

## Interview with Dennis W. Carlton, Deputy Assistant Attorney General for Economic Analysis, Antitrust Division, U.S. Department of Justice

**Editor's Note:** In this interview with The Antitrust Source, Dennis W. Carlton discusses his views on the horizontal merger guidelines, cartel activity, exclusionary conduct, resale price maintenance, and international developments. Dr. Carlton began his job as the Deputy Assistant Attorney General for Economic Analysis at the Department of Justice in October 2006. He came to the DOJ from the University of Chicago's Graduate School of Business, where he has been a professor of economics since 1984, and from Lexecon, an economics consulting firm, where he has served in several capacities, including President. Dr. Carlton has written widely on the topic of industrial organization and antitrust. He also has served as a commissioner on the Antitrust Modernization Commission. The Antitrust Source conducted this interview on January 30, 2007.

**THE ANTITRUST SOURCE:** You joined the Department of Justice as the Deputy Assistant Attorney General for Economic Analysis in October of 2006. What are your responsibilities in this role?



**Dennis W. Carlton**

**DENNIS CARLTON:** I see my responsibilities as being available to provide economic advice to the Antitrust Division on anything that comes up either internationally or domestically. I meet regularly with the economists at the DOJ and obviously interact with them quite a bit on cases, policy matters, and on various research projects.

At the policy level, I interact with really everybody in the Division. I try to make myself available to everybody and I really enjoy working with many of the section heads and the other deputies and with Tom Barnett, the Assistant Attorney General. Some of the more interesting policy issues that I have worked on include energy pricing, bid rigging in auctions, intellectual property, and vertical issues.

I have been involved with international matters and have met with foreign antitrust officials from all around the world. I have enjoyed interacting with them and have learned a lot about how the rest of the world views antitrust. I have found it intellectually stimulating and fun to exchange views with them and explain what I think are the best approaches.

**ANTITRUST SOURCE:** Would you summarize the structure of the Economic Analysis Group?

**CARLTON:** There are more than 50 economists in the EAG. They are divided up into sections with managers and assistant managers. I work closely with Ken Heyer, who was the acting Deputy before I took over this position; he is now the Economics Director. And between the two of us, we coordinate with the managers and assistant managers exactly what gets done in the EAG, on cases, policy matters, and on research.

**ANTITRUST SOURCE:** You mentioned a lot of interaction with international economists. Did you expect that there would be so much dialogue internationally among economists?

**CARLTON:** Well, I was lucky in my very first month to get to go to the OECD meetings and then to meetings with the European Commission. Soon thereafter, I had meetings in Japan and in Korea. Damien Neven, the Chief Economist for the European Commission's Competition Directorate General, and I have met and have been in contact with each other about interesting antitrust policy questions. I will be on a program with him in February in London where we will discuss some differences between the U.S. and the EC. There is no question when you interact with people from other parts of the world, it's both stimulating and can be productive in identifying important research questions. I enjoy explaining what I think are the best antitrust policies and hearing others' views.

**ANTITRUST SOURCE:** As a result of your interactions with economists in Europe and in Asia, do you see any similarities or differences in the analyses and models being used compared to those being used in the U.S.?

**CARLTON:** I would say that having a common training in economics gives you a common language and that makes communication easier. My own sense is that the Europeans have moved quickly up the learning curve in knowing how to apply economics in complicated situations. We might still have some different views on exactly what may be appropriate policy but I think those differences are narrowing.

Because of a common training in economics, the economists can usually agree on what is a reasonable analysis to do and what is not a reasonable analysis to do. This ability to agree on appropriate ways to analyze situations should lead to an expansion of the areas of agreement and a narrowing of the areas of disagreement. Where there is a different view, hopefully, you can really nail down why there is a difference.

I have seen that the level of economic sophistication can vary enormously across countries. There are some countries where the use of economics is really just beginning. An important role for the DOJ to play is to help those countries obtain the necessary economic background. To accomplish this, the DOJ can provide not only various training sessions (we hope to have such a session later this year) but also can foster ongoing communication so that if a foreign antitrust official has a question he can call someone at DOJ for an answer.

**ANTITRUST SOURCE:** Do you have any priorities or objectives that you'd like to accomplish during your tenure at the DOJ?

**CARLTON:** I would hope that the DOJ will find me to be a valuable resource and that I will be able to give them some insights into some hard questions that come up either in cases or on general policy matters.

Aside from working on cases and on whatever policy matters that might arise, I would like to make sure that the economists are doing research on projects that are policy-relevant. Research often takes time, but quantitative research can have enormous benefits in resolving what might otherwise be a purely theoretical debate. For example, knowing the magnitude of the costs that various entry restrictions impose on the economy might help the DOJ figure out where best to channel its competition advocacy. If one finds that in a particular industry certain state restrictions or federal regulations on entry are imposing enormous costs on the public that could be very relevant to states or federal regulatory agencies that are evaluating such restrictions. And the DOJ should take a role in informing the states and federal regulatory agencies of its findings. There can

be questions having to do with what's the proper competition policy in certain industries, and there may be a lot of debate. But sometimes a good research paper can provide the answer.

I would like to stimulate interest in doing those types of research projects. I think it is much easier to stop a bad law from being passed than to repeal one that is in existence. I would like to make it clear that the DOJ can be a resource both for federal and state legislators who are thinking of introducing policies that would impact competition. I would be especially happy if we could also pursue research with an international dimension.

In terms of my own priorities, I am working on a number of interesting research projects on antitrust topics and have already written some papers and given several speeches on antitrust policies since I have been here. I have already greatly benefited from exposure to a concentration of attorneys and economists with more antitrust expertise than anywhere else in the world.

**ANTITRUST SOURCE:** Let's talk about horizontal mergers. You were a consultant to the Department of Justice in the early 1990s when the Horizontal Merger Guidelines<sup>1</sup> were being developed. How well do you think the Guidelines have done in providing a framework for antitrust analyses of horizontal mergers?

**CARLTON:** I think they have done very well in the sense that they are guidelines. I also think that the Commentary<sup>2</sup> that recently came out on the Guidelines is very helpful. Anything that increases transparency is very important.

**ANTITRUST SOURCE:** To follow up on your point about transparency at the FTC and DOJ, antitrust practitioners working for parties involved in a transaction often complain that they don't have access to the agencies' economists' models. Is there an effort that is being made by the DOJ to be more open in that type of dialogue?

**CARLTON:** Well, I certainly support transparency. Before I joined the DOJ I served as a consultant on numerous matters before both the FTC and DOJ and met frequently with the agencies' staffs. I have noticed that over the last several years there has been an increase in the willingness of the agencies' economists to share their analysis with outside economic consultants for the parties. This increased openness is desirable. At least within the last few years, I have felt I had a good understanding of what the FTC or DOJ economists were doing. And I should say it's a two-way street. When I was an outside consultant, I would always like to tell the agencies what I was doing. They would sometimes ask hard questions and I felt obliged to tell them exactly what I have been doing—both the things that worked and the things that didn't work. I always found that to be very effective because they know the things that aren't working and they would ask you about them. It is the job of the economic consultant to reach an expert opinion in light of all the evidence, both the good and bad. I think it destroys an expert's credibility to present only the supportive evidence.

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<sup>1</sup> U.S. Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines (1992, revised 1997), available at <http://www.ftc.gov/bc/docs/horizmer.htm>.

<sup>2</sup> U.S. Dep't of Justice & Federal Trade Comm'n, Commentary on the Horizontal Merger Guidelines (2006), available at <http://www.usdoj.gov/atr/public/guidelines/215247.htm>.

I know that sometimes attorneys on either the government side or the private client side get nervous about allowing the economists to talk freely. My own view is that each side obtains the best understanding of its chances of prevailing in a matter when each side understands what the other side is saying. And if both sides are reasonable, having each side understand the economic arguments of the other can narrow or eliminate the areas of disagreement.

**ANTITRUST SOURCE:** Are there any changes you'd like to see made to the Guidelines?

**CARLTON:** No. My sense is that the Guidelines are pretty good as long as you emphasize the word guidelines. My own experience is that the Guidelines provide a good sense of the general antitrust issues in mergers. One typically does a much more sophisticated analysis than one based on only market shares. If you have a lot of data, you can do more sophisticated econometric work that can be much more relevant than the use of simple market definition and market shares.

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There's no question that you can always write something to make it slightly better but the question is, is it really worth it? I think the Guidelines serve their purpose and do not need to be revised.

I have found some parts of the Guidelines not to be terribly useful, such as the distinctions between whether you are a committed entrant or an uncommitted entrant. I don't know if that really matters all that much. But overall I think the Guidelines have done exactly what they were supposed to do. The Guidelines have done a very good job of indicating the types of antitrust issues that arise in mergers.

**ANTITRUST SOURCE:** Some antitrust practitioners have advocated skipping over or truncating the market definition exercise and moving straight to competitive effects. What are your thoughts on that approach?

**CARLTON:** I'm finishing a paper entitled "Market Definition: Use and Abuse" for the journal, *Competition Policy International* on exactly this topic. Market definition generally serves a very useful purpose of preventing courts and practitioners from making egregious errors, and that's a useful discipline.

Most practitioners understand that the use of market definition and market shares is just a place to start the analysis and that the use of market definition and market shares is a crude tool of analysis. The government agencies clearly understand this. Of course, some courts may be less sophisticated than the DOJ and FTC in antitrust matters and that means that although a court's antitrust analysis may overly rely on market definition, the use of market definition may assist in preventing it from making egregious errors. So I think it's a not a bad place to start. I also think it can be useful for providing safe harbors. Now, having said that, there is no question that when I analyze a merger, I wouldn't ordinarily rely just on market definition.

As I've written in several papers, econometric work can be valuable in analyzing mergers. There are really two types of analyses that can be useful. If the analyst can do a statistical analysis that relates the price to either the number of competitors or market share, and can do it in a statistically appropriate way, then those types of studies can be very valuable. If you have enough data, you might even be able to do a second type of analysis in which you estimate demand curves with a fair degree of precision. You may then be able to do a merger simulation. Merger simulation requires a lot of assumptions. So, you have to make sure your assumptions are not driving the results. But I think that merger simulation can be a useful additional tool of analysis.

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depending on the circumstances. And in some circumstances, they can really be much better.

**ANTITRUST SOURCE:** Let's talk about efficiencies. Do you think that the Guidelines give appropriate weight to efficiency arguments?

**CARLTON:** I think that they certainly can. I would pay attention to efficiencies in both marginal costs and fixed costs. A lot of fixed costs are recurring and so translate into lower future costs for, say, bringing out new products. Therefore, even fixed costs savings can translate into lower prices or better products for consumers. Of course, the parties that claim the efficiencies would have to convince the agencies that they are real. Proving efficiencies can be hard.

There is a separate issue and that is whether one should focus on consumer surplus or on total surplus, which is the sum of consumer plus producer surplus. As a practical matter, I don't think it matters for the outcome of most cases which one is used. As a logical matter I think the total surplus criterion makes more sense, as I have explained in a recent EAG Discussion Paper entitled, *Does Antitrust Need to Be Modernized?*<sup>3</sup>

**ANTITRUST SOURCE:** Do you have any advice or observations for practitioners involved in economic discussions with DOJ staff?

**CARLTON:** I will base my answer on my experience as an economic consultant when I had to meet with the DOJ. First, do not overstate the strength of your findings. An expert should be completely honest about reporting his results—both the favorable and unfavorable ones. I think it is very foolish to try to hide either bad facts or bad results. It can destroy one's credibility. The DOJ economists are very talented and they likely will know of bad facts or results. Most hard cases require making judgments and weighing the evidence. In such a case, if someone tells me, "Oh, Dennis, there are only benefits from this merger. There is no possible negative argument," I might be skeptical.

On the other hand if someone says "I thought about all the possible competitive harms but on balance they are far outweighed by the benefits" well that person likely has more credibility. So, I think credibility is very important. Don't oversell what you have.

Second, make sure that the analysis is presented clearly and given far enough in advance so that the DOJ can digest it thoroughly. If you give someone a white paper that's a thousand pages long the day before a meeting, that's not likely to be effective.

Finally, interacting with the DOJ staff so that the practitioner knows the DOJ's concerns is essential for the practitioner to be able to deliver an analysis that addresses those concerns. Ask what is bothering the DOJ and figure out how to perform an analysis that addresses those concerns. If there's something that is very technical, that can be an appendix or a separate submission. It is important to articulate the main points very clearly and precisely.

**ANTITRUST SOURCE:** Under Tom Barnett, the Department of Justice has investigated a number of industries suspected of cartel behavior and the DOJ announced in December that 2006 had the second highest level of criminal fines for cartel activity. When there is no "smoking gun," what role, if there is one, do economists play in cartel investigations?

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<sup>3</sup> Dennis W. Carlton, *Does Antitrust Need to Be Modernized?* (Economic Analysis Group Discussion Paper 07-3, Jan. 2007).

**CARLTON:** I think that if it's a per se violation and it's an issue of fact as to whether the people got together in a boardroom and communicated, it is unclear what an economist can add—an economist isn't better at digging out the facts than a lawyer. But I think there are at least two areas where economists can be useful in understanding cartels. The first is ascertaining the effects of any alleged conspiracy. The economist can help measure the effects and therefore tell you if something has changed in a surprising way. That obviously can sometimes be helpful to the attorneys in figuring out whether there is something unusual going on. In fact, at one of the OECD meeting sessions the DOJ and FTC submitted a paper on bid rigging and explained how one could use empirical methods to detect cartels.<sup>4</sup> So in that sense, economists can be helpful.

There's another important sense in which economists can be helpful. Economists study what creates stability for cartels and therefore the flipside of that is they know what creates instability. Our leniency program has been responsible for a large fraction of our recent enforcement actions. Figuring out how to create incentives for a cartel to fall apart is something that economists can help with. How much a firm is rewarded for being first to reveal a cartel compared to the punishment a cartel member suffers if he is caught in a cartel are issues that economists can analyze. There is an excellent discussion of the economic principles underlying the leniency program in the current issue of *The Review of Industrial Organization*.<sup>5</sup>

Leniency programs raise an interesting international issue of coordination. We know these amnesty programs work. It suggests that we should convince other countries not only to prosecute cartels but to use a leniency program as a device to create incentives for uncovering information about them. But someone has to pay attention to how all these leniency programs in different countries interact with each other. If you get leniency in one country but not in another, then the fact that you're not getting it in another country can undo the incentive effects of the first country. So it raises an issue about international coordination.

**ANTITRUST SOURCE:** From an economist's perspective, do you see a similar level of international coordination on criminal cartel investigations as you do on merger investigations?

**CARLTON:** In terms of my personal interaction with other economists, I haven't specifically focused on criminal investigations of cartels. However, in my meetings not just with economists but also with other policy makers, the general topic of cartels, the success of our leniency program, the optimal design of a leniency program, and the need for international coordination have all been topics of discussion.

**ANTITRUST SOURCE:** Let's talk about exclusionary conduct for a moment. As you are well aware, the FTC and DOJ have been holding hearings on single-firm conduct since the Fall of 2006. In fact, you were one of the featured speakers at the inaugural session of those meetings. In your mind, how do you define exclusionary conduct?

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<sup>4</sup> U.S. Department of Justice/FTC Submission to Oct. 19, 2006 OECD Roundtable on Competition in Bidding Markets, available at [http://www.ftc.gov/bc/international/docs/Bidding\\_US.pdf](http://www.ftc.gov/bc/international/docs/Bidding_US.pdf).

<sup>5</sup> Elizabeth Armington, Eric Emch & Ken Heyer, *The Year in Review: Economics and the Antitrust Division 2005–2006*, 29 REV. OF INDUS. ORG. 306 (2006).

**CARLTON:** I try to be very careful and make sure the context is clear. The relevant antitrust issue is to identify conduct that excludes a rival and harms competition. For purposes of discussion, let's suppose the courts are concerned with consumer surplus (not total surplus). The antitrust issue is whether the exclusion of a rival winds up harming consumers. The difficult issue with exclusionary conduct (i.e., conduct that excludes) is that vigorous competition can harm and therefore exclude rivals. Yet consumers are benefited. So it does not suffice to simply determine whether a rival is excluded in order to decide whether the antitrust laws are violated.

If you want to give the label "exclusionary" to actions that exclude rivals, then you have to be very careful not to create the impression that such conduct is necessarily bad. I understand that words can mean whatever you define them to mean, but I would caution that if you use the word "exclusionary" you should always distinguish behavior that harms consumers from behavior that doesn't harm consumers. If those behaviors do not harm consumers, the notion of calling the conduct "exclusionary" runs the risk that you're using a term which could have a negative connotation. That is perfectly OK as long as you make clear that you do not intend any negative connotation.

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**ANTITRUST SOURCE:** How do you go about figuring out in practice whether certain behavior has an exclusionary effect on rivals or an efficiency effect?

**CARLTON:** That can be very hard to do. It can be hard because a lot of actions that are procompetitive also harm rivals and therefore, figuring out the difference between a procompetitive act and the anticompetitive act can sometimes be very difficult. You certainly can't just look at whether rivals are harmed. There are different approaches you can take to analyze the antitrust issue.

For example, sometimes you're lucky enough to have data in which the bad act does not occur in one part of the country but does occur in another or occurs in one time period but not another. You can then do a comparison and measure the consequence of the bad act. If the data are available that's one of the most reliable methods of analysis.

My sense is that a lot of behavior that's attacked under Section 2 is also behavior that can be procompetitive. And if you're going to be attacking behavior that can be procompetitive, then you should be very careful in intervening because you're likely to have an adverse effect on competition elsewhere in the economy. If you become aggressive in your Section 2 cases, you risk chilling competition throughout the economy.

The other thing I would say is a lot of our theoretical models, including some of mine, which show how exclusionary conduct can wind up being anticompetitive, depend on very particular assumptions. And if you are relying on such a model to bring an antitrust action you better make sure that if the assumptions are plausibly changed, it doesn't completely undo the model's conclusions. Otherwise you have to recognize that a lot of your intuition for why an act is bad may not be robust to plausible changes in assumptions. If it's very difficult for you to figure out whether the assumptions apply to a particular industry, you have to recognize that if you intervene, you're taking a significant risk of making an error.

**ANTITRUST SOURCE:** One of the comments you made in your remarks at the Section 2 hearings last year was that you didn't necessarily think that there was one test for exclusionary conduct. Are there circumstances when it is appropriate to look at a profit-sacrifice or no economic sense test to determine whether or not the behavior is anticompetitive or procompetitive? If so, what situations would you see this test as useful?

**CARLTON:** What I said at the Section 2 hearings is that I am not enamored of the profit-sacrifice test and the no economic sense test, despite the respect I have for the authors of those tests. The reason is that there is one overriding test and that's whether the process produces a result in which one expects total welfare to rise.

So the question is whether these intermediate tests help me in creating a decision process that improves welfare. My own view is that exclusionary conduct is sufficiently varied across the cases in that what works in one type of case as a reasonable decision process may not work in other types of cases.

Let me give you an example. For predatory pricing, people generally seem to be of a consensus view that it is desirable to have a safe harbor so that if price is above cost—let's leave aside how you define cost—then we're going to leave the firm alone—that's the safe harbor. That seems very useful for predatory pricing cases because it gives the safe harbor to firms to protect them if they're competing. Now, if there's a different action under scrutiny, that safe harbor may not be relevant. I'll need a different safe harbor.

My own view is that we should figure out the relevant safe harbors for the many different types of Section 2 cases rather than trying to shoehorn each case into either the no economic sense test or profit-sacrifice test. Now the authors of those tests are very smart and I know them. I think that they and I could agree on many safe harbors. My worry is that if you simply read what some of those tests say, and you forgot about the safe harbors, you can wind up easily condemning actions that are procompetitive.

Now, I know they put safe harbors into the tests to prevent that, but that just means that the logic of the test by itself isn't compelling. You need these safe harbors to protect you. And my view is that if you need safe harbors, let's just do it on a case-by-case basis. What I really mean is a type of case basis. So for predatory pricing, we have a safe harbor that pricing above cost is okay. For other types of cases, we may want to have other safe harbors. My own view is that that's the way to address the issue rather than to try and deal with all cases with something like a profit-sacrifice test.

**ANTITRUST SOURCE:** Let's talk about refusals to deal. You have been critical of the decisions in *Aspen*<sup>6</sup> and in *Kodak*.<sup>7</sup> What is your view of the analysis that the court used in determining that there was no duty to deal in *Trinko*?<sup>8</sup>

**CARLTON:** I should tell you that I worked as a consultant for the defense in *Trinko*. In terms of duty to deal, I have a paper in the *Antitrust Law Journal* on duty to deal and refusals to deal where I criticize *Aspen* and *Kodak*.<sup>9</sup>

I thought that what the court said in *Trinko* was reasonable. There's a difference between violating a regulatory rule and creating an antitrust violation. Where the duty to deal comes from a regulation, then the violation is a regulatory issue and that should not trigger an antitrust violation. That sounds right to me.

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<sup>6</sup> *Aspen Skiing Co. v. Aspen Highlands Skiing Co.*, 472 U.S. 585 (1985).

<sup>7</sup> *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992).

<sup>8</sup> *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004).

<sup>9</sup> Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal—Why Aspen and Kodak Are Misguided*, 68 ANTITRUST L.J. 659 (2001).

I have a paper in which I compare regulation to antitrust and look at how we've been moving in the United States away from regulation towards antitrust as a way to control competition as a policy matter. I also look at the interaction between the two in industries that remain regulated. I think that the choice between relying on antitrust versus relying on regulation is actually a very interesting research topic, and it is something I'm going to be discussing at a panel in London with the European Commission's Competition Directorate General chief economist Damien Neven. There are different approaches between Europe and the United States in terms of the reliance on regulation versus antitrust.

If possible, I prefer to rely on antitrust rather than regulation. Creating a duty to deal is not something I look favorably upon under our antitrust laws. You might want to do it as a matter of regulation. But under our antitrust laws, I think it is very hard to make an economic case why it should occur.

**ANTITRUST SOURCE:** Let's circle back to market definition for a moment. What are your views on using a market definition analysis as laid out in the Horizontal Merger Guidelines to start a Section 2 exclusionary conduct analysis?

**CARLTON:** That's a good question. That's exactly a topic that I discuss in the paper I'm writing right now on market definition where I discuss the difference between market definition for a merger case versus a Section 2 case. The point I made in the Section 2 hearings and the point I'm making in this paper is that the ways in which markets have been used in Section 2 cases is either odd or misguided.

Let me just give you an example. One of the requirements in a typical Section 2 case is that there be market power. So one point to notice about that is the courts aren't asking about the change in market power as a result of some allegedly bad act. They're just asking about the level of market power.

So let's think for a moment how you'd answer the question—is there market power? Well, to define a market using the procedures of the Merger Guidelines one asks whether a hypothetical monopolist of some candidate market would raise price by some amount—let's say 5 percent—above the current level. There is some wording in the Guidelines that indicates that you don't necessarily have to always use the current level of price as the benchmark but let's ignore those details and just stick with the current level. Now in some Section 2 proceedings, what I've seen is that some people replace the current level of price with the competitive level. So, using the Merger Guidelines' procedure to define a market, one finds those products that comprise the smallest product market such that a hypothetical monopolist of those products could raise price by say 5 percent above the competitive price. After defining the market in that way one then calculates market shares to see whether a firm has a high market share.

But let's just stop for a moment. Think about what you've done. If you do not know the competitive price, then you cannot implement this procedure to define a market. Suppose you do know the competitive price and suppose it is \$5, while the current price is \$10. So you have defined the market in order to calculate market shares and if the market share is large, you're going to conclude that \$10 is higher than \$5—i.e., that there is market power. But if you know that the competitive price is \$5 and you know that the current price is \$10, you don't need to define the market to determine that \$10 is greater than \$5. It is an odd exercise to apply the Merger Guidelines' procedure for market definition in that particular way where you know both the current price and the competitive price. So in that setting I don't see the logic of why you would want to do it.

**ANTITRUST SOURCE:** Is there a better approach to take in a Section 2 case to identify whether a party has monopoly power or is dangerously close to achieving it?

**CARLTON:** You used the word “monopoly power” so you have to distinguish the difference between market power and monopoly power.

**ANTITRUST SOURCE:** Is there a difference between “market power” and “monopoly power”?

**CARLTON:** I’ve written in my textbook that there is certainly a logical distinction you can draw.<sup>10</sup> Market power could be defined as setting price profitably above marginal cost and monopoly power could be defined as doing not just that but also earning a rate of return above the competitive rate of return. Now, I’ve not seen that distinction adopted by the courts even though it’s a logical distinction. I will add that I did take it out of one of my editions and I got a number of comments from lawyers asking me to put it back in because they thought it explained a useful distinction. So it is in the current edition.

One has to recognize that there are a lot of markets in which price exceeds marginal cost and there is relatively free entry. You then have to ask yourself, what is it exactly that a Section 2 case should be focusing on in examining market power in light of this fact. I think that courts often are looking for firms that are earning supracompetitive rates of return over significant periods of time, but any attempt to calculate such rates of return would likely be a litigation nightmare.

What I think the court should focus on much more—especially at summary judgment or even earlier—is whether there’s a plausible story by which the action that is at issue is procompetitive. The focus on market definition comes in part from the reliance by the court on market definition to throw a case out early.

Flipping the analysis so that the court first looked at whether the complained-of action fell within a plausible safe harbor might help in getting rid of frivolous cases and reduce the emphasis on market definition. In any event the use of market definition to assess market power is a very crude tool, and I would also pay attention to an effects-based analysis in a Section 2 case.

**ANTITRUST SOURCE:** Let’s talk about resale price maintenance. The Supreme Court has agreed to hear the *Leegin* matter,<sup>10</sup> which is an opportunity for the Court to review *Dr. Miles*.<sup>11</sup> What is your view from an economist’s perspective on whether minimum resale price should be viewed under a per se or rule of reason standard?

**CARLTON:** When the *Leegin* case came up, I got to work on the government’s amicus brief<sup>12</sup> and that was a lot of fun. My view is that resale price maintenance should be judged under a rule of reason. The academic literature as to why that should be so is overwhelming. I discuss RPM in my textbook, where my views are described in detail.

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<sup>10</sup> PSKS, Inc. v. Leegin Creative Leather Prods., Inc., 2006 WL 690946 (5th Cir. 2006), cert granted, 127 S. Ct. 763 (2006).

<sup>11</sup> Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

<sup>12</sup> Brief for the United States as Amicus Curiae Supporting Petitioner, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 763 (2006) (No. 06-480), 2007 WL 173650.

The number of situations in which resale price maintenance can be used as a device to harm all consumers is rather limited—certainly it is understood that RPM can be used to facilitate a dealer or manufacturer cartel. But those situations do not describe the actual uses of RPM very well.

By and large, the evidence shows that resale price maintenance is typically used in ways that one would not characterize as anticompetitive. Therefore, RPM should be judged under a rule of reason standard. The simple observation I make in my textbook is that we don't typically tell a manufacturer how to produce his product, so why should we tell him how to distribute it?

**ANTITRUST SOURCE:** The Antitrust Modernization Commission, for which you have served as a commissioner, has released its preliminary findings with final findings to be released in a few months.<sup>13</sup> Do you have any comments or thoughts on what you think is the most important finding coming out of the AMC or on the AMC process?

*The number of situations in which resale price maintenance can be used as a device to harm all consumers is rather limited.*

**CARLTON:** The final report is still to come out. So the preliminary recommendations could get changed. I have a paper<sup>14</sup> that appears in the EAG Discussion Series that describes my views in detail on the major controversial antitrust issues of today.

Before discussing some of the recommendations, I want to say that the process that the AMC followed was very useful. The deliberations of the Commission were public and therefore transparent, as were the hearings and testimony. Moreover, even the background material that the staff prepared is available, and the staff did an excellent job of putting together the relevant background material. I have toyed with the idea that when I return to academia I will teach an advanced antitrust seminar in which I go through each one of the topics that the AMC studied, have the class read the pros and cons on each issue, and then have a debate in the class.

In terms of the major conclusion of our work, we were asked the question, "Should there be fundamental changes in the antitrust laws in order to make the antitrust laws relevant for an economy where there's globalization and rapid technological change?" The answer to that question is that the antitrust laws are very adaptable and that fundamental changes to the laws are not needed.

Does that mean everything is perfect? No. Can we fix certain things? Yes. And the report will make many recommendations—I forgot how many recommendations—70 or so. I like some of the recommendations better than others. The repeal of the Robinson Patman Act is one recommendation that I especially like, and if we cannot obtain repeal, then the recommendation that there be a requirement that a court find antitrust injury in order to establish liability would rank high on my list of favorite recommendations.

**ANTITRUST SOURCE:** Is there anything else you would like to add or comment on?

**CARLTON:** On the last question, one of the recommendations that I am not a big fan of is the one to repeal *Illinois Brick*.<sup>15</sup>

<sup>13</sup> See [http://www.amc.gov/pdf/meetings/list\\_of\\_recommendations\\_jan\\_11v3.pdf](http://www.amc.gov/pdf/meetings/list_of_recommendations_jan_11v3.pdf).

<sup>14</sup> Carlton, *supra* note 3.

<sup>15</sup> *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977).

As far as other comments, I'm really enjoying the job and find it stimulating. I've always admired from the outside how hard working and smart the government lawyers and economists are. I just enjoy being in an environment with them and interacting with them. They are smart. They're good. I'm obviously only going to be here temporarily. I'm glad that there are staff people here who you really have to be proud of. So that's been a real pleasure for me to be able to work with them.

**ANTITRUST SOURCE:** Thank you very much. We really appreciate your time with us today.

**CARLTON:** It's my pleasure and it was good to speak with all of you. ●

## Dr. Miles: Will the Supreme Court Find a Cure?

**Donald M. Barnes and David T. Fischer**

On December 7, 2006, the U.S. Supreme Court agreed to hear *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*,<sup>1</sup> which presents the Court with an opportunity to address the per se minimum resale price rule established almost a century ago in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*<sup>2</sup> Resale price maintenance is a vertical restraint that occurs when a seller of goods conditions the sale upon the buyer's agreement to not resell the goods below (or above) a specified price. *Dr. Miles* held that if the seller sets a *minimum* resale price, then the activity is considered per se illegal under the Sherman Act. Although some economists and lawyers—many from the “Chicago School”—have criticized *Dr. Miles* based on the rationale that minimum resale price maintenance is often beneficial to consumers,<sup>3</sup> others have argued that minimum resale price maintenance results in inefficiencies and higher prices for consumers and facilitates cartelization of either manufacturers or resellers.<sup>4</sup>

Now the Supreme Court will determine whether the *Dr. Miles* “cure” has become a competition “disease.”

### The Supreme Court's Treatment of Vertical Restraints

At the time of the *Dr. Miles* decision, the Sherman Act was only 13 years old and antitrust jurisprudence was in its infancy. The Indiana-based Dr. Miles Medical Company sold its patent medicine products to wholesalers and retailers. Its contracts with wholesalers required resale pricing equal to or greater than the price the Dr. Miles Medical Company charged the wholesaler.<sup>5</sup> The contracts with retailers prohibited the retailers from selling “at less than the full retail price as printed on the packages.”<sup>6</sup> The plaintiff, John D. Park & Sons Company, was a wholesaler that had previously purchased products from the Dr. Miles Medical Company but later refused to accept Dr. Miles's contract with the minimum resale prices and sold the products below cost.

The Supreme Court, relying in part upon the doctrine that “restraints upon alienation have been generally regarded as obnoxious to public policy,” found that “agreements or combinations between dealers, having for their sole purpose the destruction of competition and the fixing of prices, are injurious to the public interest and void. They are not saved by the advantages which

<sup>1</sup> 171 F. App'x 464 (5th Cir.), cert. granted, 127 S. Ct. 763 (2006).

<sup>2</sup> 220 U.S. 373 (1911).

<sup>3</sup> See, e.g., Barbara O. Bruckmann, *Revisiting Dr. Miles: Reinstating a Modern Rule of Reason for Vertical Minimum Resale Price Agreements*, ANTITRUST SOURCE, Feb. 2007, <http://www.abanet.org/antitrust/at-source/07/02/Feb07-Bruckmann.pdf>.

<sup>4</sup> See, e.g., Matthew Moloshok, *Dr. Miles—A Rock of Ages*, ANTITRUST SOURCE, Feb. 2007, <http://www.abanet.org/antitrust/at-source/07/02/Feb07-Moloshok.pdf>.

<sup>5</sup> 220 U.S. at 396–97.

<sup>6</sup> *Id.* at 399 (quoting form of contract at issue).

■  
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 David T. Fischer** are  
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 Wright Morris & Arthur,  
 LLP in Washington, D.C.

the participants expect to derive from the enhanced price to the consumer.”<sup>7</sup> As a result, minimum resale prices were to be treated as per se violations of the Sherman Act.

Shortly after *Dr. Miles* was decided, the Court limited its scope and its effect. In 1918, in *United States v. Colgate & Co.*, the Court was confronted with a manufacturer which, among other things, provided its dealers with a suggested “uniform price[ ] to be charged” and “urg[ed] them to adhere to such prices and notices, stating that no sales would be made to those who did not” comply.<sup>8</sup> The manufacturer also stopped selling to those dealers who failed to sell at its suggested price. The Court rejected the government’s argument that this resulted in “an unlawful combination . . . resulting from restrictive agreements” in which the dealers agreed to resell the products only at the suggested price.<sup>9</sup> Because the dealer was free to resell the goods at any price (or even give them away) there was no agreement and, thus, no violation. The distinction drawn by the *Colgate* court, i.e., the lack of a formal contract, has been criticized by many commentators.<sup>10</sup>

In addition to treating *minimum* resale price agreements as a per se violation, the Court also found that *maximum* resale price agreements were per se violations as well. *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons* involved another Indiana “drug concern,” Kiefer-Stewart, an alcohol wholesaler that brought a lawsuit against liquor companies that set a maximum resale price above which their resellers, including Kiefer-Stewart, could not sell their products.<sup>11</sup> The Court found that an agreement setting a maximum resale price was also a per se violation. It reaffirmed this decision in *Albrecht v. Herald Co.*,<sup>12</sup> but, as discussed below, the Court later reversed itself in *State Oil Co. v. Khan*.<sup>13</sup>

The Court also addressed nonprice vertical restraints. In *United States v. Arnold, Schwinn & Co.*,<sup>14</sup> the Court ruled that Schwinn’s practice of limiting the territory within which its wholesalers could resell Schwinn bicycles was a per se violation of Section 1 of the Sherman Act. The Court’s extension of per se treatment to nonprice vertical restrictions was short-lived; it overturned *Schwinn* ten years later in *Continental T.V., Inc. v. GTE Sylvania Inc.*, and held that such restraints should be judged under the rule of reason because *Schwinn* was based “upon formalistic line drawing” and there was no evidence “that vertical restrictions have or are likely to have a ‘pernicious effect on competition’ or that they ‘lack . . . any redeeming virtue.’”<sup>15</sup>

Eleven years after the Court decided *Continental T.V.*, in 1977, the Court returned to resale price restraints in *Business Electronics Corp. v. Sharp Electronics Corp.*<sup>16</sup> Sharp sold its electronic calculators to two dealers in the Houston area: Business Electronics, the petitioner, and Hartwell.

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<sup>7</sup> *Id.* at 404, 408 (citations omitted).

<sup>8</sup> 250 U.S. 300, 303 (1919).

<sup>9</sup> *Id.* at 306.

<sup>10</sup> *See, e.g.*, 7 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1445d (2d ed. 2003) (explaining that “[a]lthough it may be too late to reappraise *Colgate*, let us consider how it might be reconciled with the adoption of the implied acceptance or coercion theories of agreement” and taking 4 pages to do so); Hanno Kaiser, *May Dr. Miles Finally Rest in Peace?*, ANTITRUST REV., Sept. 9, 2006, <http://www.antitrustreview.com/archives/687>.

<sup>11</sup> 340 U.S. 211, 213 (1951), *overruled on other grounds*, *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984).

<sup>12</sup> 390 U.S. 145, 152 (1968).

<sup>13</sup> 522 U.S. 3 (1997).

<sup>14</sup> 388 U.S. 365, 375 (1967).

<sup>15</sup> 433 U.S. 36, 58–59 (1977) (citation omitted).

<sup>16</sup> 485 U.S. 717 (1988).

Sharp “published a list of suggested minimum retail prices, but its written dealership agreements with petitioner and Hartwell did not obligate either to observe them, or to charge any other specific price.”<sup>17</sup> After receiving numerous complaints from Hartwell about Business Electronics’s pricing of the electronic calculators below the suggested retail prices, Sharp terminated Business Electronics’ dealership. The Court, relying in large part upon *Continental T.V.*, held that the *per se* rule only applies to vertical restraints if there is an agreement on price or price levels, which was absent here.<sup>18</sup>

Continuing its (roughly) once-a-decade consideration of resale price maintenance issues, the Court returned to maximum resale price restraints. In *State Oil v. Khan*,<sup>19</sup> Khan, a gas station operator, purchased gasoline from State Oil. Under their agreement, Khan purchased gasoline “at a price equal to a suggested retail price set by State Oil, less a margin of 3.25 cents per gallon.”<sup>20</sup> Khan could charge any price for the gasoline it resold, but if the price was higher than the suggested retail price, the amount over the suggested retail price was rebated to State Oil. After a lengthy review of the Court’s resale price jurisprudence, the Court found it “difficult to maintain that vertically imposed maximum prices could harm consumers or competition to the extent necessary to justify their *per se* invalidation” and reversed *Kiefer-Stewart* and *Albrecht* by holding that maximum resale price maintenance should warrant rule of reason scrutiny instead of *per se* treatment.<sup>21</sup>

### **Will Dr. Miles Spell “Bad Medicine” for Leegin?**

Leegin Creative Leather Products, founded in 1966 in California, manufactured and sold products under its own brands and manufactured belts for other belt companies and for “private label retailers (belts sold under the retailer’s own label name) such as: Lands’ End, L.L. Bean, Eddie Bauer, [and] J. Crew.” In 1991, Leegin launched its Brighton brand of belts and later expanded this product line to include numerous other accessories. Today, Leegin sells its Brighton products in 50 Brighton stores and in approximately 6,000 specialty stores. No direct sales are made over the Internet or to department stores.<sup>22</sup> The plaintiff, PSKS, is a women’s clothing and accessories store doing business as Kay’s Closet in Flower Mound, Texas.

Leegin established a manufacturer’s suggested retail pricing policy called the “Brighton Retail Pricing and Promotion Policy” (Pricing Policy) in which Leegin stated it would refuse to sell to retailers who sold its Brighton products for less than the suggested price. Leegin subsequently introduced a “Heart Store Program,” which provided incentives to stores that (1) pledged to follow the Pricing Policy at all times, and (2) promoted Brighton products within a separate section of the store.<sup>23</sup>

In 2002, Leegin learned that PSKS had placed all of its Brighton products on sale, and immediately suspended shipments of Brighton products to PSKS. At trial, the jury found that Leegin and its retailers agreed to fix prices and that this resulted in antitrust injury to PSKS in the amount of

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<sup>17</sup> *Id.* at 721.

<sup>18</sup> *Id.* at 726–27.

<sup>19</sup> 522 U.S. 3 (1997).

<sup>20</sup> *Id.* at 8.

<sup>21</sup> *Id.* at 15.

<sup>22</sup> Brighton, “About Us,” <http://www.brighton.com/retail/history/index.htm>.

<sup>23</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 171 F. App’x 464, 465 (5th Cir.), *cert. granted*, 127 S. Ct. 763 (2006).

\$1.2 million (which was later trebled by the trial court). On appeal, Leegin did not directly challenge the jury's conclusion that it entered into price-fixing agreements; instead it challenged the per se rule itself.<sup>24</sup>

The Fifth Circuit rejected Leegin's argument that the Supreme Court had inconsistently applied the rule established by *Dr. Miles*. The Fifth Circuit found that the Court had consistently applied *Dr. Miles* because *Khan*, *Business Electronics*, and *Continental T.V.* all involved something other than "a vertical minimum price-fixing agreement." The Fifth Circuit also rejected Leegin's argument that the Pricing Policy "did not result in competitive harm" and therefore "qualifie[d] for an exception to the per se rule."<sup>25</sup> Leegin argued that *Broadcast Music, Inc. v. CBS, Inc.*, *Abadir & Co. v. First Mississippi Corp.*, and *United States v. Realty Multi-List, Inc.*,<sup>26</sup> established exceptions to the per se rule; the Fifth Circuit, however, stated that "none of these cases involved vertical minimum price fixing" and "[f]urthermore, each was decided before the Court reaffirmed the per se rule's application to vertical minimum price-fixing agreements" in *Business Electronics*, *Monsanto Co. v. Spray-Rite Service Corp.*,<sup>27</sup> and *Khan*.<sup>28</sup>

Leegin appealed to the Supreme Court, which granted a stay and then granted certiorari.

### Arguments For and Against Maintaining the *Dr. Miles* Rule

In its Supreme Court merits brief, Leegin argues that the per se rule against resale price maintenance "squarely conflicts with the modern economic understanding that resale price maintenance can have significant *procompetitive* effects," an understanding that "has been embraced by" the Court in its modern antitrust jurisprudence, which has rejected per se treatment of analogous vertical agreements because such treatment lacks an economic justification.<sup>29</sup>

<sup>24</sup> *Id.* at 466. Leegin also challenged the trial court's exclusion of its economic expert, PSKS's antitrust injury, and certain issues related to damages calculations. Of note, Leegin's economic expert would have testified that the per se rule should not be applied and that "Leegin's pricing practices were pro-competitive, justifying the rule of reason's application." *Id.* at 467. The Fifth Circuit upheld the trial court's decision because "[w]ith the per se rule, expert testimony regarding economic conditions and the pricing policy's pro-competitive effects is *not* relevant." *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Broadcast Music, Inc. v. CBS, Inc.*, 441 U.S. 1, 8–9 (1979) (finding blanket licenses issued by organization representing thousands of copyright holders to television and radio stations, pursuant to a consent decree with the Department of Justice, is not unlawful per se price fixing); *Abadir & Co. v. First Miss. Corp.*, 651 F.2d 422, 428–29 (5th Cir. 1981) (applying, pursuant to *Continental T.V.*, the rule of reason to a vertical market-dividing agreement); *United States v. Realty Multi-List, Inc.*, 629 F.2d 1351, 1362 (5th Cir. 1980) (holding that the membership criteria promulgated by a real estate multiple listing service which effectively allow the MLS to establish a group boycott of those real estate brokers who fail to qualify under the rules should be judged under the rule of reason).

<sup>27</sup> 465 U.S. 752 (1984). *Monsanto* concerned the evidence necessary to show that the manufacturer and other resellers were acting in concert. Of more significance to *Leegin*, in 1983 the Department of Justice, in an amicus brief filed with the Court in *Monsanto*, sought to advocate that the Supreme Court end the application of the per se rule to minimum resale pricing. The DOJ's position, however, met with disapproval from Congress, and a bipartisan alliance of 37 Senators banded together in an effort to force the DOJ to reverse its position. Those senators successfully cut off DOJ funding to advance that argument when they incorporated language into an appropriations bill that explicitly prevented the DOJ from expending any money to overturn or alter the existing prohibition against vertical price restraints. After President Reagan signed the bill, the Solicitor General, by letter, informed the clerk of the Supreme Court that the DOJ would not address the per se rule at oral argument. See generally, Lloyd Schwartz, *Justice Dept. Slapped for Antitrust Inaction*, 13 NEWS REC. (Los Angeles, Cal.), May 20, 1983, at 13; Lloyd Schwartz, *Action Time Arrives in Retail Pricing Row*, 13 NEWS REC. (Los Angeles, Cal.), Oct. 25, 1983, at 2; Robert Hershey Jr., *U.S. Will Limit Price Agreements*, N.Y. TIMES, Nov. 29, 1983, at D23.

<sup>28</sup> *Leegin*, 171 F. App'x at 467.

<sup>29</sup> Brief for Petitioner at 2, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 2007 WL 160780 (U.S. Jan. 22, 2007) (No. 06-480).

Leegin also asserts that *Dr. Miles* rested, in large part, upon the “outdated common-law prohibition” against restraints on alienation and the Court failed to consider any “economic analysis of resale price maintenance or judicial experience applying the rule of reason to such agreements.”<sup>30</sup> A concern with “restraints upon alienation” is no longer a valid justification for per se treatment in Leegin’s view. Additionally, later Supreme Court precedent, such as *Continental T.V.* and *Khan*, establishes that per se rules are only appropriate for conduct that is “manifestly anticompetitive,” such as “conduct that would always or almost always tend to restrict competition and decrease output.”<sup>31</sup>

Leegin also argues that modern economic analysis establishes that minimum resale pricing often has substantial procompetitive effects.<sup>32</sup> Such modern economic analysis has impelled the Court to overturn other, older decisions relating to per se treatment of vertical nonprice and vertical maximum resale price restraints. Similarly, minimum resale pricing results in procompetitive effects, such as creating incentives for retailers to provide service and promote the manufacturer’s products, eliminating retailer free riding, and inducing retailers to invest in capital and labor that is usually required for innovation to develop new products beneficial to the consumer. Because these effects promote interbrand competition, the per se rule is inappropriate. Moreover, although minimum resale prices could be used by a cartel to enforce a horizontal agreement, empirical studies show that such situations are very rare (and would still be condemned under the rule of reason).

Although PSKS has, at the time of this writing, yet to file its merits brief, PSKS argued in its certiorari opposition brief that the per se rule regarding minimum resale prices is well-established and that the exceptions to the rule—including the conduct allowed under *Colgate*, *Continental T.V.*, and *Business Electronics*—are broad enough to allow companies the freedom necessary to arrange their businesses “to achieve permissible economies.”<sup>33</sup> Additionally, PSKS will point out that Congress has, on several occasions, “endorsed” the per se treatment of minimum resale price maintenance.<sup>34</sup> Finally, recent economic “literature has produced impressive arguments that certain market structures and certain types of collaborative activity are much more likely to have anticompetitive consequences than the Chicago School antitrust writers imagined.”<sup>35</sup> Minimum resale price maintenance has, PSKS argues, anticompetitive effects, such as higher prices for consumers, decreased efficiencies available from price flexibility, and promotion of cartels.<sup>36</sup>

Numerous parties, including CITA-The Wireless Association, the National Association of Manufacturers, and a group of 25 economists filed amicus briefs supporting Leegin’s petition for certiorari.<sup>37</sup> CITA, Ping, Inc., the group of economists, and the Federal Trade Commission and the Department of Justice have recently filed amicus briefs on the merits supporting Leegin, and addi-

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<sup>30</sup> *Id.* at 6.

<sup>31</sup> *Id.* (quoting *Business Electronics*, 485 U.S. at 723).

<sup>32</sup> *Id.* at 13 (citing ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 76 (2006) (“[T]he ‘bulk of the economic literature on RPM . . . suggests that RPM is more likely to be used to enhance efficiency than for anticompetitive purposes.”)).

<sup>33</sup> Brief for Respondent in Opposition to Certiorari, 2006 WL 3244036, at \*10 (Nov. 6, 2006).

<sup>34</sup> *Id.* at \*11–\*15 (citing, inter alia, the Consumer Goods Pricing Act, 15 U.S.C. § 1).

<sup>35</sup> *Id.* at \*16 (quoting Herbert Hovencamp, *Post-Chicago Antitrust: A Review and Critique*, 2001 COLUM. BUS. L. REV. 257, 270 (2001)).

<sup>36</sup> PSKS will also have arguments regarding stare decisis and, more interestingly, that because Leegin sold “Brighton” products via its own “Brighton” stores, its minimum resale pricing was part of a horizontal cartel.

<sup>37</sup> These briefs, as well as the amicus briefs on the merits described *infra*, are available at <http://www.abanet.org/antitrust/at-committees/at-df/knowledge-database.shtml>.

*The Court's recent willingness to reconsider longstanding antitrust decisions in light of new economic and legal analysis, its large majorities in such cases, its reliance on contemporary economic analysis, and its acceptance of this case indicate that the Court—or at least four members of the Court—would like to revisit and likely reverse Dr. Miles.*

tional parties are also expected to file amicus briefs on the merits. Ping's brief describes its recently adopted vertical minimum resale advertising and pricing policy (its "iFIT Pricing Policy") and the "extraordinary lengths" it went through in order to achieve a minimum resale price that complies with *Colgate* and avoids *Dr. Miles's* per se rule. CITA's and the economists' briefs, by contrast, focuses mostly on the procompetitive aspects of minimum resale pricing and relevant economic literature.

The most significant amicus brief was filed jointly by the Federal Trade Commission and the Department of Justice. The United States argues that "[b]ecause the effects of RPM can be either anticompetitive or procompetitive depending on the facts in a given case, a per se rule is clearly inappropriate."<sup>38</sup> The United States also argues that the underlying rationale of *Dr. Miles* is outdated and contradicts modern economics, the Court's more recent antitrust jurisprudence undermines the reasoning in *Dr. Miles*, and that stare decisis considerations do not justify the continued application of *Dr. Miles's* per se rule.

After a spirited discussion, the ABA Section of Antitrust Law recommended that the American Bar Association file an amicus brief arguing that Section 1 "should not be interpreted to apply a rule of per se illegality to agreements between a buyer and seller setting the price at which the buyer may resell goods or services purchased from the seller."<sup>39</sup> Were the House of Delegates to approve the recommendation, the ABA would file an amicus brief as well. On a related note, the Antitrust Modernization Commission's relevant working group has suggested that the Commission not recommend legislative action to overrule *Dr. Miles* but to "defer to the common law process."<sup>40</sup>

### Has the *Dr. Miles* "Elixir" Reached Its Expiration Date?

Over the last several years, the Court has decided a number of antitrust cases, while reducing its overall caseload. The Court has revisited, revised, and reversed longstanding antitrust doctrines. The Court's recent willingness to reconsider longstanding antitrust decisions in light of new economic and legal analysis, its large majorities in such cases, its reliance on contemporary economic analysis,<sup>41</sup> and its acceptance of this case indicate that the Court—or at least four members of the Court—would like to revisit and likely reverse *Dr. Miles*.

Regardless of how the Court ultimately rules, the decision will likely have little practical effect. In the almost 100 years since *Dr. Miles* was decided, astute businesses have developed practices to avoid the *Dr. Miles* per se rule, yet achieve a de facto minimum resale price. For example, as in *Colgate*, the manufacturer can pre-announce to dealers a suggested resale price and let them know that it would stop selling to those who fail to sell at that price. Manufacturers can also use nonprice vertical restraints and can set a maximum resale price to avoid the per se rules.

<sup>38</sup> Brief for the United States as Amicus Curiae Supporting Petitioner, 2007 WL 173650, at \*3–\*4 (Jan. 22, 2007). The Federal Trade Commission vote approving the filing of the joint brief was 3–2, with Commissioners Pamela Jones Harbour and Jon Leibowitz voting no (FTC File No. P062103).

<sup>39</sup> The Section's report to the ABA House of Delegates is available at <http://www.abanet.org/antitrust/at-comments/2006/reports/ANTITRUST-RPM-REPORT-12-06.pdf>.

<sup>40</sup> Single-Firm Conduct Working Group Memorandum 15, Dec. 21, 2004, <http://www.amc.gov/pdf/meetings/Single-FirmConduct.pdf>. See generally Roxane C. Busey, *U.S. Antitrust Modernization: A Preview*, ANTITRUST SOURCE, Dec. 2006, at <http://www.abanet.org/antitrust/at-source/06/12/Dec06-Busey12=19f.pdf>.

<sup>41</sup> See, e.g., *Illinois Tool Works Inc. v. Indep. Ink*, 126 S. Ct. 1281 (2006) (overruling *Int'l Salt Co. v. United States*, 332 U.S. 392 (1947) (finding that because a patent does not automatically vest the patent owner with market power in all cases involving a tying arrangement, the plaintiff must prove that the defendant, the patent owner, has market power)).

Another common technique to avoid per se treatment under *Dr. Miles* is the use of minimum advertised pricing (MAP). The most common form of MAP occurs where a manufacturer provides marketing subsidies to a retailer, but only if the retailer advertises the product at or above the price set by the manufacturer. MAP, however, has its own limitations. For example, MAP programs cannot contain overly strict penalties or simply be “cover” for a price-fixing agreement.<sup>42</sup> Nevertheless, MAP programs are increasingly popular.

The dearth of minimum resale price cases in the last 25 years and the minimal efforts to overturn *Dr. Miles* legislatively suggest that manufacturers have been able to use alternatives to minimum resale price agreements and have not felt the need to challenge *Dr. Miles* directly.<sup>43</sup> As a result of the numerous “antidotes” that manufacturers already have, a reversal of *Dr. Miles* will have limited impact on the marketplace (although it would allow sellers to more efficiently establish a minimum resale price).

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## Conclusion

We can only speculate as to the Court's motives for granting certiorari in *Leegin*, but extrinsic factors, including marketplace effect and contemporary trends in antitrust jurisprudence, point to the formal demise of *Dr. Miles*. There is no circuit split on this issue. The U.S. government was not a party in the underlying litigation, nor did it recommend certiorari (but, as stated previously, is an amicus supporting reversal of *Dr. Miles*). As discussed above, businesses have been able to work around *Dr. Miles* and establish de facto minimum resale pricing. All of these factors, along with Chief Justice Roberts's stated deference to stare decisis and judicial restraint during his confirmation hearings and during his time on the bench, lead to the reasonable conclusion that the Court would not grant certiorari in *Leegin* except to reverse *Dr. Miles*. ●

<sup>42</sup> There are almost no cases involving MAP programs from the last decade. The notable exception was the FTC's investigation and later consent order with distributors of music CDs. The FTC's informative “Analysis to Aid Public Comment” from that case is available at <http://www.ftc.gov/os/2000/05/mapanalysis.htm>.

<sup>43</sup> See, e.g., Robert Pitofsky, *Past, Present, and Future of Antitrust Enforcement at the Federal Trade Commission*, 72 U. CHI. L. REV. 209, 224 (2005) (noting that the FTC had no minimum resale price challenges during the Reagan or George W. Bush administrations and only “a few challenges in extreme circumstances” in the George H.W. Bush administration); *Hearing on the Allocation of Antitrust Enforcement Between the States and the Federal Government, Statement of Harry First Before the Antitrust Modernization Commission*, at 22 (2005) (chart showing that state Attorneys General filed only 7 resale price maintenance cases between 1995 and 2004), [http://www.amc.gov/commission\\_hearings/pdf/Statement-First.pdf](http://www.amc.gov/commission_hearings/pdf/Statement-First.pdf).

# Revisiting *Dr. Miles*: Reinstating a Modern Rule of Reason for Vertical Minimum Resale Price Agreements

**Barbara O. Bruckmann**

In 1911, the U.S. Supreme Court in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*<sup>1</sup> held that a manufacturer's setting the minimum prices at which independent resellers may resell its products was unlawful under the common law and Section 1 of the Sherman Act.<sup>2</sup> That result spawned the current per se rule—that all such agreements are illegal under the Sherman Act without regard to their purpose or effect.<sup>3</sup> In late 2006, the Supreme Court agreed to revisit that blanket prohibition in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*<sup>4</sup> This article contends that, for the reasons set out below, the per se rule against vertical minimum resale price agreements (RPM) has outlived the underpinnings of *Dr. Miles*, is not separately justified under current antitrust principles, and thus should be abandoned and replaced with the rule of reason.

## Looking Back at *Dr. Miles*

A review of the facts and circumstances of *Dr. Miles* provides useful background in assessing the validity of the per se rule as applied to RPM. *Dr. Miles Medical Company* manufactured medicines which it sold to retail druggists through a network of over 400 jobbers and drug wholesalers operating under wholesale consignment agreements. The consignment agreements set the prices at which the wholesaler-consignees sold to retail druggists and prohibited the consignee from selling to anyone but designated retailers and other authorized wholesalers. *Dr. Miles* also entered into parallel agency agreements with literally thousands of retail druggists, which prohibited them from selling to consumers below prices printed on product packages. *Dr. Miles* claimed that its distribution system was intended to address deep discounting by department stores that had led consumers to view *Dr. Miles*' medicines as inferior and a majority of retail druggists to drop (or ignore) the line as unprofitable.<sup>5</sup>

*Dr. Miles* subsequently sued John D. Parks & Co., a drug wholesaler that had refused to enter into a consignment agreement but procured *Dr. Miles*' medicines from others in *Dr. Miles*' distribution chain. *Dr. Miles* alleged that Parks fraudulently obtained *Dr. Miles*' medicines from its consignees and agents "solely for the purpose of selling the remedies to dealers 'to be advertised,

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<sup>1</sup> 220 U.S. 373 (1911).

<sup>2</sup> *Id.* at 406–09.

<sup>3</sup> *See, e.g.,* *Euromodas, Inc. v. Zanella, Ltd.*, 368 F.3d 11, 16–21 (1st Cir. 2004) (stating minimum RPM illegal, but not proved); *Pace Elecs., Inc. v. Canon Computer Sys., Inc.*, 213 F.3d 118, 121–24 (3d Cir. 2000) (minimum RPM illegal; terminated dealer adequately alleged antitrust injury).

<sup>4</sup> 127 S. Ct. 763 (2006), *granting cert. to* *PSKS, Inc. v. Leegin Creative Leather Prods., Inc.*, 2006-1 Trade Cas. (CCH) ¶ 75,166 (5th Cir.) (not for publication) (finding vertical price fixing when manufacturer required retailers to follow suggested resale prices at all times in order to become "Brighton Heart Store").

<sup>5</sup> 220 U.S. at 375 (Statement of the Case).

sold, and marketed at cut rates,' and 'to thus attract and secure custom and patronage for other merchandise, and not for the purpose of making or receiving a direct money profit' from the sales of the remedies."<sup>6</sup> Dr. Miles sought, among other things, to stop Parks from inducing an alleged breach of trust by its consignees and agents and from selling its medicines at prices below those set by it. The court dismissed the complaint on demurrer, which was upheld by the Court of Appeals for the Sixth Circuit.

On appeal to the U.S. Supreme Court, the Court rejected Dr. Miles' inducement claim and concluded that distributor sales to Parks were not consigned for the benefit of Dr. Miles, and retail druggists were not, in form or substance, agents of Dr. Miles.<sup>7</sup> The Court then focused on the validity of the price restrictions.<sup>8</sup>

The Court's analysis of the resale price agreements began with a wrong-headed reference to the "general restraint upon alienation"—a principle now roundly rejected in all quarters<sup>9</sup>—and then framed the issue as one of reasonableness:

The question is, whether, under the particular circumstances of the case and the nature of the particular contract involved in it, the contract is, or is not, unreasonable. . . .

The public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade of themselves, if there is nothing more, are contrary to public policy, and therefore void. That is the general rule. But there are exceptions: restraints of trade . . . may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable—reasonable, that is, in reference to the interests of the parties concerned, and reasonable in reference to the interests of the public, so framed and so guarded as to afford adequate protection to the party in whose favor it is imposed, while at the same time it is in no way injurious to the public.<sup>10</sup>

But, the reasonableness analysis of the price-restrictive agreements was cut short by their failure to fit within a then-narrow set of practices amenable to such review, namely, those ancillary to a license or transfer of a business.

The present case is not analogous to that of a sale of good will, or of an interest in a business, or of the grant of a right to use a process of manufacture. . . . The agreements are designed to maintain prices after the complainant has parted with the title to the articles, and to prevent competition among those who trade in them.<sup>11</sup>

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<sup>6</sup> *Id.* at 381–82. *Dr. Miles* also contended that Parks had obliterated tracking numbers on product packages, "rendering the list of ailments and directions for use illegible," and sold those products to consumers in that condition. *Id.* at 382.

<sup>7</sup> *Id.* at 397–99.

<sup>8</sup> *Id.* at 394–95 (Opinion of the Court).

<sup>9</sup> The Court in *Dr. Miles* described the "right of alienation" as:

one of the essential incidents of a right of general property in movables, and restraints upon alienation have been generally regarded as obnoxious to public policy, which is best subserved by great freedom of traffic in such things as pass from hand to hand. General restraint in the alienation of articles, things, chattels, except when a very special kind of property is involved such as . . . an heirloom, have been generally held void.

*Id.* at 404 (citation omitted). This "principle" has been sharply criticized, and reliance on the rule described as a "misreading of legal history and a perversion of antitrust analysis." *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 53 n.21 (1977).

<sup>10</sup> *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 406–07 (1911) (citation omitted).

<sup>11</sup> *Id.* at 407.

The Court then proceeded to hold on the pleadings that “the advantage of established retail prices primarily concerns the dealers,” and collapsed the distinction between vertical agreements and dealer cartels, condemning Dr. Miles’ “plan [as one that] falls within the principle which condemns” horizontal dealer agreements.<sup>12</sup>

[Dr Miles] can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other. . . . But agreements . . . between dealers, having for their sole purpose the destruction of competition and the fixing of prices, are injurious to the public interest and void.<sup>13</sup>

The Court rejected as irrelevant whether the products at issue were produced by several manufacturers or by one, and held simply that Dr. Miles “having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic.”<sup>14</sup>

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### The Underpinnings of *Dr. Miles* Are Fatally Flawed

Antitrust law has come a long way since 1911, with the aging analysis of *Dr. Miles* now squarely at odds with current antitrust norms. As discussed below, the grounds for a per se rule against RPM as set out in *Dr. Miles* have been since separately rejected, leaving the current per se treatment of RPM unexplained and without foundation

#### **Dr. Miles’ per se rule against RPM was not derived under the demanding standards for per se treatment.**

Since *Northern Pacific Railway Co. v. United States*,<sup>15</sup> application of the per se rule has been limited to “agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.”<sup>16</sup> Measured against those “demanding standards,” the Supreme Court in *Continental T.V., Inc. v. GTE Sylvania Inc.*<sup>17</sup> rejected per se treatment of vertical nonprice restraints because “there ha[d] been no showing . . . either generally or with respect to Sylvania’s agreements, that vertical restrictions have or are likely to have a ‘pernicious effect on competition’ or that they ‘lack . . . any redeeming virtue.’”<sup>18</sup> Per se treatment is “appropriate only for ‘conduct that is manifestly anti-competitive,’ that is, conduct ‘that would always or almost always tend to restrict competition and decrease output.’”<sup>19</sup>

Decided almost a half-century before *Northern Pacific*, the Court in *Dr. Miles* did not require, nor was it confronted with, evidence from which it could reasonably conclude that vertical minimum resale price agreements were manifestly anticompetitive in virtually all circumstances. And, as observed by the dissent in *Dr. Miles*, the Court, even on a policy level, was moving into unchart-

<sup>12</sup> *Id.* at 407–08.

<sup>13</sup> *Id.* at 408.

<sup>14</sup> *Id.* at 409.

<sup>15</sup> 356 U.S. 1 (1958).

<sup>16</sup> *Id.* at 5.

<sup>17</sup> 433 U.S. 36 (1977).

<sup>18</sup> *Id.* at 58.

<sup>19</sup> *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 723 (1988) (citations omitted).

ed waters: “there is no statute covering the case; there is no body of precedent that by ineluctable logic requires the conclusion to which the court has come. The conclusion is reached by extending a certain conception of public policy to a new sphere.”<sup>20</sup>

In fact, not only did the per se rule for RPM arise under a now-discredited and narrow common law standard, it was based on price agreements which Justice Holmes, writing in dissent, thought unlikely to have any demonstrable economic effect:

I think that we greatly exaggerate the value and importance to the public of competition in the production or distribution of an article (here it is only distribution) as fixing a fair price. What really fixes that is the competition of conflicting desires. We, none of us, can have as much as we want of all the things that we want. Therefore, we have to choose. As soon as the price of something that we want goes above the point at which we are willing to give up other things to have that, we cease to buy it and buy something else. Of course, I am speaking of things that we cannot get along without. There may be necessaries that sooner or later must be dealt with like short rations in a shipwreck, but they are not Dr. Miles's medicines.<sup>21</sup>

***Per se condemnation cannot rest on a perceived need to protect intrabrand competition.*** *Dr. Miles* did not distinguish between interbrand and intrabrand competition, deemed irrelevant the presence of other producers of medicines to whom retail druggists could switch, and condemned as against public policy *any* restriction on price competition among resellers of Dr. Miles' medicines.

The preservation of intrabrand price competition, without more, is not an aim of modern antitrust law. Today, it is axiomatic that the “primary purpose of the antitrust laws is to protect interbrand competition.”<sup>22</sup> Generally, “when interbrand competition exists [as it does in most cases], it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product.”<sup>23</sup> Moreover, in situations in which interbrand competition may be weak or nonexistent, the rule of reason has proven an effective tool to assess intrabrand effects and to identify restraints that allegedly harm consumers.<sup>24</sup>

***Per se condemnation cannot rest on an assumption that a vertical practice never benefits the upstream supplier or may have horizontal effects.*** In *Dr. Miles*, the Court saw no distinction between a series of identical agreements between Dr. Miles and its individual resellers, and a dealer price-fixing cartel, claimed the only benefit from a “plan of identical contracts” went to the dealers, and held the distribution system illegal because “[i]t, in effect, creates a combination for the prohibited purposes.”<sup>25</sup>

The Supreme Court has long since rejected that approach:

There may be occasional problems in differentiating vertical restrictions from horizontal restrictions originating in agreements among the retailers. There is no doubt that restrictions in the latter category would be illegal per se, but we do not regard the problems of proof as sufficiently great to justify a per se rule [for the former].<sup>26</sup>

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<sup>20</sup> *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 411 (1911) (Holmes, J., dissenting).

<sup>21</sup> *Id.* at 412.

<sup>22</sup> *State Oil Co. v. Khan*, 522 U.S. 3, 15 (1997).

<sup>23</sup> *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 52 n.19 (1977).

<sup>24</sup> *Graphic Prods. Distribs., Inc. v. Itek Corp.*, 717 F.2d 1560 (11th Cir. 1983).

<sup>25</sup> 220 U.S. at 408.

<sup>26</sup> *Continental T.V.*, 433 U.S. at 58 n.28 (citations omitted).

Clarifying what is now plain, the Supreme Court subsequently added: “a restraint is horizontal not because it has horizontal effects, but because it is the product of a horizontal agreement.”<sup>27</sup>

There is no distinction more fundamental to modern Sherman Act Section 1 analysis than the distinction between vertical and horizontal agreements, which in turn determines the standard under which the conduct is evaluated. Antitrust courts have not shirked from that distinction, and regularly distinguish between vertical distribution agreements and alleged dealer conspiracies on the facts presented.<sup>28</sup> As noted by leading commentators, “[t]o the extent that *Dr. Miles* rests on the false categorical propositions that resale price maintenance never benefits manufacturers and always has the same effects as an illegal dealer cartel, its ruling is ripe for a reexamination the Supreme Court has never given it.”<sup>29</sup>

### ***Dr. Miles* Stands Alone Against a Trend**

The per se rule against vertical price restraints has become a shadow of itself. With the recognition that “[t]he market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition,”<sup>30</sup> per se treatment of vertical price restraints has been, correspondingly, narrowed. Unlike the ban against horizontal price fixing where “price” includes virtually any aspect of price, “price” in the context of vertical price agreements means, more narrowly, “price or price level”<sup>31</sup> and is limited to agreements on minimum resale prices.

The Supreme Court in *State Oil Co. v. Khan*<sup>32</sup> overturned application of the per se rule to vertical agreements on maximum resale prices. The potential harm of such agreements was thought to include three situations. Specifically, such agreements might: (1) depress reseller margins such that resellers could no longer offer services desired by consumers; (2) result in channeling distribution through a few large resellers, thereby excluding less efficient resellers; or (3) disguise a minimum resale price scheme.<sup>33</sup> The *Khan* Court viewed the first as unlikely, the second as not necessarily an antitrust concern, and the third as amenable to review under the rule of reason.<sup>34</sup> The fact that a reseller’s margin target may preclude selling at less than the maximum price has been held not to convert a price cap to a per se unlawful price floor.<sup>35</sup>

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<sup>27</sup> *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 730 n.4 (1988).

<sup>28</sup> *See, e.g., Generac Corp. v. Caterpillar Inc.*, 172 F.3d 971, 977 (7th Cir. 1999) (rejecting characterization as horizontal market allocation, court held “this particular agreement was a vertical one in which Generac played the role of ‘supplier’ and Caterpillar both upstream supplier of the trademark, and downstream purchaser of the finished goods”); *Toledo Mack Sales & Service, Inc. v. Mack Trucks, Inc.*, 2005 U.S. Dist. LEXIS 11052, at \*5–\*13 (E.D. Pa. Mar. 29, 2005) (sufficient evidence to infer that Mack Trucks’ reasons for its policies were pretextual and that it, instead, allegedly conspired with its dealers to limit price competition).

<sup>29</sup> PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* § 1620d, at 217 (2d ed. 2004).

<sup>30</sup> *Continental T.V.*, 433 U.S. at 51–52.

<sup>31</sup> *Business Elecs.*, 485 U.S. at 735–36; *see also* *Great Clips, Inc. v. Levine*, 1993-2 Trade Cas. (CCH) ¶ 70,390, at 71,037–38 (D. Minn. 1993) (franchisor price restrictions requiring franchisees to post even-dollar prices, charge a single even-dollar price for haircuts and limit discounting to 21 days of every 3 months not minimum RPM where franchisees could adopt any even-dollar price and offer any discount during the 21-day period and promotional coupons at any time).

<sup>32</sup> 522 U.S. 3 (1997).

<sup>33</sup> *Id.* at 12; *see also* *Caribe BMW, Inc. v. Bayerische Motoren Werke Aktiengesellschaft*, 19 F.3d 745, 753 (1st Cir. 1994).

<sup>34</sup> 522 U.S. at 17–18.

<sup>35</sup> *Khan v. State Oil Co.*, 143 F.3d 362, 364 (7th Cir. 1998) (on remand).

Agreements on minimum advertised prices (MAP), once thought to be per se illegal, are now subject to a rule of reason.<sup>36</sup> MAP programs often condition receipt of a supplier's cooperative advertising or other promotional funds on the reseller's adherence to suggested minimum advertised prices in certain designated media. The flexibility that has arisen in connection with price-restrictive cooperative advertising programs now generally extends to programs that limit price advertising without regard to the source of promotional funding, so-called bald advertising programs. Such restrictions have generally been assessed under the rule of reason, provided the distinction between resale and advertised prices is maintained.<sup>37</sup>

The relaxation of per se rules for maximum resale price agreements and price-restrictive advertising programs has been coupled with a recognition that such price restraints do not invariably harm competition and may result in procompetitive benefits.<sup>38</sup> As discussed below, the same observations apply to RPM.

Furthermore, suppliers today can engage in a broad range of unilateral activities that directly affect the resale prices of their products but do not raise the specter of RPM. For example, a supplier may unilaterally announce suggested minimum resale prices, and refuse to deal with any reseller that does not comply.<sup>39</sup> The fact that resellers independently choose to adhere to the policy to avoid termination is, without more, insufficient to establish "agreement" on resale prices,<sup>40</sup> notwithstanding the practical effect of maintaining resale prices at levels determined by the supplier. Likewise, a supplier's mere pre-ticketing products with suggested resale prices,<sup>41</sup> independent adjustments (up or down) to wholesale prices in the ordinary course to meet market con-

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<sup>36</sup> See, e.g., *Lake Hill Motors, Inc. v. Jim Bennett Yacht Sales, Inc.*, 246 F.3d 752, 754, 757 (5th Cir. 2001) (cooperative advertising program that limited reimbursement to ads containing suggested retail prices or no price subject to rule of reason); *In re Nissan Antitrust Litig.*, 577 F.2d 910, 915–17 (5th Cir. 1978) (cooperative advertising program that limited reimbursement to ads containing suggested retail prices or no price and required dealer contributions not per se unlawful, but noting evidence that dealers sold cars at whatever price they chose and were free to advertise at any price at their own expense); *Campbell v. Austin Air Sys., Ltd.*, 2005-2 Trade Cas. (CCH) ¶ 75,023, at 103,410 n.6 (W.D.N.Y. 2005) (finding Internet MAP policy limited to advertised prices not antitrust violation); *Blind Doctor Inc. v. Hunter Douglas, Inc.*, 59 Fed. R. Serv. 3d 635, 645 (N.D. Cal. 2004) (restraints limited to advertised price not per se unlawful); *In re Compact Disc Minimum Advertised Price Antitrust Litig.*, 216 F.R.D. 197, 212 (D. Me. 2003) (“[P]laintiffs have no direct precedent for their argument that the case can proceed on a theory of per se illegality . . . [B]y their terms the MAP policies at best were agreements on what prices could be advertised, not what prices could be charged.”).

<sup>37</sup> *Blind Doctor*, 59 Fed. Rules Serv. 3d at 643, 637–38, 645–46 (advertising policy restricting certain price advertising subject to rule of reason); *Cranfill v. Scott & Fetzer Co.*, 773 F. Supp. 943, 950–53 (E.D. Tex. 1991) (absent agreement on resale prices, blanket restrictions on dealer's price advertising of Kirby vacuums evaluated under rule of reason). *But cf.* *Illinois Corporate Travel, Inc. v. Am. Airlines, Inc.*, 889 F.2d 751, 752 (7th Cir. 1989) (dicta) (describing supplier's ban on price advertising as “form of” RPM).

<sup>38</sup> See *Khan*, 522 U.S. at 15 (“difficult to maintain that vertically imposed maximum prices could harm consumers or competition to the extent necessary to justify their per se invalidation”); Federal Trade Comm'n, Statement of Policy Regarding Price Restrictions in Cooperative Advertising Programs—Rescission, 6 Trade Reg. Rep. (CCH) ¶ 39,057 (May 21, 1987):

Cooperative advertising programs that restrict reimbursement for the advertising of discounts . . . do not establish the existence of an agreement on price between a supplier and a dealer and do not necessarily affect the resale prices of dealers. Like other vertical restraints that are subject to a rule of reason analysis, such cooperative advertising programs may provide competitive benefits, or they may be competitively neutral. . . . [T]he legality of such cooperative advertising programs should be assessed in each case [under the rule of reason].

<sup>39</sup> *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 761 (1984).

<sup>40</sup> *Id.*

<sup>41</sup> *Klein v. Am. Luggage Works, Inc.*, 323 F.2d 787 (3d Cir. 1963).

ditions,<sup>42</sup> setting wholesale prices based on estimated resale prices<sup>43</sup> or as a percentage of resale prices with wholesale minimums,<sup>44</sup> or using mystery shoppers to monitor resale prices<sup>45</sup> have been held not to amount to RPM. Nor is it RPM for a supplier to strive to maintain reseller margins by setting certain wholesale and suggested resale prices, so long as resellers remain free to price below suggested prices.<sup>46</sup>

This trend in the lower courts—to narrow the scope of the per se rule as applied to vertical price restraints and to treat an increasing range of price-related activity by suppliers as not directed to setting “resale” prices—heightens the need to reexamine *Dr. Miles* and the justification for retaining the per se rule for vertical minimum “resale” “price” “agreements” as construed today.

### RPM Should Be Assessed Under a Rule of Reason

*This trend in the lower courts—to narrow the scope of the per se rule as applied to vertical price restraints and to treat an increasing range of price-related activity by suppliers as not directed to setting “resale” prices—heightens the need to reexamine Dr. Miles . . .*

Continuation of per se treatment of RPM has caused the business community, practitioners, and courts to focus sharply on whether an “agreement” on “price” may be found—often on ambiguous facts perceived differently by the supplier and a disgruntled reseller. For example, a supplier may freely advocate its suggested resale prices and price positioning strategies, but its antitrust risks can substantially increase if it engages in vigorous discussion and is misperceived by the tenor of its communications as “soliciting” an “agreement.”<sup>47</sup> The line between advocacy and solicitation in the press of business is thin indeed, and the value protected by insisting on such a line (which catapults permissible conduct into the realm of per se unlawful price fixing) is hard to discern when the supplier’s underlying interest in downstream prices is legitimate.<sup>48</sup>

Much ink has been spilt over the extent to which RPM could result in distributional efficiencies and/or benefits to consumers. But the shadow of *Dr. Miles* has precluded robust analysis of such benefits on particular facts. In *Leegin*, for example, now before the Supreme Court, the district court refused to permit the defendant to introduce evidence demonstrating the alleged benefits

<sup>42</sup> *Butera v. Sun Oil Co.*, 496 F.2d 434, 437–38 (1st Cir. 1974); *see also Khan v. State Oil Co.*, 143 F.3d 362, 364 (7th Cir. 1998) (on remand) (“A supplier is free to charge any price he wants to his retailers. The fact that the higher that price is, the higher the retailer’s price will have to be unless he is willing to sell below his cost has never been thought to be price-fixing”). *But see Newberry v. Washington Post Co.*, 438 F. Supp. 470, 482 (D.D.C. 1977) (retaliatory wholesale price increase made with intent and effect of preventing reseller from departing from prices announced by supplier, or depriving him of any profit if he did depart, held coercive).

<sup>43</sup> *See Kingray, Inc. v. National Basketball Ass’n, Inc.*, 188 F. Supp. 2d 1177, 1191 (S.D. Cal. 2002) (formula for wholesale price based on estimated resale price held not to restrict freedom of reseller to set subscription prices).

<sup>44</sup> *See General Cinema Corp. v. Buena Vista Distrib. Co.*, 681 F.2d 594, 596–98 (9th Cir. 1982) (movie theaters required to pay distributor either certain percentage of each ticket sold, or same percentage of minimum ticket price whichever was greater; held not coercive where no effect on actual price charged); *Martindell v. News Group Publ’ns, Inc.*, 580 F. Supp. 330, 331–33 (E.D.N.Y. 1984) (newspaper charged carriers 77 cents to extent newspaper price did not exceed \$1.25 plus 60% of price in excess of \$1.25; held not coercive).

<sup>45</sup> *See Chavez v. Whirlpool Corp.*, 113 Cal. Rptr. 175, 182–83 (Cal. Ct. App. 2001) (under Cartwright Act). *But cf. Acquire v. Canada Dry Bottling Co. of New York*, 24 F.3d 401, 412 (2d Cir. 1994) (not reviewing magistrate’s finding of coercive “price surveillance”).

<sup>46</sup> *See Khan*, 143 F.3d at 363–64; *Butera*, 496 F.2d at 437–38.

<sup>47</sup> *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 764 n.9 (1984) (agreement means not only that reseller conformed to suggested price but that reseller “communicated its acquiescence or agreement, and that this was sought by the manufacturer”).

<sup>48</sup> *See, e.g., id.* at 762 (“A manufacturer and its distributors have legitimate reasons to exchange information about the prices and the reception of their products in the market.”); *Jack Walters & Sons Corp. v. Morton Bldg., Inc.*, 737 F.2d 698, 707 (7th Cir. 1984) (manufacturer has “vital interest” in retail prices); *In re Nissan Antitrust Litig.*, 577 F.2d 910, 917 (5th Cir. 1978) (manufacturer “vitaly interested in the continued prestige, acceptability, and marketability of [its] product”); *Great Clips, Inc. v. Levine*, 1993-2 Trade Cas. (CCH) ¶ 70,390, at 71,038 (D. Minn. 1993) (“legitimate [price-related] restrictions are the price franchisees pay for the benefits of the franchise. It is important to remember that the franchisor has legitimate and important interests in how the franchise is run, marketability of further franchises not the least among them.”).

of its pricing policies.<sup>49</sup> In counseling clients over the years, facts suggest that proposed minimum price strategies—albeit not undertaken—are frequently driven by legitimate considerations, such as price positioning commensurate with product quality, innovation or brand value, a need to maintain adequate distribution, or a need to ensure adequate reseller margins to stimulate promotional activity, pre- or post-sale services, or facility investment. Economists and scholars increasingly have recognized plausible explanations for RPM that may enhance distribution efficiencies and increase interbrand competition.<sup>50</sup> Retrospectives of RPM cases have generally disavowed the use of RPM as a facilitating practice in connection with supplier or dealer cartels (originally thought to justify per se treatment of RPM), and, instead, suggested that RPM could serve legitimate objectives.<sup>51</sup> It is worth noting that the Court in *Dr. Miles* ignored the alleged purpose of Dr. Miles’ challenged price restraints, namely, to combat loss leadering and increase the profitability of its products in order to retain adequate distribution—objectives since viewed as pro-competitive by the FTC in the context of vertical advertised-price restraints.<sup>52</sup>

**The argument in favor**

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Further, and more fundamentally, the extent to which RPM invariably causes consumer harm is far from clear. Even the dissent in *Dr. Miles* made that point. More recently, the Seventh Circuit in *Isaksen v. Vermont Castings, Inc.*<sup>53</sup> expressed the same skepticism:

[W]e would have difficulty understanding how a 10 percent factor in a tiny market could restrain competition . . . merely by placing a floor under its dealers’ prices (“resale price maintenance”). If the floor were set higher than necessary to induce dealers to provide the point-of-sale services that would maximize the sales of Vermont Castings’ stoves, Vermont Castings not only would be transferring wealth from itself to its dealers (and why would it want to do that?) but would be pricing its stoves out of the market; consumers would switch to competing products whose retail prices were not inflated by resale price maintenance.<sup>54</sup>

The recognition of plausible benefits and uncertain consumer harm cautions strongly against application of a per se standard for RPM—a standard unwarranted “where the economic impact of [the practice] is not immediately obvious.”<sup>55</sup>

The argument in favor of rule of reason treatment is not that RPM causes no harm under any circumstance; it is, simply, that it should not be treated as unlawful under all circumstances. With no marker pointing to the inevitability of anticompetitive effects, it is time to bring RPM under the umbrella of the rule of reason. The *Khan* Court recognized, albeit indirectly, that the rule of reason could effectively address RPM masquerading as maximum resale price schemes, and the Court in *Texaco Inc. v. Dagher*<sup>56</sup> arguably foreshadowed a coherent rule for maximum and mini-

<sup>49</sup> PSKS, Inc. v. Leegin Creative Leather Prods., Inc., 2006-1 Trade Cas. (CCH) ¶ 75,166 at 104,323-24 (5th Cir. 2006).

<sup>50</sup> See, e.g., ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 58-76 (2006); AREEDA & HOVENKAMP, *supra* note 29, § 1631; Howard P. Marvel, *The Resale Price Maintenance Controversy: Beyond Conventional Wisdom*, 63 ANTITRUST L.J. 59 (1994).

<sup>51</sup> See, e.g., Pauline M. Ippolito & Thomas R. Overstreet, Jr., *Resale Price Maintenance: An Economic Assessment of the Federal Trade Commission’s Case Against the Corning Glass Works*, 39 J.L. & ECON. 285 (1996); Pauline M. Ippolito, *Resale Price Maintenance: Empirical Evidence from Litigation*, 34 J.L. & ECON. 263 (1991).

<sup>52</sup> *In re Interco, Inc.*, Trade Reg. Rep. [Transfer Binder FTC Complaints and Orders 1993 to 1997] ¶ 23,791, at 23,540-42 (FTC March 27, 1995).

<sup>53</sup> 825 F.2d 1158 (7th Cir. 1987).

<sup>54</sup> *Id.* at 1161 (citation omitted).

<sup>55</sup> *Khan*, 522 U.S. at 10 (quoting *FTC v. Ind. Fed’n of Dentists*, 476 U.S. 447, 458-59 (1986)).

<sup>56</sup> 126 S. Ct. 1276 (2006).

mum resale price strategies by characterizing its holding in *Khan* as “concluding that vertical price-fixing arrangements are subject to the rule of reason.”<sup>57</sup>

RPM is not the stuff of conduct that “so often prove[s] so harmful to competition and so rarely prove[s] justified that the antitrust laws” should condemn it as per se illegal.<sup>58</sup> The failure of *Dr. Miles* to withstand antitrust law developments, emergence of economic theory that credits plausible procompetitive explanations for RPM, and the lack of coherence between per se treatment of RPM and the courts’ acceptance of (or rule of reason treatment of) a broad spectrum of other vertical price-related conduct warrant reversal in *Leegin* and restoration of a modern rule of reason for RPM. ●

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<sup>57</sup> *Id.* at 1279.

<sup>58</sup> *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 133 (1998).

## Dr. Miles—A Rock of Ages

### Matthew Moloshok

In 1911, the Supreme Court decided the case of *Dr. Miles Medical Co. v. John D. Park & Sons Co.*<sup>1</sup> By an 8–1 vote, it ruled that minimum resale price maintenance arrangements between a supplier and its dealers constituted a per se violation of Section 1 of the Sherman Act. Over the intervening 96 years, the Supreme Court showed no interest in revisiting this fundamental doctrine. Until now. In 2006, the Supreme Court, having recently added two new appointees, granted review in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*<sup>2</sup> The sole argument advanced for review was that *Dr. Miles* no longer conforms to the Supreme Court's more recent antitrust rulings and modern economic theory. The Court's acceptance of the case signals the willingness of at least four justices to consider that argument.

I, for one, hope that the Court will preserve *Dr. Miles*.<sup>3</sup> The per se prohibition against minimum resale price maintenance declared by *Dr. Miles* was and remains a proper and settled interpretation of the Sherman Act that should not be abandoned.

### Dr. Miles and Its Reasoning

The Supreme Court that decided *Dr. Miles* fully understood the purposes and proposed benefits of resale price maintenance. The Court was presented with essentially the very same arguments that Leegin and its supporters offer today in favor of allowing retail price maintenance. As summarized by the Court, *Dr. Miles*, a manufacturer of proprietary medicines, found druggists “cut prices,” and this caused “much confusion, trouble, and damage” to the complainant's business, and “injuriously affected the reputation” and “depleted the sales” of its remedies; that this injury resulted “from the fact that the majority of retail druggists as a rule cannot, or believe that they cannot realize sufficient profits” by the sale of the medicines “at the cut-prices announced by the cut-rate and department stores,” and therefore are “unwilling to, and do not keep” the medicines “in stock” or “if kept in stock, do not urge or favor sales thereof, but endeavor to foist off some similar remedy or substitute, and from the fact that in the public mind an article advertised or announced at ‘cut’ or ‘reduced’ price from the established price suffers loss of reputation and becomes of inferior value and demand.”<sup>4</sup>

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<sup>1</sup> 220 U.S. 373 (1911).

<sup>2</sup> 127 S. Ct. 763 (2006).

<sup>3</sup> I do not stand alone in this view. See, e.g., Robert Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1487, 1488–89, (1983) (“[M]inimum vertical price agreements lead to higher, and usually uniform, resale prices. . . . [E]conomically-based challenges . . . tend to ignore or downplay the practical considerations that have led courts to protect the ability of distributors to price in response to what they (as opposed to manufacturers) see as market conditions.”); see also Jean Wegman Burns, *Vertical Restraints, Efficiency and the Real World*, 62 FORDHAM L. REV. 597 (1993) (arguing that courts are out of step with public and Congressional expectations in applying economic efficiency theory to the exclusion of all other considerations).

<sup>4</sup> *Dr. Miles*, 220 U.S. at 375.

The Court fully understood that Dr. Miles wanted the restraints in order to improve its position relative to other manufacturers. Its holding reflected its concern with protecting the dealers which, having bought the Dr. Miles's products for resale, ultimately bore the risk of interbrand rivalry. Nor did the Court blindly take the view that all "restraints" were unlawful. This was, after all, a Court of an era that was strident in its defense of "freedom of contract."<sup>5</sup> Then as now, the Court sought to limit the Sherman Act's prohibition to "unreasonable" restraints. The Court took its understanding of what was "unreasonable" from the general historical perspective that "restraints upon alienation . . . [are] obnoxious to public policy, which is best subserved by great freedom of traffic in such things as pass from hand to hand."<sup>6</sup> Restraints merely "designed to maintain prices, after the complainant has parted with the title to the articles, and to prevent competition among those who trade in them" did not comport with that policy.<sup>7</sup>

To the argument that the restraints benefited the restraining manufacturer and the public by inducing dealers to put more effort into selling that manufacturer's wares, the Supreme Court responded:

[T]he advantage of established retail prices primarily concerns the dealers. The enlarged profits which would result from adherence to the established rates would go to them and not to the complainant. . . . [C]omplainant can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other.<sup>8</sup>

That is, in both motivation and effect, this was the equivalent of a dealer conspiracy. The Court's ultimate conclusion was that "[t]he complainant having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic."<sup>9</sup>

### The Path of *Dr. Miles* and the RPM Rule over the 20th Century

The Supreme Court decided *Dr. Miles* within the same generation as the Sherman Act's 1890 enactment. Shortly after the decision, Congress considered sweeping additions and changes to federal antitrust law, adopting both the Clayton Act and the Federal Trade Commission Act in 1914. Congress did not make any changes to the rule of *Dr. Miles* then and has never done so

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<sup>5</sup> *Lochner v. New York*, 198 U.S. 45 (1905).

<sup>6</sup> *Dr. Miles*, 220 U.S. at 404.

<sup>7</sup> *Id.* at 407.

<sup>8</sup> *Id.* at 407–08.

<sup>9</sup> *Id.* at 409.

<sup>10</sup> From 1937–1975, federal legislation authorized individual states, if so advised, to enact "Fair Trade" statutes. This enabled manufacturers to bypass the RPM prohibition. See Miller-Tydings Fair Trade Act, (Title VII at 50 Stat. 693) 75 P.L. 314, amended by 89 Stat. 801, Pub. L. No. 94-145 (Dec. 12, 1975); Amendment in Sec. 2 at 89 Stat. 801; McGuire Bill, 66 Stat. 631, 15 USCS §§ 45. Approximately 21 states adopted such laws. In 1975, however, Congress repealed those laws and effectively banned all "Fair Trade" statutes. Congress was fully aware it was "remitting RPM to the *Dr. Miles* regime." Brief for the United States as Amicus Curiae Supporting Petitioner at 21–22, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, No. 06-480 (U.S. Jan. 22, 2007) (describing House and Senate Reports on the Consumer Goods Pricing Act of 1975, Pub. L. No. 94-145, 89 Stat. 801, amending 15 U.S.C. §§ 1 and 45(a) (1970)).

<sup>11</sup> For example, Congress reacted to the Reagan administration's brief, amicus curiae, in *Monsanto* urging reversal of *Dr. Miles* by prohibiting the Department of Justice from using its appropriations for that purpose. (Other than during the current and Reagan administrations, I am unaware of other efforts by the Federal Trade Commission or Department of Justice to upset the per se prohibition of minimum price fixing.)

since.<sup>10</sup> Congress has consistently resisted efforts to cut back the federal per se prohibition of resale price maintenance (RPM) announced in *Dr. Miles*.<sup>11</sup>

For its part, the Supreme Court repeatedly adhered to *Dr. Miles* over the ensuing decades.<sup>12</sup> When the Supreme Court decided *Sylvania*<sup>13</sup> and directed application of the rule of reason to nonprice vertical restraints such as territorial exclusivity that arguably have similar price effects as RPM, it expressly affirmed that it was not departing from *Dr. Miles*: “The per se illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy.”<sup>14</sup> After *Sylvania*, the Supreme Court continued to apply the per se rule against RPM consistently and declined invitations to revisit the settled rule of *Dr. Miles*.<sup>15</sup>

### Enter Leegin

*Congress has*

*consistently resisted*

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*the federal per se*

*prohibition of resale*

*price maintenance*

*(RPM) announced in*

*Dr. Miles.*

There is nothing strikingly different or new about Leegin’s situation or its scheme. Leegin had terminated a complaining retailer for discounting its products. At trial, Leegin argued that its “suggested” retail pricing policies helped it compete against larger competitors; that the policies encouraged the boutiques to offer higher levels of service; and that it felt offering the products “on sale” somehow degraded the brand and made customers who paid full price at other times feel “cheated.” Leegin’s expert, economist Kenneth Elzinga, provided a report as to the procompetitive benefits of Leegin’s business model. The trial judge excluded that evidence as “irrelevant” because if Leegin had engaged in vertical price fixing, it was per se unlawful under *Dr. Miles*. The jury returned a verdict in favor of Leegin’s complaining retailer, finding that Leegin had engaged in price fixing with its retailers, and awarding \$1.2 million in damages (then trebled by the trial court). The Fifth Circuit affirmed, noting that *Dr. Miles* controlled.

Leegin then filed its certiorari petition. The petition drew instantaneous support from the National Association of Manufacturers, the American Petroleum Institute, CTIA-The Wireless Association, and a group of 25 distinguished economists, all urging abandonment of the per se rule. The complaining retailer filed the only brief opposing the grant of certiorari. The Supreme Court granted review December 7, 2006.<sup>16</sup>

<sup>12</sup> See, e.g., *FTC v. Beech-Nut Packing Co.*, 257 U.S. 441, 451–52 (1922); *United States v. Bausch & Lomb Optical Co.*, 321 U.S. 707, 721 (1944).

<sup>13</sup> *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977).

<sup>14</sup> *Id.* at 51 n.18. The Supreme Court noted Congress’s then-recent repeal of the fair trade law exception as “approval of a per se analysis of vertical price restrictions.” *Id.*

<sup>15</sup> See, e.g., *Cal. Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 102 (1980); *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 761 n.7 (1984) (declining to revisit *Dr. Miles* where the case had been tried based on a per se instruction and the challenge to *Dr. Miles* was advanced by the United States, amicus curiae, rather than the parties); *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717 (1988).

<sup>16</sup> On January 22, 2007, Leegin and its amici filed their merits briefs. The United States joined the case, when the Solicitor General filed a brief joined in by the Department of Justice Antitrust Division and the Federal Trade Commission, supporting petitioner’s request for reversal and the overturning of the per se rule. Briefs for respondent and its amici were not due at the time of writing.

Professors William S. Comanor and Frederic M. Scherer also filed an amicus brief on the merits “in support of neither party.” This is noteworthy because, on the one hand, Professor Scherer had been one of the certiorari-stage economist amici urging reversal of the per se rule, while, on the other, Professor Comanor had authored a leading article supporting the per se rule. In that article, Professor Comanor cited the many “circumstances in which manufacturers’ interests conflict with those of consumers,” noted the difficulty of differentiating vertical restraints which enhance rather than diminish efficiency, and concluded it is “more expeditious to set general policy standards, even though they will sometimes lead to improper results.” William S. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions and the New Antitrust Policy*, 98 HARV. L. REV. 983, 1001 (1985).

### Why Abolish the Per Se Rule for RPM?

For a long-standing principle, the rule in *Dr. Miles* has had many detractors. Many economists lambaste the per se treatment of RPM as bad economic policy, believing that vertical restraints generally can improve interbrand competition, thereby decreasing prices and increasing output.<sup>17</sup> Some law professors offer the same economics-based criticism.<sup>18</sup> In particular, they find fault with *Dr. Miles* because it failed to recognize that in some circumstances manufacturers could independently desire to impose RPM, so that it should not have been equated in all instances with a dealer conspiracy. The publisher of this journal, the ABA Section of Antitrust Law, has recently adopted a resolution requesting that *Dr. Miles* be overruled because RPM “like other vertical resale restraints, can stimulate interbrand competition and is not so inevitably pernicious as to warrant per se illegality.”<sup>19</sup>

*By prohibiting the practice per se, Dr. Miles established a rule which is relatively easy to understand, cost-effective to enforce, and causes little demonstrable harm to anyone.*

Perhaps the tide towards overturning the RPM rule has risen too high to be stopped. But, although RPM may not be invariably anticompetitive and may even be procompetitive in some instances, that ultimately does not provide an adequate basis to set aside *Dr. Miles*. Given the long-standing precedent of *Dr. Miles*, the burden ought to be on those urging reversal of history to show there is some inherent evil in per se condemnation of RPM that justifies abandonment of the rule. They do not satisfy that burden.

### *Dr. Miles* Is a Good Doctrine that We Should Preserve

The rule against RPM has served our economy well. In contrast, as discussed below, the circumstances in which economists posit manufacturers would desire RPM, or that RPM could be procompetitive, seem rather esoteric or can be addressed, and have been addressed for nearly a century, through other, nonprice means, making the benefits of allowing RPM rather trivial. For although RPM may not invariably be anticompetitive, it can be anticompetitive.<sup>20</sup> By prohibiting the practice per se, *Dr. Miles* established a rule which is relatively easy to understand, cost-effective to enforce, and causes little demonstrable harm to anyone. The per se rule thus works a positive good. Two maxims come to mind that explain why. The first maxim is that “an ounce of prevention is worth a pound of cure.” Having the per se rule prevents the bad conduct—even if it could cause occasional, trivial, or theoretical impediments to optimal competition. In contrast, abandoning the rule would lead to long-recognized adverse effects on competition without any cost-effective means for correction.

The second is a variant on the maxim that “war is too important to leave to the generals.” Antitrust law, as a set of positive values, can be informed by economists and economics, but in

<sup>17</sup> James C. Cooper, Luke M. Froeb, Dan O’Brien & Michael G. Vita, Vertical Antitrust Policy as a Problem of Inference (Feb. 18, 2005), available at <http://www.ftc.gov/speeches/froeb/050218verticalecon.pdf>.

<sup>18</sup> See, e.g., ROBERT H. BORK, THE ANTITRUST PARADOX 289 (1978); Roger D. Blair, Jill Boylston Herndon & John E. Lopatka, *Resale Price Maintenance and the Private Antitrust Plaintiff*, 83 WASH. U. L. Q. 657, 659–60 (2005) (“The economic effects of RPM, however, are not ‘plainly anticompetitive.’ Indeed, economic theory establishes that RPM can be procompetitive, and empirical evidence indicates that it usually is. What, then, to make of *Dr. Miles*? . . . [T]he Court misapprehended the effect of RPM on consumers, reasoning that consumers must be injured when a practice prevents a retailer from lowering a price.”).

<sup>19</sup> Joseph Angland, ABA Section of Antitrust Law, Report to the ABA House of Delegates—Recommendation (2006), available at <http://www.abanet.org/antitrust/at-comments/2006/reports/ANTITRUST-RPM-REPORT-12-06.pdf>.

<sup>20</sup> See, e.g., Peter C. Carstensen, *The Competitive Dynamics of Distribution Restraints: The Efficiency Hypothesis Versus the Rent-Seeking, Strategic Alternatives*, 69 ANTITRUST L.J. 569 (2001) (most vertical restraints serve to organize, facilitate, or implement anticompetitive and rent-seeking conduct rather than performing benign functions). See also *infra* the discussion in text accompanying note 31.

its inception, its operation, and its public acceptance, it includes, and has to include, values other than economics alone. That is to say, we must remain true to the intention of the enactors of the Sherman Act, 100 years of history, and the reasonable reliance and public expectations that those have engendered.

### Allowing RPM Will Likely Have Little Positive Benefit

If we want to maintain public confidence in antitrust law, it must not only actually promote consumer welfare, it must meet public expectations of what the antitrust laws are designed to achieve. There is no amount of judicial explanation that will convince a consumer that it should be lawful to terminate a dealer for saving that consumer money by selling them a designer handbag at a discount or otherwise permit consumers to receive the best prices they can obtain. What benefits do the proponents of the abolition of the per se rule offer as a trade-off for giving up that tangible benefit?

*There is no amount of judicial explanation that will convince a consumer that it should be lawful to terminate a dealer for saving that consumer money by selling . . . at a discount . . .*

**RPM does not enhance output.** Some economists argue that per se condemnation of RPM is wrong because there can be circumstances in which it would be procompetitive for a manufacturer to impose RPM restrictions on its dealers. It is hard to test those claims in action because vertical price fixing remains per se unlawful. The economic studies praising the benefits of vertical restraints in action mostly extrapolate from experience with nonprice vertical restraints.<sup>21</sup> But even the theoretical underpinnings for allowing RPM show it offers little meaningful promise for positive benefits. As Lester Telser's pioneering article hypothesized,<sup>22</sup> RPM can be used legitimately under limited conditions to induce certain suppliers to increase output to attract so-called "marginal" customers. But the conditions under which the parties will even agree to a price-maintenance scheme only exist where (a) the supplier already enjoys market power (otherwise dealers would not forgo the ability to set their own prices); or (b) the supplier lacks market power and looks to induce dealers to take up its products (in which case the dealer does not need to make a commitment to maintain particular prices unless the dealer's goal is to assure itself that competing dealers will collectively keep up their prices—a spoke and wheels kind of conspiracy among the dealers, run through the supplier).<sup>23</sup> Many, perhaps most, economists seem to share the view that "[t]he assertion that output-expanding resale price maintenance [RPM] enhances consumer welfare . . . should be recognized as a special case *not applicable under plausible conditions*."<sup>24</sup>

<sup>21</sup> ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 74 (2006). Cf. Francine Lafontaine & Margaret Slade, Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy (2005), available at <http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/slade/wp/ecsept2005.pdf> (noting the very small number of empirical studies of effects of various types of vertical restraints, and identifying only two examining RPM; studies are suggestive that "although the law usually discriminates between price and non-price restraints, treating the former more harshly," efficiency is likely enhanced by both price and non-price vertical restraints; and "while we find the evidence compelling, it is clearly not sufficient." ). While many economists line up with Lafontaine and Slade on this issue, others conclude that the history of Fair Trade laws and other vertical price restrictions tends to indicate strongly that allowing RPM would cause significant price increases. See *infra* notes 31–33 and accompanying text.

<sup>22</sup> Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & Econ. 86 (1960).

<sup>23</sup> Carstensen, *supra* note 20, at 576 n.28 and accompanying text (citing Ward Bowman, *The Prerequisites and Effects of Resale Price Maintenance*, 22 U. CHI. L. REV. 825 (1955)).

<sup>24</sup> Brief for William S. Comanor and Frederic M. Scherer as Amici Curiae Supporting Neither Party 2, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, No. 06-480 (U.S. Jan. 22, 2007) (emphasis added) [hereinafter Comanor-Scherer Amicus Brief].

*The disadvantages of RPM are immediate and clear: dealers give up their ability to discount the goods subject to the restraint.*

**RPM does not lead to better service.** Perhaps the most popular argument for RPM is that it will induce dealers to provide additional services that the manufacturer and consumers want and prevent “free riding.” Again, this argument seems to be based on multiple unrealistic assumptions. First, it assumes that consumers want or require a high level of service. That may be true for new or complex products, but many products with which consumers are already familiar, including those most frequently sought to be subjected to vertical price fixing, do not require those high levels of service. T-shirts, CDs, DVDs, and books come to mind, and I would warrant that belts and handbags are no different. Where higher levels of service are desirable, dealers who provide the higher level of service will be rewarded by higher prices they set themselves; they can even in many instances charge separately for the services. Suppliers can reward the higher level of service by providing promotional assistance, discounts for services, and the like. (Paying dealers to provide the desired services also assures that if competitors do “ride” on their services, the service-providing dealer was compensated.) In all events, suppliers do not need to constrain all dealers to cookie-cutter pricing.

The second assumption is that by requiring higher prices, the manufacturer assures a particular level of service will be provided. Not so: a dealer may simply pocket the extra money, without providing the services at all. Or the dealer may be so inefficient that it eats through the additional margin without actually accomplishing the desired service level.<sup>25</sup> Since monitoring then becomes required to assure that the desired, higher services are provided,<sup>26</sup> it makes more sense to impose nonprice restraints that directly require provision of the services.<sup>27</sup>

Against these theoretical advantages of RPM, the disadvantages of RPM are immediate and clear: dealers give up their ability to discount the goods subject to the restraint. That penalizes consumers by preventing truly efficient dealers from sharing their efficiency with the consumer through lower prices on those goods.

**RPM does not promote interbrand competition.** Those in favor of RPM say there is no need to worry that prices will go up on the brand subject to the restraint—interbrand competition will keep prices down in the long run. That argument does not work in practice. If dealers can maintain high margins because they enjoy (individually or collectively) market power, then interbrand competition among suppliers will not discipline those high margins.<sup>28</sup> In markets in which there are a small number of suppliers, a “thicket” of RPM arrangements by those suppliers could lead to at least tacit price fixing among the suppliers. Even in the absence of universal adoption of RPM policies by manufacturers, multi-line dealers must raise their prices on the competing brands too, so they

<sup>25</sup> *Eiberger v. Sony Corp. of America*, 622 F.2d 1068 (2d Cir. 1980), provides a classic example: a manufacturer required a “profit pass over” if a dealer sold outside its area of responsibility to compensate dealers presumed to be providing the follow-on warranty services; the problem was the arrangement was basically a sham as the charge bore no relation to actual services performed by the recipient distributor. (In consequence, the Second Circuit invalidated the arrangement under the Rule of Reason.) By extrapolation, targeting a particular gross margin neither assures that dealers will provide a particular class or level of services, nor provides the best incentive to do so.

<sup>26</sup> See Blair et al., *supra* note 18, at 669 n.226.

<sup>27</sup> A plethora of other economic analyses have been offered to try to sustain the legitimacy of RPM, including the “certification” that high-service dealerships (say a celebrity department store) implicitly confer on goods they choose, which then enables off-price dealers to profit from that certification. However, if the cost of the goods is very high to begin with, and require substantial services to induce consumers to buy the goods, they are not a good candidate for cut-rate selling. Conversely, if the mark-up for the services is excessively high because the seller cannot provide the service efficiently, there is no reason to protect those inefficiently high margins.

<sup>28</sup> Cf. *Toys “R” Us, Inc. v. FTC*, 221 F.3d 928 (7th Cir. 2000) (powerful retailer organized manufacturers into a boycott of lower priced warehouse stores).

can avoid undercutting their RPM price. To avoid the risk that parties not subject to the RPM restriction will undercut the prices, dealers may be tempted to cartelize or prevent competing dealers from getting product at all.<sup>29</sup>

***RPM does not encourage efficiency at the supplier or retailer level.*** It is often argued that suppliers that cannot fix prices vertically may be forced to vertically integrate, which would be less efficient and harmful to smaller suppliers. The problem with this line of argument is that *Dr. Miles* has been with us for nearly 100 years and yet there is scant evidence that discounting at the retail or wholesale level has produced any such effect. Where intermediate dealers purchase the product, the “purchaser”—and the consumer’s supplier—is not the ultimate consumer but the dealer. It is the dealer, not the manufacturer, who takes the risk of unsold products. Manufacturers do not accept counterpart restraints on their own pricing discretion.<sup>30</sup> Dealers also create not only service output but product output in important ways (such as creating house brands). The dealers are fully justified in requiring pricing and service discretion.

### **RPM Would Harm—Not Benefit—the Economy**

In those circumstances where Fair Trade laws or other pricing restraints have been lawfully imposed, studies indicate “vertical pricing restraints cost consumers over \$1 billion each year and raise prices by as much as fifty percent.”<sup>31</sup> When it repealed the Fair Trade laws, Congress found that Fair Trade restrictions increased the prices of the affected articles by 18–20 percent, and that business failures were 55 percent higher in the Fair Trade states.<sup>32</sup> With repeal of Fair Trade, “retail pharmacy margins fell from an average of 40 percent to approximately 20 percent—a saving to consumers and health care insurers of some \$40 billion at 2003 sales volumes.”<sup>33</sup> These experiences demonstrate that the potential for interbrand competition will not, in fact, discipline the higher prices that RPM would cause.

The triviality of any benefit from RPM is further confirmed by the fact that the vast majority of manufacturers did not make use of Fair Trade laws because they did not find them advantageous.<sup>34</sup> There is little reason to believe they would ultimately find RPM schemes advantageous, either. In the meantime, however, consumers will suffer, and dealers who want to discount will suffer, too. Thus, the actual economic consequences of RPM are typically higher prices and less output, while the touted economic benefits of RPM are either trivial or can better be accomplished through nonprice restraints.

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<sup>29</sup> LAWRENCE A. SULLIVAN, *HANDBOOK OF THE LAW OF ANTITRUST* 385–87 (1st ed. 1977).

<sup>30</sup> In several reported cases over the past ten years, distributors have sued their suppliers with varying success for setting prices of required supplies so high they knew the distributors could no longer operate profitably, asserting the supplier’s actions violated an implied covenant of good faith and fair dealing.

<sup>31</sup> Burns, *supra* note 3, at 632–35 (gathering studies and reports by Consumer Federation of America, Consumers Union, and AARP reaching these conclusions).

<sup>32</sup> S.REP. NO. 94-466 (1975), *excerpts reprinted in* 2 U.S.C.C.A.N. 1569, 1571–72. (citing, *inter alia*, studies by the Department of Justice noted in the 1969 Economic Report of the President).

<sup>33</sup> Comanor-Scherer Amicus Brief, *supra* note 24, at 8.

<sup>34</sup> Reportedly fewer than 1 percent of manufacturers elected to designate their products for Fair Trade because (1) they raised prices, hurting sales; and (2) costs of policing and administering the RPM program were too high. John A. Humbach, Comment, *Fair Trade: The Ideal and the Reality*, 27 OHIO ST. L.J. 144, 150–51 (1966).

### Other Values Trump the Trivial Economic Benefits of RPM

Even if the case for allowing RPM were stronger, the Court should still preserve the per se rule.

**Conforming to legislative intent.** The per se rule against resale price maintenance corresponds to the expectations of the sponsors of the Sherman Act. Historians generally concur that Congress did not adopt a particular view of economic theory in passing the Sherman Act, but did intend to protect historic “freedoms” of dealers,<sup>35</sup> including their power to price as they chose.

**Preserving stability.** If any rule in American antitrust law has become ‘settled law’ it is *Dr. Miles’s* per se rule, which has been there almost from the dawn of the statute.<sup>36</sup> The fact that Congress has not legislatively affirmed the rule of *Dr. Miles* is easily explained by its impression that the Supreme Court had settled the issue and was not going to change it.<sup>37</sup> Individual members of Congress have already expressed concern about the Supreme Court’s acceptance of certiorari in *Leegin*.<sup>38</sup> This may be a situation where, as “in most matters it is more important that the applicable rule of law be settled than that it be settled right.”<sup>39</sup>

*A regime where RPM is tested under the rule of reason . . . is going to lead to one of several outcomes, all bad.*

**Ease of administration.** *Dr. Miles’s* rule against minimum RPM provided something sorely lacking in many other branches of antitrust law—a predictable, easily administered, cost-effective, positive rule. That has benefits to all concerned. If we end up in a regime where RPM is tested under the rule of reason, it is going to lead to one of several outcomes, all bad. Dealers and consumers will be unable to challenge the restraint because they cannot afford to pay the prohibitive costs of hiring experts to conduct studies and assemble the necessary (and murky) economic data. Or, to handle the costs, the issues will be presented on behalf of classes of dealers and consumers, with consequent disproportionate fees to lawyers and burdens on the defendants. Or, perhaps, rather than allow themselves and litigants to be dragged into those morasses, judges will simply throw out all cases without analyzing the competitive consequences of the restraint at

<sup>35</sup> See Thomas W. Hazlett, *The Legislative History of the Sherman Act Re-Examined*, 30 ECON. INQUIRY 2, 263 (1992) (legislators sought multiple social ends rather than imposition of economic efficiency only); see also HANS B. THORELLI, *THE FEDERAL ANTITRUST POLICY: ORIGINATION OF AN AMERICAN TRADITION* 225–32, 570–72 (1954). (Thorelli asserts, however, that RPM had not been condemned at common law prior to 1890. *Id.* at 49.)

<sup>36</sup> Justice William Brennan noted more than 20 years ago: “That decision has stood for 73 years, and Congress has certainly been aware of its existence throughout that time. Yet Congress has never enacted legislation to overrule the interpretation of the Sherman Act adopted in that case. Under these circumstances, I see no reason for us to depart from our longstanding interpretation of the Act.” *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 769 (1984).

<sup>37</sup> Various bills have passed one house or another of Congress directed at overturning prior rulings like *Monsanto* and *Business Electronics v. Sharp*, which were perceived as weakening the availability of enforcement of the per se rule, albeit the Senate and House of Representatives were unable to reach consensus on a final law. See, e.g., Freedom from Vertical Price Fixing Act, passed by the House in 1987, H.R. 585, 100th Cong., 1st Sess., 133 CONG. REC. H9796 (daily ed. Nov. 9, 1987); a somewhat different bill styled “Retail Competition Improvement Act of 1987” was approved by the Senate Judiciary Committee earlier that year, S. 430, 100th Cong., 1st Sess., 133 CONG. REC. S1484 (daily ed. Feb. 2, 1987). The House and Senate approved competing versions of a Consumer Protection Against Price Fixing Act of 1991, but the Act was tabled on failure of the House to agree to the Conference Report. See CONFERENCE REPORT H.R. REP. NO. 102-605, ON S. 429, H.R. 1470; CONG. REC. (June 30, 1992 H.5657) (reporting House Roll No. 251). The tipping point may well be revocation of the per se rule.

<sup>38</sup> In a letter to the FTC and DOJ, Rep. John Conyers, Jr. (D-MI), Chair of the House Judiciary Committee, asked the agencies, among other things, “Given Congress’ active involvement in the RPM issue—on the last two occasions (in 1975 and in 1983) in unequivocal support of the *Dr. Miles* line of cases—would you agree that the Supreme Court should defer to Congress on this issue?” Letter from Rep. John Conyers, Jr. to the DOJ and FTC (Jan. 10, 2007), available at <http://judiciary.house.gov/media/pdfs/110-leegin.pdf>. (The United States’s brief seems to answer that question.) In the same letter, reportedly, Congressman Conyers referenced a briefing paper prepared by Professor Warren Grimes, which concluded that RPM “threatens the broad cross-section of multi-brand retailers,” and among all vertical restraints “is the most threatening to innovative and efficient retailing and to the consumer interest in shopping for the lowest price.”

<sup>39</sup> *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting).

all. This is not an idle fear: some commentators believe that courts abused the shift to a “rule of reason” with respect to nonprice vertical restraints by dismissing such cases without appropriate evaluation of competitive impacts.<sup>40</sup> We thus create an environment in which there would no longer be an effective “cure” for the anticompetitive impacts that we no longer provide the best tool to prevent. That would be bad for businesses generally and bad for consumers in particular.

**Keeping the public engaged.** Antitrust law will only retain the public’s trust if it delivers results that not only benefit the public but also meet the public’s expectations. If courts, after nearly 100 years, turn around and tell consumers they are better off being denied the opportunity to buy goods from discount merchants, they may understandably mistrust antitrust doctrine generally and perhaps the courts charged with protecting the public interest.<sup>41</sup>

We also need to ensure that the antitrust laws are meaningfully enforceable for dealers and consumers. If the process becomes so expensive and intractable that antitrust law is accessible and enforceable only by the government or class action attorneys it will also lose public connection and support. *Dr. Miles* achieves those necessary connections. To most people, the prevention of price fixing, whether by cartels or by RPM, is the essence of antitrust law.<sup>42</sup> We alienate the public and deny their long-standing and reasonable expectations at our peril.

If the arguments for the reversal of the per se rule were that compelling, one would assume that consumer groups would push it, and Congress would latch onto it. The proponents have every opportunity to make that case to Congress and the public: *Leegin* comes to the High Court just as the congressionally established Antitrust Modernization Commission studies what changes to antitrust policies, if any, to recommend to Congress. If there is to be a change to the RPM rule, then, it should come through that legislative process.

## Conclusion

There is no compelling reason to change *Dr. Miles*’s long-settled rule. The per se prohibition against minimum resale price maintenance has a long pedigree for a good reason—it is a respectable policy choice that Congress and the public have relied on for nearly a century and it is preferable to the alternatives. If a change is to be considered at this point, it should come from the legislative branch. The Supreme Court gave us a good doctrine in 1911. Please leave well enough alone. ●

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<sup>40</sup> Douglas H. Ginsburg, *The Effect of GTE Sylvania on Antitrust Jurisprudence: Vertical Restraints: De Facto Legality Under the Rule of Reason*, 60 ANTITRUST L.J. 67 (1991). Of course, if courts will not actually analyze the real effects of vertical restraints, it is useless to try to articulate how RPM should be evaluated. Nor would it be easy to draw up an appropriate and workable alternative to the per se rule.

<sup>41</sup> Perhaps it will raise eyebrows that within a year after the appointment of two new Justices (who both testified in their confirmation hearings of their fidelity to the principle of stare decisis), and within a month of a change in the political control of Congress, the Supreme Court elected to revisit this venerable case.

<sup>42</sup> See generally Burns, *supra* note 3.

# A Perspective on the Net Neutrality Debate

**Patrick S. Thompson**

A decade has passed since Congress enacted the Telecommunications Act of 1996. It was hoped that the Act would usher in a wave of competition and technological developments that would bring consumers lower prices and a broader array of options to meet their communications needs. Few of the hundreds of competitive carriers that entered local telephone markets have survived, but traditional cable television providers have emerged as formidable competition for the former Baby Bells. The emergence of cable in the telecommunications space has accompanied the rise of the Internet. To meet consumers' insatiable appetite for faster, more reliable access to the applications and services available on the Internet, cable companies and traditional local exchange carriers have invested billions of dollars updating network facilities.

As broadband access becomes commoditized (where customers have "free" access via municipal WiFi, hotspots, or other technologies), the prices commanded by broadband access providers should continue to fall. To retain existing customers, and attract new ones, broadband access providers have moved from just selling bandwidth to offering additional services, recognizing that they "will increase revenue and profit by selling applications bundled with a basic connection."<sup>1</sup> Offering additional services and applications, such as VoIP and video, in addition to traditional broadband access greatly increases the value of a communication provider's services.

Having made substantial capital investments in their networks, however, broadband access providers are looking for ways to recover their investment, and see charging content providers for access as an option. Content providers (such as Google and Yahoo!) fear that broadband providers may degrade service or block access to Web sites and applications offered by non-preferred content providers that refuse to pay. These concerns have led content providers to march on Washington seeking "net neutrality" regulation. Net neutrality is shorthand for allowing consumers access to the Web sites and applications offered by content providers of their choice, without the risk that content will be blocked or that consumers will be unable to access "non-preferred" content at the same speeds as "preferred" content.

While the push for net neutrality has received substantial attention in telecommunications circles and in Congress, antitrust enforcement officials have not been quick to advocate regulation. Many commentators believe existing state and federal laws afford sufficient protections from unlawful price discrimination, monopolization, or concerted action among broadband providers. The technological convergence that has prompted the call for net neutrality, the concerns expressed by content providers, and the cautious approach taken by the Federal Trade Commission and the Antitrust Division of the Department of Justice in evaluating whether current conditions justify net neutrality regulation are analyzed below.

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<sup>1</sup> Tim Wu, *The Broadband Debate, A User's Guide*, 3 J. ON TELECOMM. & HIGH TECH. L. 69, 76-77 (2004).

## New Era of Telecommunications Convergence

In 1996, “[t]he vision of the [Act] was that the traditional model of regulated monopoly was obsolete and that public policy should switch strategies to accommodate the advent of competitive networks.”<sup>2</sup> Although the primary goal of the Act was to spur capital investment in new competitive, facilities-based alternatives to incumbent local exchange carriers (ILECs), policy makers recognized that the development of competitive markets “populated by numerous competitive facilities-based carriers” would take time and require substantial capital investment.<sup>3</sup> To bridge the gap, Congress directed the Federal Communications Commission to adopt regulations that would encourage competitive local exchange carriers to enter the market quickly. Under the regime adopted by Congress, “[e]ntrants could piggy-back on incumbents’ connections, reselling service” or using component parts of the existing network, also known as unbundled network elements.<sup>4</sup>

The antitrust bar responded to these legislative developments with litigation premised on theories of refusal to deal and denial of essential facilities in an effort to force the legacy regional Bell operating companies to unbundle their networks to allow competitive carriers, known as CLECs, to use existing network architecture to provide consumers competitive alternatives.

The battles for network unbundling were waged in the courts and in extensive proceedings before state and federal regulatory agencies.<sup>5</sup> The regulatory battles were brought to a standstill by the dismantling of the network unbundling rules by the federal courts.<sup>6</sup> And the prospect of recourse based on antitrust theories was eliminated by the U.S. Supreme Court’s decision in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, which held that an ILEC’s unwillingness to make available its network facilities to a competitive reseller does not constitute an unlawful refusal to deal or a denial of access to essential facilities under federal antitrust law.<sup>7</sup>

While the ILECs and CLECs were waging regulatory and legal battles centered around access to the existing public switched telephone network, cable companies invested billions to upgrade their lines to enable them to offer customers integrated voice and data services in addition to their traditional entertainment offerings.<sup>8</sup>

The Act’s supporters cite the emergence of cable as evidence of vibrant competition, but critics contend that “the ‘cozy duopolies’ that have been created have not brought benefits to large segments of the consumer market on price or innovation.”<sup>9</sup> Duopoly might offer marginal benefits when compared to the traditional regulated monopoly model, but consumers can only realize sub-

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<sup>2</sup> Thomas W. Hazlett, *Rivalrous Telecommunications Networks With and Without Mandatory Sharing*, 58 FED. COMM. L.J. 477, 483 (2006).

<sup>3</sup> Johannes M. Bauer & Steven S. Wildman, *Looking Backwards and Looking Forwards in Contemplating the Next Rewrite of the Communications Act*, 58 FED. COMM. L.J. 415, 424 (2006).

<sup>4</sup> *Id.*

<sup>5</sup> See, e.g., *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366 (1999); *GTE Service Corp. v. FCC*, 205 F.3d 416 (D.C. Cir. 2000); *MCI Telecomm. Corp. v. U.S. West Commc’ns*, 204 F.3d 1262 (9th Cir. 2000); *Verizon Commc’ns Inc. v. FCC*, 535 U.S. 467 (2002); *In the Matter of Unbundled Access to Network Elements*, 20 F.C.C.R. 2533 (2005).

<sup>6</sup> *U.S. Telecom Ass’n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004); see generally Hazlett, *supra* note 2.

<sup>7</sup> 540 U.S. 398 (2004).

<sup>8</sup> Ronald Grover, *A Boost from Two Cable Giants*, Bus. Wk., July 27, 2004, available at [http://www.businessweek.com/bwdaily/dnflash/jul2004/nf20040727\\_6866\\_db035.htm?chan=search](http://www.businessweek.com/bwdaily/dnflash/jul2004/nf20040727_6866_db035.htm?chan=search).

<sup>9</sup> Gene Kimmelman, *The Failure of Competition Under the 1996 Telecommunications Act*, 58 FED. COMM. L.J. 511, 512 (2006).

stantial benefits from “greater innovation, declining prices, and improved service quality” through more robust competition with more players in the marketplace.<sup>10</sup>

Critics of the Act generally ignore, or downplay, the fact that other competitive modalities—that is, alternative forms of network access—have gained ground during the past decade as a result of firms investing billions in wireless and satellite technologies.<sup>11</sup>

Although room remains for genuine debate on the successes and failures of the Act, the DOJ and FCC have made clear that the growth and market acceptance of new modalities have changed the competitive landscape. In the late 1990s, then-FCC Chairman Reed Hundt called the combination of AT&T and a regional Bell operating company “unthinkable” under the antitrust laws.<sup>12</sup> By 2005, the FCC had a vastly different perspective on the competitive threat posed by such a combination. In approving the merger of SBC Communications and AT&T, the FCC commented on the “rapid growth of intermodal competitors—particularly cable telephony providers (whether circuit switched or Voice Over Internet Protocol (VoIP))—as an increasingly significant competitive force” in the mass market, and the likelihood that competitors “will play an increasingly important role with respect to future mass market competition.”<sup>13</sup> The FCC added that “[b]ased on recent market and technological developments, including increased subscription to mobile wireless services that provide a bundle of local and long distance services, we find it appropriate to refine our market analysis.”<sup>14</sup> The FCC applied similar reasoning in approving the Verizon-MCI merger and the merger between the new AT&T and BellSouth.<sup>15</sup>

The FCC’s position on these mergers reveals a significant shift in focus from commodity phone service to a marketplace where consumers choose integrated, multi-media offerings at premium prices. Today, few consumers could imagine life without real time downloads via broadband access. In 1999, dial-up Internet access was the norm, and broadband penetration was a mere 1.7 million households.<sup>16</sup> Seven years later, about 43 million American households had access to broadband.<sup>17</sup> Although the FCC reports that over 90 percent of consumer broadband access is through Digital Subscriber Line (DSL) or cable modem, consumers are increasingly turning to wireless hot spots, WiMax, and satellite alternatives.<sup>18</sup> And “[a]lmost 3 million Americans use high-speed Internet services provided by satellite services, wireless phone companies, fiber optic wires or other wireline connections.”<sup>19</sup>

The shift in emphasis from traditional telephone services to broadband has led to significant regulatory changes that have called into question the definition of a telecommunications service,

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<sup>10</sup> Donna N. Lampert, *No Sight Like Hindsight: The 1996 Act and the View Ten Years Later*, 58 FED. COMM. L.J. 519, 526 (2006).

<sup>11</sup> Marguerite Reardon, *Wireless Driving Profits for Big Phone Carriers*, C/NET NEWS.COM, Oct. 30, 2006, available at [http://news.com.com/Wireless+driving+profits+for+big+phone+carriers/2100-1036\\_3-6130688.html](http://news.com.com/Wireless+driving+profits+for+big+phone+carriers/2100-1036_3-6130688.html).

<sup>12</sup> *FCC Chairman Reed Hundt Calls Combination of AT&T and an RBOC “Unthinkable,”* FCC NEWS, June 19, 1997, available at [http://www.fcc.gov/Bureaus/Miscellaneous/News\\_Releases/1997/nrmc7041.html](http://www.fcc.gov/Bureaus/Miscellaneous/News_Releases/1997/nrmc7041.html).

<sup>13</sup> In the Matter of SBC Communications Inc. and AT&T Corp. Application for Approval of Transfer of Control, 20 F.C.C.R. 18290, 18293 (2005).

<sup>14</sup> *Id.* at 18336.

<sup>15</sup> In the Matter of Verizon Communications Inc. and MCI, Inc., 20 F.C.C.R. 18433 (2005); FCC Approves Merger of AT&T and BellSouth Corp., 2006 WL 3847995 (Dec. 29, 2006); In the Matter of SBC Commc’ns Inc. and AT&T Corp. Application for Approval of Transfer of Control, 20 F.C.C.R. 18290, 18293 (2005).

<sup>16</sup> FCC, High-Speed Services for Internet Access: Subscribership as of June 30, 2005 at 8 (2006).

<sup>17</sup> FCC, High-Speed Services for Internet Access: Status as of December 31, 2005 at 4 (2006).

<sup>18</sup> *Id.*

<sup>19</sup> William G. Laxton, Jr., *The End of Net Neutrality*, 15 DUKE L. & TECH. REV. 1, 8 (2006).

subject to common carrier regulation by the FCC, versus an “information service” that is generally unregulated. The Supreme Court addressed this question in reversing the Ninth Circuit’s *Brand X* decision.<sup>20</sup> The Court determined that the FCC had reasonably classified cable broadband as an information service not subject to common carrier regulations under the Act. The Court did not require the FCC to extend the same standard to DSL broadband providers. The FCC did, however, reclassify DSL as an information service shortly after the *Brand X* decision was handed down.<sup>21</sup>

In light of the removal of regulatory checks applicable to common carriers and the FCC’s view that broadband services “should exist in a minimal regulatory environment that promotes investment and innovation in a competitive market,” new concerns have emerged about broadband providers engaging in anticompetitive conduct.<sup>22</sup> Freed from common carrier regulations, traditional broadband access providers, including telephone companies such as Verizon and AT&T, and cable operators such as Comcast and Cox, will continue on the path of vertical integration. Such integration offers the promise of uniting communications and entertainment services and giving consumers the benefit of a broad array of services. But these benefits may come at substantial cost to consumers whose choices are limited to comprehensive bundles of products they do not really want or need.<sup>23</sup> Instead of receiving price reductions, it is feared, many customers will pay substantially more.

In addition, content providers, such as Google, Yahoo!, and eBay, fear that they will be forced to bear the costs of the capital investments being made by broadband providers through direct charges, exclusive license agreements, or other concessions. If a content provider refuses to pay, it may find that consumers can no longer visit its Web site or use the applications it offers.

*The term net neutrality generally refers to the notion that the Internet does not favor one application or Web site over another, and that consumers should have equal access to the content of their choice.*

### The Call for Network Neutrality

“Whereas the [Act] focused on creating greater competition at the physical layer” of network access, “net neutrality proposals focus directly on protecting competition at the applications and content layers.”<sup>24</sup> The term net neutrality generally refers to the notion that the Internet does not favor one application or Web site over another, and that consumers should have equal access to the content of their choice.<sup>25</sup> In hearings before the Senate Committee on Commerce, Science and Transportation, Vinton Cerf, Vice President and Chief Internet Evangelist at Google, summarized the widely held views of content providers as follows: “Google believes that consumer[s] should be able to use the Internet connections that they pay for the way that they want. This principle—that users pick winners and losers in the Internet marketplace, not carriers—is an architectural and policy choice critical to innovation online.”<sup>26</sup>

<sup>20</sup> National Cable & Telecommunications Ass’n v. Brand X Internet Servs., 545 U.S. 967 (2005).

<sup>21</sup> In the Matters of Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, 20 F.C.C.R. 14853 (2005).

<sup>22</sup> *In re Inquiry Concerning High-Speed Access of Internet over Cable and Other Facilities*, 17 F.C.C.R. 4798 (2002); see also Laxton, *supra* note 19, at 13; Marguerite Reardon, *AT&T Chief, FCC Chair Clarify on Net Neutrality*, C/NET NEWS.COM, Mar. 21, 2006, at 2, available at [http://news.com.com/AT38T+chief%2C+FCC+chair+clarify+on+Net+neutrality/2100-1034\\_3-6052239.html](http://news.com.com/AT38T+chief%2C+FCC+chair+clarify+on+Net+neutrality/2100-1034_3-6052239.html).

<sup>23</sup> Kimmelman, *supra* note 9, at 512.

<sup>24</sup> Jonathan E. Nuechterlein, *The Digital Broadband Migration: Confronting the New Regulatory Frontiers*, 5 J. ON TELECOMM. & HIGH TECH. L. 1, 9 (2006).

<sup>25</sup> Laxton, *supra* note 19, at 14.

<sup>26</sup> *Net Neutrality: Hearing Before the Committee on Science, Commerce, and Transportation*, 109th Cong. (2006) (testimony of Vinton G. Cerf, Vice President and Chief Internet Evangelist of Google), <http://commerce.senate.gov/pdf/cerf-020706.pdf> [hereinafter Cerf Testimony].

The net neutrality debate arises from concerns about how broadband providers will finance their capital investments, and whether content providers should be the ones forced to pay. The primary concerns driving the net neutrality debate can be placed in two categories: (1) broadband providers' blocking Web sites or applications (content blocking), and (2) broadband providers' favoring certain applications over others and "granting different download speeds to different applications (a two-tiered Internet)."<sup>27</sup>

**Content Blocking.** When access providers forge relationships with content providers to offer integrated suites of services, they position themselves to offer products at premium prices, allowing broadband providers to obtain a return on their vast capital investments. Content providers that do not enter into these deals with broadband providers face the prospect of paying the broadband provider a fee to access subscribers, or, if unwilling to pay the fee, having subscribers blocked from accessing their content at all. The prospect of content blocking is not far-fetched.

In *Madison River Communications*, the FCC investigated a carrier's practice of blocking ports used for VoIP and preventing customers from using competitive VoIP offerings.<sup>28</sup> As a result of the FCC's investigation, Madison River entered into a consent decree that required it to cease blocking ports used for VoIP and to pay a nominal (\$15,000) fine.<sup>29</sup>

Net neutrality advocates cite such examples to support their argument that regulation is necessary "to ensure that consumers are truly able to select the services that best meet their needs."<sup>30</sup> "As we journey into a world of ever-growing IP and broadband service options, we should ensure that if consumers choose video or IP applications through one provider (e.g., Google or EarthLink) the network facilities owner should not be able to undermine those choices."<sup>31</sup>

The principal argument in favor of regulation to prevent content blocking is that allowing broadband providers to "control what people see and do online would fundamentally undermine the principles" underlying the free and open Internet.<sup>32</sup> The proponents of net neutrality regulation contend that not only would content blocking limit consumer choice, content blocking by broadband providers will place the country at a competitive disadvantage: "[I]n places like Japan, Korea, Singapore, and the United Kingdom, higher-bandwidth and *neutral* broadband platforms are unleashing waves of innovation that threaten to leave the U.S. further and further behind."<sup>33</sup>

Opponents argue that further regulation is unnecessary because market forces will ensure that consumers have access to the content they want, and a unilateral decision by a broadband provider to charge content providers is not anticompetitive. Even in a duopoly market (with only cable and DSL providers offering broadband services), broadband providers are unlikely to preclude subscribers from accessing popular content, such as Google or eBay, because, if they were to do so, consumers will choose the competitive alternative.<sup>34</sup> If there is sufficient demand for the blocked content, the opponents of regulation contend that wireless and satellite providers will

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<sup>27</sup> Laxton, *supra* note 19, at 14.

<sup>28</sup> In the Matter of Madison River Communications, LLC and Affiliated Companies, 20 F.C.C.R. 4295 (2005).

<sup>29</sup> *Id.*

<sup>30</sup> Lampert, *supra* note 10, at 527.

<sup>31</sup> *Id.* at 528.

<sup>32</sup> Cerf Testimony, *supra* note 26.

<sup>33</sup> *Id.*

<sup>34</sup> Alfred E. Kahn, *Industry Structure: Telecommunications: The Transition From Regulation to Antitrust*, 5 J. ON TELECOMM. & HIGH TECH. L. 159, 179 (2006).

become popular alternatives to fill the void. In short, if access providers were to engage in content discrimination (limiting consumer choice), it would be economically imprudent because they could find their customers turning to competitive alternatives, cause them to lose customers, and leave them unable to recoup their investment in short-term content discrimination.

Opponents of further regulation argue that the antitrust laws and existing regulatory oversight are sufficient. In a duopoly environment, neither cable nor DSL providers have the ability to act unilaterally to exclude competition or raise prices. Should a broadband access provider decide unilaterally to block content, the other competitor could respond by offering the blocked content to its subscribers. Were broadband providers to collude to charge content providers access fees, they would violate Section 1 of the Sherman Act. If there is only one broadband or cable provider in a given area that could be defined as a relevant geographic market, content providers could assert monopolization claims.

*The second issue in the neutrality debate is whether broadband providers should be permitted to provide faster access to preferred applications and Web sites that have paid them a fee.*

Finally, even though the FCC's jurisdiction has been significantly curtailed by the elimination of the common carrier regulations, FCC Chair Kevin Martin maintains that "the FCC has authority to act . . . [a]nd it has done so in the past."<sup>35</sup> Content providers might seek to draw sweeping (and arguably speculative) conclusions from *Madison River*, but that example alone does not justify broad net neutrality regulation. Arguably, the lesson from *Madison River* is that regulators and enforcers will take action where conduct threatens old-fashioned competition and fair play.

**The Two-Tiered Internet.** The second issue in the neutrality debate is whether broadband providers should be permitted to provide faster access to preferred applications and Web sites that have paid them a fee. Content providers contend that broadband providers should not be allowed to degrade services to those who will not pay to play; rather, consumers should have equal access to any content available on the Internet. As one commentator noted, the "basic principle behind a network anti-discrimination regime is to give *users* the right to use non-harmful network attachments or applications, and give innovators the corresponding freedom to supply them."<sup>36</sup>

There are two problems with this argument. First, contrary to the assertions of content providers about equal access, consumers do not currently have access to all content, all the time, on the same speeds and at the same degree of availability.<sup>37</sup> Tiered prioritization is what we already see on the Internet.<sup>38</sup> For example, content providers already prioritize information and access by allowing subscribers to choose specialized services to obtain preferred content.<sup>39</sup> In addition, key advertisers enjoy prime real estate when consumers use search engines, such as Yahoo! and Google. Content providers might argue that their ability to prioritize content is different because they do not enjoy market power. But, except in limited geographic locations where there is a single provider, broadband providers also generally do not have market power. Moreover, over time, innovation will likely continue, and the intensity of competition for broadband access will grow as consumers turn to alternative modalities to access the Internet.

<sup>35</sup> Reardon, *supra* note 22.

<sup>36</sup> Tim Wu, *Network Neutrality, Broadband Discrimination*, 2 J. ON TELECOMM. & HIGH TECH. L. 141, 142 (2005).

<sup>37</sup> *Id.* See also Jonathan E. Nuechterlein, *Video Games: The Oddly Familiar Terms of Debate About Telco Entry Into The Video Services Market*, 5 J. ON TELECOMM. & HIGH TECH. L. 1, 10 (2006).

<sup>38</sup> Christopher S. Yoo, *Network Neutrality and the Economics of Congestion*, 94 GEO. L.J. 1847, 1854 (2006).

<sup>39</sup> *Id.*

Second, bandwidth is not unlimited, and prioritization is also an effective means of addressing congestion.<sup>40</sup> Even with broadband connections, consumers experience a slow down when they attempt to download information from some Web sites or when they use certain applications. Broadband providers might find it more cost effective to manage Internet access transaction costs by prioritizing access to preferred applications or Web sites, and imposing restrictions on bandwidth-intensive activities, than by requiring all customers to bear those costs.<sup>41</sup>

While the concerns about tiered access, service degradation, and discrimination have been widely discussed, there is little evidence that actual service degradation, or outright discrimination is either technically feasible or economically rational. Responding to the discrimination concerns expressed by content providers, AT&T Chief Executive Ed Whitacre stated bluntly: “AT&T will not block or degrade traffic, period . . . and we won’t change [our position] no matter what sky-is-falling rhetoric you hear. Markets work best when consumers have choices.”<sup>42</sup> These sentiments were echoed by Verizon’s Chief Technology Officer Mark Wegleitner, who observed that broadband access providers only have an economic incentive to create different tiers of service to manage traffic, not to create new revenue streams or keep competitors off their networks.<sup>43</sup> Due to “voluntary” commitments made in connection with merger approvals in the past two years, however, neither AT&T or Verizon can engage in such discrimination in any event.<sup>44</sup> Last year, AT&T’s commitment was extended several years as a condition to obtaining FCC approval of its merger with BellSouth.<sup>45</sup> Given the economic disincentives to degrade service and the regulatory conditions already in place, the concern about service discrimination is not ripe for a legislative fix.

*Congress has been more bullish in pressing for greater regulation to ensure net neutrality.*

### Views of the Antitrust Enforcement Officials and the Congressional Response

The FCC has been the primary regulatory agency engaged in the net neutrality debate. Antitrust enforcement offices have not ignored the issue but they have urged further study and restraint before pressing for net neutrality regulation or pursuing enforcement actions. While all the regulatory agencies have been willing to impose discrete fixes (such as the enforcement action in *Madison River*, and the conditions imposed in the AT&T and Verizon mergers), Congress has been more bullish in pressing for greater regulation to ensure net neutrality.

In 2006, the FTC established an Internet Access Task Force to conduct a comprehensive analysis of the issues related to government regulation and the technological developments on the Internet, including “the most hotly debated issue in communications, so-called ‘network neutrality.’”<sup>46</sup> Without concrete evidence of market failure or anticompetitive behavior, FTC Chairman Deborah Majoras has cautioned against blind support for further government regulation of broadband access providers and has argued that adopting such regulation prematurely could have

<sup>40</sup> Kahn, *supra* note 34, at 176–77.

<sup>41</sup> Yoo, *supra* note 38, at 1862.

<sup>42</sup> Reardon, *supra* note 22.

<sup>43</sup> Marguerite Reardon, *Verizon Says Net Neutrality Is Overhyped*, C/NET NEWS.COM, Mar. 31, 2006, available at [http://news.com.com/Verizon+says+Net+neutrality+is+overhyped/2008-1037\\_3-6056210.html](http://news.com.com/Verizon+says+Net+neutrality+is+overhyped/2008-1037_3-6056210.html).

<sup>44</sup> Yoo, *supra* note 38, at 1859.

<sup>45</sup> Press Release, FCC, FCC Approves Merger of AT&T Inc. and BellSouth Corporation, Appendix, at 8–9 (Dec. 29, 2006), available at [http://www.fcc.gov/ATT-BellSouth\\_Press\\_Release.pdf](http://www.fcc.gov/ATT-BellSouth_Press_Release.pdf) [hereinafter AT&T-BellSouth Merger Commitments].

<sup>46</sup> Deborah Platt Majoras, Chairman, FTC, The Federal Trade Commission in the Online World: Protecting Competition and Protecting Consumers, Remarks Before the Progress and Freedom Foundation’s Aspen Summit 12 (Aug. 21, 2006), available at <http://www.ftc.gov/speeches/majoras/060821pfaspennfinal.pdf>.

significant negative consequences on the Internet, namely “entrenching existing broadband platforms and market positions” resulting in a “diminution, rather than an increase in competition.”<sup>47</sup> In addition to the Task Force, the FTC sponsored three days of public hearings last year on technology and consumer protection at the conference entitled: “Protecting Consumers in the Next Tech-ade,” and hosted a two-day public workshop on broadband connectivity competition policy this month.

The DOJ may consider the issue of net neutrality as it examines standards for enforcing Section 2 of the Sherman Act, but it is unclear whether the issue is on the agenda. In considering standards for unilateral conduct in the Internet era, the agency should certainly consider the network effects associated with the technological convergence that has spurred the entire net neutrality debate.

The lack of a push for proscriptive regulation by antitrust enforcers is not surprising. Indeed, it is prudent. The DOJ and FTC are enforcement agencies charged with addressing anticompetitive behavior, not creating a comprehensive, national communications policy.

While the FCC has broad jurisdiction in this area, the agency as a whole (as opposed to individual commissioners) has not jumped on the bandwagon for net neutrality. FCC Chair Kevin Martin has acknowledged the agency’s jurisdiction to regulate, but has urged caution in considering further regulation. The FCC has not been silent on the issue of net neutrality, however. Indeed, in 2006, the agency adopted principles designed to ensure that “broadband networks are widely deployed, open, affordable, and accessible to all consumers.”<sup>48</sup> These four principles entitle consumers to:

1. access lawful Internet content of their choice;
2. run applications and use services of their choice, subject to the needs of law enforcement;
3. connect their choice of legal devices that do not harm the network;
4. competition among network providers, application and service providers, and content providers.

The Democratic appointees to the FCC cited these principles in seeking an extension of net neutrality conditions in reviewing the AT&T/BellSouth merger, even though the DOJ had given its blessing to the merger months earlier. The impasse was created because the two Democrats sought net neutrality conditions, while the two Republican appointees wanted the merger to be approved without them. (One Republican appointee abstained from the deliberations due to a prior professional affiliation with a competitor of the merging parties.) Ultimately, AT&T agreed to adhere to the FCC’s net neutrality principles for 30 months, and not to privilege, degrade, or prioritize data transmitted over its broadband network based on the source of the data for two years, or until Congress enacts comprehensive legislation on net neutrality.<sup>49</sup>

Because the FCC has not adopted net neutrality regulations that would apply across the board, Congressional leaders have stepped in to respond to the content providers’ cries for across-the-board regulation. In the 109th Congress, six different bills proposed net neutrality regulations, including H.R. 5417 sponsored by Jim Sensenbrenner [R-WI] and John Conyers [D-MI]. H.R. 5417, which was passed by the House Judiciary Committee, seeks to expand the Clayton Act by

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<sup>47</sup> *Id.* at 17.

<sup>48</sup> In the Matters of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, 20 F.C.C.R. 14986 (2005).

<sup>49</sup> AT&T-BellSouth Merger Commitments, *supra* note 45, at 8–9.

prohibiting broadband access providers from (1) denying content providers the ability to offer services in a “manner that is at least equal to the manner in which the [access] provider or its affiliates offer content, applications, and services, free of any surcharge,” (2) refusing to interconnect with other access providers; (3) blocking or interfering with the ability of consumers to use the access service of their choice; (4) prioritizing or offering enhanced quality service in a manner favoring the access provider.<sup>50</sup> The bill does not preclude access providers from taking steps to maintain their facilities, prioritize in the event of emergencies, or offer consumer protection services (such as parental controls) that may block certain types of content.<sup>51</sup> In short, H.R. 5417 seeks to preserve the ability of content providers to offer consumers the content and applications that they want, not simply those selected for them or prioritized by broadband access providers.

This legislation was not passed last year. Considering the positions taken by the Democratic appointees to the FCC, there is a greater likelihood that the 110th Congress will impose further regulation given the shift in power. Indeed, Senators Byron Dorgan (D-ND) and Olympia Snowe (R-ME) have already revived the prospect of net neutrality regulation in the Internet Freedom Preservation Act (S.215). Citing the concessions accepted by AT&T to win FCC approval of its merger with BellSouth and invoking the rhetoric of net neutrality advocates, Senator Snowe observed:

The tide has turned in the debate between those who seek to maintain equality and those who would benefit from the creation of a toll road on the Internet super highway . . . The reintroduction of this legislation and the FCC’s imposition of net neutrality conditions as part of the AT&T-BellSouth merger, are significant victories in the fight to ensure nondiscrimination on the Internet, and I look forward to continuing that fight alongside Senator Dorgan in the new Congress.<sup>52</sup>

### Is Do No Harm the Better Approach?

Internet users currently have access to all the content and applications available, regardless of access provider. Although content providers are urging Congress to adopt new rules to ensure non-discriminatory equal access, the antitrust enforcers and the FCC have taken a cautious approach to regulation. Content providers have not made a strong case for expansive regulation or rigorous antitrust enforcement to address concerns that broadband access providers may engage in anticompetitive conduct. As things stand, the DOJ and FCC have recognized that broadband access providers will continue to face competition and that access providers are trying to find ways to compete. With consumers demanding choice, the market will likely dictate the winners and losers. Whenever the market is working properly this way, further regulation is unnecessary and could be counterproductive. Should there be a market failure, or an abuse by broadband access or content providers, antitrust enforcers and the private bar are poised to address them. ●

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<sup>50</sup> Internet Freedom and Nondiscrimination Act of 2006, H.R. 5417, 109th Cong. (2006).

<sup>51</sup> *Id.*

<sup>52</sup> Nate Anderson, *Bipartisan Network Neutrality Bill Introduced in Senate*, ARS TECHNICA, Jan. 10, 2007, available at <http://arstechnica.com/news.ars/post/20070110-8590.html>.

# The “Aggregation Theory”: A Recent Series of Decisions in Bundled Discounting Cases Threatens to Expand Section One into Uncharted Territory

**Frank M. Hinman and Brian C. Rocca**

Since the Third Circuit’s en banc decision in *LePage’s v. 3M*,<sup>1</sup> exclusive dealing cases have been back in vogue. While *LePage’s* blessed a theory of Section 2 liability based on exclusionary pricing behavior, it provided little analysis or guidance for future cases. As a result, the likely competitive effects of “bundled discounts” or related practices, and even the proper antitrust analysis to evaluate them, remain hotly contested.

A recent series of “de facto” exclusive dealing cases in the medical device industry has focused on a variety of alleged exclusionary pricing practices under Sections 1 and 2, and sometimes Section 3, of the Clayton Act. Plaintiffs, usually smaller medical device suppliers, have challenged the relationships between large suppliers and group purchasing organizations (GPOs), firms that negotiate supply contracts on behalf of their member hospitals or other health care providers. These plaintiffs generally argue that certain manufacturer-GPO contract terms—such as bundled rebates and market share discounts—unreasonably exclude them and, in some cases, allow large suppliers to monopolize the markets for the products at issue. Several of these cases have resulted in large verdicts or settlements.<sup>2</sup>

However, one recent development in the medical supply cases has gone relatively unnoticed despite its potential far-reaching implications for antitrust practitioners and their clients. Two decisions from the Eastern District of Texas,<sup>3</sup> and one from the Central District of California,<sup>4</sup> have held that a competitor with an indisputably small market share (and no alleged market power) can nevertheless be held liable under Section 1 of the Sherman Act for an allegedly exclusive contract, based on “aggregating” its small market share (and thus potential market foreclosure) with that of its competitors who may have entered similar contracts, *even with no allegation of any agreement—express, tacit, or otherwise—between (or among) them.*

The evolution of this “aggregation theory,” which is ungrounded in Section 1 precedent and sets unsound antitrust policy, is explored below, and some suggestions are offered on how firms can try to stay out of the aggregation theory trap.

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<sup>1</sup> 324 F.3d 141 (3d Cir. 2003).

<sup>2</sup> *Masimo Corp. v. Tyco Health Care Group, L.P.*, No. 02-4770 (C.D. Cal. filed May 22, 2002) (a \$140 million pre-trebling jury verdict against Tyco Healthcare). The verdict was partially vacated on post-trial motions and the damages case was recently re-tried. *See Masimo*, 2006 WL 1236666 (C.D. Cal. Mar. 22, 2006). Other cases have also ended with nine-figure verdicts or settlements. *See, e.g.*, *Retractable Techs., Inc. v. Becton Dickinson*, No. 5:01-cv-00036-DF (E.D. Tex. filed Jan. 29, 2001) (\$100 million settlement); *Spartanburg Reg. Health Servs. v. Hillenbrand Indus.*, No. 7:03-cv-02141-HFF (D.S.C. filed June 30, 2003) (\$337.5 million settlement).

<sup>3</sup> *See Genico, Inc. v. Ethicon*, No. 5:04-CV-229-DF (E.D. Tex.) (order dated Mar. 23, 2006); *Daniels Sharpsmart, Inc. v. Tyco Int’l*, No. 5:05-CV-169-DF (E.D. Tex.) (order dated Oct. 18, 2006).

<sup>4</sup> *See Applied Med. Res. Corp. v. Johnson & Johnson*, No. 8:03-cv-01329-JVS (C.D. Cal.) (order dated Feb. 23, 2004).

### Professor Elhaug's Statement Before the DOJ-FTC Hearings on GPOs

This new twist on Section 1 liability appears to have its origins in a paper presented to the Department of Justice (DOJ) and Federal Trade Commission (FTC) on behalf of medical device manufacturers by Professor Einer Elhaug, who has also represented some manufacturer-plaintiffs in courts and in Congress.<sup>5</sup> Professor Elhaug argued that the competitive effects of GPO agreements “do not depend on all the foreclosure being accomplished by one agreement, one type of agreement, or even by agreements with one dominant firm.”<sup>6</sup> Rather, he contended, anti-competitive effects arise when a number of exclusionary agreements “cumulatively” cause sufficient marketwide foreclosure.<sup>7</sup>

Professor Elhaug offered an example of two manufacturers with multiple exclusive agreements with buyers that “in aggregate” foreclose enough of the market to preclude rivals from achieving minimum efficient scale. In such circumstances, he suggested that the aggregate effect of all of the independent contracts should give rise to Section 1 liability against both manufacturers, regardless of the foreclosure achieved by either, and even in the absence of any horizontal conspiracy between them, or their respective contracting partners, or anyone.<sup>8</sup> Professor Elhaug cited “many” Supreme Court decisions that hold “the foreclosure produced by exclusionary agreements must be aggregated among even more than two manufacturers.”<sup>9</sup>

Notably, Professor Elhaug did not address whether this aggregation theory, or the Supreme Court cases that he claimed support it, should be extended to create Section 1 liability for small, independent buyers that merely happened to contract with one or both manufacturers. However, three recent district court decisions, relying on the same purported authority, have extended Professor Elhaug's aggregation theory to reach this result.

### *Applied Medical, Genicon, and Daniels*

The first court to adopt this novel Section 1 aggregation theory was the Central District of California, in *Applied Medical*. The *Genicon* and *Daniels* decisions, which followed similar reasoning, were both issued from the same judge in the Eastern District of Texas. All three cases involve many of the same parties, experts, and lawyers.<sup>10</sup> In each, a small manufacturer of medical devices brought an antitrust action against one or more competing manufacturers (only one of which an alleged monopolist) and several GPOs (with varying alleged market shares).<sup>11</sup> The only alleged Section 1 conspiracies were the various independent vertical supply agreements, each between one manufacturer and one GPO.

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<sup>5</sup> See Einer Elhaug, Antitrust Analysis of GPO Exclusionary Agreements, Comments Regarding Hearings on Health Care and Competition Law and Policy—Statement for DOJ-FTC Hearings on GPOs (Sept. 26, 2003), available at [http://www.law.harvard.edu/faculty/elhaug/pdf/statement\\_ftcdoj.pdf](http://www.law.harvard.edu/faculty/elhaug/pdf/statement_ftcdoj.pdf).

<sup>6</sup> *Id.* at 13.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 15.

<sup>10</sup> The plaintiff in *Applied Medical*, a manufacturer of endo-mechanical surgery devices, sued competitor Johnson & Johnson (J&J) and GPO Novation. The plaintiff in *Genicon*, another endo-mechanical device manufacturer, sued competitors J&J and Tyco, and GPOs Novation, Premier, Broadlane, and Healthtrust Purchasing Group. The plaintiff in *Daniels*, a manufacturer of reusable containers for bio-hazardous medical materials, sued competitors Tyco and Becton Dickinson, and GPOs Novation, Premier and Consorta.

<sup>11</sup> Specifically, the *Genicon* and *Daniels* plaintiffs brought Sherman Act § 2 and Clayton Act § 3 claims against the alleged monopolist-manufacturers, and Sherman Act § 1 claims against all the defendants. The Clayton Act claims against at least some of the GPOs were dismissed or abandoned. In *Applied Medical*, the plaintiff asserted § 2 claims against J&J and a § 1 claim against J&J and Novation.

The plaintiffs in all of these cases thus alleged a “rimless wheel” Section 1 conspiracy. Widely recognized in criminal cases,<sup>12</sup> a “rimless wheel” involves a “hub” (in these cases, large medical suppliers) entering into a series of agreements with unrelated “spokes” (in these cases, GPOs purchasing on behalf of their member hospitals). Where the hub has facilitated a horizontal agreement (or “rim”) among the spokes, the hub and all of the spokes may be jointly liable for the overarching “hub-and-spoke” conspiracy.<sup>13</sup> In contrast, as the Fourth Circuit has observed, “[a] rimless wheel conspiracy is one in which various defendants enter into separate agreements with a common defendant, but where the defendants have no connection with one another, other than the common defendant’s involvement in each transaction.”<sup>14</sup>

In *Genicon*, the smaller manufacturer-defendant and the two small GPO-defendants moved to dismiss. They argued that the plaintiff failed to state cognizable Section 1 claims against them, in light of the plaintiff’s allegations that their individual contracts did not foreclose a legally significant share of the relevant market. Similarly, in *Daniels*, the smaller manufacturer-defendant moved to dismiss the Section 1 claim against it, on the grounds that its alleged market share was legally insufficient to state a claim.

Judge Folsom of the Eastern District of Texas denied all of the motions to dismiss. The Court accepted the respective plaintiffs’ aggregation theories that, despite the absence of any horizontal agreement, they could nonetheless prove that all of the defendants’ agreements *collectively* foreclosed the relevant markets, thus subjecting each defendant to joint and several liability based on every other defendant’s independent contracts.<sup>15</sup>

In *Applied Medical*, decided before *Genicon* and *Daniels*, GPO Novation moved to dismiss the Section 1 claim because the plaintiff failed to plead sufficient market foreclosure resulting from its individual contract with Johnson & Johnson (J&J).<sup>16</sup> As in *Genicon* and *Daniels*, the court denied the motion to dismiss:

[J&J’s] contracts with the two largest GPOs, Novation and Premier, foreclose 65% of the relevant markets for trocars and clip appliers. The court finds that aggregating the foreclosure produced by these agreements between [J&J] and multiple buyers is appropriate, in spite of Novation’s assertions to the contrary.<sup>17</sup>

Thus, as with *Genicon*, the *Applied Medical* court concluded that an individual spoke-defendant in a rimless wheel could be liable for the separate agreements of other spokes.<sup>18</sup>

<sup>12</sup> See, e.g., *United States v. Chandler*, 388 F.3d 796, 807 (11th Cir. 2004); *United States v. Levine*, 546 F.2d 658, 663 (5th Cir. 1977), *overruled on other grounds by United States v. Lane*, 474 U.S. 438 (1986).

<sup>13</sup> See, e.g., *Toys ‘R’ Us, Inc. v. FTC*, 221 F.3d 928 (7th Cir. 2000); *In re Microsoft Corp. Antitrust Litig.*, 127 F. Supp. 2d 728, 733 (D. Md. 2001).

<sup>14</sup> *Dickson v. Microsoft Corp.*, 309 F.3d 193, 203 (4th Cir. 2002).

<sup>15</sup> See *Genicon*, No. 5:04-CV-229-DF (E.D. Tex. Mar. 23, 2006) (order denying motion to dismiss); *Daniels*, No. 5:05-CV-169-DF (E.D. Tex. Oct. 18, 2006) (same). The moving defendants in both cases unsuccessfully sought interlocutory appellate review. See *Genicon*, No. 5:04-CV-229-DF (E.D. Tex. June 5, 2006) (order denying motion for reconsideration and, alternatively, request for certification for interlocutory appeal); *Daniels*, No. 5:05-CV-169-DF (E.D. Tex. Jan. 16, 2007) (order denying request for certification for interlocutory appeal).

<sup>16</sup> The *Applied Medical* complaint alleged that Novation controlled 35% of the hospitals in the relevant market. Arguably, the court could have found that foreclosure sufficient to defeat a motion to dismiss, because most courts acknowledge a minimum market foreclosure threshold of 30–40%. See *infra* note 35.

<sup>17</sup> See *Applied Medical*, No. 8:03-cv-1329-JVS, slip op. at 4–5 (C.D. Cal. Feb. 26, 2004).

<sup>18</sup> The *Applied Medical* plaintiff dismissed its claims against Novation on October 6, 2004, pursuant to a settlement. The claims against J&J went to trial in July and August 2006. The jury returned a verdict in favor of J&J, and judgment was entered in J&J’s favor on September 26, 2006. See *Applied Medical*, No. 8:03-cv-1329-JVS (C.D. Cal.) (judgment dated Sept. 26, 2006).

### The Upshot: Unsound Policy and Precedent

These decisions set unsound, indeed anticompetitive, precedent. The aggregation theory is a hub-and-spoke conspiracy without the rim, and thus erases the fundamental “contract, combination, and conspiracy” requirement from Section 1. It is also unprincipled and limitless, because aggregating shares always has the potential to reach 100 percent.<sup>19</sup>

The decisions also impose significant transaction costs on firms and subject them to potential liability (or at least very expensive litigation) with little ability to be counseled or protect themselves ex ante. Because a firm could be held liable for the agreements entered into by its competitors, it must attempt to monitor the activities of others in the marketplace and adjust its own competitive activities in light of them. That obligation is (a) impractical at best; (b) impossible in many instances, for example where other contracts are entered later; (c) chilling of legitimate competitive conduct, including exclusive (or quasi-exclusive) contracting; and (d) itself potentially a facilitating practice under Section 1.

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But for defendants sued under the “aggregation theory,” the recent developments are even more troubling. As articulated by plaintiffs and adopted by these courts, one need only allege the theory to survive a challenge based upon insufficient market share or market foreclosure. As the *Genicon* court stated: “Because Plaintiff employs an aggregation theory, however, Defendants’ challenge fails.”<sup>20</sup> Although articulated in the context of Rule 12, the court’s reasoning does not appear to stop there, and begs a number of important questions as to the further development of such a “bundled discounting” case. So long as several similar, albeit unrelated, vertical contracts exist, how would a small party to one of them defeat an aggregation theory at trial, much less on summary judgment? On the other hand, how can a theory raise “material issues of fact” for trial when it does not appear to depend on any facts, beyond the bare existence of similar contracts? Is the aggregation theory a newly discovered route to per se Section 1 liability?

Although that seems unlikely to be the effect, or even the intent, of these opinions, their reasoning imposes a heavy, if not impossible, burden on small Section 1 defendants confronted with the aggregation theory. The error appears to stem from a misreading of early Supreme Court authority.

### The Supreme Court Cases that Purportedly Support the Theory

The *Genicon*, *Daniels*, and *Applied Medical* orders, and Professor Elhauge’s statement to the DOJ/FTC, rely principally on three old Supreme Court cases: *Standard Fashion Co. v. Magrane-Houston Co.*,<sup>21</sup> *Standard Oil Co. v. United States*,<sup>22</sup> and *FTC v. Motion Picture Advertising Service Co.*<sup>23</sup> As a starting point, these cases were not decided under the Sherman Act, but rather under broader “incipiency” statutes, the Clayton and FTC Acts.<sup>24</sup>

<sup>19</sup> The question of whether a defendant can be held liable under §§ 1 or 2, or both, for the cumulative effect of its own similar agreements is beyond the scope of this article. Suffice it to say that combining the foreclosure resulting from a single party’s agreements to evaluate that party’s potential liability is quite different from exposing an indisputably small competitor with no market power to liability based on the alleged cumulative effect of contracts it did not enter and had nothing to do with.

<sup>20</sup> *Genicon*, No. 5:04-CV-229-DF, slip op. at 8 (E.D. Tex. Mar. 23, 2006).

<sup>21</sup> 258 U.S. 346 (1922).

<sup>22</sup> 337 U.S. 293 (1949).

<sup>23</sup> 344 U.S. 392 (1953).

<sup>24</sup> *Standard Fashion*, 258 U.S. at 357 (Clayton Act); *Standard Oil*, 337 U.S. at 297, 314 (Clayton Act); *Motion Picture*, 344 U.S. at 394 (FTC Act).

*Apart from resting on questionable interpretation of questionable precedent, Genicon, Daniels, and Applied Medical undermine the very foundation of Section 1 liability. It is, and always has been, fundamental antitrust law that a Section 1 defendant may be liable only for an agreement it enters, and cannot be liable for an agreement it does not.*

In any event, those cases did not hold or suggest that an individual spoke in an alleged rimless wheel could be liable for the aggregate effect of the hub's agreements with other, unrelated spokes. At most, they suggest that a single hub-defendant may be liable based on the combined foreclosure of *its own contracts*.<sup>25</sup> Thus, *Genicon*, *Daniels*, and *Applied Medical* ignore critical distinctions in market position. Under the aggregation theory endorsed by those decisions, each of the 20,000 retail stores in *Standard Fashion* would have been jointly liable for the manufacturer's 19,999 other contracts. No case, including this Supreme Court trilogy, has ever made such a holding. Indeed, Justice Frankfurter, the author of *Standard Oil*, made clear in his dissent in *Motion Picture* that "this Court has never decided that [exclusive contracts] may, in the absence of conspiracy, be aggregated to support a charge of Sherman Act violation."<sup>26</sup>

Even putting this debate aside, the wisdom of drawing a new antitrust liability theory from these cases is dubious given that they emerged from the early years of antitrust, which also produced such since-discredited opinions as *International Salt*, *Schwinn*, and *Albrecht* (and perhaps soon, *Dr. Miles*).<sup>27</sup> That is not to say the authors of these opinions were not capable, even brilliant, jurists—they were—but a person with perfect vision would stumble in an unfamiliar, dark room. The Court's attempt to come to grips with the legal and economic underpinnings of the Clayton Act in *Standard Fashion*, for example, is almost painful to read. The plaintiff, a Boston retail store, entered an exclusive contract to sell the defendants' patterns. The defendant had similar contracts with some 20,000 stores around the nation. The Court reached its holding that the defendant had threatened competition in Boston by considering the exclusive contracts with other stores in other parts of the country and concluding that it must have a monopoly "in hundreds, perhaps in thousands, of small communities," but not necessarily Boston.<sup>28</sup> These cases should be allowed to continue gathering dust, not revived and extended to areas they never addressed in the first place.

Apart from resting on questionable interpretation of questionable precedent, *Genicon*, *Daniels*, and *Applied Medical* undermine the very foundation of Section 1 liability. It is, and always has been, fundamental antitrust law that a Section 1 defendant may be liable only for an agreement it enters, and cannot be liable for an agreement it does not. Before these decisions, as the Seventh Circuit noted in *Paddock Publications, Inc. v. Chicago Tribune Co.*,<sup>29</sup> no case had ever held otherwise. Nonetheless, under the aggregation theory espoused in these new decisions, every defendant, regardless of its minimal market share or lack of market power, may be held accountable under Section 1 based on the share or market power of another, unrelated defendant, or perhaps several of them put together. That cannot and should not be the law and, actually, it is not.

### Modern Authority's Rejection of the Aggregation Theory

In *Paddock*, the Seventh Circuit refused to aggregate the foreclosure of exclusive agreements held by the two largest newspapers in Chicago. The court considered the same Supreme Court authority that the plaintiffs (and courts) relied on *Genicon*, *Daniels*, and *Applied Medical*, but concluded

<sup>25</sup> See *Standard Oil*, 337 U.S. at 295, 297, 314–15 (finding against single oil company, not individual gas stations); *Motion Picture*, 344 U.S. at 393–96 (finding against single advertising distributor, not individual theaters).

<sup>26</sup> *Motion Picture*, 344 U.S. at 400 (Frankfurter, J., dissenting) (emphasis added).

<sup>27</sup> *Int'l Salt Co. v. United States*, 332 U.S. 392 (1947); *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967); *Albrecht v. Herald Co.*, 390 U.S. 145 (1968); *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

<sup>28</sup> *Standard Fashion*, 258 U.S. at 357.

<sup>29</sup> 103 F.3d 42 (7th Cir. 1996).

the cases do not establish that exclusive contracts independently entered by two competitors can be aggregated to hold either liable for the other's agreement: "[N]o subsequent case has read *Motion Picture Advertising Service* to abolish the requirement of concerted action under § 1 of the Sherman Act."<sup>30</sup>

The Fourth Circuit reached the same conclusion in *Dickson v. Microsoft Corporation*.<sup>31</sup> In *Dickson*, a class of plaintiff-consumers alleged a rimless wheel scenario between Microsoft and two computer manufacturers (OEMs), Compaq and Dell. The complaint alleged that Microsoft and the OEMs violated Sherman Act Sections 1 and 2 by entering into separate licensing agreements that ensured Microsoft's applications would be installed on new computers. The OEMs moved to dismiss the Section 1 claim on the grounds that their individual agreements with Microsoft could not, as a matter of law, foreclose a sufficient share of the relevant market. The district court granted the OEMs' motions, and the Fourth Circuit affirmed. According to the Fourth Circuit, "a wheel without a rim is not a single conspiracy," and thus the agreements must be evaluated individually.<sup>32</sup>

The *Dickson* plaintiffs argued that Microsoft, as the dominant hub, had sufficient market power to state a claim arising from each spoke agreement. However, the Fourth Circuit held that was not enough. "[A]bsent an allegation regarding Compaq's or Dell's power or share in the PC market, there is no basis in [plaintiffs'] complaint for concluding that either of the two licensing agreements at issue, when considered individually, are likely to foreclose a significant share of the relevant software markets."<sup>33</sup> The court reasoned as follows: "*The relevant focus of the § 1 inquiry, however, is the anticompetitive effects of the conspiracy qua conspiracy*; therefore the plaintiff must demonstrate that the conspiratorial agreement itself affected competition in ways that would not have obtained absent the agreement."<sup>34</sup>

Thus, *Paddock* and *Dickson* confirm the principle that the *Genicon*, *Daniels* and *Applied Medical* courts ignored (or misunderstood)—Section 1 reaches only as far as the agreement actually entered.

### A Potential Dilemma for Antitrust Practitioners and Their Clients

Still, *Genicon*, *Daniels*, and *Applied Medical* remain on the books, and the aggregation theory they approve is poised to wrongly entangle small defendants in large antitrust cases, especially if they find themselves in the wrong court. Before their appearance, practitioners could safely advise their clients that rule of reason cases generally require a 30–40 percent market share (or foreclosure) for a Section 1 violation as a matter of law.<sup>35</sup> Thus, companies that enter agreements with large—

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<sup>30</sup> *Paddock*, 103 F.3d at 46.

<sup>31</sup> 309 F.3d 193, 200 (4th Cir. 2002).

<sup>32</sup> *Dickson*, 309 F.3d at 203–04.

<sup>33</sup> *Id.* at 209 (citing *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961)).

<sup>34</sup> *Id.* at 210 (emphasis added) (citation omitted); accord *Spectators' Comm'n Network Inc. v. Colonial Country Club*, 253 F.3d 215 (5th Cir. 2001); *Royal Drug Co. v. Group Life & Health Ins. Co.*, 737 F.2d 1433, 1436–37 (5th Cir. 1984) (contracts entered separately between powerful buyer and competing sellers not horizontal combination without evidence of agreement among sellers).

<sup>35</sup> *See, e.g.*, *Stop & Shop Supermarket Co. v. Blue Cross & Blue Shield of R.I.*, 373 F.3d 57, 68 (1st Cir. 2004) (30–40% minimum foreclosure rate required for violation; "low numbers make dismissal easy"); *United States v. Microsoft Corp.*, 253 F.3d 34, 70 (D.C. Cir. 2001) (40–50% required); *Minnesota Mining & Mfg. Co. v. Appleton Papers, Inc.*, 35 F. Supp. 2d 1138, 1143 (D. Minn. 1999) ("at least 30 percent to 40 percent" required). Of course, these thresholds are not bright lines, and they vary somewhat case to case based on other factual or economic circumstances. However, any comfort they provide, particularly for companies well below them, is eliminated by the aggregation theory.

even monopolistic—suppliers could, for the most part, avoid the reach of Section 1 so long as the agreement does not constitute a per se violation, or create actual harm to competition.

The aggregation theory endorsed (actually, created) by the *Applied Medical*, *Genicon*, and *Daniels* orders dramatically increases uncertainty in the law of Section 1. Taken literally, it could expose to antitrust liability every company that operates in vertical relationships with one (or more) suppliers that could be said to have some foreclosure effect, where other such contracts may also exist.

So how can practitioners and their clients protect themselves? With difficulty, though a few options may be available. First, companies should carefully evaluate their current and prospective vertical supply agreements to (1) identify potential issues, such as bundled, market share, or loyalty discounts; (2) determine their likely exclusionary effect, if any; and (3) weigh any exclusionary effect against likely procompetitive effects. This process is especially important (although evidently not essential under the theory) if the supplier has a significant market share and thus is likely to present a bigger litigation target. If the risk of such contract terms appears to outweigh the contract's business advantages, several devices may help soften any "foreclosure" effect, including the use of termination clauses, shorter term contracts, and "carve out" provisions to allow the buyer to deal with smaller market participants without forgoing contract incentives. Second, if a company is aware of an industry-wide contracting practice—particularly in a concentrated market, as many medical device markets are claimed to be—it should exercise caution before "falling in line" with that practice.<sup>36</sup> Finally, companies can vigorously defend themselves if attacked under the aggregation theory, and attempt to create better precedent by taking any adverse decision up for appeal. ●

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<sup>36</sup> Companies that are told by a supplier in negotiations that others have entered similar contracts so they should "fall in line" should spill their proverbial drink and leave the room, because this could lead to the inference of a "rim" that makes the aggregation theory unnecessary. *See supra* note 13. *See, e.g., Interstate Circuit v. United States*, 306 U.S. 208, 222 (1939) (inferring horizontal conspiracy from the nature of the proposals made to the defendants, the manner in which they were made, and the unanimity of action taken); *Toys 'R' Us*, 221 F.3d at 935 (inferring horizontal conspiracy where toy companies agreed to distributor's demand on the condition that its competitors "were doing the same thing").

## Paper Trail: Working Papers and Recent Scholarship

**Editor's Note:** In this edition we note one recent paper that draws lessons from the history of antitrust and industry-specific regulation in the United States and another that extends an analysis taken from standard game-theoretic models for evaluating unilateral effects to consider the effect of a merger on the likelihood of collusion.

Send suggestions for papers to review, or your comments, to Editors William Page at [page@law.ufl.edu](mailto:page@law.ufl.edu) and John Woodbury at [jwoodbury@crai.com](mailto:jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

### Recent Papers and Speeches

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#### Dennis W. Carlton & Randal C. Picker, **Antitrust and Regulation**

[http://papers.ssrn.com/sol3/Delivery.cfm/SSRN\\_ID937020\\_code249436.pdf?abstractid=937020&mirid=1](http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID937020_code249436.pdf?abstractid=937020&mirid=1)

Dennis Carlton is an economist at the University of Chicago Business School and, since last August, the Deputy Assistant Attorney General for Economic Analysis at the Antitrust Division. Randall Picker is a professor at the University of Chicago Law School. In this paper, they survey the history of antitrust and “industry-specific regulation” in the United States since 1887 (selectively, of course) and draw conclusions about the strengths and weaknesses of the two regulatory regimes. They conclude that “the Sherman Act has turned out to be more enduring than regulation” because the courts interpreting it have learned the lessons of economics and applied those lessons for the benefit of consumers better than independent commissions, which have proven more responsive to special interests. Consequently, the domain of antitrust has expanded as the domain of agency regulation has contracted. In modern regulation, the two regimes should be viewed as complements in which regulatory tasks are assigned according to what history has shown to be the regimes’ relative competences.

In the first part of the paper, the authors review public choice considerations in the framing of regulatory legislation. They note that firms seeking regulation must recognize the necessity of delegation to a regulatory agent—court or agency—which may “drift” or renege on the regulatory bargain. Thus, the regulatory agent should have characteristics suited to its delegated task. Regulatory agencies (and members of Congress who may influence them) are more subject to post-enactment political control than the independent federal judiciary. For this reason, agencies are better able to accommodate “democratic” questions, like the need for cross-subsidies for certain groups. Moreover, agencies are more likely than courts to be consistent in their decision making over a narrowly defined domain, at least during a given political party’s administration. These considerations may explain why Congress created the Interstate Commerce Commission in 1887 to regulate railroads (“the first great network industry”), a task that demanded regulatory consistency on issues like interconnection. Three years later, however, when Congress chose to regulate competitive practices in the economy as a whole, a task that required less coordination and perhaps fewer overtly political choices, it delegated the task to the courts by enacting the Sherman Act.

Carlton and Picker also consider a third alternative—leaving an industry both largely unregulated and free of antitrust restrictions. They suggest that these sorts of antitrust exemptions may seek to avoid the inefficiencies of some overinclusive antitrust prohibitions, where collective action is particularly beneficial, as it may be in R&D joint ventures. More often, however, antitrust exemptions seek to immunize cartels from both prosecution and entry. A simple exemption coupled with restrictions on entry would be the first preference of any powerful private interest group; regulation, even with entry restrictions, would be less preferred because the group would have to contend with other interest groups in the regulatory process.

In the second part of the paper, the authors focus on the interaction of regulation and antitrust enforcement in the railroad industry. They suggest (generously) that Congress created the ICC to “protect shippers from monopoly power while making it possible for railroad investors to earn competitive rates of return.” Only three years later, Congress enacted the Sherman Act, without specifying how it might apply to railroads. In *Trans-Missouri*,<sup>1</sup> the Supreme Court held collective ratemaking by railroads illegal per se under the Sherman Act, and in the same year denied the ICC the power to prescribe rates, other than by issuing cease and desist orders against unjust or unreasonable rates. In the ensuing decades, even as antitrust enforcement continued, reinforced by the passage of the Clayton and Federal Trade Commission Acts in 1914,<sup>2</sup> Congress repeatedly tightened federal regulatory control over railroad rates, evidently viewing competition as incompatible with railroad markets.

In the final section of the paper, Carlton and Picker examine the application of antitrust and regulation in modern network industries, like telephony and transportation. In this kind of industry, a regulator must assure interconnection but will often try to maintain prices and restrict entry in order to preserve cross-subsidies. Regulators also often try to prevent vertical and horizontal integration in these industries in an effort to prevent the emergence of larger politically powerful firms, even if integration would be efficient. The exposure of these measures as anticompetitive has led Congress to deregulate. In these instances, antitrust may substitute for regulation, as in the case of full deregulation, or may coexist with regulation, either in unregulated portions of industries (those that do not require rate regulation or detailed administrative orders) or as a superimposed constraint on regulation. These steps have repeatedly led to “massive consolidation, increased industry concentration, an end to cross-subsidy, and a fall in price.”

Carlton and Picker describe, for example, AT&T’s growth into an interconnected, “universal” system rife with cross-subsidies protected by FCC regulation. The high prices necessary to preserve the subsidies attracted MCI’s entry into long-distance service, aided by regulatory and antitrust actions in the 1970s to compel AT&T to interconnect.

A parallel government antitrust suit led to the famous 1982 consent decree that dismantled the Bell System, allowing AT&T to compete in long-distance service, but separating it from local networks under the control of regional Bell operating companies. The consent decree subjected

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<sup>1</sup> *United States v. Trans-Missouri Freight Ass’n*, 166 U.S. 290 (1897).

<sup>2</sup> The authors make the odd statement that the “Supreme Court’s 1911 decision in *Standard Oil* had already muted some of the pressure for antitrust reform” by “abandon[ing] the literalism of *Trans-Missouri*” in favor of the rule of reason. The more conventional view is that antitrust reformers endorsed the position of Justice Harlan that *Standard Oil* had “by mere interpretation, modified the act of Congress, and deprived it of practical value as a defensive measure against the evils to be remedied.” *Standard Oil Co. of N.J. v. United States*, 221 U.S. 1, 99 (1911) (Harlan, J., dissenting in part). Though false, this view played a key role in the adoption of the Clayton Act, which sought to specify antitrust offenses. See ROBERT H. BORK, *THE ANTITRUST PARADOX* 34–35 (1978).

American telephony to the control of a federal antitrust court until 1996, when Congress displaced it by passing the Telecommunications Act. The Act required incumbent local carriers, not only to interconnect with competing entrants, but to facilitate their entry by unbundling and making available the elements of the local network. Despite these regulatory obligations, the Act's savings clause preserved the applicability of antitrust to telephony, ostensibly to assure that both antitrust and regulation would remain as complementary constraints. In *Trinko*,<sup>3</sup> however, the Supreme Court held that, despite the savings clause, a regional operating company's failure to comply with the 1996 Act's interconnection requirements did not violate the Sherman Act, which only in rare instances imposes a duty to deal with rivals. Carlton and Picker view *Trinko* as an appropriate recognition of the relative competence of antitrust courts and agencies: "Given antitrust's own deficits in the area of affirmative dealing, the Court wisely decided that *Trinko* would have represented a particularly poor situation to try to use antitrust to police errant regulators." Interestingly, however, the authors offer no data on the effects of these regulatory transformations on telephone consumers.

Carlton and Picker then analyze the displacement of airline regulation by antitrust. They describe the inefficiencies of Civil Aeronautics Board regulation and the legal and economic consequences of deregulation. They point to studies showing that deregulation has cut prices by around 20 percent and has fostered extensive entry and exit. At the same time, airlines moved to a hub-and-spoke structure that greatly reduced their need to interconnect with other airlines. Concentration has increased nationally, entirely because of dramatic increases at hub airports. Industry profits and wages have plunged, to the extent that many airlines are now in or on the verge of bankruptcy. Antitrust enforcement has been common throughout the period of deregulation. The authors describe both the Antitrust Division's action alleging that airlines coordinated prices through "codes" in published tariffs and its later action charging American Airlines with predatory price and capacity changes aimed at excluding low-cost airlines from the Dallas-Fort Worth hub. Although the authors do not elaborate, they suggest that these antitrust actions (and a related regulatory action by the Department of Transportation) were unnecessary.

Carlton and Picker then describe the effects of deregulation of railroads and the transfer of authority over railroad mergers to the Surface Transportation Board (STB). In the wake of these regulatory changes, railroads abandoned over one-third of their track. Mergers reduced the number of Class I railroads from 40 in 1980 to 7 in 2004. Despite DOJ opposition, the STB almost invariably approved merger applications until 2000, when it finally imposed a moratorium. The net effect has been to reduce rates overall, but at the expense of "captive" shippers who often pay higher rates. More recently, there has been pressure to reimpose antitrust constraints on the industry. During the same period, deregulation of trucking has led to a huge increase in the number of truckload shippers and a decline in the number of less-than-truckload shippers, although not by merger. In both instances, studies suggest that the changes reflected corrections of inefficiencies imposed by regulation. Employment increased, but union employment plummeted, along with wages, particularly in the truckload segment of the industry.

The authors suggest that as antitrust has become "economically coherent within the last 30 years," it has proven to be "reasonably good" at promoting efficiency, except where that task might be thought to entail prescribing industry-specific rules. Deregulation has narrowed the

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<sup>3</sup> Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).

domain of regulatory agencies to those areas in which antitrust has proven ineffective, particularly in defining prices and standards for interconnection. In industries in which regulation persists, antitrust has become a complementary policy limiting regulators' ability to "allow incumbents to acquire market power either through merger or predatory acts." These trends have "brought benefits to consumers." This ambiguous conclusion leaves open whether the existing pattern of antitrust enforcement and direct regulation is the best we can do.

—WHP

**William E. Kovacic, Robert C. Marshall, Leslie M. Marx, and Steven P. Schulenberg,  
Quantitative Analysis of Coordinated Effects (June 2006)<sup>4</sup>**

<http://faculty.fuqua.duke.edu/~marx/bio/papers/QACE2.pdf>

In the not-too-distant past,<sup>5</sup> I observed that economists have more to say about quantifying the likelihood of coordinated effects than some economists (and perhaps many lawyers) think. I am happy to report that this particular paper by Kovacic et al. contributes to an expansion of that literature. Specifically, the authors observe that standard game-theoretic models for evaluating unilateral effects—both bidding models and Bertrand models of product differentiation—can be easily extended to consider the effect of a merger on the likelihood of collusion. In particular, the models can be used to evaluate the incremental payoff to successful coordination between the merged firm and any other firm or collection of firms in the industry. If collusion were perfect, then that coordination would be equivalent to a merger.

So suppose that pre-merger, there were 4 firms bidding or competing in a differentiated product market. Firms 1 and 2 choose to merge, resulting in 3 firms in the market. Standard unilateral effects analysis is used to simulate the price effects of the merger and the increased profits of the merged firm (although the latter is not the usual focus of a competitive effects analysis).

But Kovacic et al. note that pre-merger, the same models can be used to determine the payoff to perfect collusion between firm 1 and firm 3 (or firms 1 and 4), by assuming a merger between firm 1 and 3. That is, since perfect collusion would be equivalent to a merger between firms 1 and 3, the model can be used to estimate the profits to the colluding firms. Then one can also use the model to determine the payoff to firm 1 colluding with firm 3 *after* the merger between firm 1 and firm 2. The merger-induced increase in the payoff to firm 1 colluding with firm 3 then identifies how the merger affects the gains from that collusion.

For example, suppose that pre-merger, firm 1 collusion with firm 3 would generate \$100 of profits for the two firms over and above that which the two firms would earn if they behaved non-cooperatively. Firm 1 then merges with firm 2 and experiences an increase in profitability as a result of standard unilateral effects.

Post-merger, collusion between the newly merged firm 1 and firm 3 might generate profits of \$150 for the two firms combined, above and beyond that resulting from non-cooperative behavior between the merged firm and firm 3. Thus, the effect of the merger is to raise the payoff to

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<sup>4</sup> William E. Kovacic is currently an FTC Commissioner and formerly was FTC General Counsel. Robert C. Marshall is a professor at Penn State University. Leslie Marx, a former FCC Chief Economist, is a professor at Duke. Steven Schulenberg is at Bates White, LLC.

<sup>5</sup> William H. Page & John R. Woodbury, *Paper Trail: Working Papers and Recent Scholarship*, ANTITRUST SOURCE, July 2005, at <http://www.abanet.org/antitrust/at-source/05/07/Jul05-PaperTrail7=28f.pdf>.

collusion by 50 percent (i.e., \$50/\$100). The same model can be used to predict the incremental (i.e., pre-merger vs. post-merger) profitability of firm 1 collusion with firm 4 or of firm 1 collusion with both firms 3 and 4.

The authors observe that it's reasonable to suppose that the likelihood of collusion increases with the payoff that would result from collusion. Thus, in the example above, one might conclude that a 50 percent increase in the payoff to collusion resulting from the merger might generate substantially more concern about the likelihood of post-merger coordinated effects than 10 percent increase in the payoff.

The authors are quick to acknowledge that this is not a full-blown theory of collusion. Obviously, perfect post-merger collusion is not a likely outcome of a merger. Thus, among other factors, the merger analysis still needs to consider the likelihood that a tacitly collusive agreement could be reached among the colluding firms and the likelihood that deviations from the agreement could be quickly and easily detected and punished.

In my view, this analysis could be helpful in evaluating qualitatively how much weight needs to be attached to evidence on the likelihood of agreement and enforcement in considering the post-merger likelihood of collusion. The greater the merger-induced payoff to collusion, the more convincing the evidence on the inability to reach a tacit agreement or to enforce an agreement must be to overcome collusion concerns. This follows the standard unilateral effects analysis—the greater the predicted price increase from a merger, the more convincing the evidence must be on entry, repositioning, and efficiencies to overcome concerns of a unilateral post-merger price increase. (Note that there could still be substantial coordinated effects concerns even if the models suggest that there is no significant unilateral effects concern.)

The authors apply this analysis to one recently litigated (and much discussed) case, *Arch Coal*,<sup>6</sup> and another somewhat less recently litigated (but still much discussed) case, *Hospital Corporation of America*.<sup>7</sup> In the former, Arch Coal sought to acquire one of its smaller rivals (and to divest one mine to ease antitrust concerns). The FTC had expressed the concern that the merger would facilitate tacit collusion between Arch Coal and its remaining larger rivals. The FTC lost this case in part because the court concluded that the bidding process used by buyers of coal was sufficient to keep the post-merger market competitive.

Kovacic et al. use a bidding model to evaluate the FTC concern. The authors conclude that the results of the simulation would have bolstered the FTC's case. The incremental profitability of collusion between Arch Coal and its two largest rivals rose by 59 percent after the merger. The incremental profitability of collusion between Arch Coal and its three largest rivals increased by 70 percent. Thus, these simulations suggest that the FTC was right to be concerned.

In *Hospital Corporation of America*, Hospital Corporation acquired ownership or control of 5 of 11 hospitals in the region around and including Chattanooga, Tennessee, a deal that would make it the second largest hospital in the region. There were three other large hospitals in this area, and the FTC argued that this acquisition would increase the likelihood of coordinated effects between Hospital Corporation and these three other hospitals. The FTC won this case. Using a model of

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<sup>6</sup> *FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109 (D.D.C. 2004).

<sup>7</sup> *Hospital Corp. of Am. v. FTC*, 807 F.2d 1381 (7th Cir. 1986).

differentiated product competition with linear demand, the authors find that the profitability of collusion increased by 68 percent as a result of the merger.<sup>8</sup>

There are certainly issues one can have with this approach. For example, while the authors assume linear demand in the model of differentiated product competition, the actual predictions from these models are very sensitive to the assumed shape of the demand curve—linear, log-linear, or logit in particular. Some practitioners may be skeptical because of a view that these models are not calibrated to reality, i.e., they are too stylized and abstract excessively from the complexity of real-world competition. And as with other unilateral effects models, there is the issue of benchmarking: Any merger in these models will produce a price increase and (in this context) an increase in the likelihood of collusion. How do we know when that likelihood is sufficiently small that we can dismiss any antitrust concern with post-merger coordinated effects? None of these are inherently new issues raised by the paper.

However, I do wonder about how to interpret the results of the simulations. Going back to my 4-firm numerical example, suppose the model predicts that after the merger between firms 1 and 2, the incremental profitability of collusion between the merged firm and firm 3 increase the profits of the firms by 50 percent. But suppose as well that pre-merger, collusion between firms 1 and 3 would have increased profits by 100 percent as compared to non-cooperative behavior between firms 1 and 3. The apparently high payoff to pre-merger collusion suggests that if there is no evidence of pre-merger collusion, collusion is very difficult to establish and maintain (or that the model is wrong). This, in turn, suggests that the 50 percent increase in the payoff to collusion following the merger may overstate the likelihood of post-merger collusion.

The models in this paper lack the elegance of other models that embed predictions of the likelihood of collusion within a complete theory of collusion.<sup>9</sup> Nonetheless, the authors' approach seems far easier to implement than the more elegant models. If used properly, this approach can be an interesting and valuable addition to our merger-analysis toolkit. ●

—JRW

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<sup>8</sup> The authors note that this approach to evaluating the prospects of post-merger collusion is rich enough to encompass competitive fringe and efficiency claims, including claims of increased quality. However, some of these extensions appear a bit contrived. For example, in the differentiated products model, the authors calibrate the demand analysis to generate the pre-merger configuration of market shares. Roughly speaking, the authors argue that the highest weight achieved by the product of any individual firm in this demand generation process is the product of highest quality. So post-merger, a claim of higher quality could be equivalent to a claim that the product of the merged firm now carries a weight identical to that of the highest quality firm. Why that would be a reasonable assumption is unclear. The quality improvement could be substantially greater or less than that of the highest-weighted firm.

<sup>9</sup> See, e.g., Oliver Compte, Frederic Jenney & Patrick Rey, *Capacity Constraints, Mergers and Collusion*, 46 EUR. ECON. REV. 1 (2002). I note in passing that this paper (as well as the others discussed in the July 2005 *Paper Trail*) are not included among the references. While Kovacic et al. seem to dismiss the concept of a maverick firm ("whatever they are"), the cited paper provides a clear definition of a maverick. See Page & Woodbury, *supra* note 5.