the area under MC is addition to total cost from the same units; the difference is the loss in profit attributable to the price reduction.

For a price change from p_3 to p_4 (the competitive price), however, total welfare increases only by the small triangle between D and MC and between q_3 and q_4 .⁴ But the loss in profit to the monopolist is the much larger darkened area between MC and MR and between those levels of output.⁵

Ian Ayres has suggested that the envelope theorem implies that antitrust policy should focus on deterring monopolists from extracting the last increment in monopoly profits. See Ian Ayres, *Pushing the Envelope: Antitrust Implications of the Envelope Theorem*, 17 MISS. C. L. REV. 21 (1996). Nalebuff uses the theorem differently, showing that the disparity between the loss to the monopolist and the gain to consumers gives the monopolist an opportunity for profit: “a monopolist in A facing competition in B” can make a Pareto-improving price offer to consumers, proposing to reduce the price of A in return for the consumers’ agreement to buy all of their requirements of B from the monopolist “at an inflated price.” Nalebuff offers a mathematical proof, but the intuition is (again, from the envelope theorem) that the monopolist’s reduction in the price of A has little effect on its profits, because consumers will buy more of A at the slightly lower (but still high) price; because consumers gain significantly by the increased sales of A at a lower price, they are willing to pay the premium on B, so the monopolist comes out ahead.

Nalebuff then asks:

What about the Chicago argument that there is only one monopoly profit? The answer is that the monopoly in A is inefficient. If it is possible to reduce the inefficiency (which is the result of lowering the monopoly price below m [the profit maximizing price, p_1 in the diagram, *supra*]), then the total pie is bigger. If the monopolist can find a way to get some of that extra surplus (say by raising the price in good B), it can make more than the regular monopoly profit.

As this explanation indicates, the antitrust policy implications of Nalebuff’s point are unclear. The monopolist and consumers both gain, and social welfare increases, so it would appear that under any criterion, the net effect of “mixed tying” is beneficial. (Indeed, as I noted above, Ian Ayres has argued that antitrust should seek to *encourage* monopolists to produce those marginal units beyond the monopoly output.) Nevertheless, Nalebuff suggests that the exclusion of competitors incident to bundling may have a long-run negative effect if the market for B becomes non-competitive and reentry by competitors is difficult. He concedes, however, that calculating the long-run welfare effects would require “a dynamic model of competition” that neither he nor anyone else has yet provided.⁶ Nalebuff correctly concludes that the “ability of a monopolist to extend its influence to adjacent markets is a challenge both to the competitors in those markets and to economists looking to understand the antitrust implications of bundling.”

—WHP

⁴ Again, the cost of producing the additional units between q_3 and q_4 is the area under MC; the consumer valuation of those units is the area under D; and the increase in consumers surplus is the difference.

⁵ It costs the monopolist an amount equal to the area between MC and the q axis to produce those additional units, and the monopolist actually reduces its total revenue by an amount equal to the area between the Q axis and the MR curve. The loss in profit is the sum of these areas.

⁶ For some dynamic models of tying see Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 AM. ECON. REV. 837 (1990); Dennis W. Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. ECON. 194 (2002); Jay P. Choi & Christodoulos Stefanadis, *Tying, Investment, and the Dynamic Leverage Theory*, 32 RAND J. ECON. 52 (2001).

The Muris Legacy

Thomas B. Leary

Early in the year 2001, when it became clear that Timothy Muris would be the new Chairman of the Federal Trade Commission, there was considerable speculation about the impact that his appointment would have. Some predicted dramatic changes that would reverse the policies of his predecessor, Bob Pitofsky; others predicted continuity with the Pitofsky regime. I was one of the people who predicted continuity,¹ and I am tempted to crow about it because Muris emphasized continuity throughout his thirty-eight months as chairman. But, my prediction was only half right because there were also a lot of surprises. Tim Muris did not reverse Robert Pitofsky's policies but he did move the Commission in some new directions that no one had predicted.

Before I discuss what I believe are the highlights of the Muris legacy, I should address a preliminary caveat. The Commission is a multi-headed body, any chairman has only one vote in five, and the terms are staggered in a way that is designed to further dilute the influence of a newly-appointed chairman. For two of his three years in office, Muris served with four holdovers who were appointed by President Clinton.² In his final year, there still were three. Muris did have two holdover members of the same political party throughout his term (Orson Swindle and I) but, in my experience, the Federal Trade Commission is not a place where party identification is emphasized at any level.³ Holdover commissioners, regardless of party, have reached a certain equilibrium in their interactions with one another. It is therefore appropriate to ask whether we can really identify "The Muris Legacy."

I believe that we can, for reasons that will become clear. Although FTC chairmen are not comparable to unitary heads of other government bodies,⁴ they are not just one of a gang of five. It is appropriate to talk about the Muris legacy, and it is also appropriate to acknowledge up front the leadership skills that enabled him not just to put together a majority but generally to secure *unanimous* approval of his ambitious and sometimes risky agenda.

Before addressing the Muris contributions, it is also appropriate to acknowledge the substantial contributions of his predecessor, with whom I also was privileged to serve. In fact, I think much

■ **Thomas B. Leary** is a Commissioner, Federal Trade Commission. This is a later written version of a speech delivered at a program of the American Bar Association, Section of Antitrust Law, held in connection with the Annual Meeting of the Association on August 7, 2004, just eight days before the effective date of Chairman Muris's resignation. The views expressed in this article are the author's and not necessarily shared by the other present Commissioners or by the subject of the article.

¹ See, e.g., *Interview with FTC Commissioner Thomas B. Leary*, COMPUTER INDUSTRY COMMITTEE NEWSL. (ABA Section of Antitrust Law), Spring 2001, at 10–11, available at <http://www.abanet.org>.

² Holdovers from previous administrations are, of course, routine, but no chairman since 1950 has served for so long with so many as Muris. Caspar Weinberger served with four holdovers, but only for eight months. His successor, Miles Kirkpatrick served with four, for only one month. Kirkpatrick, Pitofsky, and Jim Miller did serve for an extended time with three holdovers.

³ The absence of strong party identification in the Commission means that a chairman does not have an automatic three votes, but it also means that there is no automatic resistance from the minority. Moreover, there seems to be a broad intellectual consensus in many areas of policy today.

⁴ This does not necessarily mean that chairmen ultimately have less discretionary power. Chairmen of an independent agency like the FTC may need to get the votes of their peers, but they are also relatively insulated from direction by the other branches of government. A chairman can also set the affirmative agenda through the power to appoint bureau heads and principal deputies.

of Tim Muris's success is attributable to the fact that Bob Pitofsky left the agency in such fine shape—and I refer not only to the quality of the staff but also to the unprecedented level of public regard for the agency's work. Muris could stand on some very broad shoulders, and he had one significant advantage that Pitofsky did not have—the resources to do what he wanted to do. It was Pitofsky's fortune (or misfortune) to serve in the midst of the greatest merger wave in the history of this country. The Commission's efforts to accommodate its shared responsibility for merger review consumed a disproportionate share of the agency's resources and of its intellectual energies. It is hard to be innovative in other areas when you are struggling to keep your head above water.⁵

With these preliminary caveats and acknowledgments, I will turn to the subject at hand. I group Muris' most significant initiatives into five broad categories, with full realization that the selection and the arrangement may be arbitrary.

Muris could stand on

some very broad

shoulders, and he

had one significant

advantage that Pitofsky

did not have—the

resources to do what

he wanted to do.

Increased Visibility of the Consumer Protection Mission

Lawyers who attend ABA Antitrust Section meetings tend to practice primarily in areas covered by the Commission's Bureau of Competition. As a result, the Section's programs and publications have emphasized competition issues. Inside the Commission itself, the Bureaus of Competition and Consumer Protection have historically been treated as two separate principalities.

The barriers are now coming down.⁶ There is increasing appreciation of the fact that competition law and consumer protection law have a common core. Both are concerned with distortions in the free market. Both can be analyzed and addressed in economic terms. The difference is that competition offenses, like price-fixing or exclusionary conduct, tend to cause distortions on the supply side while consumer protection offenses, like deceptive advertising, tend to cause distortions on the demand side.

Tim Muris deserves much of the credit for this development. He was interested in consumer protection issues to a greater degree than any chairman in recent memory and had focused on this area in his previous academic publications. Many of these publications were co-authored with his colleague, Howard Beales, an economist by training, who came on board with Muris as Director of the Bureau of Consumer Protection. Together, they sought to apply a more sophisticated economic analysis to consumer protection problems.

For example, economic realities suggest that the best way to reduce the harmful effects of fraudulent promotions is to shut down the operations as quickly as possible. The optimal strategy generally is to pare the case down to its essentials and obtain prompt injunctive relief. Therefore, the speed of settlement (and most cases are settled) may ultimately be more important than the breadth of the relief or the size of the dollar judgments, which are often uncollectible anyway. The optimal strategy for a particular case must be balanced, however, against the need for general deterrence and the potentially subversive message conveyed by relatively mild negotiated settlements. These sometimes conflicting objectives were often candidly addressed when particular complaints or settlements were presented for a vote.

⁵ The impact of the merger wave can be demonstrated by objective data. There also may be subjective factors at work. My impression, after some period of close association with both, is that Pitofsky was temperamentally more cautious and risk averse than Muris. (In this sense, the Democrat was more "conservative" than the Republican.) This is not a judgmental assessment. It may be easier to take risks when you have an existing reservoir of good will, husbanded by a more cautious conservator.

⁶ One striking indication is the fact that the most recent edition of the Section's *Antitrust* magazine, devoted almost the entire issue to consumer protection matters. See ANTITRUST, Summer 2004.

I do not mean to suggest that sophisticated economic considerations were ignored before the Muris years. For example, Bob Pitofsky and his Bureau Director, Jodie Bernstein, launched extensive and innovative consumer education programs, in a variety of areas, in recognition of the simple economic fact that the Commission cannot be everywhere and that, to a large extent, consumers have to be educated to look out for themselves. All I am saying is that economic analysis was employed more extensively under Muris and Beales than had been done before.

One particularly imaginative Muris initiative was the campaign against deceptive advertisements of worthless weight-loss products. Part of the campaign followed traditional lines: bring some high-visibility cases and publicize them widely, in order to deter future wrongdoing and to alert consumers. The imaginative part was the effort to persuade responsible media representatives that they should screen out the most blatantly fraudulent advertising on their own initiative—just as they screen out ads that are obscene or otherwise offensive.

This initiative was not only imaginative but daring because media people, who dispense advice so readily, are not comfortable on the receiving end. They complained that we were asking them to decide complicated scientific questions, although the Commission had already published a brochure that identified the most fraudulent claims, in order to make the job easy.⁷ They complained that it would be costly to act alone and that collective action to cut off fraudulent advertisers could be construed as an illegal “boycott.” The response was that the agency would make no such claim and that the antitrust risks were minimal.⁸ In fact, despite public objections, there has been substantial quiet compliance with the Commission’s request.

The most noteworthy achievement on the consumer protection side was, of course, the publication of the “Do Not Call” Rule,⁹ which now benefits over 60 million households (with thousands still added every day). This has turned out to be the most popular initiative in the Commission’s history. In fact, it is so popular that when implementation was temporarily stalled by an unfavorable court decision,¹⁰ corrective legislation passed both houses of Congress and was signed by the President within a day!¹¹

People may not fully appreciate that the Do Not Call Rule was also an imaginative way for Muris to avoid a divisive pre-existing debate over “privacy” legislation and to re-channel the agency’s energies in a way that could command unanimous support internally and externally. The previous debate had focused on one aspect of consumer privacy—the protection of personal information obtained in e-commerce transactions—and the subject was controversial both in the Commission

⁷ See FEDERAL TRADE COMM’N, RED FLAG: A REFERENCE GUIDE FOR MEDIA ON BOGUS WEIGHT LOSS CLAIM DETECTION, available at <http://www.ftc.gov/bcp/online/pubs/buspubs/redflag.pdf>.

⁸ For a brief discussion of the antitrust issues, see Thomas Leary, Self Regulation and the Interface Between Consumer Protection and Antitrust, available at <http://www.ftc.gov/speeches/leary/040128deweyballantine.pdf>.

⁹ Telemarketing Sales Rule, 16 C.F.R. part 310, as amended by 68 Fed. Reg. 4580, 4669 (Jan. 29, 2003); see also FTC Press Release, National Do Not Call Registry Opens (June 27, 2003), available at <http://www.ftc.gov/opa/2003/06/donotcall.htm>.

¹⁰ *Mainstream Mktg. Servs. v. FTC*, 283 F. Supp. 2d 1151 (D. Colo. 2003). This case was consolidated with three other cases that also challenged the National Do Not Call Registry. The U.S. Court of Appeals for the Tenth Circuit reversed the judgments in two of the cases, and denied review of the other two cases. *Mainstream Mktg. Servs.*, 358 F.3d 1228 (10th Cir. 2004). The Supreme Court denied certiorari on October 4, 2004. *Mainstream Mktg. Servs.*, 2004 U.S. LEXIS 5564.

¹¹ See FTC Press Release, Statement of Chairman Muris (Sept. 25, 2003), available at <http://www.ftc.gov/opa/2003/09/dnc030925.htm>; White House Press Release, President Signs Do Not Call Registry, Remarks by the President on the Do Not Call Registry (Sept. 29, 2003), available at <http://www.whitehouse.gov/news/releases/2003/09/20030929-10.html>.

and in the Congress.¹² Muris shifted the focus to another aspect of consumer privacy—the reduction of unwanted commercial intrusions into the home—and the entire nation applauded.

In the afterglow of success, we should not forget that “do-not-call” could have been a disaster for the Commission, and particularly the Chairman. For example, I believed that First Amendment objections would ultimately be rejected (as they were), but the objections were not frivolous. Moreover, there was a substantial risk that the immediate rush to sign on would overwhelm the capabilities of the system or, alternatively, that massive non-compliance by telemarketers would overwhelm our limited prosecutorial resources. Muris was daring.

A Structure for Rule of Reason Analysis

The longstanding dichotomy between rule of reason and per se offenses had become blurred at the edges. Some so-called per se offenses can only be resolved after a considerable factual inquiry,¹³ yet it also had been said that a rule of reason review could sometimes be done “in the twinkling of an eye.”¹⁴ An already clouded picture became further clouded following the Supreme Court’s 5–4 opinion in the 1999 *California Dental* case.¹⁵ In particular, there were questions about the parameters of so-called “quick look” or truncated analyses. Two ambitious opinions during the Muris years attempted to re-introduce some clarity and precision.

I do not believe it is appropriate to discuss the *Polygram (3-Tenors)*¹⁶ and *Schering*¹⁷ decisions in any depth because they both are now on appeal, and it is possible that they could be remanded to the Commission for further proceedings. I can say, however, that the two opinions were similar in that they each rejected a per se label, but factual differences prompted different analytical approaches. The Muris opinion for the Commission in *Polygram* focused on the nature of the restraint in issue, found that it was “inherently suspect,” and concluded that the issues could be resolved in a truncated proceeding. My own opinion for the Commission in *Schering*, by contrast, applied a full rule of reason analysis. The *Schering* opinion also found, however, that the traditional method of proving market shares and then drawing inferences about competitive effects was not necessary when more direct proof of competitive effects was available. The two opinions set out some guideposts for rule of reason analysis, in an effort to resolve some questions left open in *California Dental*.

Some may wonder why the *Schering* case is included in a discussion of the Muris legacy, since the case was brought in the Pitofsky years and I signed the opinion for the Commission. The reason is that the *Schering* case was initially brought as part of a family of cases that dealt with set-

¹² See FEDERAL TRADE COMMISSION, PRIVACY ONLINE: FAIR INFORMATION PRACTICES IN THE ELECTRONIC MARKETPLACE: A FEDERAL TRADE COMMISSION REPORT TO CONGRESS (May 2000), available at <http://www.ftc.gov/reports/privacy2000/privacy2000.pdf>; Dissenting Statement of Commissioner Orson Swindle, available at <http://ftc.gov/reports/privacy2000/swindledissent.pdf>; Statement of Commissioner Thomas B. Leary, Concurring in Part and Dissenting in Part, available at <http://ftc.gov/reports/privacy2000/learystmt.pdf>.

¹³ See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984).

¹⁴ See *NCAA v. Board of Regents of the Univ. of Okla.*, 468 U.S. 85, 109 n.39 (1984) (quoting Phillip Areeda, *The “Rule of Reason” in Antitrust Analysis: General Issues*, 37–38 (Federal Judicial Center, June 1981)).

¹⁵ *California Dental Ass’n v. FTC*, 526 U.S. 756 (1999). For an extended discussion, see Stephen Calkins, *California Dental Association: Not a Quick Look But Not the Full Monty*, 67 ANTITRUST L.J. 495 (2000).

¹⁶ *Polygram Holding, Inc.*, 5 Trade Reg. Rep. (CCH) ¶ 15,453 (FTC 2003), available at <http://www.ftc.gov/os/adjpro/d9298/030724commopinionandfinalorder.pdf>.

¹⁷ *Schering-Plough Corp.*, FTC Docket No. 9297 (Dec. 18, 2003) (Commission Opinion), available at <http://www.ftc.gov/os/adjpro/d9297/031218commissionopinion.pdf>.

tlement agreements between the manufacturers of patented drugs and potential generic challengers. These cases collectively presented, and still present, a number of challenging issues at the intersection of patent law and antitrust law, and these were the issues that we all focused on when the *Schering* complaint was voted out and that I focused on in the first draft of the opinion. It was Muris who saw most clearly the similarities and the differences between *Schering* and *Polygram*, purely as a matter of legal structure, wholly apart from the widely divergent factual issues in the two cases. The *Schering* words may be mine but I acknowledge his unique contributions to the analysis in the opinion.

We do not know right now what will happen in the courts of appeal, so it is premature to speculate on the influence, if any, that these opinions will have. However, Tim Muris deserves a large measure of credit for the effort to bring some clarity to a muddy area of law—and the fact that both the *Polygram* and the *Schering* opinions were unanimous also says a lot about the atmosphere of the Commission under his leadership.

Tim Muris deserves a large measure of credit for the effort to bring some clarity to a muddy area of law—and the fact that both the Polygram and the Schering opinions were unanimous also says a lot about the atmosphere of the Commission under his leadership.

Narrowing Antitrust Exemptions

Many students of antitrust believe that the most effective and durable restraints on competition are those that are mandated, or at least tolerated, by governments. For this reason, they also believe that the so-called “state action”¹⁸ or *Noerr*¹⁹ defenses should be narrowly construed. When Muris found himself in a position to do something about it, he took full advantage of the opportunity. This is noteworthy in itself but equally interesting is the way he went about it.

The first thing that he did was prepare the ground carefully by ordering an extensive internal evaluation of existing law on the state action and the *Noerr* defenses. Successive drafts of these evaluations were shared with his fellow commissioners, who had the opportunity to comment. In this way, Muris was able to achieve a broad internal consensus on principles and objectives before there were any public expressions of opinion. He also then had in place an extensive body of scholarship, which facilitated prompt and principled Commission responses as opportunities arose.

These responses have included statements to state legislatures on pending bills,²⁰ amicus briefs in pending cases in other jurisdictions,²¹ as well as the initiation of administrative complaints.²² The Commission’s efforts to limit the scope of antitrust exemptions and immunities has focused on matters like restrictions on the provision of professional services, maximum or minimum price fixing, and bans on Internet sales. The bottom line results have been mixed—for the most part, other decision makers have agreed with the Commission but sometimes they have not

¹⁸ See *Parker v. Brown*, 317 U.S. 341 (1943).

¹⁹ See *Eastern R.R. Presidents Conf. v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961).

²⁰ See, e.g., FTC/DOJ Letter to the Standing Committee on the Unlicensed Practice of Law, State Bar of Georgia (Mar. 20, 2003), available at <http://www.ftc.gov/be/v030007.htm>.

²¹ See, e.g., Announced Action for June 4, 2004, Commission authorization of joint amicus brief filing in Jackson Tennessee Hospital Co., No. 04-5387 (6th Cir.), available at <http://www.ftc.gov/opa/2004/06/fyi0436.htm>.

²² See, e.g., South Carolina Board of Dentistry, FTC Docket No. 9311 (Sept. 12, 2003) (complaint), available at <http://www.ftc.gov/os/2003/09/socodentistcomp.pdf>; Indiana Household Movers and Warehousemen, Inc., FTC Docket No. C-4077 (Apr. 25, 2003) (consent order), available at <http://www.ftc.gov/os/2003/04/ihmwdo.htm>; Union Oil Company of California, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), available at <http://www.ftc.gov/os/2003/03/unocalcmp.htm>.

and, of course, the Commission's own administrative complaints may or may not be supported when all the facts are in. It is noteworthy, however, that all of these initiatives were approved unananimously, and I predict that—regardless of individual outcomes—the cumulative effect will be an important part of the Muris legacy.

Restoration of the Commission's Traditional Functions

The Federal Trade Commission was originally designed to be a deliberative agency that could provide expert guidance for the future, rather than a prosecutorial agency that would focus on punishment for past offenses. For a variety of reasons, that deliberative and future-oriented role of the FTC had been neglected. The ability to get prompt injunctions and ancillary equitable relief like asset freezes and disgorgement orders under Section 13(b) of the FTC Act²³ meant that most consumer protection cases migrated into federal courts. At roughly the same time, pre-merger notification under Hart-Scott-Rodino had shifted the focus away from administrative proceedings and toward preliminary injunction actions in federal courts. The Commission was just one more prosecutor.

Tim Muris took a number of actions designed to restore the agency's special role.

Revival of Administrative Litigation. During Muris's tenure, there was a marked increase in administrative litigation. Some twenty-two cases were brought or decided in the three years that he served—a dramatic increase over the immediately preceding years.²⁴ Most of the cases settled, as might be expected, but currently there are thirteen cases pending. Two are now pending in federal courts of appeal and eleven are pending in various stages of the Commission's administrative process.

A few years ago, we were concerned that our Administrative Law Judges were not fully utilized. Today, we are concerned that they may be overburdened. Other commissioners endorsed these initiatives with near unanimity, but it was Muris who drove them.

Transparency. "Transparency" is a fancy word for the agency's effort to explain its actions, even when it is not required to do so. In particular, the term has been applied to voluntary explanations of decisions *not* to act. Agencies have traditionally been reluctant to volunteer these explanations—in part, because they impose additional burdens on limited resources and, in part, because there always is the fear that explanations for non-action in some situations will provide ammunition for parties who are resisting action in other situations that may superficially appear comparable.

On the other hand, an agency like the FTC, with an overtly educational mission, does have a greater than normal obligation to explain itself. In the Muris years, the Commission has done so to a greater degree than ever before. The effort has been noted and favorably received, even by people who may have disagreed with the underlying substantive decision.²⁵

The almost uniform unanimity that we observe when cases are brought seems to break down when the Commission undertakes to explain why cases were not brought or settlements accept-

²³ 15 U.S.C. § 53(b).

²⁴ The Commission's Web site, <http://www.ftc.gov/os/adjpro/index.htm>, lists all Part 3 Commission complaints issued over the last eight years.

²⁵ See, e.g., Warren S. Grimes et al., *The FTC's Cruise Lines Decisions: Three Cheers for Transparency*, FTC: WATCH No. 599, Nov. 18, 2002, available at <http://www.antitrustinstitute.org/recent2/217.cfm>.

During Muris's tenure, the Commission was in an almost continuous hearing or "workshop" mode on subjects ranging from basic patent/antitrust issues to Internet privacy, with input from all spectra of opinion.

ed.²⁶ It may be that the samples are just too small to support any conclusions, or it may be that commissioners feel greater freedom to express individual views when matters are terminated, one way or another, and there is no risk that these views will affect later litigation in the matter.

Emphasis on Research and Education. The Commission was not created just to bring cases. A study of the legislative history of the FTC Act demonstrates that the Commission was intended primarily to fill an educational role. The Supreme Court decided the *Standard Oil* case in 1911 and held, among other things, that the antitrust laws were subject to a so-called "rule of reason."²⁷ Congress believed that people in the business community needed some guidance on what would be considered reasonable and what would not, and that it would be better if they could find out before they were sued. The Clayton Act²⁸ and the FTC Act²⁹ were considered and passed as a package to meet this need. The Clayton Act had more specific provisions on matters like exclusive dealing, mergers and director interlocks; the FTC Act created an administrative body to provide informed guidance.

As time passed, the educational role of the FTC was progressively de-emphasized. The impact of Hart-Scott-Rodino and the particularly attractive remedies under Section 13(b) of the FTC Act have already been mentioned. Other factors include the ponderous nature of "notice and comment rule making" and the hostile reaction to some Commission rule making efforts in the late 1970s, as well as the evolution of a rich "rule of reason" jurisprudence in the courts, which mitigated the need for administrative guidance.

In more recent years, however, it has become evident that some issues were a lot more complicated than we had believed—we really did not know as much as we thought we did. Bob Pitofsky first recognized this in 1995 and held extensive hearings, which focused on complex high-tech problems in an international setting but also ranged much further afield.³⁰ During Muris's tenure, the Commission was in an almost continuous hearing or "workshop" mode on subjects ranging from basic patent/antitrust issues to Internet privacy,³¹ with input from all spectra of opinion. There is now available an immense body of learning that will be an invaluable resource for decision makers and other interested groups for many years to come. Tim Muris cannot be credited with the original idea but he can fairly be given credit for adopting it and expanding it.

²⁶ See, e.g., Dissenting Statement of Commissioner Mozelle W. Thompson, Genzyme Corporation's Acquisition of Novazyme Pharmaceuticals Inc., available at <http://www.ftc.gov/os/2004/01/thompsongenzymestmt.pdf>; Statement of Commissioner Pamela Jones Harbour, Genzyme Corporation's Acquisition of Novazyme Pharmaceuticals Inc., available at <http://www.ftc.gov/os/2004/01/harbourgenzymestmt.pdf>; Dissenting Statement of Commissioners Sheila F. Anthony and Mozelle W. Thompson, Royal Caribbean/Princess and Carnival/Princess (Oct. 4, 2002), available at <http://www.ftc.gov/os/2002/10/cruisedissent.htm>.

²⁷ *Standard Oil Co. v. United States*, 221 U.S. 1 (1911).

²⁸ 15 U.S.C. §§ 12–26.

²⁹ 15 U.S.C. §§ 41–58.

³⁰ See Hearings on Global Competition/High-Tech Innovation, Federal Trade Commission, Oct.–Nov. 1995, available at <http://www.ftc.gov/opp/hitech/global.htm>; FEDERAL TRADE COMMISSION, OFFICE OF POLICY PLANNING REPORT, ANTICIPATING THE 21ST CENTURY: COMPETITION POLICY IN THE NEW HIGH-TECH GLOBAL MARKETPLACE (1996), available at <http://www.ftc.gov/opp/hitech/global.htm>.

³¹ See, e.g., FTC/DOJ Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy, Feb. 2002–Oct. 2002, available at <http://www.ftc.gov/opp/intellect/index.htm>; FTC/DOJ Hearings on Health Care and Competition Law and Policy, Feb. 2003–Sept. 2003, available at <http://www.ftc.gov/ogc/healthcarehearings/index.htm>; FTC Public Workshop: Possible Anticompetitive Efforts to Restrict Competition on the Internet, Oct. 2002, available at <http://www.ftc.gov/opa/2002/09/ecomagenda.htm>; FTC Public Conference: Factors that Affect Prices of Refined Petroleum Products, Aug. 2001, May 2002, available at <http://www.ftc.gov/bc/gasconf/index.htm>; FTC Workshop: Technologies For Protecting Personal Information, May 2003, June 2003, available at <http://www.ftc.gov/bcp/workshops/technology/index.html>. For a more complete listing of workshops, conferences and reports during the Muris tenure, see <http://www.ftc.gov/ftc/workshops.htm>.

Unfinished Business

Tim Muris, like any other chairman, inevitably leaves some unfinished business behind. Some of the landmark cases brought during his term are still in active litigation;³² very recently the Commission lost its application for a preliminary injunction in a case that raised significant issues in the analysis of coordinated effects;³³ and the effort to eliminate case-by-case clearance battles with the Department of Justice had to be abandoned after the then-Chairman of the Senate Commerce Committee raised vehement objections.³⁴

It obviously would not be appropriate to express an individual opinion on the merits of any pending cases that may still require Commission action and it would be even more inappropriate to speculate on what Muris's opinions would be if he were still on board. The legal standard for voting out a complaint is very different from the standard we apply when judging the merits and, equally important, the post-trial record often differs substantially from the facts available to us when the complaint is brought. The most important point is that Muris was not afraid to lead the Commission into uncharted waters—and his meticulous preparation and powers of persuasion were sufficient to secure the near-unanimous approval of his peers.³⁵

In my opinion, the clearance agreement that was negotiated by Muris and Charles James, then head of the Department of Justice's Antitrust Division, was a superb and mutually unselfish act of statesmanship—and its coerced abandonment was a serious setback for rational government.³⁶ The problem was that critics mischaracterized the agreement as a fundamental realignment of responsibilities when it really did nothing more than institutionalize the most likely outcomes of the traditionally private and ad hoc determinations made by the two agency heads. In retrospect, Muris and James probably should have just implemented their agreement quietly, instead of announcing it with fanfare. Perhaps, with luck and some lawmaker retirements, two successors down the road will be able to strike a deal that will survive political scrutiny.

³² See, e.g., *Polygram Holding*, supra note 16; *Schering-Plough*, supra note 17; *South Carolina Board of Dentistry*, supra note 22; *Union Oil Company*, supra note 22; *Rambus Inc.*, FTC Docket No. 9302 (complaint) (June 18, 2002), available at <http://www.ftc.gov/os/adjpro/d9302/index.htm>; *Evanston Northwestern Healthcare Corp.*, FTC Docket No. 9315 (complaint) (Feb. 10, 2004), available at <http://www.ftc.gov/os/adjpro/d9315/index.htm>.

³³ See *Arch Coal, Inc.*, FTC Docket No. 9316 (Order Withdrawing Matter From Adjudication), available at <http://www.ftc.gov/os/adjpro/d9316/040910orderwithdrawmatterfromadjudi.pdf>.

³⁴ *Agencies' Antitrust Market Division Deal Kaput*, FTC: WATCH No. 590, June 3, 2002; Department of Justice Press Release, Statement by Charles A. James Regarding DOJ/FTC Clearance Agreement (May 20, 2002), available at http://www.usdoj.gov/atr/public/press_release/2002/11178.htm.

³⁵ In the *Arch Coal* matter, the Commission vote to authorize the preliminary injunction was 4–1. I dissented from the decision to seek a preliminary injunction, and would have preferred to proceed directly to an administrative trial. See FTC Press Release, *FTC To Challenge Arch Coal's Proposed Acquisition of Triton Coal Company* (Mar. 30, 2004), available at <http://www.ftc.gov/opa/2004/03/archcoal.htm>; Statement of Commissioner Thomas B. Leary, *Arch Coal Inc.*, available at <http://www.ftc.gov/os/caselist/0310191/040407learystatement0310191.pdf>. In the *Evanston Northwestern Healthcare Corporation and ENH Medical Group* matter, the Commission vote to authorize an administrative complaint was 4–1, with Commissioner Pamela Jones Harbour dissenting. See FTC Press Release, *FTC Challenges Hospital Merger That Allegedly Led to Anticompetitive Price Increases* (Feb. 10, 2004), available at <http://www.ftc.gov/opa/2004/02/enh.htm>.

³⁶ See Statement of Commissioners Orson Swindle and Thomas B. Leary, Memorandum of Agreement Between the Federal Trade Commission and the Antitrust Division of the United States Department of Justice Concerning Clearance Procedures for Investigations (Jan. 18, 2002), available at <http://www.ftc.gov/opa/2002/01/ftcdojostl.htm>.

Conclusion

It has been a privilege to serve with Bob Pitofsky and Tim Muris, two of the finest chairmen in the history of the Federal Trade Commission. When I celebrate the significant contributions that Muris made, I do not mean to neglect the significant contributions of his predecessor. Each had different areas of primary interest and each faced a different external environment. They each left behind an agency that was even stronger and more esteemed than the agency that they inherited. The bar continues to be raised—and that is a formidable legacy and a challenge for those of us who remain. ●

The Antitrust Modernization Commission: An Introduction

Ronan P. Harty

THE ANTITRUST MODERNIZATION COMMISSION, authorized by Congress to examine whether the need exists to modernize the federal antitrust laws, has begun its work. A task force of the Antitrust Section of the ABA has already submitted a report to the Commission, suggesting topics for study, and will continue to be involved in the process. This article outlines the background and membership of the Commission and its work to date, and summarizes the report of the Antitrust Section task force. Further details on the Antitrust Modernization Commission, as well as the text of all public comments, including the report of the Antitrust Section, can be found on the Commission's Web site at www.amc.gov.

■ The Antitrust Modernization Commission plans to hold its next public meeting on January 13, 2005. At that meeting, the Commissioners will consider the recommendations of its working groups, with a view to setting an agenda of topics for study. The Commission has indicated, however, that there may be a further Commission meeting in February if necessary in order to finalize the agenda.

We are planning to publish in the March issue of *The Antitrust Source* some articles on the topics the Commission will be studying. We welcome the submission of articles on relevant topics from our readers. Send inquiries and submissions to: antitrust@att.net.

Introduction

The Antitrust Modernization Commission (Commission) was established by the Antitrust Modernization Commission Act of 2002 (Act).¹ The Act was introduced in June 2001 by House Judiciary Committee Chairman, F. James Sensenbrenner, Jr. When the legislation was introduced, Chairman Sensenbrenner stated that he expected the Commission to address at least three areas: (1) the role of intellectual property law in antitrust law; (2) how antitrust enforcement should change in the global economy; and (3) the role of state attorneys general in enforcing antitrust laws.

However, the legislation as enacted is drafted more broadly and gives the Commission the freedom to set its own agenda. The Act defines the duties of the Commission as follows: "(1) to examine whether the need exists to modernize the antitrust laws and to identify and study related issues; (2) to solicit views of all parties concerned with the operation of the antitrust laws; (3) to evaluate the advisability of proposals and current arrangements with respect to any issues so identified; and (4) to prepare and to submit to Congress and the President a report . . ."

The Commission's report, which is to be submitted not later than three years after the Commission's first meeting, must contain "a detailed statement of the findings and conclusions of the Commission, together with recommendations for legislative or administrative action the Commission considers to be appropriate."

The Commission has the power to hold hearings, take testimony, administer oaths, obtain data directly from any executive agency or court, and request facilities and support services from an

■ **Ronan P. Harty** is a partner at Davis Polk and Wardwell in New York and an Editor of *The Antitrust Source*. He is a member of the ABA Section of Antitrust Law Modernization Commission Task Force.

¹ Pub. L. No. 102-273 §§ 11051-60, 116 Stat.1856.

executive agency. It may also appoint an executive director and other staff as necessary. It has a budget of \$ 4 million to carry out its charge.

Although there have been several reviews of U.S. antitrust law over the past few decades, the last time such a commission was established by Congress was in 1938.

The Commissioners

The Commission consists of twelve members, four of whom were appointed by the President (with a maximum of two members from each political party), another four of whom were appointed by the leadership of the Senate (two from each of the majority and minority leaders), and the final four members being appointed by the leadership of the House of Representatives (again, two from each of the majority and minority leaders).

The Presidential appointees are Deborah Garza (Chair), a partner at Fried, Frank, Harris, Shriver & Jacobson in Washington, D.C.; Dennis Carlton, Professor of Economics at the University of Chicago Graduate School of Business; Sanford Litvack, a partner at Hogan & Hartson in Los Angeles, and previously General Counsel and Vice Chairman of the Board of Directors for the Walt Disney Company. The fourth Presidential appointee, Deborah Platt Majoras, is now Chairman of the Federal Trade Commission and thus can no longer serve as a Commissioner. The Act provides that, "if a member of the Commission who is appointed to the Commission as . . . an individual who is not an officer or employee of a government becomes an officer or employee of a government . . . then such member shall cease to be a member of the Commission . . ." Her replacement, who will also be selected by the President, has yet to be appointed.

The Republican appointees are Stephen Cannon, Senior Vice President and General Counsel of Circuit City Stores, Inc.; Makan Delrahim, Deputy Assistant Attorney General for International, Policy, and Appellate Matters in the Antitrust Division of the Department of Justice; Donald Kempf, Executive Vice President, Chief Legal Officer, and Secretary for Morgan Stanley in New York; and John Warden, a partner at Sullivan & Cromwell in New York.

The Democrat appointees are Jonathan Jacobson, a partner at Akin, Gump, Strauss, Hauer & Feld in New York; John Shenefield, a partner at Morgan Lewis in Washington, D.C.; Debra Valentine, Vice President, Secretary, and Associate General Counsel for United Technologies Corporation; and Jonathan Yarowsky (Vice-Chair), a partner at Patton Boggs in Washington, D.C.

The Commissioners have appointed various members of staff, including Andrew Heimert as the Commission's Executive Director and General Counsel. Mr. Heimert was previously an attorney in the Federal Trade Commission's Office of Policy and Evaluation.

Work of the Commission to Date

The Commission has held two public meetings, the first on July 15, 2004, and the second on October 20, 2004. At the first meeting, after some opening remarks and suggestions of topics by Chairman Sensenbrenner, the Commission adopted a procedure for identifying issues to study, which included inviting the public to recommend topics for its agenda by September 30. At the second meeting, the Commissioners explained that they have formed eight working groups to address different areas (including mergers, immunities and exemptions, intellectual property, and single firm dominance) and discussed the criteria which these working groups might use for selecting issues to study.

The working groups are to make recommendations as to which issues are most worthy of Commission study by December 17, 2004, in order to give the Commissioners time to review them before their next public meeting on January 13, 2005.

The Contribution of the ABA Section of Antitrust Law

A specially formed task force of the ABA Antitrust Law Section submitted a report to the Commission on September 30, identifying certain topics for consideration by the Commission. These were organized into four broad areas: Antitrust Enforcers and the Remedies They Seek; Ways to Improve Antitrust Enforcement; Antitrust Exemptions; and Issues of Substantive Antitrust Law.

Under the first of these areas, the task force suggested that the Commission consider the rule applicable to indirect purchasers under *Illinois Brick*, and especially the interaction between federal and state antitrust law; the role of state enforcement and specialist industry regulators; the Foreign Trade Antitrust Improvements Act, and in particular what should constitute a direct, substantial and reasonably foreseeable effect on the United States; the nature, scope and efficacy of antitrust remedies in both public and private enforcement actions; the impact of the Federal Sentencing Guidelines on antitrust criminal penalties and fines; and criminal anomalies, such as Section 3 of the Robinson-Patman Act and Section 2 of the Sherman Act.

Under the second heading—"Ways to Improve Antitrust Enforcement"—the task force suggested the following topics to the Commission: the criteria for appointment of FTC Administrative Law Judges, and in particular whether judges should have some expertise or training in antitrust law; the application of the Sunshine Act to the FTC; overlapping antitrust enforcement by the DOJ and FTC for mergers, and division of responsibility between the two by industry (for both mergers and enforcement actions); and the burdens of the Hart-Scott-Rodino Antitrust Improvements Act, especially the second request process, and multi-jurisdictional merger filings.

As regards "Exemptions and Special Considerations," the task force suggested that the Commission consider the application of the antitrust rules to the public sector, including: (a) whether a clarification of the state action doctrine might be helpful, (b) the *Noerr-Pennington* doctrine, and (c) governmental restrictions of competition, such as Medicaid's "most favored nation" requirement. The task force also suggested that the Commission might undertake a systematic review of statutory exemptions from the antitrust laws and consider the future of the Webb-Pomerene and Export Trading Company Acts.

The task force also identified certain issues of substantive antitrust law as potential areas for the Commission to study. These were the repeal or amendment of the Robinson-Patman Act; the interface of intellectual property and antitrust, and in particular the recommendations of the FTC's October 2003 report entitled "To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy"; and how antitrust laws are functioning in the "new economy" and the challenges to antitrust posed by network industries.

The task force will continue to be involved in the Commission process. At the second public meeting, the Commission Chair, Deborah Garza, referred to the report of the task force and also to the Antitrust Section's offer to undertake some background work for the Commission if necessary. She indicated that it was likely that the Commission would be approaching the Section in due course to take it up on this offer.

Web Links

The Commission's Web site can be found at www.amc.gov. The site contains general information about the Commission and the Act, as well as biographies of the Commission members, information on Commission meetings (including documents handed out and transcripts), and the full text of all public comments. The report of the ABA task force can be found at www.amc.gov/comments/abaantitrustsec.pdf. ●

Book Review

The Art of the Cartel

Christopher Mason

Art of the Steal: Inside the Sotheby's-Christie's Auction House Scandal

Putnam Publishing Group • 2004

Reviewed by Christopher R. Leslie

In *The Art of the Steal*, journalist Christopher Mason provides a well-researched, in-depth, and balanced look into the price-fixing agreements between the two largest auction houses in the world, Sotheby's and Christie's. This book joins such classic case studies in price fixing as *The Great Price Conspiracy* and *The Informant*, which explored the formation and collapse of the electrical equipment and lysine cartels, respectively.

The book begins with biographic backgrounds of the four pivotal players. Alfred Taubman rose from modest beginnings to become a multimillionaire who would serve as a white knight to buy the struggling Sotheby's and save it from a hostile takeover by two carpet manufacturers from New Jersey. After he became the chairman of Sotheby's, Taubman elevated Dede Brooks to the position of CEO of Sotheby's, the first woman to lead a major auction house. Born into a world of privilege, Brooks would nevertheless have to work her way to the top, leaving her position in the financial sector to begin life at Sotheby's, initially without any salary at all.

The two key players from Christie's also presented a tale of two different paths to power. While Anthony Tennant came from the privileged classes to head Christie's as its chairman, Christopher Davidge took a different route. After Christie's lost its chairman following a scandal (he lied to the press about the money fetched by two paintings at auction), Christie's did the unthinkable and hired Christopher Davidge, a man from England's lower-middle class who was raised in a government housing project in North London and had been running the catalog printing division at Christie's immediately prior to being tapped for the top position.

Early Competition

The book begins by demonstrating that the introduction of new blood can revitalize competition in a marketplace. Until the early 1980s, both Christie's and Sotheby's were relatively staid, conservative institutions run by establishment Englishmen bred from the upper classes who attended the proper schools. After Sotheby's hired Alfred Taubman, the American businessman introduced a new competitive spirit into the market that forced Christie's to respond. Davidge took over the day-to-day operations of Christie's at a time when Sotheby's new aggressive competitive approach was putting pressure on Christie's executives.

There was a time when Taubman was "obsessed with beating Christie's," according to Sotheby's CEO in 1984. When Sotheby's and Christie's operated as hated rivals, the seller's commission that could be as high as 10 percent would be bid down to as low as 2 percent or in some rare cases, even zero, as firms tried to convince sellers to consign with Sotheby's over Christie's. As *The Art of the Steal* shows, however, when firms begin to work together, have joint ventures, and form personal

■
Christopher R. Leslie
is Associate Professor
of Law, Chicago-Kent
College of Law.

bonds, this hatred dissipates and with it the fierce competition that drives prices down.

The book does an excellent job of showing the competitive rivalry between Christie's and Sotheby's as they fought estate by estate, painting by painting for the right to auction off major works. The competition between Sotheby's and Christie's took many forms. For example, although Christie's had previously derided Sotheby's for giving guarantees to sellers—whereby the auction house would pay the seller a minimum amount even if the item did not sell at auction—Christie's eventually had to give in and began offering guarantees as well in 1990. In addition to guarantees, Sotheby's sought to attract business by providing cash advances to sellers. Finally, Sotheby's attempted to up the competitive stakes at one point by offering to make financial contributions to the charity of the seller's choice should the seller auction their goods through Sotheby's. The book shows how competition is a dynamic process that extends beyond price alone. Moreover, sophisticated sellers knew how to play the competitors off of each other in order to negotiate more concessions.

Earlier Collusion

Perhaps antitrust authorities should have been on the lookout for anticompetitive collusion between Sotheby's and Christie's because they were the two dominant firms in the market and because of their suspicious activities in the past. Long before the collusion on sellers' commissions that ultimately led to criminal convictions, the auction houses had been suspected of price fixing. In 1975, Christie's announced that it would begin imposing a 10 percent buyers' premium, a premium that had not existed in England. Three days later on Monday, June 2, Sotheby's announced it would follow suit. This buyer's premium would be on top of the 14 percent seller's premium that both firms were charging in 1975.

There was much talk and some evidence that the two auction houses had maintained a secret agreement to adopt buyers' premiums as a way to increase profits. Ultimately, art dealers filed a lawsuit in London, but the British anti-cartel law at the time was relatively anemic. The art dealers' competition suit against Sotheby's and Christie's was a losing proposition from the beginning because the maximum penalty under British law would have been a fine of £2,000, approximately \$3,913. By late 1981, the art dealers' legal expenses alone were £150,000, over \$290,000. Anxious to avoid the greater scandal and notoriety of a lawsuit, Christie's and Sotheby's reached a settlement with the art dealers by agreeing to pay £75,000, half of the dealers' legal costs to date.

Christopher Davidge witnessed this anticompetitive collusion between Sotheby's and Christie's. He observed that none of the individual actors were found to be personally liable or to have suffered any serious damage to their reputations. The fact that the litigation was resolved in a manner that allowed the firms to keep the hated buyer's commission in place may have given Davidge the impression that collusion was simply business as usual.

The Conspiracy

The book details how Tennant approached Taubman in the name of cooperation. At their high-level meetings, Tennant and Taubman agreed in principle to eliminate certain forms of guarantees and advances, to limit credit to buyers and introductory commissions to third parties, to stop offering charitable contributions as a way to entice sellers, and to cease "poaching" each others' employees.

Tennant and Taubman agreed to step back and let their CEOs hammer out the specifics of the collusion after Dede Brooks assumed her new position as CEO of Sotheby's. Mason notes that

only days after the official announcement in November of 1993 appointing her as the new CEO of Sotheby's, Brooks telephoned Davidge to set up their first in-person meeting to discuss cooperation between the auction house rivals. Brooks and Davidge met soon thereafter and began the process of fixing commissions. They agreed that Christie's would announce the increase first and Sotheby's would follow. The two also agreed to meet the following month to follow up on their discussions of greater cooperation between the rival auction houses. Davidge and Brooks reported back to Tennant and Taubman, respectively. Davidge and Brooks decided not to meet in public, suggesting the two knew what they were doing was wrong.

At their meeting in London in December of 1993, Brooks and Davidge continued their discussions on a wide range of agreements, including vendors' commissions, market share, guarantees, trade commissions, introductory commissions, poaching of staff, as well as other subjects. This shows that the range of agreements was much more complicated than just setting the commission rate for sellers' commissions. Davidge and Brooks agreed to stop giving interest-free advances. Although sellers' commissions generally ranged from 6 to 15 percent, many sellers were demanding zero-commission deals and some were getting them. Brooks and Davidge discussed ways to develop a sellers' commission that would be nonnegotiable.

After the successful announcement of their new non-negotiable sellers' commission rates in spring of 1995, Davidge proposed to Brooks that the two auction houses also refuse to grant concessions to major sellers, "such as waiving expenses for catalog illustrations, shipping and insurance charges." This is an example of how an initial level of collusion can expand into agreements to collude on a multitude of issues. It also shows how conspirators attempt to prevent cheating at the fringes. In the commodities cartels of the past, cartel members cheated by giving discounts on delivery. In the case of auctions houses, Davidge was concerned that the auction houses would chip away at the new commission rates by granting concessions in other areas. He sought to reduce the possibility of this by reaching collusive deals on these peripheral issues as well.

The conspiracy between the auction houses shows that price-fixing agreements are not implemented instantaneously. For example, it took more than a year from the first meeting between Tennant and Taubman in April 1993 until the agreements, fleshed out by Davidge and Brooks, were carried out in any meaningful way. And this only occurred after a dismal auction season in the spring of 1994.

The auction house conspiracy also illustrates the danger of trusting one's cartel partner, especially trusting them not to create and keep evidence of the conspiracy. Christopher Davidge, the CEO of Christie's, kept dozens of pages of notes from the illegal meetings that documented the illegal agreements he had entered into with Brooks, the CEO of Sotheby's. For example, after his December 1993 meeting with Brooks, Davidge wrote down the substance of their agreement on a legal pad in order to give a full report to Tennant about the topics discussed and the agreements reached between Brooks and Davidge. Davidge also kept documentation of his confidential communications with Sir Anthony Tennant, the then-worldwide chairman of Christie's. Finally, Davidge also had Tennant's handwritten notes that memorialized Tennant's agreements with Alfred Taubman, the chairman and controlling shareholder of Sotheby's. Because he possessed these handwritten notes, Davidge had significant leverage when the American antitrust authorities began investigating potential antitrust violations by the auction houses.

Leniency

Based on the parallel conduct between Sotheby's and Christie's, federal authorities initiated an investigation into possible antitrust violations by the auction houses. This investigation created ten-

The auction house

conspiracy also

illustrates the danger

of trusting one's cartel

partner, especially

trusting them not to

create and keep

evidence of the

conspiracy.

sion and distrust between conspirators both within and across firms, particularly between Christie's executives and Davidge, once Davidge resigned his position at Christie's. Both worried about being set up as the fall guy. Christie's felt that it needed to make a deal with the American government before Sotheby's did but also felt that it needed Davidge's documents, which it did not know for certain existed, in order to make such a deal. Davidge, in contrast, wanted to make a deal with antitrust authorities before Christie's did so that he could get individual leniency. Davidge's attorney worried that Christie's might attempt a carve-out whereby a corporation confessing to participating in an antitrust conspiracy attempts to exclude one of its executives from any leniency deal.

The auction house price-fixing case also shows how the antitrust leniency guidelines work to create a strong incentive to be the first to confess. After Christie's received Davidge's handwritten notes that laid out the antitrust conspiracy, Christie's had a strong incentive to make a deal with the American prosecutors before Davidge did. Furthermore, since Davidge had just left Christie's, the executives at Christie's were aware that Sotheby's executives might also worry that Davidge would expose the conspiracy. As a result, Christie's executives feared Sotheby's could attempt to secure amnesty from the antitrust prosecutors by turning in Christie's for its role in the price-fixing conspiracy.

Armed with Davidge's incriminating documents, Christie's outside counsel delivered all of these documents as well as other relevant documents—a 600-page package of materials—to antitrust prosecutors on December 29, 1999. Christie's was the first participant in the price-fixing cartel to come clean to the government. Christie's handed over all of these incriminating documents to the American prosecutors in hopes of getting amnesty, but without any guarantees.

The Art of the Steal provides a good inside look at the struggle over whether to seek leniency, both by the firms and the individual conspirators. Once presented with Davidge's documents, Christie's had to decide whether to turn over the documents and make a deal with antitrust authorities. Its caution was well-founded since the government investigation had already begun. When Christie's did approach the government with its proffer, the government made amnesty conditional on Christie's showing that it took "prompt and effective action" to withdraw from the conspiracy once it knew about it and that Christie's had not initiated the conspiracy.

The amnesty deal that Christie's worked out is interesting for a couple of reasons. First, Christie's, through its CEO at the beginning of the conspiracy, Anthony Tennant, was clearly the instigator of the cartel. Yet, Christie's received amnesty despite its ringleader status. Second, the explicit conditions of the amnesty were not fulfilled: Christie's had been the originator of the cartel agreement and several Christie's executives had suspected illegal collusion, but did not report their suspicions to the relevant authorities. Nevertheless, Christie's secured amnesty from criminal prosecution.

The Convictions

In light of the overwhelming evidence, Brooks pleaded guilty and agreed to cooperate with antitrust authorities. Taubman declined, however, forcing Brooks to testify against her former mentor. Without taking the stand, Taubman was convicted. Although Taubman and Tennant had twelve meetings, the defense proffered no real explanation for what was discussed at the meetings between the chairmen of Sotheby's and Christie's. This allowed the jury to speculate that if the two men were meeting in secret and no alternative explanation for the meetings was presented, then the men must have gotten together for the purpose of conspiring to fix prices.

The judge initially sentenced Taubman to one year in prison and a \$7.5 million fine. Taubman's

attorney asked for the sentence to be increased to a year and a day in order to make Taubman eligible for time off for good behavior, a request that the judge granted. The judge sentenced Brooks to three years probation, which included six months of home detention wearing an electronic monitoring device, and an additional 1,000 hours of community service and a criminal fine of \$350,000.

Lessons

The Art of the Steal exposes the culture of collusion that permeates much international business. When warned about the inappropriate nature of too much communication and cooperation between business rivals, Anthony Tennant was alleged to reply, "Nonsense. In my experience, a close relationship with one's competitor is to everyone's advantage. It takes out a level of competition which is unnecessary." At the beginning, at their second meeting, Taubman told Tennant in no uncertain terms that the men could not talk about price and that Taubman would not violate the Sherman Act. But Taubman was the exception, and his protestations were short-lived. The four principal players all knew that they were violating both English and American law and, according to Mason, ultimately, none had any moral qualms about breaking the law.

The auction house price-fixing case also shows how price fixers evade and deceive their own attorneys. For example, after Christie's announced its decision to impose non-negotiable commissions, Sotheby's chief in-house counsel brought in an antitrust lawyer to meet with Sotheby's executives before Sotheby's announced its response to Christie's move. Dede Brooks initially stayed clear of the outside antitrust attorney so as to avoid any direct questions about her relationship with Davidge. This could be a sign for antitrust attorneys everywhere when your own client attempts to avoid discussions with you that may be an indication of antitrust collusion. Davidge, in contrast, had no problem simply lying to Christie's in-house and outside counsel, a practice Brooks soon became more comfortable with. For example, Dede Brooks lied to her friend Donaldson Pillsbury when hiring him as Sotheby's new in-house general counsel. Pillsbury was concerned about the ongoing antitrust investigation and Brooks assured him that no violations had taken place. Even after the Department of Justice subpoenaed all their records, Brooks still told her attorneys that she had only met with Davidge to discuss "legitimate industry issues."

Another interesting fact: antitrust lawyers were only allowed to attend meetings where the firms had no intention of violating the antitrust laws. Thus, for example, when a firm called Centrox approached both Sotheby's and Christie's about pooling their auction sales information into a central database, both firms brought attorneys to the meetings to monitor the content in order to ensure compliance with antitrust laws. In contrast, no lawyers ever attended meetings with Davidge and Brooks because the sole purpose of those meetings was to violate the antitrust laws.

The book also illustrates the dubious value of antitrust compliance policies. After its board meeting in 1996, Christie's circulated its antitrust policy, which was signed by American employees who strongly believed that Davidge and Brooks were violating antitrust laws, as well as Davidge himself who was expressly violating American antitrust law.

In the ultimate irony, almost two weeks after the antitrust violations were announced to the world, Christie's disclosed that it was increasing its buyers' premium significantly and that same month Sotheby's announced it would increase its buyers' commissions even more. The new CEO of Christie's lamented that this showed how collusion was "completely unnecessary" because the firms could have raised prices in tandem without agreement and without violation of American antitrust laws.

Conclusion

It is important to understand how cartels actually work. Many theorists argue that cartels are inherently unstable and suggest that antitrust law is not terribly important because cartels will necessarily unravel on their own. Understanding how cartels actually operate can show that although cartels are inherently unstable in the abstract, some cartel participants have devised ways to successfully stabilize cartels. It is important for scholars to understand how cartels actually operate so that we can better study the phenomenon and advocate changes in antitrust law that will help detect, punish, and deter price fixing in the future. It is important for prosecutors to understand how cartels actually work so that they can better detect activities that may indicate the presence of price-fixing conspiracies and to get a better sense of how to get individuals in a cartel to confess and cooperate with prosecutors against their former co-conspirators. Finally, it is important for attorneys who counsel potential antitrust defendants to understand how price fixers actually operate so that they can give better guidance to their clients for what to look for within their own organizations.

Cartels are inherently difficult to study. In-depth case studies like *The Art of the Steal* help fill the void in the academic literature. They provide critical data so that we can better determine whether or not the theoretical models of cartel behavior proposed by economists and legal scholars actually reflect price-fixing behavior as it exists in the business world. As we gain a better understanding of how cartels operate, this facilitates enforcement actions against antitrust conspirators. ●