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2019 ABA Antitrust Law Section Nominating Committee Report
Using Efficiencies To Defend Mergers: The Current Legal Landscape

Erin L. Shencopp and Nathaniel J. Harris

The D.C. Circuit’s 2017 decision in United States v. Anthem provides the most recent appellate court evaluation of the efficiencies defense to merger challenges under the federal antitrust laws. In that case, the Justice Department and 11 states sued successfully in the U.S. District Court for the District of Columbia to block the proposed merger of Anthem and Cigna, two prominent national health insurance carriers. The merging parties appealed, arguing that the trial court improperly rejected their claims that the merger would result in billions of dollars in cost-saving efficiencies, which they had asserted would outweigh any potential competitive harm from the proposed transaction. The D.C. Circuit affirmed the lower court, holding, inter alia, that the trial court had not abused its discretion in finding that the parties had failed to prove the existence of “the kind of extraordinary efficiencies necessary to offset” the anticompetitive effects of the merger. Judge Judith Rogers, authoring the majority opinion, also questioned whether the court could even consider efficiencies as a defense to an otherwise unlawful merger: “[I]t is not at all clear that [efficiencies] offer a viable legal defense to illegality under [Clayton Act] Section 7.” Then-Judge Brett Kavanaugh dissented, arguing in part that the court was required to account for claimed efficiencies. In his view, “Any suggestion to the contrary is not the law.”

This article surveys the legal status of the efficiencies defense through the lens of Anthem and other recent circuit court opinions. It further provides practical considerations for developing efficiencies that a court would credit in evaluating a merger’s lawfulness.

Are Efficiencies a Recognizable Defense?

Merging parties spend significant resources analyzing potential efficiencies from a transaction, both to understand the value of the deal and to support the benefits of the deal before the antitrust agencies. The 2010 Horizontal Merger Guidelines recognize the role of efficiencies in offsetting a merger’s potential anticompetitive effects: “The Agencies will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.” Accordingly, the U.S. Department of Justice Antitrust Division and the Federal Trade Commission routinely consider efficiencies in analyzing a merger and credit efficiencies where they meet the agencies’ criteria.

1 855 F.3d 345 (D.C. Cir. 2017).
2 Id. at 349.
3 Id. at 353.
4 Id. at 377 (Kavanaugh, J., dissenting).
Courts, however, sometimes view efficiencies claims through a different lens. Some opine that the Supreme Court has rejected the concept of an efficiencies defense, and although lower courts generally do give at least some consideration to efficiencies, a number of courts have expressed skepticism toward assigning any significant weight to them. To date, no case has held that the merging parties’ asserted efficiencies alone were sufficient to overcome established anticompetitive effects of a merger.

The Supreme Court, in its 1967 opinion in *FTC v. Proctor & Gamble Co.*, stated that “[p]ossible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition.” 6 The key legal issues in the case, however, did not focus on efficiencies, and at least one leading treatise has indicated that “[t]he Court’s brief and unelaborated language cannot reasonably be taken as a definitive disposition of so important and complex an issue as the proper role of economies in analyzing the legality of a merger.” 7

Nevertheless, a few appellate courts recently have cited the language in *Procter & Gamble* to question the legitimacy of an efficiencies defense. In addition to the *Anthem* case discussed here, in *Saint Alphonsus Medical Center-Nampa Inc. v. St. Luke’s Health System, Ltd.* , the Ninth Circuit took note of “the Supreme Court’s statements” in *Proctor & Gamble* questioning whether a true efficiencies defense is viable under the law. 8 The court expressed concern with an efficiencies defense because of the complexities it added to reviewing mergers. 9 But it nonetheless decided to “assume . . . that because § 7 of the Clayton Act only prohibits those mergers whose effect may be substantially to lessen competition, a defendant can rebut a prima facie case with evidence that the proposed merger will create a more efficient combined entity and thus increase competition.” 10 The Third Circuit, in *FTC v. Penn State Hershey Medical Center*, also questioned whether “an efficiencies defense even exists” based on *Proctor & Gamble*. 11 It declined to take a position on the defense because it held that the merging parties could not “clearly show that their claimed efficiencies will offset any anticompetitive effects of the merger.” 12

As noted above, the D.C. Circuit most recently addressed the efficiencies defense in *United States v. Anthem*, a decision that featured a significant debate between the majority and dissent. 13 Unlike the Ninth and Third Circuits, however, the court in *Anthem* faced prior precedent in its circuit, *FTC v. H.J. Heinz Co.* , which had adopted “the trend among lower courts . . . to recognize the defense.” 14 The majority in *Anthem* criticized *Heinz* because “it could not overrule Supreme

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6 386 U.S. 568, 580 (1967); see also United States v. Phila. Nat’l Bank, 374 U.S. 321, 371 (1963) (“We are clear, however, that a merger the effect of which ‘may be substantially to lessen competition’ is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice . . . has been made for us already, by Congress when it enacted the amended § 7. Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.”).

7 PHILLIP E. AREEDA & HERBERT HOVENKAMP, AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 970c2 (2018).

8 778 F.3d 775, 789 (9th Cir. 2015).

9 Id. at 790.

10 Id. (internal citation and quotation marks omitted).

11 838 F.3d 327, 348 (3d Cir. 2016).

12 Id.; see also FTC v. Staples, Inc., 970 F. Supp. 1066, 1088 (D.D.C. 1997) (“There has been great disagreement regarding the meaning of this precedent and whether an efficiencies defense is permitted.”).

13 855 F.3d 345.

14 246 F.3d 708, 720 (D.C. Cir. 2001).
Court precedent." It ultimately decided to follow *Heinz* for the principle that “efficiencies could rebut a prima facie showing” that a merger was anticompetitive, but noted that this “is not invariably the same as an ultimate defense to Section 7 illegality,” and that it would “leave for another day whether efficiencies can be an ultimate defense to Section 7 illegality.”

In dissent, Judge Kavanaugh reasoned that intervening Supreme Court precedent in cases such as *United States v. General Dynamics*, and *Continental T.V. v. GTE Sylvania Inc.*, reflects a more modern approach to antitrust analysis focusing on consumer welfare. He suggested that this newer approach effectively overturned prior precedent. Given this change in the law and the *Heinz* decision, Judge Kavanaugh argued that the court “must take account of the efficiencies and consumer benefits that would result from this merger.” The majority disputed Judge Kavanaugh’s reliance on cases that did not address efficiencies and that did not expressly overrule *Proctor & Gamble*. They claimed that he applied “the law as he wishes it were, not as it currently is.”

Courts expressing skepticism about the efficiencies defense have raised concerns about applying it in practice. They have noted challenges in measuring asserted efficiencies that have not yet occurred and the extent to which the merged firm would pass those efficiencies through to consumers. Some commentators also have questioned the need for the defense, arguing that merger-specific efficiencies likely are rare and that many companies need not rely on efficiencies to survive antitrust scrutiny because their market shares are low or they can benefit from the failing firm defense. In contrast, courts and commentators supporting an efficiencies defense argue that a proper goal of antitrust policy should be to determine whether a proposed merger is likely to result in lower prices, improved quality, or innovation in determining whether, on balance, it negatively impacts competition.

The Department of Justice and the Federal Trade Commission have trended toward the latter view, accepting efficiencies as part of an integrated competitive effects analysis, though requir-
ing strict standards of proof and applying skepticism that efficiencies can carry the day when indicia of lessened competition are strong. In their 1997 revisions to the 1992 Horizontal Merger Guidelines, the agencies updated earlier guidance on efficiencies, noting that “the primary benefit of mergers to the economy is their potential to generate such efficiencies,” and indicating that the agencies “will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.” The 2010 Merger Guidelines reiterated this position. The 2010 Merger Guidelines also make clear, however, that “efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great,” and that efficiencies “almost never justify a merger to monopoly or near-monopoly.” And at least some at the agencies have expressed concern that “accepting specific efficiencies defenses is fraught with difficulties,” including the ability to verify efficiencies and whether efficiencies are actually realized by the merging parties.

While the agencies have tended to assess efficiencies as part of the overall integrated competitive effects analysis, at least some courts appear to place significance on how they are treated procedurally. In a merger challenge, the government typically must make a prima facie showing that the transaction “will substantially lessen competition.” If the government makes such a showing, the burden shifts to the defendant to rebut the government’s case. “If the defendant successfully rebuts the presumption, the burden of producing additional evidence of anticompetitive effect shifts to the government, and merges with the ultimate burden of persuasion, which remains with the government at all times.” In rebutting a prima facie showing, defendants may present evidence on a variety of matters, such as weaknesses in the government’s market share data, the competitive significance of the parties, ease of entry, buyer power and sophistication, as well as efficiencies.

Courts typically consider efficiencies as part of a defendant’s rebuttal to the government’s prima facie case, but as discussed above at least some have expressed reluctance to consider an actual efficiencies defense. In theory, this distinction should make little difference, as efficiencies are weighed against evidence of anticompetitive harm in either case. In all scenarios, the government has the burden to prove that the merger is unlawful, and defendants have the burden to prove efficiencies. Yet, courts seem to place some importance on procedural considerations. As Judge Rodgers stated in Anthem, considering efficiencies as part of the rebuttal of the government’s prima facie case “is not invariably the same as an ultimate defense to Section 7 illegality.” But whether this distinction makes an actual difference remains to be seen.

28 2010 Merger Guidelines, supra note 5, § 10.
29 Id.
32 Id.
33 Id. at 983.
34 Id. at 985–89.
35 See, e.g., United States v. Aetna Inc., 240 F. Supp. 3d 1, 94–99 (D.D.C. 2017); Heinz, 246 F.3d at 720–22 (D.C. Cir. 2001); University Health, 938 F.2d at 1222.
36 855 F.3d at 355.
Regardless of whether efficiencies are a defense or a way to rebut anticompetitive effects, even those courts that question the legitimacy of the defense ultimately appear willing to assess efficiencies when analyzing a merger’s effects. In practice, however, courts rarely balance efficiencies against anticompetitive effects, at least in any quantitative sense, and “none of the reported appellate decisions have actually held that a § 7 defendant has rebutted a prima facie case with an efficiencies defense.”37 Rather, courts tend to conclude either that the efficiencies are not merger-specific or verifiable, or that the merger will not harm competition and appears to generate efficiencies.38

**Standard for Proving Efficiencies**

Courts usually follow the 2010 Merger Guidelines in setting the standard for proving efficiencies, requiring the merging parties to show that any claimed efficiencies are merger-specific, verifiable, and do “not arise from any anticompetitive reduction in output or service.”39 In addition, courts have held that if the merging firms have “high market concentration levels” they must supply “proof of extraordinary efficiencies” to rebut a prima facie case that the merger is unlawful.40

Efficiencies are merger-specific if they “cannot be achieved by either company alone” or through some other means.41 Thus, if merging parties will prevail on an efficiencies defense they must be able to show what “can” or “could” be done by the merged entity.42 To be verifiable, asserted efficiencies cannot be “vague” or “speculative” and must be verifiable by “reasonable means.”43 The agency or court assessing claimed efficiencies may be skeptical of efficiencies determined “outside of the usual business planning process,”44 although merging parties often use consultants and economic experts to assess and present the efficiencies to the antitrust agency or court.

The standard for proving efficiencies is difficult to meet, given that the merging parties are forecasting into the future how their combined business will operate and the savings, innovations, and other benefits the combination will generate. More often than not, courts find that the parties failed to prove that their efficiencies are merger-specific or verifiable.

In *Anthem*, for example, the court held that Anthem’s claimed efficiencies were neither merger-specific nor verifiable. Anthem argued that rates would decrease and quality would improve as

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37 *St. Luke’s*, 778 F.3d at 789. We have similarly found no cases holding that efficiencies alone rebut the government’s prima facie case. See infra note 38.

38 Compare *University Health*, 938 F.2d at 1223–24 (holding that appellees could not rely on an efficiencies defense “because they failed to demonstrate that their proposed acquisition would yield significant economies”), *and* United States v. H&R Block, Inc., 833 F. Supp. 2d 36, 89–92 (D.D.C. 2011) (finding claimed efficiencies were not merger-specific and verifiable), *with* FTC v. Arch Coal Inc. 329 F. Supp. 2d 109, 158–59 (D.D.C. 2004) (denying preliminary injunction to prevent merger based on failure to show a likelihood of demonstrating a substantial lessening of competition and also finding that while defendants failed to prove a specific amount of cognizable efficiencies, the merger would create some efficiencies that “provide[d] some limited additional evidence to rebut the claim of post-merger anticompetitive effects”), *and* United States v. Carilion Health Sys., 707 F. Supp. 840, 842, 849 (W.D. Va.), *aff’d*, 892 F.2d 1042 (4th Cir. 1989) (denying challenge to merger because of failure to show anticompetitive effects and also noting efficiencies).

39 2010 Merger Guidelines, supra note 5, § 10.

40 Heinze, 246 F.3d at 720; see also *Anthem*, 855 F.3d at 364; *University Health*, 938 F.2d at 1223; 2010 Merger Guidelines, supra note 5, § 10.

41 Heinze, 246 F.3d at 722; 2010 Merger Guidelines, supra note 5, § 10.

42 Note that in *Anthem* the merging parties criticized the district court because it did not assess the “likelihood” of achieving the efficiencies and instead required certainty, 855 F.3d at 356. But the court focused on the fact that it is what Anthem “can” or “could” achieve.

43 2010 Merger Guidelines, supra note 5, § 10; *Anthem*, 855 F.3d at 359 (quoting the Merger Guidelines for the verifiability standard).

44 2010 Merger Guidelines, supra note 5, § 10.
the companies’ combined the best of both parties and rebranded products under the Anthem brand. The majority concluded, however, that Anthem could obtain any quality benefits on its own by implementing better marketing and better products. In contrast, Judge Kavanaugh reasoned that “enhanced bargaining power is a large part of what would enable Anthem-Cigna to negotiate the lower provider rates that in turn would lead to cost savings for employers,” and that this “is a direct result of the merger.”

The majority further took issue with the speculative nature of the claimed efficiencies. Anthem argued that it could apply its provider rates to Cigna customers after the merger. The court noted, however, testimony from Anthem’s CEO that the company would not immediately lower rates because it could hurt its provider relationships. It also noted the fact that providers could terminate agreements with 90 days’ notice. Thus, the court was skeptical that Anthem would achieve the claimed efficiencies.

Judge Kavanaugh viewed Anthem’s efficiencies more favorably. He stated that to be verifiable, the efficiencies “need not be certain. They merely must be probable.” He pointed to the work done by the merging parties’ economist, integration planning team, and third-party consultants, and credited the claimed savings to be between $1.7 and $3.3 billion annually, which, according to Kavanaugh, “would be largely passed through to employers (as the contracts and basic structure of this self-insured market require).”

As the majority did in *Anthem*, courts test efficiencies rigorously and hesitate to give the merging parties the benefit of the doubt. Merger challenges necessarily involve hypotheticals as the key question is whether the merger—an event that typically has not yet occurred—will likely lead to a substantial lessening of competition in the future. When it comes to determining anticompetitive effects, courts focus on “probabilities, not certainties or possibilities.” Yet when dealing with efficiencies, courts seem to require more. This reflects a balance that favors erring on the side of avoiding consumer harm in close calls.

**Key Considerations Regarding the Efficiencies Defense**

While the state of the efficiencies defense remains unsettled, some things are clear. Despite Supreme Court precedent that has questioned the efficiencies defense and other criticism of the defense, most courts will continue to evaluate claimed efficiencies in some manner when deciding a merger challenge. This is likely in part because the antitrust agencies charged with reviewing and challenging mergers include efficiencies as a component of their analysis. The trend in the appellate and district courts is to consider efficiencies at least when deciding whether a defendant has rebutted the plaintiff’s prima facie case that a merger is unlawful.

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45 *Anthem*, 855 F.3d at 357-58.
46 Id. at 375 (Kavanaugh, J., dissenting).
47 Id. at 360.
48 Id. at 359.
49 Id. at 375 (Kavanaugh, J., dissenting).
50 Id.
51 See, e.g., *Heinz*, 246 F.3d at 720.
52 *Baker Hughes*, 908 F.2d at 984.
53 Amici in *Anthem* raised precisely this concern, that “the merger-specificity and verifiability requirements . . . place an asymmetric burden on merging parties that could doom beneficial mergers.” *Anthem*, 855 F.3d at 356. The majority, however, favored “the policy that consumers should not bear the loss of a competitor if the offsetting benefit could be achieved without a merger.” Id.
The Supreme Court also is likely to recognize the defense should it have the opportunity to do so. Now-Justice Kavanaugh clearly supports such a defense and others on the Supreme Court have shown support for a “modern” approach to antitrust law reflected in more recent case law.\(^\text{54}\)

Even as courts continue to consider efficiencies in defense of a merger, however, the merging parties are unlikely to prevail on efficiencies where a court finds the merger is otherwise deemed likely to have significant anticompetitive effects.\(^\text{55}\) In addition, the bar to successfully proving efficiencies will remain high. Merging parties should ensure that asserted efficiencies are likely to be achieved given business realities and past experiences. Where contractual terms, customer or supplier relationships, or actual business plans call into question efficiencies that a party wants to assert before the antitrust agencies or a court, the parties should re-evaluate those efficiencies and ensure they are consistent with the evidence. When quantifying efficiencies, the company or an outside consultant also should use conservative estimates based on cost savings that are most likely to occur and are supported by clear ordinary course documentation. The parties should expect rigorous testing of their asserted efficiencies given that the agencies and courts will err in favor of protecting consumers against potential harm rather than assuming potential efficiencies will result in cost savings passed onto them.\(^\text{●}\)

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\(^\text{55}\) Aetna Inc., 240 F. Supp. 3d at 94–95 (Despite Aetna and Humana implementing an “integration management office” that performed a detailed analysis through functional teams, third-party consultants, an expert at trial, and a prior acquisition where Aetna obtained efficiencies, the district court was unpersuaded “that the efficiencies generated by the merger will be sufficient to mitigate the transaction’s anticompetitive effects for consumers in the challenged markets.”); Penn State Hershey Medical Center, 838 F.3d at 349–50 (Despite the district court finding that the efficiencies offset any harm, and the circuit court concluding the capital savings are cognizable (Hershey would not have to build $277 million dollar bed tower), the circuit court concluded that the efficiencies were “insufficient to rebut the presumption of anticompetitiveness.”).
Kavanaugh’s Dissent in the Proposed Whole Foods Merger: The Transformation of the Grocery Industry

Jeffrey Klenk and Jeff Armstrong

While sitting on the D.C. Court of Appeals, then-Judge Brett Kavanaugh wrote a dissenting opinion in the action by the Federal Trade Commission to enjoin the proposed merger of Whole Foods and Wild Oats. During the nomination process for his appointment to the U.S. Supreme Court, Kavanaugh was asked questions about his dissenting opinion. The questions suggested that he is hostile to merger enforcement and pre-disposed to side with businesses in antitrust cases. Other commentary has suggested that Kavanaugh’s dissent put him “outside the mainstream bipartisan consensus supporting antitrust enforcement.” Looking back at Kavanaugh’s dissent, though, his willingness to consider economic evidence indicating that transformative forces were at work in the grocery industry appears in retrospect to have been correct. Furthermore, his embrace of economic evidence related to the transformation occurring in the grocery industry as justification for allowing the merger to proceed is consistent with both prior merger analysis by U.S. courts and with established economic theory.

Background of the Proposed Merger

In February 2007, Whole Foods and Wild Oats, two purveyors of natural and organic foods, entered into a merger agreement whereby Whole Foods would acquire 100 percent of the voting shares of Wild Oats. In what was then a confidential memo that Whole Foods submitted to its board of directors (but has since become public through discovery), Whole Foods offered a number of reasons for acquiring Wild Oats, including the apparent “elimination of an acquisition opportunity for a conventional supermarket” and the apparent “elimination of a competitor.” The FTC filed suit challenging the merger.

1 In the preamble to one of the questions posed to Kavanaugh by Senator Amy Klobuchar, she stated, “I’m concerned that the Court, the Roberts Court, is going down the wrong path and your major antitrust opinions would have rejected challenges to mergers that majorities found to be anticompetitive.” Senator Klobuchar went on to conclude that “I’m afraid you’re going to move it even further down the path.” See US: Klobuchar Questions Kavanaugh on Antitrust, COMPETITION POL’Y INT’L (Sept. 6, 2018), https://www.competitionpolicyinternational.com/us-sen-klobuchar-questions-kavanaugh-on-antitrust; see also Matthew Perlman, Kavanaugh Sidesteps Tough Questions on Merger Opinions, Law360 (Sept. 5, 2018), https://www.law360.com/articles/108011/kavanaugh-sidesteps-tough-questions-on-merger-opinions.


Among the reasons advanced by the FTC for halting the merger was the claim that “in each of the markets in which they overlap, Whole Foods and Wild Oats are each other’s closest substitute” and that “[a]fter the merger, Whole Foods likely would be able to raise prices unilaterally, to the detriment of customers of premium natural and organic supermarkets.” The FTC lost its request for an injunction, with the district court concluding that the FTC was unlikely to prevail on the merits of its case since it was unlikely that the FTC could prove its asserted product market or that the proposed merger would substantially lessen competition. Days after the district court’s opinion, Whole Foods finalized its merger with Wild Oats.

The FTC appealed the district court’s decision, despite Whole Foods’ claim that the merger was a fait accompli and could not be reversed. As the court of appeals observed, “Only in a rare case would we agree a transaction is truly irreversible” and noted that “divestiture is a common form of relief from unlawful mergers.” The court of appeals then disagreed with what it characterized as a “thoughtful” opinion by the district court, with the majority finding that the FTC had, in fact, successfully delineated a relevant product market limited to just the premium natural and organic supermarkets product space and that competition from Wild Oats had a specific effect on Whole Foods’ pricing. Given its finding that the district court erred in its assessment of the relevant antitrust market, the court of appeals reversed and remanded the proceeding. Kavanaugh offered a dissenting opinion.

The FTC ultimately reached a settlement with Whole Foods that required the divestiture of 32 former Wild Oats stores, including 19 stores that Whole Foods had closed but where leases still existed. According to the FTC, the settlement would “restore competition in 17 geographic markets that were impacted by the acquisition” and “also could provide a ‘springboard’ from which an acquirer might expand into other geographic markets” through the purchase of the divested stores.

Kavanaugh’s Consideration of the Economic Evidence
Both the FTC and Whole Foods advanced economic evidence purporting to define the relevant antitrust markets as well as the likely effects on consumer prices stemming from the proposed merger. According to the FTC’s expert, Whole Foods and Wild Oats were each “highly differentiated, premium positioned brands” and even other upscale stores, such as Wegman’s, or specialty stores, such as Trader Joe’s, were “clearly significantly differentiated relative to the [merging] par-

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9 Id.

10 Id.

11 See id. at 1039–42.

12 In the majority opinion, Kavanaugh’s colleagues accused him of “ignor[ing] both circuit precedent and Section 13(b)” of the Federal Trade Commission Act. Id. at 1043. Because of that, the majority contended, Kavanaugh’s dissent “misses the mark” by holding the FTC to too high of a standard of proof. Id. at 1046. The majority also claimed that Kavanaugh “gloss[ed] over [the] distinction” between a product market defined as just “organic” products in contrast to a product market defined as “premium natural and organic” products. Id. at 1045.


14 Id.
ties.”

In support of those conclusions, the FTC’s expert implemented the so-called “hypothetical monopolist test” to determine whether a sole-seller of products within the “premium natural and organic supermarkets” product space would be able to impose a small but significant, non-transitory increase in price (also known as a SSNIP) without losing so many customers as to make that price increase unprofitable. Assuming a price increase of 1 percent persisting for two years, the FTC’s expert performed a SSNIP test, and concluded that the relevant antitrust product market was no larger than premium natural and organic supermarkets. The FTC’s expert then concluded that, were Whole Foods and Wild Oats to merge, the combined entity would be able to profitably raise prices without losing too many customers to potential competitors.

The expert retained by Whole Foods concluded, in contrast, that even with a relatively small SSNIP the extent of the sales lost by a hypothetical monopolist would be sufficiently large so as to make that SSNIP unprofitable. Furthermore, Whole Foods’ expert presented granular pricing analyses conducted at a regional level that purportedly showed that Whole Foods’ prices did not differ on the basis of whether other “organic supermarkets” were located in the same geographic vicinity as a Whole Foods store. In particular, Whole Foods’ expert concluded that Whole Foods’ “prices are set across broad geographic areas” and that “differences in prices across stores are generally very small (less than one half of one percent and there is no systematic pattern as to the presence or absence of [organic-supermarket] competition.” Thus, according to the district court, the evidence advanced by Whole Foods’ expert “demonstrates that the relevant product market must be broader than the market proposed by the FTC” and that the “relevant product market must encompass at least all supermarkets.”

In considering the economic evidence and empirical analyses advanced by both sides’ experts, Kavanaugh agreed with the majority that the key issue in this case revolved around properly defining the relevant product market. Kavanaugh also accepted that Whole Foods and Wild

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16 Id. ¶ 77.
17 See id. § IX. In designing his test, the FTC’s expert relied upon the 1992 Horizontal Merger Guidelines. The Guidelines were subsequently updated in 2010, but it is not clear if using the updated Guidelines instead would have meaningfully changed his conclusions.
18 See id. for a general discussion of the SSNIP test performed by the FTC’s expert.
19 Id. ¶¶ 100, 104.
20 Id. ¶¶ 139–140.
22 Whole Foods, 548 F.3d at 1053.
23 Id. (quoting Schefman Expert Report).
24 Whole Foods, 502 F. Supp. 2d at 19.
25 Whole Foods, 548 F.3d at 1051 (“As in many antitrust cases, the analysis comes down to one issue: market definition.”).
Oats were the only “significant competitors” in a market limited to just organic supermarkets and that a merger “would substantially lessen competition in such a narrowly defined market.” Kavanaugh argued, however, that the relevant product market was not limited to just organic supermarkets and adopted the district court’s conclusion that “Whole Foods competes against all supermarkets and not just so-called organic stores.” Kavanaugh largely based this conclusion on the evidence presented by Whole Foods’ expert that purportedly showed Whole Foods’ prices were set across broad geographic areas and did not differ on the basis of whether a Wild Oats store was located in close proximity to a Whole Foods store.

Kavanaugh summarized, in his dissent, much of the economic analysis advanced by Whole Foods’ expert. Kavanaugh specifically homed in on the expert’s granular pricing analyses, noting that those analyses were “all-but-dispositive price evidence” that Whole Foods did not price in response to Wild Oats. Kavanaugh drew a distinction between this merger and the merger proposed by Staples and Office Depot, observing that “the facts here contrast sharply with Staples, where Staples charged significantly different prices based on the presence or absence of office-superstore competitors in a particular area.” Kavanaugh went on to conclude that the “evidence there showed that Staples charged prices 13 percent higher in markets without office-superstore competitors than in markets with such competitors” and that “[t]here is nothing remotely like that in this case.” As a result, Kavanaugh affirmed that “the relevant market for evaluating this merger for antitrust purposes is all supermarkets; and the merger of Whole Foods and Wild Oats would not substantially lessen competition in a market that includes all supermarkets.”

Changes in the Grocery Industry Support Kavanaugh’s Analysis and Conclusions

In addition to relying on the pricing analyses advanced by Whole Foods’ expert, Kavanaugh accepted the economic evidence that Whole Foods’ expert presented, based on trade journals and other industry information, showing that the “dividing line between ‘organic’ and conventional supermarkets has blurred” and that “[t]his is an industry in transition.” This evidence, as interpreted by Kavanaugh and as written in his dissent, indicated:

- Whole Foods has pioneered a product differentiation that in turn has caused other supermarket chains to update their offerings. These are not separate markets; this is a market where all supermarkets including so-called organic supermarkets are clawing tooth and nail to differentiate themselves, beat the competition, and make money.

Many merging parties, of course, claim that their industry is one in transition. In the particular instance of Whole Foods, though, the district court—and ultimately, Kavanaugh—found the evidence of transition to be more than mere speculation. The district court, in fact, directly confront-

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26 Id.
27 Id.
28 Id. at 1053–54.
29 Id.
30 Id.
31 Id.
32 Id.
33 Id. at 1054–55 (emphasis added).
34 Id.
ed the FTC’s claim that potential competitors to Whole Foods would be unable to “reposition” themselves in such a way to provide effective pricing discipline, observing that “[t]he problem with the FTC’s analysis is that the evidence shows that retailers have already begun repositioning their formats, services and product selection in order to respond to the growing consumer demand for natural and organic foods and to better compete against Whole Foods.”35 After then describing the repositioning of six potential competitors to Whole Foods, including such large industry participants as Safeway, Publix, and Kroger, the district court concluded that “the snapshot of the marketplace today is very different than it may have been a few years ago” and “[t]o put it colloquially, this train has already left the station.”36 Kavanaugh specifically cited the district court’s metaphor, as well as the district court’s extensive consideration of the economic evidence of repositioning, in accepting that the grocery industry was in transition.37

Whole Foods was already experiencing pressure from other industry participants’ repositioning at the time of the proposed merger. Leading up to the proposed merger, Whole Foods had the reputation of being a high-priced grocer.38 In response to the repositioning observed by the district court, however, Whole Foods began to focus more attention on pricing issues. In fact, Whole Foods disclosed that in early 2009 it “made a shift from being fairly reactionary on pricing to being much more strategic.”39 As Whole Foods explained, “we survey 63 competitors on 400 items across the country to just stay on track of where we are. . . . We check all the competitors. It’s everything from sunflower sprouts all the way to Wal-Mart. We’re checking them all.”40 Whole Foods subsequently observed that “one of the big things we’ve really tried to work on the last couple of years is improving our price competitiveness . . . [a]nd so we monitor and follow many more competitors than we did a couple of years ago.”41 This change in pricing strategy is consistent with Kavanaugh’s interpretation of the economic evidence indicating the marketplace was becoming increasingly competitive.

Industry-wide changes that have unfolded over the past decade are also consistent with Kavanaugh’s interpretation of the economic evidence. In an earnings call in 2016, Whole Foods itself observed:

There’s a lot more competitors in the marketplace, and there’s a lot of new formats in the marketplace from home meal replacement through meal kits, fast casual restaurant growth, more entrants in the natural and organic food space . . . mainstreaming of natural and organic . . . .[S]o people may not be driving as frequently as far as they used to because they can stop by a Kroger or a HEB or a Wegmans [to get products that they] used to only be able to get at Whole Foods.42

36 Id. at 48.
37 Whole Foods, 548 F.3d at 1054–55.
38 See, e.g., Hadley Freeman, Over the Top and Over Here: “Disney World” of Food Opens First UK Store, THE GUARDIAN (June 7, 2007), https://www.theguardian.com/business/2007/jun/07/retail.supermarkets. Of course, having higher prices than competitors does not by itself mean that Whole Foods does not compete against its lower-priced competitors. As Whole Food explains, “We’ve never been, and we never will be, trying to be the lowest-priced supermarket.” Whole Foods Market, Inc., Q1:2015 Earnings Call, S&P GLOBAL MARKET INTELLIGENCE 13 (Feb. 11, 2015). Nor did Whole Foods want to become a “commodity where [it is] trying to just compete on the basis of price.” Rather, Whole Foods claims to compete on the basis of “differentiation, innovation, service, quality and overall experience” that it provides to its customers. See Whole Foods Market, Inc., Q2:2014 Earnings Call, S&P GLOBAL MARKET INTELLIGENCE 15 (May 6, 2014).
40 Id.
Other supermarket chains have likewise acknowledged these types of changes unfolding in the grocery industry. In language nearly identical to that used by Kavanaugh in his dissent, Kroger observed:

[T]he natural/organic customer is changing and growing in numbers, and those that shop the grocery store are also crossing over, and the blurring of grocery and natural foods is becoming more and more difficult when you look around the store and you can see organic items on the regular grocery shelf . . . . There’s a lot of product innovation in that space as well.43

This transition observed by both Kavanaugh and market participants means that Whole Foods has increasingly come into competition with more mainstream supermarkets (to the extent that it was not already competing with them). As one indication of the competitive overlap between Whole Foods and other supermarkets, on the day that Amazon laid out its strategy for integrating Whole Foods into the Amazon ecosystem, the stock prices of major supermarket chains such as Kroger fell over 5 percent.44 Such stock price declines suggest a sufficient competitive overlap between Whole Foods and other supermarkets that investors were concerned that any new strategy implemented by Whole Foods—such as reducing prices would negatively impact other supermarkets’ profitability.45

Also consistent with Kavanaugh’s reasoning, a number of new services and products have emerged, which, in retrospect, could have exerted further pricing discipline on a merged Whole Foods-Wild Oats entity. One example is Good Eggs, an online grocery service that has been described as a “digital version of a farmer’s market” and that “bring[s] local produce to customers who [don’t] have time to shop in person.”46 After obtaining over $50 million in funding, at least one industry source believes that Good Eggs is well-positioned to compete against Whole Foods, particularly since the size of Whole Foods makes it difficult for Whole Foods to source locally across all of its stores.47

Examples of alternative products that could have exerted pricing discipline include so-called meal kits, sold by companies such as Blue Apron and Hello Fresh, which delivers all the ingredients needed to assemble a meal to customers. Both Blue Apron and Hello Fresh specifically advertise the quality of their ingredients, noting their ingredients are sourced by family-owned and environmentally-sustainable farms.48

Merger Analysis by U.S. Courts and Economic Theory Support Kavanaugh’s Reasoning

In adopting a view that antitrust law should account for and credit changing conditions in the marketplace, Kavanaugh’s dissent was in line with at least one prior court decision denying an agency

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43 Kroger, Q2:2014 Earnings Call, BLOOMBERG 13 (Sept. 11, 2014) (emphasis added).
45 Attributing any given movement in stock price to a specific event can often require sophisticated econometric analysis to isolate the possible effects of that event relative to other factors.
47 Id.
challenge to a proposed merger. Although not explicitly referenced by Kavanaugh in his dissent, the district court’s decision in the proposed merger between Oracle and PeopleSoft contains many of the same themes and relies on much of the same type of economic evidence. Kavanaugh’s reasoning in Whole Foods regarding competitive conditions in the marketplace thus was consistent with the reasoning contemporaneously adopted by at least one other jurist.

In the proposed merger between Oracle and PeopleSoft, which the Department of Justice challenged in 2004, one item the court highlighted was the likelihood of entry into the enterprise resource planning (ERP) marketplace by vendors other than those identified by the DOJ as already participating in that marketplace. In particular, one of the witnesses called at trial testified, with respect to Microsoft’s likely entry into the ERP marketplace, that it was “pretty clear they’re coming.”

Based on that testimony, the court accepted that, even though Microsoft might not yet be a competitor, it would be “able to extend its reach into an arena in which plaintiffs contend that only Oracle, PeopleSoft and SAP now compete.” The court also noted that Microsoft had the money, the reputation and the sales force necessary “to become a major competitor.” Given Microsoft’s ability to discipline any potential price increases after the merger, the court rejected the conclusion advanced by the plaintiffs’ expert that a SSNIP would be possible. The court also noted that “Microsoft’s entry into competition may be achieved by a business model different from that followed” by the existing vendors.

Both the Oracle court’s conclusion that likely entry can be sufficient to defeat a SSNIP, as well as its conclusion that such entry might follow a different business model than the incumbents, would have been relevant to Kavanaugh’s consideration of how the grocery industry might react in the wake of the proposed merger between Whole Foods and Wild Oats. At the time of Kavanaugh’s dissent, the district court had already identified many potential competitors that could have played the role Microsoft served in Oracle, and would have had the resources necessary to begin marketing natural and organic products. In particular, the district court found Safeway, Publix, and Kroger, among others, had “already proven themselves adept at repositioning and proving competitive in the premium natural and organic food field” and noted that these were large, national chains with thousands of stores among them.

Such potential competitors would not have had to create new standalone outlets focusing just on natural and organic products, as Whole Foods did, but rather could have pursued a different business model and added those products as complementary business lines within their existing stores. In fact, that is what many of the competitors identified by the district court did. Kroger, for example, launched its own private label brand, Simple Truth, in 2012 specifically for natural and organic products. By 2015, sales of Simple Truth products exceeded one billion dollars annually while, across all of its product lines, Kroger’s annual sales of organic and natural products were around $11 billion. In comparison, Whole Foods’ system-wide annual sales at the same time were only slightly higher, at around $14 billion.

50 Id.
51 Id. at 1135, 1160.
52 Id. at 1135.
The reasoning in Kavanaugh’s dissent is supported by a long strand of economic theory on the effect of innovation on competition and is consistent with his belief that it is relevant to consider how an “industry in transition” might look in a few years’ time.\(^{56}\) Beginning with the publication of Joseph Schumpeter’s *Capitalism, Socialism and Democracy* in 1942, which popularized the idea of creative destruction as constantly changing the existing economic order of industries, a number of economists have argued that innovation will invariably drive competition and that existing market shares within an industry are not necessarily an accurate proxy for the ability of firms to exercise market power.\(^{56}\)

As explained by Schumpeter:

> [I]t is not that kind of [price] competition that counts but the competition that comes from the new commodity, the new technology, the new source of supply, the new type of organization . . . competition which commands a decisive cost or quality advantage and which strikes not at the margins or the profits and the outputs of the existing firms but at their foundations and their very lives. . . . It is hardly necessary to point out that competition of the kind we now have in mind acts not only when in being but also *when it is merely an ever-present threat*. It disciplines before it attacks.\(^{57}\)

It was the threat of future entry by Microsoft that caused the court in *Oracle* to conclude that a SSNIP would ultimately be unsuccessful.\(^{58}\) As explained by Richard Schmalensee, a professor at MIT, in the software industry in particular, “[c]ategory leaders are not generally threatened by ‘me too’ products competing on price, but as in Schumpeter’s vision, they risk being obliterated by the superior products that regularly emerge from intense dynamic competition.”\(^{59}\) Likewise, in *Whole Foods*, Kavanaugh based his dissent in large part on the threat of mainstream supermarkets introducing organic and natural products and initiating greater competition against Whole Foods. Such a threat ultimately materialized given that within two years of the merger being unwound, Whole

\(^{55}\) See, e.g., J. Gregory Sidak & David J. Teece, *Dynamic Competition in Antitrust Law*, 5 J. COMPETITION L. & ECON. 581, 623–24 (2009) (noting that Kavanaugh’s dissent in *Whole Foods* reflected the importance of innovation over static competition and was consistent as well with the position of Thomas Barnett, the Assistant Attorney General at that time); see also Thomas O. Barnett, *Maximizing Welfare Through Technological Innovation* 5 Presentation to the George Mason Univ. L. REV. 11th Annual Symposium on Antitrust (Oct. 31, 2007), https://www.justice.gov/atr/file/519216/download (“Antitrust policy must embrace a more sophisticated model of competition, one that recognizes the importance of innovation and other factors that increase efficiency.”).

\(^{56}\) See, e.g., Richard Schmalensee, *Antitrust Issues in Schumpeterian Industries*, 90 Am. Econ. Rev. 192, 193 (2000) (“In particular, when innovation is rapid, market shares that depend almost entirely on intellectual property are likely to lack predictive power. To assess fragility, one must either consider the intensity of dynamic competition directly or look for indirect evidence of its effects.”) A review of the modern scholarship discussing the application of Schumpeter’s ideas to antitrust can be found in Thomas McCraw, *Joseph Schumpeter on Competition*, 8 COMPETITION POL’Y INT’L 194 (Spring 2012). See also Tom Nicholas, *Why Schumpeter Was Right: Innovation, Market Power and Creative Destruction in 1920s America*, 63 J. Econ. Hist. 1023, 1055 (Dec. 2003) (“[T]he threat of creative destruction does discipline the product market. . . . The lesson for policy makers is that antitrust intervention in product markets may disturb the very incentive structures that lead to rapid technological change.”).


\(^{58}\) This reasoning on the part of Schumpeter has led at least some economists to conclude that the two-year window in which to assess the potential effects of a SSNIP (as suggested by § 3.2 of the U.S. Department of Justice and Federal Trade Commission 1992 Horizontal Merger Guidelines, relied upon by the FTC’s expert in *Whole Foods*) might be too short given that the competition exerted by potential new entry or by potential new technology could take a longer period of time to fully develop. See Thomas Jorde & David Teece, *Introduction, in Antitrust, Innovation, and Competitiveness* 9 (Thomas Jorde & David Teece eds., 1992). In fact, the current version of the Horizontal Merger Guidelines now omits references to new entry occurring within two years of a merger and instead contends that “entry must be rapid enough to make unprofitable” the actions “thus leading to entry.” See U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 9.1 (2010).

\(^{59}\) Schmalensee, supra note 56, at 193.
Foods was already experiencing competition from a number of supermarkets that had begun to reposition themselves. Other forms of competition, such as those posed by home delivery services and meal kits, perhaps could have been anticipated given how dynamic the grocery industry was becoming.

In retrospect, one might infer that Kavanaugh’s reasoning has portended a more general shift towards viewing potential anticompetitive concerns in a dynamic context. An article from 2008, published about the same time as Kavanaugh’s dissent, observes that the “static focus of modern industrial organization is a problem both for itself as a branch of economic science and as a body of knowledge that is relevant to the big issues within antitrust.”60 The Assistant Attorney General for the Antitrust Division of the DOJ, Makan Delrahim, stated a decade later that “we must be careful in analyzing the real-world competitive dynamics before ascribing market power to a firm.”61 Delrahim then elaborated:

High market shares can be fleeting, especially in dynamic markets. A high market share or high profit margins may reflect the advantage that comes with being the “first mover.” High profits enable firms to recoup investment in sunk costs and provide incentives to take on the risks inherent in innovation. Sustained high prices also can serve as an engine of innovation, inviting entry and even disruption by new competitors. . . . Firms that fail to innovate are often left behind in the dust.62

Delrahim’s observation that high market shares and profit margins might simply reflect that a given firm was one of the first to enter a particular industry aligns closely with Kavanaugh’s own observation. A decade earlier Kavanaugh had observed that Whole Foods in fact largely created, or at least made mainstream, the natural and organic product category and that, as supermarkets began to compete in that product category, they would begin to erode any advantages Whole Foods initially might have had.63

Other scholars have also begun to echo the observations of Delrahim and Kavanaugh. One recent article observed that the “reality is that current (and historical) market shares are of little moment when it comes to analyzing dynamic competition” and that “[c]urrent market shares and market positions are often at best only a very weak proxy for competitive position.”64 This article goes on to argue that “[a]ntitrust policy needs to pivot to a deeper understanding of innovation processes and competition over the long run” and that a “singular focus on short-term price impacts infects too many aspects of our national policy.”65

60 David S. Evans & Keith N. Hylton, The Lawful Acquisition and Exercise of Monopoly Power and Its Implications for the Objectives of Antitrust, 4 COMPETITION POL’Y INT’L 203, 240 (Autumn 2008).
62 Id.
63 See Whole Foods, 548 F.3d at 1054–55.
65 Id. at 38.
Conclusion
Kavanaugh’s dissent indicates a willingness to consider, and credit as determinative, economic evidence on how an industry might look in the future. Such a treatment is consistent both with prior merger analysis and with mainstream economic theory and scholarship. Given the number of new competitors that have emerged in the grocery industry and the new products that have since been developed, Kavanaugh’s approach appears to have been vindicated. Some recent scholarship also suggests that merger policy over the next few years might indeed tack fairly closely to Kavanaugh’s reasoning. ●
Antitrust Out of Focus: The FTC’s Myopic Pursuit of 1-800 Contacts’ Trademark Settlements

Geoffrey A. Manne, Hal Singer, and Joshua D. Wright

On November 14, 2018, the Federal Trade Commission issued an opinion condemning as an antitrust violation trademark settlement agreements between 1-800 Contacts and 14 online sellers of contact lenses. The settlement agreements arise from trademark infringement claims brought by 1-800 Contacts against these online rivals. The agreements require the parties to: (1) refrain from bidding on each other’s trademark terms (e.g., “1-800 Contacts”) in search-based keyword advertising, and (2) employ “negative” keywords to prevent its ads from displaying when a consumer searches online for the other party’s trademarks. The settlement agreements do not limit either party’s ability to advertise through other media (e.g., print, television, radio, or other forms of online advertising) or even through paid search advertising generally (e.g., “contact lens”), as long as advertisements are not displayed in response to a search for the other party’s trademark. Most of the settlement agreements explicitly exempted non-infringing uses, including comparative advertising.

FTC Chairman Joseph Simons, a Republican, authored the Commission’s opinion and was joined by the two Democratic Commissioners, Rohit Chopra and Rebecca Slaughter.¹ The Commission majority—based upon its determination that the agreements were “inherently suspect”—concluded that a truncated rule of reason analysis was sufficient to evaluate the settlement agreements and, on this basis concluded that the settlement agreements violated Section 1 of the Sherman Act. Notably, Republican Commissioner Noah Phillips dissented from both the application of a truncated analysis, as well as the majority’s condemnation of the challenged agreements.²

In finding that the settlement agreements violated Section 1 of the Sherman Act, Chairman Simons and the majority commit two critical errors—one legal, the other economic—that render the Commission opinion, in our view, highly vulnerable to reversal upon appeal. First, the Commission improperly applies the Polygram “inherently suspect” framework to substantiate its truncated approach, which is reserved for agreements between rivals that are well established—whether through judicial learning or economic evidence—to have anticompetitive effects.³ As Judge Douglas Ginsburg wrote in Polygram, the approach is reserved for agreements that “have a close family resemblance to those already convicted in the court of consumer welfare.”⁴ Yet we are not

⁴ Polygram, 416 F.3d at 37.
aware of any economic articles or studies, nor of any judicial decisions, that document any harm flowing from agreements with a “close family resemblance” to the agreements challenged here.

The second error is the majority’s use of an economic analysis that, in contrast to the challenged agreements, is inherently suspect. The FTC analyzed contact lens prices as the appropriate metric of antitrust injury. The Commission deploys that economic analysis and evidence of 1-800 Contacts’ pricing premium among online contact lens retailers to claim that the agreements have anticompetitive effects. Yet evidence of 1-800 Contacts’ price premium relative to smaller online rivals—how the alleged anticompetitive harm manifests itself according to the Commission—is unrelated to the trademark settlements and falls woefully short of evidence of consumer injury. Indeed, 1-800 Contacts commanded the same premium prior to the challenged conduct.

And although the Commission marshals significant analytical tools to demonstrate how Google allegedly lost millions of ads due to the settlements, harm to an online platform does not by itself constitute harm to consumers. That the alleged restraint may have caused some transactions to occur at 1-800 Contacts’ relatively higher price cannot by itself constitute anticompetitive conduct; such a rule would condemn any commercial arrangement that commanded a price premium, regardless of whether output was restricted.

Commissioner Phillips’ dissent identifies each of these errors, and we believe that his dissent clearly and correctly lays out the factual and legal inconsistencies in the Commission opinion. Moreover, Commissioner Phillips correctly focuses upon an important aspect of the case that the majority largely dismisses: the intellectual property interest at stake.

In addition, as Commissioner Phillips recognizes, the Commission’s analysis falls short of the standard set forth by the Supreme Court. The Supreme Court rejected the FTC’s plea to apply a quick look approach in Actavis and California Dental, two cases involving agreements that, on their face, appeared far more suspect than the challenged agreements in this case. Actavis remains the Supreme Court’s latest word on the application of Section 1 of the Sherman Act to settlement agreements involving intellectual property rights (such as the trademark settlements here), and the Court applied the rule of reason in that case. Further, Actavis rejected truncated analysis for intellectual property settlements in evaluating conduct that included splitting monopoly rents—conduct that is far more likely to harm competition than the conduct alleged here. Reviewing 1-800 Contacts’ trademark settlement agreements under the inherently suspect framework is unlikely to withstand scrutiny from the Second Circuit, to which 1-800 Contacts has appealed the Commission’s decision.

The Trademark Settlement Agreements Are Not Inherently Suspect

Chairman Simons’ opinion relies heavily upon quotes from and citations to Polygram. The Commission’s analysis begins by outlining the definition of inherently suspect conduct as stated in the FTC and D.C. Circuit opinions:

Inherently suspect conduct “ordinarily encompasses behavior that past judicial experience and current economic learning have shown to warrant summary condemnation.” Consequently, our analysis considers whether there is a “close family resemblance between the suspect practice and another

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practice that already stands convicted in the court of consumer welfare.” The determination is based on the conduct’s “likely tendency to suppress competition.”7

The Commission finds that the challenged settlement agreements constitute a type of advertising restriction that is likely to harm competition because they withhold from consumers truthful information to compare and evaluate prices among online sellers at the “crucial moment” when sales are about to be made.8 The Commission then concludes that “[e]conomic theory indicates that restrictions on this type of advertising are likely to harm competition.”9

Invocation of the inherently suspect framework is reserved for evaluation of agreements where there is substantial evidence—from judicial experience or economic learning—that the agreements at issue are known to have anticompetitive effects.10 Given the necessity of closely tethering summary condemnation of a particular restraint to rigorous economic evidence, one expects to see somewhere in the Commission opinion citations to studies demonstrating that restrictions that bear the “close family resemblance” to those embedded into the trademark settlements at issue here harmed competition. Yet the Commission presents no such evidence.

Indeed, a careful reading of the Commission opinion reveals that the Commission only cites studies of the effects of advertising restrictions in unrelated contexts. Not one citation appears relevant to evaluating the competitive effects of a settlement of non-sham trademark infringement claims,11 least of all in the context of paid search keyword auctions. The Commission’s conclusion that the settlement agreements are inherently suspect also cannot be reconciled logically with the admission that search-based keyword advertising is “relatively new” and that e-commerce is a “comparatively recent” phenomenon.12

The Supreme Court has repeatedly affirmed that a truncated rule of reason analysis is “appropriate only where ‘an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets.’”13 As Commissioner Phillips explains, the challenged agreements do not resemble—much less bear a “close family resemblance” to—the general restrictions on advertising contemplated by the economic studies and case law that Chairman Simons cites in support of characterizing the settlement agreements as inherently suspect.14 Thus, without anything to rely upon to find the agreements inherently suspect, the Commission’s conclusion is unsustainable.

This conflation of general restrictions on advertising and the settlement agreements at issue in the case appears to reflect a crucial factual error that pervades the Commission opinion. Chairman Simons states that the settlement agreements “effectively shut off an entire—and very

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7 Commission opinion, supra note 1, at 19 (quoting Polygram, 416 F.3d at 37; 136 F.T.C. at 344–45).
8 Id. at 20–21 (“Thus, even when the Court did not affirm liability in California Dental, it recognized that in ordinary commercial markets, bans on truthful advertising normally are likely to cause competitive harm.”).
9 Id. at 20 (emphasis added).
10 Polygram, 136 F.T.C. at 344–45.
11 The Commission concedes that “[t]he trademark litigation underlying the settlement agreements was not sham.” See Commission opinion, supra note 1, at 23.
12 Id. at 1, 28.
14 See Phillips dissent, supra note 2, at 10–11 (“The Trademark Settlements do not approximate conduct that the Commission or courts have previously found to be inherently suspect, much less per se illegal. Those precedents make abundantly clear that the Commission should not treat the Trademark Settlements as presumptively unlawful. That is especially so given the trademark rights involved, an issue that none of the cases on which the majority rely even consider.”).
important—channel of advertising." 15 This assertion is highly relevant to whether the Commission is able to invoke a presumption of anticompetitive harm based upon truncated analysis or, instead, has to prove its case with economic evidence.

Commissioner Phillips’ dissent correctly emphasizes that the challenged agreements restrict only a narrow subset of advertising: paid search advertising triggered when a user searched for the settlement parties’ trademarked terms. That is, the agreements did not restrict any form of advertising per se, but only the placement of a settlement party’s paid search ads on certain search results pages. The settlement agreements did not prevent or restrict either party’s ability to engage in advertising through print, television, radio, internet display advertising, affiliate marketing, social media advertising, or search engine optimization. 16 And the settling parties were entitled to, and in fact did, engage in paid search advertising responsive to generic terms and phrases and, of course, their own trademarks. 17

The Commission thus conflates the effect of the settlement agreements on a specific mechanism by which paid search advertising is purchased with online search generally—a lapse that then leads the majority to find—inaccurately—that the agreements “effectively eliminat[e] an entire channel of competitive advertising.” 18 Online search may very well be “one of the key methods by which consumers discover vendors and compare products and services.” 19 But prohibiting a company from bidding on certain trademarked terms as keywords to trigger paid search advertising does not “impede” consumers’ ability to compare prices “at the critical time when they are about to make a purchase.” 20 Indeed, as Commissioner Phillips notes, the settlement agreements specifically permit “comparative advertising . . . and similar non-infringing uses.” 21 Consumers searching online would still be presented with organic results, likely including links to websites discussing and comparing online sellers of contact lenses, even if a consumer performs a purely navigational search of “1-800 Contacts” and especially if a user searching “at the critical time when they are about to make a purchase” includes search terms in the search query indicating a desire to compare online contact sellers (e.g., “1-800 Contacts cheaper”).

Accordingly, Commissioner Phillips also points out that none of the cases cited in the Commission opinion support the Commission’s analytical approach based upon the facts of this case:

Critically, none involve intellectual property. And all involve advertising restrictions that bear no resemblance to the Trademark Settlements because the restraints at issue were: (1) complete bans on advertising; (2) restrictions on the content of advertisements (i.e., limitations or bans on the ability to advertise price or quality); or (3) restrictions akin to per se violations of the Sherman Act. The distinction between the restrictions at issue in those cases and the Trademark Settlements is significant, because it is obvious how a complete ban on advertising (without implicating intellectual property rights) and these other types of restrictions could be anticompetitive. Far less obvious is how some consumers not seeing advertisements in response to searches for certain trademarked terms has the

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15 Id. at 14.
16 Id. at 9.
17 Id.
18 Commission opinion, supra note 1, at 14.
19 Id. at 20.
20 Id. at 47.
21 Phillips dissent, supra note 2, at 9.
same effect. That is precisely the line drawn in California Dental, and there should be no doubt on which side the Trademark Settlements fall.\textsuperscript{22}

The settlement agreements at issue here do not entail a complete ban on advertising, nor do they limit the parties’ ability to advertise lower prices compared to 1-800 Contacts. Yet by failing to recognize this fundamental distinction, the Commission opinion ends up citing as support cases that are inapposite.

1-800 Contacts offered two procompetitive justifications for the settlement agreements: avoidance of litigation costs through settlement and trademark protection. The Commission finds those justifications to be cognizable and facially plausible, but ultimately rejects them as having no basis in fact.\textsuperscript{23} Specifically, the Commission opinion holds that to prove its justifications were valid, 1-800 Contacts would have had to demonstrate that litigation cost savings would be passed through to consumers and that the underlying trademark litigations had more merit than merely surviving challenges as shams.\textsuperscript{24} Yet those positions are not supported by case law or economic theory, as Commissioner Phillips emphasizes in his dissent.\textsuperscript{25} Avoidance of litigation costs is a well-recognized procompetitive justification, even under Actavis,\textsuperscript{26} as is the protection of intellectual property rights.\textsuperscript{27}

The Commission asserted that limitations on truthful advertising on the basis of trademark protection must be narrowly tailored, and that the non-use restrictions render the challenged agreements unreasonably overbroad.\textsuperscript{28} Commissioner Phillips’ dissent points out that non-use restrictions are the most common means of settling trademark infringement litigation.\textsuperscript{29} The Commission opinion dismisses that fact, holding that such restrictions “cut off an important channel of truthful price advertising” in a situation where company names are not alleged to cause confusion.\textsuperscript{30}

A lack of confusion appears to be key to the Commission’s decision to discredit 1-800 Contacts’ justification of trademark protection. The Commission opinion states that

apart from a single district court summary judgment decision from over ten years ago, no court has found bidding on trademark keywords to constitute trademark infringement, absent some additional factor, such as a misleading use of the trademark in the ad text that confuses consumers as to the advertisement’s source, sponsorship, or affiliation.\textsuperscript{31}

\textsuperscript{22} Id. at 14.

\textsuperscript{23} Commission opinion, supra note 1, at 23, 36.

\textsuperscript{24} Id. at 37, 40.

\textsuperscript{25} Phillips dissent, supra note 2, at 35–37.


\textsuperscript{27} See Commission opinion, supra note 1, at 23 (citing Actavis, 570 U.S. at 153; Schering-Plough I, 136 F.T.C. 956, 1003 (2003); In re Tamoxifen Citrate Antitrust Litig., 466 F.3d 187, 202 (2d Cir. 2006)); see also Phillips dissent, supra note 2, at 27 (“The procompetitive benefits of trademarks are precisely why courts like the Second Circuit have encouraged zealous trademark enforcement, and declined to impose upon mark owners the fear of treble antitrust damages.”).

\textsuperscript{28} Commission opinion, supra note 1, at 25.

\textsuperscript{29} Phillips dissent, supra note 2, at 28.

\textsuperscript{30} Commission opinion, supra note 1, at 26.

\textsuperscript{31} Id. at 38.
Commissioner Phillips aptly criticized the majority for evaluating 1-800 Contact’s inherently fact-intensive infringement claims and rejecting the trademark-related justification for the challenged agreements: “the Commission should not be in the business of litigating (or re-litigating) the underlying trademark infringement claim.”

The Supreme Court explicitly rejected as inappropriate the Commission’s invitation to adopt a truncated analysis for reverse payment settlements of claimed patent infringements in *Actavis*, a case in which the “alleged conduct at issue was far more harmful to competition than anything at issue here, as well-established economic evidence demonstrated,” as Commissioner Phillips points out. We find it unlikely that an appellate court following *Actavis* closely would be willing to apply a truncated analysis to the settlement agreements at issue here. The challenged agreements are not inherently suspect and should have been analyzed under the full rule of reason framework.

**The Commission’s Economic Analysis Is Unsound**

Not only is the Commission Opinion on shaky legal ground, but also the economic analysis endorsed by Chairman Simons and Commissioners Chopra and Slaughter is exceedingly weak. The antitrust laws require any antitrust plaintiff, including the government, to connect the conduct being challenged with an antitrust injury. Common forms of injury include elevated prices, reduced output, and reduced quality of service attributable to the challenged conduct. To satisfy its prima facie burden of demonstrating that the challenged agreements violate Section 1 of the Sherman Act, an antitrust plaintiff must establish the causal relationship between conduct and anticompetitive effect. This is typically, but not exclusively, made via a regression model, which controls for other factors that also might affect prices. Love it or hate it, the consumer welfare standard is fairly exacting.

To satisfy its burden, the FTC points to contact lens prices as the appropriate metric of antitrust injury. But rather than connecting 1-800 Contacts’ higher lens prices to the allegedly anticompetitive trademark settlements, the agency rests its case on 1-800 Contacts’ pricing premium among online lens retailers—a premium that predated the challenged conduct. Given its small footprint in the overall contact lens business, 1-800 Contacts does not necessarily enjoy pricing power. According to the FTC, online retailers (not including brick-and-mortar retailers like Walmart and Target, which also sell online) collectively account for only 17 percent of total lens sales in the United States. To the extent that 1-800 Contacts accounts for 50 to 60 percent of such online sales...
sales, as the record suggests,\textsuperscript{36} it follows that the company accounts for only about 8 to 10 percent of total U.S. contact lens sales.\textsuperscript{37} Indeed, 1-800 Contacts positions itself as a pricing maverick, aiming for consumers who would otherwise purchase a more expensive lens from an eyecare practitioner or a brick-and-mortar store.\textsuperscript{38}

As the leader among online lens retailers with widespread brand-name recognition—attributable to its first-mover advantage in online contact lens sales and to its significant marketing expenditures to drive brand awareness—1-800 Contacts commands a pricing premium relative to lesser-known online rivals.\textsuperscript{39} The relevant question from an economic perspective—and the question a plaintiff must answer to prevail—is whether and to what extent any portion of 1-800 Contacts’ premium can be attributed to the allegedly anticompetitive trademark settlements. Put differently, in the absence of the settlements, by how much would 1-800 Contacts have been forced to cut its prices to fend off the threat of customer substitution towards lesser-known rivals? Although there was some record evidence that 1-800 Contacts’ weekly sales were positively correlated with the elimination of a rival’s ads using the 1-800 Contacts search term, the FTC’s proof of antitrust injury did not establish that 1-800 Contacts’ prices were artificially inflated due to the settlements. Thus, there is no demonstrated connection between the challenged conduct and antitrust injury, and no proof of anticompetitive effects.

The FTC’s expert economists did offer up a regression model. However, they focused not on 1-800 Contacts’ prices, but instead at a target largely disconnected from consumer welfare: Google’s ad sales for the keyword “1-800 Contacts.” According to David Evans, one of the two FTC expert economic witnesses, absent the trademark settlements, Google would have sold 114 million additional ads for rival online retailers in response to queries containing the phrase “1-800 Contacts.” This may be bad news for Google, but the link between Google’s ad sales and consumer welfare overall—whether through lower prices or higher quality search results—is tenuous at best.

As the Commission opinion acknowledges, contact lenses are “commodity products,” and thus “consumers can comparison shop” across all corners of the internet—not just Google’s search pages. Indeed, online shopping for any product, including, presumably, lenses, has for several years been more likely to originate on non-Google shopping platforms, such as Amazon or Walmart.\textsuperscript{40} Even if Google’s platform was somehow deemed an essential input for 1-800 Contacts’ rivals to compete effectively online, the trademark settlements did not bar those rivals from buying lens-related keywords on Google’s site; instead, the agreements merely barred those rivals from buying the phrase “1-800 Contacts” and required rivals to employ negative keywords to ensure their ads did not appear in response to a search for 1-800 Contacts’ trademarked terms. The FTC’s proof of anticompetitive effects failed to show that consumers paid higher prices or that output was reduced due to the challenged settlement agreements.

\textsuperscript{36} See Complaint ¶ 14, 1-800 Contacts, Inc., FTC Docket No. 9372 (Aug. 8, 2016) (asserting that 1-800 Contacts’ sales “represent[] approximately 50 percent of the online retail sales of contact lenses”); Commission opinion, supra note 1 (citing 1-800 Contacts’ CEO testimony that its sales “constituted more than 60 percent of the online contact lens market”).

\textsuperscript{37} The FTC also asserted quality degradation in search results, but it used search engine harm as a proxy for consumer harm, a fatal flaw we address below.

\textsuperscript{38} Commission opinion, supra note 1, at 4.

\textsuperscript{39} Phillips dissent, supra note 2, at 3–4.

Conclusion

The Commission took an aggressive approach in this case, which could have important implications for parties seeking to settle legitimate trademark infringement claims, as well as for parties seeking to protect intellectual property rights more broadly. Commissioner Phillips raises legitimate concerns about the Commission’s remedy, including a reduced incentive to settle trademark infringement disputes, which may materialize as either less trademark enforcement or more costly litigation. Public policy counsels against both of those outcomes, but they are no doubt more likely, absent a reversal of the Commission’s decision.

As noted, 1-800 Contacts is appealing the Commission’s decision. We believe that the legal and economic errors discussed above each independently requires reversal. The Second Circuit will also have the benefit of Commissioner Phillips’ dissent, which thoroughly repudiates the majority opinion’s approach in favor of adherence to legal precedent and application of rigorous economic analysis.

The direction of antitrust enforcement under the Trump administration has no doubt been a hot topic among the antitrust bar. The unusual lineup in this case—a majority party Chairman joined by two minority Commissioners, without support from another Commissioner of his own party—has rarely occurred in the Commission’s history; indeed, to our knowledge no case has been decided along these lines since 1990. While the unusual lineup is certainly not dispositive of the direction the Commission will take in the future, it does raise some interesting questions about the Commission’s future enforcement priorities.

Chairman Simons’ position in this case also suggests a potential divergence from his Republican colleagues, as well as the DOJ Antitrust Division, on the approach to antitrust analysis of intellectual property rights. Striking the appropriate balance between protecting intellectual property rights and enforcing the antitrust laws is a complicated but important task. Imposing antitrust liability where a legitimate intellectual property interest is at stake has the potential to chill procompetitive behavior. Doing so is fully appropriate where the economic evidence indicates harm to consumers (and not just to rivals) or where harm can properly be inferred from economic learning. Neither is the case here.

41 See Petition for Review of Agency Order, supra note 6.


43 Voting data was collected by the authors from FTC records, Fed. Trade Comm’n, Cases and Proceedings, https://www.ftc.gov/enforcement/cases-proceedings (data on file with authors).
NOMINATING COMMITTEE REPORT

To: Deborah A. Garza, Chair,
ABA Section of Antitrust Law

From: William C. MacLeod, Chair, Nominating Committee,
ABA Section of Antitrust Law

Date: April 3, 2019

I am pleased to present the report of the 2018-19 Nominating Committee of the Section of Antitrust Law. This year’s Nominating Committee, on which I had the privilege of serving as Chair, consisted of Melanie L. Aitken, Richard G. Parker, Douglas C. Ross, and Margaret A. Ward. The ex officio members who also participated in our deliberations, along with you, were Jonathan M. Jacobson, Brian R. Henry, and Gary P. Zanfagna.

The Committee has nominated the following Section members for the positions and terms listed below. Pursuant to the Section’s Bylaws, these nominees will be submitted for a vote at the Section’s Business Meeting at the August 2019 ABA Annual Meeting in San Francisco.

**Officers:**
- Vice Chair (2019-2020) - Jonathan I. Gleklen, Washington, DC
- Committee Officer (2019-2021) - Fiona A. Schaeffer, New York, NY
- International Officer (2019-2021) - Renata B. Hesse, Washington, DC
- Program Officer (2019-2021) - Subrata Bhattacharjee, Toronto, ON
- Secretary & Communications Officer (2019-2020) - Scott A. Martin, New York, NY
- Marketing Officer (2019-2021) - Steven J. Cernak, Ann Arbor, MI

**Council Members (2019-2022):**
- D. Jarrett Arp, Washington, DC
- Deborah Feinstein, Washington, DC
- Amanda P. Reeves, Washington, DC
- Paula W. Render, Chicago, IL
- Suzanne E. Wachsstock, New York, NY

**Reserves Board Member (2019-2022):**
- Brian K. Grube, Cleveland, OH

We congratulate the nominees and are confident that the Section will be well served by this outstanding group of individuals.

Respectfully submitted on behalf of the Nominating Committee.