

The Supreme Court's 2005 Term: Formalism Under Review

Susan Creighton

Antitrust law should be based on empirical analysis of behavior in specific markets, not on rigid formalism or abstract propositions. Three Sherman Act cases now before the Supreme Court provide the Court with the opportunity to reaffirm this basic principle. The three matters are *Independent Ink*, *Dagher*, and *Schering Plough*. The Supreme Court has already granted certiorari on the first two cases, and the Federal Trade Commission seeks the Court's review on the third. Good decisions here will help to push back against what I fear may become a creeping formalism in antitrust law.

In each of these cases, the FTC has taken a strong position on the merits because, in each case, the Commission believes the court of appeals got it wrong. Each case departed from the modern, bipartisan consensus on antitrust methodology. Rather than carry out a concrete empirical economics-based assessment of the impacts of challenged practices on consumer welfare, efficiency, and innovation, the three circuit court decisions simply relied on formal rules that were based on formal legal constructs. After affixing a label to the conduct on the basis of these formalistic categories, the courts gave little consideration to whether these formalistic analyses actually fit with the underlying purposes of the antitrust laws or the specific realities of the marketplaces at issue.

Each of these cases, if allowed to stand, will harm the Commission's ability to enforce a properly balanced antitrust policy—one targeted, as it should be, at protecting the welfare of consumers while leaving entrepreneurs the freedom they must have to innovate, to cut prices, and to compete vigorously with their rivals. This term gives the Court a chance to carry out the judicial equivalent of baseball's triple play. Just as three runners are put out during the same play in a triple play, the Commission is hoping all three of these cases will be called "out" during the Court's October 2005 term.

*Illinois Tool Works, Inc. v. Independent Ink, Inc.*¹

In the *Independent Ink* case, the circuit court made a formalistic presumption that a patent automatically confers market power.

The defendant makes patented printheads. Those devices are later incorporated into the specialty printers that place bar codes on cartons. It is important to design the printheads so that they can efficiently handle the significant amount of ink required. Three solutions to this problem are available in the market, only one of which is the product patented by defendant. Defendant also

■ **Susan Creighton** is Director, Bureau of Competition, Federal Trade Commission. The views expressed here are the author's own and are not necessarily the views of the Commission as a whole or of any individual Commissioner. Any information of value, however, is due entirely to the contributions of my FTC colleagues, Tom Krattenmaker and Neil Averitt.

¹ Cert. granted, 125 S. Ct. 2937 (U.S. June 20, 2005) (No. 04-1329).

manufactures ink, and it allows its customers to make, use, or sell its patented printhead only when they also use in it the ink that the defendant supplies.

The plaintiff makes a competing ink that is usable in the defendant's printheads. The plaintiff alleged that the defendant's tie-in arrangement violated both Section 1 of the Sherman Act, as an illegal restraint of trade, and Section 2, as attempted monopolization. On motions for summary judgment, the district court dismissed both these claims.²

On appeal, the Federal Circuit affirmed dismissal of the Section 2 count.³ Attempted monopolization requires that there be a dangerous probability of success—in this case, that defendant would succeed in achieving market power in ink. The court held that summary dismissal was appropriate because the plaintiff had made only conclusory allegations regarding the appropriate market.

There is no reason to condemn a tie-in in the absence of market power. No one thinks that supracompetitive prices can be charged in circumstances where the seller lacks market power in the tying product.

Nevertheless, the Federal Circuit panel reinstated the Section 1 claim. Whether a tie-in constitutes an unreasonable restraint of trade depends, as a threshold matter, on whether the party has market power in the tying product—here, the printhead machines. The circuit court believed it was bound by Supreme Court precedent which it read as holding that, in tie-in cases involving patented or copyrighted products, the requisite economic power is at least rebuttably presumed to exist.⁴ Despite the presence of several other printhead offerings in this market, and despite the circuit court's other conclusion that there was no evidence of potential harm to competition in the ink market, the court concluded that this presumption made summary judgment inappropriate.

The Supreme Court granted certiorari to consider whether market power should be presumed from the simple presence of a patent, or whether, instead, a tie-in case requires the plaintiff to prove such power. The Solicitor General filed an amicus curiae brief signed by officials of the DOJ's Antitrust Division, the FTC, and the Patent and Trademark Office.⁵

The amicus brief argues three main points: (1) there is no reason to condemn tying arrangements in the absence of market power; (2) possession of a patent on the tying product does not establish market power; and (3) a presumption that patents confer market power would conflict with the procompetitive policies of the antitrust laws. I believe that each of these principles is clearly correct.

First of all, there is no reason to condemn a tie-in in the absence of market power. No one thinks that supracompetitive prices can be charged in circumstances where the seller lacks market power in the tying product. The buyer confronted with such a demand would simply move elsewhere. The Supreme Court has made this point in a number of cases, including *Eastman Kodak*⁶ and *Jefferson Parish*.⁷

² 210 F. Supp. 2d 1155 (C.D. Cal. 2002).

³ 396 F.3d 1342 (Fed. Cir. 2005).

⁴ See *United States v. Loew's, Inc.*, 371 U.S. 38 (1962); *United States v. Int'l Salt Co.*, 332 U.S. 392 (1947).

⁵ Deciding whether to participate in an amicus effort can sometimes be a complex process. Many factors are relevant to the Commission's decision, including whether there has been an invitation from the Court; the importance of the legal issues at stake; the extent to which the agency has particular expertise or particular enforcement priorities in those issues; the competing demands on the Commission's time and resources; and the clarity with which the issue is presented by the fact pattern of the case. These factors often counsel against participating on behalf of private parties at the cert petition stage. Once a case has been accepted by the Court, however, the Commission will often want a chance to participate in the proper development of the law.

⁶ *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 462 (1992).

⁷ *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 12–18 (1984).

Next, there is no reason to presume that the mere possession of a patent establishes this kind of market power. A patent gives a right to practice a particular invention, but the invention itself does not have market power if there are other methods, patented or not, that can accomplish more or less the same thing. In the United States, it is possible to patent a particular configuration of a golf course, but the owner of such a course surely cannot charge monopoly rents to all golfers. A patented mousetrap does not have market power in a world containing many designs of mousetrap. This point has been made by a number of scholarly commentaries.⁸ It has also been formally stated by the antitrust agencies in their Guidelines. The agencies do “not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner,” because, “[a]lthough [a patent] right confers the power to exclude with respect to the *specific* product, process, or work in question, there will often be sufficient actual or potential close substitutes . . . to prevent the exercise of market power.”⁹

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The Federal Circuit understood these arguments, but believed that it was bound by Supreme Court precedent on the presumption. In the amicus brief, it is noted that these precedents were forty years old and have been undercut by subsequent events. One such event was the decision in *Northern Pacific*, which came between the two cases that the circuit court relied upon, and questioned the putative linkage between patents and market power.¹⁰ Another event was legislation in 1988, which specified that a tying arrangement does not constitute patent misuse in the absence of market power.¹¹ For both these reasons, it appears that the old precedents are no longer controlling. But if the Supreme Court believes that they retain some validity, then the Commission suggests that the time has come to overrule them.

Finally, applying a presumption that patents confer market power would conflict with the pro-competitive policies of the antitrust laws, which foster rationality and efficiency. Were the decision below to be upheld, the antitrust legality of important business arrangements would no longer turn rationally on their actual competitive impacts but rather on the formal source of the property rights involved. Tying arrangements involving patented products would be treated, for no good reason, in a way fundamentally different from other tying arrangements. Casting doubt on tie-ins in this way could impede a number of efficient and beneficial uses—convenient combinations that consumers affirmatively value. The presence or absence of patents should not determine whether cars can be sold with radios, whether right shoes and left shoes can be boxed together, and whether a gas station that insists we buy a car wash along with our gasoline would lose not only many customers but also an antitrust suit.

⁸ A patent grant “creates an antitrust ‘monopoly’ only if it succeeds in giving . . . the exclusive right to make something for which there are not adequate market alternatives, and for which consumers would be willing to pay a monopoly price.” 1 HERBERT HOVENKAMP ET AL., IP AND ANTITRUST § 4.2, at 4–9 (2002); J. Dianne Brinson, *Proof of Economic Power in a Sherman Act Tying Case: Should Economic Power Be Presumed When the Tying Product is Patented or Copyrighted?*, 48 LA. L. REV. 29 (1987).

⁹ U.S. Dep’t of Justice & Federal Trade Comm’n, Antitrust Guidelines for the Licensing of Intellectual Property § 2.2 (1995), available at <http://www.usdoj.gov/atr/public/guidelines/0558.htm>.

¹⁰ *N. Pac. Ry. Co. v. United States*, 356 U.S. 1 (1958).

¹¹ The Patent Misuse Reform Act, 35 U.S.C. § 271(d)(5).

*Texaco Inc. v. Dagher*¹²

In the *Dagher* case, the court assumed that simply because two products exist as distinct brands they are required to be in price competition with one another, even if both brands are owned by the same legal joint venture.

Plaintiffs are a class of 23,000 gas station owners. They sued Shell and Texaco for price fixing gasoline. The two suppliers were once, it is true, fierce competitors in all aspects of the oil and gasoline markets. And the firms had, indeed, agreed to unify the pricing of Shell and Texaco gas in certain areas. But in 1998, they had formed joint ventures to refine, market, and sell both Shell and Texaco gasoline, one venture for the eastern United States, the other for the western part of the country. The FTC had reviewed the formation of these joint ventures, obtained a consent order mandating certain specific divestitures necessary for competition, and otherwise let the rest of the ventures go forward.¹³ Following this resolution, Shell and Texaco transferred all the assets related to their downstream marketing functions to the joint ventures, and ceased competing in the downstream markets themselves. Shell and Texaco retail gasolines maintained their unique chemical compositions, their brand names, and their marketing strategies. But the exclusive licenses to sell both brands were held by the joint ventures. The managers of the ventures decided that they would sell each brand at the same price in the same market area.

Petitioners urged that this “price-fixing” agreement was unlawful per se and therefore offered no proof of actual effects. Most importantly, the petitioners did not challenge in any way the legality of the joint venture. They also disavowed any reliance on a rule of reason analysis in which actual anticompetitive effects need be demonstrated. Consequently, the petitioners were left to contend that the arrangement on prices was per se unlawful although the joint venture itself was unobjectionable.

The district court granted summary judgment for defendants,¹⁴ but the Ninth Circuit Court of Appeals, in a divided opinion, reversed.¹⁵ To the court majority, defendants were seeking “an exception to the per se prohibition on price fixing where two entities have established a joint venture that unifies their production and marketing functions *yet continue to sell their formerly competitive products as distinct brands.*”¹⁶ Finding no such exception in the case law, the court reversed the grant of summary judgment. The court sent the case back to the trial court for a determination whether defendants had actually violated the Act by agreeing to unify the gas prices.

It does not require detailed analysis to see that the circuit court in *Dagher* was not only wrong, but plainly wrong. The court simply forgot that one cannot restrain competition where there is no competition to be restrained.

To return to baseball analogies, the *Dagher* decision may be dubbed the Merkle’s Boner of antitrust law. Merkle’s Boner occurred in 1908 when Fred Merkle, a young first-baseman for the NY Giants who went on to have a distinguished career, forgot to touch second base on a ball hit to centerfield with two outs that would have driven in the winning run for his team in a pivotal game.

¹² *Cert. granted*, 125 S. Ct. 2957–58 (U.S. June 27, 2005) (Nos. 04-805, 04-814).

¹³ *See Shell Oil Co.*, 125 F.T.C. 769 (1998).

¹⁴ D.C. No. CV-99-06114-GHK (C.D. Cal.).

¹⁵ 369 F.3d 1108 (9th Cir. 2004).

¹⁶ *Id.* at 1116 (emphasis added).

Because Merkle never touched the base, he was forced out at second. Consequently, the other base runner could not score and, ultimately, the Giants lost the game. Having lost the game, his team had to play in a playoff game, which they also lost. So Merkle's Boner cost his team both a championship and a trip to the World Series.

The *Dagher* court committed a Merkle's Boner here. The majority judges forgot to touch all the bases. Specifically, they forgot to ask what the purpose is of the per se prohibition against price fixing. Had they stopped to ask that question, they would have understood that it is to protect against restraints on competition, and that there is no actual competition within a joint venture.

The Supreme Court granted certiorari.¹⁷ The Solicitor General's amicus brief, signed by both the FTC and the Antitrust Division, makes two simple and inarguably correct points: (1) an agreement between the owners of a legitimate joint venture respecting the pricing of the joint venture's products, where neither of the owners competes with the joint venture, cannot violate the antitrust laws; and (2) the court of appeals' contrary conclusion is inconsistent with the procompetitive purposes of the antitrust laws.

Per se analysis is reserved for conduct that is pernicious, virtually without potential benefits to consumers, and "manifestly anticompetitive."¹⁸ The conduct here cannot be characterized that way. There being no competition whatsoever between Shell and Texaco on the presumed facts of this case, the agreement to unify prices might look like a price-fixing agreement between competing brands, but it was not so in fact. Yes, there were—and still are—two brands here: Shell and Texaco. But with plaintiffs offering no challenge to the formation of the joint venture, making no assertion of demonstrable anticompetitive effects, and failing to claim a "sham" agreement to mask price fixing, those brands did not compete with each other or with any other brand of either defendant.¹⁹ Thus the agreement did not restrain anything with which antitrust law is concerned.²⁰

More fundamentally, the circuit court's pursuit of this matter is unresponsive to the underlying procompetitive purposes of the antitrust laws. It threatens to turn antitrust into an engine of inefficiency at best, and chaos at worst. If allowed to stand, the court's decision would prohibit all manner of routine agreements that have no effect on competition. Imagine telling Pepsi that because Pepsi and Diet Pepsi are distinct brands they cannot be priced together.

It is worth noting that the decisions in *Independent Ink* and in *Dagher*, otherwise quite different cases, operate from a common misperception—that because the law places a formal label on some intellectual property, that label alone will generate answers to antitrust questions. In *Independent Ink*, the defendant possesses a "patent," a label that is taken to mean "monopoly over production of the product," which is then assumed to serve as proof of "market power" for tying purposes. In *Dagher*, defendants own two trademarked "brands," Shell and Texaco—a label that is then taken to mean rival or "competing" goods, and is then applied to deem an agreement between their owners a forbidden "restraint of trade."

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¹⁷ Nos. 04-805 and 04-814.

¹⁸ *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49–50 (1977).

¹⁹ *Cf. Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984).

²⁰ As the amicus brief noted, the joint venture partners "could have agreed to market a single brand of [joint venture] gasoline at a fixed price, and their decision to maintain two brands at the same price" is functionally the same. Brief for the United States and the Federal Trade Commission, *Texaco v. Dagher*.

*FTC v. Schering-Plough*²¹

A very similar error underlies the Eleventh Circuit's decision in the *Schering-Plough* case, which the Commission hopes the Court will add to its error-correction docket. In *Schering-Plough*, the court assumed that a patent automatically gives a right to exclude competitors, disregarding the possibility that the competitor might be using noninfringing technology.

Schering-Plough sold a drug, "K-Dur 20," that was the most frequently prescribed potassium supplement. Its active ingredient, potassium chloride, is in common use and is unpatentable. But Schering owns a formulation patent, which will expire in 2006, that relates to the coating on the pills, providing an extended-release mechanism.

To fully understand the competitive dynamics of this case would require a fairly elaborate course in U.S. drug law. Suffice it to say that two companies, ESI and Upsher-Smith, each developed a generic version of Schering's K-Dur 20, and each certified to the FDA that its drug was a non-infringing bioequivalent of K-Dur 20. Schering filed two infringement actions opposing that entry, one against each company. Both infringement cases were settled.

The Commission held both settlements unlawful.²² To understand fully the nature of the disputed settlements would require another seminar in the complexities of the parties' negotiations and their final agreement. It is possible to skip over most of that as well, however, and focus only on the simpler of the two settlements, involving Schering and ESI.

The ESI settlement, reached in 1998, provided that ESI would not market any generic version of Schering's K-Dur 20 until January 2004. Among other terms, the agreement provided that Schering was to pay ESI \$10 million for this delay. Under the agreement, ESI was not entitled to the payment until it received FDA approval of its application to sell the generic. ESI received that approval, forewent entering the market, and Schering then paid ESI the \$10 million.²³

The Commission, after a lengthy administrative trial, held that this arrangement violated the antitrust laws. The evidence showed that Schering had expected to encounter generic competition before its patent expired in 2006. The evidence also showed that, following a well-established pattern of prescription drug pricing after generic entry, ESI's generic would be priced substantially below the branded drug, and that generic competitors (ESI and Upsher) would rapidly garner most of the market. Generic entry would thus save consumers tens of millions of dollars.²⁴

Schering-Plough argued that the challenged arrangement permitted ESI's entry more than two years before the Schering patent was to expire. (ESI settled separately with the Commission.)

²¹ *Petition for cert. filed*, Aug. 29, 2005. The Court has subsequently invited the Solicitor General to express the views of the United States (Oct. 31, 2005).

²² *FTC v. Schering-Plough Corp.*, FTC Docket No. 9297 (Dec. 18, 2003) (final order), available at <http://www.ftc.gov/os/adjpro/d9297/031218finalorder.pdf>.

²³ A second anticompetitive settlement was made between Schering and Upsher, with Upsher paid \$60 million to delay its entry. The parties created a fig leaf for themselves in that Schering received rights to an unrelated product that it could claim it valued at that sum. The Commission found that the payment was actually for delay, however, and the circuit court's refusal to accept that factual finding is another issue for certiorari.

²⁴ *FTC v. Schering-Plough Corp.*, FTC Docket No. 9297 at 16–23 (Opinion of the Commission), available at <http://www.ftc.gov/os/adjpro/d9297/031218commissionopinion.pdf>. In the recent past, generic competition following successful patent challenges to Prozac, Zantac, Taxol, and Plantinol alone is estimated to have saved consumers more than \$9 billion. *Generic Pharmaceuticals Marketplace Access and Consumer Issues: Hearing Before the Senate Commerce Committee*, 107th Cong. (Apr. 23, 2002) (statement of Kathleen D. Jaeger).

Therefore, Schering claimed, the settlement had the dual benefit of settling patent litigation and bringing more competition faster to the market.²⁵

The Commission held that, although the arrangements to delay entry were not per se unlawful, they caused significant anticompetitive effects. The key point in the Commission's analysis is the recognition, widely agreed to by those who specialize in the economics of patents, that the strength of a patent depends only in part on its expiration date. The probability that litigation will or will not lead the patent to be judged valid or, in this case, infringed, is also relevant. Therefore, a hypothetical settlement, in which the parties compromised on a time of entry without cash payments, would reflect the strength of the patent as viewed by the parties.²⁶

In some cases, the Commission held, the addition of a cash payment might still remain consistent with this efficient assessment of risk. For example, the patent holder might compensate the generic for its expected litigation costs. In the absence of some plausible efficient justification, however, a payment by the brand raises the question what the brand is receiving in exchange. The ESI case involved this more troublesome type of cash payment because there was no explanation for the \$10 million payment other than the agreed-upon entry date. The Commission found that the likely effect of the payment was therefore to delay entry by sharing monopoly profits with a potential challenger. The agreement was therefore anticompetitive because it caused substantial anticompetitive price effects while serving no discernible or conceivable procompetitive purpose—only the purpose of further delaying entry. Thus, the agency need not decide on the exact scope or effect of the patent. The agreement acted to *increase* the exclusionary effect, whatever the specific baseline starting point of that effect may have been, by acting to give the patent holder more exclusion than it expected to achieve from the litigation alone.

On review, a panel of the Eleventh Circuit reversed, finding that the agreement was not only unlawful, it was (virtually) per se lawful.²⁷ Why? Because of formalistic assumptions about the scope of a patent. The court of appeals reasoned that the agreed-upon entry date was prior to the expiration of the patent, and the settlement served the public purpose of bringing litigation to a close. Schering was entitled to the full exclusionary force of its patent, the court found, until an antitrust challenger met the burden of proving that the patent was invalid or not infringed. Absent such a showing, the settlement could not have anticompetitive effects, the court of appeals held, because it was within the exclusionary potential of the patent.

The Commission is seeking Supreme Court review of this decision.²⁸ About 30 years ago, Congress gave the FTC the authority to act on its own to seek certiorari, independently of the Solicitor General, in cases the Commission deems vital. Here, for only the third time, the Commission has exercised that authority.²⁹ The petition concisely explains the problems with the circuit court decision: (1) the decision fails to recognize how some agreements limiting entry during the term of a patent can still be improper; and (2) the decision jeopardizes particularly important consumer interests.

²⁵ *FTC v. Schering-Plough Corp.*, FTC Docket No. 9297 at 36–39 (Opinion of the Commission), available at <http://www.ftc.gov/os/adjpro/d9297/031218commissionopinion.pdf>.

²⁶ *Id.* at 79.

²⁷ 402 F.3d 1056 (11th Cir. 2005).

²⁸ No. 05-273.

²⁹ The other two cases were *FTC v. Superior Court Trial Lawyers' Ass'n*, 493 U.S. 411 (1990), and *FTC v. Indiana Federation of Dentists*, 476 U.S. 447 (1986). The Commission won both those cases, *Indiana Federation of Dentists* unanimously, and *SCTLA* through an opinion that was unanimous as to four of its six sections.

First of all, the circuit court decision is wrong for the same reason that *Independent Ink* and *Dagher* are wrong. Only an excessively formalistic approach would conclude that the effect of a patent is to exclude, until its expiration date, anyone else from making a competing product. For one thing, not all granted patents, when challenged, are found to be valid; in fact, 46 percent of those challenged in litigation are invalidated.³⁰ Indeed, in the pharmaceutical context in which *Schering* arose, an FTC study found that 73 percent of the brands lost their cases to challengers in disputes that reached a final decision.³¹ For another thing, infringement is not to be presumed. It must be proved by the patent holder, not disproved by a challenger.³² Otherwise, the holder of a single patent could harass and inflict damage on hundreds of rivals. For all these reasons, the court was wrong to rule that a payment to a patentee, accompanied by an agreement by the challenger to defer entry, could not support an inference that the challenger had agreed to the later date in return for the payment, especially if there was no other plausible explanation for the payment.

The court's formulaic approach did more than harm sound patent-antitrust doctrine. It also put important consumer interests at risk. This decision would give virtual carte blanche to owners of branded drugs who enjoy market power to buy off their potential rivals by offering them a better deal: share in monopoly rents rather than earn competitive rates of return, while leaving consumers to pay ever higher drug prices. The stakes are high. Of the 20 top-selling prescription pharmaceuticals in the United States, today, 11 drugs, with combined annual sales of nearly \$25 billion, have been involved in brand-generic patent litigation this year. These include such well known products as Lipitor, Neurontin, and Celebrex. In all these cases, the generic manufacturers would be better off—if it were legal—to split monopoly rents with the brand company rather than compete. But the gains for the parties' agreement are the consumers' loss. If left on the books, the *Schering* decision will give pharmaceutical companies unwarranted reason to think that they are now free to buy off those generic competitors.

Courts understandably would like to see patent litigation settled rather than tried, but the antitrust laws provide no exception for anticompetitive settlements, patent suit or not.

Conclusion

We need to be careful with abstract constructions. It is not correct that merely because two products have different brand labels that they are in competition with one another. *Dagher*. It is not correct that a patent, which confers a right to exclude, therefore also confers an economic (or antitrust) monopoly on its holder. *Independent Ink*. And it is equally incorrect to assert that the expiration date of a patent suitably measures its exclusionary potential. *Schering-Plough*.

Antitrust enforcement cannot be premised on such constructs, divorced from the economic realities of the particular marketplace to be examined. This term presents the Court with an opportunity to re-affirm what it has said in cases like *Sylvania*. The antitrust laws are a consumer welfare prescription, and it is the economic effects of commercial practices that bear on that welfare, not the formalistic legal labels under which the parties may operate outside the antitrust arena. ●

³⁰ See John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q.J. 185, 205–06 (1998).

³¹ FEDERAL TRADE COMM'N, *GENERIC DRUG ENTRY PRIOR TO PATENT EXPIRATION: AN FTC STUDY 19–20* (July 2002), available at <http://www.ftc.gov/os/2002/07/genericdrugstudy.pdf>.

³² See *Kegel Co. v. AMF Bowling*, 127 F.3d 1420, 1425 (Fed. Cir. 1997); *Wolverine World Wide v. Nike, Inc.*, 38 F.3d 1192, 1196 (Fed. Cir. 1994).

Evaluating the Competitive Effects of Exclusive Dealing Agreements

An ABA Section of Antitrust Law and ABA Center for Continuing Legal Education Telesminar, in Cooperation with the Antitrust Section of the Houston Bar Association (Houston, Texas June 24, 2005)*

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ANTHONY CHAVEZ: Professor Calkins, would you like to start our program?

STEVE CALKINS: My assignment is the boring part. I do the history. The interesting material will be covered by those who come after me, so stay tuned.

For inspiration, I turned to *Antitrust Law Developments* and, in particular, the original, first edition, copyright 1975.¹ When I looked up exclusive dealing, here is what I found: The Supreme Court addressed exclusive dealing in 1949 in *Standard Stations*,² where it applied what is known as the “quantitative substantiality” test and held that foreclosure of 6.7 percent of a market is presumptively unlawful, at least where a sufficient number of rival firms employ similar exclusive contracts. A dozen years later, in *Tampa Electric*,³ the Court applied a different test keyed to the overall effect on competition (known as the “qualitative substantiality” test) and found no violation where the foreclosure was less than one percent. Finally, the issue arose in *FTC v. Brown Shoe*,⁴ in which the Court focused more on deference to the Commission than on substantive standards; illegality was found when “a significant number” of outlets were tied up. In *Brown Shoe*, 650 franchised dealers contracted to purchase “primarily” from the second largest shoe manufacturer.⁵

* Edited for publication.

¹ ABA SECTION OF ANTITRUST LAW, *ANTITRUST LAW DEVELOPMENTS* 43–46 (1975).

² *Standard Oil Co. v. United States*, 337 U.S. 293 (1949).

³ *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961).

⁴ *FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966).

⁵ *Brown Shoe Co.*, 62 F.T.C. 679, 714 (1963), *rev'd*, 339 F.2d 45 (8th Cir. 1964), *rev'd*, 384 U.S. 316 (1966).

Amazingly enough, since 1975 (when that book was written), no Supreme Court holding has addressed exclusive dealing.⁶ The Supreme Court has not changed any of the Black Letter law. Just as with merger law, the Supreme Court has been largely missing in action. And yet, just as what we think of as the prevailing law of mergers differs radically from the law circa 1975, so too the prevailing law of exclusive dealing differs substantially from where it was in 1975.

That was brought about through a concurring opinion followed by a series of lower court decisions. In her *Jefferson Parish* concurrence,⁷ Justice O'Connor observed that exclusive dealing "may be substantially procompetitive by ensuring stable markets and encouraging long-term, mutually advantageous business relationships." She cited *Standard Stations* as holding that such contracts are problematic "only when a significant fraction of buyers or sellers are frozen out," and then expressed no concern about an exclusive arrangement involving a hospital with a 30 percent market share. Contrast that with the 6.7 percent in *Standard Stations*. And, indeed, since *Jefferson Parish*, the consistent theme in lower court exclusive dealing cases has been that the defendant almost always wins.

Over time, the minimum foreclosure required to suggest possible illegality has gradually increased. Nowadays, you can find cases saying that the plaintiff has to set out a 20 percent foreclosure, or a 30 percent foreclosure, or a 40 percent foreclosure, or a 50 percent foreclosure—the numbers are dramatically higher than they used to be. It is rare to find a court troubled with less than 30 percent foreclosure, and a number of courts say that the standard minimum is 40 percent.

But more than mere numbers have moved. Today, as Judge Boudin wrote for the First Circuit, "while low numbers make dismissal easy, high numbers do not automatically condemn but only encourage closer scrutiny."⁸ In other words, we still live in a world of numerology, where numbers are terribly important—but whereas numbers used to do a lot for plaintiffs' lawyers, now they do a lot only for defendants' lawyers.

Courts have credited several different factors in deciding to uphold (often through summary judgment) exclusive dealing arrangements involving claims of quite substantial foreclosure. Perhaps the most frequently cited factor has been the length of the restriction, with a number of courts suggesting that any contract of one year or less is presumptively lawful. Other decisions emphasize ease of termination, with some courts indicating that any contract terminable on relatively short notice is lawful (in terms of exclusive dealing).⁹ Beyond these two factors, courts attempt to examine the actual effect of a restriction, and give attention to factors such as industry concentration, entry barriers, alternative ways of reaching customers, the extent of power of the firms involved, and justifications for the restriction. It is a full-blown rule of reason analysis, as suggested by *Tampa Electric*, and now made real through litigation in the lower courts. We have reached a very different world indeed.

Ironically, exclusive dealing is one of the unusual antitrust violations in that it is covered by three different statutory provisions. Today, it is most commonly evaluated under Sherman Act Section 1, as an agreement possibly in restraint of trade. Congressional concern about the practice led

⁶ Cf. ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 214–28 (5th ed. 2002). For a modern discussion of exclusive dealing, see Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L.J. 311 (2002).

⁷ *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 45 (1984) (O'Connor, J., concurring).

⁸ *Stop & Shop Supermarket Co. v. Blue Cross & Blue Shield*, 373 F.3d 57, 68 (1st Cir. 2004).

⁹ See, e.g., *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000); *Omega Envtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157 (9th Cir. 1997).

to the more specific, detailed prohibition in Clayton Act Section 3. Finally, it can be found to be a means of monopolization or attempted monopolization and condemned under Sherman Act Section 2. Yet think for a minute about where we have come. In particular, consider what happened in three cases—*Microsoft*,¹⁰ *LePage's*,¹¹ and *Dentsply*.¹² In the *Microsoft* trial court, the Justice Department lost its Section 1 exclusive dealing count because (the court ruled) rivals were not totally excluded from reaching customers.¹³ The Department did not appeal from that setback, but relied instead only on its monopoly claim.¹⁴ In *LePage's*, the plaintiffs lost at trial on exclusive dealing and did not appeal (they won on Section 2). And then in *Dentsply*, the Justice Department lost on exclusive dealing at trial¹⁵—again, the court found that there were alternative ways of reaching customers—and the government did not appeal that setback either, appealing only on Section 2.

Has the law evolved such that any arrangement that does not violate Section 2, as monopolization or attempted monopolization, is lawful?

—STEVE CALKINS

We have arrived at a position where one can ask with seriousness: Is there anything to Clayton Act Section 3's treatment of exclusive dealing? For that matter, need one ever consider exclusive dealing under Section 1? Has the law evolved such that any arrangement that does not violate Section 2, as monopolization or attempted monopolization, is lawful? I look forward to the thoughts of my co-panelists.

ANTHONY CHAVEZ: Now we are going to find out if Joe agrees with that assessment on the likelihood of success by plaintiffs in pursuing these actions.

JOE GRINSTEIN: I am here to represent the plaintiff's perspective on these cases. I feel a bit like a defendant here, however, because I have to defend the proposition that these cases actually have some merit for plaintiffs. Of course, I think they do. And so, I would invite everyone to view these cases from a plaintiff's perspective through the lens of a recent trial that occurred in Los Angeles called *Masimo v. Tyco*.

Masimo was filed in May 2002 by my law firm, Susman Godfrey. It is a case that challenged exclusionary contracting practices in the medical device industry, whereby a medical device monopolist—that is, Tyco—entered into contracts with medical middlemen—called Group Purchasing Organizations (GPOs)—in the pulse oximetry market. Pulse oximetry devices are instruments that monitor your oxygen level when you are in the hospital.

Masimo was brought under Section 1 and Section 2 of the Sherman Act and under Section 3 of the Clayton Act. The court denied Tyco's summary judgment motion in June 2004.¹⁶ The trial occurred in Los Angeles in February and March of 2005, and the jury returned a pre-trebling ver-

¹⁰ *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) (en banc).

¹¹ *LePage's v. 3M*, 324 F.3d 141 (3d Cir. 2003), cert. denied, 542 U.S. 953 (2004).

¹² *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181 (3d Cir. 2005), petition for cert. filed, 74 U.S.L.W. 3162 (U.S. Sept. 14, 2005) (No. 05-337).

¹³ *United States v. Microsoft Corp.*, 87 F. Supp. 2d 39, 51–54 (D.D.C. 2000), aff'd in part, rev'd in part, 253 F.3d 34 (D.C. Cir. 2001).

¹⁴ Brief for Appellees United States and the State Plaintiffs at 77, *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) ("The government believes that the court's total-exclusion test demands far more than the law requires, but it had no occasion to appeal that ruling because the court's Section 2 remedy provides full relief from the challenged conduct.")

¹⁵ *United States v. Dentsply Int'l, Inc.*, 277 F. Supp. 2d 387, 448–51 (D. Del. 2003), rev'd, 399 F.3d 181 (3d Cir. 2005), petition for cert. filed, 74 U.S.L.W. 3162 (U.S. Sept. 14, 2005) (No. 05-337).

¹⁶ *Masimo Corp. v. Tyco Health Care Group, L.P.*, No. CV 02-4770, 2004 U.S. Dist. LEXIS 26916 (C.D. Cal. June 9, 2004) (granting in part and denying in part defendants' motion for summary judgment); see also *Masimo Corp. v. Tyco Health Care Group, L.P.*, No. CV 02-4770, 2004 U.S. Dist. LEXIS 26915 (C.D. Cal. Dec. 15, 2004) (denying defendants' second motion for summary judgment).

dict of \$140 million against Tyco. Sadly, I wasn't on that trial team, but I'm going to gloat about that result nonetheless. The jury's verdict obviously is subject to trebling to \$420 million, although post-trial proceedings are under way right now, so final judgment has not yet been entered.

The *Masimo* plaintiff focused on several exclusionary contracting practices. First, it challenged contracts Tyco had with the GPOs that were referred to as "sole-source" contracts. These sole-source contracts restricted the GPOs from purchasing pulse oximetry products from anyone other than Tyco. Second, the case also focused on features of these GPO contracts known as "market share compliance," which essentially dictated that hospital members of these GPOs would receive better pricing from Tyco based upon the percentage of pulse oximetry products that they purchased from Tyco. Third, the case focused on bundling, wherein Tyco gave better prices to GPO hospital customers on unrelated Tyco products if they achieved a certain market share in pulse oximetry products. And there were a few other features of the challenged GPO contracts which I will not discuss in as much detail.

The plaintiff *Masimo* challenged each of those practices individually, and it also lumped them together into what everyone likes to call the monopoly broth. *Masimo* is instructive as a plaintiff's model for a variety of reasons. First, it reflects many of the recent themes that plaintiffs emphasize in the case law. Second, there are other cases in the medical device industry based on very similar contracting practices. To name a few, plaintiffs secured a \$521 million verdict in a case called *Kinetic Concepts*¹⁷ in 2002. The *Retractable Technologies*¹⁸ case settled last year for \$100 million. And there is a similar case that I am handling right now called *Applied Medical Resources v. Johnson & Johnson*¹⁹ that again focuses on these GPO practices. Third, *Masimo* is instructive because there are similar practices being challenged in other industries and other portions of the health care industry, particularly in the pharmaceutical realm.

I will discuss four themes for plaintiffs that we can discern from the *Masimo* case: (1) the focus on the "middlemen," (2) the loyalty discounts, (3) the bundled contracts, and (4) the importance of the jury instructions.

First, "attacking the middlemen" is a very hot area in the law now. From a plaintiff's perspective, a lot of the current focus is not so much on monopolist contracts with end users, but rather on monopolist contracts with distributors who then pass on those contracts or the effect of those contracts to the end users. For example, *Masimo* focused on the contracts that Tyco had entered into with GPOs, which were entities that arranged global purchase contracts for their hospital members. *Masimo* pointed out that these contracts were sole-sourced and that therefore they gave GPO hospitals a choice only to purchase from Tyco.

Tyco had several responses to this argument at summary judgment and at trial. One response was that the contracts Tyco had with GPOs were "easily terminable"—according to Tyco, they could be canceled without cause within 90 days. Tyco also argued that *Masimo* did not have to use GPOs to distribute its products; it could always sell directly to hospitals. And, in many defendants' minds, Tyco's arguments here were very well taken. There is a line of case law—for example, the *Gilbarco*²⁰ case out of the Ninth Circuit—that frowns upon exclusive dealing cases that

¹⁷ *Kinetic Concepts, Inc. v. Hillenbrand Indus., Inc.*, 262 F. Supp. 2d 722 (W.D. Tex. 2003).

¹⁸ *Retractable Techs. v. Becton Dickinson & Co.*, No. 01-CV-036 (E.D. Tex. filed Jan. 29, 2001).

¹⁹ *Applied Med. Res. Corp. v. Johnson & Johnson, Inc.*, No. 03-CV-1329 (C.D. Cal. filed Sept. 5, 2003).

²⁰ *Omega Evtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157 (9th Cir. 1997).

involve exclusive contracts with distributors and certainly picks up the theme that contracts terminable on short notice are not contracts that support an exclusive dealing claim.

STEVE CALKINS: Joe, let me press you for a minute on that. A number of cases suggest that contracts with distributors are less of a concern than contracts with ultimate customers because producers may be able to circumvent distributors and reach ultimate customers in other ways.²¹

JOE GRINSTEIN: That is definitely right and it is something that a plaintiff has to consider. The response to that is best illustrated by the *Dentsply* case, which acknowledged the reality that a firm that ties up the key dealers really rules the market. So the plaintiff's response to this issue is to argue that there may be "alternative means of distribution," but if you have a case where, for example, GPOs dominate the distribution market, then tying up the GPOs amounts to tying up the market. The other response to these sorts of arguments is that the alleged "ease of termination" feature in contracts is sometimes a feature that is a little overblown. What should matter is not so much the words in the contracts, but rather whether or not the contracts are really easily terminable in practice. That is part of the basis by which *Masimo* got past summary judgment on that point.

STEVE CALKINS: But were the contracts easily terminable? How did you handle that issue?

JOE GRINSTEIN: From the plaintiff's perspective, the "easily terminable" point is one of the defendant's weakest arguments because one has to assume there is something anticompetitive going on that is making customers or distributors enter into these contracts in the first place. After all, by their very nature, every exclusive dealing contract or arrangement is a voluntary arrangement. Unless you have a situation where a monopolist is holding a gun to someone's head, they are all voluntary arrangements. So the same anticompetitive pressures that cause someone to enter into one of these contracts "voluntarily" are going to be the same pressures that keep them in the contracts—despite nominal contractual language that might say you can get out of them at any time. So the most damaging evidence that a defendant might bring to bear against a plaintiff in such a case is not so much proof that the contracts on their face are easily terminable, but instead proof that in practice people actually do terminate them.

A second plaintiff's theme reflected in the *Masimo* case is the challenge to "loyalty" discounting. The hospitals in the *Masimo* case received additional "discounts" if they purchased 90 percent or more of their pulse oximetry product from Tyco. So those discounts were not based on volume, but rather on market share. If challenged, of course, Tyco and every other defendant in a similar situation will respond with the obvious procompetitive justification that there is nothing wrong with loyalty discounting—after all, the best customer should get the best pricing. So how do plaintiffs reply? One strategy is to redefine the terms. It is important to ask why would you call loyalty discounting "discounting" in the first place? Isn't giving someone a better price if they buy 90 percent or more of your product really the same as saying you are going to penalize somebody if they buy less than 90 percent of your product? In fact, in the *Masimo* closing argument, the plaintiff showed a very powerful demonstrative to the jury which recited examples from Tyco's documents where Tyco itself called this pricing structure a "penalty" structure, not a "discounting"

²¹ See, e.g., *CDC Tech., Inc. v. Idexx Labs., Inc.*, 186 F.3d 74, 80 (2d Cir. 1999) (quoting *Gilbarco*, 127 F.3d at 1163).

structure. Another response to this argument is, why reward your best customers with a “loyalty” discount? Why not do it instead through a less restrictive alternative like a volume discount?

STEVE CALKINS: Are you saying that a loyalty discount that results in 90 percent patronage is worse than a regular exclusive dealing arrangement? A regular exclusive dealing arrangement results in 100 percent patronage, doesn't it? You seem to be suggesting that a loyalty discount keyed to 90 percent has an air of sleaziness about it that makes it worse than regular exclusive dealing. Is that where you are coming from?

JOE GRINSTEIN: In a way. A 90 percent market share compliance contract that effectively forces customers to purchase 90 percent or more of their requirements from a single supplier fits within the case law that recognizes de facto exclusive dealing arrangements. And this is particularly true in a situation like the medical supply/medical device industry, where hospitals like to standardize and make sure that their doctors are trained on one type of device. If hospitals are forced to buy 90 percent or more from one supplier, then they are going to be somewhat unwilling to buy their remaining 10 percent from another competitor.

ANTHONY CHAVEZ: Joe, are you using the term “force” to refer to the rebates and incentives?

JOE GRINSTEIN: Yes. And you can redefine the terms any way you want. A “typical” exclusive dealing arrangement might involve a contract that says you will buy 100 percent of your needs from me, and if you buy 100 percent of your needs from me, then this is the price you will get. A monopolist might enforce that contract by suing someone for purchasing from a competitor, and if the monopolist sues someone for violating that contract, then that customer is going to have to pay damages or face similar remedies. Now think about it from the perspective of a “discount” contract. The threat in that sort of a contract is not so much that the monopolist will sue and collect damages, but rather that the monopolist extracts a penalty on the front end by charging a customer more for these products if that customer does not remain “loyal.” So one key to these cases for plaintiffs is not to get caught up in labels—“this is this kind of a contract,” “this is that kind of a contract”—but rather to delve into the economic substance of the contract.

ANTHONY CHAVEZ: Continuing on with that aspect, your claim in *Masimo* was brought under Sections 1 and 2 of the Sherman Act and Section 3 of the Clayton Act. Professor Calkins commented that the focus seems to have been in recent years on Section 2 of the Sherman Act. Do you see the degree of required foreclosure differing under the three statutes?

JOE GRINSTEIN: The case law is pretty unclear on that. I would say that the degree to which you have to prove foreclosure probably differs among the three statutes. Section 2 is a little easier because you are not necessarily within the rule of reason analysis. The *Microsoft* decision suggested that a Section 2 foreclosure finding can be made at something less than is required for Sections 1 or 3. Although when *Microsoft* said that, the court was talking about a Section 1 and 3 foreclosure percentage at 40 percent or 50 percent. So there is no bright line number in Section 2, but it is legitimate to say the number is probably less than Section 1 or Section 3.

ANTHONY CHAVEZ: Professor Calkins, do you have an opinion on whether or not the degree of foreclosure should differ among the three statutes?

STEVE CALKINS: I am not sure that it does differ because I am not sure there is much left of Section 1 or Clayton 3 in a lot of courts. But I agree with Joe that at least in theory a smaller amount of foreclosure should trigger concern about a monopolist than about a firm with less market power.

JOE GRINSTEIN: The third plaintiff's theme from the *Masimo* case, which is important, was Masimo's attack on the practice of bundling. In the *Masimo* case, Tyco did not only say that if you purchase more than 90 percent of your pulse oximetry products from us, you will get a better price on those pulse oximetry products, but it also said that hitting 90 percent on pulse oximetry products would entitle customers to "discounts" on a whole slew of unrelated products. And obviously that creates an enormous incentive on the customer's part to hit that 90 percent, because otherwise not only would the customer face higher prices on pulse oximetry, it would also face higher prices on all the other Tyco products it might be buying. It is important to say that this is not necessarily a tying theory from the antitrust law perspective, but from an economic perspective it is similar. So bundling can be very important to a plaintiff's case. Indeed, many of the recent appellate opinions that are friendly to plaintiffs have an aspect of bundling to them—most notably the *LePage's* case from the Third Circuit. Moreover, exclusive dealing cases that are not friendly to plaintiffs—for example, the *Concord Boat*²² case from the Eighth Circuit—seem to leave room for finding liability in the situation in which the monopolist is bundling. So one of the more important themes plaintiffs should bring out in these types of cases is any notion that the monopolist might be bundling the product at issue with other products for which the plaintiff would not be able to compete.

So the lesson to take away from the Masimo case is that the exclusive dealings world is not completely bleak for plaintiffs, as a pre-trebling \$140 million verdict just a couple of months ago proves.

—JOE GRINSTEIN

The last thing I want to mention with respect to *Masimo* is the importance of jury instructions. One of the lessons we like to give to new associates at my firm is that one of the very first things you should do in a case is draft the jury instructions. It is not something you should leave until three weeks before trial. Instead, if you have your jury instructions from the beginning, you get a much better understanding of what you are going to need to prove in the case and how hard it is going to be to win at trial. That is sage advice in these exclusive dealing cases. The *Masimo* jury instructions were very helpful to a plaintiff's case, and of course, they come straight from the case law, so other defendants should be seeing something similar.

Among the things that the jury instructions in the *Masimo* case made clear was that exclusive dealing arrangements do not need to require a 100 percent commitment from the customer. They explained that there can be de facto arrangements that essentially require exclusive dealing if not expressly requiring 100 percent commitment. The instructions also made clear that the jury is supposed to consider the impact of the monopolist's market power on all of its various activities, and that the monopolist cannot defend itself by saying that the non-monopolist undertakes the same conduct too. At least from a Section 2 perspective, there is conduct that monopolists can undertake that might be improper under Section 2, but which a non-monopolist is otherwise free to pursue. That concept was right in the *Masimo* jury instructions.

So the lesson to take away from the *Masimo* case is that the exclusive dealings world is not completely bleak for plaintiffs, as a pre-trebling \$140 million verdict just a couple of months ago proves. Well-constructed cases will get past summary judgment and will get to the jury, and when they do, jury instructions like the *Masimo* jury instructions can create some serious liability issues for defendants.

²² *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000).

ANNE RODGERS: That was a very sizeable verdict you got in *Masimo*. Do you think that was because the case arose in the health care context, i.e., the doctors and the patients were being deprived of choices? Would the result have been quite as good for you in a context where the jurors might not react so personally to the case?

JOE GRINSTEIN: It is hard to say what a different case would look like, but I will say that the health care aspect of the *Masimo* case was very, very powerful. *Masimo* had very strong evidence that its pulse oximetry products were better technologically than Tyco's pulse oximetry products. That fact supported the element of anticompetitive effect that *Masimo* had to show, because it demonstrated an injury to competition through the denial to consumers of life-saving products.

ALISON SMITH: I am here to present the defendant's perspective on these cases, and, not surprisingly, my view is that defendants not only normally win these cases, but that they *should* win them. Under both law and economics, these arrangements are presumptively lawful. That means that their potential for procompetitive effects greatly outweighs their potential for harm, so consumers are better off if defendants can employ these common tools in distributing and selling their products.

Let's talk about some of the procompetitive benefits that have been recognized as resulting from exclusive dealing. In defending cases like this, there should be no end to the defendant's consideration of ways these contracts help consumers. *Standard Stations* told us early on that, for the seller of the product, an exclusive dealing arrangement can reduce the cost of marketing and distributing its product. It therefore reduces transaction costs, which means that consumers are benefiting. Exclusive dealing also avoids the seller's need to vertically integrate into distribution and therefore makes the market more free.

Standard Stations also says that buyers are helped by exclusive dealing. A buyer can ensure a steady supply of input at a known cost by entering an exclusive dealing arrangement with a supplier and therefore protect against price increases. It also can avoid the transaction costs involved in making repeated buying decisions and the need to hold a large inventory. So it is frequently the buyer who initiates an exclusive dealing arrangement. What else can an exclusive dealing arrangement do? It can, through precommitment, help a seller enter or expand in the market. Sometimes entry seems like a highly risky proposition to the seller. One way to reduce that risk is to enter a requirements contract with a buyer for its purchase of the seller's product and thereby guarantee a market. The seller is more willing to enter the market. This means more competition and consumers are benefited.

For years, we have understood the value of exclusive dealing in the dealership context. The seller's ability to offer exclusivity to a dealer can help ensure brand loyalty. For example, why, if you are a seller, would you want your dealer to offer your competitor's product against you? Exclusive dealing is thus one way to facilitate the distribution of your product. And it can also help ensure that your dealer will make the necessary investments so that it will adequately sell and distribute your product. Exclusive dealing is a way to reduce the problem of free riding among distributors, which arises when one distributor invests in the seller's brand and markets and explains the product to consumers, but loses the sale when the consumer walks next door to a no-frills dealer who wins the business simply on price. Free riding is not in the interests of the seller and, ultimately, it is not in the interests of the buyer.

Exclusive dealing can also protect the seller's trade secrets. Imagine this scenario: if you distribute through a dealer who is handling competing products, you have to worry that, if you

announce a new product innovation, the dealer is going to use that information against you in furthering the interests of the competing seller. A similar problem occurs with customer lists. You give your customer list to your dealer, but that dealer uses the same customer list to solicit business for the competing brand. Finally, exclusive dealing actually encourages interbrand competition. That is, if a seller enters an exclusive arrangement with a particular dealer, that deal will encourage other dealers to enter exclusive contracts with other manufacturers, thus increasing distribution and sale of the product.

All that said, exclusive dealing contracts are not always procompetitive. Their benefits do not mean that defendants should always win these cases, although they should normally do so. Anticompetitive effect is possible. If sellers at the upstream level enter into downstream exclusive dealing, there is a risk that upstream competitors will be foreclosed from reaching their downstream market—either customers or dealers. And under some circumstances, very limited circumstances, that can harm competition. Hovenkamp gives an example, derived from *Brown Shoe*, of the shoe manufacturer who requires all the independently owned shoe stores in town to enter exclusive deals.²³ When the customer goes shoe shopping, she will only find the shoes of that particular manufacturer. Does that necessarily harm competition? Only under certain circumstances.

In exclusive dealing cases that the defendants have lost, the defendants have frequently conceded monopoly power in the upstream market.

If you are defending such a case, you have a lot of arrows in the quiver to shoot down the plaintiff's case and many things to consider in developing your defense. First, the upstream market may not be concentrated. If, for example, there are 20 shoe manufacturers, no one manufacturer can impose an unwanted exclusive dealing arrangement on a retail outlet. Why? Because that retail outlet will want to buy input for as low a price as possible and will simply contract with another supplier if it can't get the deal that it wants. If the upstream market is not concentrated, a defendant is way down the road towards a successful defense in these cases. In exclusive dealing cases that the defendants have lost, the defendants have frequently conceded monopoly power in the upstream market. *Microsoft*, *Dentsply*, and *LePage's* are examples of that, or at least examples of cases in which a concentrated upstream market was found. Given what we are now seeing in the Section 2 cases, it would be a very foolish move on the part of any defendant to concede monopoly power.

—ALISON SMITH

Second, the downstream market may not be concentrated. Suppose there are numerous outlets, numerous dealers. If so, the upstream rival is not foreclosed from anything. There may be existing outlets or there may be potential outlets that now exist but are simply not carrying the product. For example, in the *Brown Shoe* situation, suppose there were department stores that did not sell shoes. Why couldn't they just add shoes to their inventory? Defendants win these cases too if there is ease of entry, either at the manufacturer or the retail level. That was what *Concord Boat* held. The manufacturer simply cannot tie up distribution through exclusive dealing if a rival at its level can enter and establish its own distribution network.

ANTHONY CHAVEZ: Was the *Masimo* case one of those rare cases where there was an anticompetitive effect or did the court just misapply the law?

ALISON SMITH: I can't say that the *Masimo* court necessarily misapplied the law, but it did use a standardless methodology to determine whether the defendant's conduct was exclusionary. It

²³ 11 HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 1802E (2d ed. 2005).

gave the fact-finder no guidance, and just asked the vague question whether the conduct excluded rivals on some unnecessary basis.

ANTHONY CHAVEZ: From your perspective, should the *Masimo* case have been submitted to a jury?

ALISON SMITH: If the plaintiff had shown that there was an absence of procompetitive justification for the conduct, there might have been a jury question. But a procompetitive basis for exclusive dealing ordinarily exists in most of these cases, so they should usually be won by the defendant on summary judgment.

STEVE CALKINS: Anthony, it is interesting to contrast *Masimo* with the *JBDL* opinion by the Southern District of Ohio.²⁴ The court in *JBDL* specifically disagreed with *Masimo*, writing that “[t]his Court of course is not bound to adopt the reasoning of the California district court, and it is not inclined to do so.” The *JBDL* court objected to *Masimo*’s relying on *LePage’s* (which it also disparaged). Picking up on Alison’s theme, the *JBDL* court is uncomfortable about entrusting a “monopoly broth” to a jury. Thus, we have a nice, sharp disagreement between two geographically distant district courts.

ANTHONY CHAVEZ: That is precisely what I wanted to highlight by my question; the tension in the results in these cases and in the analysis used in deciding whether to grant or deny defendant’s motion for summary judgment.

ALISON SMITH: There is tremendous tension in the law, as those two decisions well illustrate. The source of the new exclusive dealing cases against defendants is *LePage’s*, which is a wretched opinion that came out of the Third Circuit. I don’t think *LePage’s* will survive, at least in the form that it is written.

Continuing on the defensive themes, Joe mentioned that one of the threshold questions is whether the conduct or contract is actually exclusive. In many cases, a defendant can show that the contract is not exclusive in nature—it may only be a partial requirements contract, or maybe only for a fixed volume. There may only be incentives to deal exclusively or simply incentives to buy the product. Those generally won’t foreclose the market.

Joe described these incentives to deal exclusively as “penalties,” but another way of looking at it is that the seller is reducing price to the buyer, which consumers really ought to like. So even if there is an exclusive contract, it is still perfectly fine if it does not substantially foreclose competition. Also important, the contract may be of short duration or terminable on short notice. Many courts hold that contracts of a short duration, perhaps one year or less, are presumptively lawful because short exclusive contracts don’t preclude rival sellers from anything. If there is a sufficient number of exclusive contracts of short duration in the market, these contracts come up for renewal routinely and offer rival seller the opportunity to offer a better deal.

ANNE RODGERS: Alison, isn’t Joe’s point well taken that it is not what the contract says, but what the parties in the market actually do that the courts should look at?

²⁴ *J.B.D.L. Corp. v. Wyeth-Ayerst Labs., Inc.*, Nos. 1:01-cv-704, 1:03-cv-781, 2005 U.S. Dist. LEXIS 11676 (S.D. Ohio June 13, 2005).

ALISON SMITH: It is what they actually *can* do. I don't know that what they actually do is necessarily significant. People may continue under a relationship a long time because they like it and it serves their interests. The question for the court should be: "Is the contract, as a practical matter, terminable at will?"

ANTHONY CHAVEZ: Didn't the *Dentsply* case involve agreements that were terminable at will?

ALISON SMITH: *Dentsply* did say that—or tried to dismiss that the contracts at issue were terminable at will by saying that, in reality, they were not. But the court did not satisfactorily explain its reasoning. Now if a party to an exclusive contract cannot switch easily, or faces high switching costs, perhaps the contract is terminable at will only in theory.

STEVE CLAKINS: My recollection of *Dentsply*—and Bruce surely knows the case better than I—was that this was the ultimate judicial call to "get real." Yes, it was true that dealers legally could abandon *Dentsply*, the industry giant, to switch and carry some upstart line. Dealers were not bound to *Dentsply* by legal fetters, but the court concluded that economic ties were just as effective.²⁵

BRUCE McDONALD: *Dentsply* actually did not have exclusive contracts with the dealers. Instead, *Dentsply* had a policy of terminating dealers that dealt in its rivals' artificial teeth. But Alison's point is still made: the exclusive relationship theoretically could be ended quickly, by a dealer's deciding that he was going to buy somebody else's teeth, but in practice that never happened. So Steve is right about the thrust of the Third Circuit's decision: focus on the "market realities," which showed that *Dentsply*'s exclusionary policy made a significant contribution to preserving its monopoly, notwithstanding the presence of the kind of facts that often dispose of Section 1 exclusive dealing cases.

ALISON SMITH: Well, *Dentsply* is a very peculiar case. The court very unconvincingly described the market in which distribution was restrained. It was almost as though there was a snapshot of the current market without really looking at what the reasonable alternatives were. The court admitted there were literally hundreds of dealers in the market, but said that it was concerned only about the 23 key dealers—or what it called key dealers—tied up by *Dentsply*.

A couple more points before we talk about those cases. Under Section 1 and Section 2, contracts might not substantially foreclose the market unless they cover a fairly large percentage of the market. As Professor Calkins mentioned, the numbers have grown quite a bit now and, as *Microsoft* commented, to violate Section 1 or Section 3, foreclosure rates have to be in the neighborhood of 40–50 percent.

Another important consideration is whether the restraint operates in the distribution market as opposed to the end user market. There may be no concern at all if the restraint is at the distribution level because rivals may have a realistic opportunity to distribute their products through alternate distribution channels. Under those circumstances, the fact that a channel is tied up does not realistically harm their ability to reach consumers. And in many cases, a plaintiff who com-

²⁵ *Dentsply*, 399 F.3d at 194 ("[I]n spite of the legal ease with which the relationship can be terminated, the dealers have a strong economic incentive to continue carrying *Dentsply*'s teeth. Dealer Criterion 6 [which barred carrying a rival brand] is not edentulous.") (omitting foot-note distinguishing cases that upheld short duration exclusive contracts).

There are rather thoughtful, principled arguments that when a firm with a monopoly product bundles it with another product, such that no rival firm selling only the latter product has any hope of competing, and when the combined discounts on the bundled products are so large that they would amount to predatory pricing were they concentrated on the single competitive product, antitrust law has a role to play.

—STEVE CALKINS

plaintiffs about exclusive dealing is simply unwilling to compete. They complain about the exclusivity, but are not willing to counter in terms of offering their own better deal or finding their own distribution.

Finally, the biggest thing defendants have going for them is the procompetitive justification for these deals. We can talk about exclusivity all we want. We can talk about foreclosure all we want. But so long as the defendant has a legitimate reason for exclusive dealing, that reason goes a very, very long way toward successfully defending these cases.

Why are we concerned about exclusive dealing with all these great things in favor of the defendant? The reason is that the Department of Justice has brought a number of cases, or did not oppose Supreme Court review of private cases, that went in favor of the plaintiffs under Section 2. And that has resulted in a slew of private antitrust cases challenging exclusive dealing.

The first is *Microsoft*, which used the very loose Section 2 standard to determine whether the conduct was exclusionary. It specifically distinguished the Section 1 and Section 3 rule that requires exclusive dealing to result in a substantial foreclosure of 40–50 percent of the market and held that the amount of foreclosure could be less under Section 2. In *Dentsply*, the DOJ successfully challenged an exclusivity policy involving 23 dealers. That is, Dentsply imposed this policy on its 23 dealers prohibiting them from carrying competing products. But those contracts were terminable at will. There were literally hundreds of dealers in the market and rivals could and did distribute their products directly to the end user. Finally, the case of most concern is *LePage's*, in which the Third Circuit condemned bundling of rebates across multiple product lines. That was true even though the discounts were admittedly above the manufacturer's cost and the foreclosed plaintiff managed to hold on to 67 percent of the business.

What is common about all these cases? They are brought under Section 2 and are leveled at purported monopolists. The conduct was found illegal because it was exclusionary, and fact-finders were allowed to reach that conclusion without regard to the standards that would ordinarily govern exclusive dealing under Section 1 and Section 3. And because the standard was so ill-defined, jury risks are very real in these cases. The question is, will they survive? *LePage's* is strongly under attack now because it condemned conduct that was arguably procompetitive and because the court did not require the plaintiff to prove that the defendant's conduct was in any way anticompetitive.

ANTHONY CHAVEZ: By anticompetitive do you mean that they did not establish that they were selling below cost or the bundled rebates had the effect of being below-cost pricing?

ALISON SMITH: That is right. There was no evidence that 3M was in any way sacrificing profit or that its prices were predatory.

STEVE CALKINS: Alison, surely there is an argument for the plaintiff in *LePage's*. If you want to criticize the opinion, you ought to criticize its lack of clarity. But there are rather thoughtful, principled arguments that when a firm with a monopoly product bundles it with another product, such that no rival firm selling only the latter product has any hope of competing, and when the combined discounts on the bundled products are so large that they would amount to predatory pricing were they concentrated on the single competitive product, antitrust law has a role to play. The real frustration about *LePage's* is that none of this kind of thinking was sorted out, so it is hard to draw practical counseling lessons from the case. But it is not the case that a plaintiff only has to mention "bundling" in order to prevail.

ALISON SMITH: Certainly that is true, but in *LePage's*, there was no evidence of any predatory pricing. In fact, it was conceded that 3M's prices were above cost, so we don't have predatory pricing. Now maybe under the circumstances you describe, *LePage's* could be justified. But the court did not require *LePage's* to show that it could not compete. There was no evidence that it could not have offered a similar discount. There was no evidence that *LePage's* could not have joint ventured with rivals or manufacturers of products that it did not manufacture.

STEVE CALKINS: I am confident that plaintiffs' lawyers would say that what really happened is that defense counsel simply insisted that 3M was not pricing below cost, and left the ball there—and *LePage's* would argue that there was evidence that it was unable to compete because of the bundled rebate. But I certainly agree with you that the facts are quite unclear.

ALISON SMITH: So this is the bottom line from the defense perspective—I don't think anything has really changed. Defendants are still slated to win these cases, but there has definitely been a warning shot in the Section 2 arena. That Section 2 employs such a loose standard means a common and generally procompetitive practice plausibly can be challenged and possibly held unlawful.

ANTHONY CHAVEZ: Before we turn it over to Bruce, Alison has launched so many arrows out of her quiver towards the plaintiff's side, I think we should give Joe an opportunity to try to pluck some of them out.

JOE GRINSTEIN: I agree there is a lot of case law out there that is not pro-plaintiff. That being said, the one problem with defendants in these cases is—and I'm not criticizing Alison, of course—that they reflexively apply concepts in the case law without appreciating the underlying economic substance of the contracts at issue. For example, in cases like *Masimo*, the issue really wasn't whether or not Tyco was discounting its product below cost. In fact, the issue was the exact opposite: the extent to which a monopolist is supracompetitively pricing its products and achieving monopoly rents. Whether or not a "discount" is a good thing in theory, is a discount really good thing if it is a discount off a price that is supracompetitively inflated?

The same principle applies to the ease of terminability of the contract. Again, that a contract says it is terminable in 90 days does not mean that as a practical matter it is terminable in 90 days. For example, in these bundling-type situations, a customer surely could walk away from a contract in 90 days and wash its hands of the contract and go purchase its tape from *LePage's*, but if it did that it would start paying enormous price penalties on other products that *LePage's* did not make. So while there might have been a contractual, legal ability to walk away under the contract, as a practical business matter, there was not an ability to do that. Thus, the way plaintiffs have to respond to these sort of legal challenges is to be creative and to focus on the economic substance of the challenged practice, rather than getting tied up in the broad platitudes of the case law.

ALISON SMITH: Although it does strike me as odd to say that it is anticompetitive to reduce price. And that is effectively what you have said.

JOE GRINSTEIN: My response to that is the vehicle of the foreclosure is not as important as whether or not there is foreclosure. If what a monopolist is doing through the maintenance of its monopoly—and we are talking Section 2 here, of course—is charging supracompetitive prices to peo-

ple who do not comply with its conditions, then its exclusive dealing arrangements would really be offering “discounts” off prices that should not be as high as they were in the first place. There is some anticompetitive concern there.

ANTHONY CHAVEZ: But whether the monopolist allegedly has supracompetitive prices is not by itself actionable, and for predatory pricing under Section 2, the law is well-developed that below-cost pricing is required.

JOE GRINSTEIN: I do not think the analysis of these cases is proper under the predatory pricing framework. I think the example is a good one—calling these things discounts is simply a concession to the defendant. What you really could call them is pricing penalties—unless you enter into this exclusive dealing arrangement, I am going to charge you more. So that takes that out of the realm of discounting below cost, and takes it into the realm of penalizing people for not entering into arrangements that feature exclusivity.

ANTHONY CHAVEZ: Bruce, we are ready to turn it over to you and we will revisit some of these issues as we go along.

BRUCE McDONALD: Providing the government perspective here, I may take a middle way between Alison and Joe. I agree with Alison’s observation that exclusive dealing arrangements are usually lawful, they have many procompetitive benefits, and it is difficult for a plaintiff to prove either a Section 1 or Section 2 violation, especially where there are other avenues for rival manufacturers to get to consumers. I am also a little sympathetic with Joe, because it certainly is not true that exclusive dealing is always lawful. An exclusive dealing contract or a series of contracts may foreclose enough of the market that rival manufacturers cannot get to customers and it can become non-competitive and consumers lose competitive choices. The basic outlines in exclusive dealing cases continue to be viable. It is just that there probably are not very many exclusive dealing arrangements that actually meet the requirements.

I should contrast the traditional exclusive dealing case with the cases the government has brought in recent years. Those cases have been characterized as exclusive dealing cases, but do not fit the traditional mold. The traditional mold includes some of the cases we have been discussing, maybe *Masimo*, including *Gilbarco*, which Joe mentioned. In that very typical exclusive dealing case, the manufacturer of petroleum-dispensing equipment had exclusives with 24 percent of the distributors, which represented about 38 percent of the market. Those started to get to be large numbers for that case brought in the 1990s, but direct sales were definitely an alternative. Further, there were other companies that were well-suited to become distributors and, going back to a couple of Alison’s key factors, the contract terms were only one year and terminable within 60 days. The Ninth Circuit reversed a jury verdict for the plaintiff.

*Roland Machinery*²⁶ is another classic exclusive dealing case under Clayton Act Section 3. Judge Posner authored the decision. One of the key reasons he rejected the claim is that there was no agreement. The plaintiff made the mistake of arguing that there was a “secret” agreement implicit in the policy that the manufacturer imposed on his construction equipment dealers. A secret agreement is no agreement at all. And Judge Posner went on to make the point that it was

²⁶ *Roland Mach. Co. v. Dresser Indus., Inc.*, 749 F.2d 380 (7th Cir. 1984).

unlikely that this exclusion would have the necessary anticompetitive effect. The new manufacturer that wanted to sell through the plaintiff dealer could enter the market through any dealer because no dealer had a real long-term exclusive contract. Further, the new manufacturer ought to be able to get in by setting up his own dealers.

In these classic exclusive dealing cases, *Gilbarco* and *Roland Machinery*, and in others, such as *CDC Technologies*,²⁷ the factors Alison outlined usually are the key to the defendant's winning.

STEVE CALKINS: Bruce, let me follow up on that. The government has not filed an exclusive dealing case in a long time. The DOJ and the FTC have not filed a Section 1 or Section 3 exclusive dealing case in the past five years, and not many had been filed before that, either. Can you imagine the current administration's ever filing a Section 1 or Section 3 exclusive dealing case that was not also a Section 2 case?

BRUCE McDONALD: Certainly there is no policy to limit pursuit of exclusive dealing violations under Section 1 and Section 3. The *Visa*²⁸ case, while not classic exclusive dealing, was brought only under Section 1. The *Dentsply* case, a little closer to classic exclusive dealing, was filed under Sections 1, 3, and 2, but then appealed only on Section 2.

ANTHONY CHAVEZ: Why did the government decide not to appeal the district court's ruling in *Dentsply* on Section 1 of the Sherman Act and Section 3 of the Clayton Act?

BRUCE McDONALD: The district court ruled for the defendant under all three provisions, but the government appealed only on Section 2. From the facts of the case, you can see it is best described as monopoly maintenance rather than foreclosure. *Dentsply* had for 15 years maintained its position as the dominant manufacturer of artificial teeth, with a 75–80 percent market share. The teeth are sold by all manufacturers mostly through dealers to dental labs, which put them into dentures. There were some direct sales, but not many, and there was evidence to show that sales through distributors were more attractive to manufacturers and customers than direct sales. *Dentsply* had a policy that it would not sell to any dealers that also dealt in rivals' teeth. *Dentsply* did not have contracts with its various dealers requiring exclusivity. The district court ruled against the government on all three claims, pointing out that distribution was not completely foreclosed because rivals could sell directly to the dental labs. The district court characterized direct sales as "viable," and the applicability of the word "viable" became a contentious question on appeal.

The government appealed only the Section 2 claim, arguing that the policy was exclusionary and prevented *Dentsply*'s manufacturer rivals from building enough of a presence to challenge the monopoly that *Dentsply* had held for 15 years. Why appeal only on Section 2 and not on Sections 1 and 3? As we have discussed, traditional Section 1 and Section 3 cases focus on foreclosure, which of course is a proxy for anticompetitive effect, but the cases focus on the percentage foreclosed. Attention to percentage of dealers foreclosed did not seem the best way to describe to the appeals court what was wrong with the *Dentsply* policy. Because the district court had itself emphasized that it was a lack of total foreclosure, it seemed that Section 2 was a better way to focus the appeals court's attention on the actual effect of the exclusive policy, which was, despite

²⁷ *CDC Tech., Inc. v. Idexx Labs., Inc.*, 186 F.3d 81 (2d Cir. 1999).

²⁸ *United States v. Visa U.S.A., Inc.*, 344 F.3d 229 (2d Cir. 2003).

the desires of the customers and the best efforts of the rivals, to keep rivals from developing a presence such that they could challenge Dentsply's monopoly. Further, a decision that the conduct did not violate Sections 1 and 3 does not dispose of the Section 2 question.

On appeal, Dentsply tried to turn the court's attention to the traditional exclusive dealing cases, like *Tampa Electric* and *Gilbarco* and *CDC*. Dentsply emphasized, as Alison would, the at-will nature of its relationships with the dealers. The dealers were not contractually obliged to continue buying from Dentsply beyond the next sale. The Third Circuit opinion does cite some law relating to exclusive dealing arrangements in its opinion, but that is not decisive, and it recognizes that there were no exclusive agreements and that you did not need to find the "agreement" to find the Section 2 violation.

The Third Circuit focused on what it called the market realities, which showed the Dentsply's exclusionary policy had made a significant contribution to preserving Dentsply's monopoly using the *Microsoft* Section 2 standard. The direct sales, while available, had not been a practical alternative for most manufacturers. Alison pointed out that Dentsply had used only 23 dealers and others were available. Yet sales through other dealers or direct to labs had not been effective for rivals, and none of the 23 dealers had been convinced by a rival to drop Dentsply despite the rivals' efforts. At bottom, Dentsply had kept rivals' sales below the critical level necessary to pose a threat to the Dentsply monopoly. Addressing the district court finding that direct sales were "viable," the court of appeals—faced with the market realities—had to say that direct sales may be viable in terms of allowing rivals enough sales to stay in business, but certainly not viable in the sense that the rivals can use direct sales to challenge Dentsply's monopoly. *Dentsply* has been characterized as an exclusive dealing case, but it is really not an exclusive dealing case in the traditional sense.

Let me briefly mention the *Visa* case. This also did not involve a typical exclusive dealing contract between one manufacturer and a dealer or a group of dealers that sell to the ultimate consumers. *Visa* is better described as a horizontal agreement among the 20,000 banks that are almost all members of both the Visa and MasterCard networks. Their horizontal contract prohibited the banks from issuing cards on behalf of American Express and Discover, and the Second Circuit found the agreement restrained competition in the market for card services. The *Visa* decision would have allowed exclusivity between either of the networks, Visa or MasterCard, and individual banks; what the court found unlawful was the horizontal agreement among the 20,000 banks that were members of *both* networks. It is not a typical exclusive dealing case.

Microsoft has already been discussed. Unsurprisingly, it is a little different than these other cases. The district court and the court of appeals addressed Microsoft's exclusive arrangement with Internet access providers like AOL, which had agreed not to promote the Netscape browser. Both courts held that agreement did not unreasonably restrain trade in the browser market, but found it did help prevent Netscape from becoming an alternative platform to compete with the Microsoft operating system. In the operating system market, there was a Section 2 violation. Microsoft was able to maintain its operating system monopoly in part by keeping the Netscape browser from establishing a strong presence. Again, Section 2, and not a typical exclusive dealing case, although often characterized as exclusive dealing.

LePage's we have talked about at length. I will agree with Alison that it is not likely to survive, but exclusive dealing is a small part of the case. The big question is under what circumstances could bundled discounts be exclusionary for purposes of Section 2.

In general, the Department of Justice would not suggest that the typical exclusive dealing pattern could never make a viable case. It is just that in the situations that have been presented to us

We thought that the lower courts and academic commentators ought to have more time to develop the legal principles and economic analysis before we sought our once-in-a-decade chance to get the Court to speak on bundled discounts.

recently, the facts have best been characterized with something that does not quite fit that pattern.

ANTHONY CHAVEZ: Bruce, looking to the future, do you see the government's filing any traditional exclusive dealing cases under Section 1 and Clayton Section 3?

BRUCE McDONALD: We do not have any in litigation today, but I do not see any reason why in the right fact circumstances we would not, recognizing the usual procompetitive nature of exclusive dealing agreements.

STEVE CALKINS: Bruce, why did the government not support the granting of certiorari in the *LePage's* case?

BRUCE McDONALD: The *LePage's* court addressed the application of Section 2 to bundled discounts, but its opinion was not a very suitable vehicle for Supreme Court consideration of when bundled discounts may be exclusionary. One problem was that the appeals court had not clearly stated what aspect of the 3M bundled rebates it believed was exclusionary. Further, we thought that the lower courts and academic commentators ought to have more time to develop the legal principles and economic analysis before we sought our once-in-a-decade chance to get the Court to speak on bundled discounts. ●

—BRUCE McDONALD

Competition Issues in Real Estate Brokerage

Maureen K. Ohlhausen

The purchase of a home has long represented the achievement of the American dream. Given the importance of home ownership in our society, it is not surprising that real estate brokerage is big business. It is also not surprising that recent trends playing out across the U.S. economy have had significant effects on real estate brokerage services. For example, as home prices have skyrocketed around the country, so have the fees paid for residential real estate brokerage services.¹

At the same time, real estate brokerage, like many other industries, has been affected by new, technology-driven business models and trends toward unbundling of services. Real estate agents and brokers, state legislatures, real estate commissions, and officials who regulate brokers have responded to these trends in a variety of ways. Their responses have included the imposition of new private rules or the passage of new laws or regulations, some of which raise competitive concerns that have caught the attention of the Federal Trade Commission and the Department of Justice Antitrust Division.

Concerns about anticompetitive restraints in the real estate industry are not new. For example, the FTC had a number of cases in the late 1980s and early 1990s alleging that traditional, full-service agents took collective action to disadvantage lower-priced competitors who used a different business model.² Today, while technological changes may have altered the form of anticompetitive restraint, the goal on the part of some of hampering competition remains the same.

Analyzing potential barriers to competition in any industry requires a careful approach that considers costs and benefits to consumers and relies on empirical evidence. In their analysis of competition issues in the real estate industry, the FTC and the DOJ have undertaken a wide variety of activities, including: enforcement; advocacy; convening a forum for industry regulators and academics to discuss the issues; and encouraging study of the state of the market and the impact of new models and new restrictions. The goal of this analysis is not to supplant consumer choice by deciding that a certain business model or technology is better for consumers; rather, it is to help ensure that consumers are free to make their own choices without unnecessary government restrictions or private anticompetitive activity.

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These views are her own
and do not necessarily
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Commissioner.

Background

Currently, in the vast majority of residential real estate transactions, real estate professionals perform virtually all services relating to the sale of a home. The key tasks involved in selling a property include marketing, negotiating with potential buyers, and coordinating the closing of the

¹ GOVERNMENT ACCOUNTABILITY OFFICE, REAL ESTATE BROKERAGE: FACTORS THAT MAY AFFECT PRICE COMPETITION 1 (2005) (Noting that while comprehensive data do not exist, reliable estimates indicate that “in 2004 consumers paid about \$61 billion in real estate brokerage fees related to home sales, up from approximately \$43 billion in 2000.”).

² See, e.g., United Real Estate Brokers of Rockland, Ltd., 116 F.T.C. 972 (1993); Orange County Bd. of Realtors, Inc., 106 F.T.C. 88 (1985).

transaction. Marketing includes listing the property in the local multiple listing service (MLS), placing advertisements in local media, and conducting open houses. Real estate brokers share information about properties for sale, known as listings, through the MLS, which is a joint venture among competing brokers.³ Participation in the local MLS enables a broker to provide customers with listings for the vast majority of properties for sale in the community.

Brokers traditionally provided listings for properties to their customers in a variety of ways, such as by hand at their offices, by mail, or by fax. Contract negotiation services might include providing advice on pricing, home inspections, or other contractual terms. Overseeing the closing of the transaction involves coordinating the completion of all the legal and financial requirements for transfers of real property. For these efforts, the real estate professionals usually receive a commission based on a percentage of the sales price of the home (typically 5–7 percent).

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to competition.

New Technology. Although the traditional brokerage model remains dominant, new technologies like the Internet have allowed innovative real estate brokers to reduce costs and develop new services and offerings, thereby expanding consumer choice. These new, lower-cost services may threaten entrenched players, who, rather than competing on the merits, may try to ward off rivals in ways that reduce consumer choice and are harmful to competition.

Beginning in the 1990s, some pioneering brokers began to display their listings on their own Web sites.⁴ This was followed by national Web sites that began posting information about MLS listings, such as Realtor.com and Homestore.com, both of which are affiliated with the National Association of Realtors (NAR). In 1999, two brokers that operated primarily online, eRealty.com and zipRealty Inc., made their debut.

Online brokers offer brokerage services to customers over the Internet, using so-called virtual office Web sites, or VOWs. VOWs are password-protected Internet sites that allow a broker's customers to search the MLS database directly, using home computers to obtain the same information that would be available in a broker's office. This model has benefits for consumers, enabling them to educate themselves about their options at their own pace and schedule. It also has benefits for brokers. By allowing consumers to do some of the searching and sorting of listings themselves—thereby reducing the time that agents spend searching the MLS database or showing homes that the customer dislikes—VOWs reduce brokers' costs.

In this way, the Internet can deliver brokerage services more efficiently to customers, resulting in better service for those customers who prefer to perform some tasks themselves. It can also lead to lower prices to consumers, often through rebates of part of the agent's commission to the buyer. Brokers who use the Internet also represent a competitive challenge to traditional brokers. Shortly after eRealty started operations in Austin, Texas, the Austin Board of Realtors filed a legal challenge, arguing that eRealty's delivery of MLS data over its Web site violated the Board's newly adopted rule limiting display of such data to approved sites, and violated the MLS system's copyright. eRealty counterclaimed that the Board's actions violated the Sherman Act. A district court granted eRealty a preliminary injunction to stop the Board from terminating its MLS privileges, holding that the Board lacked legitimate procompetitive reasons for withholding the data.⁵ After the injunction issued, NAR promulgated a new set of MLS rules for all Realtor associations

³ The MLS is a directory of property listings typically operated by local organizations of real estate brokers. The MLS enables brokers to share information about properties, including the compensation each seller offers to an agent who finds a buyer for the property.

⁴ See, e.g., David Wessel, *Web May Soon Work Magic in Real Estate*, WALL ST. J., Oct. 31, 2002, at A2.

⁵ Austin Bd. of Realtors v. e-Realty, Inc., No. A-00-CA-154JN (W.D. Tex. Mar. 3, 2000).

that required them to permit MLS participants to display on their sites MLS information from other participants, subject to certain limitations. The parties eventually settled the litigation in early 2001, after the general counsel of NAR sent a letter to the president and CEO of eRealty stating that, in NAR's opinion, eRealty's delivery of MLS data did not violate the MLS system's rule regarding the distribution of individual property records.⁶ This suit foreshadowed the concerns surrounding NAR's policies on Internet listing of MLS data, which remain controversial.

Unbundling. In addition to—and sometimes as a result of—the effects of new technology, it is becoming increasingly common for home sellers to buy some, but not all, of the traditional brokerage services. For example, some sellers might want help promoting their homes among potential buyers but want to negotiate the sales price and other terms themselves. Other consumers might find a buyer without assistance, perhaps through an online service or advertisement, but would like to hire a real estate professional to assist them with the negotiation of the sales price.

The marketplace is evolving in response to these consumer demands. Real estate professionals who are willing to provide only those services a home seller wants have emerged throughout the country. These “fee-for-service” or “menu-driven” business models operate in many states and typically enable consumers to save thousands of dollars by allowing them to pay only for those services they want. These à la carte services are often much less expensive than hiring traditional, full-service, full-commission real estate agents to handle all aspects of a transaction. Perhaps not surprisingly, the offering of services on an unbundled basis has sparked strong opposition from representatives of full-service brokers, such as state Realtor associations. This opposition has taken the form of private actions and state regulation.

In one of the opening skirmishes of what would become a widespread battle on fee-for-service brokerage, in 2002 the Texas Real Estate Commission (TREC) proposed the adoption of a rule that would prohibit a broker from contracting with a client to provide fewer services than offered in the traditional brokerage bundle. Aaron Farmer, a pioneering Texas discount broker, challenged TREC's proposal as being unauthorized by statute for failing to comply with procedural requirements of the Texas Administrative Procedure Act. The court granted Farmer a temporary restraining order⁷ and TREC withdrew the proposal.⁸

Taking unbundling one step further, “for sale by owner” (FSBO) sellers eschew traditional brokerage services completely (by dealing with the buyer directly) or partially (by paying a fee to an agent who brings in a buyer.) The Internet, which makes it much easier for buyers to find and search home listings outside the MLS and for sellers to provide extensive information to prospective buyers, greatly facilitates this model.

ForSaleByOwner.com is an online classified advertising and information service that charges a flat fee to property owners who advertise their property on the company's Web site, which interested consumers can search for free. The property owners determine the content and format of the advertisement, and the fee varies based on the length of the advertisement and the period of time it appears on the Web site. For an additional fee, property owners can have their homes listed on the MLS through a real estate agent affiliated with ForSaleByOwner.com. The company does

⁶ Letter from Laurene K. Janik, General Counsel, National Association of Realtors, to Russell Capper, President and CEO, eRealty.com (Jan. 29, 2001) (on file with the author).

⁷ Farmer v. Texas Real Estate Comm'n, Case No. GN 204238 (Travis County, Tex. Dist. Ct. Nov. 25, 2002).

⁸ Minutes, Texas Real Estate Commission (Jan. 6, 2003), available at <http://www.trec.state.tx.us/pdf/meetings/commission/minutes/mn20030106.pdf>.

not represent or negotiate on behalf of property owners or prospective purchasers and has a disclaimer on the Web site stating that it is not a real estate agent and is legally prohibited from taking part in the actual sales transaction.

In 2001 California's Department of Real Estate sent letters to various companies, including ForSaleByOwner.com, notifying them that they must obtain real estate brokerage licenses to advertise properties in the state. California law required that anyone who, for compensation, solicits prospective property sellers or purchasers or listings for the purchase, sale, or exchange of real property or charges an advance fee to promote the sale of property by listing or advertisement, must be a licensed real estate broker.⁹ The law exempted from the licensing requirement, however, a "newspaper of general circulation,"¹⁰ despite the fact that many California newspapers operate Web sites that contain property listings that are purchased in advance by property owners and which customers can search online.

In 2003 two Internet real estate listing companies—ForSaleByOwner.com and its affiliate that publishes ForSaleByOwner.com magazine in California—challenged on First Amendment grounds California's real estate licensing requirements. The federal district court upheld ForSaleByOwner.com's challenge, concluding that the Web site is entitled to the greatest protection under the First Amendment. The court reasoned that the Web site is not commercial speech—which would be subject to more limited protection—because the company does not propose an economic transaction between itself and a prospective purchaser. Instead, the court found that the Web site provides generalized information not tailored to any specific client.¹¹ The court also found that the California law unconstitutionally discriminated based on media type and that its distinction between online publications and newspapers was wholly arbitrary and unsupported by a compelling state interest. Though not an antitrust decision, this outcome was a real victory for consumer choice. It preserved the ability of California consumers to use the power of the Internet to inform themselves and others about their options for selling and purchasing real estate between principals directly, as an alternative to the real-estate-broker controlled MLS.

Agency Activities

While the events described above were unfolding, the FTC and the DOJ were examining the impact on competition of certain new industry practices. For example, in 2002 the FTC sponsored a workshop on "Possible Anticompetitive Efforts to Restrict Competition on the Internet" that included 70 representatives of industry, academia, state and federal government agencies, and public policy organizations, who discussed possible e-commerce barriers in ten different industries, including real estate.¹² Panelists identified a wide variety of barriers to new real estate business models, including prohibitions on rebates to consumers, industry self-regulatory proposals, such as new rules regarding the online display of MLS data, and state licensing requirements.¹³

⁹ See CAL. BUS. & PROF. CODE §§ 10130, 10131(a), 10131.2.

¹⁰ *Id.* § 10026.

¹¹ ForSaleByOwner.com Corp. v. Zinnemann, 347 F. Supp. 2d 868, 876-77 (E.D. Cal. 2004).

¹² Notice of Public Workshop and Opportunity to Comment, 67 Fed. Reg. 48,472 (July 24, 2002). The workshop agenda, the participants' written statements, a transcript, and public submissions are available at <http://www.ftc.gov/opp/e-commerce/anticompetitive/index.htm>.

¹³ See Transcript of Public Workshop on Possible Anticompetitive Efforts to Restrict Competition on the Internet, at 727-95 (Oct. 10, 2002), available at <http://www.ftc.gov/opp/e-commerce/anticompetitive/021010antitrans.pdf>.

The DOJ took direct action in court against rebate prohibitions, filing a civil antitrust lawsuit in March 2005 against the Kentucky Real Estate Commission,¹⁴ alleging that the Commission violated Section 1 of the Sherman Act by promulgating and enforcing a regulation that prohibits Kentucky real estate brokers and sales associates from offering rebates and other inducements to attract customers. The DOJ later reached a settlement of the matter pursuant to which real estate brokers in the state would be able to offer such rebates and inducements to consumers.¹⁵

The effects of this lawsuit and other investigations by the DOJ are not limited to Kentucky. In response to a DOJ investigation, the South Dakota Real Estate Commission rescinded two rulings prohibiting brokers from offering rebates, inducements, and other discounts to consumers.¹⁶ The competitive benefits of removing these restrictions are obvious, as it is difficult to conceive of a pro-consumer justification for such restrictions on price competition.

The display of MLS listings on Internet sites is another issue that has attracted the attention of the federal enforcement agencies. On September 8, 2005, the DOJ filed a civil antitrust suit against the NAR to challenge its policy concerning the online display of listings. In the complaint, the DOJ alleges that the NAR's policy restrains competition by requiring NAR-affiliated MLSs to adopt rules that will allow brokers to withhold their clients' listings from specific competing brokers' Web sites by means of an "opt out."¹⁷ When exercised, the NAR rule would prevent Web-based brokers from providing consumers online access to all MLS listings from brokers that have opted out. According to the DOJ's complaint, the NAR's policy enables traditional brokers to block their competitors' customers from having full on-line access to all of the MLS's listings. This policy significantly alters the rules that govern MLSs by permitting traditional brokers to discriminate against other brokers based on their business model, denying them the full benefits of MLS participation.

On the day that the DOJ filed its suit, the NAR announced a modification of its policy to include a blanket (rather than a specific) opt-out that allows brokers to prevent their listings from being shown online by any competing broker. The modified policy specifically exempted the NAR's own site, Realtor.com, from the blanket opt-out.¹⁸ In addition, the NAR altered its definition of an MLS participant in a way that would prevent brokers who operate "referral" businesses from joining local MLSs to obtain MLS listings to display on their Web sites.¹⁹

On October 4, 2005, the DOJ amended its lawsuit, charging that the modified policy still obstructs competition.²⁰ Defenders of the NAR policy maintain that brokers should have the right

¹⁴ See Complaint, *United States v. Kentucky Real Estate Comm'n*, Civ. Action No. 3:05CV188-H (W.D. Ky. filed Mar. 31, 2005), available at <http://www.usdoj.gov/atr/cases/f208300/208393.htm>.

¹⁵ See Proposed Amended Final Judgment, *United States v. Kentucky Real Estate Comm'n*, Civ. Action No. 3:05CV188-H (W.D. Ky. filed July 15, 2005), available at <http://www.usdoj.gov/atr/cases/f210100/210142.htm>.

¹⁶ See Press Release, Department of Justice, South Dakota Real Estate Commission Permits Real Estate Brokers to Offer Rebates and Inducements (Aug. 17, 2005), available at http://www.usdoj.gov/atr/public/press_releases/2005/210637.htm.

¹⁷ See Complaint, *United States v. Nat'l Ass'n of Realtors*, Civ. Action No. 05C-5140 (N.D. Ill. filed Sept. 8, 2005), available at <http://www.usdoj.gov/atr/cases/f211000/211009.pdf>.

¹⁸ According to the Department's complaint, brokers who participated in the NAR work group that formulated the VOW policy recognized that the opt-out right would be "abused beyond belief." The chairman of the working group admitted that the opt-out right was likely to be exercised by brokers despite the fact that, as the Department wrote in its filing, "it may not be in the sellers' best interest to opt out." See *id.*

¹⁹ A referral business includes, for example, an online service such as LendingTree, Inc., which provides consumers with mortgage loan offers and also refers interested customers to real estate agents in their local areas.

²⁰ Press Release, Department of Justice, Department of Justice Amends Antitrust Lawsuit Against National Association of Realtors (Oct. 4, 2005) available at http://www.usdoj.gov/atr/public/press_releases/2005/211754.htm.

to control where their listings are displayed. They emphasize that the blanket opt-out policy allows brokers to prohibit their listings from appearing on any competitors' sites, not just sites of Internet-based brokers, at the cost of forgoing the ability to post other brokers' listings on their sites.

The FTC and the DOJ argued that by prohibiting core limited-service brokerage options and therefore requiring some home sellers to purchase services that they otherwise would choose to perform themselves, the proposals were likely to harm consumers by reducing their choices and likely raising prices without providing any countervailing benefits.

The federal agencies have also been active in promoting awareness of real estate competition issues at the state level. For example, the FTC and DOJ sent a series of joint letters to the Texas Real Estate Commission,²¹ the Alabama Senate,²² Missouri Governor Blunt,²³ and the Michigan Senate and Michigan Department of Labor and Economic Growth²⁴ regarding proposed regulations and legislation that would impose minimum service requirements on real estate brokers and prohibit them from offering completely unbundled services. These state proposals typically require listing brokers to (1) accept and present to the principal offers and counter-offers to buy, sell, or lease the principal's property or property the principal seeks to buy or lease; (2) assist the principal in developing, communicating, and presenting offers, counter-offers, and notices that relate to the offers and counter-offers; and (3) answer the principal's questions relating to offers, counter-offers, and notices. One effect of these restrictions would be to force consumers to choose between purchasing a larger bundle of real estate services than they would otherwise desire or forgoing the help of a real estate agent altogether. For example, a consumer who wanted to negotiate offers himself but have his property listed on the MLS would either have to contract for the agent to negotiate offers or do without the MLS listing. The FTC and the DOJ argued that by prohibiting core limited-service brokerage options and therefore requiring some home sellers to purchase services that they otherwise would choose to perform themselves, the proposals were likely to harm consumers by reducing their choices and likely raising prices without providing any countervailing benefits.²⁵

Although the proponents of these limitations generally claim that such restrictions are necessary to protect consumers from receiving fewer services than they expect, to date, the agencies have seen no evidence that fee-for-service brokerage harms consumers. Moreover, even if evidence did show that fee-for-service real estate services result in harm, the agencies have argued that such concerns likely could be addressed through an approach that is less restrictive of consumer choice and competition. For instance, if there were a concern that home sellers may mistakenly expect to receive more assistance from the fee-for-service real estate professionals than that for which they contracted, states could require that brokers offering fee-for-service options specifically delineate in writing those services the client will *not* receive. This disclosure require-

²¹ Letter from the FTC and the Justice Department to Loretta R. DeHay, Gen. Counsel, Texas Real Estate Comm'n (Apr. 20, 2005), available at http://www.usdoj.gov/atr/public/press_releases/2005/208653a.htm.

²² Letter from the FTC and the Justice Department to Alabama Senate (May 12, 2005), available at <http://www.ftc.gov/os/2005/05/050512ltralabamarealtors.pdf>.

²³ Letter from the FTC and the Justice Department to Governor Matt Blunt (May 23, 2005), available at <http://www.ftc.gov/be/V050010.pdf>.

²⁴ Letter from the FTC and the Justice Department to the Honorable Alan Sanborn, Michigan Senate, and David C. Hollister, Michigan Dep't of Labor and Economic Growth (Oct. 19, 2005), available at <http://www.ftc.gov/os/2005/10/051020commmihousebill4849.pdf>.

²⁵ See Glenn Roberts Jr., *Flat-Fee Brokers Adapt to New Real Estate Law*, INMAN NEWS, Oct. 12, 2005, available at <http://www.inman.com/inmannews.aspx?ID=48325>. After Texas enacted a minimum service requirement, some Texas brokers raised their prices for limited real estate services and attributed the increase directly to the new law. See, e.g., <http://www.texasdiscountrealty.com/laws.htm> (Web site of Texas Discount Realty explaining that "[b]ecause of the added responsibilities forced on to you, the seller and us the broker, by [the Texas minimum service law], we are forced, as most brokers, to adjust our prices.")

ment would highlight what the consumer has or has not purchased and what other services might be available.²⁶

Initially, the federal agencies had little success with this issue on the state level: Texas, Alabama, and Missouri all eventually adopted legislation restricting fee-for-service brokerage. The tide may be turning, however. For example, in Michigan, the proposed restrictive legislation recently died in committee.²⁷ The agencies have also been successful in prompting greater public awareness of these limits on consumer choice.²⁸

In addition to their enforcement and competition advocacy efforts, the agencies also sponsored a joint workshop on competition policy and the real estate industry on October 25, 2005.²⁹ The workshop covered three primary areas. The first area was private and public restraints that affect alternative sellers' brokers. This included issues relating to new business models—such as fee-for-service brokers and FSBOs—and MLS discrimination against limited-service listings. The second area focused on private and public restraints that affect alternative buyers' brokers, and it included such issues as restrictions on the use of MLS listings by VOWs and referral businesses and prohibitions on brokers rebating commissions to buyers. The workshop's third area focused on empirical evidence about the state of competition in the industry and the effects of restraints on certain new business models.

The agencies sought a wide range of views at the workshop, which was intended as a forum for all sides to air their concerns and explain their positions. Accordingly, the workshop included as panelists NAR officials, representatives of some of the largest real estate brokerage companies in the United States, state real estate regulators, representatives of state Realtor associations, limited service brokers, representatives of services that assist consumers who choose the FSBO route, representatives of referral businesses, and economists.³⁰ The agencies also solicited public comments, which are available on the workshop's Web site.

Conclusion

The FTC and the DOJ have been very active in examining and attempting to prevent anticompetitive restrictions and practices in real estate brokerage, an industry that significantly affects a great many Americans. The agencies will continue to maintain their focus on real estate brokerage as the enforcement actions proceed, their advocacy continues, and they digest the learning from their public workshop. Based on their actions so far, areas of concern will likely be agreements or rules that exclude entry by, or impede the activities of, firms that use new technology or innovative business models to offer consumers greater choices of service levels and price.

²⁶ Some proponents of these limitations have also argued that a fee-for-service arrangement where the listing agent does not advise the seller may put an agent for a buyer into a conflict situation (representing both buyer and seller in the transaction) if the buyer's agent answers questions posed by a seller. In real estate parlance, this conflict situation is called undisclosed dual agency. However, a disclosure could also advise consumers of fee-for-service brokerage that they should not expect help from the buyer's agent and thus ameliorate concerns over undisclosed dual agency.

²⁷ Michigan HB # 4849 was never reported out of the Senate Committee on Economic Development, Small Business and Regulatory Reform.

²⁸ In an August 2005 editorial, the *Wall Street Journal* criticized the governors of Texas, Alabama, and Missouri for signing into law legislation that protects real estate agents from discount competitors to the detriment of consumers. *The Realtor Racket*, WALL ST. J., Aug. 12, 2005, at A8.

²⁹ See Public Workshop: Competition Policy and the Real Estate Industry, 70 Fed. Reg. 53,362 (Sept. 8, 2005), available at <http://www.ftc.gov/os/2005/09/050913realestateworkshopfrn.pdf>.

³⁰ See Agenda, Competition Policy and the Real Estate Industry, available at <http://www.ftc.gov/opp/workshops/comprealstate/agenda.pdf>.

The attention the competition agencies have directed to this area is consistent with their long-standing practice of examining private and public restrictions on new technologies and business models. As other industries and their regulators react to challenges wrought by new technologies and evolving business models and develop new rules and regulations, they should pay close attention to the impact of such rules and regulations on competition and consumers. Certainly, the competition agencies will do so. ●

e-Normous: The Increasing Burden Associated with Electronic Document Production in Second Request Investigations

Scott Sher and Daryl Teshima

The Problem

By now, everyone recognizes the increasing costs associated with the production of electronic discovery in the Second Request process.¹ The volume of electronic documents, including e-mails, PowerPoint presentations, memos and notes, is overwhelming, and increasing at a rate that puts Moore's Law² to shame.

At the same time, the Second Request process has remained largely the same, and the document demands from the Federal Trade Commission and the Department of Justice do not take into account the substantial burdens associated with electronic document review. The agencies still require parties to produce all potentially responsive documents, including the tremendous amount of accumulated electronic information maintained by companies in the ordinary course of business. As a result, parties are subjected to an increasingly expensive Second Request process they view as unnecessarily long and which prevents them from closing quickly and capturing efficiencies from their deals. On the other hand, the agencies require a process that ensures that they gain access to all important information from all relevant employees so that they properly can assess the likely competitive effects of transactions they review.

Although some in the Bar reflexively fault the agencies for the substantial burden of Second Request review, the responsibility lies both with the agencies and the Bar to streamline the process. After all, the agencies are not responsible for the massive accumulation of electronic data and cannot be expected to understand the complexities of every company's document retention and storage program. Only the parties themselves can educate the government as to where potentially responsive information resides and how the agencies can best gain quick and reasonably comprehensive access to it.

As a result, both the merging parties subject to Second Request investigations and the agencies must devise solutions that reduce the cost, time, and burden of producing electronic docu-

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¹ Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, parties to any merger or acquisition of assets or voting securities exceeding a certain value (\$53.1 million at the time this article went to press) must file a notification of the transaction with the Department of Justice, Antitrust Division, and the Federal Trade Commission. See 15 U.S.C. § 18a. By statute, the agencies have 30 days to determine whether to "clear" the deal and take no enforcement action, or issue a Request for Additional Information (commonly referred to as a Second Request) seeking additional documentary and narrative evidence regarding the competitive implications of the transaction. See *id.* The agencies use the Second Request process to determine whether any particular transaction will serve to "substantially lessen competition" in contravention to Section 7 of the Clayton Act. See 15 U.S.C. § 18.

² Gordon E. Moore's empirical observation that at current rates of technological development, the complexity of an integrated circuit will double every 18–24 months. See http://en.wikipedia.org/wiki/Moore's_Law.

ments without compromising the integrity of the Second Request process.³ In this article, we offer some observations based upon our experience and the data that we have collected over time. Most significantly, it is important for parties to share with the agencies, at the outset of any investigation, detailed information regarding the amount of electronic data, its nature, and its location throughout the company. Only with such a detailed understanding will the agencies be able to determine what information they need, and from whom. Once the agencies have such information, we believe that they should be in a better position to demand only what is reasonably likely to yield responsive and relevant information.

Analysis of Prior Second Request Electronic Document Productions

In our effort to better understand the extent of the problem created by the substantial and growing volume of electronic documents maintained by companies, and to help craft some practical suggestions for how to resolve it, we compiled information relating to Second Request productions from the last five years. We compiled the data by collecting information from a number of Second Request investigations that we have managed for clients over time. We set forth some of our results regarding electronic productions from a representative subset of those deals. Because we primarily manage government investigations for high-tech companies, we acknowledge that it is possible that this information is skewed because, as some have suggested, high-tech companies make greater use of electronic document communication and tend to store more of that information. Anecdotally, however, many so-called “old-economy” companies make equal use of electronic documents and may have a *greater* volume of electronic documents due to retention programs that mandate maintaining employee data for an even greater length of time.

Whatever the bias introduced by examining only high-tech investigations, one thing is clear: because the cost of electronic document storage has declined so dramatically in recent years, companies tend to allow electronic data to reside on their underutilized storage systems for a very long time. Our clients maintain vast numbers of servers and storage devices that house nothing but old data—data that they no longer use but which is nonetheless potentially responsive to a Second Request investigation. Moreover, with the increasing automation of company-wide data—in the form of enterprise relationship (ERP) databases—our clients generally maintain a tremendous amount of information regarding their sales process in centrally located servers. As a result, there is the equivalent of tens of thousands of boxes of documents located in a company’s electronic repositories. It is costly and burdensome for parties to review and produce all of this information, and the government is no doubt also burdened by reviewing such a large volume of material.

Some of the results from our study are highlighted below:

- The overall volume of electronic documents has steadily increased over time—from 0.73 gigabytes collected per employee in 2001 to 7.08 gigabytes collected per employee in 2005. This represents an increase of almost 970 percent, in just over four years. (See Chart 1.)
- Technology has improved over the last four years, greatly increasing our ability to quickly discard a subset of non-responsive documents, without a significant investment of time

Because the cost of electronic document storage has declined so dramatically in recent years, companies tend to allow electronic data to reside on their underutilized storage systems for a very long time [and] there is the equivalent of tens of thousands of boxes of documents located in a company’s electronic repositories.

³ For a good discussion of the issues relating to FTC policy on electronic productions, see D. Bruce Hoffman, *The Digital Age at the FTC: Current Issues in Electronic Document Production and Review*, ANTITRUST SOURCE, Mar. 2004, <http://www.abanet.org/antitrust/source/03-04/hoffman.pdf>.

and money. Nevertheless, even with aggressive document “culling,” the volume of electronic documents that demand more careful review has increased steadily over time.

- Some categories of information—deleted e-mails, for example—demand an incredible amount of review time without yielding much in the way of responsive information. There has been no instance in our experience where a deleted item was significant in an investigation. In fact, even though deleted e-mails constitute over 21 percent of e-mails that need to be reviewed, they only amount to 0.45 percent of “responsive” information.
- While the volume of information collected from sales employees is huge, such information is far less likely to be responsive than information maintained by company executives.

We analyzed information related to electronic document collection, review, and production from five deals that we managed during the period beginning in early 2001 and ending in early 2005. Each of the deals discussed were subject to a Second Request—and reviewed by either the FTC or DOJ.⁴ Each involved roughly the same Second Request demand: asking for responsive data from the companies for a period of approximately three years. We provide information related to the collection, review, and production of *all* electronic documents pertaining to these investigations, not merely e-mails and not only stand-alone electronic documents. We recognize that the results of our analysis can only be used to inform our discussion in an anecdotal, not scientific, way.

Methodologies for Collecting, Reviewing, and Producing Electronic Documents

Collecting Electronic Documents. Perhaps the most difficult and overlooked aspect of electronic discovery is the burden of collecting information required by the Second Request. Because the agencies rely on the Second Request as their primary opportunity to obtain documents during a merger investigation, the scope of the Second Request is intentionally broad and often applies to all business-related documents and data within the organization.

The casting of such a wide discovery net historically has been tempered by the limitations inherent in storing paper. There is a limit to how much square footage a company can devote to housing paper documents. Electronic data and documents do not share these same physical and cost barriers. In addition, the requirements imposed on companies by Sarbanes-Oxley⁵ and other federal and state regulations⁶ have fostered a “keep everything” environment. All of these factors

⁴ The five deals surveyed by this article are:

- Deal “A”; October 2001 (Predominately a Hardware Deal; Reviewed by FTC Mergers II)
- Deal “B”; March 2003 (Software / Services Deal; Reviewed by DOJ NetTech)
- Deal “C”; June 2003; (Chip Deal; Reviewed by FTC Mergers II)
- Deal “D”; July 2003; (Software Deal; Reviewed by SF DOJ)
- Deal “E”; January 2005; (Software Deal; Reviewed by FTC Mergers II)

⁵ Pub. L. No. 107-204 § 802(a).

⁶ SEC regulations are the primary source of statutory requirements that mandate document retention. For example, section 802(a)(1) of the Sarbanes-Oxley Act requires auditors of public companies to maintain “all audit or review workpapers” for five years, and directs the SEC to enact related regulations. Thereafter, the SEC amended Reg S-X by adopting Rule 2-06 that established a seven-year retention period for “records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, other documents, and records (including electronic records), which (1) are created, sent or received in connection with the audit or review, and (2) contain conclusions, opinions, analyses, or financial data related to the audit or review.” 17 C.F.R. § 210.2-06(a). In addition, many companies are under document retention orders as defendants in private litigations; this too adds to the volume of electronic documents stored by firms.

have resulted in a perfect storm of overwhelming electronic data volumes that, in turn, are often demanded as part of the Second Request process. Over the past four years, we have seen this increase firsthand. In 2001, we collected from our clients the equivalent of 14.6 boxes per employee of electronically sourced documents. As of 2005, this number had increased almost tenfold, with an average of 141.6 boxes collected per employee.⁷ (See Chart 1.)

Clients increasingly are unwilling to absorb a corresponding tenfold increase in Second Request compliance costs and fees, and often look to their legal counsel for suggestions on how to control the costs associated with this expanding document universe. One way to control the volume increase is through a more discriminating collection methodology. Traditionally, three strategies for collecting electronic data during Second Requests are employed:

1. Assign collection duties to the company's internal staff, such as the information systems group;
2. Hire forensic collection specialists who make images of hard drives and servers that contain every bit and byte from a employee; or
3. Assign collection duties to individual employees to self-select responsive electronic documents.

Unfortunately, these traditional strategies often result in the collection of either too much data (the continuing problem of the over-collection of non-responsive documents) or too little. Both the use of forensic imaging of hard drives and the sole reliance on a company's internal IT staff to collect electronic documents usually result in over-collection. Forensic imaging copies not only user-generated data, but also system and program files that do not require review. Similarly, a company's IT staff uses tools that are geared toward data recovery, which results in the collection of duplicative and non-user-generated electronic files. Conversely, relying primarily on the individual employee to identify responsive data often results in the collection of too little data (especially considering the broad scope of Second Requests). As a practical matter, it is also difficult to get busy employees and executives to take the time to properly identify data that is potentially responsive to the Second Request.

Despite these disadvantages, there are benefits to each of the above collection methodologies. A company's IT staff has unique access and knowledge of internal systems, allowing them to develop the most efficient and least intrusive method of collection. Alternatively, utilizing forensic tools and procedures properly preserves metadata and the chain of custody for the file. Last, no one better understands the substance and significance of the data to be collected than the custodian of that data. A hybrid approach accordingly incorporates the best elements of each strategy. Generally, such an approach follows these steps:

- **Catalog Data Universe**—The first step is to determine the various possible data sources at the company. This is usually done in conjunction with the company's IT staff. Generally, four main data stores are useful targets:
 - **Individual Employee Files**—These files are controlled by individual employees on their computers, e-mail servers, or private network shares. The scope of these files could extend to an employee's home computer, personal data assistants, and other devices, depending on how an individual employee operates.

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⁷ These metrics reflect the total amount of user-generated data collected for each employee. It does not include system and program files, which were excluded from the collection specification.

- *Department/Group Files*—These files are controlled by a department or select group at the company and are typically stored on the company's network server.
- *Enterprise Databases*—These company-wide systems contain personnel records, accounting and financial information, customer and sales records, and other business information. Due to the complexity of these systems, they are usually maintained by the company's IT staff and access is limited to a select group. Most users access these systems through regularly-generated reports.
- *Backup Tapes*—Usually stored on removable media, this data is comprised of information that the company regularly backs up and is controlled by the IT staff. Depending on the electronic data retention policy (and tape backup recycle system) in place, hundreds of these backup snapshots are conceivably available. In general, this data is often highly duplicative of data found in the other three data stores.
- **Interview Employees (and learn how they organize their e-mail/electronic documents)**—A collection interview should be set up with individual employees in order to: (1) allow the counsel to evaluate each employee; (2) collect electronic data controlled by every employee (e.g., such as data on laptop, computer, etc.); and (3) verify that all relevant data from each employee is being collected.
- **Sweep Data**—Counsel should arrange to “sweep” an employee's hard-drive during the employee interview (or remotely, over the network) to find material that is likely to be relevant, based on objective criteria, such as file-type, date of file, and so on. Files that meet the criteria can be copied by a program onto the collection media. The sweep collection can also include a topical culling stage where the employee identifies data that will be extremely unlikely to be responsive (such as personal folders). The sweep method, if performed properly, can also properly preserve all metadata and make the collection more forensically sound.
- **Compile Metrics**—After the collection is completed, counsel should determine the volume of data collected for each company employee. To do this, one must accurately translate the amount of data collected into pages, which will give the attorneys, clients, and agencies a measuring unit that they can readily understand. Using these metrics, descriptive charts can help clients and the agencies understand the nature and composition of the collected data and, ultimately, identify the documents most relevant to the Second Request.
- **Prepare Descriptions and Reports from Key Enterprise Databases**—Unlike individually maintained electronic files and e-mails, simply copying (or printing out) databases will not likely generate information that can be meaningfully reviewed. Likewise, the detailed delivery of database schemas and descriptions that we have seen in several Second Requests does little to generate usable information. The best approach is to create a high-level description of the database, as well as a list of the relevant reports generated and distributed by these databases and their applications. By focusing on producing or generating reports (or data exports), counsel can then use these reports as the basis for negotiations with staff and use them as a method to modify or satisfy the burdens of the Second Request.
- **Verify that Backups Contain Duplicative Data**—The large volume of data collected calls into question the relevance of collecting information from backup tapes or other disaster recovery media. Backup tapes are often highly duplicative of e-mails and electronic files already collected and are quite expensive to restore. Further, because backup tapes are

made for disaster recovery purposes by IT personnel and are designed to restore all data at an enterprise, rather than the individual files of a particular person, the recovery process is complex.⁸ In order to avoid this process, parties should verify (usually by the date range of files and e-mails collected) with the agencies that all responsive information has been collected without the need to restore backup tapes. Absent a date gap in the collection or a situation where the backup contains the only copy of material (if for example, an employee's hard drive was erased completely and never restored), restoration of backup tapes may be unnecessary and avoidable.

Reviewing Electronic Documents. Unfortunately, even following a hybrid collection approach⁹ does not guarantee that the parties will have a manageable universe of potentially responsive documents to review. As previously mentioned, an average collection can easily yield the equivalent of over 140 boxes per employee to review. It is not possible to review this volume efficiently or in a timely manner without excessive attorney-review costs. Thus, counsel should take additional steps to further narrow the universe of potentially responsive documents

The logistics of completing a hard-copy review are ill-matched to the mountains of data generated by electronic discovery.

Traditionally, documents are reviewed in hard-copy paper form, which is often the most familiar and comfortable method for attorneys. But the logistics of completing a hard-copy review are ill-matched to the mountains of data generated by electronic discovery. First, printing electronic documents is an expensive proposition, and can cost anywhere from \$0.06 to \$0.12 per page to print, depending on the type of data to be printed—and that is for just one copy.¹⁰ Second, the only way to review paper is page-by-page. Since the typical digital discovery collection can average millions of pages, resource (or budget) limitations may not permit adoption of a paper-based approach.

In response to issues raised by a paper review, litigation review databases have proven to be a common, cost-effective solution to reviewing electronic discovery. There are hundreds of service providers (and even off-the-shelf programs) that can take electronic files and e-mails (at a cost ranging from \$0.08 to \$0.25 per page) and perform two basic functions: (1) extract all the metadata and full-text into a searchable database; and (2) generate corresponding electronic printouts (usually in .tiff (or .tif) or Adobe .pdf formats) of the electronic data that can be linked to the extracted searchable text. Once processed, the searchable text and images can be loaded into a database as well as made available through the Internet by a number of application service providers (ASPs). All of the above litigation support programs help attorneys reduce the cost of photocopying yet provide the option to print paper sets at any time. In addition, everything that can be done during a paper review (e.g., capture attorney calls, redact documents, organize into groups) can likewise occur electronically.

Taking electronic files and e-mails and placing them in a searchable database format can reduce by as much as two-thirds the cost of transforming paper into a similar searchable data-

⁸ To recover a particular user's files and e-mails from backups, the entire set of data must be restored. Only after the data is restored can individual e-mails and electronic files be reviewed.

⁹ This hybrid collection approach represents a smaller subset of the entire data universe controlled by an employee, and does not include non-user generated files (such as Windows system and application files) or files identified by the employee as non-responsive (such as folders where personal e-mails and documents are kept). By using these filters at the time of collection, the total volume of the collection is usually reduced by 50–70 percent.

¹⁰ Paper-based reviews usually require at least one pristine copy, multiple working copies, and a final production set that is properly Bates-numbered.

base. Attorneys further minimize the number of paper copy sets generated, often resulting in considerable cost savings.

And over time, the searchability of a database helps attorneys achieve faster paper-review speeds and allows the parties and ultimately the agencies to identify and filter out clearly non-responsive documents. If searchable, electronic data can often be effectively narrowed utilizing the following culling criteria:¹¹

- **Date Range**—If there is a relevant date range for the matter, then e-mails and files can be filtered to ensure that they fall within the applicable time period.
- **Duplicates**—Using a variety of methods, duplicates can be objectively identified and ultimately removed from the electronic data collection. An important factor is the universe of documents from which documents are eliminated
- **File Types**—Electronic data that is not user-generated (e.g., system files, applications) or yields poor results when printed / converted (e.g., databases, multimedia files) can be logged and not processed.
- **Keywords**—Search terms and names can effectively separate the wheat from the chaff. In practice, however, we have found that negotiating keyword search terms with the agencies is a time-consuming process because it is difficult to reach agreement on which terms to utilize.¹² Such a negotiation process often requires a significant amount of time and explanation, and eventually results in a slight reduction in the overall volume to be searched. We do not blame the agencies for this process—after all, from their perspective, it is impossible to know what is lost from review if too narrow a universe of search terms is agreed upon. None of the Second Requests surveyed in this article utilized keyword searches to eliminate documents to review.

For each of the Second Request productions we surveyed the data was put into a litigation database and reviewed online over the Web. This gave the counsel's review team (situated in different locations) a centralized system by which they could search all documents as they are being reviewed, as well as the ability to cull documents using some of the criteria discussed above. As technology has improved, the ability to cull has likewise dramatically increased. For example, as discussed below, we were able to reduce total volume by over 70 percent in our most recent Second Request. But even improvement in filtering and culling techniques has only allowed us to tread water, as the amount of documents we have had to review after filtering has increased 300 percent since 2001.

¹¹ On December 11, 2002, the FTC published its Statement of the Federal Trade Commission's Bureau of Competition on Guidelines for Merger Investigations, which discusses best practices with regard to the production of electronic data. See Federal Trade Comm'n, Statement of the Federal Trade Commission's Bureau of Competition on Guidelines for Merger Investigation §§ 6.b and 6.d (Dec. 2002) [hereinafter FTC BC's Merger Investigation Guidelines], available at <http://www.ftc.gov/os/2002/12/bcguidelines021211.htm>. Among other things, these Guidelines acknowledge the efficiencies gained with electronic productions and contemplate the use of term searches to cut down the volume of e-mails.

¹² FTC BC's Merger Investigation Guidelines contemplate the use of term searches to help reduce the volume of documents that need to be reviewed by the parties. See FTC BC's Merger Investigation Guidelines §§ 6.b and 6.d, available at <http://www.ftc.gov/os/2002/12/bcguidelines021211.htm>. These guidelines also acknowledge the difficulty in negotiating term searches because it is difficult to negotiate searches without understanding the documents and the industry. In order to negotiate term searches, the Guidelines recommend that the responding party provide: (1) organizational charts and background on how electronic data is kept at the company; (2) glossary of industry and company terminology; (3) proposed search methodology and search samples and results for staff to evaluate; (4) rolling production so that search terms can be adjusted; (5) exceptions from searching for certain key employees; and (6) safeguards to ensure that responsive documents found outside searches will be produced, or not relied upon by the party. As one would suspect, such negotiations are cumbersome, and in our view, actually serve to hinder the pace of review.

Producing Electronic Documents. The only reliable constant in Second Request production formats is unpredictability.¹³ For each of the surveyed Second Requests, the government has requested different production format combinations, which include:

- **Access to Online Review System**—Online review gives the agencies Web access (usually the same one used by us during our review) to the universe of documents that the parties produce in response to the Second Request. To address concerns about reliability, performance, and security of the online review system, we have agreed to enter into service-level agreements with the agency, whereby the agency maintains control over the data and the parties have no access to the agencies' online review.
- **Paper**—Paper is the traditional method of production, and requires the parties to print out each electronic document, which is impractical, expensive, and kills trees.
- **Database and .tiffs**—In some instances, the agencies demand production of documents in a database—usually Concordance or Summation—that contains full-text and non-work-product metadata linked to a .tiff electronic image of the document (similar to a black and white photocopy).
- **.pdfs**—The agencies have also asked for production of documents in searchable Adobe Portable Document Format (.pdf) (which is a color, searchable photocopy).
- **Native Files**—The agencies also sometimes accept a copy of the original files from the parties without converting the files into an electronic image or paper. To date, we are not aware of any instance where the agencies have accepted a production comprised entirely of native files, but instead, require native file formats only where the agencies seek to have the ability to “modify” the document and manipulate the core assumptions in the document (e.g., Excel spreadsheets).

Although each of the production formats has various benefits and disadvantages, all are sufficient for giving the agency an opportunity to review and assess the production. While we generally are production format agnostic, the most significant non-attorney expense is the cost of processing the collected data into a common-denominator format, whether paper or an electronic image. This conversion process also takes a significant amount of time, significantly delaying the review and production process. Accordingly, there is increasing pressure from clients to skip this conversion step and instead review and produce just using the native files (e.g., documents that have not been converted into searchable reproductions such as .tiff or .pdf images). A native-file review was very difficult to execute a few years ago due to the limits of available technology and tools, but significant developments have made this process easier.

Because electronic-file volumes likely will not decrease in the future, the ability of the agencies to accept a native-file production (especially because these are how the files are kept in the ordinary course of business) will become critical. At present, however, it is difficult to negotiate a native-file production with the agencies. We leave for another day the debate as to whether the HSR Act allows the agencies to demand a specific format for production or whether production of documents in native-file format would somehow not constitute “substantial compliance” under the Act.¹⁴

¹³ In fairness to the agencies, there is no standard production format in the litigation support industry. As with any emerging technology industry, new applications and services emerge every day. To their credit, the agencies have tried to implement standards. See Hoffman, *supra* note 3.

¹⁴ 15 U.S.C. § 18a(g)(2) (setting forth substantial compliance timeframes). There has not been any formal or informal guidance, to date, as to whether native production of electronic documents would constitute substantial compliance.

The problem created by the uncertainty surrounding production formats is that it often limits choices in the selection of litigation support vendors that will generate the production sets. That vendor needs to have a scalable online review system, as well as the ability to turn around the large production volumes (in a variety of the above production formats) generated from a Second Request review. Decisions regarding production formats also tend to come late in the negotiations between staff and the responding party, which makes it hard for the responding party to plan efficiently. The lack of clear production guidelines also can result in deliveries that do not meet the technical specifications of the agency, further delaying the entire process. Whatever the format, the establishment of consistent, reasonable, and clear production guidelines will make the process more efficient.

Results of Our Survey

Observation #1: The volume of electronic documents is expanding exponentially.

In the deals that we examined, the average volume of documents collected per employee has increased at an almost unbelievable rate. We observed that from 2001 until early 2005, the average volume collected (converted from gigabytes to estimated boxes) per employee jumped from 14.6 boxes to 141 boxes, an increase of over 969 percent. (See Chart 1). To put that into the context of complying with a Second Request, the same number of attorneys required to review documents from 14 employees in 2005 would have been used to review 135 employees' documents in 2001. That alone has increased the cost of the Second Request process tremendously.

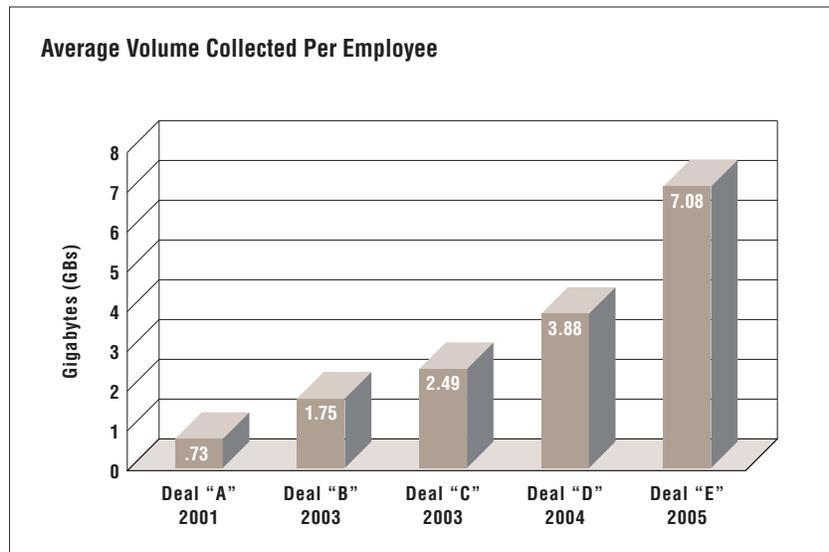


Chart 1: For the five deals surveyed, this chart tracks the average volume of data collected per employee. In general, one gigabyte of data is equal to 50,000 pages (or 20 boxes).

Observation #2: E-mail represents the single largest source of electronic documents (see Chart 2) and in all likelihood accounts for the most substantial component of electronic discovery cost in Second Requests.

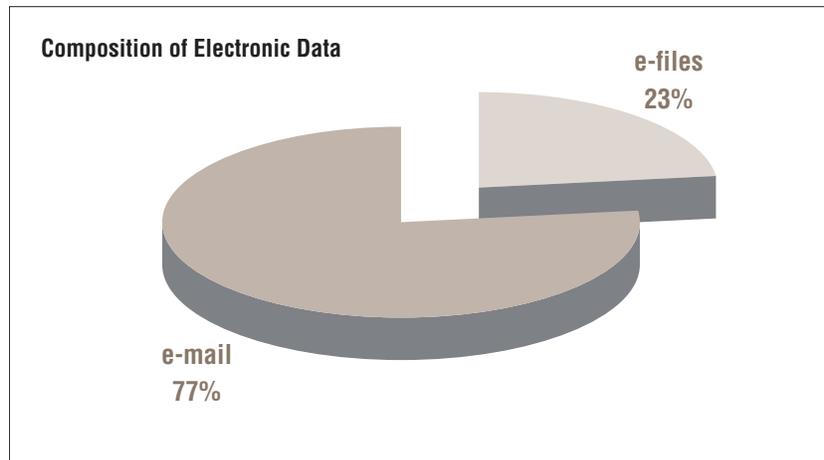


Chart 2: For the five second requests surveyed, the vast majority of data collected was e-mail.

For our clients, at least, e-mail has become the most important method by which they communicate—with their work colleagues, customers, suppliers, and lawyers. E-mail is an easy way to communicate information quickly and concisely, and for many of our clients, it simply never goes away. It is not uncommon these days to open the e-mail folders of the Vice President of Sales and find *several hundred thousand* e-mails in her inbox and the same number in her deleted items folder. These e-mails are unsorted—the equivalent of dumping several hundred or thousand boxes of documents on the floor. Multiply that by the number of employees that the parties must search to respond to a Second Request and it is clear how quickly the burdens can become enormous.

Observation #3: Technology improvements have made it easier to “cull” non-responsive documents from production (see Chart 3); however, the improvements do not keep up with the increasing volume of documents. As a result, culling does not solve the problem of burdensome document reviews.

“Culling” electronic documents is the process of discarding electronic documents that clearly are not responsive to a Second Request, without investing a significant amount of attorney time. Given the volume of electronic data, culling most importantly includes the automated removal of documents that fall outside of the responsive date range in a Second Request, or the elimination of duplicates.

We have also increasingly turned to other methods of “electronic” culling. For example, prior to a detailed review of documents, we often manually review the file trees (i.e., an electronic directory of each individual’s electronic documents) collected from each employee from whom we need to collect in order to respond to the Second Request. Where file trees clearly contain non-responsive information (e.g., a file folder entitled “Johnny’s Third Birthday” or a file folder containing information regarding products not included within the scope of the Second Request), we eliminate such documents from the review process. This culling has a large impact on the scope of our actual detailed review.

Even with aggressive culling procedures, we are still reviewing a significantly larger universe of documents. (See Chart 4). Note that in Deal A, in 2001, we had not yet developed a reliable method to cull information, so we manually reviewed every electronic document collected from each employee whom we searched at the company. By 2005, we were able to eliminate a full 70

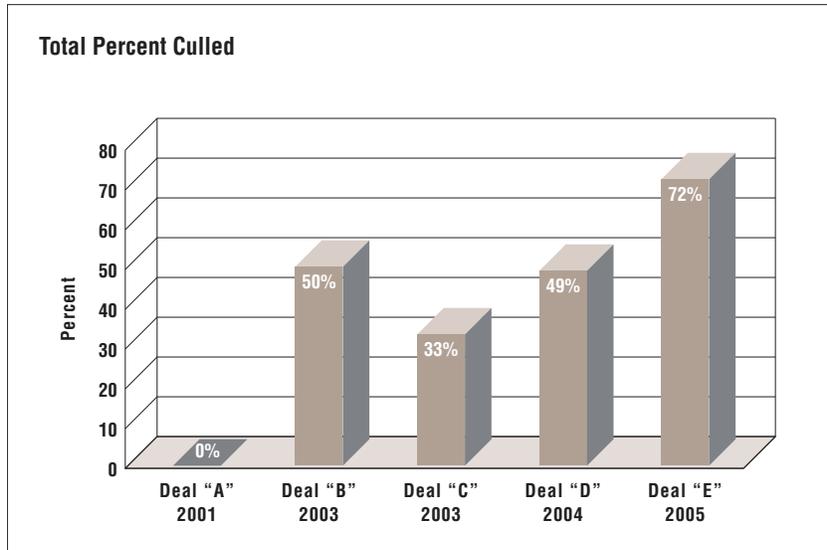


Chart 3: This chart demonstrates the percentage of documents that we have been able to cull from the review universe utilizing a variety of technologies and techniques.

percent of documents that we collected without conducting an extensive review of every document within each employee’s electronic document cache. Nevertheless, even with aggressive culling methodologies, we are still reviewing a tremendous amount of information—more than three times more than we reviewed in 2001, before reliable culling methodologies were adopted.

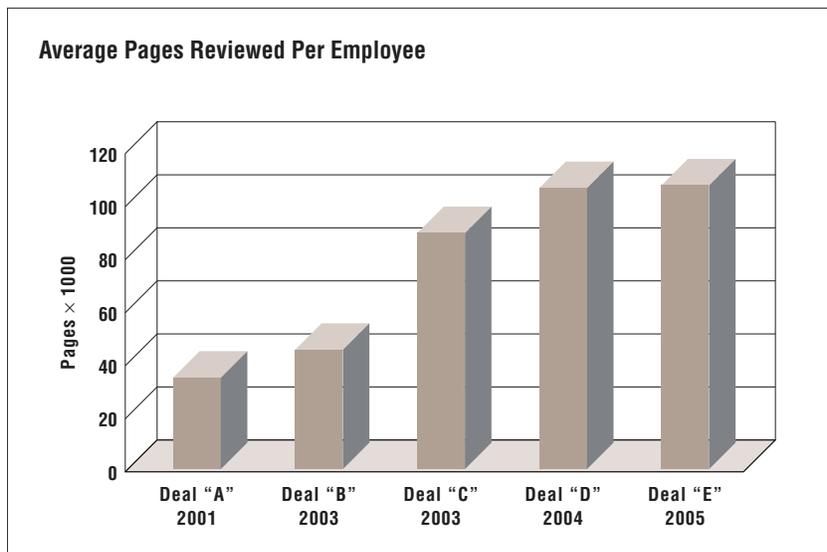


Chart 4: By employing more aggressive culling techniques, the average number of pages reviewed per employee has plateaued for the time being.

Chart 5 indicates that, even with aggressive attempts to eliminate clearly non-responsive information without detailed review, parties are still forced to expend a significant amount of time and money on review of clearly non-responsive documents. In a recent Second Request (Deal E), only one-third of electronic documents that were reviewed after eliminating clearly non-responsive documents were actually responsive to the government’s Second Request demand.

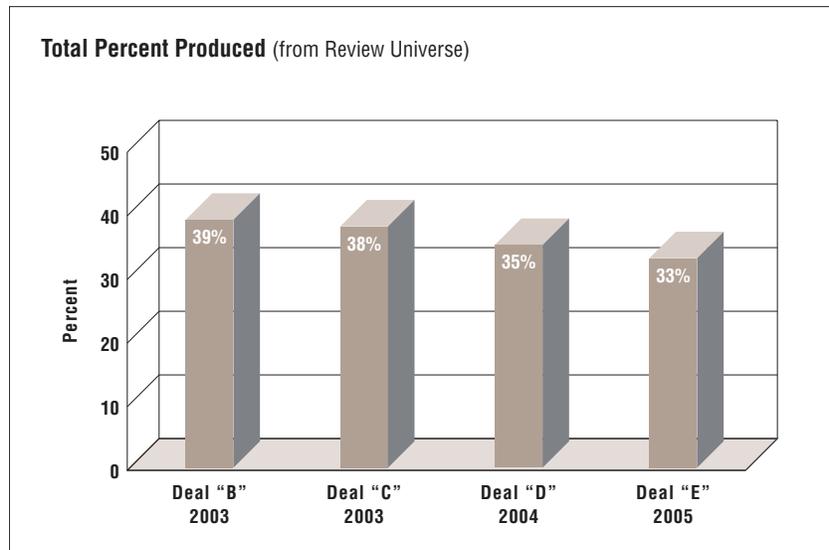


Chart 5: Even with more accurate culling techniques, there is still a great deal of non-responsive data that needs to be identified by the review team.

Observation #4: Management has the highest percentage of responsive documents; the sales force has a high volume of documents of questionable value. (See Chart 6).

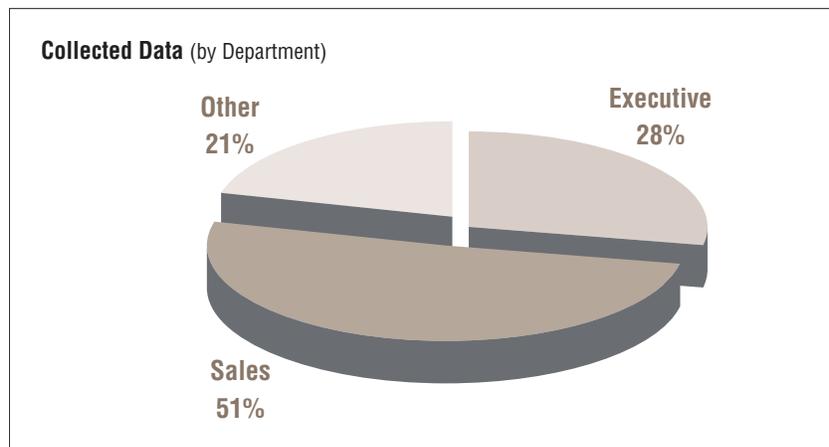


Chart 6: The largest source of documents is from the Sales department.

The sales force of a company tends to send and receive the most e-mail. There is often a considerable amount of chatter between sales representatives, some of which indeed may be “technically responsive” to a Second Request—for example, banter regarding a particular potential customer. We agree that such information may indeed be valuable. But especially where such customer-specific data is captured in centrally stored enterprise databases, we question whether the production of additional data adds anything to an agency’s investigation. Further, older “banter” (e.g., from three years before the merger’s occurrence), seems so distant as likely to be irrelevant to analyze the current state of competition in a market.

Recommendations

Recommendation #1: At the outset of an investigation, the parties should provide the agencies with detailed information regarding the content of electronic databases. In return, the agencies should agree to reasonable limitations on the production of electronic documents.

At the start of any investigation, the parties should make available to the agencies the individuals responsible or most knowledgeable for the maintenance of the companies' electronic documents. If necessary, the parties should agree to a deposition of such individuals at the outset of the investigation, or agree to answer "contention-type" interrogatories regarding the nature of their electronic document systems. As discussed above, the parties have available to them sophisticated tools and visualizations that quickly enable them to identify electronic document volumes and sources. These tools can be critically important in the Second Request negotiation process.

Recommendation #2: The agencies should be amenable to multiple production methodologies to limit the costs associated with Second Request production; the parties should agree to provide the agencies with the information necessary to complete an expeditious investigation.

As discussed above, there are numerous ways to produce documents—in paper format, natively, in Summation or Concordance, or online via a secure ASP. The agencies should work to overcome their reluctance to accept documents in multiple formats *and should accept any format*, so long as the parties are at the same time willing to certify that production via any methodology will not prejudice the agency's review. Often, we have negotiated with the reviewing agency concerning the production methodology and have promised "back-up" production for certain documents, if the methodology initially selected failed to produce all necessary information in a format that enabled the agency to complete an adequate review.

Recommendation #3: The agencies should pare down the number of sales employees searched and produced; the parties should promptly provide information regarding the type of documents maintained by each employee.

There have been calls to statutorily limit the number of employees from which the agencies can demand documents. We believe that such artificial limitations are not helpful and a one-size-fits-all approach is not appropriate. A merger involving two organizations, each with 30 employees, naturally demands a more limited production than a merger involving two organizations, each with 5,000 employees. Setting a fixed number of employees from which the agencies can search files helps no one.

Rather, the agencies must carefully consider the nature of their request. It goes without saying that the FTC and DOJ must focus their document demands. Perhaps, as some have suggested, if the agencies were required to publicly produce statistics to Congress regarding the metrics of document demands and production, and were required to meet certain performance objectives, this would create sufficient incentive for staff to temper their document requests.

The staff cannot reduce their demands, however, if parties require them to throw darts blindfolded. The parties must provide information early in the process regarding the nature of each employee's job responsibilities, and must take care to document carefully which employees likely will have the most responsive information. Anything less than that will contribute to the problem—and the parties cannot then blame the staff for burdensome production demands.

Recommendation #4: The agencies should limit the time scope of e-mails to be searched very carefully and should consider eliminating “deleted” items from Second Request productions; the parties should provide “representative samples” of such documents to the agencies.

Merger investigations are not conduct investigations. There likely will not be a smoking gun in someone’s e-mail describing the effect of the merger on the market, and we have never seen the random e-mail from someone in field sales that ex ante described the competitive effects of consolidation on the market. In conduct investigations such smoking guns may exist—there may very well be the e-mail that describes a price-fixing scheme—but that is not the world of merger investigations.

As a result, we believe that the percentage of truly relevant e-mails is low. The percentage of ground-breaking e-mails is even lower. The percentage of deleted or unsorted in-box e-mail from two years prior to the contemplation is largely irrelevant. The burden to review such information is enormous. As the data shows, e-mails are the bane of merger review, and the process of collecting, reviewing, and producing such information is staggering, especially relative to its actual value. It is critical that something be done to control the e-mail production process. The agencies should consider seriously from which employees e-mails are relevant and the parties should quickly provide statistics to the agencies regarding the volume of such information.

Recommendation #5: The agencies should streamline the privilege log process.

Besides producing responsive documents, another significant production task is the generation of a privilege log. The amount of detail for the production log requires the parties to devote significant (and senior) review resources. While the parties can take advantage of document metadata (such as author, recipients, date, document type) associated with the document, and capture the necessary review basis and description during the online review process, the entire process is cumbersome and usually is the last item that is completed before certifying compliance with a Second Request.

Although we recognize the need to justify a decision to withhold a document on the basis of privilege considerations, we do not believe that the current process for privilege log production is rational. We believe that there is a middle ground that can streamline the process. For example, the agencies should simplify the level of detail for the production log and eliminate much of the data requested regarding each document in the production. The agencies could also limit the creation of a production log to a subset of documents (such as for only a few employees to be named by the agency). This would provide the agency with the ability to spot check the privilege calls made by the party and reduce the resources required to generate the privilege log. Another possibility—and one that we strongly believe is warranted—is the elimination of in-house counsel from the demands of a Second Request in all but the most limited of circumstances (e.g., where the General Counsel is also responsible for corporate development or has access to lawsuits that are relevant to the investigation, or has other necessary information that cannot be gleaned from non-attorney sources). It goes without saying that counsel is likely to have a tremendous amount of privileged data, and the cost and time associated with logging such information in a cumbersome log simply is not justifiable where the agencies can satisfy their need for information from other sources. ●

Book Review

Competition Law and Public Service in the European Union and the United States

Tony Prosser

The Limits of Competition Law: Markets and Public Services

Oxford Studies in European Law ■ 2005

Reviewed by Jim Rossi

When competition laws and other public service principles are in tension, can courts avoid a collision or will it be necessary to pick a winner? In *The Limits of Competition Law: Markets and Public Services*,¹ Tony Prosser, a Professor of Public Law at the University of Bristol, England, sheds light on the debate. He pays particular attention to public service obligations and their implications for the regulation of state monopoly in the European Union, drawing interesting and important connections between antitrust principles in the UK and elsewhere in Europe, specifically France and Italy.

Although the notions of sovereignty that predominate in the EU differ fundamentally from those of federalism in the United States, Prosser's discussion parallels familiar American debates about the scope of defenses for regulated industries under antitrust laws. By highlighting comparative differences between the UK and continental approaches to addressing potential conflicts between antitrust and public service law, Prosser emphasizes how a normative understanding of the nature of governmental intervention can contribute to a more robust assessment of the overlapping domains of competition law and public service obligations more generally. His analysis warns against an overly legal positivist understanding of antitrust defenses for regulated industries.

Competition Law and Public Service in the EU

Prosser begins his book by highlighting the tension between markets and competition law, on the one hand, and public service obligations, on the other. This tension is well known, paralleling the apparent divide between efficiency and fairness or equity as antitrust law's goals. Whenever government has an active scheme of regulation for universal service in health care, compulsory access for telecommunications and broadcast providers, or energy service, the question about the scope of antitrust intervention is implicated.

As Prosser illustrates in his book, the UK has a long tradition of public service regulation, but recent legal decisions echo the *Report on Regulatory Reform* of the Organization for Economic Cooperation and Development (OECD) (published in 2002). Traditionally, UK notions of public service were largely "political and discretionary," (p. 43) "part of an ill-defined concept of the public interest to be protected through nationalization rather than a set of specific norms susceptible

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¹ Page references to this book appear in the text throughout this review.

to legal enforcement” (p. 44). Nevertheless, for most of the 20th century, a broad “public interest” helped to create a safe harbor for public service regulation.

In contrast to this traditional approach, the OECD report suggests “a very strong preference for regulation only through competition law; any exceptions must be justified by ‘clear evidence’ and ‘compelling public interests’” (p. 4). Recent UK decisions appear to echo this approach. Industry privatization coupled with the recent UK approach to antitrust immunities—reflected in the Competition Act of 1998 and the Enterprise Act of 2002—disfavor public service obligations. Prosser observes that the new approach has practical implications for industries in the UK. One example is the Office of Fair Trading’s investigation of entry restrictions for retail pharmacy services, which “concluded that all control of entry regulations for retail pharmacies should be abolished because of the benefits of increased competition for prices and service quality . . .” (p. 51).² Another example discussed is the UK agency’s *BetterCare* decision (2003), in which the new UK competition law was applied to an entity that exercised public functions, indicating that the scope of competition laws in the UK is broad and emphasizing the increasing significance of the definition of exceptions (pp. 56–57).³

With the emergence of this new approach in the UK, Prosser warns that “there appears to have been little development of principles relating to the special needs of public services” (p. 65). He finds this particularly worrisome given the “gradual development of social regulation based on public service concerns, notably in relation to protecting university service and the interest of consumers in newly competitive markets” (p. 93). Consumer protections in the UK are described by Prosser as “pragmatic” (p. 67), at best, and “uncoordinated and inconsistent” and leading to “inefficiencies and inequities,” (p. 94) at worse.

In contrast to the UK approach, what Prosser labels the “Continental tradition of public service” begins from first principles rather than politics. He uses the French law of *le service public* and the Italian law of *servizio pubblico*, much of which takes on constitutional status, as illustrations. As Prosser highlights, *le service public* operates at a high level of generality but is central to French administrative law and appears in several French legal sources. Italy’s *servizio pubblico*, which appears in its constitution, reflects “the inherent duties of the state to ensure its proper delivery, either through ownership or through effective private operators” (p. 119). What these approaches share is an emphasis on social solidarity over competition and markets—a topic Prosser explores in a conceptual chapter early in his book (Chapter 2, titled “Competition Law, Citizenship Rights, and Social Solidarity”).

After tracing the Continental tradition of public service, Prosser discusses its fit with European Community law. As is discussed in the book, this is a complex issue, in part because of the decentralized approach of the EU and the radically different notions of public service, law, and politics among its 25 Member States. It is also complex because EU laws themselves pull in differing directions, presenting a difficulty in “reconciling liberalized markets and competition on the one hand and protection of public service goals on the other” (p. 124). Prosser’s examination of the relevant articles and rules of competition law illustrates this potential tension. EU competition law contains strong protections for competitive markets. For instance, Article 31, as amended by the Treaty of Amsterdam, prohibits discrimination in commercial dealings between Member States. In a manner similar to the Sherman Act, Articles 81 and 82 present general rules of competition law,

² Office of Fair Trading, *The Control of Entry Regulations and Retail Pharmacy Services in the UK*, OFT 609 (Jan. 2003).

³ Office of Fair Trading, *BetterCare Group Ltd/North & West Belfast Health and Social Services Trust (Remitted Case)*, Decision 98/09/2003.

prohibiting agreements between undertakings and concerted practice (akin to Sherman Section 1 violations) and abuse of a dominant position (akin to Sherman Section 2 claims). Enforcement can be carried out by the European Commission or by enforcement authorities in any of the 25 Member States.

However, Prosser notes that EU law also creates some safe harbors for public service regulation. Article 86(1) carves out an exception from the general rules of competition for “public undertakings and undertakings to which Member States grant special or exclusive rights.” Article 86(2) provides an exception for undertakings “entrusted with the operation of services of general economic interest or having the character of revenue producing monopoly” As Prosser highlights, a real tension exists between Article 82 and Article 86’s exceptions, but courts recognize broad exceptions for universal service purposes. He discusses some of the leading cases. For instance, a challenge to the Belgian postal service’s exclusive right to collect, transport and deliver mail to sustain universal service led to the celebrated *Corbeau* case.⁴ There it was recognized that the exclusion of competition for special services is permissible if competition in them would compromise the economic equilibrium of service of general economic interest.

In another case, German restrictions on commercial entry to provide ambulance services intended to protect emergency ambulance services was upheld on the ground that the restrictions were necessary to maintain the quality and reliability of service.⁵ Prosser’s analysis also highlights such cases as the European Court of Justice’s *Altmark* decision, which addresses the scope of permissible state aid for monopolies that provide public services.⁶

These cases appear to interpret the exceptions to competition law broadly, even where there are less restrictive alternatives for competition that Member States could have used. For example, the Court may permit companies to enter into exclusive purchase and sale agreements for electricity to ensure uninterrupted service to meet a state-imposed requirement, even if the agreements have the effect of precluding imports from Member States and even if other means of providing uninterrupted service (such as competitive bidding) were less restrictive of competition. The Court has recognized that restrictions on competition must be permitted to allow an undertaking “entrusted with such a task of general interest to perform it.” It also has recognized that “it is necessary to take into consideration the economic conditions in which the undertaking operates, in particular the costs which it has to bear and the legislation, particularly concerning the environment, to which it is subject.”⁷

Further bolstering EU law’s strong tendency toward public service values is Article 16 of the Treaty of Amsterdam, which provides that Member States shall take care that services operate on the basis of principles and conditions that enable them to fulfill their missions. Some legal commentators have argued that this creates a positive legal obligation for Member States to provide public service.⁸ Prosser does not adopt this ambitious view of Article 16, but does urge a much more expansive understanding of public service obligations than the recent UK approach. In discussing the application of public service obligations to telecommunications, energy, postal services, and transportation, Prosser argues that EU law gives a “clearer, more coherent, and more

⁴ Case C-320/91, *Procureur de Rui v. Paul Corbeau*, [1993] E.C.R. I-2533.

⁵ Case C-475/99, *Ambulanz Glöckner v. Landkreis Südwestpfalz*, [2001] E.C.R. I-2533.

⁶ C-280/00, *Altmark Trans GmbH*, [2003] E.C.R. I-7747.

⁷ Case C-393/92, *Almelo* [1994] E.C.R. I-1477.

⁸ Malcolm Ross, *Article 16 EC and Service of General Interest: From Derogation to Obligation?*, 25 EUR. L. REV. 22 (2000).

legally enforceable basis for the implementation of public service than had been the case in the UK . . .” (p. 205). He addresses the expansion of public service values by statute, as has been done in UK broadcast regulation, but favors a judicial over a statutory approach to the problem.

General Lessons for Regulated Industry Defenses in Antitrust Law

Prosser takes as his point of departure the obvious tension between competition, reflected in the ideal of common markets supported by EU competition law, and public service values, reflected in the positive consumer protection laws of the individual Member States. Perhaps these values are incommensurable, highlighting the limits of any effort to develop common markets through an interstate legal system. The looser the notion of federalism, the more intractable the problem is likely to be. Indeed, one latent message of Prosser’s is that competitive markets and public service reflect a clash of fundamental values—a subtheme that reverberates throughout the book but which Prosser concedes to be largely beyond its scope. To the extent these values are incommensurable, this may limit any lessons that can be drawn from a comparative survey.

However, despite the apparent tension between these values, Prosser highlights some important lessons for federalism-based defenses to competition law in both the U.S. and the EU. In the context of EU law, Prosser usefully separates the negative public service restrictions, reflected in Article 86, from the positive public service obligations that appear in Article 16. In so doing, he highlights the legal sources for many European Community decisions that embrace public service values over competitive markets. For instance, a 2003 Green Paper on Services of General Interest recognized a Community conception of general economic interest, which includes universal service, continuity, quality of service, affordability, and user and consumer protections. Prosser makes a strong case for viewing these obligations as more than mere abstractions in the EU context.

Moreover, Prosser provides a sketch for the implementation of public service goals in liberalized markets. Drawing on the *Altmark* decision, which envisioned a reconciliation of competitive markets and public service through the substantive evaluation of competitive tendering, he elaborates on the importance of choosing a public service provider and supervisory institutions in liberalized markets. The primary substantive condition for approving competitive tendering for public service is that “either the compensation was awarded through a public procurement procedure based on the lowest cost, or that the compensation was no greater than that which a notionally efficient undertaking would require” (p. 241).

Prosser argues, however, that while competitive tendering may be necessary, it is not sufficient to resolving the tension between competitive markets and public service in politically accountable ways. His book suggests a broader analysis that is attentive to institutions. Using the example of the British public service broadcasting system, he argues that “there may be situations in which it will simply be impossible to create proper competitive tendering because there are overwhelming reasons to favour a particular incumbent because of its critical mass of skills and established expertise” (p. 242). In the case of the BBC, Prosser observes that regulators “concentrated on the institutional arrangement to secure transparency in the relationship between publicly funded and commercial services.” (p. 243)

Ultimately, Prosser argues, “proceduralization” or “appropriate institutional arrangements, including independent regulation” (p. 244) will be necessary to simultaneously balance competitive markets and public service without sacrificing accountability. Common markets are critical of state-sanctioned regulatory barriers, while public service regulation may embrace such barriers. The institutional arrangements surrounding a state-sanctioned barrier, including transparency

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and independent decision making (presumably to avoid corruption), as well as competitive tendering, thus take on a fundamental role in evaluating the legitimacy of the barrier.

Prosser leans strongly toward general expansion of public service values in competition law. However, the analytical and legal framework of competition law would not necessarily lead to this result in every instance. Attention to procedural and institutional features can give courts a reason to question exceptions to competition laws as well as to embrace them. Prosser's analysis reminds us why a firm's claim of public service values like consumer protection should not give rise to automatic exceptions from antitrust enforcement. His attention to institutional arrangements suggests that, in deciding when state "public service" regulation provides a legitimate defense to antitrust enforcement, attention to political accountability must serve as a safeguard against abuse of the antitrust laws by dominant firms. Careful assessment of procedure, along with transparency of regulatory processes, should be required before extending antitrust immunities to regulated industries.

This observation has application to discussions of antitrust immunities involving regulated industries in the United States, a topic the Antitrust Modernization Commission currently has placed on its agenda for discussion.⁹ In the United States, the problem Prosser discusses takes on the greatest significance in state action defenses to antitrust law, which carve out a safe harbor from antitrust enforcement where state and/or local regulators engage in regulation that reflects a clearly articulated state policy to displace antitrust law and where there is active supervision by regulatory officials of the conduct at issue.

One of the issues courts in the United States are struggling with is how to reconcile competitively restructured markets with partial schemes of regulation at the state and local level. Much state and local regulation is directed to furthering public service related values, including universal service and equal access. As a number of antitrust scholars in the United States have recognized, where a regulator is not acting in transparent ways to enforce standards, the extension of an exemption from antitrust principles seems questionable. Antitrust law can play a role in ensuring a baseline of competitive markets where firms might otherwise attempt to abuse the governmental process for private gain. Courts and regulators in the United States thus might take a lesson from Prosser's comparative study of the conflict between competition law and public service. As Prosser illustrates, a legal positivist approach to state regulation cannot, by itself, reconcile competition laws with public service values. If the mere fact of a law supporting state or local public service precludes antitrust enforcement, this could encourage dominant firms to engage in more strategic lobbying than is socially optimal. State-sponsored public service laws can serve important goals, as Prosser recognizes, but his framework may also give courts grounds to recognize that sometimes state or industry claims of public service goals values are unjustified.

Prosser's study carefully surveys the issue in the UK and EU, raising many interesting questions for competition law. Common markets may seem idealistic, especially in complex multistate settings with loose federalism. Prosser's book will certainly be of great interest to comparative law scholars and to EU and Member State regulators and courts. A glance at EU law can prove instructive to both regulators and courts in the United States as well. ●

⁹ See <http://www.amc.gov/pdf/meetings/ImmunitiesExemptionsStudyPlan.pdf>.

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: In this issue of the Paper Trail, we look at the recent speeches of Michael Salinger, the newly installed FTC Bureau of Economics Director.

If you have any comments, questions, or suggestions please e-mail them to Bill Page (page@law.ufl.edu) or John Woodbury (jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

Recent Speeches

In June of this year, FTC Chairman Deborah Majoras appointed Michael Salinger, a member of the faculty of the Boston University School of Management and former Chairman of the Department of Finance and Economics, to succeed Luke Froeb as Director of the Bureau of Economics. Since becoming Director, Salinger has been quite active on the speaker circuit, and his presentations provide insight into his views as an economist.

On September 14, the Antitrust Section's Economics Committee hosted a brown bag program with Salinger, moderated by Ilene Gotts, the Section of Antitrust Law's International Officer, and a partner at Wachtell Lipton Rosen & Katz.

In his prepared remarks, Salinger posed four key questions about antitrust enforcement (<http://www.ftc.gov/speeches/salinger/050914ababrownbag.pdf>). First, he addressed the age-old question of why efficiencies don't seem to matter in merger enforcement decisions. His response was that by and large, he considered most efficiency claims to be more fantastic than real, and so shouldn't carry much or any weight in the enforcement decision process. Salinger did acknowledge that that may be true because the agencies are perceived to have historically attached so little weight to efficiencies. Consequently, the merging parties have little to gain by incurring the expense of developing an estimate of the cognizable efficiencies (in the words of the Merger Guidelines).¹ And for good or for ill (and I think the latter), the Guidelines themselves state that efficiencies will only count in close calls ("when the likely adverse competitive effects, absent the efficiencies, are not great," Merger Guidelines, Section 4, <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>). While Salinger promised that the Bureau of Economics would consider seriously serious efficiency estimates in the Bureau's merger-enforcement recommendations, it remains to be seen whether efficiencies will serve more than just the role of a tie-breaker in an otherwise borderline case.

Second, Salinger posed the question of why the agencies are so reluctant to bring coordinated effects cases. His answer was brief but to the point: they're hard to win. From a practitioner's standpoint, the implications of this response are not obvious, in light of the views of Salinger's recent predecessors (Dave Scheffman and Luke Froeb) that coordinated effects analyses are ris-

¹ Interestingly, he did note that any claim of a substantial reduction in fixed costs would seem incredible, because these costs really are not fixed. Does that mean that the agencies will treat credible G&A savings as variable cost efficiencies?

ing in importance at the agencies. In particular, does it mean a swing back (or partly back) to unilateral effects analyses?

He follows up both of these questions with a third: If the parties do not offer credible efficiency evidence, why not challenge the merger? His response is that every merger policy must weigh the costs of “false positives” (i.e., mistakenly challenging a procompetitive merger) and “false negatives” (i.e., failing to challenge an anticompetitive merger). And relying on past studies, he assumes that on average, a merger will lead to a 1–3 percent productivity increase. So, even in the absence of a credible efficiency estimate, Salinger will assume that the merger will lead to benefits that are on average at least this large. That is, Salinger presumes that (other things equal), one would expect that any particular merger will generate efficiency savings of 1–3 percent, what he calls the “standard deduction” for a merger. Thus, challenging every merger would reduce consumer welfare. But even given this “standard deduction” for efficiencies, he notes that mergers in antitrust markets characterized by relatively inelastic demands and high entry barriers can substantially reduce consumer welfare. And the standard deduction notwithstanding, some of these mergers should be challenged even if tacit collusion is not the likely outcome (i.e., there is less than a 50 percent chance of the merger having a collusion-increasing effect) because the expected consumer welfare loss is large if the merger is cleared.²

So Salinger seems to be suggesting that in the absence of an efficiency defense that is specific to the merger being reviewed, some mergers should be challenged even if they don’t have a substantial probability of being anticompetitive. The irony of this view is that it places much more weight on efficiencies than appears to be current practice—one might still recall the D.C. Circuit Court of Appeals describing the efficiency defense in the Heinz/Beech-Nut matter as “novel.” (*FTC v. H.J. Heinz Co.*, 246 F.3d 708 (D.C. Cir. 2001.)) And I have no doubt that the Bureau of Economics will be receptive to cognizable efficiencies as an offset to any perceived anticompetitive harm. But will the Bureau of Competition and the Commissioners’ Offices have the same receptivity to an efficiency defense?³ While I don’t question Mike’s sincerity, this is déjà vu all over again.

In another recent talk, Salinger addressed the way in which one might evaluate vertical concerns that arise as a result of a merger (<http://www.ftc.gov/speeches/salinger/050927isitlive.pdf>). Direct evidence of effects is ideal, but unlikely; purely structural indicia are far less appropriate in vertical than in horizontal cases, given the difference in the nature of the concern; *Arch Coal* and *Oracle* aside (*FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109, 2004 U.S. Dist. LEXIS 15996 (D.D.C. Aug. 16, 2004); *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 2004 U.S. Dist. LEXIS 18063 (N.D. Cal. Sept 9, 2004)), the complaining customers are frequently the downstream rivals of the one of the merging parties, and there is a small likelihood of finding “hot” documents.

In these circumstances, a model of the vertical effects of a merger may well be appropriate and can guide the enforcement decision. But Salinger also opines that many economists try to make the case fit the model, instead of developing a model to fit the case. In addition, it should not be a surprise to many that, typically, the models in the economics literature are so stylized that “they are not going to form the foundation of a valid basis for challenging vertical mergers.” Against the

² Indeed, it seems to me that as the pass-through rates dip below 100%, one might be prepared to challenge almost every non-trivial merger given the assumed efficiencies. It’s not unusual for unilateral effects models to produce merger-induced price increases that exceed 1–3 percent, even with modest diversion ratios between the products of the merging firms.

³ For those readers keeping track, the fourth key question is best reviewed in Salinger’s prepared remarks. I could not do justice to that question here.

background of the general presumption that vertical mergers are likely to be efficient, Salinger will not attach much weight to a model of merger-related vertical effects unless it's clearly designed to model the specific "facts" of the industry.

In a different presentation (<http://www.ftc.gov/speeches/salinger/050711santefe.pdf>), Salinger briefly addressed the economics and antitrust analysis of tying. If a dominant firm engages in tying behavior, how can we determine whether or not that tying is anticompetitive? He notes that if that same practice is undertaken in competitive industries, then that does suggest that the tying by the dominant firm may have the same or similar underlying efficiency rationale. Salinger does not go so far as to say that, as a result, the dominant firm is absolved of any anticompetitive sin. But he also doesn't (in these remarks) provide a method of addressing whether there are any claimed anticompetitive effects from the tying practices.⁴

Finally, Salinger has addressed the issue of convergence between U.S. and European antitrust law (<http://www.ftc.gov/speeches/salinger/050920antitrustsymposium.pdf>). He argues that such convergence in the first instance depends on the extent to which we share common antitrust objectives. In particular, Salinger notes that both the U.S. and European antitrust authorities share the view that it is competition and not competitors that the antitrust laws were designed to protect. But he seems to suggest (albeit indirectly and diplomatically) that the Europeans are prepared to preserve competitors in the short run to preserve competition in the long run, a view that is not widely held in the United States. Thus, at a very basic level, divergence of objectives can prevent convergence of antitrust policies.

Even if the objectives are shared, the agencies in the United States may approach the antitrust analysis differently from their European counterparts. On the one hand, in Salinger's view, tying and bundling in the United States are viewed as much more in harmony with the goal of advancing consumer welfare than is true in Europe (although, it seems to me, that this particular difference could be driven by the difference in objectives). On the other hand, Salinger is more optimistic about convergence on vertical foreclosure analysis. Both sides of the Atlantic understand that the use of restrictive contractual terms (e.g., exclusivity) by a dominant firm can be efficient, but those same terms can be used to raise rivals' costs. (But again, if the difference in the perspective on tying is driven by the difference in objectives, it's not obvious why actions that foreclose rivals, even if efficient, would not be viewed by the European agencies as ones that will reduce long-run competition.)

Salinger's remarks to date do not suggest any substantial break with his immediate predecessors. Like Dave Scheffman and Luke Froeb, he emphasizes the importance of efficiencies in antitrust analysis and the need to carefully evaluate modeling efforts to ensure that the facts are driving the model, and not vice-versa. And like Dave and Luke, Mike begins with a strong presumption that vertical restraints are efficient.⁵

Mike is a careful and thoughtful economist. It will be interesting to watch the evolution of his views as he settles into the Director's chair. ●

⁴ Importantly, Salinger makes the point that understanding the economic basis for an efficient tying arrangement can be critical to courts considering the à la carte sale of the tied and tying goods as a remedy for any perceived anticompetitive harm. Mandating the separate sale of the goods may result in incurring substantial costs in producing both the à la carte and the tied version of the good. For a more detailed exposition of Salinger's views on tying, see http://papers.ssrn.com/sol3/papers.cfm?abstract_id=550884.

⁵ Salinger seems to endorse the views taken in a recent paper by Luke Froeb and other FTC staffers on the appropriate decision-theoretic framework for the evaluation of vertical restrictions. See our discussion in the May ANTITRUST SOURCE, <http://www.abanet.org/antitrust/source/05-05/may05-papertrail.pdf>.