

Correct Answers to Large Questions about *Verizon v. Trinko*

Robert A. Skitol

Perhaps the title of this article is a bit presumptuous, but I do presume to have irrefutable answers to questions that are now keeping the antitrust world awake at night about the true meaning of the Supreme Court's January 2004 opinion in *Verizon v. Trinko*.¹ These answers became all the more urgent to share in the wake of Assistant Attorney General Hewitt Pate's March 2004 declaration that "unilateral competitive conduct [is] the most ambiguous and controversial area of antitrust enforcement."² Mr. Pate thereby echoed Einer Elhauge's recent (pre-*Trinko*) charge that "for decades monopolization doctrine has been governed by standards that are not just vague but vacuous."³ Did *Trinko* help? Not too much according to Eleanor Fox, who has called the decision "a child in a china shop of Section 2."⁴ So let's assess the damage it brought, pick up the pieces, and move on.

The Decision in a Nutshell

Trinko was a consumer class action on behalf of New York City customers of AT&T in its capacity as a new-entrant local phone service provider competing with Verizon, the incumbent monopoly local service provider. The thrust of the complaint was that Verizon refused to provide AT&T with access to its systems and support operations in a reasonable manner, thereby impairing AT&T's ability to provide competitive service. Plaintiffs alleged that this refusal violated Verizon's obligations under the Telecommunications Act of 1996, and thereby also amounted to anticompetitive and exclusionary conduct cognizable under Section 2 of the Sherman Act.

The district court granted Verizon's Rule 12(b) motion to dismiss, relying on the authority of *Goldwasser v. Ameritech*,⁵ in which the Seventh Circuit held that similar allegations against another monopoly service provider failed to state a Section 2 claim. The Second Circuit reversed, and reinstated the antitrust claim, suggesting the allegations could establish Section 2 liability under either the essential facilities doctrine or the monopoly leveraging doctrine. The Supreme Court reversed the Second Circuit, thereby bringing the case to an end.

Justice Scalia's opinion on behalf of six members of the Court began by explaining that the Telecom Act neither foreclosed nor created new antitrust liabilities in light of the Act's savings

■
Robert A. Skitol is a partner in Drinker Biddle & Reath LLP, Washington, DC.

¹ *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, 124 S. Ct. 872 (2004), *rev'g* 305 F.3d 89 (2d Cir. 2002).

² U.S. Dep't of Justice, Antitrust Div., Press Release, Assistant Attorney General for Antitrust, R. Hewitt Pate, Issues Statement on The EC's Decision in its Microsoft Investigation (Mar. 24, 2004), http://www.usdoj.gov/atr/public/press_releases/2004/202976.htm.

³ Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 255 (2003).

⁴ Eleanor Fox, *The Trouble with Trinko 4* (Paper Prepared for ABA Section of Antitrust Law Spring Meeting Apr. 1, 2004).

⁵ 222 F.3d 390 (7th Cir. 2000).

clause to the effect that nothing therein “shall be construed to modify, impair, or supersede the applicability of any of the antitrust laws.”⁶

The Court then turned to the question whether Verizon’s alleged refusal to deal with its rival on reasonable terms “violates preexisting antitrust standards.”⁷ The starting point in the analysis of that issue was a sweeping restatement of the *Colgate* holding that the Sherman Act “does not restrict the long recognized right of [a] trader or manufacturer engaged in an entirely private business freely to exercise his own independent discretion as to the parties with whom he will deal.”⁸ The Court acknowledged that this right is not unqualified, but emphasized that “[w]e have been very cautious in recognizing” exceptions.⁹ *Aspen Skiing*¹⁰ was discussed at length as an exception involving termination of a voluntary and “presumably profitable” course of dealing, a case the Court called “at or near the outer boundary of Section 2 liability.”¹¹ In contrast, Verizon never voluntarily assisted its rivals and would not have done so absent the compulsion of the Telecom Act. The dispositive difference was that Aspen’s conduct “suggested a willingness to forsake short-term profits to achieve an anticompetitive end”; no such factor was present in the Verizon situation.¹²

On that ground, the Court then held that “Verizon’s alleged insufficient assistance in the provision of service to rivals is not a recognized antitrust claim . . .”¹³ And this conclusion, the Court continued, “would be unchanged even if we considered to be established law the ‘essential facilities’ doctrine crafted by some lower courts . . .”¹⁴ The “indispensable requirement” under that doctrine is unavailability of access to an essential facility, an element missing in this case in light of the Telecom Act’s imposition of access obligations.¹⁵

The Court went on to explain why it did not believe traditional antitrust principles justified “adding the present case to the few existing exceptions from the proposition that there is no duty to aid competitors.”¹⁶ The Court emphasized the presence of an extensive “regulatory structure designed to deter and remedy anticompetitive harm,” leading to a judgment that the “slight benefits” of antitrust intervention are outweighed by the costs and risks of any court’s attempted enforcement of “detailed sharing obligations.”¹⁷ In a footnote at that point, the Court then disposed of the Second Circuit’s suggestion that plaintiffs could rely on a monopoly leveraging theory: “To the extent the Court of Appeals dispensed with a requirement that there be a ‘dangerous probability of success’ in monopolizing a second market, it erred” (citing *Spectrum Sports*).¹⁸

The dispositive

difference was that

Aspen’s conduct

“suggested a

willingness to forsake

short-term profits

to achieve an

anticompetitive end”;

no such factor was

present in the

Verizon situation.

⁶ 47 U.S.C. § 152.

⁷ *Trinko*, 124 S. Ct. at 878.

⁸ *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919).

⁹ *Trinko*, 124 S. Ct. at 879.

¹⁰ *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985).

¹¹ *Trinko*, 124 S. Ct. at 879.

¹² *Id.* at 880.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 881.

¹⁶ *Id.*

¹⁷ *Id.* at 882–83.

¹⁸ *Id.* at 883 n.4 (citing *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447 (1993)).

There was no dissent. Justice Stevens, joined by Justices Souter and Thomas, wrote separately to concur in the judgment on the ground that the complaint should have been dismissed for plaintiffs' lack of standing, without reaching the merits of the allegations.¹⁹ In their view, plaintiffs' alleged injury was "purely derivative" of the alleged injury to AT&T, precluding standing under *Associated General Contractors*.²⁰

Burning Questions

1. Is short-term profit sacrifice now the definitive test for when a refusal to deal—and other kinds of unilateral conduct—can be the basis for a Section 2 claim? Answer: Yes and No.

On the one hand, Justice Scalia did sharply distinguish between *Aspen Ski* liability and *Verizon* non-liability on the ground that profit sacrifice was present in the former but not in the latter situation. And he provided several reasons why, absent that factor, it would be a bad idea to make a monopolist's refusal to share or cooperate with rivals an antitrust offense: lessening of investment incentives, requiring courts "to act as central planners," facilitating collusion.²¹ If one now interprets the opinion as effectively limiting any departures from the right to refuse to deal with rivals to profit sacrifice scenarios, the result will be a felicitous convergence between the definition of exclusionary or predatory pricing conduct and the definition of exclusionary or predatory nonprice conduct.²² One might then easily apply the same idea to cases involving conduct that combines both price and nonprice elements, such as the bundled rebates and discounts to induce exclusivity at issue in *LePage's v. 3M*.²³ absent a showing of profit sacrifice, there are good reasons to allow the conduct and so there should be no liability. *Trinko* might thus mean more generally that a monopolist's showing that its conduct maximized short-term profits is a per se valid business justification and will thus always be a dispositive defense to any Section 2 claim.

On the other hand, as Professor Elhauge argues, profit sacrifice is both underinclusive and overinclusive as a standard of general applicability.²⁴ There are practices like U.S. Tobacco's "dirty tricks" to remove competitors' products from store shelves²⁵ and Microsoft's "deception" of Java application developers²⁶ that entail no apparent profit sacrifice but can bring about exclusionary effects without any redeeming justification and without any downside to judicial intervention. Conversely, there are practices, such as high-cost and high-risk innovation initiatives, that may well necessitate profit sacrifice over a significant period and that may well have adverse effects on all rivals but that the law should not condemn or chill. Surely, even Justice Scalia would reject any notion that "one size fits all" for antitrust treatment of unilateral conduct generally.

The long-running search for "unifying principles" will continue but remain as elusive as ever. Thus, competing or at least complementary tests will continue to appeal to the courts and enforcement agencies alike: DOJ/FTC's focus on whether the conduct would not make business

¹⁹ *Id.* at 884–85.

²⁰ *Associated Gen. Contractors of Cal., Inc. v. Cal. State Council of Carpenters*, 459 U.S. 519, 529–35 (1983).

²¹ *Trinko*, 124 S. Ct. at 879.

²² *See Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

²³ *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (petition for cert. pending).

²⁴ Elhauge, *supra* note 3, at 268–94.

²⁵ *See Conwood Co. v. United States Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002).

²⁶ *See United States v. Microsoft Corp.*, 253 F.3d 34, 76–77 (D.C. Cir. 2001).

sense but for its exclusionary effect;²⁷ Judge Posner's focus on whether the conduct excludes an equally efficient rival;²⁸ the Krattenmaker-Salop concept of "raising rivals' costs";²⁹ Professor Elhauge's standard of conduct that impairs a rival's efficiency without contributing to the monopolist's efficiency;³⁰ the D.C. Circuit's rule of reason balancing approach;³¹ other tests destined to be either new wine in old bottles or old wine in new bottles.

2. Has the Court now newly elevated motive or intent as a central element in Section 2 law in contrast to lower courts' recent preference for a focus on effects in Section 2 cases? Answer: Yes and No.

On the one hand, the Court did emphasize motive/intent differences between *Aspen Ski* and the Verizon facts: *Aspen Ski's* termination of a voluntary and "presumably profitable" course of dealing "suggested a willingness to forsake short-term profits to achieve an anticompetitive end" and "a distinctly anticompetitive bent";³² Verizon had never voluntarily engaged in any such course of dealing so its prior conduct "sheds no light upon the motivation of its refusal to deal."³³ One Fifth Circuit panel has already applied *Trinko* in this light, holding its key lesson to be that "courts must be careful in determining that a business's refusal to deal is based on anticompetitive motives versus a valid business strategy."³⁴ A related message would seem to be that discontinuance of an existing relationship is now considerably more vulnerable to a Section 2 claim than is a refusal to initiate a relationship of any kind: an inference of anticompetitive intent will or may often be at least plausible in the former but not in the latter situation. Indeed, plaintiffs in discontinuance situations should now be able comfortably to survive Rule 12(b) motions and move into serious discovery (unlike the plaintiffs in the *Trinko* case itself) as long as they can adequately allege something in the nature of a deliberate profit sacrifice and a motive to recoup through later elimination of competition. Indeed, even in cases that involve longtime refusals, rather than discontinuance or changed policies, the opinion can be read as requiring some inquiry into intent, as exemplified by the DOJ's use of it in its recent brief on appeal from dismissal of its Section 2 case against Dentsply International.³⁵

On the other hand, it is inconceivable that Justice Scalia and his colleagues meant to diminish in any manner the fundamental place of effects evidence in Section 2 cases. As the D.C. Circuit has said, the overall focus is on "the effect of [the challenged] conduct, not upon the intent behind it"; the monopolist's intent "is relevant only to the extent it helps us understand the likely effect of the monopolist's conduct."³⁶ One clue to what *Trinko* may have done to that idea is its surely deliberate omission of any discussion of or even citation to the Court's *Kodak* decision,³⁷

... discontinuance of
an existing relationship
is now considerably
more vulnerable to a
Section 2 claim than
is a refusal to initiate
a relationship of
any kind . . .

²⁷ See Brief for the United States and the Federal Trade Comm'n as Amici Curiae Supporting Petitioner in Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, S. Ct. Docket 02-682 (May 30, 2003).

²⁸ See RICHARD POSNER, ANTITRUST LAW 193-256 (2d ed. 2001).

²⁹ See Thomas Krattenmaker & Steven Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986).

³⁰ See Elhauge, *supra* note 3.

³¹ See *Microsoft Corp.*, 253 F.3d at 58-59.

³² *Trinko*, 124 S. Ct. at 880.

³³ *Id.*

³⁴ Am. Cent. E. Texas Gas Co. v. Union Pac. Resources Group Inc., 2004-1 Trade Cas. (CCH) ¶ 74,271, at 98, 227 (5th Cir. 2004).

³⁵ Brief for the United States in United States v. Dentsply Int'l, Inc., 3d Cir. Docket 03-4097, at 38-39 (Jan. 16, 2004), available at <http://www.usdoj.gov/atr/cases/f202100/202141.htm>.

³⁶ *Microsoft Corp.*, 253 F.3d at 59.

³⁷ *Eastman Kodak Co. v. Image Technical Servs., Inc.* 504 U.S. 451 (1992).

a refusal-to-deal precedent much more recent than *Aspen Ski* and one in which Scalia sharply dissented. *Kodak* suggests that a refusal to deal with exclusionary effect is unlawful unless defendant then proves “valid business reasons” that were bona fide rather than “pretextual” explanations for the actions at issue.³⁸ *Trinko* can be read as reversing that burden: plaintiffs do not allege or establish a Section 2 claim unless they show anticompetitive intent and thereby also affirmatively eliminate the possibility of a meaningful efficiency or other valid alternative explanation. And the Court suggests that this will be virtually impossible in refusal-to-initiate situations. As declared at the end of the Court’s opinion, the Sherman Act “does not give judges *carte blanche* to insist that a monopolist alter its way of doing business whenever some other approach might yield greater competition.”³⁹ The more general bottom line may be that the Court has now made proof of bad intent an additional significant burden on plaintiffs rather than one diminishing the longstanding significant burden of providing anticompetitive effect.

3. Are the essential facilities and monopoly leveraging doctrines still viable grounds for Section 2 claims? Answer: No and Yes.

On the one hand, the Court was not subtle about its disdain for both doctrines. While expressly declining either to recognize or to repudiate the essential facilities doctrine, the Court cited approvingly to Professor Areeda’s frontal attack on it⁴⁰ and offered three general policy reasons why monopolists in control of “infrastructure” assets should not be required to share them with rivals: any such requirement (1) “may lessen the incentive for the monopolist, the rival, or both to invest in those economically beneficial facilities,” (2) would require courts to regulate prices and other access terms, and (3) “may facilitate the supreme evil of antitrust,” namely collusion.⁴¹ The monopoly leveraging doctrine was given short shrift: to the extent the lower court relied on it but “dispensed with a requirement that there be a ‘dangerous probability of success’ in monopolizing a second market, it erred”; and, “[i]n any event, leveraging presupposes anticompetitive conduct, which in this case could only be the refusal-to-deal claim we have rejected.”⁴² Certainly, therefore, common invocations of these doctrines over the past two decades are no longer sufficient to state a Section 2 claim: mere denial of access to an essential facility, even if access is feasible and rivals have no alternative way to compete, is not enough; mere leveraging of monopoly power in one market to gain competitive advantage in another market is not enough.

On the other hand, more robust versions of both doctrines survive and can be grounds for future Section 2 cases consistent with the thrust of Justice Scalia’s opinion. His specific reason for rejecting the essential facilities argument on the *Trinko* facts was that a necessary element—unavailability of access to essential facilities—was not met since the applicable telecom regulatory regime ensured that access.⁴³ In markets without that regulatory protection, a monopolist’s discontinuance of rivals’ access to facilities required for their viability in circumstances supporting an inference of anticompetitive intent for the discontinuance should still be a sound basis for Section 2 liability. Similarly, nothing in the above-quoted monopoly leveraging footnote precludes

³⁸ *Id.* at 483–86.

³⁹ *Trinko*, 124 S. Ct. at 883.

⁴⁰ *Id.* at 880–81 (citing Phillip Areeda, *Essential Facilities: An Epithet in Need of Limiting Principles*, 58 ANTITRUST L.J. 841 (1989)).

⁴¹ *Trinko*, 124 S. Ct. at 879.

⁴² *Id.* at 883 n.4.

⁴³ *Id.* at 881.

a claim based on various “exclusionary” uses of monopoly power in one market to undercut competitors in another market if it threatens actual monopolization over that other market.

More fundamentally, and as recent months have dramatically shown, neither the U.S. Supreme Court nor the U.S. antitrust authorities speak for the whole of antitrust law with regard to these doctrines in today’s global economy. The European Commission’s March 2004 decision in its *Microsoft* proceeding appears to rest in large part upon variations of both the essential facilities and monopoly leveraging concepts as developed under Article 82 with its focus on “abuse of a dominant position.”⁴⁴ Relatedly, at the risk of igniting a new federalism war within the United States, I would suggest that neither state courts nor state attorneys general interpreting and applying state law counterparts to Section 2 are foreclosed from continued use and development of these doctrines in one form or another in future state antitrust litigation—even in ways that may not be entirely consistent with the fate of these concepts in the hand of courts and enforcers more clearly bound by the Supreme Court’s Sherman Act decisions.⁴⁵

Neither state courts

nor state attorneys

general interpreting

and applying state

law counterparts to

Section 2 are

foreclosed from

continued use and

development of

[the essential facilities

and monopoly

leveraging doctrines].

* * * * *

There are other questions that *Trinko* raises and that also warrant “Yes and No” or “No and Yes” answers. I conclude for now with this list for other practitioners to address over the months ahead:

- Does *Trinko* have a bearing on the conflict between the Federal and Ninth Circuits on standards applicable to the refusal to share—or refusal to continue sharing—intellectual property with other aftermarket or other complementary market rivals?⁴⁶ Does the Court’s focus on investment incentives support the Federal Circuit approach while the focus on intent or motive supports the Ninth Circuit approach?
- Does *Trinko* demand fresh consideration of the rationality of any per se rule for tying conduct? Is there a remaining principled basis for different outcomes regarding (1) a unilateral refusal to sell product A separately from product B (even when there is a “leveraging” aspect to it) as tested under Section 2 and (2) “conditioning” the sale of one on purchase of another when artificially deemed to entail “concerted” action subject to Section 1?⁴⁷
- Do Justice Scalia’s extensive remarks about regulatory agencies efficiently serving the antitrust function and about costs versus benefits of antitrust law’s applicability to markets subject to such regulation invite lower courts generally to find firms in these kinds of markets no longer subject to large parts of Section 2 law?
- Will Justice Stevens’ concurring opinion on the *Trinko* plaintiffs’ lack of standing become a newly accepted general basis for dismissing Section 2 claims by customers of mistreated rivals (as exemplified already by one post-*Trinko* district court)?⁴⁸
- Would Senator Sherman and a majority of his colleagues in 1890 have approved of the whole thrust of Justice Scalia’s opinion as consistent with their “original intent”? Would the Standard Oil Trust still be with us to this day if *Trinko* had been the law of the land in 1911?

⁴⁴ Case COMP/C-3/37.792 Microsoft, <http://europa.eu.int/comm/competition/antitrust/cases/decisions/37792/en.pdf>.

⁴⁵ See generally ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 803–34 (5th ed. 2002).

⁴⁶ *In Re Indep. Serv. Org. Antitrust Litig.*, 203 F.3d 1322 (Fed. Cir. 2000); *Image Technical Servs., Inc. v. Eastman Kodak Co.*, 125 F.3d 1195 (9th Cir. 1997).

⁴⁷ See Denise Diaz & Robert Skitol, *Vertical Law Reform: Fertile Ground for a New Antitrust Modernization Commission*, ANTITRUST, Fall 2003, at 61–63.

⁴⁸ *Levine v. Bellsouth Corp.*, 302 F. Supp. 2d 1358 (S.D. Fla. 2004).

Any stab at answering the questions within that last bullet must take account of Justice Scalia's clear celebration of the monopolist's right to monopoly rents: charging monopoly prices "is an important element of the free-market system" and the "opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth."⁴⁹ While that statement reflects the conventional wisdom of our day, it is far cry from the first three decades of the Sherman Act's history when monopolists were called Robber Barons and what to do about them was a loud issue in a half dozen presidential elections.⁵⁰ ●

⁴⁹ *Trinko*, 124 S. Ct. at 879.

⁵⁰ See Robert Skitol, *The Shifting Sands of Antitrust Policy: Where It Has Been, Where It Is Now, Where It Will Be in Its Third Century*, 9 CORNELL J.L. & PUB. POL'Y 239, 240–42 (1999).

The Second Circuit's Decision in *United States v. Visa/MasterCard*

An ABA Section of Antitrust Law "Brown Bag" Program Held December 9, 2003,
Sponsored by the Financial Markets and Institutions, Section 1, and Civil Practice Committees

MODERATOR

PARTICIPANTS



Melvin Schwarz
Partner, Dechert LLP



Adam D. Hirsh
Attorney, Appellate Section,
Antitrust Division, U.S.
Department of Justice



**M. Laurence
Popofsky**
Partner, Heller, Ehrman



Kenneth A. Gallo
Partner, Paul, Weiss,
Rifkind, Wharton &
Garrison LLP

Editor's Note: Look in your wallet or pocketbook. How many charge or credit cards do you find there? About 75 percent of those cards are issued by competing consortia of banks—the well-known Visa and MasterCard brands, representing 50 percent and 26 percent, respectively, of general purpose cards.

American Express and Discover, in contrast, are proprietary firms that also offer well-known cards. They have, in recent years, sought to convince some of the banks in the Visa and MasterCard consortia to carry their cards. So-called exclusionary rules of both consortia prevent this—even though the consortia allow any bank to be a dual issuer of both Visa and MasterCard cards.

In 1998, the U.S. Department of Justice began a case challenging both Visa's and MasterCard's rules as anticompetitive. In a decision by a unanimous three-judge panel in the fall of 2003, the Second Circuit, applying the rule of reason, agreed that the Visa and MasterCard "exclusionary rules" had caused actual, unreasonably anticompetitive effects.

Three committees of the Antitrust Section—Financial Markets and Institutions, Section 1, and Civil Practice—found the decision of great interest and jointly sponsored a "brown bag" telephone conference. That conference featured a spirited discussion of the issues among four of the attorneys who participated in the trial of the case and the appeal to the Second Circuit.

The panelists challenged each other on a variety of questions that went to the core of the Second Circuit's application of the rule of reason:

- Could MasterCard, a firm that holds a 26 percent market share, really hold market power?
- Could a rule that allowed a bank to be a dual issuer of Visa and MasterCard cards, but prohibited a bank from issuing either American Express or Discover cards, be viewed as appropriate and ancillary to the joint ventures?
- If an arrangement is subject to the rule of reason, should (and did) the court's analysis change because the rules were promulgated by joint ventures of horizontal competitors?

- *Can the Second Circuit's ruling in the government's suit square with the Tenth Circuit's 1994 ruling in the private Mountain West action?*
- *Did the courts properly consider the practices of the card issuers in foreign markets in determining that use of the exclusionary rule in the United States was unlawful?*

The participants stand at loggerheads on these issues. And, as we go to press, Visa and MasterCard are expected to apply to the Supreme Court for certiorari, with their petitions for certiorari due on May 10, 2004.

—MATTHEW MOLOSHOK

MELVIN SCHWARZ: This is a “brown bag” program sponsored by three different committees of the ABA Antitrust Section: the Financial Markets and Institutions Committee, the Section 1 Committee, and the Civil Practice Committee.

I was trial counsel for the United States in this case in the district court. Our three panelists are: Adam Hirsh of the U.S. Department of Justice, Antitrust Division, who argued the appeal of this case in the Second Circuit; Larry Popofsky, who participated in the trial and has been counsel for Visa USA for many years; and, last but not least, Ken Gallo, who was trial counsel for MasterCard.

I'd like to give you a very brief thumbnail sketch of the case. This case was brought in October 1998 by the Department of Justice. Its complaint was based solely on Section 1 of the Sherman Act.¹ The complaint named three defendants: Visa USA, Visa International (the parent umbrella entity for Visa's international operations), and MasterCard International (which includes within it the U.S. operation).

The DOJ challenged two practices. The first was the defendants' practice of permitting their boards of directors to have substantial portfolios of “general purpose cards” in the other's system. As a result, Visa's board included members whose banks issued substantial (and in some case more) MasterCard cards than Visa cards—although that was rare for Visa. The flip side was that MasterCard board members could have a substantial portion or even a majority of Visa cards while they sat on the MasterCard board and made policy. It was the government's view that this last practice, which we referred to in shorthand as “dual governance,” had significant anti-competitive effects.

Before I go into the second practice, I should define the term “general purpose cards.” That term refers to credit and charge cards, also referred to as “payment cards,” that are accepted by a broad range of unaffiliated merchants. That distinguishes it from a card that might be accepted only at a particular department store or a group of stores, rather than being generally accepted.

The second practice was followed in the United States only. Both Visa and MasterCard had what we call exclusionary rules. These rules barred any of their member banks from issuing either American Express or Discover cards but did not bar them from issuing the other bank-owned network's cards.

The government viewed the exclusionary rules as substantially restricting competition in two markets. The first market was the market for general purpose cards, which is to say, a consumer market. The second market was for general purpose card network services, that is, the market in

¹ 15 U.S.C. § 1.

which card issuers seek to obtain clearing services and other network processes that permit acceptance of the cards nationally and internationally.

There was a thirty-four-day trial in the Summer of 2000 in the Southern District of New York before Judge Barbara Jones. The witnesses included merchants, present and former Visa and MasterCard executives, competitor witnesses from American Express and Discover, and four different economists—one from the Government, two from Visa and, one for MasterCard. In October 2001, Judge Jones issued a lengthy decision.² In it, Judge Jones ruled against the government on the “dual governance” count but in favor of the government on the exclusionary rules. (I should note in passing that the Judge also held Visa International liable for Visa USA’s exclusionary rule although Visa International had not imposed this rule and did not use it internationally). The government did not file an appeal, but all three defendants appealed. The Second Circuit affirmed on September 17, 2003.³

That gives you the general gist. To begin the discussion, each of the panelists will comment briefly on what lessons they take away from the Second Circuit decision.

ADAM HIRSH: I should start by giving a disclaimer that I’m here today in my personal capacity. The views expressed are my own. They do not purport to reflect those of the Antitrust Division or the U.S. Department of Justice.

The first thing to note about the Second Circuit decision is that it is short, direct, and concise. The slip opinion is only twenty-three pages, half of which sets out the background. So there’s only about eleven pages of discussion of the legal issues. The Second Circuit relies heavily on Judge Jones’s district court opinion, which the court of appeals praised as “commendably comprehensive and careful.”⁴

The second thing I’ll note is that facts matter. This was a full-blown rule of reason case. The district court made numerous findings, in a 157-page slip opinion. Essentially, the Second Circuit upheld those findings. The first finding concerned market power. The Second Circuit agreed with the district court that Visa and MasterCard, jointly and each separately, held market power. An important point here (which I’m sure Ken Gallo from MasterCard will talk about) is that the finding of market power was not based on their market shares. MasterCard’s share was 26 percent. It’s what you *do* with that share that indicates whether you hold market power.⁵

The second finding concerned anticompetitive effects. The Second Circuit agreed that, at the network level, “competition has been seriously damaged by the defendants’ exclusionary rules.”⁶ These rules resulted in “the total exclusion” of American Express and Discover from bank networks. The Second Circuit agreed that banks would issue American Express and Discover cards but for the bylaws at issue. Thus, the record indicated “price competition and innovation in services would be enhanced if four competitors, rather than only two, were able to compete . . . for issuing banks.”⁷

² *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322 (S.D.N.Y. 2001) (opinion and proposed final judgment), *modified*, 183 F. Supp. 2d 613 (S.D.N.Y. 2001) (making changes to the proposed final judgment and entering judgment).

³ *United States v. Visa USA Inc.*, 344 F.3d 229 (2d Cir. 2003).

⁴ *Id.* at 234.

⁵ *Id.* at 238–40.

⁶ *Id.* at 240.

⁷ *Id.* at 241.

The fourth finding was

that the exclusionary

rule had harmed

competition.

The defendants argued

that all that was at

stake was harm to

competitors, not

competition, but the

Second Circuit made

clear that those are not

mutually exclusive . . .

—HIRSH

The third finding (and the Second Circuit was very strong on this) was that the exclusionary rules should be characterized as horizontal, rather than vertical, restraints. Defendants spent a lot of time arguing that this should be treated as a vertical case, but the Second Court flatly rejected that argument.⁸ And what makes it horizontal is that it is “an agreement among competitors on the way in which they will compete with one another.”⁹

The fourth finding was that the exclusionary rule had harmed competition. The defendants argued that all that was at stake was harm to competitors, not competition, but the Second Circuit made clear that those are not mutually exclusive, stating: “Without doubt the exclusionary rules in question harm competitors. The fact that they harm competitors does not, however, mean that they do not also harm competition.”¹⁰ Antitrust lawyers are always quoting *Brunswick*¹¹ about harm to competitors, not competition. This case addresses that.

The last thing I would take away concerns procompetitive justifications. The Second Circuit held that it is not sufficient to claim a procompetitive justification; you have to back it up with facts. Visa and MasterCard had claimed that their rules were ancillary to their joint venture. The district court rejected that on the facts. The Second Circuit agreed that, without factual support, there were no procompetitive justifications to outweigh the competitive harm.¹²

M. LAURENCE POPOFSKY: Can I start with a disclaimer, too? My disclaimer is I don’t mean to be disrespectful to the government. But it’s clear from what I will say that I think the courts applied an appalling analysis. Why the government should have (a) won it, and (b) defended it is quite beyond me.

Let me start out with an observation about history, since at heart I’m really a misplaced historian. Once upon a time, which is to say in the early 1970s, several banks formed the Visa organization as a joint venture to get around the fact that there was no interstate banking permitted then. MasterCard did the same. The world as it evolved initially, therefore, was there was a Visa joint venture, a MasterCard joint venture, and proprietary firms, American Express and, much later on, Discover and a few others.

Along the way, Visa made the judgment, then being somewhat smaller than MasterCard, that competition for it and for the world as a whole would be better if it had a rule which prohibited MasterCard banks from issuing Visa cards. And it passed such a rule. That was challenged by a Visa bank and eventually upheld under the rule of reason—upheld in the sense that to evaluate it you would have to have a full trial.¹³

Visa in the meantime went to the DOJ and asked, “Will you support us so that competition can be preserved between the systems, between the networks, if you will?” The DOJ, in what Bill Baxter called the worst decision that it ever made, declined to do so.¹⁴ Visa abandoned its rule.

⁸ *Id.* at 241–43.

⁹ *Id.* at 242–43 (quoting *NCAA v. Bd. of Regents*, 468 U.S. 85, 99 (1984)).

¹⁰ *Id.* at 243.

¹¹ *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477 (1977).

¹² 344 F.3d at 243.

¹³ *Worthern Bank & Trust Co. v. Nat’l BankAmericard, Inc.*, 485 F.2d 119 (8th Cir. 1973).

¹⁴ See DONALD BAKER & R. BRANDEL, *THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS* ¶ 23.02[3] (1988). Baxter later filed an affidavit in the *Mountain West* litigation (see *infra* note 15) on behalf of Visa in which he characterized the Division’s position with respect to duality as a “serious mistake.”

To the surprise of the DOJ, virtually every bank in the United States went dual, i.e., chose to issue both MasterCard and Visa. So, the world that evolved featured this remarkable phenomenon—two joint ventures competing with one another, yet having joint members and competing at the same time with proprietary firms.

We now flash forward to 1988. Discover tried to issue a Visa card. Visa refused, passing a rule that said, Discover, you're a competitor; you can't issue a Visa card. Visa's rule was upheld by the Tenth Circuit (after Visa had lost at the trial) and cert was denied.¹⁵ In 1996, AmEx said that it would like to start soliciting Visa and MasterCard banks to issue AmEx cards. And Visa responded with a rule, and MasterCard with a policy, saying that's a no-go as well because AmEx was trying to reconstruct the bad, once-upon-a-time world of duality, only AmEx wanted it to be *tri*-ality, where banks would issue AmEx, as well as Visa, as well as MasterCard.

What's remarkable is that the government, having previously declined in the '70s to construct a perfect world of what this industry should look like, chose to use the present lawsuit to do precisely that.

What's remarkable is that the government, having previously declined in the '70s to construct a perfect world of what this industry should look like, chose to use the present lawsuit to do precisely that.

First, the government sought to regulate governance between the associations. That effort was roundly rejected by the trial court, again, "on the facts." Second, the government asked the courts to order the associations to permit AmEx and Discover to be issued by the banks. In other words, even though the government wanted Visa banks out of MasterCard's board and vice versa, it would force them both to carry AmEx and Discover. The two claims were at war with one another. The government ends up with what I think is the worst possible result. They are, in effect, compelling the market to go to triality and quadrality, although that is not what they wanted initially. Nor was it consistent with what they said about their concerns over opportunism if, in fact, AmEx and Discover were permitted to issue Visa or MasterCard cards.

So, what do we have then in the Second Circuit's opinion? Adam's absolutely right. It's an eleven-page discussion in which virtually nothing is defensible. It is true that the Circuit honored the trial court's findings as a basis for affirmance. But in doing that, it makes two fundamental assumptions about how a trial court should view the facts, i.e., the prism for evaluating facts before it.

First, in evaluating harm to competition, the trial court and the court of appeals both pay lip service to the rule of reason—the correct rule—the rule the government itself espoused. The courts then proceed to apply essentially a *per se* analysis to the facts because the joint venture is definitionally horizontal in one sense. In that way, these rulings sidestep all the vertical cases that focus on harm to competition. And in that way, these rulings avoid the facts of the case, which showed there was no harm to competition or any foreclosure in the usual sense of either American Express or Discover.

The second prism that these courts looked through was the justification prism. The trial court, instead of accepting the obvious—that joint venture rules that prohibit "moonlighting" are standard, procompetitive, and justified—started looking for something else. And the court of appeals said, well, that was just a factual inquiry.

Take your paradigm case: No lawyer is permitted simultaneously to practice law at Paul, Weiss and at Sullivan & Cromwell. Both are partnerships, a kind of joint venture. You would not expect that a lawyer could do that. Nor should you expect to need a great deal of effort trying to demon-

—POPOFSKY

¹⁵ SCFC ILC Inc. v. Visa USA Inc., 36 F.3d 958 (10th Cir. 1994), *reversing in part*, 819 F. Supp. 956 (D. Utah 1993), *cert. denied sub nom.*, Mountain West Fin. Corp. v. Visa USA Inc., 515 U.S. 1153 (1995) (*Mountain West*).

strate why a firm's establishment of such a restriction was procompetitive. It seems self-evident. But these courts ignored it, refused to address it, ignored the precedents and, in a few lines, simply say that such a restriction is unreasonable.

SCHWARZ: Let me interject one fact that I didn't mention but which was relevant to your comment, Larry. Just before trial, Visa USA instituted a requirement that all Visa's board members had to have at least 75 percent of their card portfolio in the Visa system. Judge Jones noted that rule change as a factor in her decision. And with that, Ken, would you care to add your thoughts?

[The Second Circuit]

held this is not a

vertical case; this is

a horizontal agreement

among the members

of the joint venture.

The circuit court

implied, if it didn't say

it expressly, that this

meant that a lesser

showing was required

under the rule of

reason. I think that's

just wrong.

KENNETH GALLO: I'll make two brief points, picking up on some things Larry touched on. First, the Second Circuit essentially said that whether the restraint in question is vertical or horizontal impacts the substantive rule of reason analysis.

Defendants had argued that American Express was not competitively disadvantaged by this rule because there was no showing that American Express was foreclosed from getting its product to consumers. American Express was a very effective competitor, having a market share only slightly smaller than MasterCard's. Since American Express could get its product to consumers and expand output if there was demand for its product, there was no anticompetitive effect. But the Second Circuit gave that argument very short shrift. It held this is not a vertical case; this is a horizontal agreement among the members of the joint venture. The circuit court implied, if it didn't say it expressly, that this meant that a lesser showing was required under the rule of reason. I think that's just wrong.

The question of whether a restraint is horizontal or vertical goes to the issue of whether the *per se* rule or rule of reason applies. But once one agrees that the rule of reason applies—which everybody did in this case, including the lower court, the Second Circuit, and the government—then the geometry doesn't matter anymore. At that point, under cases like *North American Soccer League*¹⁶ and *Clorox*,¹⁷ the question ought to be whether the competitor is being effectively foreclosed from getting its products to consumers. The Second Circuit dodged that issue by acting as if the horizontal versus vertical character resolved, or was very important to, the rule of reason question. That is a real problem and is likely to create problems in the future.

Second, the district court and the Second Circuit found that MasterCard had market power with a 26 percent share. But a lot of case law, including *Jefferson Parish*,¹⁸ says there's a very strong presumption that if you have less than a 30 percent share, you don't have market power. There's no mention of those cases in the Second Circuit's decision. Nor is there any explanation as to how MasterCard, with a 26 percent share, could reduce output or raise prices when it has a competitor like Visa in the marketplace who had nearly a 50 percent share, and would pick up any of MasterCard's reduced output. Last, there's no explanation as to why MasterCard should be deemed to have market power at 26 percent and we need the full weight of the federal antitrust laws to protect American Express when American Express had about a 20 percent share. Somehow, with a 20 percent share, American Express has been substantially foreclosed from competing. But at a 26 percent share, MasterCard is able to exercise substantial market power.

—GALLO

¹⁶ *N. Am. Soccer League v. Nat'l Football League*, 670 F.2d 1249 (2d Cir. 1982).

¹⁷ *Clorox Co. v. Sterling Winthrop, Inc.*, 117 F.3d 50 (2d Cir. 1997).

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

The case really doesn't address any of those anomalies. I think addressing them would have been essential to a cogent examination of market power.

The last point is that if someone's counseling a joint venture in light of this opinion, you have to pause very long on the ancillary restraint doctrine and how viable it is. If MasterCard, with a 26 percent share, can be deemed to have violated the federal antitrust laws because it has a loyalty rule of a type used very routinely in joint ventures, one needs to be very careful counseling around that issue.

SCHWARZ: It's slightly inaccurate to suggest that, in the trial court, the government conceded that a full-blown rule of reason analysis was necessary. Once we proved, as we thought we had, substantial anticompetitive effects, one only needed to make a quick look to see if there was any pro-competitive justification. It quickly became a moot point because a full-blown rule of reason analysis was conducted in any event.

HIRSH: The Second Circuit addresses that, by saying, in effect, that since we have a very large record in front of us, we don't need to decide whether the government could have gotten away with proving less.¹⁹

POPOFSKY: I'm really perplexed at the thought that this kind of controversy could have been addressed and resolved on a quick look basis. Although I know the government made a pass at it in the trial court, I thought it was almost a throw away, particularly after *California Dental*.²⁰

On its face, we had a practice which, as Ken pointed out, raised significant issues about whether there was an actual harm to competition. In addition, there was the interplay between this issue and whether the arrangement in question was horizontal or vertical. On its face, we had a restraint, the justification for which was virtually self-evident and which, as Justice Rehnquist once said, is at the core of the old ancillary restraint doctrine.²¹ So it is inconceivable a district court could seriously say, on a quick look, that is presumptively illegal.

Let me put it to you that

Visa and MasterCard

did not have, in our

view, an exclusivity

provision. They had a

duality provision.

SCHWARZ: Larry, let me put it to you that Visa and MasterCard did not have, in our view, an exclusivity provision. They had a duality provision. That is, it was okay for some of their supposed competitors to have access to banks—indeed, there were even exceptions in the case of Citibank, which had its Carte Blanche on a separate network—yet there was express discrimination against American Express and Discover.

That fact undercuts your Paul, Weiss/Sullivan & Cromwell example, because in this case, it was okay to work at some firms, but not at others.

—SCHWARZ

GALLO: MasterCard and Visa, for the historical reasons that Larry laid out, had evolved in this so-called duality context. There's no question in my mind that the backdrop of Visa and MasterCard having banks that issued each other's cards made a big difference to the courts. That made it a much more complicated case instead of a simple case of a loyalty rule.

¹⁹ 344 F.3d at 238 n.4.

²⁰ *California Dental Ass'n v. FTC*, 526 U.S. 756 (1999).

²¹ *Nat'l Football League v. N. Am. Soccer League*, 459 U.S. 1074, 1078 (1982) (Rehnquist, J., dissenting from denial of *cert.*).

Having said that, a loyalty rule is generally viewed as an ancillary restraint. Do you come to it from a legal perspective, with a sort of favorable presumption or not? And can MasterCard and Visa explain the distinction that was made with respect to American Express? The Second Circuit and the trial court didn't struggle very hard to figure out if there was a distinction. In essence, they said, "You have a different rule for Visa than you do for American Express, therefore, it must be a pretext." It seems to me it's considerably more complicated than that, given the history in the industry.

The district court found,

and the Second Circuit

agreed, that these

so-called loyalty rules

were so riddled with

exceptions that they

weren't procompetitive.

HIRSH: Loyalty rules are not necessarily ancillary. What makes a restraint ancillary is whether it's reasonably necessary to further the procompetitive aspects of the joint venture. You have to look at why it's enacted and how it's applied. Loyalty could just be another word for "not dealing with competitors." It may be beneficial to the joint venture, but that doesn't make it procompetitive.

What were the actual facts about these loyalty rules? The district court found, and the Second Circuit agreed, that these so-called loyalty rules were so riddled with exceptions that they weren't procompetitive. There was MasterCard's and Visa's exemptions for each other, their largest competitor. Also, Citibank, as Mel pointed out, which owns its own network—the Diners Club/Carte Blanche network—is dedicated to MasterCard but could still issue Visa cards. You've also got the foreign experience, where exclusionary rules don't apply—there, you have some banks that issue both Visa and MasterCard, and American Express cards. There was no evidence that that caused any lack of loyalty or that the associations were concerned about it.

—HIRSH

So, the district court rejected this particular procompetitive justification on the facts and the Second Circuit said, "That's right."

POPOFSKY: But there's no sense at all in this opinion, or even in the district court opinion, that they considered whether the Visa rule is analogous to a loyalty provision for a partnership. How you can get to a right result without analyzing that? The defendants were compelled, in a practical sense, to have a dual system, if you look back at the history of it. The defendants ended up hung by the history but without analysis.

As we got to the modern era as it were, Visa, at least, thought it would try to break duality. Hence, the rule that Mel mentioned, that started to try, internally, to control governance based on portfolio percentages. Visa was, in effect, saying, we'll draw the line in the sand on duality and not go to triality and quadrality because that would be harmful, not only to us, but to competition as a whole. From Visa's point of view, duality necessarily compromised competitive incentives. Visa, at least in its promotions, had had to hold its punches. It didn't say MasterCard had bad products and we're much better. All they ever did was say, "We're everywhere you want to be." So, there was no economic question that duality has a negative impact on competition. But that doesn't justify forcing triality.

Finally, Visa offered an expert to address the remarkable anomaly that American Express, if the government position is sustained, could sign up a Visa bank on a unilateral basis whenever it wanted and whosoever wanted. AmEx is not an open joint venture. It could pick and choose the members it wanted. That was what raised the opportunism issue. Visa and MasterCard are both open joint ventures. And our expert detailed why that mattered, and mattered dramatically. What ought to occur, and was occurring, was not an extension into triality to accommodate American Express, but a retreat from duality. We end up with a world which is, on its face, irreconcilable with the loyalty oath world one would like to see in place.

HIRSH: On Larry's duality point, we were always, I think, consistent that dual *issuance* was pro-competitive. We were trying to carve away the anticompetitive aspects of dual *governance* while maintaining the procompetitive aspects of dual or multi-issuance.

SCHWARZ: Ken, let me ask you a more focused question. The Second Circuit found a separate market for general purpose cards and also for network card services. But the trial court did not have any specific elasticity data. Is defining a market without looking at elasticity of demand data a significant departure from past precedents?

GALLO: I didn't view it as a substantial departure from precedent. There are many cases where the court determines the contours of a market and does a market definition analysis without using cross-elasticity data as such.

This was a strange situation because consumers really don't perceive they are paying a price for using their cards. (Sometimes they actually get a benefit for using their general purpose card if, for example, they get mileage on an airline.) That made it very difficult to figure out how you would apply the standard 5 percent test to ascertain if consumers would change from a general purpose card to a different form of payment if the consumer faced a price increase. The consumer was paying zero. A 5 percent increase of zero is still zero.

Nevertheless, having found that the consumers viewed it as a zero price, the district court then purported to apply the 5 percent test and said, even if the price went up 5 percent, people wouldn't switch. So, therefore, general purpose cards do not compete with other forms of payment, such as cash or checks. To me, it was a little bit mind-boggling to say the price is zero but yet we're going to go ahead and rely on a price test.

It seemed to us that the right test would have been to figure out whether MasterCard and Visa innovate in order to take share away from cash and check. Do they bring out new products? Do they have those competitive products on their radar screen when they bring out new innovations? If they innovate, they face competition. That is the analysis that we think should have been done but wasn't done.

SCHWARZ: Did defendants dispute the existence of a separate general card network services market?

POPOFSKY: Absolutely. Because it was always a wordplay without economic meaning. The network market may be just another name for systems competition. There clearly is competition between Visa, MasterCard, AmEx, and Discover. But a Visa or MasterCard rule that prohibited members of the joint venture from issuing Discover or AmEx points at the issuing market, not at the services or brand market. And when the government said that what you were doing was stopping the brands from competing for banks, what they were really saying was you were stopping the brands from getting their product to the consumer because you had a rule that was directed at issuance. No matter how you looked at it, it was all about the issuing market. This notion that somehow network markets were being impacted was entirely derivative of what happened in the issuing market.

You'll see the opinion discusses Coke and Pepsi and the whole question of exclusive distributorships.²² In any exclusive distributorship, you could say "network competition" was harmed,

It seemed to us that the right test would have been to figure out whether MasterCard and Visa innovate in order to take share away from cash and check. . . . If they innovate, they face competition. . . . That is the analysis that we think should have been done but wasn't done.

—GALLO

²² 344 F.3d at 242–43.

independent of what happens in the resale of the products by distributors to consumers. But we don't think of exclusive arrangements that way. No one thinks that integrated firms are denying their competitors network services because they're integrated. One could have a network market that mattered. Suppose Visa had a rule that required member banks to obtain security services from Visa when security services are available from lots of others, including AmEx. But this wasn't about that. This was about the AmEx brand presented to consumers. So, the invocation, if you will, of network services had a certain mysticism about it that was severed from what the trial was all about.

HIRSH: This is about input markets. Network services are an input to issuing. If there was a problem with three-inch screws as an input for making airplanes, that may not have a significant competitive impact on the price of airplanes. But sometimes problems in the input market will cause competitive impacts. This is one of those cases. The networks do not just sell services to issuing banks. They work with the banks to develop new products. You get innovation at the network level. You get a lot of support at the network level besides just the backbone services. That's not to cut short the backbone services because the courts found that increased competition among four networks (rather than just Visa and MasterCard) for bank services would improve network services themselves.

So the court found lots of areas where competition at a network level has real-world competitive effects for consumers. As a result, even though consumers get their cards from banks at the issuing level, as Larry is fond of pointing out, that all goes back to what competition is like at the network level.

SCHWARZ: Ken, I'm going to turn back to what I think is an important legal issue in the case. The Second Circuit distinguished precedents like *CDC*²³ and the Ninth Circuit's *Gilbarco* case,²⁴ which treated exclusive dealing arrangements as presumptively legal. The Second Circuit asserted that this was a different situation because they were horizontal arrangements.

Assume first that a MasterCard director testified we had to have this rule because either all the banks should get access to American Express and Discover cards or none of the banks should. How do you tie that evidence in with your analysis or maybe you view it as irrelevant?

GALLO: I see it in two different steps. I see, first, the question of the Second Circuit's approach to whether this rule had an anticompetitive effect on the marketplace. On that question, they distinguished cases that they characterized as vertical, like *CDC* and *Gilbarco*, and drew a distinction between vertical and horizontal restraints.

The question you posed to me goes more to MasterCard's business justification for having this so-called loyalty rule. I think the Second Circuit made a mistake, because it said that whether the arrangement is horizontal affects the rule of reason analysis one applies. I just don't think that's right. You should look at whether it's horizontal or vertical for deciding whether to apply the per se rule. Once you apply the rule of reason analysis, the fact that it's horizontal or vertical should not determine the outcome.

²³ *CDC Techs., Inc. v. IDEXX Labs., Inc.*, 186 F.3d 74, 80 (2d Cir. 1999).

²⁴ *Omega Envtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157 (9th Cir. 1997).

Obviously, when you have a joint venture structure like MasterCard, rules or policies that MasterCard adopts can usually be characterized as having a horizontal element to them. But the question that the rule of reason requires you to answer is this: has MasterCard passed a rule or policy that forecloses American Express from being able to get products to the ultimate consumer? If American Express can get products to consumers, it seems to me that American Express has the ability and motivation to compete with MasterCard on innovations and quality, as we expect in interbrand competition. In those circumstances, we ought not really be worried about the question of whether the policy is horizontal or vertical. If American Express can get its product there, then we're going to have interbrand competition for quality and variety and innovation.

The Second Circuit seems to assume that more variety and more innovation is always better. That's not necessarily true. There may be no consumer benefit to having yet another version of a credit card or charge card on the market.

Competition will generate the best and cheapest products. And it's for the market to determine. It is not up to the collective agreement of horizontal competitors to decide which products will come out and which won't.

HIRSH: Ken keeps saying that American Express can get whatever card it wants to consumers. That's just not so. It can certainly mail a card to anyone, but it can't get the cards it wants to consumers because the cards it wants to get to consumers are the ones issued through banks. What the district court found, and the Second Circuit agreed, is that a network issuing a card with a bank is a different kind of card. A Citibank-issued American Express card is different from a Bank of America-issued American Express card—just as banks issuing on the Visa or MasterCard networks create different cards. Those are different kinds of products. As a result, if they are kept out of the bank-owned network, American Express and Discover cannot get all the cards they want to consumers.

The second point is this: Ken said that the court is assuming that more is better. Well, that's pretty much the basis of antitrust law, isn't it? Competition will generate the best and cheapest products. And it's for the market to determine. It is not up to the collective agreement of horizontal competitors to decide which products will come out and which won't. If American Express or Discover decided not to issue certain products, that is a unilateral business decision. But it's not up to a collective agreement of banks to decide what American Express and Discover can or cannot issue.

On the other point, relating to the difference between vertical and horizontal restraints, courts have always drawn a sharp distinction between vertical and horizontal agreements. People should be happy about that. There's a real wariness about when competitors get together and start making rules among themselves that affect competition. If you didn't differentiate vertical from horizontal, vertical agreements would actually end up suffering because they wouldn't get the lenient treatment that they do.

Ken at the outset asserted that the Second Circuit turned this into a per se case once it determined the restraint was horizontal. I don't think that's true at all. The court said this is not a presumptively legal arrangement.²⁵ It's a classic horizontal agreement. It didn't then say, therefore, defendants lose. The court instead found actual anticompetitive effects and that is why defendants lost. It wasn't just because the arrangements were horizontal.

—HIRSH

GALLO: The notion that American Express should get access to MasterCard banks (because it wants to “compete better” as a partner with some MasterCard bank that has some unique or very valuable marketing skill) should only withstand scrutiny if the government and American Express

²⁵ 344 F.3d at 242–43.

would allow it to work the other way. That is, does MasterCard get access to American Express assets?

*I don't think the
anticompetitive effect
should be determined
by the structure of
the competitors.
That's where I think the
Second Circuit went
wrong. Its opinion
strikes at the heart of
joint venture law.
The ruling in effect
says, joint ventures,
you are second-class
citizens.*

—*POPOFSKY*

POPOFSKY: Does MasterCard get access to a portion of the integrated American Express Corporation simply because it decides that American Express, for example, has a very good marketing skill? Most people would laugh at that notion. But because MasterCard is structured as a joint venture, the government says those banks should be available to American Express to pick and choose as it likes. I don't think the anticompetitive effect should be determined by the structure of the competitors. That's where I think the Second Circuit went wrong. Its opinion strikes at the heart of joint venture law. The ruling in effect says, joint ventures, you are second-class citizens. Because you're horizontal, everything you do is suspect. And my goodness, I thought that had been rejected twenty-plus years ago. But here it is again.

The second thing I would say, as proof of the pudding, if you will, is the Tenth Circuit decision in *Dean Witter*.²⁶ There, Discover wanted to issue a Visa card. It said it would be one of the ten biggest and best Visa cards in the whole wide world if it were permitted to do so, offer new features, benefits for the consumer, improve competition, etc. The Tenth Circuit saw it as a horizontal arrangement. Of course: it was a joint venture. But the Tenth Circuit looked at the issuing market, and determined that, with hundreds and hundreds of issuers, how in the world could the denial of Discover's right to issue a Visa card make any significant competitive difference? What in the world is the difference in the horizontal agreement there from the horizontal agreement here? So, I concur with Ken's observations: Geometry ought not to matter. Ultimately, I think the Tenth and Second Circuit decisions are absolutely irreconcilable.

HIRSH: Four judges have now disagreed with your view of that case.

POPOFSKY: I think the shocking thing is that the Second Circuit doesn't even address it.

SCHWARZ: The government never saw any irreconcilability at all between the two. The holding in the Tenth Circuit case was basically that competition among the networks was more important than additional intrabrand competition in the form of one additional issuer among thousands. We believed that this case stands exactly in the same position—that interbrand competition among the networks is extremely important and needs to be protected.

GALLO: American Express does, in fact, compete in the network services market. It does so as an integrated corporation, and it uses its network services, in conjunction with its issuance and distribution facilities, to provide an integrated product to the ultimate consumer. And MasterCard competes as a joint venture, both as a network and as an issuer, to provide a complete product to the consumer.

If American Express can begin to pick apart the joint venture, it could reduce interbrand competition. It creates the incentive for American Express to pick some feature that it likes that a MasterCard bank has, rather than develop a competitive product. Worse yet, MasterCard doesn't have the corresponding ability to do that to American Express. Cohesion of the joint venture was a procompetitive justification for the policy.

²⁶ *SCFC ILC, Inc.*, *supra* note 15.

HIRSH: I'll note that the Second Circuit says, "The District Court found no evidence to suggest that allowing member banks to issue cards of rival networks would endanger cohesion in a manner adverse to the competitive process."²⁷

SCHWARZ: Fair enough. Would it have mattered if Visa and MasterCard intended their rules to create cohesion but they turned out to be wrong?

HIRSH: The district court looked and didn't find evidence that the exclusionary rules were adopted to enhance or bring about cohesion. The court also found that the rules in practice do not enhance cohesion, and also that American Express or Discover cards being issued by banks wouldn't endanger cohesion. So, the district court found three different levels of facts to reject that purported justification.

If you're asking, what if the court had found facts the other way? To be ancillary, they'd have to have a reasonable design to enhance a procompetitive aspect of the joint venture. Then, if there had been procompetitive justifications, they'd have to be weighed against the anticompetitive effects that were found. It's a fact-intensive inquiry.

POPOFSKY: Visa passed its rule specifically to protect cohesion. MasterCard had a different experience but it focused very much on American Express's statements that they were going out to try to cherry pick. So the cohesion purpose was self-evident.

Both the district court judge and perhaps the appellate court were impacted by the foreign evidence that Visa did not have comparable rules abroad. The courts reasoned that, if you didn't have them in Portugal, you must not really care about them in the United States. But why accept foreign evidence without a predicate showing of comparable circumstances? The government's expert actually disclaimed an ability to compare the circumstances. There was no showing that any of the experiences abroad were comparable to the American market where Visa and AmEx stood in an entirely different position vis-à-vis each other. I don't need to go in beyond that, but I think it's an unfortunate fact that the foreign evidence weighed so heavily.

SCHWARZ: I would just note for the audience that if you are looking for case law that would support the notion that comparison to markets outside the United States is a valid way to make a point with respect to your antitrust arguments, this is the case. ●

²⁷ 344 F.3d at 243.

Making Sense of the Telemarketing Laws: How the FTC Rule, the FCC Rule, and State Laws Fit Together

Edward Correia

As most telemarketing companies have discovered by now, there are three legal regimes that apply to telemarketing—the Federal Communication Commission Rule,¹ the Federal Trade Commission Rule,² and state laws. The involvement of two federal agencies as well as the states attests to the long-term concern about telemarketing but, until recently, no effort to develop a truly national approach to regulation.³

The most important recent development in telemarketing regulation does reflect a national effort—the bar on calling numbers registered on the national Do Not Call (DNC) registry administered by the FTC. This consumer protection program has to be one of the most popular ever conceived in the United States. At this writing more than 58 million numbers are registered, representing far more individuals. The speed and zeal with which households registered suggest the pervasiveness of telemarketing as a phenomenon and the public's desire to be free of it most of the time.

The media's focus upon the national DNC has tended to obscure the fact that there are a number of federal and state laws which impose separate duties and prohibitions on telemarketers. These laws address disclosures that must be made during the call, calling hour restrictions, limitations on the use of pre-recorded messages and automatic dialing equipment, limits on "abandoned calls" (i.e., calls made by a computerized dialing system that fail to connect a live operator when the consumer answers), and more. Inconsistencies exist between the state and federal regimes, and, indeed between the FTC Rule and the FCC Rule.

This article describes how these various regulatory schemes do and do not fit together and what happens when they clash. As we shall see, there are still some major unanswered questions, particularly the extent to which state laws can be preempted.

The Do Not Call Lists

There are currently three kinds of DNC lists: company-specific lists that are maintained by individual companies based on consumer requests; state lists, many of which have existed for several years; and the national DNC registry, administered by the FTC. The FTC plans to integrate

■
Edward Correia is an attorney with Latham & Watkins LLP. He was formerly an attorney with the Federal Trade Commission.

¹ Restrictions on Telemarketing and Telephone Solicitation, 47 C.F.R. Part 64, Subpart L (FCC Rule).

² Federal Trade Commission Telemarketing Sales Rule, 16 C.F.R. Part 310 (FTC Rule).

³ Both the FTC and the FCC have statutory authority to regulate telemarketing calls and to create a DNC registry. *See infra* note 7. Sensibly enough, the FCC has said that there will only be one national list administered by the FTC. FCC, Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991 ¶ 75. (released, July 3, 2003) (FCC Order), available at http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-03-153A1.pdf.

existing state lists into the national list.⁴ As states integrate their lists into the national list, there will no longer be a requirement for telemarketers to access the state lists. Many states have already begun this process, but the process of integration may take some time.⁵ In the interim, telemarketers have to be aware of the existence of multiple DNC lists.⁶ For example, if Indiana has not integrated its list into the national registry, telemarketers calling into Indiana need to download numbers from the state list in addition to the national registry.

Scope of the Rules

Not surprisingly, since they are based on different sources of authority, the FTC Rule, the FCC Rule, and the various state laws do not have identical scope.⁷ The FTC rule applies only to interstate calls. In addition, the FTC Statement makes clear that the Commission interpreted its statutory authority not to extend to entities that are exempt from the FTC Act: banks, credit unions, savings and loan institutions, airlines and other common carriers,⁸ the business of insurance,⁹ and non-profit entities.¹⁰ On the other hand, telemarketers that make calls on behalf of exempt entities are subject to the FTC Rule.¹¹

The reach of the FCC Rule extends much further. The FCC Rule essentially applies to all entities in the United States, including both persons that are exempt from the FTC Act and persons that are subject to the FTC Rule. Most significantly, the FCC Rule applies to intrastate as well as interstate calls.¹²

State laws vary widely in coverage. Many have exemptions for certain industries, such as charitable organizations, and real estate brokers. Moreover, many states claim the authority to apply their statutes to calls originating outside the state.¹³

⁴ FTC Statement of Basis and Purpose, 68 Fed. Reg. 4580, 4641 (Jan. 29, 2003) (FTC Statement), available at <http://www.ftc.gov/os/2003/01/tsfrn.pdf>.

⁵ Indiana, for example, has indicated that it may take three years to import its DNC list into the national registry. *Id.*

⁶ The FTC Rule defines “telemarketer” as any person who “in connection with telemarketing, initiates or receives telephone calls from a customer or donor.” § 310.2(bb). That definition includes direct product sellers and companies that specialize in making telemarketing calls on behalf of sellers. In this article, I use the term “telemarketing companies” to refer to the latter group.

⁷ The FCC Rule is based on the Telephone Consumer Protection Act of 1991 (TCPA), 47 U.S.C. § 227. The FTC Rule is based on the Telemarketing Consumer Fraud and Abuse Prevention Act, 15 U.S.C. §§ 6101–6108.

⁸ FTC Statement, *supra* note 4, at 4586.

⁹ The McCarran-Ferguson Act, 15 U.S.C. § 1012(b), exempts the “business of insurance” from the antitrust laws, “to the extent it regulated by state law.” FTC Statement, *supra* note 4, at 4584.

¹⁰ FTC Statement, *supra* note 4, at 4585.

¹¹ *Id.* at 4586.

¹² FCC Order, ¶ 212 (“The FCC’s jurisdiction over telemarketing is significantly broader than the FTC’s. . . . [T]he FCC’s telemarketing rules apply without exception to any entity engaged in any of the telemarketing activities targeted by the TCPA and the Commission’s rules, including those that involve purely intrastate activities.” Congress amended Section 2(b) of the TCPA to give the FCC authority over both interstate and intrastate calls. Congress was apparently concerned that the states could not regulate interstate calls. S. REP. NO. 102-178, at 3.

¹³ “More than 300 enforcement actions have been taken against telemarketers, with nearly half of this number involving telemarketing companies calling from across state lines.” Comments and Recommendations of the State Attorneys General n.34, FCC Docket No. 02-278 (Dec. 9, 2002) (State Attorneys General Statement). A number of decisions have upheld the applications of state laws. *See, e.g., State ex. rel. Nixon v. Beer Nuts Ltd.*, 29 S.W.3d 828, 833–36 (Mo. App. 2000); *State ex. rel. Miller v. Internal Energy Mgmt. Corp.*, 324 N.W.2d 707, 710 (Iowa 1982).

While the FTC and FCC rules have only minor differences, there are significant differences between these two federal rules and state law. The FTC has expressly stated that its Rule does not preempt any state laws.

Inconsistencies Between the FCC and FTC Rules

There are only a few substantive inconsistencies between the FTC Rule and the FCC Rule. For example, the FTC Rule requires that a pre-recorded message be played in the case of an abandoned call and that the message include both the name and number of the seller on whose behalf the call was placed.¹⁴ The FCC Rule requires, in addition, that the recorded message state that the call is for “telemarketing purposes.”¹⁵ Both rules provide a 3 percent safe harbor for abandoned calls—calls answered by a live person where no operator comes to the phone within two seconds.¹⁶ However, the FCC calculates the safe harbor over a thirty-day period,¹⁷ while the FTC Rule calculates the safe harbor on a daily basis for each calling campaign.¹⁸ Allowing companies to calculate the 3 percent threshold over a longer period and over multiple campaigns is considerably more permissive. Both rules require disclosure of the name of the seller and a telephone number. The FTC Rule also includes a number of specific disclosures before a transaction is completed.¹⁹ The FCC Rule, unlike the FTC Rule, has specific limitations on the use of faxes and automatic dialing equipment that leaves prerecorded messages.²⁰

Inconsistencies Between Federal and State Laws: The Problem of Preemption

While the FTC and FCC rules have only minor differences, there are significant differences between these two federal rules and state law. The FTC has expressly stated that its Rule does not preempt any state laws.²¹ Nevertheless, since telemarketers are required to comply with both the FTC Rule and state law in the case of interstate calls, less restrictive state laws are rendered moot in these cases. The FTC Rule is in effect a “floor” on regulation of interstate calls made by any entities subject to FTC jurisdiction.

Exercising its authority one step further, the FCC has stated that its Rule constitutes a “floor” for both intrastate and interstate calls.²² In addition, the FCC has taken the position that its statutory authority allows it to preempt more restrictive laws applicable to interstate calls. The FCC stopped short of saying that its rule preempts all inconsistent state laws, but it indicated strongly that almost all such laws are preempted.²³

Of course, courts may not agree with the FCC’s expansive claims for its statutory authority. In fact, the state attorneys general filed a lengthy comment with the FTC when the DNC Rule was being drafted, arguing that the FCC does not have the authority to preempt state laws applicable

¹⁴ FTC Rule, § 310.4(b)(4)(iii).

¹⁵ FCC Rule, § 64.1200(a)(6).

¹⁶ FTC Rule, § 310.4(b)(4)(i); FCC Rule, § 64.1200(a)(6). The FCC Rule specifically addresses the use of calls with prerecorded messages and provides that these calls can be made in certain situations, e.g., with prior consent or in the case of an established business relationship. § 64.1200(a)(2). A literal reading of the FTC Rule would conclude that all these calls are “abandoned.” However, this appears to be an oversight since the TCPA expressly authorizes the FCC to regulate these calls, and the FCC Rule expressly permits them under certain circumstances.

¹⁷ FCC Rule, § 64.1200(a)(6).

¹⁸ FTC Rule, § 310.4(b)(4)(i).

¹⁹ FTC Rule, § 310.3(a)(1).

²⁰ FCC Rule, § 64.1200(a)(2)–(3).

²¹ FTC Rule, § 310.7(b).

²² FCC Order, ¶ 81.

²³ FCC Order, ¶ 84. (“We therefore believe that any state regulation that differs from our rules almost certainly would conflict with and frustrate the federal scheme and almost certainly would be preempted.”)

to both intrastate and interstate calls.²⁴ The TCPA reserves from federal preemption more restrictive state laws that address intrastate calls; however the TCPA does not expressly state that other state laws are preempted.²⁵ On the grounds that Congress had failed to state expressly that other state laws *are* preempted, one court found that Minnesota's law on the use of automatic dialing equipment was not preempted by the TCPA.²⁶ It remains to be seen whether some states will seek to enforce their laws and force the issue of preemption to the courts.

Some Basic Propositions

- Companies that are subject to both federal rules, e.g., telemarketing companies, must comply with the stricter rule. Companies that are subject only to the FCC Rule, e.g., banks and broadcasters, need only comply with the FCC Rule. These are no companies that are subject only to the FTC Rule.
- The FTC and the FCC rules, either singly or together, represent a federal "floor," which effectively renders moot less restrictive state laws in situations where the federal rules apply.
- The FCC Rule does not preempt intrastate calls that are subject to a more restrictive state regulation.²⁷
- According to the FCC, the FCC Rule "almost certainly" preempts inconsistent laws applicable to interstate calls, but the FCC will decide the precise extent of preemption on a case by case basis.²⁸

Some Hypotheticals

1. Safe Harbor for "Abandoned Calls." "Abandoned calls" are answered by a "live" consumer, i.e., not a recorded message, but a "live" telemarketer does not come on the line within two seconds. They are caused by the frequent use of computerized dialing systems that make several calls simultaneously. Both the FCC Rule and the FTC Rule provide a 3 percent safe harbor, i.e., the maximum percentage of calls that a telemarketer may abandon within a specified period. However, the agencies' rules are inconsistent with regard to the relevant period. The FTC Rule is more restrictive because telemarketers must meet the 3 percent standard each day for every calling campaign. The FCC Rule permits the safe harbor calculation to be made over a thirty-day period. The FTC Rule applies to all interstate calls except those made by non-profit organizations and certain industries that are exempt from FTC jurisdiction, such as banks and common carriers. Accordingly, banks and common carriers can take advantage of the more permissive safe harbor calculation, but telemarketing companies cannot.

What about state law? California, for example, has considered adopting a 1 percent abandoned call safe harbor.²⁹ If the state did adopt such a stricter standard, telemarketing calls within California would have to comply. What about calls into California from out of state? It is likely that

²⁴ State Attorneys General Statement, 8–11.

²⁵ 47 U.S.C. § 227(e)(1).

²⁶ *Van Bergen v. Minnesota*, 59 F.3d 1541, 1547 (8th Cir. 1995). In *Van Bergen*, the plaintiff claimed that state law was preempted by the TCPA. The court found that there was no express preemption and companies could comply with both federal and state law.

²⁷ FCC Order, ¶ 82.

²⁸ FCC Order, ¶ 84.

²⁹ The California Assembly has given authority to the Public Utilities Commission to establish abandoned call limitations. CAL. PUB. UTIL. CODE § 2875.5. The Commission has decided to retain the 3% threshold for now. Public Utilities Commission Order, D.03-03-038 (Mar. 17, 2003).

the FCC would claim federal preemption of the state law, since programming predictive dialers to meet different abandoned call thresholds in different parts of the country would lead to “burdensome compliance costs.”³⁰

2. “Telemarketing Purposes” Disclosure. The FCC Rule requires that a recorded message include a statement that the call is for “telemarketing purposes,” a requirement not included in the FTC Rule. Since the FCC Rule applies to virtually all companies in the United States, as well as both intrastate and interstate calls, all these entities must comply, at least in theory. However, the FTC has primary responsibility for policing telemarketing companies, and the FCC has primary responsibility for policing companies exempt from the FTC Rule. Thus, banks that call consumers directly—and as a practical matter must pay more attention to the FCC rule—are presumably under a greater risk for failing to comply with the stricter FCC provision.

3. Calling Hours. Both the FTC Rule and the FCC Rule restrict telemarketing calls to the hours between 8:00 A.M. and 9:00 P.M.³¹ However, several states have more limited calling hours. Such state laws apply to intrastate calls and to any calls into the state. A telemarketer needs to decide what law applies. As in our previous examples, it is clear that telemarketing companies must comply with the stricter state calling hour restrictions for intrastate calls. But what about interstate calls? Again, the FTC Rule would have no preemptive effect, but does the FCC Rule preempt the state’s more restrictive call hour limitation? The answer apparently depends upon whether the different calling hour restriction would “frustrate the federal scheme.”³² State calling hour restrictions frustrate the federal scheme in the sense that it is easier for companies to comply with a uniform rule than with dozens of different calling hour restrictions. At the very least, different calling hour restrictions are confusing. Telemarketing companies must train their staffs and implement a compliance program to ensure that calls are made within certain time periods. Avoiding confusion was an FCC rationale for adopting the FTC Rule’s calling hour restrictions.³³ There may be technological difficulties as well. On the other hand, the FCC might take the position that calling hour restrictions are examples of state laws where lack of uniformity is not unduly burdensome. The question can be resolved by filing a petition with the FCC.³⁴ The frequency of these petitions and the time of response to them remain to be seen.

Toward Greater Uniformity

This quick survey of telemarketing laws should make clear that there is a need for the states, the FCC, and the FTC to move toward greater uniformity. States are understandably reluctant to give up on their prerogatives to enforce their own laws, but the additional protection given to consumers by state laws is usually marginal. The benefits to consumers from greater overall compliance with a uniform rule probably outweigh the benefits of slightly more restrictive state laws.

In addition, the FTC and the FCC should take steps to make their rules identical wherever possible. In some cases, e.g., jurisdiction over certain industries and intrastate calls, the FCC has statutory authority and the FTC does not. Except for differences in scope of coverage, however, there is no good policy reason for the rules to be different. It is clear that the FTC and FCC’s efforts

³⁰ FCC Order, ¶ 83.

³¹ FTC Rule, § 310.4(c); FCC Rule, § 64.1200(c)(1).

³² FCC Order, ¶ 84.

³³ FCC Order, ¶ 210.

³⁴ *Id.* ¶ 84.

to regulate telemarketing have struck a responsive chord with the public: consumers welcome curbs on the intrusiveness of telemarketing. On the other hand, the new rules have imposed a major burden on this industry and have substantially limited its ability to operate. It seems only fair that the agencies should take steps to reduce the compliance burden, too. ●

Whither Merger Simulation?

An ABA Section of Antitrust Law “Brown Bag” Program Held January 29, 2004

MODERATOR



Michael S. Becker
Partner, Kirkland & Ellis

PARTICIPANTS



Luke Froeb
Director, FTC Bureau
of Economics



David T. Scheffman
Director, LECG,
Adjunct Professor,
Owen School of
Management, and
Former Director,
FTC Bureau of
Economics



Gregory J. Werden
Senior Economic Counsel,
Antitrust Division,
U.S. Department
of Justice

Editor’s Note: The beginning of Dave Scheffman’s second incarnation as the Economics Bureau Director at the FTC might be regarded by some as a “reign of terror” when the topic was the utility of Bertrand simulations for unilateral effects analysis. Indeed, Scheffman seemed to almost single-handedly bring coordinated effects (warts and all) back into the merger analysis limelight as he “dissed” unilateral effects.

A recent ABA brown bag on merger simulations included Luke Froeb, the current Bureau of Economics Director, and Greg Werden from the Antitrust Division—both of whom are particularly well-versed in the estimation and use of simulation models—as well as Scheffman. For those who wonder how the DOJ and the FTC view simulations as a methodology for evaluating mergers and for those who might wonder whether time has mellowed Scheffman’s views, cruising through the transcript—an easy read—should be helpful. I, for one, did not see any mellowing.

A few samples of the discussion follow. All three speakers agree that there is no real evidence—or maybe just no evidence—that Bertrand simulations are reasonable predictors of the post-merger effects. Werden and Froeb, however, conclude that if the simulation can predict the present (and its assumptions are, at least in a stylized way, consistent with what we know about the particular industry), it can in fact be used as a tool in merger analysis. While Scheffman seemingly agreed with that conclusion, the inability (in his view) of the model to take into account important competitive variables (such as non-price competition) certainly suggests that the Bertrand simulation is a tool worth leaving to rust in the tool box.

All three presenters seemed to agree that the Bertrand’s focus on price-effects alone is not a sufficient analysis. All agreed that the economist evaluating merger effects must also consider repositioning, entry, and retail-wholesale relationships, and other factors. But (in my read) where Werden and Froeb would use these facts along with the (correctly calibrated) simulation in a complete

evaluation of the merger's effects, Scheffman seemed to believe that the Bertrand model is so far removed from a model of competition that the use of the Bertrand simulation in merger analysis should have a weight close to zero.

Scheffman also opined that one substantial cost of using the simulations in merger analysis is that analysts (lawyers, and maybe even some economists) have supported or opposed a merger based on vague factual (or maybe, metaphysical) views on the closeness of the products of the merging parties, what Scheffman calls "squishy" facts. But Werden and Froeb are clear that for economists, all of the assumptions of the model must be vetted against the facts and the model's sensitivity to those assumptions tested before it can be usefully employed in merger analysis.

My take on this debate is straightforward. The general view that in the context of unilateral effects, the simulation model properly used can be a helpful and insightful tool in merger analysis seems unobjectionable. A simulation model that can capture the essence of price competition in an industry and predicts a non-trivial post-merger price increase tells us something about the burden that must be carried by other arguments—entry, repositioning, advertising, innovation, capacity constraints, etc.—if the merger is to be cleared. Scheffman is surely right that simulations are not a substitute for thinking. But simulations thoughtfully used can be the beginning of a careful and focused merger analysis.

—JOHN R. WOODBURY

MICHAEL BECKER: The topic today is merger simulation. I think today's presentation can provide us with an overview of the pros and cons of merger simulation and help enlighten us on where the agencies think the current state of the art is. We have three speakers today. The first two speakers are Greg Werden and Luke Froeb. Greg is Senior Economic Counsel at the Antitrust Division at DOJ and Luke is the Director of the Bureau of Economics at the FTC. Both Greg and Luke have written on merger simulations. I think it's fair to say they are viewed as proponents of simulation, and they'll be discussing some of the pros of merger simulation and some of the misuse too. The final speaker will be David Scheffman, who is Luke's predecessor at the FTC and is now with Vanderbilt University and LECG. David's role today is to play the critic of merger simulation.

GREG WERDEN: Merger simulation uses standard tools of economics to predict the unilateral competitive effects of proposed mergers. An oligopoly model is selected that reasonably reflects the nature of competition in the industry, and the model is calibrated using prices, market shares, and other observable quantities. The calibrated model is then used to compute the post-merger prices and shares that internalize competition among merging products.

Although merger simulation can be applied to many types of industries, the main application is with branded consumer products. In that application, all of the attributes of the products are held constant, and competition is strictly on the basis of price. A lot of other assumptions are conventionally made, including that marginal costs are constant and, in most applications, that retailers take constant percentage markups over wholesale prices.

The calibration of such a merger simulation is designed to make the model perfectly predict some "but for" world. That usually is the actual world observed before the merger, but it can be something else if the future is likely to differ significantly from the past, absent the merger. Calibration involves prices, shares, and demand elasticities. The prices and shares don't raise many issues, but the elasticities can cause a lot of problems. I'm not going to talk about estimation at all today, but there are a host of issues in the estimation of demand elasticities that can be very challenging.

The advantages of the merger simulation are, first, it provides quantitative predictions of the unilateral price effects of mergers. It's not the only way to do that, but I think it's the main way. It's also easy in a merger simulation to take account of marginal cost reductions from merger synergies and compute net effects on price. Finally, merger simulation can be a great tool for focusing an investigation by identifying critical facts: what things matter, what things don't, how things matter, and how much they matter. By facilitating the identification of vulnerabilities, merger simulation helps indicate how best to allocate the investigative resources.

Of course, there are serious limitations. One important limitation is that a conventional merger simulation requires an assumption about functional form for the demand curve, and the predictions are fairly sensitive to that assumption. My advice on that is to make the assumption that's the least advantageous to whatever side you're working for. Merger simulation does not, as it's generally practiced, allow the investigation of prospects for entry or product repositioning; they are assumed away. And it's perfectly possible that firms in the real world do not play the same strategies that they do in the model, so it's not necessarily the case that merger simulation tells you what's actually going to happen after a merger.

There are several things I call "non-fatal flaws" in merger simulation. These are problems I don't worry much about. One is that the models available for use in merger simulation cannot possibly capture every nuance of competition in the real world. But that really isn't necessary. Capturing enough makes the predictions good enough. Models are never going to be perfect, and that is not the goal. The price increase predictions are at best rough estimates, but rough estimates are better than no estimates.

Finally, merger simulation cannot predict the long-run evolution of an industry. It cannot say much about entry or product repositioning; it cannot say much about changes in marketing strategy. It indicates only relatively short-term effects: how prices will be adjusted by the merging firms after the merger, and how the non-merging firms will respond to those price changes.

There are also potentially fatal flaws in merger simulation. First, an improperly calibrated merger simulation doesn't predict the merger-induced price changes. While I think it's fairly trivial to calibrate a merger simulation properly, I have seen that not done. I don't mean done improperly, but rather not at all, which produces nonsensical comparisons between the predicted post-merger prices and the pre-merger prices. Secondly, doing a merger simulation requires a well-specified economic model of oligopoly, and the available models don't fit all the industries. Sometimes they don't fit very well at all. They may not explain how manufacturers compete; they may not explain how retailing works; and they may not explain the relations between manufacturers and retailers. If they are far enough off, the predictions may be useless, and the models should not be used.

In a merger simulation, the general practice is to start from prices, shares, and demand elasticities, and work backwards to what the marginal costs would have had to have been if those prices, shares, and demand elasticities were an equilibrium before the merger. This infers the marginal costs, and provides a set of inferred marginal costs that can be compared to whatever evidence there may be on actual marginal costs. This comparison is important. It indicates whether the model jibes with the real world in terms of the general level of intensity of competition. It's not uncommon that some of the inferred marginal costs are very implausible, and something has to be done about that. The something may be abandoning the whole project, but usually there are less drastic and more useful things to do.

The foregoing is all introduction. My basic thesis is that merger simulation should be disciplined, whether in the courtroom or outside, by the Federal Rule of Evidence 702 and the *Daubert* decision (*Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993)) and its progeny,

My basic thesis is that merger simulation should be disciplined, whether in the courtroom or outside, by the Federal Rule of Evidence 702 and the Daubert decision and its progeny . . .

—WERDEN

which limit the courtroom admissibility of expert testimony in ways that I think the analysis done outside of court similarly should be limited. Translating Rule 702 into principles for economic testimony, there are basically three conditions for admissibility of expert economic testimony: First, the witness has to be an expert in the relevant field of economics, and I emphasize relevant field. Being an economist, even a Ph.D. economist, is not nearly enough, and the case law is starting to recognize that. Second, the testimony has to employ sound methods from the relevant field of economics. Under the Federal Rules of Evidence, whatever methods economics considers sound may be used in court. Finally, the testimony has to apply those methods reliably to the facts of the case, and that's really the most important thing. Merger simulation should be based on the facts.

My slides go through some case law precedent and offer some arguments based on this precedent. [Ed. Note: Slides are available at <http://www.ftc.gov/speeches/other/040129werden.pdf>] I won't go through them in detail, but there are a couple of interesting points I'll mention. Some antitrust cases have excluded economic testimony because the witness was not considered an expert. The one I find most interesting excluded testimony on the relevant market from a Ph.D. economist who had "no background in antitrust markets." (*Nelson v. Monroe Regional Medical Center*, 925 F.2d 1555, 1572 (7th Cir. 1991)) He was a health care economist, and it was a health care case, so it made some sense to use him as a witness. But in a concurring opinion, one judge in the Seventh Circuit found that he had no business testifying about relevant markets because he didn't know anything about the analysis of relevant markets. I think there will be a lot more decisions in which Ph.D. economists are not allowed to testify about certain antitrust issues because they don't know anything about those issues. I certainly hope we get decisions like that.

In my view, merger simulation testimony should be excluded if the witness doesn't have some experience doing merger simulation. A quote from physicist Werner Heisenberg captures well the issue here: "An expert is someone who knows some of the worst mistakes that can be made in his subject and who manages to avoid them." Luke and I learned through trial and error how to avoid doing merger simulations badly. The only way I know how to learn to do anything is to do it, and experience teaches what not to do.

Economic testimony has been excluded in antitrust cases for failure to meet professional standards in economics. Most such testimony was empirical analysis, but the same rationale would apply to merger simulation. As to whether merger simulation is a sound method, in a sense, the answer is simply "yes." Merger simulation uses sound methods from economics—standard oligopoly models. If estimation is done, it uses standard econometric techniques. All of that is theoretically sound. What we cannot say is that merger simulation is empirically sound; we cannot say that merger simulation accurately predicts the actual effects of mergers. We don't know. On the other hand, there is no evidence that any method accurately predicts the actual effects of mergers, so simulation is on par with other methods of analysis in that regard.

Daubert and progeny have taught us that economists have to go into court with the tools of economics. While the lawyers can get away with invoking presumptions based on market shares and case law precedent, expert witnesses cannot; they must have something else. Merger simulation isn't the only something else, but it's one possibility.

In the slides, I quote dicta from *Daubert* and *General Electric Co. v. Joiner* on the issue of fit. One of my favorite quotes, which I use quite a lot, is that a court should not "admit expert opinion that is connected to the existing data only by the *ipse dixit* of the expert." (*General Electric Co. v. Joiner*, 522 U.S. 136, 146 (1997)) Traditionally, I think a lot of expert testimony was connected to the existing data only by the *ipse dixit* of the expert, and one should be alert for that possibility.

Without a strong connection to the facts, the analysis ought not to be admitted in court or done out of court. Quite a few decisions have excluded expert economic testimony for ignoring important facts. Some of these involved empirical analyses, and some of them did not. My slides give examples that are fairly well known from the *Brand Name Prescription Drugs Antitrust Litigation*, as well as a couple that aren't quite so well known.

My bottom line is that every modeling choice, and there are a lot of them, has to be justified in some way. The justification can be that economic theory dictates that particular choice. For example, I think the only justification needed for the profit maximization assumption is that that's what economists assume.

One particularly interesting case, which I'm sure you've all heard about, is *Concord Boat*, in which the testimony of Robert Hall was excluded and a substantial damage award vacated because his oligopoly model was "not grounded in the economic realities of the industry." (*Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039, 1056 (8th Cir. 2000)) What the Eighth Circuit did in that case is exactly what courts should do when confronted with merger simulation. The court looked at what Hall did and found it just didn't match up with the real world. His model was a perfectly fine model, but just not the right model for that industry. And the way he calibrated the model, to use merger simulation terminology, did not make sense. His model said the defendant's market share wouldn't be more than 50 percent without engaging in the challenged practices, but the defendant's share was 75 percent before it engaged in any of the challenged practices. The court didn't think that made any sense, and neither do I, and a lot of money changed hands because it didn't make any sense.

A less well-known case, but one that has a very nice statement of what was wrong with the expert's analysis (or could have been wrong, since I don't know if it really was wrong) is the *Booksellers* case. Frank Fisher's testimony on how to reckon damages was excluded because it contained "too many assumptions and simplifications which are not supported by real world evidence." (*American Booksellers Ass'n, Inc. v. Barnes & Noble, Inc.*, 135 F. Supp. 2d 1031, 1041 (N.D. Cal. 2001)) Doing any kind of economic modeling requires making assumptions and simplifications. The court was looking for evidence that the assumptions made sense, and it didn't think it had enough such evidence. I have no idea what evidence it had, but I find heartening that it was asking the right question.

Of course, a perfect fit is not required; in fact, it's not even desirable. Trying to make the model fit all the facts makes it too complicated and no longer a useful model. It's not going to predict. In selecting a model, the totality of the evidence should be examined to see what can be learned about how competition works. If there is such a model, a model should be selected that fits the resulting understanding of how competition works. Of course, different people may look at these facts and come away with different views about how competition works. That's okay. *Daubert's* requirement of intellectual rigor doesn't mean that there's only one right analysis.

My bottom line is that every modeling choice, and there are a lot of them, has to be justified in some way. The justification can be that economic theory dictates that particular choice. For example, I think the only justification needed for the profit maximization assumption is that that's what economists assume. A choice can be supported by industry data; for example, observed prices and shares are used to calibrate a model. Assumptions also can be consistent with stylized facts. If the industry sells differentiated products, it shouldn't be hard to muster facts that buyers and sellers perceive the product as differentiated—that brands matter. Or, an assumption can be unimportant. It may be fairly easy to show that nothing much changes from tweaking a particular assumption a little. If that is so, no further justification is required.

—WERDEN

Finally, absent any of the foregoing, some kind of sensitivity analysis is required to show how the predictions depend on the assumptions. Some assumptions are very important: Changing them changes the predictions substantially. With such assumptions, it is best to take a conservative course. Testifying for the government, I would always go with the low range of price increase

predictions, depending on different assumptions like demand functional form, ranges of elasticities, and things like that.

Any sort of economic analysis, and we're talking about merger simulation today, has to be based on something, largely the facts, and Luke and Dave are going to basically continue with that theme.

I think the discipline of modeling, and the link that it exposes between the evidence in a case and the conclusions drawn, are its main virtue. A model forces the economists to "put their cards on the table."

—FROEB

LUKE FROEB: We've been doing merger simulations for at least a decade, and we've learned a lot of things by trying to actually model mergers and fit models to the facts of the industry. There are a lot of surprising things, perhaps the most basic of which is that the merger effects are so small. When we started out doing this, we had some very big mergers, and it just was inconceivable that we were getting such miniscule effects, given the elasticities and all the assumptions that we had made. We've fit models to industries that are capacity constrained, and we've learned that capacity constraints on the merging firms matter a lot more than the capacity constraints on the non-merging firms. Capacity constraints on the merging firms attenuate the merger effect by much more than capacity constraints on the non-merging firms amplify them.

I think the discipline of modeling, and the link that it exposes between the evidence in a case and the conclusions drawn, are its main virtue. A model forces the economists to "put their cards on the table." Attorneys can then challenge a model by challenging the evidence that feeds into it, or they can challenge the link between the evidence and the conclusion. A model should be used to interpret the evidence, not to substitute for evidence in a case. That's my basic outline, and I'm going to illustrate some of the principles that Greg has discussed. [*Ed. Note:* Slides are available at <http://www.ftc.gov/speeches/other/040129froeb.pdf>.]

Let me just start out with some definitions. The "back end" is the use of a structural model, meaning we actually have models about how firms, consumers, and retailers behave, and we have an equilibrium notion about how they all interact and what happens. The "front end" involves the parameters that feed into the models, which come from evidence or estimation. Pre-merger, we observe an equilibrium and post-merger, we're predicting an equilibrium.

Antitrust, or certainly the model side of antitrust, hasn't been in the prediction business for very long, and we can learn from our sister field of macroeconomics. Macroeconomists had written down all these models to describe what they could observe, and somebody got the bright idea of using the models to forecast what we can't observe. When they started forecasting out of sample, they found out that they really couldn't predict as well as they thought they could. The Clayton Act put us into the prediction business, so what we'd like is evidence on the accuracy of out-of-sample forecasts, but for a lot of reasons, we're not going to get much. It's difficult to estimate the effects of mergers after the fact, and even if you do estimate the effects of a merger, it's very difficult to go back and actually run a simulation using evidence that would have been available only at the time of the merger. So, for a variety of reasons, we're not likely to get good evidence on out-of-sample forecasting accuracy. What are we then left with? How do we evaluate the reliability of these models?

What Greg is proposing is that if a model does not accurately predict what we can observe, we ought to be very suspect about using the model to forecast what we can't observe. If you can't predict the present, you shouldn't use the model to forecast the future. Having said that, the three of us don't completely agree on how well the model should be able to predict what is observed, e.g., what facts are relevant, to determine whether a model is reliable or not.

Much of the criticism of structural modeling comes from attorneys who worry both about the costs of merger simulation—estimating the parameters of the models can be a long and costly

undertaking—and about the way they can focus an investigation on evidence that is unlikely to inform the fundamental questions raised by the case. For example, attorneys who have used modeling have run up large bills only to see the estimates as being wacky or not consistent with their prior beliefs. So merger simulation has gotten a bit of a black eye. The pro estimation side of the debate would be to say: Data are the only source of knowledge; the way to interpret data is econometrics; and any problems we run into we have satisfactory solutions. The con side is: The data just doesn't speak to the policy question that we're trying to answer; a lot of problems don't have satisfactory solutions; and it's a very costly proposition.

Where do I come away on the estimation debate? This is going to annoy you as I'm sure it annoys my students at Vanderbilt when I tell them, the answer is, "it depends." I always wait until they've paid their tuition before I tell them that, but it does depend on what you're trying to do, and merger simulation should not be used as a black box that applies in every case. It's a tool, and you can only judge the utility of a tool by the use to which you put it. It's appropriate for some jobs, but not for others.

Is simulation likely to convince the key decision makers? Again, it depends. It depends on how well the model describes the evidence. Is it likely to reduce uncertainty? Before you engage in a long estimation exercise, ask the economists what would we get if we didn't have to estimate the demand, what if we knew exactly what the model was going to predict, what would we be able to say? Would that convince anybody? If you estimate an outcome that favors your client, would that convince anybody that you weren't just fishing for that outcome? So put your economists to the test, ask them some questions. We're going to give you some questions to ask them.

Is simulation necessary for defensive reasons? Critiquing methodology is really hard without first replicating it. Does some number beat no number? I think that's certainly true in a damage estimation, and these models are used in damage estimation. In a case I worked on shortly before coming to the FTC, we successfully defended a damages case without putting out our own number, but it was difficult. Without a model, you have to argue that their model is not any good at all; whereas if you put up your own model, your burden is lower as all you have to do is argue that your model is better than their model.

The crucial question is, are we simplifying too much? Do the models abstract away from crucial pieces of behavior, of reality?

—FROEB

One of the reasons we started doing simulations is that, in the late eighties, the Department of Justice got away from coordinated effects stories for a lot of reasons. We weren't bringing merger cases in the kinds of industries where we saw collusion. We were bringing cases in the kinds of industries where we didn't see collusion, and the stories evolved into unilateral effects stories that fit the facts of those cases much better. The basic unilateral effects story is that, pre-merger, the merging firms price independently, and post-merger they take account of cannibalization, which changes their profit calculus. That changes the equilibrium, and the merged firms raise their prices, and the non-merging firms raise their price sympathetically. This makes it seem like the only issue is how much, but behind the unilateral effects story is a very complex structural game theoretic model built on assumptions about how firms, retailers, and consumers behave.

How do we know when these models give reliable forecasts? Well, we don't know. The ultimate proof is prediction. There's been very little out-of-sample prediction with these models. We're seeing more of this. We're trying to do some of that at the FTC, but it's very difficult to do. In the absence of evidence of good out-of-sample predictions, I think we go back to the *Daubert* discipline and ask how well these can models describe what we can observe.

I'm going to illustrate how to bring the *Daubert* discipline to the modeling choices. The crucial question is, are we simplifying too much? Do the models abstract away from crucial pieces of behavior, of reality? What we three have come up with is a rule saying: If an assumption matters

to the model and matters to how you interpret the results of the model, then the assumption either ought to be supported by evidence or, if you don't have good evidence, you ought to do sensitivity analysis to give the decision makers some idea of how sensitive the model is to the assumptions. Let me give you some examples.

One of the things that we commonly do when we use merger simulation is to ignore the retail sector, or assume it just marks up the wholesale price and passes on whatever upstream merger effect there is. That story could be right, but if it isn't right, merger effects can disappear. If a retailer and a manufacturer jointly maximize the profit pie between them, there's one price that maximizes the profit pie, and that price is not going to change post-merger. That's a second story. The split of the profit pie might change, but the retail price does not. So if that's how the retailers are behaving, there is no merger effect. Then a third story is that there's double marginalization, and that can either amplify or attenuate merger effects. This assumption really matters. You have to gather evidence on it. One thing you might do is try to look at retail margins and wholesale margins and see if you can distinguish among these three stories.

Another thing that matters is demand curvature. I've plotted four demand curves between the common competitive equilibrium and the four different monopoly equilibria. These four demand curves all share the same competitive point, which is a quantity of ten and a price of four. When we extrapolate to the post-merger equilibrium, we get dramatically different results. If you had only data at the pre-merger equilibrium, how could you distinguish between those four demand curves? There's no way to do it. So here's an assumption that matters a lot. You get three times the merger effect if you use a constant elasticity demand curve than if you use a linear demand curve. If you don't have any evidence, and you won't, you have to do a sensitivity analysis and make a conservative assumption. If you're the plaintiff, assume linear or logit demand. If you're the defendant, assume a constant elasticity or an AIDS demand.

Demand elasticities matter a lot in these models. They're difficult to estimate precisely. If you use a strict classical confidence interval, assuming you could compute one—and that's not a trivial exercise—often the uncertainty is so large that both the pro- and anticompetitive scenarios are in that confidence interval. One of the things you can do is a sensitivity analysis, and here I've taken data from the WorldCom-Sprint merger that was challenged by the DOJ and then abandoned. I've used a logit demand model calibrated to the WorldCom demand elasticity. This demand curve depends on only two parameters, which reflects an assumption about what the cross elasticities look like. Given this assumption, the merger effects don't depend that much on the elasticities. You get from a half a percent to about a 1.25 percent industry price rise following this merger, and these are relatively easily offset by small efficiencies.

Be careful about hiring academics, and I say this as an academic. Don't trust us. We are interested in methodological innovation, while practitioners want to know how well does a methodology fit the facts of the case, and I think that's the crucial concern. The conclusion of every academic article is, "it depends," and you show the tradeoffs in some kind of elegant way, and you get published in a journal that nobody reads. A practitioner wants an answer, and it's very difficult to get an academic to come down on one side or the other. As academics, you get peer review. I've got five of these sitting on my desk, and I'm probably going to devote a little bit of time to each one of them. But if you use one of these models in a damage case, you'll get a \$100,000 referee report. In many ways, I think that the legal standard is higher. The analysis you come up with has got to be practicable and it's got to fit the facts of the case.

My final flag is probably going to go over the heads of anybody who hasn't read *Das Kapital*, but I'm trying to put this in a larger framework. What are we trying to do here? We're trying to push

economics forward, make it more relevant and more useful to practitioners. Greg and I are older, wiser, and much more cautious than we were ten years ago. Dave has been a very useful critic of ours, forcing us to reexamine everything we thought was true, and hopefully we'll come up with a synthesis. Modelers must pay attention to the details of the industry—you can't just assume a can opener—you've got to make it fit the facts of the case. A lot of times we're dealing with complex situations that are simply beyond our capabilities or we have an alternate, simpler, empirical reduced-form methodology—natural experiments—that we can exploit to draw inferences about the effects of the merger.

One of the things that the Chairman asked me to do when I came here is follow up on the enforcement R&D started by my predecessor by actually trying to do some of the merger retro-spectives and provide evidence on out-of-sample forecasting that's necessary to validate these things, and finally to come up with more realistic or better models to do merger analysis. I expect that this effort will help us better identify those situations where simulations work.

DAVID SCHEFFMAN: This will be part love him and—given that Greg and I are here—well, knowing Greg, I don't know what the other part will be. I've been very critical of simulations, publicly, and I'm going to say some things that are somewhat critical today. Let me say I have the highest regard for Luke and Greg. I'll say, and I don't give compliments easily, I don't think anyone's contributed more to antitrust economics over the last twenty plus years than Greg. He's very careful, very thorough, and his contributions have all been very important, both to economics and to policy and particularly how we analyze mergers. Luke is a first rate applied econometrician and industrial organization economist and the two of them together have made a lot of contributions, one of which is merger simulations.

I won't talk about how old I am and where my perspective comes from. I am an economist, which some of you don't believe. I do believe in models and modeling, that models and modeling can be useful and, yes, models simplify things but they necessarily have to. My colleagues who I argued with often when I was back at the FTC when I made all these pronouncements about merger simulations, it's not so much that they were wedded to merger simulations but that they developed the view that I was criticizing economics, and they always made the point, as I have in that last paragraph there on that slide, which is absolutely right. [*Ed. Note:* Slides are available at <http://www.ftc.gov/speeches/other/040129scheffman.pdf>] They say, but wait a minute, look what's on the other side. Look what the lawyers are doing. They have some sort of model, who knows what it is, that leads to their recommendations on a merger case. At least we have some economic methodology, we're up front about our assumptions, and that's better than the alternative, and as an economist, I'm inclined to be sympathetic to that view.

I think one thing that happened with the rise of unilateral effects analysis was that it was a dangerous tool for lawyers. Simulations weren't the problem because simulations actually didn't have much effect one way or the other, at least in the U.S. And simulations may turn out to be beneficial as we learn more. The problem is that, from the point of view of how the agency lawyers would look at unilateral effects—as I've often said, we went back to the 1960s style of merger analysis—lawyers concluding that two companies compete with one another and on the basis of often very squishy arguments, concluding that they compete particularly closely with one another. So, *voilà*, we have a unilateral effects theory. That's just not right as a matter of law and it's certainly not right as a matter of economics, and so we have a problem. I'm not criticizing the lawyers at the FTC—both agencies are absolutely superb at what they do—and they're very good at basic economics. But the problem we have here is a gap between very formal models that the economists use

and what we more often do: We apply economics in a very squishy situation but hopefully with some economic discipline. That requires you to be very sophisticated as an economist or that you be a lawyer who's pretty good in basic economics but doesn't have the background or sophistication to do simulations.

So what do I like about simulation? I like Greg's and Luke's paper in the Swedish volume, I think—the general argument about why simulations are a good idea. That is, you should try in some disciplined way to put all the factual information together—cost, demand, what you know about competition and other sorts of things—to try and reach a sound conclusion. Very often in the agencies and on the outside, things get pretty squishy and you say, well it's anticompetitive based on a lot of relatively squishy stuff, which might be right. I think what economists can do is try and put all that evidence together and come up with a conclusion, nothing anywhere near as precise as a Bertrand simulation model, but that at least provides something economists can argue about as to what assumptions, what facts are important as to whether we really thought the price increase was going to be 10 percent or 1 percent and why, etc.

My concern is that, as

we all know, we don't

usually use models in

most merger analyses.

Most matters are too

complicated.

—SCHEFFMAN

So I like that paper a lot, I like the work that both Luke and Greg have done. It's been recognized academically, helped Luke get tenure at a first-rate university, and rightfully so, but I think it's just the beginning. It's a very promising beginning. But we have much more work to do.

Enough lovefest. Let me talk about my concerns. My concern is that, as we all know, we don't usually use models in most merger analyses. Most matters are too complicated. Fortunately, in industrial mergers, we can rely a lot on customer opinions and other sorts of things. In bidding situations, we can use models and, in my view, those are probably the situations where models are most useful. But on average, in the agencies we economists don't use models. We often do not even have the data really to do much modeling.

But, when we say "differentiated products" and we have some data at the consumer level, *voilà!*—all of a sudden we can model because we have a 150-year-old model—Bertrand—and we have some data two or more levels down. I'm not saying that's not a potentially useful exercise but it requires some thought.

Now here's where the "non-economist," or as I would rather put it, the "augmented economist" side of me comes in. I have been a strategy and marketing professor now for fifteen years at a pretty good business school, and clearly Bertrand does not at all replicate the way competition really works. It does not have anything very important to say about how competition occurs in branded products mergers. That's because, as I'll discuss in a minute, Bertrand is not really a model of competition.

So my concern is that we have something which is actually very complicated to explain, really much more complicated than our typical industrial products merger because we have branding, we have retailers, we have consumers, we have all sort of complexities, complex relationships between retailers and manufacturers and we say, *voilà!*—because it's differentiated products we can explain it with a simple model. I'm very skeptical of that.

Nonetheless, I would not say that that can't be true, and that's because even though it clearly does not at all replicate real behavior in consumer products markets, it may be a useful metaphor for explaining equilibrium. That's what I understand to be the "Willig justification"—what I ascribed to Bobby, but probably came from Greg. The Willig justification for unilateral effects says if you think about Bertrand, all that's really going on in Bertrand is internalizing the cannibalization that occurs between the competing brands, and that might provide a post-merger incentive to raise price. What you could say, perhaps, is that in any sort of model where cannibalization considerations are going to be important, Willig is probably right.

The question is, how important? And does that internalization of cannibalization dominate how the competition really works in the model, in reality? That's the important question. It's possible that Bertrand is right, but it's certainly not right as a depiction of how competition actually works. Nonetheless, it could conceivably be the explanation of equilibrium in the long run. That is, the internalization of cannibalization could dominate the pricing decision, but I would need a lot of convincing that that was true, and I would require much more testing of Bertrand than we normally do, and I'll talk about that.

Now one of the reasons why I think Bertrand is such a strange model for us to use in mergers is that we're only looking at mergers where there are a very small number of competitors, usually four, or at most five, these days. So we're evaluating the classic oligopoly situation that economists have been looking at for decades and decades, which is the problem of the small number of competitors. With a small number of competitors, each competitor realizes that not only does it affect the marketplace by what it does, but it knows what it does will stimulate a reaction by its competitors and therefore a competitor is going to take that into account in what it does. That is, Bertrand has none of that oligopolistic interaction which absolutely has to be true as a matter of behavior in a market where there's only four or five (or fewer) competitors.

Now I agree that it's possible that, despite all that competitive interaction, what happens in the equilibrium might actually be explained by a Bertrand model, but that's an empirical question. While it's possible, there really is no basis in actual market behavior to think that the Bertrand model is right—there's no basis to believe that the Bertrand model in any way replicates what really goes on in competition. This is certainly true in consumer products where the real competitive interaction is taking place between the retailers and the manufacturers, and down to the consumer level and the manufacturers. But it's still an empirical issue. It could be right in some circumstances as a metaphor for equilibrium. We have to figure out when it's right in what circumstances.

I think Greg and Luke pointed out very well the problem with simulation, and they stress it's far more complicated than you think it is. Lawyers agree with that, they think it's black magic, but economists who have done this a lot—and no one has probably done more of these than Greg—know that it's really quite subtle and complicated even though it seems a simple model. You have to really think through the assumptions and the interrelationship among the assumptions, so you have to do a lot of testing. Greg's paper on bread is very good. I know Greg would never do a case unless he immersed himself in all the evidence in the case and convinced himself that the simulation tool was valid and useful in a given situation. Now I may or may not agree with Greg in a specific case, but I know that Greg would have covered all the bases and would have certainly absorbed all the facts in the situation and factored those into his decision.

So merger simulation is a tool, it's not an answer. No one, none of these economists who created this would say you could make a decision on a merger based on a simulation. That's not the way they do work—that's not the way anyone does. One of the problems is in the past several years is that lawyers have been hiring economists to come to the agencies knowing only what their simulation model results are, which is worthless at the agency and should be. Merger simulation is not a substitute for thinking or assessing the totality of the institutional setting, I think we all agree on that.

Let me get to the part that will get Greg's juices going. For lots of reasons, I'm absolutely convinced Bertrand is not the right model. But as I discussed earlier, it might be, it could be right as a model to explain equilibrium. I would just need a lot of convincing of that. This view is quite consistent with the discussion in the Fudenberg and Tirole game theory text, which makes clear what Bertrand's limitations are.

*For lots of reasons,
I'm absolutely con-
vinced Bertrand is not
the right model. But as
I discussed earlier,
it might be, it could be
right as a model to
explain equilibrium.*

—SCHEFFMAN

The issue is really, does the internalization of cannibalization—which is all that drives Bertrand simulation models—dominate all that other stuff which is really very important? It might, but I think we need more work to figure out whether that's true.

—SCHEFFMAN

What are my specific gripes? Well, I've been griping a long time about retail versus manufacturer. I simply don't believe that you can look at elasticities estimated at the consumer level and jump to any inference about what that means about mergers at the manufacturer's level. You really have to do a lot of thinking about that and I think Greg and Luke and I agree on that. I think we probably may differ as to how important that is but I think we all agree now that that's an important issue. As they pointed out, Bertrand doesn't include what I, the marketing professor, think is really the most important sort of activity in terms of competition, which is about products and advertising and promotions with retailers and shelf space and placement—i.e., nonprice competition—all those things, that's what the real competition is about and you need to take that into account. I certainly agree that it's possible that all those are important, but with respect to pricing and effects of a merger on pricing maybe that would be separable, in some sense. It's possible. I would need a lot of convincing on a given case that that was true, but it's possible.

Bertrand is really a very simple model. What Bertrand is, I'll say this very strongly, Bertrand is a reduced form monopoly model. Think about what each Bertrand competitor does. It maximizes profits subject to a *ceteris paribus* demand curve. That is what the monopolist does. Now what does Bertrand do? It forces the equilibrium of these reduced form monopoly maximization problems to be consistent among all those reduced form monopolies.

In a simplistic dynamic sense, there is "some" competition in Bertrand. Bertrand is a posted price model. Somehow, there's some demand curve, you post your price, some people come, they buy, you figure out whether you sold what you expected to sell. If not, you change your price up or down. That's all there is to the competition. You post your price. You change it if sales were not consistent with your expectations about demand. There's nothing about trying to get business away from your competitors. There's nothing about positioning your product differently, doing any of the sort of things which real world marketing is all about. I think those things are likely to be very important, but it's the empirical issue. The issue is really, does the internalization of cannibalization—which is *all* that drives Bertrand simulation models—dominate all that other stuff which is really very important? It might, but I think we need more work to figure out whether that's true.

Okay, let's come back to the lawyers. I criticize the lawyers but the lawyers are asking the right questions. The most important question in analyzing the potential for unilateral effects arising from a merger is, does the competition between the parties to the merger make the prices lower than it otherwise would be? That undoubtedly is the answer to the question of whether the merger is likely to be anticompetitive. Now where the lawyers go wrong is that we don't usually have evidence on whether competition makes a difference in the price, unless the economists would be able to do some analysis from natural experiments. But the lawyers are asking the right question. Where the lawyers go wrong is taking a lot of squishy evidence and arguing that two products really compete with one another and maybe to some extent stretching the evidence to argue that they compete "particularly closely."

That will not get to the right answer—but the question is the right question. That is, I think we would agree as economists this is the real question, which is a *Staples/Office Depot* sort of question. Does the competition between the parties make the prices of their products lower than it would be if they didn't compete? Bertrand doesn't tell us the answer to that question. Bertrand does tell us if we get the elasticities right, there's an incentive to internalize the cannibalization. Now, whether you actually can internalize the cannibalization by changing your price depends on what? On the nature of competition, interaction with retailers, all that sort of stuff. So if Bertrand is important, it's an input into the analysis of the "real" question, it does not address directly THE

question—THE question is the *Staples/Office Depot* sort of question. We need more economic tools to try and get better at the question.

I don't know that I disagree with Greg and Luke—we'll find out quickly in a minute—but they've always been careful in their papers in talking about calibration and in part looking at demand elasticity versus the Lerner equation and bringing other cost information to see whether the implied margin (or marginal costs) are consistent with estimates of the actual margin (or marginal costs). If they're not, obviously there's something wrong with the model.

I certainly agree with that, but in my view that's much too weak a test; that's like using one degree of freedom, one observation to test the model—it's more than that, but it's a very weak test of whether the model is "right," particularly when you're talking about whether it predicts merger effects accurately. So I've proposed a number of other tests. The tests really should be (and I don't think Greg and Luke and I disagree on this), whether the Bertrand model really explains the historical data—not just in terms of satisfying the Lerner equation. For example, if you have enough history and you know there's been significant changes in costs (or other shocks), the Bertrand model makes very specific predictions about what should happen to prices. Did it happen or not? You're looking for certain natural experiments in the past to see whether the Bertrand model correctly predicted explained the price path.

Another issue—is there volatility in shares? As both a competitive analysis and a marketing professor, I think the most important thing in analyzing branded products mergers is, what do the different competitors think about their shares? Do they have inconsistent views about shares? Is it like the beer industry in which for the last twenty years, Anheuser Busch has had increasingly aggressive share targets and has achieved those targets because it diverted sales away from its competition? That's a situation of a very competitive market where I wouldn't be very worried (other things equal) about mergers of producers not involving Anheuser Busch, or I'd be less worried than I would be if the shares are relatively stable, as in, say, the breakfast cereal industry in the '70s, where, to overcharacterize, everyone seemed to be pretty happy with what they were doing. So Bertrand with respect to price might fit (but I would need to really test it). But if there's volatility in shares, is that explainable by Bertrand? In my experience, the volatility is not usually going to be explained by shifts in competitor-specific costs. And in my experience, shifts in demand are generally stimulated by nonprice competition. So in that case, what can Bertrand tell us?

However, I agree with Greg and Luke on the following, and I said this to my colleagues in the Bureau of Economics: It's good for the economists, and a necessity for the economists, to take all the stuff you're putting together and try to put it into some consistent story and say, "Well, as a result of this, I think prices are going to rise to such and such, and this is why—here are my assumptions, here's the sort of model I'm using." Maybe it's a formal model, maybe it's not. Or the economist might say, "Here's why I think prices aren't going to go up and here are my assumptions, etc." But we need to do things in a disciplined way. I think good economists do that. I think we need to do it more often and write it down and show it to the attorneys so they can see the disciplined analysis—where you lay out your assumptions and you test those assumptions, and how you reached a conclusion, as opposed to the way the lawyers do it, which again—they do a good job but there is not a rigorous discipline in what they do. That uses up my time. Thank you very much.

GREG WERDEN: Dave said I was going to respond, and I wouldn't want to disappoint him. I need to say a few things about the Bertrand model. It took economists 50 to 75 years to understand how they ought to be thinking about such oligopoly models, but now we've got it sorted out. All that these models are telling us is, "What is the result of competitor interaction?" They do not say quite

how that process works, just where it ends up. So the test is: Does the model really tell you where the industry ends up?

The Bertrand equilibrium is a set of prices such that competitors are happy with their prices, given the prices they observe for their rivals; they don't want to move. Bertrand equilibrium is a specific application of the concept of Nash non-cooperative equilibrium, which is basically the only equilibrium concept industrial organization economists have used for the last quarter century and what earned John Nash his Nobel Prize. Nash equilibrium applied to price competition—that competitors don't want to change their prices—is Bertrand equilibrium, and it's only fairly recently that it was understood that this is not a naïve equilibrium concept. It does not assume away all strategic interaction. The Nash equilibrium is the result of the infinite regress in which everyone anticipates what everyone else is doing, and everyone anticipates being anticipated, and so on. Nash equilibrium is where things end up when all that is figured out, so it's a sensible equilibrium concept.

Bertrand, in particular, is a short-run equilibrium concept. The short-run in economics is a period sufficiently short that there is no entry, exit, or changes in capital investment. If all those things are held constant, what is there to compete about? Well, the big thing, of course, is price, and that is what the Bertrand model focuses on. By focusing just on price, the Bertrand model leaves things out, which may be important, but Dave tends to think they are more important than I do. I have studied branded products industries in which I thought the Bertrand model reflected the competitive process quite well.

In terms of the tests Dave suggested, let me just say what it is that we are trying to test, and that is whether the model can reasonably accurately predict the average level of prices over a period of a year or two. It is ridiculous to try to predict price on a particular day or how price will change from week to week. Why would anyone care? What matters is whether the merger is going to cause prices, on average, to go up for a sustained period of time. If it does, the fine details are immaterial. Asking the Bertrand model to explain certain fine details is asking for it to do too much.

I think a very important test, I would say the most important test, is whether the margins implied by Bertrand equilibrium are consistent with the actual margins in the industry. If they are consistent, that says to me that the Bertrand model accurately predicts the intensity of competition, as measured by the difference between prices and marginal costs. That's awfully important. Industries could be more intensely competitive than the Bertrand model says they are; they can be less intensely competitive than the Bertrand model says they are. In either case, the Bertrand model is not a very good model to use. But it might be a very good model to use if the intensity of competition is what the Bertrand model says it is.

I'm not very worried about share volatility. It's an issue; it may mean that there is more variance in the predictions than one would like, but that is not a big thing. We three agree that many considerations should go into deciding whether Bertrand is an appropriate model, but I could not write down a definitive list of what to look at. One has to come away from looking at all those things with a conviction that Bertrand is the right model and a conviction that one could persuade a trier of fact that it's the right model. I was always prepared to persuade a trier of fact when I was preparing to bring this model into court.

DAVID SCHEFFMAN: I'd look at anything Greg did and, if he came in from the outside with a simulation model, I'd look seriously at it because I'd know he'd have a thoughtful basis for it. As I said, a problem on average, and I've come in from the outside, is that we don't see that sort of thing. In part, being on the outside—you don't have all the information you have on the inside, but I urge

you—because I see a lot of consultants here—get your clients to go back more to what they were doing in the 1980s, which is pay you to read the documents because you'll get flushed in a second if you do not know the basic facts at issue in the matter and how those affect your conclusions. I've seen it often enough where economists come in and they don't know the documents—our economists won't pay attention to you—you've got to master the industry and you've got to be able to explain what you did and why the data are relevant, and why you should pay attention to the results, because that's the way economists inside do it.

LUKE FROEB: I just want to put a plug in for looking at the ex-ante competition to get onto the shelf. I worked on a couple of cases where I thought that was an important dimension of competition that was being overlooked. And this is an example where using the wrong model can lead an investigation astray. If there is ex-ante competition to get onto the shelf, or to “win” an agreement with a retailer so that you can go on special three out of every four weeks, it is important to model and understand this competition. This is a case where an acquisition could increase the ex-ante competition for shelf space. But if you looked only at the ex-post competition, by estimating and simulating a merger using estimated demand, you would be missing the ex-ante competition. ●

Congress Poised to Bolster Criminal Antitrust Penalties: An Update on H.R. 1086

Melanie Sabo

For years, federal prosecutors, judges and academics have questioned whether the criminal penalties for violating the antitrust laws are too lenient. In the wake of several high profile enforcement actions and the Enron, WorldCom and Adelphia fraudulent accounting scandals, Congress is poised to swing the pendulum in the opposite direction with H.R. 1086 (previously considered as S. 1797), which passed the Senate on April 2, 2004. H.R. 1086 amends the Sherman Act¹ to raise the maximum sentence for criminal antitrust violations to \$1 million and ten years imprisonment for individuals, and a \$100 million fine for corporations.

Although the Antitrust Division has had great success in obtaining corporate fines well above \$10 million in recent years through use of the alternative maximum fine provisions of 18 U.S.C. § 3571(d),² Congress seems intent on aligning the penalties for antitrust violators with the increased penalties now available for securities fraud violations as a result of Sarbanes-Oxley. Price fixing, bid rigging, and market allocation may well cause customers to pay more for goods or services, but it is debatable whether the impact of such conduct is at all comparable to that of the fraudulent accounting schemes uncovered in recent years.

Whether one views the new maximum penalties as proportional or not, the passage of H.R. 1086 appears likely. On June 10, 2003, the House passed what is now Title I of the bill—the Standards Development Organization Advancement Act of 2003, introduced by Representative Sensenbrenner, Chair of the House Judiciary Committee. This title would amend the National Cooperative Research and Production Act³ to provide that specified standards-setting activities of a “standards development organization” would be subject to rule of reason treatment in any action under federal or state antitrust laws.⁴ Title I also would limit recovery to single damages when the nature and scope of the standards-setting organization’s activities have been disclosed in advance to federal antitrust enforcement agencies.

■
Melanie Sabo is a partner in the antitrust and trade regulation group at Preston, Gates & Ellis LLP, and Vice Chair of the Legislation Committee of the ABA Section of Antitrust Law.

¹ 15 U.S.C. §§ 1–3.

² 18 U.S.C. § 3571(d) provides that the government can set as an alternative to the statutory maximum fine an amount that is twice the gain or twice the loss from the conduct. The principal reason for the Antitrust Division’s success in this area is that corporate defendants usually enter into a negotiated plea agreement rather than challenge the Division at trial and, if necessary, at a contested sentencing hearing. Plea agreements may include non-prosecution provisions involving other product areas or for corporate executives, resolution of U.S. travel status for individuals who are not U.S. citizens, or other benefits that outweigh the cost of agreeing to a fine much higher than the Sherman Act statutory maximum. Since 1996, the Division has obtained fines in excess of the statutory maximum \$10 million in more than 30 cases, obtaining a fine as high as \$500 million from a defendant of the vitamins cartel.

³ 15 U.S.C. §§ 4301–4305.

⁴ For further discussion of Title I of the bill, see ABA SECTION OF ANTITRUST LAW, REPORT AND RECOMMENDATION ON H.R. 1086, STANDARDS DEVELOPMENT ORGANIZATION ADVANCEMENT ACT (Nov. 2003), available at <http://www.abanet.org/antitrust/comments/ncrpa.pdf>.

After referral to the Senate Judiciary Committee, the bill was reported out with an amendment in the nature of a substitute that incorporated S. 1797—the Antitrust Criminal Penalty Enhancement and Reform Act of 2003, now Title II of H.R. 1086. In addition to the increased fines and jail terms discussed above, Title II also contains a provision to reduce civil liability for corporations that participate in the Antitrust Division’s corporate leniency program,⁵ and provides for slight modifications to the Tunney Act.⁶

The modest Tunney Act amendment is dramatically different from the bill as introduced, which drew criticism from both the private antitrust bar and reportedly the Antitrust Division.⁷ In response to the perception that federal judges were simply “rubber-stamping” any proposed consent decrees put before them by the Antitrust Division, the amendment would have required federal judges to make an “independent” determination that the proposed settlement is in the public interest following a judicial finding that there is a “reasonable belief, based on substantial evidence and reasoned analysis, to support the United States’ conclusion that the consent judgment is in the public interest.” That language has been removed. The findings still state that the purpose of the amendment is to “effectuate the original Congressional intent in enacting the Tunney Act” and that it misconstrues the original intent to limit review to whether a “consent judgment would make a ‘mockery of the judicial function,’”⁸ but the revised language simply requires that judges “shall” consider certain identified factors when reviewing a decree submitted by the parties. Those factors are largely unchanged from the current language, and are routinely addressed by the Antitrust Division in their motion papers when seeking entry of a decree.⁹ The bill specifically states that the reviewing court is not required to conduct an evidentiary hearing, nor required to permit anyone to intervene.¹⁰ As a practical matter, the change is unlikely to affect or alter the current procedures.¹¹

As of this writing, H.R. 1086 awaits floor consideration at the House of Representatives. The cartel penalty and the Tunney Act provisions have not been the subject of hearings or substantial debate in Congress, and no hearings are anticipated at this juncture. It appears likely that a Conference between House and Senate will be unnecessary. There are a number of measures lined up ahead of the bill, but the House could take it up in the in next several weeks. The Bush Administration has taken no formal position on the bill at this time. ●

⁵ Under H.R. 1086, participants in the leniency program would be liable only for single damages and only with respect to the sales of their own goods or services. De-trebling would be available only to corporations found by a court to have provided a “full account” of relevant facts and otherwise “provided satisfactory cooperation” to private plaintiffs. The de-trebling provisions would sunset after five years. Proposed H.R. 1086, §§ 211–214.

⁶ The Antitrust Procedures and Penalties Act of 1974, 15 U.S.C. §§ 16(b)–(h).

⁷ For the Section’s comments, see COMMENTS OF THE AMERICAN BAR ASSOCIATION SECTION OF ANTITRUST LAW ON H.R. 1086: INCREASED CRIMINAL PENALTIES, LENIENCY DETREBLING AND THE TUNNEY ACT AMENDMENT (Jan. 2004), available at <http://www.abanet.org/antitrust/comments/increasedcriminalpenalties.pdf>.

⁸ Proposed H.R. 1086, § 221(a).

⁹ The only new factors identified are (i) whether the terms of the decree are ambiguous; and (ii) the impact of the decree on competition in the relevant market or markets. See Proposed H.R. 1086 at §221(b)(2).

¹⁰ *Id.*

¹¹ One modification of the Tunney Act that the Antitrust Division may have supported allows alternatives to publishing all comments received and the Division’s responses to those comments in the *Federal Register*. Use of an alternative method must be based upon a finding that the publication expense in the *Federal Register* exceeds the public interest benefits to be gained. See Proposed H.R. 1086 at 221(b)(1). The Antitrust Division received thousands of comments in response to the consent decree filed in the *Microsoft* case, and this provision may be intended to address similar situations.

FTC/DOJ Organization Charts and Photos

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

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

—GARY ZANFAGNA

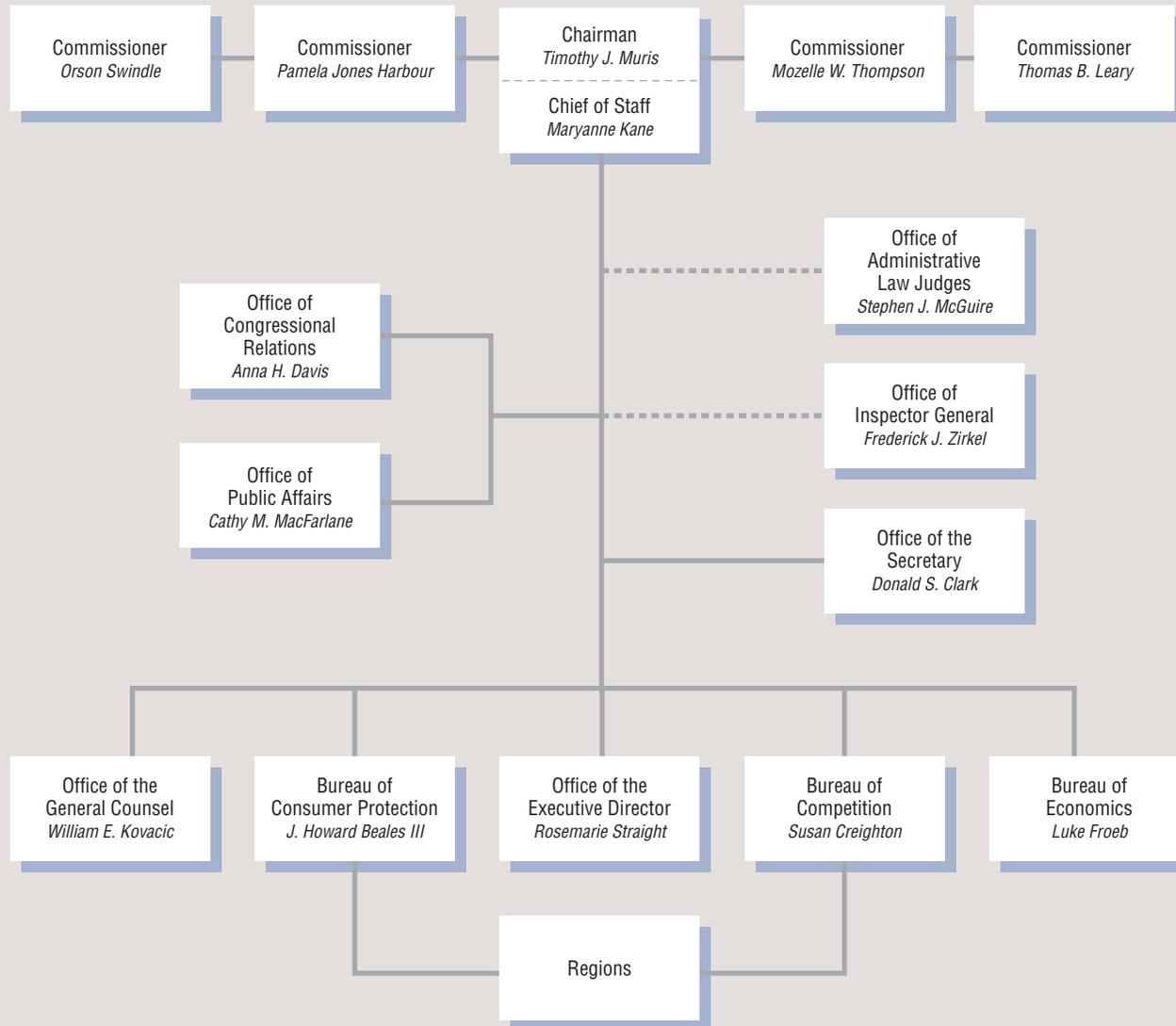
For the FTC, speeches are available for:

- **Timothy J. Muris**, Chairman: <http://www.ftc.gov/speeches/muris.htm>
- **Pamela Jones Harbour**, Commissioner: <http://www.ftc.gov/speeches/harbour.htm>
- **Thomas B. Leary**, Commissioner: <http://www.ftc.gov/speeches/leary.htm>
- **Orson Swindle**, Commissioner: <http://www.ftc.gov/speeches/swindle.htm>
- **Mozelle W. Thompson**, Commissioner: <http://www.ftc.gov/speeches/thomp1.htm>
- **Susan A. Creighton**, Director, Bureau of Competition: <http://www.ftc.gov/speeches/creighton.htm>
- **J. Howard Beales, III**, Director, Bureau of Consumer Protection: <http://www.ftc.gov/speeches/beales.htm>
- **Luke M. Froeb**, Director, Bureau of Economics: <http://www.ftc.gov/speeches/froeb.htm>
- **William E. Kovacic**, General Counsel: <http://www.ftc.gov/speeches/kovacic.htm>

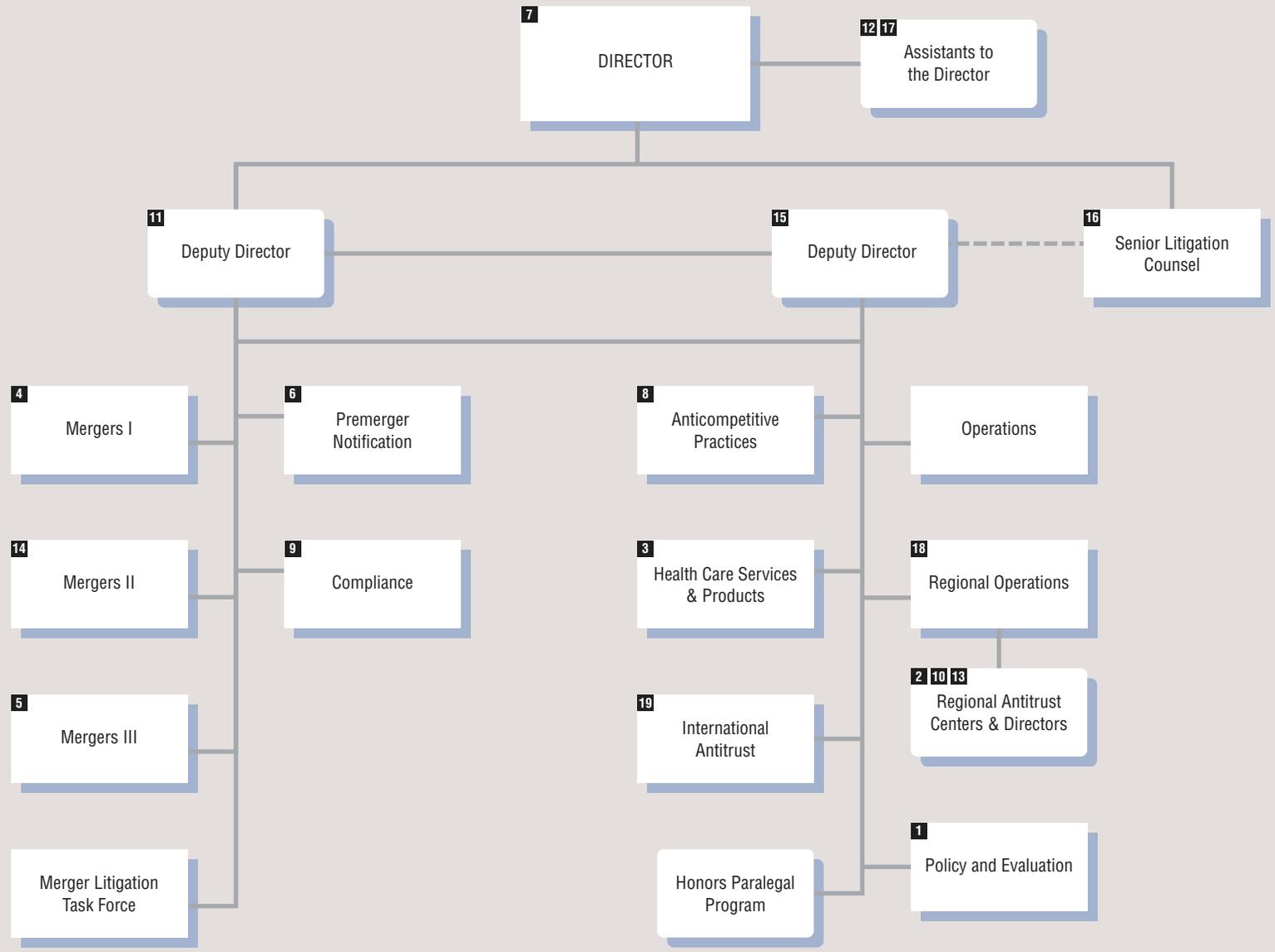
For the Antitrust Division, speeches are available for:

- **R. Hewitt Pate**, Assistant Attorney General: http://www.usdoj.gov/atr/public/speeches/speech_pate.htm
- **Makan Delrahim**, DAAG: http://www.usdoj.gov/atr/public/speeches/speech_delrahim.htm
- **James M. Griffin**, DAAG: http://www.usdoj.gov/atr/public/speeches/speech_griff.htm
- **J. Bruce McDonald**, DAAG: http://www.usdoj.gov/atr/public/speeches/speech_mcdonald.htm
- **Mark J. Botti**, Chief, Litigation I Section: http://www.usdoj.gov/atr/public/speeches/speech_botti.htm
- **Roger Fones**, Chief, Transportation, Energy and Agriculture Section:
http://www.usdoj.gov/atr/public/speeches/speech_fones.htm
- **Scott D. Hammond**, Director of Criminal Enforcement:
http://www.usdoj.gov/atr/public/speeches/speech_hammond.htm
- **Robert J. Kramer II**, Director, Office of Operations:
http://www.usdoj.gov/atr/public/speeches/speech_kramer.htm
- **Douglas Ross**, Special Counsel for Agriculture: http://www.usdoj.gov/atr/public/speeches/speech_ross.htm

FEDERAL TRADE COMMISSION



F T C B U R E A U O F C O M P E T I T I O N



F T C B U R E A U O F C O M P E T I T I O N



1
Alden F. Abbott
Assistant Director,
Policy and
Evaluation



2
Barbara Anthony
Director, North
Eastern Regional
Office



3
Jeff Brennan
Assistant Director,
Health Care
Services and
Products



4
Mike Moiseyev
Assistant Director,
Mergers I



5
Phillip Broyles
Assistant Director,
Mergers III



6
Marian Bruno
Assistant Director,
Premerger
Notification



7
Susan Creighton
Director, Bureau of
Competition



8
Richard B. Dagen
Assistant Director,
Anticompetitive
Practices



9
Daniel P. Ducore
Assistant Director,
Compliance



10
Charles A. Harwood
Director, North
Western Regional
Office



11
D. Bruce Hoffman
Deputy Director



12
Tom Klotz
Assistant to the
Director



13
Jeffrey A. Klurfeld
Director, Western
Regional Office



14
Michael H. Knight
Assistant Director,
Mergers II



15
Barry Nigro
Deputy Director



16
Melvin Orlans
Senior Litigation
Counsel



17
Seth Silber
Assistant to the
Director

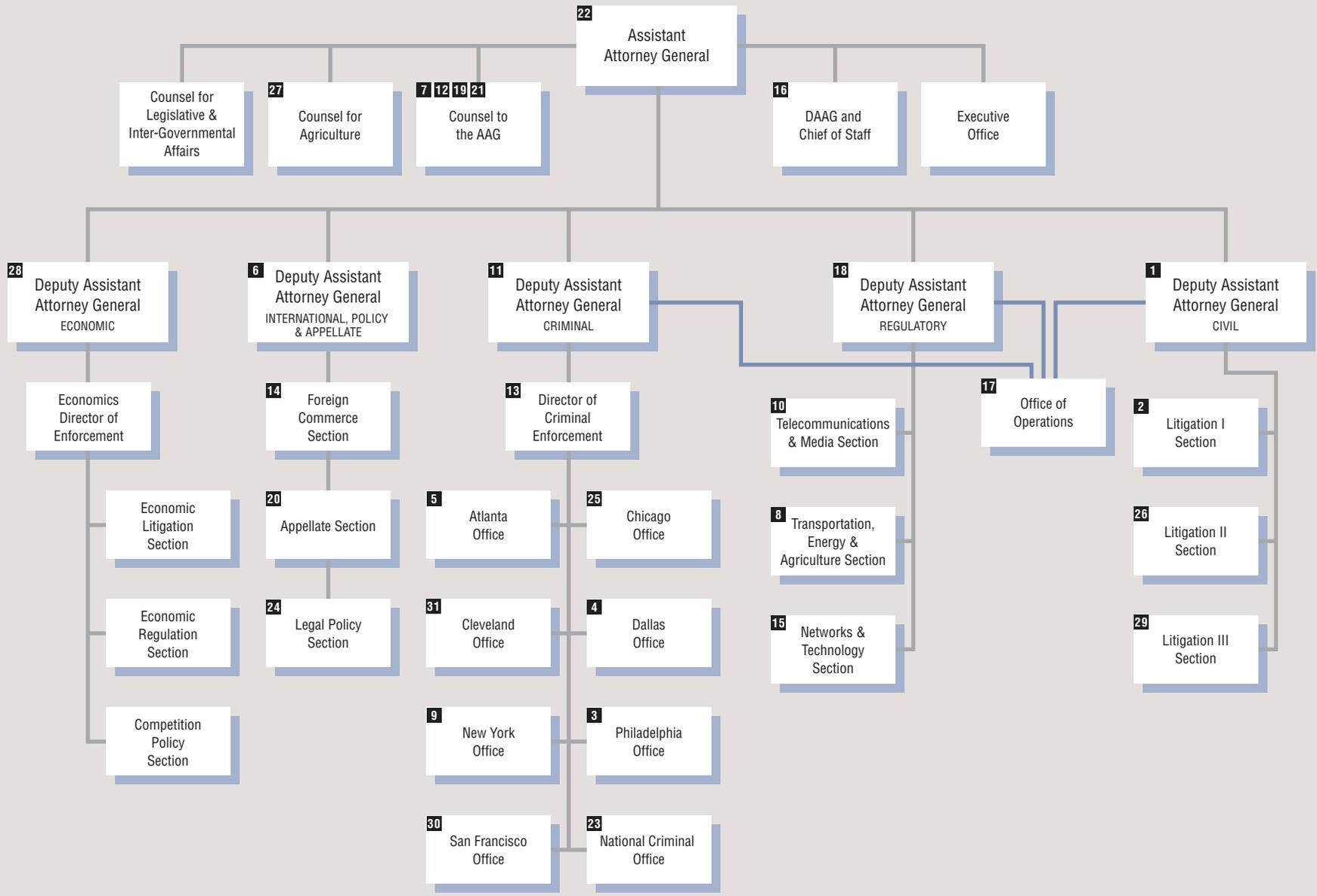


18
Jerome A. Swindell
Associate Director
for Regional
Operations



19
Randolph W. Tritell
Assistant Director,
International
Antitrust

DOJ ANTITRUST DIVISION



D O J A N T I T R U S T D I V I S I O N



1
Thomas O. Barnett
DAAG, Civil



2
Mark J. Botti
Chief, Litigation I
Section



3
Robert E. Connolly
Chief, Philadelphia
Field Office



4
Duncan S. Currie
Chief, Dallas Field
Office



5
Nezida S. Davis
Chief, Atlanta Field
Office



6
Makan Delrahim
DAAG, International,
Appellate & Legal
Policy



7
Andrew Finch
Counsel to the AAG



8
Roger W. Fones
Chief, Transportation,
Energy & Agriculture
Section



9
Ralph T. Giordano
Chief, New York
Field Office



10
Nancy M. Goodman
Chief,
Telecommunications
and Media Section



11
James M. Griffin
DAAG, Criminal
Enforcement



12
Eric Grannon
Counsel to the AAG



13
Scott D. Hammond
Director of Criminal
Enforcement



14
Edward T. Hand
Chief, Foreign
Commerce Section



15
Renata B. Hesse
Chief, Networks
and Technology
Section



16
David A. Higbee
DAAG and
Chief of Staff



17
Robert J. Kramer II
Director, Office of
Operations



18
J. Bruce McDonald
DAAG, Regulatory



19
James J.
O'Connell, Jr.
Counsel to the AAG



20
Cathy G. O'Sullivan
Chief, Appellate
Section



21
Leslie C. Overton
Counsel to the AAG



22
R. Hewitt Pate
Assistant Attorney
General



23
Lisa M. Phelan
Chief, National
Criminal Enforcement
Section



24
Robert A. Potter
Chief, Legal Policy
Section



25
Marvin N. Price Jr.
Chief, Chicago Field
Office



26
Mary Beth Petrizzi
Chief, Litigation II
Section



27
Douglas Ross
Special Counsel
for Agriculture



28
David S. Sibley
DAAG, Economics



29
James R. Wade
Chief, Litigation III



30
Phillip H. Warren
Chief, San Francisco
Field Office



31
Scott M. Watson
Chief, Cleveland
Field Office

Paper Trail: Working Papers and Recent Scholarship

Editor's Note: In this issue, we offer three notes on recent papers. The first discusses Christopher Leslie's analysis of the role of trust in facilitating cartels and the role of antitrust in undermining it. The second discusses Marina Lao's critique of today's Noerr doctrine. The third discusses Alan Meese's proposal of a property rights theory of intrabrand restraints. All three of these articles suggest that the reader revisit, and perhaps reconsider, some common concepts about commercial behavior that is subject to the antitrust laws. Send suggestions for papers to review to: page@law.ufl.edu or jwoodbury@crai.com.

—WHP

Papers and Summaries

Christopher R. Leslie, Trust, Distrust, and Antitrust, 82 *Texas L. Rev.* 515 (2004).

In this massive article (165 pages, 1130 footnotes), Professor Leslie of Chicago-Kent analyzes the role of trust among conspirators in the formation and operation of cartels, and the role of antitrust enforcement in sowing distrust. He begins with a lucid discussion of the Prisoners' Dilemma as a model of the cartel problem, under plausible assumptions, with cheating as the dominant strategy for cartel members. He then shows that trust—the willingness to make oneself vulnerable to the actions of another—can solve the dilemma by facilitating cooperation, a substitute for a binding contract among the conspirators.

Leslie identifies a variety of sources of trust: communication, reputation, social norms, and ethnic and class homogeneity. He then surveys studies of over fifty cartels, from the Kanawha salt cartel in the 19th century up to the lysine and Sotheby's cartels of the past decade. In this portion of the article, Leslie identifies the ways distrust undermines cartels and how trust may facilitate them. For example, distrust leads cartels initially to charge prices lower than those of a profit-maximizing monopoly, in order to forestall cheating. Cartel members may, however, foster trust by forging personal relationships, making goodwill gestures (like generous market share allocations), enhancing transparency in cartel dealings (e.g., by price-reporting mechanisms and standardization), communicating frequently, and building cartel-friendly social norms (mainly through trade associations). As an example of cartel ethics, Leslie reports that members of the Kanawha salt cartel swore on a Bible to stick to the cartel price. In addition, cartels have sought members from the same social class. In an especially interesting section, Leslie describes how experience in a successful cartel in one market can be extended to other markets by a process of "cartel creep." He also describes a variety of cartel substitutes (such as government regulation) and a variety of mechanisms for detecting and punishing cheaters.

Having shown how trust facilitates cartels, Leslie shows how antitrust undermines trust and thus fosters cheating. The discussion almost exactly mirrors the preceding one, showing, for example, how antitrust impedes transparency and communication and builds anti-cartel norms. Leslie then discusses how antitrust (particularly the DOJ leniency program) promotes another form of defection from cartels: whistle-blowing to the authorities.

In a final section, Leslie makes a number of suggestions based on the insights of his study. For example, he suggests increasing cartel penalties and the rewards for confessing. In a particularly intriguing discussion, he points out the danger of "cartel blowback" from governmentally approved

cooperation among rivals. He notes, for example, that cartels formed under the auspices of the NRA during the New Deal provided reservoirs of trust that facilitated later illegal cartels. More controversially, he suggests that joint ventures between rivals should be viewed with greater suspicion, in spite of any productive efficiencies, because they may foster trust between the participants. Leslie acknowledges the danger of overdeterrence in this suggestion.

Finally, Leslie suggests how his study might indicate the need for reevaluation of a variety of practices in cases requiring inference of a conspiracy. He argues that trust-building measures of various forms, and the participation of members with cartel experience, should be viewed as weighing more heavily toward inference of an agreement.

Marina Lao, Reforming the *Noerr-Pennington* Antitrust Immunity Doctrine, 55 *Rutgers L. Rev.* 965 (2003).

In this article, Professor Lao of Seton Hall argues the courts have interpreted *Noerr* petitioning immunity too broadly to encompass any effort to influence any governmental entity, whether legislative, judicial, executive, or administrative. Moreover, cases like *Omni Outdoor Advertising* and *Professional Real Estate Investors* have interpreted the sham exception to *Noerr* immunity too narrowly to cover only those petitions that are objectively baseless (under stringent standards), and subjectively intended to harm a competitor through governmental process rather than the outcome of the process. Lao argues that business efforts to influence government action pose particularly significant threats to competition, and that not all of them implicate the First Amendment policies underlying *Noerr*. For example, while efforts to mislead legislatures might warrant some First Amendment protection because of the need for unfettered debate, efforts to mislead courts or administrative adjudicators in their more focused factual inquiries would not. Many legal provisions (e.g., Rule 11) already prohibit baseless factual and legal representations to courts; antitrust law should not extend protection to misrepresentations either.

Lao proposes narrowing the scope of petitioning immunity to cover only efforts to persuade governmental actors to take discretionary action, for example, by denying a certificate of need to a competitor in a regulated market. The immunity should not cover submissions that merely trigger ministerial governmental acts, such as filings of drug patents with the FDA for inclusion in its Orange Book. She also proposes that the courts recognize a fraud and misrepresentation exception to *Noerr* that is independent of the sham exception. She notes that *Walker Process* already recognizes an exception from the antitrust patent immunity for infringement suits based on patents obtained by fraud on the Patent Office. These suits would not be covered by the present sham exception to *Noerr* immunity, because the patent application genuinely sought the patent—it was not merely sought to disadvantage competitors by a governmental process. Lao argues that the principle of *Walker Process* should be extended to except from *Noerr* protection petitioning based on fraudulent representations that are “material” to the proposed governmental decision.

Finally, Lao proposes expanding the sham exception in two ways. First, she suggests that a suit should be considered objectively baseless if a litigant could not reasonably expect to win on the merits. Second, she suggests that the requirement of subjectively bad intent be dropped for cases of allegedly sham litigation.

Alan J. Meese, Property Rights and Intra-brand Restraints, 89 *Cornell L. Rev.* 553 (2004).

In another of his reconceptualizations of antitrust law, Professor Alan Meese of William & Mary argues that intra-brand restraints are best understood as efforts to grant dealers property rights in

the information they create to promote the manufacturer's goods. The property rights explanation accepts the widely shared view of contemporary economists that intrabrand restraints induce dealers to provide an optimal level of point-of-sale services, but offers, Meese argues, a more complete explanation of how the restraints accomplish this goal.

In his classic article, *Why Should Manufacturers Want Fair Trade?* (1960), Lester Telser suggested that intrabrand restraints, like resale price maintenance, foster nonprice competition in point-of-sale promotional services by eliminating free riding by discounters. Benjamin Klein and Kevin Murphy, however, argued in *Vertical Restraints as Contract Enforcement Mechanisms* (1988), that Telser's account did not explain why nonprice competition would necessarily produce the optimal level of services. Dealers could evade the restrictions by secret discounts of various forms, or simply consume the excess profits. Instead, Klein and Murphy suggest that the protections provided by intrabrand restraints function as a performance bond that the dealer will forfeit if the manufacturer finds that the dealer is not performing the point-of-sale services the manufacturer wants. Those services might include non-promotional services, like maintenance of freshness standards.

Both of these accounts assume the manufacturer uses intrabrand restraints to induce dealers to provide a known list of preferred point-of-sale services, just as a vertically integrated firm might direct its employees to provide the same services. But this sort of planning involves gathering local information, a process that the manufacturer, as a centralized planner (analogous, in some ways, to a socialist planning board), may not be best situated to accomplish at the optimal cost. Meese argues that resale price maintenance differs from vertical integration by fostering decentralization in decisions about appropriate point-of-sale services. It does this by conferring on dealers a kind of property right in promotional information, which provides the incentive to provide optimal services. Recognizing this characteristic of intrabrand restraints supports Telser's account by identifying the mechanism by which the restraints promote optimal dealer services.

The sale of the product to the dealer transfers property in the goods, with the right to capture the returns from sales to any customers the dealer can find and persuade to buy. But free riding by rivals can undermine the dealers' incentives to capture the value created by the sellers' promotional efforts. Vertical restraints allow the manufacturer to adjust the dealers' incentives by protecting the property rights of the dealers in their promotional information, and thus in the returns from their promotional investments. Thus, the manufacturer retains the benefits of competition and decentralization in distribution. According to Meese, "Once in possession of a property right, a dealer would determine how best to exploit the right in question, given the dealer's unique knowledge, capabilities, and assessment of local consumers' preferences."

This view of vertical restraints provides an answer to those who argue that such restraints limit dealer freedom to make key choices. The point of vertical restraints, Meese argues, is to enhance, not restrict, dealer autonomy. By conferring property rights, they restrict "freedom," but only to the extent that all property rights do:

The alternative—a war of all against all for whatever resources individuals can capture—would replicate the tragedy of the commons throughout society. Market-based competition requires property, including property that parties create by contract. Courts have long recognized that contracts are not suspect merely because they eliminate rivalry that would otherwise have occurred. Recognition of property, including property created by contract, does not constitute improper administration in any economically meaningful sense.

Thus, the failure of the manufacturer to prescribe specific promotional activities is not an indication that the restraint is not aimed at fostering optimal services. ●

Message from the Antitrust Section Chair: Nominating Committee Report



ONE OF THE SECTION'S MOST IMPORTANT COMMITTEES WITH ONE OF THE MOST difficult tasks is our Nominating Committee. This year's Nominating Committee had a particularly challenging task because of the large number of extremely qualified individuals for the small number of positions. The Section was fortunate that Roxane Busey served as Chair of the Nominating Committee. The other members of the Committee were Pamela Jones Harbour, Elise Kirban, Dan Wall, and Steve Armstrong. Under the Bylaws, the Immediate Past Chair, the Chair, Chair-Elect, and Vice-Chair, serve as ex officio, non-voting members. I am pleased to report that I have received from Roxane the report of the Nominating Committee. The Committee has recommended the following slate of Officers and Council Members for election at the Section's Annual Meeting in August 2004, pursuant to Article IV, Section 1 of the Section's Bylaws:

Officers:

<i>Vice Chair:</i>	Joseph Angland, New York, NY (2004–05)
<i>Finance Officer:</i>	William L. Greene, Minneapolis, MN (2004–06)
<i>Secretary:</i>	Richard M. Steuer, New York, NY (2004–05)
<i>Publications Officer:</i>	Theodore Voorhees, Washington, DC (2004–06)
<i>Program Officer:</i>	Ilene Knable Gotts, New York, NY (2004–05)
<i>Section Delegate:</i>	James A. Wilson, Columbus, OH (2004–06)

Council Members for Three Year Terms Ending in 2007:

Jonathan B. Baker, Washington, DC
 H. Stephen Harris, Jr., Atlanta, GA
 Christopher B. Hockett, San Francisco, CA
 Richard G. Parker, Washington, DC
 Debra A. Valentine, Hartford, CT

Certain other officers automatically assume new positions or continue in existing positions for the coming year under the Section Bylaws. These include:

<i>Chair:</i>	Richard J. Wallis, Redmond, WA
<i>Chair-Elect:</i>	Donald C. Klawiter, Washington, DC
<i>Immediate Past Chair:</i>	Kevin E. Grady, Atlanta, GA
<i>Committee Officer:</i>	Kathryn M. Fenton, Washington, DC
<i>International Officer:</i>	William Blumenthal, Washington, DC
<i>Section Delegate:</i>	Allan Van Fleet, Houston, TX

On behalf of the Section I want to express my appreciation to Roxane and the other members of the Nominating Committee for providing such important service to the Section.

Sincerely,
 Kevin E. Grady
 Chair