

Roundtable Conference with Enforcement Officials

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MODERATOR

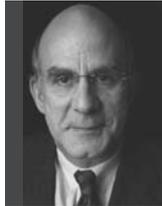


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PANELISTS



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Michael J. Reynolds
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ILENE GOTTS: Welcome to the Enforcers Roundtable.* I thought we would start out by introducing the panel. I'll start with our international guests.

As you can see, our format is a little bit different from last year's. Melanie Aitken is the Commissioner of Competition at the Canadian Competition Bureau. Melanie joined the Competition Bureau in 2005 and was appointed as the Commissioner on August 4, 2009. Her appointment is for a five-year term. Prior to joining the Bureau, Melanie was a partner, first at Davies Ward Phillips & Vineberg and then at Bennett Jones. She also spent two years as a Senior Counsel with the Canadian Department of Justice. What I love the best on her résumé is that she was a Bencher of the Law Society of Upper Canada.

By way of video technology, we have Dr. Alexander Italianer, who has been the Director-General for Competition of the European Commission since February of 2010. He comes to this position after a long and distinguished career within the Commission. He joined the Commission in 1985, spent several years in its Directorate-General for Economic and Financial Affairs, includ-

* **Editor's Note:** This Roundtable was edited for publication.

ing acting as its Director. He also worked in the cabinet of two Commission Presidents, Santer and Barroso, and two Commissioners. Between 2006 and his appointment in DG Competition, he served as the Deputy Secretary General in charge of, among other things, the Better Regulation Agenda. I think we will hear a little bit about that later.

Moving on to our U.S. guests, we have Christine Varney. We are delighted to have Christine join us this year up here. Christine has been the Assistant Attorney General in charge of the Antitrust Division of the U.S. Department of Justice since April 21, 2009. She served as the Chief Counsel of the Clinton and Gore campaigns, General Counsel to the Democratic National Campaign Committee, and Assistant to the President and Secretary to the Cabinet in the Clinton Administration. From 1994–1997 she was an FTC Commissioner. Prior to joining the Antitrust Division, she was a partner at Hogan & Hartson.

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We have Jon Leibowitz joining us again. He is the Chairman of the Federal Trade Commission. He became a Commissioner in 2004 and was designated to serve as Chairman in March 2009. He joined the FTC from a position as the Vice President for Congressional Affairs at the Motion Picture Association of America and before that had a long and very distinguished career on Capitol Hill, and continues to this day to have a very good relationship with his colleagues on the other side of Pennsylvania Avenue, on the Hill.

Jim Donahue heads the Pennsylvania Attorney General's Antitrust Section and is the Chair of the NAAG Multistate Antitrust Task Force. He joined the Pennsylvania Office of Attorney General in 1985 and was appointed as the Chief Deputy Attorney General in 1997.

I have my two questioners here: Roxann Henry, who is a partner at Howrey here in Washington, D.C., and also a Co-Chair of the Spring Meeting Program; and Michael Reynolds, who is a partner at Allen & Overy in both London and Brussels and also currently serves as the Secretary General for the International Bar Association.

With that, I am going to ask, Christine, that we open with a brief statement from you.

CHRISTINE VARNEY: Thank you, Ilene, and congratulations on such a terrific Spring Meeting. I have heard nothing but great things from everybody. I am glad to have the opportunity to see so many friends and colleagues this morning.

I want to start by saying it has been a great year. You know, I got to the Division one year ago as this Spring Meeting ended, and I was committed to transparency, stability, and predictability for business. It was in that vein that we undertook a review of the Horizontal Merger Guidelines. I've been practicing in front of the Division and the Commission for the last decade and have done a lot of mergers at both agencies. One of the things that struck me as I was walking in the door was that I knew the 1992 Merger Guidelines didn't reflect the actual practice of the agency. So, working with Jon and with several of our staff, we all agreed that what we needed to do was to take a look at the Guidelines and talk to you and see if we couldn't make them more transparent.

While I understand many of you have many views as to what motivated the Guidelines—and I'm sure we will talk about them this morning—I think you should know from our end—and Jon, I think, will echo this—our effort here is to be transparent. I fundamentally believe that people in Chicago, Miami, Dallas, Kansas, and Los Angeles are as entitled to know what the agencies really do as those of us who are there on a more daily basis. So while you have differing views as to what the Guidelines may or may not do, let me just emphasize the Guidelines draft that came out earlier this week is our best attempt to really put a light on what it is we do.

If you disagree with us, if you think we have the wrong theory, that's fine, and we should have that conversation. But I don't want to pretend that we don't do the kind of analysis that we in fact

—ASSISTANT ATTORNEY
GENERAL
CHRISTINE VARNEY

do and that many of you understand on a first-hand basis.

Let me start with that, because that is my marker—transparency, predictability, stability. I believe both businesses and practitioners are best served when we have all of those elements in place.

To that end, we have had a busy year. We are in one litigation, *Dean Foods*. We were prepared to sue on several others that either went to settlement or were abandoned. I think that we will probably talk this morning about some of the better-known settlements, including *Ticketmaster*.

We have an active non-merger program. We have a number of investigations, which I can't comment on because we don't talk about investigations.

Our criminal program continues to be very robust. I think you all know the *Air Cargo* investigation continues; *Marine Hose* continues; we have *Cathode Ray*; we have *Liquid Crystal Display Screens*. So we have a number of criminal undertakings, and I look forward to talking more about them.

The final thing that I'll mention is that we are doing a lot of what we like to think of as competition advocacy. We are advocating internationally, we are advocating on Capitol Hill, and we are advocating in the agencies here in Washington that competition be considered in every aspect of undertaking, whether it is Legislative or Executive.

MS. GOTTS: Thank you.

Jon?

JON LEIBOWITZ: Thank you, Ilene.

As I look around at the panel and I see Alexander, I think almost all of us—Jim, Melanie, Christine, Alexander, and I—have been in our jobs for a relatively short period of time—Christine just celebrated the first anniversary of her excellent tenure, and I've been there a little bit longer, and Melanie a little bit less, and Jim, you've been doing this gig for how long?

JIM DONAHUE: At the Task Force nine months.

MR. LEIBOWITZ: So we're all newbies up here. But we do try to do our best.

In general, our Commission's composition has changed a little bit over the last year—we have two terrific new Commissioners, Edith Ramirez and Julie Brill. Our competition priorities really haven't changed at all since I spoke to you a year ago on this same panel. From our perspective, a lot of it is doing the same things we always do. It is reviewing mergers, and it is looking at instances of potential anticompetitive conduct.

Beyond that, we have a few priorities, and you probably know them. One is fixing the pay-for-delay settlement problem, where we have had a fair amount of success, both legislatively and in litigation; establishing Section 5 as something more than a "me too" antitrust statute, and using it in the way Congress originally intended when it created the FTC in 1914; adjusting the Merger Guidelines—and I think Christine spoke very eloquently about that—to be more in line with the way the agencies actually review deals. I don't think any of this surprises anyone. I will talk a little bit more about each.

In the "pay for delay" settlement area, there have been some promising signs in litigation. We survived a motion to dismiss in a Philadelphia district court. We had a wonderful collaboration with the Antitrust Division and the Solicitor General's Office in the *Cipro* brief to the Second Circuit, and the Second Circuit is looking at revising its all-too-permissive rules on "pay for delay" settlements.

On the legislative side, legislation to solve the “pay for delay” problem, a sort of bright-line test, passed the House as a part of health care reform, and in the Senate came out of the Senate Judiciary Committee. It became part of the President’s health care plan. Although we didn’t get it over the finish line, in part because of the obscure and exceedingly technical rules of reconciliation, we are very, very optimistic that we will find a legislative solution and Congress will enact a legislative solution sometime this year. It helps when the problem is worth about \$3.5 billion a year to consumers and that according to the Congressional Budget Office, the legislation we support will save the government \$2 billion over ten years.

On Section 5, the majority of the Commission believes that it is a critical tool to protect consumers. As you have seen, we have used it in the Intel case that we brought earlier this year. We did a 2008 workshop under Bill Kovacic on Section 5. I think we are going to try to publish the report based on that workshop sometime in the fall.

On the Horizontal Merger Guidelines, I think Christine got it absolutely right. This is all about transparency. It is our intent to try to really explain to the business community and to the courts and to the folks in the audience how we look at mergers. It was a marvelous collaboration with many of the stakeholders in this room, and with the Justice Department. We are looking forward to receiving comments from you. But we think we have done a pretty good job. Again, we want to work with you.

I see Jim Rill, who is an author of the 1992 Guidelines, sitting in the front row. Those Guidelines, I think, reflected the way the Justice Department and the FTC reviewed mergers then. We have learned a little bit since. We think, and I hope Jim would agree, that the draft Guidelines that we put out are consistent with the 1992 Guidelines.

And then, on merger enforcement we are on a little bit of a winning streak. Since a year ago April, we have challenged nineteen mergers, resulting in eleven consents, three abandoned deals, and our first successful preliminary injunction motion in *CCC/Mitchell*, which was an insurance estimatics case, since 2003—the first time since I was on the Commission that we won a PI.

I should also say that we have closed a number of matters, which is important too. In one of our divisions, in the Bureau of Competition, we probably had something like thirty-two open investigations when I became Chairman. We reviewed all of those cases under Rich Feinstein’s leadership, and we ended up closing a little more than half of them. So that is just as important too, figuring out what a good case is and moving on when an investigation doesn’t pan out.

Very briefly on the consumer protection side, we have focused on two things this year. One of them is helping out people who are victims of the economic downturn. We brought about twenty foreclosure rescue scam cases, and with our partners, mostly state attorneys general, more than 200 cases involving foreclosure rescue scams and stimulus scams.

We also have an important initiative on Internet privacy, where we are trying to consider what the rules of the road should be on behavioral marketing. It is a very complex issue, but a very important one to consumers.

We were involved in the Consumer Financial Protection Act for financial reform, which has passed the House and which is expected to go to the Senate floor next week.¹

The other administrative or policy function we have, really going back to our origins, is to just look at industries and issues and study the way industries behave and the way technology is evolving to the public.

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—FTC CHAIRMAN
JON LEIBOWITZ

¹ On May 20, 2010, the Senate approved Senate Bill S.3217, The Restoring American Financial Stability Act of 2010.

One of the initiatives we are most proud of and we spend a lot of time on is a series of workshops on the future of news reporting. Obviously, ad revenues for television networks and newspapers have been dropping precipitously with the growth of the Internet. The escalating growth of the Internet is in most ways a very, very good thing. But it is just not certain whether the creative destruction of news gathering and coverage that we are seeing is going to be good for the American public. Unlike, say, if you own a hotel on Route 1 or on an old federal highway and they build an interstate (bad for you, good for society), here we are dealing with the role of journalism, something that is a core need for democracy. So we are going to do one more workshop, we are going to write a report, and hopefully we can give some advice to policymakers.

MS. GOTTS: Thank you, Jon.

Alexander, would you like to say a few words?

ALEXANDER ITALIANER: I am really glad I can be with you. Some of us here in Europe are still under the volcano, if I may quote Malcolm Lowry. But I hope to be with you next year.

Like many of the others, I am a rookie. I feel a bit like Daniel in the lion's den, also being an economist.

The first thing I want to mention is that what we are doing at the European Commission is also state aid control. This is not like the other agencies represented on the other side of the Atlantic. This has been quite important over the past year in terms of stabilizing the financial crisis. We have been authorizing, in particular, rescue measures and trying to ensure that a level playing field continues to be ensured and that competition problems were not exported from one country to another.

What we are doing right now is looking at the restructuring plans of the banks, and we are dealing altogether with some forty cases. This has been a task that is quite important and keeping us quite busy as we are coming out of the recession.

But of course, it was also "business as usual" from an enforcement authority's perspective. Like the other three agencies, we have constantly been looking at our Guidelines. One of the things we have been revising—actually adopted this week—was a revision of the Guidelines on Vertical Agreements.² In particular, looking at Internet sales and also looking at the conditions under which distributors can benefit from an exemption agreement, we imposed a new market share threshold of 30 percent, which will be applicable on the buyer's upstream market. This threshold already applies on the suppliers' market.

With regard to our enforcement policy, I would like to mention two sectors in particular. The first sector is the energy sector, which is perhaps fairly specific for Europe, where we have quite a few cases, including many commitment cases resulting from an investigation under our dominance rule, Article 102 of the Treaty. The terms of the commitments include parties agreeing to release capacity for consumers or to improve their grid management to remedy the competition concerns, such as possible foreclosure derived from vertical integration or lack of access to the infrastructure.

On the IT side, our actions have, of course, been quite visible on the other side of the Atlantic, with the *Intel* case, also with the Microsoft Web browser commitments that were obtained at the end of last year, impacting, of course, a lot of the European consumers.

² The revised guidelines can be found at http://ec.europa.eu/competition/antitrust/legislation/guidelines_vertical_en.pdf.

We also are working on standards, in particular the need for standard-setting bodies to have open and transparent procedures. I think that the commitments that we obtained in the Rambus case are quite relevant there.

As I look forward to the year ahead, I think that the activities resulting from the crisis will still keep us busy. Like I said, there are forty banks under restructuring. We have only dealt with a couple of them. We will try to analyze them all before the end of the year.

At the same time, we will be reviewing our Guidelines on the horizontal agreements, with a particular focus on information exchange and standards, trying to build on the case practice and the case law, and trying to integrate that into our Guidelines.

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Of course, our bread and butter is antitrust, in particular cartels, where we will continue to be very strict. We will pay due attention to companies that are in genuine financial difficulties when it comes to paying the fines. I think that the crisis reminds us that maintaining competition enforcement is important to maintain a level playing field in order to get out of the crisis in as forceful a way as possible.

Finally, as regards our enforcement system as such, I think that our system in Europe is a bit different when compared to others in the rest of the world. I think it compares to the best systems in the world. But we continue to look at improvements.

We have just published in January some text on new best practices that we are applying as regards the antitrust proceedings and the best practices of our hearing officers; also we published guidelines on the submission of economic evidence because we try to incorporate more and more economic evidence in what we are doing.

And, like Christine mentioned when she referred to the Merger Guidelines, we try to build more predictability and transparency into our own procedures. So far the reactions have been quite good.

The last thing I would like to mention—I would say it is last but not least—is our very firm intention on this side of the ocean to cooperate very closely with our counterparts in other jurisdictions, and in particular the United States and Canada. I think we already have an excellent track record, whenever needed, I speak to my colleagues. I would say that the recent cooperation we had on the *Cisco/Tandberg* merger is again an excellent example of our cooperation. I would like to thank our colleagues for that.

I am sure that in the rest of this discussion we will discuss cooperation and convergence.

Thank you.

—DIRECTOR-GENERAL
ALEXANDER ITALIANER

MS. GOTTS: Thank you.

Melanie, would you like to go next?

MELANIE AITKEN: Sure, I'd be pleased to.

First of all, I'd like to say just how extremely pleased I am to be here. Thank you, Ilene, for inviting me. It's a real privilege to participate with the crowd up here.

If there is a key message to be taken from the events of the past year in Canada, it is that we entered a new chapter in Canadian competition law. We have substantially revised laws as of last Spring, and we have a revitalized mandate from Parliament to enforce those laws.

There are two areas where changes occurred that are probably of most interest to this audience, and they are in respect of our merger review process and our assessment of competitor collaborations. Very briefly, with respect to mergers, I want to emphasize that we haven't changed our analytical approach. Certainly, we will be watching what is happening with the U.S. Guidelines

and considering whether we want to be doing anything there.

But clearly, the reforms in our laws have been to do with process. They have really introduced a balanced framework that allows us, in circumstances where there is a real risk of anticompetitive consequences arising from a merger, to actually access the information that we need to perform our review before the merger closes—it may sound surprising to this audience that we didn't have it this way before these amendments came into force.

The new framework allows us to thoroughly review mergers that do pose real concerns. We don't look to turn over every rock or exhaustively look at every issue, but rather to focus very early on the key issues with the case, work with the counsel, try to front-end-load documentary production, and the like, and simply just make this work.

With respect to assessment of competitor collaborations, we now have a per se criminal offense for hard-core cartels—again, something you all take for granted, but that we didn't have. We were a bit of an anomaly around the world, in that we had to prove an actual market effect, even in the face of a naked cartel agreement.

At the same time, we have removed a chill from our law, which subjected all competitor collaborations to potential criminal investigation. Of course, we didn't think that was the right balance either. Whether it made a real difference in practice, in theory it was a real anomaly. I think it caused a bit of a disjunction with our colleagues, particularly in the United States, in terms of trying to make sure that we could collaborate and align our investigations as closely as possible, and to reap all the benefits that that sort of cooperation entails.

While I firmly believe that these amendments are extremely good for Canada and for all those who carry on business in Canada, they do come with a very significant responsibility on our part. Our reaction when these amendments came into force relatively quickly, and a little bit unexpectedly, last year, was to become very active in our outreach to the consumer community, to the business community, and to their advisors, to try to educate, to listen, to learn, and to develop the best possible enforcement processes and practices that we could. This outreach has greatly assisted us in putting these terrific new amendments into play in a way that is good for business and good for consumers in Canada.

At the same time, and really more a matter of personal philosophy—and I certainly see it echoed in my colleagues here in the United States, and I'm sure it was ever thus—I have taken a very active role in our major enforcement matters. I think businesses have the right to know that I am engaged and, while I may not show up everywhere, they can be confident that I am aware of what is going on. I will be available and accessible at key milestone events, and I will be the one to tell them the news, whether they actually like the news or not.

In terms of the amendments, we were very active in releasing guidance on our enforcement approach. Within a few weeks of Royal Assent, we issued draft guidelines on the merger review process, very significantly assisted by our friends here—and, indeed, I would be remiss if I didn't mention the enormous support that we got before the amendments even came into place. Agencies and individuals out in practice not only gave us guidance as to how we could do this better, but also commented on these guidelines and gave us some really good ideas on how we might be able to do the best job in our particular Canadian circumstances.

While we adopted a lot—and I think we are very lucky to benefit from the input from the United States—we also strived to make it a “made in Canada” version, if you will, to reflect our different context and the fact that we have a different tradition that, perhaps by necessity, and certainly under the old regime, demanded an enormous amount of flexibility and accommodation. We issued those guidelines in draft in the Spring and finalized them in the Fall.

We don't look to turn over every rock or exhaustively look at every issue, but rather to focus very early on the key issues with the case, work with the counsel, try to front-end-load documentary production, and the like, and simply just make this work.

—COMMISSIONER
MELANIE AITKEN

Likewise, we issued draft guidelines on our competitor collaboration provisions to calm, frankly, those who were worried—and I understand why, because there are limits to the English language in terms of how you articulate a per se offense in a statute. We don't have the many, many years of jurisprudence that you do, so we were trying to fit it into a statutory provision. So we got out to try to articulate that as best we could.

I think we were pretty bold and brave in taking a lot of things off the table very explicitly in our enforcement policy. Dual distribution agreements, franchise agreements, non-competes—those are not going to be considered under our criminal provision. If they are considered at all, they will be considered under a civil provision, which does require a market effect, and even—very Canadian—an efficiencies defense is available.

For obvious reasons, my priority this coming year, as it has been in the past year, is to get these amendments off onto a solid footing. In that context, there are a number of areas of our law in which we don't have very much jurisprudence.

And so, as one looks around the world—and I think the United States is an excellent example—you see authorities very willing to step in and say, "We are going to do our best to delineate the bounds of lawful and unlawful conduct." I think Canadians and those who carry on business in Canada should expect no less from us.

Really, this all sounds very good, but what does that mean in practice? To me, it means two things. It means, first of all, that we are going to continue to develop and refresh guidelines to the extent that we possibly can, so as to provide as much guidance and transparency as we can. Second, we are not going to hesitate to enforce in circumstances where it is necessary, in our view, to do so. Our first, second, and third preference will always be to resolve a matter consensually. But in appropriate cases, we won't be deterred by the fact that we very well might lose—that's always a real prospect because we wouldn't be having a tough fight if it weren't a close call. We won't be afraid of losing, and we will take cases to litigation. A loss in that context, to me, is not a loss, provided we do it in a principled and measured fashion, which, of course, is our commitment. We will clarify the law, we will increase transparency, and we will effect deterrence. In my view, there is absolutely no better deterrent to those considering anticompetitive conduct than to know that if they do it, we have the will and the courage to enforce the law.

Now, I must say that a well-articulated commitment to enforcement does come with its own set of challenges. I have every reason to believe that the experience has been the same here in this administration and, no doubt, before that. But if you are clear that you will enforce the law if parties are over the line, parties have this tendency—and this is good—to play ball and to get you the remedy that you think you need in the public interest.

It doesn't make for great statistics, and the media loves to look at a lackluster enforcement record, but it is clearly the right thing to do, in our case, for Canadians, but obviously, and more generally, around the world.

We have been very active in our enforcement in mergers. We have had six consent agreements in seven months, in one period over the last year. We had an abuse settlement in very robust terms in a waste collection case. We have an active abuse of dominance case for the first time in seven years, in front of the Competition Tribunal. And, of course, we have been active on the criminal and consumer protection front as well.

I echo Jon's comment in terms of focus, focus, focus. In our case, even more so—we have fewer resources. But our view is that we can do a lot more by doing fewer things, focusing on where there are real issues and making sure that we see them through. Advocacy, yes, but probably more so these days through cases, advocacy through shining a light on issues through active enforcement.

Just to sum up, it is an exciting time for us in Canada. I encourage you to keep an eye north of the border. There is a lot of change going on. But I can assure you, to borrow a phrase I heard yesterday, that “we are on the beat.” I think those who are in Canada and carrying on business in Canada can be confident that we are doing our best to ensure that competitive and honest markets are promoted to the best of our ability. We will certainly be looking forward to working with our international colleagues to that effective end.

I think the states are

Thank you.

going to focus on three

MS. GOTTS: Thank you.

things in the coming

Jim, what are the states up to?

year: conduct that

JAMES DONAHUE: Thank you, Ilene.

is going to harm

I think the states are going to focus on three things in the coming year: conduct that is going to harm consumers; conduct that would harm state and local governments; and health care. I will talk a little bit about each of those three things very quickly.

consumers; conduct

On the consumer side, the states are going to look at the traditional types of anticompetitive conduct that harm consumers—like price fixing, like vertical price fixing; market allocations; other types of arrangements that have a harm, where consumers result in paying higher prices for the goods and services they need and purchase.

that would harm state

We also are going to look, and have looked, at mergers that impact consumers. Where the merging parties are largely people who sell products to consumers, we are going to be involved in those types of cases.

and local governments;

and health care.

Thirdly, most attorneys general have very active consumer protection offices. They handle everything, from the situation where the roofer takes the deposit from the consumer and then disappears, to the things that Jon was talking about, where many states have worked with the Federal Trade Commission on mortgage repair scams or debt repair scams or any number of other things where there is a nationwide impact. We work together with the Federal Trade Commission to end that type of conduct.

—TASK FORCE CHAIR

JAMES DONAHUE

On the state and local government side, as everybody here knows, state governments, in particular, and local governments are in a considerable amount of financial distress. There are a number of things that we are doing.

We are working very closely with the Department of Justice. Christine Varney has set up a process where the states and the Department of Justice are going out and doing bid-rigging training of state and governmental purchasing people, to have them better help us to be able to detect bid-rigging and other types of conduct that raise the price of the products that governments purchase and that governments need to function.

Another thing that we will be active in is those mergers where the merging parties sell stuff to governments. We are going to talk about a case a little bit later on today where I think you will be surprised that the states and the local governments were a major purchaser in that instance.

So mergers where the product is something that the states use: We have previously been involved in things like rock salt, which obviously everybody, at least in the northern part of the country, is familiar with; obviously, the states are the biggest purchasers of rock salt. Aggregate is another thing. But there is a wide variety of products that states purchase, from computer products to other things, where if there is a merger there, we are going to look at that very carefully.

Now, let me talk for just a couple minutes about health care. One of the things that happened in the health care reform bill is that there was a lot of focus on failures in coverage, making sure

that people who didn't have insurance coverage got it. There was less focus in that bill on the competitive impacts in health care. This is an area where the states have been very active, both with the FTC and the Department of Justice and by themselves over the past several years. Let me give you a couple of examples.

The Nevada Attorney General's Office, with the Department of Justice, about a year ago reached a settlement involving Medicare beneficiaries in Las Vegas. There were two competing Medicare HMO plans that were merging. They took action that required divestiture there. The Texas Attorney General's Office took action against a hospital that was requiring health plans that dealt with it to not deal with other providers that were competitors of it. They stopped that conduct.

Two years ago, during this meeting, a merger in Scranton, Pennsylvania, involving two hospitals and a health insurer fell apart after our office said that we would go in and challenge that transaction.

The important thing here is the last two examples I gave you, the Texas example and the Pennsylvania example, were situations where the states were acting on their own. They weren't acting with a partner federal agency. Now, we often are, especially in health care, and we have a very good working relationship with the FTC and the Department of Justice, and we have active things going on, many in health care with the FTC, a couple of things with DOJ. We are working with both of those agencies both on a one-to-one state basis. We've got a particular case in Pennsylvania where we are working with the Federal Trade Commission, and we also have multi-state cases where we are working with the Federal Trade Commission and the DOJ.

Christine and Jon have been very helpful in encouraging their staffs to work together with us. We have had a very positive working relationship. We see that continuing and enabling all three of us to do more effective enforcement over the coming years.

Thank you.

ROXANN HENRY: Cartel enforcement has captured a large part of the enforcement resources across the globe, so we'd like to start with a couple of questions focusing on the cartel area.

Melanie, the 1985 Mutual Legal Assistance Treaty (MLAT) between the United States and Canada provides for the sharing of extremely confidential business information, and even provides for the sharing of grand jury evidence. Can you give us some sense of what cooperation has taken place under that MLAT?

MS. AITKEN: Sure, I'll be happy to.

I should introduce the topic by saying that we don't need to use MLATs very often, because we tend to cooperate using other less formal means, and increasingly even, so that our relationships become ever closer.

The MLAT process is quite involved and offers affected parties the ability to contest it. This can be very expensive and very time-consuming. But it effectively allows law enforcers, including competition authorities, to request formal assistance from each other in obtaining and transmitting evidence relating to criminal matters, including hard-core cartels.

We have MLATs in Canada with thirty different jurisdictions, including the United States. Over the past ten years, we have only resorted to using the MLAT about six times, as I understand it, to or from the United States.

Requests under the MLAT can cover quite a range of things. They can involve depositions, witness interviews, search and seizure and requests for records. Most commonly, requests have been made for searches to be conducted by the other country, or for documents that we couldn't otherwise access.

As Roxann mentioned, it is possible for the Canadian Bureau to gain access to U.S. grand jury evidence through the MLAT process, if the U.S. court authorizes the waiving of grand jury secrecy. So in that way, we would get something from the U.S. Department of Justice that they had collected for their own investigation.

Under the MLAT, we are also able to request that the United States subpoena for us information from the specified companies or actually conduct a search.

Obviously, we are talking about very confidential information. These MLAT requests come with very, very strict confidentiality requirements, such as restrictions on use of the information and documents received, and various conditions imposed by the requested authority. In the case of an MLAT request to conduct a search, when applying for a search warrant, the Bureau will, in appropriate circumstances, seek a sealing order to seal the request and any information submitted to the court in support of the search warrant.

It is not unique to the criminal context that we attach this importance to confidentiality, but, obviously, it takes on special meaning in this area. We are very aware of—and I want to emphasize very—and very sensitive to the fact that our stock in trade and our credibility turn very much on our ability to zealously protect that confidential information and I can assure you that we do so.

We do have other tools for getting information. By far the most important vehicle that we use is informal communication and cooperation. With respect to our colleagues here in the United States, we are fortunate to do that on almost a daily basis.

We have a provision in our Act that allows us, at our own initiative, to share information for the administration and enforcement of the Act. But again, in that context, let me assure you that we use that provision very, very carefully and we always require commitments with respect to how the information would be used. And frankly, we are very careful about the circumstances, and indeed the requesting authorities, as to whether we would provide that information.

As to what we share under this informal sharing mechanism, it's everything that you would expect: theories, information, sources of evidence, strategic issues, and the timing and the use of formal powers. With the advent of immunity and leniency programs around the world, it often means that we are going to get this information voluntarily from parties, which is, of course, the easiest route of all. Waivers are also becoming much more common, and in those cases we can get much greater detail.

So we really just look to the MLAT procedure to get evidence that is held in the United States or in one of the other countries that we cannot otherwise access.

MS. HENRY: Looking across the ocean, Alexander, cartels are not criminally prosecuted, but European fines have become astronomical. Certain folks are very concerned that the fines have gotten to the level where they are threatening the competitive viability of the companies, and certainly their overall viability in this economic environment.

Can you give some perspective on how that squares with the 2020 objectives? And also, could you comment just briefly on whether the Commission is looking at any ways to focus more on the culpable individuals instead of just heaping more fines on the companies?

DR. ITALIANER: Thank you, Roxann.

First of all, a word about the 2020 objectives. This is part of the new economic strategy that we are devising at the European level. It became necessary, in particular when we were coming out of the crisis, to move more to an economy that is based on knowledge, on innovation, is also sustainable and creates more jobs. So it is really a new economic strategy.

I would say that cartel enforcement has to be part of that strategy because a level playing field, competition, I think is the most beneficial breeding ground for a knowledge- and innovation-based economy.

As regards the fines and the level of our fines, it is true that the level has increased quite substantially since we introduced new fining guidelines a couple of years ago. We recognized that the level of our fines was clearly not deterrent beforehand, so we had to increase it in order to increase the deterrence.

I would say that the absolute level of the fines may sound astronomical, but it is not so important per se because we are very often looking at quite a large group of offenders with very large turnovers. So I think that has to be related to the turnovers of the companies. There we have an absolute cap on this, which is a 10 percent cap, which has existed since 1962. I think it has proven its value over the years.

Now, of course, when it comes to the actual payment of the fines, which very often may take place years later than when the actual offense occurred, we very closely look at the financial situation of the firms, like I said in my introductory statement. If there are real problems that would, for instance, lead to insolvency or bankruptcy, then we are ready to look at the fines. But, generally speaking, I think that the level of the fines is okay at this time.

When it comes to the fining of individuals, I think that this can only be additional to what we are doing in terms of fining companies because, after all, it is the companies that benefit from the excess pricing that they can obtain through a cartel. So I think the companies will always need to be fined.

It would be very hard to imagine that the European Commission with its powers could prosecute individuals in a way that this can be done in other jurisdictions. So I don't think this is something that will come very soon. But there are a couple of our Member States where this is possible and it is actually happening. There are not that many cases, but there have been a few cases, in the United Kingdom, for instance.

I think we need to consider the interaction between prosecuting individuals and the process and procedures and transparency on the one side, and the access to files that we have for the fining and infringement process with regard to firms on the other side. So there is quite a nexus between prosecuting individuals and prosecuting the companies. I think that if there is some progress to be made there, it is probably better done at the national level, at the level of our Member States.

MR. LEIBOWITZ: From the perspective of an agency that doesn't have the authority to seek monetary penalties for most of the cases that we bring, I think imposing a high level of fines is a really important deterrent to stopping bad conduct.

Moreover, in Europe you don't have the development of class actions and private damage litigation that you have here. Now, some people may say, "You know, here we've let it go perhaps too far"—and I might agree—and there is a toxic combination sometimes of class actions and treble-damage litigation.

But when you don't have those remedies—and in Europe they don't—then you really do need fining authority and you need to use it vigorously to stop malefactors. Of course, reasonable people can disagree about whether the fines that the European Union has imposed on companies are appropriate.

MS. HENRY: Christine, you bask in the glory of an outstanding criminal enforcement record. At the

We recognized that the level of our fines was clearly not deterrent beforehand, so we had to increase it in order to increase the deterrence.

—DIRECTOR-GENERAL
ITALIANER

same time, Judge Douglas Ginsburg, even as early as this morning, in a terrific program that I hope some of you attended, has looked at it and said that corporate fines are the wrong way to go, that the focus is misplaced; corporate fines are really punishing shareholders, and possibly the consumers when the companies have to increase their margins after they pay all these huge fines. He has advocated focusing on the individuals and less on the corporations.

Do you have any thoughts on that?

I do believe a robust

corporate compliance

program creates a

culture of compliance,

which is what you want

to see in corporations.

—ASSISTANT ATTORNEY

GENERAL VARNEY

MS. VARNEY: Let me start by saying that your first observation, that I bask in the glory of a terrific criminal program, is absolutely correct, going way back. As has been mentioned, Jim [Rill] is in the front of the audience, and Anne Bingaman certainly did a lot, and it is led by our terrific Deputy, Scott Hammond.

You know, we have a unique provision in the Division, where the corporate leniency program really does encourage cartel participants to be the first ones to come forward. It has been significant for us in detecting cartels around the world that the leniency program has worked so well.

Now, I believe that the leniency program works very well for two reasons. One is that if you are caught and you are not the first one in the door, you will go to jail. The second one is there will be significant fines imposed, coming out of the corporate treasury, that we believe deter corporations from allowing this kind of behavior to go forward.

You and I had a chance to chat about this a little bit beforehand. You know, I have served on corporate boards, and on Fortune 100 corporate boards, and I can tell you as a board member my first concern was always maximizing and protecting shareholder and stakeholder value. I would have been remiss as a director if I was not sure that we had a very robust compliance program, where every member of the corporation operating divisions understood what the rules were, regardless of the environment—environmental rules, antitrust rules, health rules, worker safety rules. I mean there is a wide variety of legal compliance issues.

I do believe a robust corporate compliance program creates a culture of compliance, which is what you want to see in corporations.

Now, in every corporation of significant size, there is a possibility of rogue actors. So we will look at every transaction, every violation, on the facts and the evidence of the violation. If, for example, you have a corporation that has an extremely robust compliance program, a corporate culture of compliance and responsibility, that no amount of training could have detected a very well-insulated rogue actor, that will be a factor in whether or not we prosecute the corporation and seek corporate fines.

With all respect to Judge Ginsburg, who has added so much to the theory and practice of law here, I do believe, both as a law enforcement officer and as a former corporate officer, that corporate fines are a very large deterrent. They are a very good incentive to get everybody focused on what you need to do to ensure knowledge and compliance with all relevant laws throughout the company.

MS. HENRY: Jim, the states have certainly not been absent from cartel enforcement. You touched earlier on bid rigging in your statement. Can you give us a little bit of insight into whether the economy has provoked greater bid rigging, or at least whether it has become any larger part of your agenda at the state level?

MR. DONAHUE: Yes, it has become a larger part of the agenda, for a couple of reasons. As I mentioned, the stuff we have been doing with the Department of Justice has led to some important

leads. So we expect that, maybe over the next year or so, we will be bringing additional bid-rigging cases.

In terms of complaints, I don't know, I can't do a scientific study, but certainly we have gotten more complaints about bid rigging over the past year than we have in a while.

The other thing that we see in the bidding area is an effort to maybe not use bid rigging to remove competition, but to use other things to remove competition. For example, now we are seeing specifications coming through for a particular product that is exclusively distributed by one particular manufacturer or one particular bidder. Those things are increasing the cost of products to government.

The thing we are getting from the government agency representatives is: "What can you do? Is there something that you can do to reduce the cost of these products? They have gone up, and we're concerned about it, because now we have this budget crisis and we've got to find ways to cut. The fact that something is 10 or 20 percent more than it was a year ago is a big problem."

MS. GOTTS: Let's focus for a few minutes on mergers if we could. I'd like start out with Melanie.

Melanie, you have changed the timing of your merger review process. Perhaps this is designed to make Canadian merger review more akin to the United States, with a thirty-day review process and a second request. How is it working?

MS. AITKEN: Well, it is early days still, but we have had some opportunity to assess our new process since it came into force last March.

I would note that it is a little complicated because, notwithstanding we all had fewer—dramatically fewer—merger notifications last year, we certainly were faced with a number of very, very complex strategic mergers that required, perhaps a little bit disproportionately to some of the years prior when we were looking at a lot of equity deals, real attention and real information.

By way of background for those of you who don't closely follow Canadian merger developments, we have a new, two-stage merger review process, much like the second-request process. I hesitate to say that at home, but I will say it in this audience. It is a "made in Canada" version, but it does very much replicate the second-request process in structure.

The reason I hesitate, of course, is because of the concerns you all hear so much about, or perhaps articulate yourselves, with respect to the sometimes real and sometimes perceived burdens associated with complying with a second request. Certainly—and I don't say so pejoratively—we heard those kinds of concerns from our business and our legal community in the period leading up to the implementation of the new merger review process. We already have an acronym. It's a Supplementary Information Request or "SIR," so "To SIR with Love," or something.

But in any event, there was a real concern over the costs and resources involved in complying with a SIR, and that SIRs would lead to excessive burdens on businesses.

I have to digress to say that I think most practitioners have been very supportive in Canada. We have really just gotten down to business and not distracted ourselves with hand-wringing.

But the excessive burdens haven't really materialized. We now actually just have a framework that makes sense. It is a framework that is not arbitrary, turning on the risk tolerance of the parties to close without comfort.

But I think part of the reason excessive burdens haven't materialized is that we did not add resources to our merger team. We are still in the fifty-five-person range. So we have a much-aligned incentive to not over-request information.

I think, more in a principled manner, we are very, very conscious of the power and effectiveness

of this tool if used properly, and we want very much to preserve it. Certainly, the early experience has shown that it is doing exactly what we hoped it would do.

I know you don't always believe it, but at the end of the day, we are actually not looking to make life difficult. We do want to get to the very same place you do, which is to dispense with reviews as quickly as we can in most mergers where they are efficiency-enhancing, and get down to business and focus on the core key issues in other cases as early as possible, so as to ascertain whether we have an issue, and, if we do have an issue, to identify what remedy is necessary to resolve it. Our interests are very much aligned in that respect as well.

And so what we did was concentrate—and I mentioned this earlier—on coming up with guidelines and practices that do the most that we can to focus early, use counsel to help us do that, and get access to the clients as quickly as we can. And, indeed, we engage in things like what we call a pre-issuance dialogue of our Supplementary Information Request. What that means is that by day twenty-five in the first thirty days, we are sending off to parties a draft list of questions on the issues that hopefully we have narrowed, to drop some off the table, to get their comments—not so much to negotiate it, so much as to say, “Look, can you even give us the information in this way, or can you suggest to us a more efficient way to access a proxy for exploring whatever issue it might be?” Pre-issuance dialogue also assists us in making sure that the requests set out in the SIR are as narrow as they can reasonably be.

We also have limits, as do your Guidelines, on custodial numbers, time periods, and the like.

I think all of those measures are going a long way to demonstrating a commitment on our part to reduce the parties' burden as much as reasonably possible, and these measures are working out well in practice. We even managed to dispense with a SIR altogether in a case where one would have thought it was almost obvious we would need one. In those cases where we have had to issue them—and there have only been seven in just over a year—they have been much narrower than one might have expected. Only four have gone to full compliance, even on the terms that we have issued them.

I think we are very firmly of the view that the amendments have established a much more efficient and effective process.

I'd be remiss not to mention, of course, that it also aligns us much more closely with the U.S. process, which makes coordination much better. I think, frankly, on a very practical level, my observation is that the Canadian counsel who are representing the Canadian side are able to access and talk in a more direct way with U.S. counsel or European counsel because they are really speaking the same language. In the past, sometimes we've had a difference because it was a disjointed process and the clients decided to address the issues in the United States first, especially since they had an absolute right to close in Canada if they actually wanted to go that way and could tolerate the risk.

We had an early example of success with the new process in our very own *Exxon/Mobil* deal, *Petro-Canada/Suncor*. The deal arrived right out of the gate, literally within a week of the introduction of our new merger review process. Even so, we managed to get one of the most complex transactions we had seen in a decade resolved to a satisfactory and very robust remedy in less than four months. And we got a pretty good report card, for the most part, from the parties and the public, as well.

This process obviously requires an enormous commitment from us to address a variety of new issues that we are struggling very hard to get on top of as quickly as we can. I know we will make mistakes. But I must say again that I tip my hat to the counsel with whom we have been working. People realized that we've got a new process, it can work really well, and as long as we get it off on the right foot, we can do a lot of real good with it.

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—COMMISSIONER AITKEN

MS. GOTTS: It sounds a lot like the United States—cooperation with the parties, etc.

Now, something that doesn't sound familiar to us in the United States, Alexander, is the very complex system you have in Europe for deciding who has jurisdiction. Some mergers escape the EU thresholds as a result of the "two-thirds" rule, which states that a transaction that otherwise meets the thresholds of the Merger Control Regulation is not reportable in Brussels if the parties generate at least two-thirds of their revenues in a single jurisdiction. In some cases, that has meant a suspension of the national rules by the National Competition Authorities—for instance, in the *Lloyds* matter or in the *Alitalia* matter.

Is the Commission going to seek to change this, Alexander, the next time you have an opportunity to review the Merger Regulation?

DR. ITALIANER: We have indeed, as regards mergers, a somewhat more diverse system than we have for antitrust, because in antitrust there is really a unified legal framework that is being applied both by the European Commission and by the national competition authorities.

For mergers the system is somewhat different, in the sense that we are trying to have a "one-stop shop" system, so that mergers only need to be notified either with us or with the national competition authorities.

But then, when it comes to the application of the rules, there is not the harmonization that we have for antitrust. There is, of course, a lot of national convergence, but in the legal sense they are not harmonized. One has to weigh convergence concerns here against efficiency concerns.

That is why we have this "one-stop shop" system, where if the merging parties realize more than two-thirds of their turnover in a single country, it is the competition authority of that country that takes over the case. Generally, this has worked quite well, and I think it is appreciated by the business community.

There have been a couple of cases, and you cited two of them, where other concerns than purely competition concerns have come in to the national merger decisions. So there are still a couple of our Member States where the competition authorities can be set aside for other concerns, for reason of public interest. In a sense, that is regrettable, because we don't have a similar system at the EU level. But I think it is not a particular reason to change the system.

We have recently reviewed our system, which in its current form is now five years old—and if I look at the United States, that is relatively young, given the time lag you have in reviewing your Guidelines. Our preliminary conclusion is that the system is working actually quite well. We may in the future proceed to some adjustments at the margin.

It is a bit too early to say. We have a new Commission, and Vice President Almunia has only been in office for two months. But I wouldn't expect a radical change in the system.

MS. GOTTS: Thank you.

Christine and Jon, I was waiting and watching by the hour this week to see when the draft Horizontal Merger Guidelines would come out, and on Tuesday you released them. The buzz around the rooms that I have heard—though I only hear some of the comments—are the following three general themes: (1) there is less emphasis on market definition, which is now described as one analytical tool among several; (2) there are higher concentration levels, but the word "presumption" still appears in it; and (3) while the Guidelines contain few surprises, what I am hearing from the lawyers who practice before the agencies is that they wonder what the impact will be in the courts.

So I was wondering, from your perspective, what do you view as being the key changes, Christine?

MS. VARNEY: I know it was entirely coincidental that Jon managed to get a vote and get them out on Tuesday. That was great work on his part.

It was important to us both, I think, to have them out for this week, because both of us have had the opportunity to have many, many conversations with people and begin to get feedback.

Ilene, I think you have identified what I am hearing. Again, on market definition, I think anybody who has done a merger, in the last four or five years at least, at either agency would agree the market definition is an iterative process. Sometimes that works to the parties' benefit and sometimes it works to their detriment. Every transaction is viewed on the facts of the transaction.

So when you've got a repositioning or an entry argument in what otherwise would be an anti-competitive merger, I think this is something that you are obviously going to like. It does tend to cut both ways, but, more importantly, it reflects the reality of how we do the work.

One of the things you didn't mention, which I always found interesting, was whenever I was doing a merger in private practice, we tried to overwhelm the agency with the direct evidence that told our side of the story. So I thought it was very important—I think everybody agreed—to get direct evidence into the Guidelines, and you now see that is given the place that it deserves because we do rely quite a bit on direct evidence.

The thing that I have heard a lot as I've walked around is, "Oh, you've expanded your power and your jurisdiction by your description of how you will look at unilateral effects."

Well, frankly, we haven't. Whenever you have a merger—a four-to-three, a three-to-two—when you are bringing that merger to the agency and you are in a second request, you are doing everything you can to persuade the agency that there will not be a substantial lessening of competition.

I can't tell you how many times in private practice I generated critical loss analysis, I used price and cost margin, I looked at critical loss and put it in front of the agencies. These are tools that we have used consistently when you have a very complex merger in what might be an increasingly concentrated industry, and you have the data, and you have the ability to look at the data through a variety of prisms. It is what we do. It is not in my view an expansion of authority or an expansion of power.

Now, you can quibble with whether or not you like that we do it, whether or not various econometric models are actually predictive of a post-merger environment. But we use it, we look to it; the courts use it, the courts look to it.

It would be foolhardy to predict what the courts will do in response to the Guidelines. Some courts pay attention to them sometimes; some courts do not. Some courts endorse them; some courts specifically critique them.

Again, this is an effort for us to be transparent, to explain to the broader community what we do when we analyze a merger. I have had—I know you all have had this experience too—general counsels of companies say: "Well, why do you need that data? That data is not in the Merger Guidelines." You explain to them: "We are in a second request. If we generate this kind of data, it really is going to be helpful to our story." Then they get it.

It is odd to me, but general counsels actually do pick up the Merger Guidelines and read them. When you are the counselor telling them, "Well, I know it says that, but that's not quite how the agency does it," that's not good for anybody.

So I don't think the Guidelines are all that different in substance either from 1992 or 1997, and I certainly don't think they are really any different than the practice today.

MS. GOTTS: Thank you. Jon?

So from my perspective, although to some extent there might be a little less certainty with the proposed Guidelines—there’s not a “check the box” approach—but to another extent, it explains what we are doing much better to people who are practitioners, and also to district court judges whom we want to understand best practices.

—CHAIRMAN LEIBOWITZ

MR. LEIBOWITZ: I do agree almost entirely with Christine. I think she is right. So I guess I would just make a couple points following up.

This has been the most open Horizontal Merger Guidelines update process ever. I know that Jim Rill involved lots of stakeholders. We did too. We also had multiple workshops all around the country. We put the Guidelines out for comment.

And also, we got it done pretty fast. The process started just last fall.

I would say there are a couple of things that I am most proud of or would focus on.

One is, of course, we changed the HHI threshold. Again, we changed it consistent with the way the agencies think about it, and it does a better job of describing how we actually use them. I think that is helpful to general counsels and to practitioners all around the country.

And then, maybe the most important thing from my perspective is we explain that market definition isn’t an end itself or a necessary starting point of merger analysis, but instead it is a tool.

I will tell you two experiences that I have had as a Commissioner that made me think that we need to have a direct evidence section. One was our evidence in an internal Commission case, a hospital merger case north of Chicago, in North Shore, in which the direct evidence was absolutely overwhelming. Another was *Giant/Western*, which was a petroleum merger case in the Southwest, in which the judge just took a very mechanistic view. This is, of course, not the intent of the 1992 Guidelines, and it wasn’t the way most informed, smart, generalist district court judges look at them. And he might have been right in his decision, so I don’t want to say he was wrong. We lost our PI, of course. But he took an incredibly mechanistic view of how the Merger Guidelines—and he looked at the Merger Guidelines—but a mechanistic view of how they should be interpreted. So he looked to see will we have coordinated effects—maybe, maybe not; will we have unilateral effects—maybe, maybe not. But he didn’t really look at the totality of the evidence, which is what we should be doing and what judges should be doing.

So from my perspective, although to some extent there might be a little less certainty with the proposed Guidelines—there’s not a “check the box” approach—but to another extent, it explains what we are doing much better to people who are practitioners, and also to district court judges whom we want to understand best practices. They can disagree with us, of course, and they can certainly disagree with the evidence we bring to bear in a case.

Part of this is informing the business community. Part of it is informing the judiciary. We think we have done a better job. And again, we are taking comments.

MS. GOTTS: Jim, are we going to see the states get into the game as well and update what might be outdated Guidelines?

MR. DONAHUE: I don’t know that we are going to update our Guidelines in the near future. We’ve got a lot of priorities. And it is difficult for us. Unlike the Department of Justice or the Federal Trade Commission, most of the states don’t have economists on staff. We don’t have policy offices.

I get calls like I got a couple of weeks ago. We had a very successful case involving TriCor. We got \$22.5 million. I sent the check out to the agencies. Then I got a call a couple weeks later saying, “Look, we really like that check you sent us. Can you get us another check in some other case?”

The idea that we would stop doing everything and work on Guidelines isn’t something that we can normally do in the short term. So I don’t think that we are going to do that.

In terms of our Guidelines, there are a lot of concepts in the new Guidelines that are very similar to the concepts that were in the NAAG Guidelines. Some of the stuff that we’ve talked about,

about having really empirical evidence of efficiencies, are now more incorporated into the new Guidelines. That was something that was in our Guidelines a while ago.

The focus on the ultimate effect of a merger (is it going to mean a price increase?) was a concept that is in our Guidelines. It is now talked a lot about in the new Guidelines.

The other thing that I hear all the time, or I have seen in the past couple of days, is “Will the Guidelines mean some great new ability to enforce merger cases or block merger cases?” No, that doesn’t mean that. I think everybody here has said that the Guidelines are incorporating practice. But when it comes down to the decision whether to sue or not sue, it is based on what is the evidence like, what does the economic data say, what are your economists going to say. The Guidelines don’t really change this.

We had a case a couple years ago with the FTC. We were jointly investigating this particular merger. You would think we were investigating a merger of crime families, because every witness who went on said, “Look, we’ll tell you, but we really don’t want to testify, because we’re fearful of these merging companies and what they are going to do to us.” The Guidelines don’t change that fear that’s out there. That’s going to still be there. People aren’t going to say, “Oh, there are new Guidelines, so I can freely talk to the Department of Justice or the FTC or the states about my fears about this transaction.”

MS. GOTTS: Michael?

MICHAEL REYNOLDS: Going to Alexander, I had a question on European merger control. Alexander, you mentioned the new 2020 objectives, the new strategy in Europe. I think we are all very interested to see the effect of that on competition enforcement in Europe, particularly in the merger area.

For example, in the final declaration, the Council stresses, and I quote, “the importance of promoting economic, social, and territorial cohesion, as well as developing infrastructure in order to contribute to the success of the new strategy.”

Are mergers going to be assessed any differently in Europe as a result of having regard to the 2020 objectives?

DR. ITALIANER: I wouldn’t think so. This new strategy is a strategy to create an economy which is more competitive, more knowledge-based, more based on innovation. The best thing that we can do there is to ensure that markets work better, which is the objective of our policy. When we look at a merger, we will still look at whether a merger significantly impedes effective competition. If that is not the case, then we will clear it.

I think the way competition policy more broadly can contribute to this objective is by clarifying the Guidelines in the way we apply competition policy in the areas where it is relevant for this knowledge-based economy. One of the important objectives in Europe, for instance, is to have complete coverage of broadband. So what we are currently working on are guidelines to make it easier for operators to ensure the full coverage of broadband and the conditions under which this can take place.

I mentioned also the Guidelines on Vertical Agreements, where we are now clearer about the possibilities for agreements on Internet sales. The review of the horizontal agreements that we will undertake this year will look, in particular, at the issue of the standards, which is also very important for innovation.

So it is rather in sharpening and clarifying the way we use our competition tools that we will con-

tribute to this strategy rather than radically changing the way we use these tools.

MS. GOTTS: I'd like to turn to merger remedies if I could.

Melanie, Canada is a model in working cooperatively with other jurisdictions, including in the formation of remedies and, where appropriate, in not taking the lead on grounds of comity.

Could you discuss how you go about that process of deciding where you must get a remedy that is independent of, for instance, the United States, and when it is that you could be happy with what the United States comes up with?

MS. AITKEN: Certainly.

We obviously work very closely with the other jurisdictions that are implicated in whichever mergers we are looking at. Of course, very frequently that involves the Department of Justice and the Federal Trade Commission. Just in this past number of months, we have worked together on *Ticketmaster/Live Nation*, *Pfizer/Wyeth*, and *Merck/Schering-Plough*.

There are obvious benefits to sharing information, sharing analysis, and all of those things that we have done for many, many years. But in recent years, we have enhanced our focus in trying to talk about how we can get the most effective remedies, ensuring that, at a minimum, we do not undermine one another's remedies, but also that we design a remedy that will be more effective across jurisdictions. I think, increasingly, we all recognize that, to be effective, it must be a remedy that has an effective implementation mechanism in other jurisdictions.

Very recently, in BASF's proposed acquisition of Ciba Holding, the agreement with the European Commission and the FTC was one that we felt would discharge any Canadian concerns. We did not even require a specific consent agreement in that case.

More recently, the FTC consent decree signed by Danaher Corporation in connection with the MDS acquisition adequately resolved our concerns as well.

There are other examples where we haven't insisted on a separate remedy. But the cases—and I guess this really goes to your question—where we consider whether we need an exclusive remedy turn on a number of different factors.

Most often, we will require some kind of formal agreement that the parties will either ensure that the remedy is implemented in Canada or do what is necessary to ensure that it affects the Canadian market in the appropriate way. But whether we need a separate remedy, whether we need a complete memorialization through a consent agreement, is really dependent on a variety of factors. Some of the things that we would think about include whether it is necessary in the circumstances to participate in the blessing of the buyer of the particular assets; and whether the particular transaction has very immediate effects in Canada or whether they are really more incidental.

I emphasize that this is not deference, but rather a practical approach in circumstances where we've all got issues and remedies are going to be designed and implemented by jurisdictions in which we have enormous faith and trusting relationships. We say, "We need to be sure and confident that we have done what we need to do for the Canadian marketplace," but that doesn't necessarily require belts and suspenders in every case. Sometimes, it can simply be a sign-on that's formalized. Sometimes, it can be a minimalized version of a consent agreement, and in certain cases we can dispense with a remedy altogether. In a case like *Thomson/Reuters*, we had a one-page letter agreement—obviously, a complex deal with very complex remedies, but it wasn't necessary in that case to engage in discussions on a separate remedy.

In cases where there may be a separate consent agreement, I want to emphasize that the

Most often, we will require some kind of formal agreement that the parties will either ensure that the remedy is implemented in Canada or do what is necessary to ensure that it affects the Canadian market in the appropriate way.
—COMMISSIONER AITKEN

Bureau will make every effort to ensure that the remedy remains coordinated with the remedies issued by its counterparts in other jurisdictions.

MS. GOTTS: Alexander, if we could focus on merger remedies abroad for a second. When it comes to horizontal mergers there has been some resistance to the licensing of IP rights being the solution to the competition concerns. I thought your *Cisco/Tandberg* remedy recently raised a really interesting way to resolve that issue. Could you explain this?

DR. ITALIANER: The first thing I want to underline was the extremely close cooperation with the Justice Department on this merger, and in particular on the timing and remedies and with lots of exchanges. Of course, we did this with the consent of the parties. So I think cooperation is really a very good example of how we can achieve a common result.

Now, the competition concerns we had in this merger stem from the horizontal overlap of the parties in certain markets for videoconference equipment, and in particular the interoperability issues that this entailed. The remedy that we devised here, rather than going through licensing, is to divest the rights attached to the proprietary protocol TIP [Telepresence Interoperability Protocol] that was linked to the interoperability to an independent industry body, which would allow other vendors to participate in the development and in the implementation of the protocol. On that basis we cleared the merger. So what we have actually done is bring the remedy very close to an open standard-setting process, which I think is extremely important nowadays for technological development. In this way the protocol is available not only for the large entity but also for the competitors.

Now, this was a very specific remedy. So to deduce from this result that this could be applied more generally I would say is an overstatement. It is a bit like what Jon and Christine said in the previous description. You have to look at it on the merits of the case and do what makes sense. This is something that made sense in this particular merger. We do not have any general approach towards licensing.

MR. REYNOLDS: I wanted to take us for about ten minutes to the important area of international cooperation and greater efforts at convergence. All the agencies here—the European Commission, the DOJ, FTC, Canadian Bureau—over recent years have really made enormous efforts and invested considerable resources in this direction, towards the goal of greater outreach in enforcement to other jurisdictions.

I wanted to ask each of you what you thought was the singular most important accomplishment as a result of all this effort, perhaps starting here in the United States with the FTC, with Jon or Christine.

MS. VARNEY: I don't think that there has been a single most important accomplishment. I think that if you look over the last decade, kind of the evolution of the attitudes, that we can respect each other's unique historic cultural/legal traditions while coming to a common understanding of how you look at both mergers and anticompetitive conduct.

I think the dialogue that has been going on in the forums, such as the OECD [Organization for Economic Cooperation and Development] and the ICN [International Competition Network], has been tremendously important to getting to a common understanding. Jon runs an absolutely first-rate technical assistance program around the world that has also, I think, increased the understanding.

A lot of it is personal. Neelie Kroes and I talked whenever we needed to. We'd pick up the phone and we called each other. Alexander and I talk routinely.

I think *Cisco/Tandberg* was a terrific example of what we will be doing going forward. Again, that was in large part due to the parties. The parties decided that they wanted to try and move this transaction in parallel and gave us both all of the consents that we needed and put the information to us at the same time.

Despite enormous speculation to the contrary, *Sun/Oracle* was also a very cooperative undertaking. We worked with the Europeans. They worked with us. They had questions we didn't have. They ultimately came to their own decision. But it wasn't a divergence in terms of the substantive standards that were applied. It was a very good working experience at the end of the day, which led us to think about how we were going to approach *Cisco/Tandberg* based on what we'd gone through in *Oracle/Sun* and where we could cooperate more fully and at different points in the process.

I think that you are going to continue to see more and more cooperation between the United States and international jurisdictions, particularly when it comes to merger reviews, but frankly, only if the parties perceive that it is in their interest to do the merger that way. If they don't, then there's not that much we can do.

MR. LEIBOWITZ: I agree with Christine. From our perspective, I'd say no one thing stands out more than others, but it's a combination of things. We're fortunate enough to have wonderful relationships with the other competition agencies, such as the Canadian Competition Authority and the European Commission. A lot of our bilateral work has been critically important for both agencies and for the parties, and of course for consumers and competition. It has been mostly on mergers, but it has also been, for example, on the European Union's pharmaceutical initiative, where we've been working with them and they've been working with us.

The technical assistance program, which Christine knows well because she was present at its creation, has now expanded to the extent that we did sixty-three technical assistance missions in thirty countries last year. Some of that is funded by USAID, which is very helpful from the budget perspective. When you are in the business of running an agency, you need to make sure you have enough money to do the things you want.

And then, probably the third, as Christine mentioned, is, on the multilateral front, including our work at the OECD, very often with the Department of Justice, and ICN. Volcanic ash notwithstanding, the ICN meeting next week is probably going to be a very, very important place for developing relationships with our international colleagues and laying the groundwork for working together with them.

Michael, as you pointed out, just as the economy has become far more global in the last several decades, I think our collaborative work here has become far more important and we hope to continue it.

MR. REYNOLDS: Alexander, would you like to just say a few words from the European Commission's point of view?

DR. ITALIANER: I am very much in line with Christine and Jon. No particular outstanding achievement, but a constant improvement in the course of the year.

I was asking my colleagues when I arrived here, "How many cases are we working on with our international colleagues?" They said, "Well, we don't count; it is daily contact." As Christine said,

I think that you are going to continue to see more and more cooperation between the United States and international jurisdictions, particularly when it comes to merger reviews, but frankly, only if the parties perceive that it is in their interest to do the merger that way.

—ASSISTANT ATTORNEY
GENERAL VARNEY

it is easy to pick up the phone, and the same with our contacts, very good contacts, with the Competition Bureau. So it is something that is certainly very natural.

I should underline how important it is to do this also with the consent of the parties, because I think it is in their interest to have a converged treatment of their cases by the various jurisdictions. So I would only encourage this. I know that many mergers are very complicated. They have to be notified sometimes in ten or twenty jurisdictions. I think this underlines the importance of achieving convergence at the international level.

OECD was already mentioned. I would also like to highlight the work of the ICN. I think the ICN is a very interesting example where in times when it is difficult to achieve focus in other areas, such as the WTO, what you are actually doing, in a very informal way, is to replace an international treaty by another system of governance, but as a very informal process. One example of an informal process is the Working Group on Unilateral Conduct. We have very different traditions in various jurisdictions on unilateral conduct. But to have this working group allows better understanding and imparts some convergence in the long term. We are very happy to host the Working Group on Unilateral Conduct at the end of the year. When we come together in Istanbul next week, I hope we can take stock of all the efforts that are being made in a very active and cooperative way in the ICN.

With globalization, with the need for convergence in the treatment of multinational firms when it comes to mergers and also anticompetitive conduct, I think this is a very important development that should only be encouraged.

MS. HENRY: Let's turn now to civil enforcement. I'd like to stay with Alexander for a moment. Can you give us some insight into what lessons you have learned from the pharmaceutical sector inquiry that you have done?

DR. ITALIANER: It is fairly recent since we concluded the sector inquiry that we undertook in 2008, and which we concluded in July 2009. Our work is still progressing.

I think one of the lessons we have learned from looking at the sector is that there are certain very peculiar behavioral practices that may raise competitive concerns. One of these practices is the so-called "pay-for-delay" settlements, where originator companies pay the generic companies for delaying the introduction of their generic products. Actually, the two cases that we have started are in that area.

But there are potentially also problems either between the originator companies or between the generic companies. Since we are still investigating, there is not much that I can say about this.

But I think what is clear is when you go into a particular sector, you find behavior that otherwise you wouldn't easily detect through complaints or through supervision or monitoring of the market. So I think when you look in this direct way, this is a very useful instrument, at least the way we have experienced it in Europe.

MS. HENRY: Jon, let me turn to you with a quick-and-easy softball question. You've been particularly vocal and the FTC has been particularly vocal about your position on reverse patent payment settlements. The legislative initiative sort of fizzled. The courts are not being overly supportive. Is it time to give up or do you have an alternative plan?

MR. LEIBOWITZ: Roxann, I think I would disagree with a part of your premise. I think we are closer to solving this problem than we have been at any time since I have been at the Commission.

Of course, it has been a collaborative effort for all the Commissioners and for the staff. We really do try to take the sort of Jeremy Bentham “greatest good for the greatest number of people” approach to figuring out what our priorities should be. And we also look at where is the case law the worst. This was a great confluence of both of those factors.

Pay for delay settlements are a very important problem for American consumers. Our Bureau of Economics estimates that the harm to consumers for brands literally paying generics to stay out of the market is \$3.5 billion a year—and of course the generics make more money by not competing because their margins are so much lower. I think that is a very conservative estimate, because the push-out time—some of the circuit courts have very permissive rules—has gotten longer over the last year.

We take the approach that we are going to keep on fighting these settlements. I do think on the legislative side, in part because there is a savings for government—as we know, for a variety of reasons, we are running a major deficit—I think that will be part of the reason, as well as what we think is substantively good policy, that we have a very good chance of getting legislation enacted this year, even though we didn’t get it done in health care reform because of the complications surrounding reconciliation in the Byrd Amendment. But we are working with lawmakers to try to find another vehicle.

And then, on the litigation front, the Justice Department and the FTC are largely in lock-step on an approach that makes these deals presumptively illegal but allows for rebuttal. This was certainly not true during our *Schering* case, where the Justice Department told the Supreme Court, “Do not take the Federal Trade Commission’s cert appeal.”

The Second Circuit is reviewing its own standard, which we believe is too permissive. An excellent brief was filed by Christine and her staff.

And then, you know, judges, when they think about this issue, they seem to be getting it. You might disagree, for those of you who follow this, with the formula or the methodology used by the district court judge—I think it’s Judge Goldberg, but I could be wrong about that—in Philadelphia. But he sort of got it. We survived a motion to dismiss in the Cephalon case because he thought that we had the right to prove that they bought extra protection by paying \$200 million to four generics, who otherwise we believe would have entered the market.

So I don’t think we are ready to give up or throw in the towel for all the people who pay a little bit more for their insurance because of the high price of pharmaceuticals. And then, more importantly, we think it is a critical issue to stay involved with the legislation for the 47 million whose prescription costs will be reduced and for the many uninsured.

MS. HENRY: Jim, McCarran-Ferguson also didn’t make the legislative agenda. It’s still there. But the states do have a lot of power over the insurance industry. Can you tell us if there is an appetite at the state level to examine the competitiveness of the insurance industry?

MR. DONAHUE: This is a good question because actually right now our office is defending the Pennsylvania Insurance Department, which has been sued by Highmark and Blue Cross/Blue Shield to prevent the Insurance Department from releasing a report about the state of competition in health insurance in Pennsylvania. Here is advocacy that is being done by our Insurance Department. Highmark is trying to prevent the Department from releasing that information. We are defending them. We’ve got a PI hearing next week. We are actually doing briefing today. So that’s right on there.

Insurance is 15 percent of the health care dollar. Eighty-five percent of it is providers. I can give

you a long list of states that are doing hospital mergers. Oregon and Pennsylvania are looking at physician mergers. I mentioned the Tricor case. We have partnered with the FTC on many of these drug cases.

One thing I should not forget to mention is Massachusetts. They have done a series of reports about the pricing of different hospitals. Health care pricing has always been completely opaque. They are taking that blanket off and exposing that and advocating that people want to consider the cost of different providers when they get their health care.

Health care pricing has

So there is a lot going on at the state level.

always been completely

MS. HENRY: Christine, let's turn to high tech. The *Microsoft* cases started in the early 1990s at the FTC; they then proceeded to the DOJ. Remedies at the DOJ were implemented in 2002, in Europe in 2004. It took a long time to get serious remedies.

opaque. They are taking

Where are you looking to invest in your pipeline in the high-tech area and what should we expect to see?

that blanket off and

exposing that and

MS. VARNEY: I don't think that you should expect to see the DOJ undertaking investigations and actions to put points on the board. That's not what we're about.

advocating that people

When we look at any particular industry, we are always looking at: What are the bottlenecks? What is preventing robust competition? What is in the way of getting more output, lower prices, faster innovation?

want to consider the

In high tech, as you know, Roxann, it's additionally complicated because it is so laden with IP, and in many, many industries the network effects can be such that the first winner takes all and locks in for quite a long time.

cost of different

providers when they

We are very conscious that in the United States we have several world-class companies that through innovation and competition have come to a place in the market where they enjoy a significant market share. With that market share comes enormous responsibility. Our view is that companies who have that market share and are behaving responsibly have nothing to fear from the Department of Justice. We are supportive of their efforts internationally to be competitive.

get their health care.

On the other hand, we have a very keen, very sharp eye for those companies that are attempting to retard competition. As I have said repeatedly, our touchstones are the Supreme Court-articulated precedents in *Lorain Journal*, in *Aspen Skiing*, and in that part of the *Microsoft* case that went up on appeal and was sustained.

—CHAIR DONAHUE

I wouldn't tell you that you ought to watch anything in particular. Counsel your clients well.

I heard a lot of commentary last May, when we withdrew the DOJ Section 2 Report and aligned ourselves with the Federal Trade Commission. I heard "Well, what will I tell my clients?" Again, having been in practice for the last dozen years, I know exactly what to tell my clients as to when they were really pushing the envelope and taking on more risk than might have been acceptable and when they were operating completely within a zone of conduct that was sustainable under the antitrust laws.

So I think for practitioners it is pretty clear when you've got a company that enjoys market power that they do have special responsibilities and obligations, and I would expect again that they would adhere to it.

MS. GOTTS: Consumer protection is an area in which our Section is very interested these days. In connection with that, Jon, I was very interested that you indicated your agreement with creating another consumer protection agency. How do you see the definition of the role of the FTC if such an agency were launched?

MR. LEIBOWITZ: Well, we will probably know better after next week, when the Senate finishes debate on it.

From my perspective, I would say this. Reasonable people can disagree about the creation of a new consumer financial agency. That's what they did in the House bill. And in the Senate bill, it looks more like a bureau. I think we have a divergence of opinions on the Commission, with most of us supporting it. And all of us support elevating consumer protection.

But from my perspective, it is really not so much about something that's new as sort of rearranging the very balkanized pieces among banking regulators, to come up with a more robust, more effective consumer protection entity. There are four or five different agencies that have some responsibility for consumer protection over banks. We have responsibility for consumer protection over non-bank financial institutions and services and products. Within most of those agencies, what they focus on is safety and soundness, or bank examination, or, in the case of the Fed, protecting the economy. And so while they are good agencies and dedicated public servants, consumer protection is usually not at the top of their agenda.

And as we all know, what we have seen in the last few years was the result of a spectacular lack of regulation or oversight largely by, but not entirely by, the banking agencies. So from my perspective, creating a new consumer financial agency or a new bureau that could have a laser-like focus on protecting consumers seems to me to be a good idea, and we will see where it goes.

It is not entirely certain it will go much farther than the Senate. But I think actually more and more people are coming around towards the notion of creating it, and maybe with some bipartisan support, which I think gives institutions the support they need going forward, to know that they will be there for years, and perhaps decades, and not simply months, as the political tide changes.

MS. GOTTS: Well, let's hope they learned a few things from the formation of Homeland Security on how to make the work a little bit easier.

MR. LEIBOWITZ: One can only hope, yes.

MS. GOTTS: Jim, the states have been very active in consumer protection. Are there any scams that we should be aware of as consumers? And how are your resources holding up on things like Internet-based schemes?

MR. DONAHUE: Let me answer the last part of the question first, although it relates to the first part.

On Internet-based schemes, we have the resources to go after them. They are really no different, in a sense, than your run-of-the-mill scheme. The big problem with the Internet is trying to find the little buggers. They may not be in this country. The Nigerian letter thing has now been transferred to an email, and there's a variety of things that occur that take you overseas to countries with no cooperation arrangements with our country or the European countries or the Canadian authorities. So that's a big problem on the Internet side.

But in terms of resources, yes, we have the resources to look at it.

In terms of the focus on the consumer protection side, there has been a lot of focus, as Jon mentioned, on the impact of the economic crisis. That has spawned a whole bunch of scams involving mortgage repair and debt repair and all of this sort of stuff. That has been a focus of the attorneys general over the past couple of years, and it probably will continue to be a focus in the near future.

So from my perspective, creating a new consumer financial agency or a new bureau that could have a laser-like focus on protecting consumers seems to me to be a good idea, and we will see where it goes.

—CHAIRMAN LEIBOWITZ

MS. GOTTS: I would like to take the last five minutes to give each of our panelists one minute to give us their summary of something they want us to walk away with and remember.

We'll start with Christine.

MS. VARNEY: When you come to the Department of Justice, you can expect and demand a fair, transparent, and open examination of the issue conducted by the most professional staff I have ever encountered, led by some of the most terrific lawyers in the world as our deputies.

In closing, let me say that this year we went green and our annual report is online. You can find it at usdoj.gov. Click on "antitrust." It's great. It has lots of pictures and lots of interesting statistics and facts.

We look forward to seeing you in the coming year.

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—COMMISSIONER AITKEN

MS. GOTTS: And, after seeing our ability to hook in Europe like this, I'm starting to believe we can actually pull things over the Internet.

Melanie?

MS. AITKEN: I would just like to say that it's a transformative time in Canada, with a new coherent criminal cartel provision and, I think, a far more effective merger review process. But that's a very significant challenge for us, and we have a responsibility to ensure that we do the most that we can with those new provisions for all who carry on business in Canada.

We will certainly try to be accommodating, creative, and flexible where we can—polite Canadians, if you will—but we will certainly also ensure that we do our job. We will be taking a principled and measured approach, but we will not hesitate to enforce the law, and you can be confident about that.

MS. GOTTS: This is a hard act for you to follow, Jon.

MR. LEIBOWITZ: It really is.

We too will try to take a principled and measured approach.

And we like to think of ourselves as going green. We are in the process of writing green guides, which is something we are doing on the consumer protection side, and moving the American society from watts to lumens, which I know you are all very excited about. But we have hard copies of our annual report here for you. You can also get it online.

From my perspective, we are a wonderful little agency with terrific professionals, a Commission that really wants to try to solve practical problems, or solve problems with practical solutions. We try to do the best we can. We have had a lot of interaction with so many of you in the audience. Please let us know when you think we've made a mistake. You can also let us know once in a while when you think we're doing a good job.

Thank you so much, and thank you for the opportunity to be here today.

MS. GOTTS: Jim?

MR. DONAHUE: I have been the Task Force Chair for nine months, but I have been in the Attorney General's Office for more than twenty years. I've gotten to know many of the staffs of many of the AGs around the country. There are really terrific attorneys, great litigators, a lot of really phenomenal professionals whom I have had the opportunity to work with. Coming to an AG's office, that's

the sort of treatment that you are going to get. You are going to be treated by professionals.

If you are dealing with consumer products, stuff that governments buy, or health care, you need to know that we are going to be looking at those issues carefully.

MS. GOTTS: I have not forgotten about you, Alexander.

DR. ITALIANER: Although I am only two months in my job, I must say that I am really impressed by the professionalism and the quality of the team that I encountered when arriving here. Certainly, not coming from the competition world myself—in fact, I used to do econometrics a long time ago—what I find most surprising is the way in which my institution is able to adjust to new circumstances, including the extremely rapid reaction we had to the potential financial meltdown in Europe. I know this is not so much the concern of the other agencies here because they don't have this responsibility. But this is really impressive. So it is an extremely versatile and resilient organization. I really have full trust in the capacity of my people to ensure a competitive economy in Europe that can coincide with the new 2020 goals that we are pursuing.

I must say how much I enjoyed being with you through technological means, and I hope to see all my colleagues in person in Istanbul. So we have had a good exchange and are working towards this global governance I was talking about.

I would say: Enforcers of the world, unite!

MS. GOTTS: Alexander, I wish you a bon weekend. I also would like to particularly thank you for your willingness of going this extra mile to participate.

I would ask the entire audience to thank Alexander and the rest of our panelists for participating. ●

A Note on Loyalty Discounts

Jonathan M. Jacobson

Loyalty (or “market share”) discounts have become increasingly visible in antitrust policy debates.¹ Loyalty discounts are prevalent in the sale of medical devices and pharmaceutical products, especially by dominant firms,² and are being used more frequently by firms in other industries as well. Intel’s use of them has led to antitrust proceedings by AMD,³ the European Commission,⁴ the New York Attorney General,⁵ and, most recently, the Federal Trade Commission.⁶

This note examines reasons firms offer for the use of loyalty discounts, the sparse case law addressing their use, and how antitrust policy might be applied going forward in evaluating their legality. The note’s analysis suggests that loyalty discounts are essentially a form of exclusive dealing. Application of the sort of price-cost test typically used in analyzing predatory pricing therefore seems inappropriate. And while use of an attribution test similar to that used in analyzing bundled pricing conduct might make sense in theory, the real-world difficulties in applying such a test to loyalty discounts render that approach impractical. The suggestion here, therefore, is to apply basic rule of reason analysis—to determine whether the impairment of rivals, net of efficiencies, is likely to reduce market output or otherwise cause material consumer harm.

■ **Jonathan Jacobson** is a Partner, Wilson Sonsini Goodrich & Rosati, New York, and formerly, Commissioner, Antitrust Modernization Commission. He thanks Einer Elhauge, Richard Gilbert, and Herbert Hovenkamp for helpful discussion and Edward Holman for research assistance. Mr. Jacobson represents clients in the Intel and Sanofi-Aventis matters mentioned in this article. The views expressed here, however, are his alone and do not necessarily correspond with those of any of his clients or his law firm.

Introduction

A loyalty or market share discount is a price break given by a supplier in return for the customer’s commitment to take a given percentage of its requirements from the supplier in question. A simple type of discount might be one that is limited to the units in excess of a stated amount. So, if a supplier’s nominal price for its product is \$100, the supplier might offer customers a discount of \$15 on all units in excess of 50 percent of the customer’s requirements. In this example, a customer whose total requirements are 100 units would pay the supplier \$7550 for 80 units, saving \$450 from the nominal price (\$15 apiece on the incremental 30 units).

Another type of loyalty discount is the “first dollar” discount. The same supplier using this sort of discount would offer the \$15 price break on *all* units purchased provided that the customer

¹ Compare, e.g., U.S. DEP’T OF JUSTICE, COMPETITION & MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 106–19 (2008) [hereinafter BUSH DOJ REPORT] (withdrawn effective May 11, 2009), available at <http://www.usdoj.gov/atr/public/reports/236681.pdf> (urging largely laissez-faire approach), with, e.g., Statement of Commissioners Harbour, Leibowitz & Rosch on the Issuance of the Section 2 Report by the Department of Justice 5–6 (FTC Sept. 8, 2008), available at <http://www.ftc.gov/os/2008/09/080908section2stmt.pdf> (evaluating loyalty discounts as a form of exclusive dealing).

² See Einer Elhauge, *The Failed Resurrection of the Single Monopoly Profit Theory*, COMPETITION POL’Y INT’L, Spring 2010, at 11.

³ *Advanced Micro Devices, Inc. v. Intel Corp.*, No. 05-441 (D. Del. filed June 27, 2005). The case settled on November 12, 2009.

⁴ Commission Decision, COMP/C-3/37.900—Intel Corp., May 13, 2009, available at <http://ec.europa.eu/competition/sectors/ICT/intel.html>.

⁵ *New York v. Intel Corp.*, 1:2009cv00827 (D. Del. filed Nov. 4, 2009).

⁶ Complaint, Intel Corp., FTC Docket No. 9341 (Dec. 16, 2009), available at <http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf>.

obtains at least 50 percent of its requirements from the supplier. Using the same example, the customer buying 80 units would pay \$6800. The loyalty devices that most frequently encounter antitrust scrutiny are these “first dollar” discounts, and the discussion below will focus on them.

Why do firms use loyalty discounts? The main reason, of course, is to sell more. In this example, the customer will be tempted to buy more if its average unit price is \$85 rather than \$100. The analysis cannot stop there, however, because a loyalty discount is not a simple price cut. The supplier could always simply charge \$85 for its product across the board. By conditioning the discount on a percentage requirement, the supplier is inducing the customer to take more from the supplier and also to take *less* from rivals. In some instances, moreover, the “discount” might in fact be a disguised penalty for “disloyal” buyers. The competitive equilibrium price, in the same example, might be \$85, meaning that, if the 50 percent loyalty requirement is not met, the supplier’s resulting price of \$100 per unit will include a \$15 per unit penalty.

Adding the loyalty

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Altering the example to incorporate the sort of numeric values encountered in actual cases highlights the problem. Take a supplier with a significant market share who is applying a discount of 20 percent to customers who purchase at least 90 percent of their requirements. For a customer purchasing 100 units, there is a strong inducement to purchase all (or at least 90 percent) from the supplier. If rival suppliers charge \$80, the customer purchasing 90 units or more from the supplier pays \$8000 in total for 100 units. But if the customer wants to take 20 units from rivals, there is a significant penalty. The 80 units from the defendant supplier cost \$8000 at the \$100 price, the same price as 100 units if the customer had met the 90 percent loyalty requirement. Rivals therefore must give their product away for free for the customer to avoid paying more. The first dollar loyalty discount, in this example, may operate effectively as an exclusive dealing requirement.

Is that a problem? Exclusive dealing arrangements are typically associated with potentially significant efficiencies. An exclusive dealer will focus its energies on the supplier’s products and promote them more effectively. Exclusivity tends to limit free riding, assure quality, inhibit passing off, reduce out-of-stocks, and may provide commitments of volume necessary to achieve economies of scale.⁷ Traditional exclusive dealing thus involves significant complementary investments in which both supplier and customer devote time, energy, and money to their mutual success.

Many loyalty discounts, however, are generally associated with *no* complementary investments and are different from exclusive dealing in this respect. Because some competitive product purchases are permitted, the supplier generally is not trying to get its dealer to provide an entirely dedicated focus to the distribution of its products. Loyalty discounts, moreover, are sometimes applied to end-user purchasers, such as hospitals, where complementary investments are rare. Typically, then, the principal goal underlying a loyalty arrangement is not to further more effective distribution, it is just to get the customer to buy more—and to get rivals to supply less. So firms using first dollar loyalty discounts, at least in the general case, *might* be trying to compete on the merits by selling more, *might* be trying to exclude rivals, but may *not* be seeking to achieve the efficiencies achieved by the complementary investments with which ordinary exclusive dealing is typically associated. Importantly, the customer benefit is limited to the lower price associated with the discount—a benefit that could be achieved equally by simply reducing the price. Adding the loyalty condition generally provides no benefit to the customer. It benefits only the supplier, and may cause rivals considerable harm.

⁷ See Jonathan M. Jacobson, *Exclusive Dealing, “Foreclosure” and Consumer Harm*, 70 ANTITRUST L.J. 311, 357–60 (2002).

These general principles are not without some exceptions. If a supplier uses its loyalty discount, for example, to reward distributors who invest in the supplier's products—by providing better facilities, more adequate stock, dedicated promotional activity, and the like—the efficiency effects may well resemble those associated with more traditional exclusive dealing arrangements. In some instances, moreover, involving products with high fixed costs, loyalty discounts may assure greater sales and, thus, lower prices. Whether loyalty discounts are reasonably necessary to achieve these goals, however, is less clear. A supplier can offer volume discounts or other price concessions, without loyalty commitments, to generate volume to account for high fixed costs. Similarly, dealer services can be compensated directly or achieved through incentive payments, without imposing a condition of loyalty. Nevertheless, in cases where loyalty less than complete dedication may give rise to more effective distribution, and where the arrangements in question are likely to achieve that goal, condemnation may not be appropriate.

Case Law

The legality of loyalty discounts can be analyzed as agreements in restraint of trade under Sherman Act Section 1⁸ or, if the product in issue is a commodity, as condition or agreement lessening competition under Clayton Act Section 3.⁹ If the defendant has significant market power, analysis under Sherman Act Section 2¹⁰ may be appropriate as well. The primary issue addressed in this note is whether the arrangement at issue is anticompetitive, and, for purposes of answering that question, the analysis under each of the three statutes should essentially be the same.

Analysis of loyalty discounts has led to diverse treatment in the rather sparse case law. Three of the reported cases on the issue involve fact patterns in which there was little, if any, harmful effect because the plaintiff could easily overcome the discount by offering an above-cost favorable price. In each of *Concord Boat Corp. v. Brunswick Corp.*,¹¹ *Allied Orthopedic Appliances v. Tyco Health Care Group*,¹² and *Virgin Atlantic Airways v. British Airways*,¹³ the defendant prevailed because of insufficient evidence that customers were economically coerced into buying from the defendant. In *Concord*, for example, the court agreed that de facto exclusive dealing achieved by a discounting scheme could be a violation,¹⁴ but that the discounts at issue were sufficiently modest, and the plaintiff enjoyed sufficient room to compete for any and all of the available business, such that a violation finding could not be sustained.¹⁵

In *Masimo Corp. v. Tyco Health Care Group*,¹⁶ in contrast, the Ninth Circuit sustained a jury verdict of loyalty discount liability. The district court concluded that Tyco's 90 percent market share requirement was coercive because the existing installed base of Tyco equipment required customers to take some appreciable portion of their requirements from Tyco no matter what, such that, at least for some customers, Masimo "could not price its sensors low enough" to compensate for

⁸ 15 U.S.C. § 1.

⁹ 15 U.S.C. § 14.

¹⁰ 15 U.S.C. § 2.

¹¹ 207 F.3d 1039 (8th Cir. 2000).

¹² 592 F.3d 991 (9th Cir. 2010).

¹³ 257 F.3d 256 (2d Cir. 2001).

¹⁴ 207 F.3d at 1062–63.

¹⁵ *Id.* at 1059–60.

¹⁶ No. CV-02-4770 (MRP), 2006 WL 1236666 (C.D. Cal. Mar. 22, 2006), *aff'd*, 30 Fed. App'x 95 (9th Cir. 2009).

the discounts lost by the failure to satisfy the market share requirement.¹⁷ Put differently, on the volume for which Masimo could compete—the “contestable volume”—Tyco’s prices were below cost.

The much-discussed (and often criticized) decision in *LePage’s, Inc. v. 3M*,¹⁸ typically thought of as a bundled discount case, can also be viewed as involving loyalty discounts. 3M provided discounts on transparent tape that applied not only to its dominant “Scotch” brand but to private label tape (where LePage’s competed) as well. The Third Circuit condemned the discounts as exclusionary, notwithstanding the absence of any evidence that the prices were below cost under an “attribution” standard or any other basis, because they had the practical effect of requiring customers to award all or almost all their tape business to 3M.¹⁹

Loyalty discounts were also involved in the recent district court decision in *Univac Dental Co. v. Dentsply International Inc.*,²⁰ a private damages action filed in the wake of the Justice Department’s successful exclusive dealing case against the company.²¹ In a brief discussion, the court denied summary judgment to the defendant in connection with a claim that rebates conditioned on exclusivity violated Section 2—without any requirement of proof of pricing below cost (however measured).²²

Somewhat surprisingly, given all the current debate about loyalty discounts, these cases provide the only decisions specifically addressing loyalty discounts in the modern antitrust era. And they provide scant guidance. *LePage’s* and *Dentsply* involved a variety of different practices. *Concord*, *Allied*, and *Virgin* involved contexts where there was little, if any, harmful impairment of rivals,²³ while *Masimo* involved a context in which impairment was obvious. The considerable middle ground has not been touched in any meaningful way.

The much-discussed (and often criticized) decision in LePage’s, Inc. v. 3M, typically thought of as a bundled discount case, can also be viewed as involving loyalty discounts.

Arguments Against Applying Exclusive Dealing Standards

The purpose of any loyalty discount, by definition, is to induce partial or complete exclusivity. The customer is offered a price break in return for a promise to take all, or a stated minimum percentage, of its requirements from the supplier. Without more, of course, there is nothing anticompetitive in that sort of arrangement. If the supplier lacks market power, for example, exclusivity—whether induced by loyalty discounts or not—will not be problematic. Even where the supplier has market power, application of standard exclusive dealing analysis will condemn only those arrangements that lack significant efficiencies and have the actual or probable effect of causing significant consumer harm.

Still, even though loyalty discounts are designed to create results essentially the same as exclusive dealing arrangements, arguments have been advanced to suggest that exclusive dealing standards should not apply. None of these arguments has much merit.

¹⁷ *Id.* A similar result was reached in *Eisai Inc. v. Sanofi-Aventis LLC*, No. 3:08 Civ. 4168 (D.N.J. June 12, 2009) (transcript of hearing).

¹⁸ 324 F.3d 141 (3d Cir. 2003) (en banc).

¹⁹ *Id.* at 159–63. Although the relevant market in the case was all tape, branded or private label, the case is still better viewed from the multiple-product bundled discount perspective because the 3M discounts were premised on purchases of all its various products, not just tape. The “attribution” standard is discussed further below in the text accompanying notes 38–42.

²⁰ No. 1:07-CV 0493 (M.D. Pa. Mar. 31, 2010).

²¹ *United States v. Dentsply Int’l*, 399 F.3d 181 (3d Cir. 2005).

²² *Dentsply*, No. 1:07-CV-0493, slip op. at 13.

²³ Courts regularly use the term “foreclosure” to signify a harmful impairment of rivals. For an argument that the “foreclosure” terminology is confusing, circular, and ultimately not useful, see Jacobson, *supra* note 7.

One argument is that, because loyalty discounts involve pricing, the predatory pricing standard of *Brooke Group*²⁴ should apply.²⁵ None of the decided cases supports that view, however, and it does not withstand analysis.

In circumstances where loyalty discounts may be harmful, the problem is not the price level; it is that rivals are denied access to customer volume. If the effect is to prevent rivals from constraining the defendant's market power, consumer harm may result.²⁶ Application of a predatory pricing standard does not accomplish the necessary analysis.

Professor Elhauge provides a useful example of why exclusivity, rather than price levels, should be the focus of the analysis:

Suppose a monopolist charges \$200 for a product that costs \$100 to make. Other firms stand poised to enter the market, or to expand until they achieve sufficient scale to reduce their costs to \$100, in which case competition will drive prices down to \$100. To prevent this competitive outcome, the monopolist announces a loyalty program under which its price is \$250 unless buyers agree to be loyal and buy 90% of their needs from the monopolist, in which case buyers get a nominal "discount" of \$50. All the buyers agree to avoid the \$50 price penalty, foreclosing 90% of the market. As a result, rivals cannot enter, or expand enough to achieve their minimum efficient scale, and the buyers all continue to pay the monopoly price of \$200, which is double the \$100 price they would have paid but for the loyalty program.²⁷

As this illustration demonstrates, the seller's prices can remain well above cost on any measure while still excluding rivals and, in so doing, raising customer prices above competitive levels. No court in any traditional exclusive dealing case has asked whether the defendant's prices are above or below cost because the question is simply not relevant in that context. The same is true in cases involving loyalty discounts.²⁸

A second argument is that exclusive dealing analysis is not applicable because a loyalty percentage requirement less than 100 percent is not "exclusive" dealing.²⁹

The argument is unpersuasive. Plainly, a 99.9 percent loyalty requirement is "exclusive" in every meaningful sense of the term. Requirements of 90%, 80%, or 65%, are variously less so, but they may still bar rivals from access to the levels of volume needed to compete effectively. An outright exclusive dealing arrangement affecting 60 percent of a given market may or may not be unlawful but clearly merits scrutiny. The analysis is no different if the arrangement is for 80 percent of customer's "loyalty" requirements by a firm with a 75 percent market share. In both instances, 60 percent of the available market may be out of reach of rival firms.

The case law appears to put this argument out of bounds in any event. The Supreme Court has twice held under Section 3 of the Clayton Act that the question is whether the arrangement has the "practical effect" of excluding rivals,³⁰ and lower court cases apply the same analysis in

²⁴ *Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

²⁵ See BUSH DOJ REPORT, *supra* note 1, at 116–17 ("the standard predatory-pricing approach to single-product loyalty discounts has a number of advantages").

²⁶ *E.g.*, Jacobson *supra* note 7, at 347–57.

²⁷ Declaration of Professor Einer Elhauge on behalf of Eisai Inc. ¶ 3, *Eisai Inc. v. Sanofi-Aventis LLC*, No. 3:08 Civ. 4168 (D.N.J. Nov. 17, 2008).

²⁸ See Harbour, Leibowitz & Rosch Statement, *supra* note 1, at 6–7; Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615, 636–38 (2000).

²⁹ See BUSH DOJ REPORT, *supra* note 1, at 115.

³⁰ See *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 326 (1961); *United Shoe Mach. Corp. v. United States*, 258 U.S. 451, 457 (1922).

cases under Sections 1 and 2 of the Sherman Act.³¹

Yet another argument is that exclusive dealing analysis should not apply because exclusivity is not an absolute requirement; it is instead, conditioned on discounts.³² Again, however, logic and precedent are to the contrary.

Although many loyalty discounts are nominal and not at all coercive, that is not so universally true to warrant exempting them from effective scrutiny. If a loyalty condition is sufficiently steep, and if customers must take some portion of their requirements from the defendant in any event, the condition is not much different from express exclusivity. As Professor Elhauge's illustration demonstrates, there are often cases in which rivals cannot meet the discount without giving their product away.

The specific text of Section 3 of the Clayton Act is informative. It refers expressly to any agreement to sell or lease goods "or [to] fix a price charged therefor, or *discount* from, or rebate upon, such price," conditioned on exclusivity.³³ Supreme Court precedent is to the same effect. In *Northern Pacific Railway v. United States*,³⁴ the agreement in issue required shipment over the defendant's railroad only if "its rates (and in some instances its service) were equal to those of competing carriers."³⁵ The Court held that this type of exclusivity was sufficient to hold the conduct unlawful because "these agreements are binding obligations held over the heads of vendees which deny defendant's competitors access to the fenced-off market on the same terms as the defendant."³⁶ The ability of customers to avoid exclusivity by charging a lower price was no defense. *Northern Pacific* is more than fifty years old, but no recent case has suggested any contrary result in this context.³⁷

* * * *

It seems reasonably clear that neither the conditional nature of loyalty discounts nor the absence of total exclusivity provides any basis for exempting loyalty arrangements from traditional antitrust scrutiny. It seems equally clear that the analysis should not be based on predatory pricing standards.

Alternative Approaches

Because loyalty discounts most closely resemble exclusive dealing, logic suggests analyzing them under a similar standard. Loyalty discounts differ, however, from standard exclusive dealing arrangements in two important respects: first, their exclusion of rivals will tend to be less severe; and, second, they often lack the complementary investment efficiencies that exclusive dealing typically yields. Do these differences warrant a different kind of analysis? The answer, ultimately, seems to be "no," but the other potential approaches at least merit further discussion.

³¹ *E.g.*, *United States v. Microsoft Corp.*, 253 F.3d 34, 61–62 (D.C. Cir. 2001); *United States v. Standard Oil Co.*, 362 F. Supp. 1331, 1335, 1337–38, 1341 (N.D. Cal. 1972) (60% requirements), *aff'd*, 412 U.S. 924 (1973); *Sewell Plastics Inc. v. Coca-Cola Co.*, 720 F. Supp. 1196, 1209–10, 1217–20 (W.D.N.C. 1989) (80% requirements), *aff'd mem.*, 912 F.2d 463 (4th Cir. 1990).

³² See BUSH DOJ REPORT, *supra* note 1, at 115.

³³ Clayton Act § 3, 15 U.S.C. § 14 (emphasis added). The text and legislative history of the Act demonstrate Congress' desire to overrule *Whitwell v. Continental Tobacco*, 125 F. 454 (8th Cir. 1903), which had held otherwise. See, *e.g.*, 51 CONG. REC. 9161–62 (1914); Jacobson, *supra* note 7, at 317–18.

³⁴ 356 U.S. 1 (1958).

³⁵ *Id.* at 3.

³⁶ *Id.* at 12.

³⁷ The one decision to address the point, *Masimo*, 2006 WL 1236666, at *5, is consistent with *Northern Pacific Railway*.

Although many loyalty discounts are nominal and not at all coercive, that is not so universally true to warrant exempting them from effective scrutiny.

Discount Attribution Test. One way of analyzing the question would be to attempt to mirror the analysis adopted for bundled pricing arrangements by the Ninth Circuit in *PeaceHealth*,³⁸ based on a recommendation by the Antitrust Modernization Commission.³⁹ Under that test, with variations not relevant here, the discount on all products in the bundle is attributed to the competitive product in which exclusion is claimed. If the defendant's "price" (on this attribution basis) is below an appropriate measure of cost, *and* the net effect of the bundled pricing is to cause material consumer harm (for example, by leading to higher prices overall), the arrangement is considered unlawful.

The utility of this attribution test in bundling cases is that findings of illegality are limited to instances in which the discounts in issue exclude equally efficient rivals. But the test, while useful and important, especially in the bundling context, is no panacea. The difficulties in determining the appropriate measure of cost in important industries where marginal costs are unusually low—such as pharmaceuticals, software, and microprocessors—and the corresponding difficulty in accounting for significant costs (such as research, development, and marketing)⁴⁰ render any cost-based test difficult to administer. The attribution safe harbor this test creates for bundled discount arrangements remains appropriate in light of the frequent customer demand for these discounts so frequently encountered in the bundling context. But the test is not as useful in the loyalty discount arena for two main reasons.

First, determining how to apply the attribution test to a loyalty discount is problematic. Doing so requires identification, and separation, of "contestable" and "incontestable" portions of a customer's demand. To illustrate, suppose that the customer needs 100 units. It must take 50 from the defendant (the incontestable portion) because only the defendant sells a full line with all sizes; no rival sells a full line. The defendant's pre-entry price is \$75 but, upon entry, it raises prices to \$100, with a 25 percent loyalty discount for customers who agree to take 90 percent or more of their requirements from the defendant. Cost for the defendant and rivals is \$60 per unit. If the customer takes 90 or more units from the defendant, and if rivals' prices are also \$75, the customer pays \$7500 for 100 units. But what if the customer wants to get 50 units from rivals? The 50 units will cost \$5000, so rivals must charge no more than \$2500 for the remaining 50 (the contestable portion) to make the customer whole. That comes to \$50 per unit. Since cost is \$60, however, the defendant's sales on the contestable 50 units are below cost—applying the same sort of attribution analysis used in the bundling context.

The difficulty is that, while there are fact patterns, such as the one above, in which determining how to apply a discount attribution analysis in loyalty cases is readily achievable, in the real world these patterns are difficult to discern. In contrast to bundling cases, where distinct products are involved, and where it is comparatively easy to determine the sum of the discounts being

³⁸ *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008).

³⁹ ANTITRUST MODERNIZATION COMMISSION, REPORT & RECOMMENDATIONS 83 (2007); *see also* Jonathan M. Jacobson, *Exploring the Antitrust Modernization Commission's Proposed Test for Bundled Pricing*, ANTITRUST, Summer 2007, at 23; Janusz Ordovery & Greg Shaffer, *Exclusionary Discounts* (CCP Working Paper No. 07-13, Aug. 25, 2006), available at http://www.ftc.gov/os/sectiontwohearings/docs/Ordovery_Shaffer_two-units_final.pdf. Application of this discount attribution test to loyalty discounts is recommended in 3A PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 749e, at 341 (3d ed. 2008); the authors do not, however, address the problems associated with the application of this test in the loyalty context that are identified below.

⁴⁰ *See* Jonathan M. Jacobson, *Cost-Based Rules in the New Economy*, Paper Prepared for ABA Section of Antitrust Law Spring Meeting (Mar. 25, 2009), available at <http://www.wsgr.com>.

applied to all the products in the bundle,⁴¹ the analysis of what is contestable and what is not in loyalty cases can be extremely difficult. How do we know whether the incontestable portion is 50 units, or 70, or 20, or zero? The defendant will argue that none or very little of its volume is incontestable, and the plaintiff will argue otherwise. Adding this complexity to the pre-existing problems, inherent even in bundling cases, of determining the appropriate measure of costs results in a mode of analysis that, while useful in theory, fails as a workable rule of decision (or counseling) far more often than it succeeds.

Second, loyalty discounts are different from bundled discounts in that the harm they cause may be worse and the benefits they yield tend to be fewer. The harm from impairment of rivals is similar to the harm that bundled discounts may cause. But with loyalty discounts, there is an additional problem. As Professor Elhauge has explained, the imposition of loyalty discounts by dominant firms tends to reduce large firm incentives to compete for available customers not subject to loyalty discounts while also discouraging rivals from competing for the business of firms receiving the discounts. The consequence of these reciprocal incentives is that prices may be raised to all customers across the board.⁴²

Correspondingly, in many cases, there are few, if any, cost-reducing efficiencies associated with loyalty discounts. The principal benefit is the reduction in price to the customer, but—as we have seen—that price reduction may simply be the elimination or reduction of a price *penalty*. Net prices may well not be reduced, and may even increase. The defendant can always charge the same or even lower prices without attaching any loyalty requirement. Application of an attribution discount safe harbor therefore has far less justification than in the bundling context in which that safe harbor originated.

Coercion Requirement. The most significant problem with loyalty discounts, when there is one, is the same sort of impairment of rivals encountered in traditional exclusive dealing cases. Therefore, another way to analyze loyalty discounts would be to develop a test to determine when the discount is sufficiently coercive to amount to de facto exclusive dealing. This approach has considerable merit in theory. If the customer has no practical economic choice other than to accept the minimum loyalty requirement, the arrangement is the same as exclusive dealing in every important sense. To date, however, no one appears to have been able to propose a reasonable test of “coercion” in this context. So while this option may be attractive, alternative methods of analysis would seem preferable until some operable test comes along.

Competitive Effects/Rule of Reason Approach. In the present state of knowledge, one approach to loyalty discount analysis that seems to work is a straight competitive effects analysis. This would require the plaintiff to demonstrate (1) that the defendant has (or is likely to achieve) market power, (2) that an appreciable portion of the relevant market is covered by the loyalty arrangements in question, and (3) that the effect is to lessen competition substantially—by raising the price, reducing output or quality, or significantly limiting the choices available to consumers in the market as a whole.

Calculating the portion of the market covered should not be complicated. It is the share of the market covered by the defendant’s arrangements times the loyalty percentage requirement. So,

⁴¹ This is certainly not always the case, however. Determining what the “discount” is on any given product may be difficult if the price changes for all products are not adopted at the same time. The determination may be difficult in other contexts as well.

⁴² See Einer Elhauge & Abraham L. Wickelgren, *Robust Exclusion Through Loyalty Discounts* (Working Paper, Jan. 28, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544008.

if the defendant has a 70 percent share, has loyalty arrangements for all of its customers, and the loyalty percentage is 70 percent, the percentage of the market affected is 49 percent (70% × 70%). The resulting value is appropriately treated in the same way as the “foreclosure” percentage in standard exclusive dealing cases. If the percentage is lower than 30%–40%, the plaintiff’s case will be weak and subject to a motion to dismiss or for summary judgment on that basis.⁴³

If the plaintiff can satisfy this market coverage requirement, the remaining analysis should focus on the actual and potential harm to consumers: Is there an impairment of the plaintiff and other rivals to a degree sufficient to prevent them from constraining the defendant? If so, is the result to create or enhance the defendant’s market power such that consumers are likely to be harmed? Has the arrangement in fact reduced sellers’ incentives to discount to new and existing customers such that price competition is reduced in a material way? This analysis is standard in rule of reason cases and is similar to the approach used in evaluating mergers. It is a process with which litigants, agencies, and courts are familiar.⁴⁴

One difference between loyalty discount and standard exclusive dealing cases is that, in the latter, at least in theory, a difficult balancing may be required to conclude the analysis. If there are adverse competitive effects and potentially countervailing efficiencies, the two may have to be weighed and a conclusion reached as to the net effect on competition and consumers. In fact, cases involving such a difficult balancing are extremely few and far between; but the potential need to balance has still been perceived as a potential problem.⁴⁵ Whatever one’s view on that subject, however, it seems clear that it is not any kind of a serious problem in loyalty discount cases because, as mentioned, loyalty discounts generally involve no cost-saving or similar customer benefits that cannot be achieved with equal effectiveness through simple price reductions without associated loyalty conditions. In this respect, rule of reason analysis for loyalty discounts is simpler and easier.

Safety Zone

As in many areas of antitrust, determining a precise boundary between the lawful and the problematic may not be easy, but determining what conduct is reasonably safe is not especially difficult. Application of the rule of reason in the manner suggested should enable adequate counseling in this regard. Specifically, firms can be advised that loyalty discounts are safe where:

- The supplier lacks market power;
- Less than 30%–40% of the market is covered by the agreements in question;
- The discount is not coercive, either because it is not a first-dollar discount or because it can be met or exceeded by an equally efficient rival; or
- Competition for customer contracts is sufficiently effective that the exclusivity effect poses little risk of raising the market price of the product in question.

Is this type of guidance a roadmap to certainty? Plainly not. But it is sufficient to allow counselors and their clients to determine which loyalty discounts are unlikely to be challenged and which, in contrast, carry litigation risk.

⁴³ See ABA SECTION OF ANTITRUST LAW, *ANTITRUST LAW DEVELOPMENTS* 216–18 (6th ed. 2007).

⁴⁴ See, e.g., *United States v. Microsoft Corp.*, 253 F.3d 34, 58–59 (D.C. Cir. 2001) (en banc).

⁴⁵ See A. Douglas Melamed, *Exclusive Dealing Agreements and Other Exclusionary Conduct—Are There Unifying Principles?*, 73 *ANTITRUST L.J.* 375 (2006); Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The “No Economic Sense” Test*, 73 *ANTITRUST L.J.* 413 (2006). For a contrary view, see Jonathan M. Jacobson & Scott A. Sher, *“No Economic Sense” Makes No Sense for Exclusive Dealing*, 73 *ANTITRUST L.J.* 779 (2006).

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Loyalty discounts present significant issues for antitrust analysis. As they become more and more prevalent in real world markets, the need to develop a fair test that allows firms to receive even more accurate counseling in their use, and more specific guidance for rules of decision for courts and agencies, will become increasingly important. Loyalty discounts most closely resemble exclusive dealing and should be analyzed in largely the same manner. Accordingly, until specific rules applicable to these discounts can be developed, standard rule of reason analysis appears to be the most appropriate decisional guide. ●

Behavioral Antitrust: Unanswered Questions on the Horizon

Amanda P. Reeves

Beginning with Judge Robert Bork's *Antitrust Paradox* and continuing through the present, the assumption that humans behave as perfectly rational, profit-maximizing actors has taken center stage in modern antitrust law. As one scholar recently put it, "Antitrust law now worships at the shrine of rationality"¹ and therefore assumes that human and firm behavior comports with profit-maximizing behavior. Over the last fifteen years, however, a growing tide of literature in the behavioral economics field has questioned the assumption that humans always behave perfectly rationally.² That literature increasingly suggests (not surprisingly) that humans are imperfect decision makers and, on occasion, will predictably act in ways that are contrary to their own self-interest. The question for law generally—and antitrust specifically—is whether and in what contexts the insight that humans are imperfect decision makers is doctrinally relevant.

Scholars are now at work defining the new field of "behavioral antitrust"—i.e., the study of how behavioral economics can inform antitrust law.³ As the behavioral antitrust literature continues to grow, so too will the debate over whether there is any practical value in applying behavioral economics to antitrust law. Several questions in conjunction with that analysis remain unanswered. Those questions include: (1) whether behavioral economics is viable in the absence of an organizing principle; (2) whether behavioral economics is helpful in analyzing firm—as distinct from individual—behavior; (3) who should make the hard decisions about whether behavioral economics should apply, if ever; and (4) whether one must adopt a particular view about the goal of antitrust law for behavioral economics to be useful. I provide some thoughts on these questions below.

Rationality and Behavioral Economics

Neoclassical economics, which is widely considered to provide the foundation for modern antitrust law,⁴ is premised on the assumption that human beings—and by extension firms—are rational maximizers. This does not mean that neoclassical economists believe actual human beings

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¹ Christopher R. Leslie, *Rationality Analysis in Antitrust*, 158 U. PA. L. REV. 261, 265 (2010).

² Douglas H. Ginsburg & Derek W. Moore, *The Future of Behavioral Economics in Antitrust Jurisprudence*, COMPETITION POLICY INT'L, Spring 2010, at 93–94 (surveying citations to "behavioral economics" in law review texts and titles between 1980 and 2009).

³ Maurice Stucke and Avishalom Tor have been at the forefront of this movement. See, e.g., Maurice E. Stucke, *Behavioral Economists at the Gate: Antitrust in the Twenty-First Century*, 38 LOY. U. CHI. L.J. 513, 529–30 (2007) [hereinafter *Behavioral Economists*]; Avishalom Tor, *The Methodology of the Behavioral Analysis of Law*, 4 HAIFA L. REV. 237, 242–43 (2008).

⁴ I use the term "neoclassical economics" to refer broadly to those schools of economic thought, including Chicago School, Post-Chicago School, and Harvard School, which rely on the assumption of rationality as a central tenet in their analyses. See, e.g., Herbert Hovenkamp, *Post-Chicago Antitrust Analysis: A Review and Critique*, 2001 COLUM. BUS. L. REV. 257 (2001) (discussing the role of Chicago School and post-Chicago School economics in the development of modern antitrust law); William E. Kovacic, *The Intellectual DNA of Modern U.S. Competition Law for Dominant Firm Conduct: The Chicago/Harvard Double Helix*, 2007 COLUM. BUS. L. REV. 1 (2007) (discussing role of Chicago, Post-Chicago, and Harvard schools of economics in the development of modern antitrust law).

Behavioral economics**attacks the rational****profit-maximizer****assumption head on****by assuming that****humans have cognitive****limitations that prevent****them from processing****information perfectly****and maximizing****their utility.**

always act rationally.⁵ Instead, they believe that markets are self-correcting and will counteract faulty decision making, thereby leaving rational behavior in control. The assumption of rationality therefore provides a powerful shortcut which facilitates the development of sophisticated economic models of markets that are, in turn, considered an accurate reflection of reality. The basic principles of those models (also termed “price theory”) include the propositions “that demand curves slope downward, that an increase in the price of a product will reduce the demand for its complement, that resources gravitate to the areas where they will earn the highest return, etc.”⁶

Judge Bork’s *Antitrust Paradox*, along with the work of Judge Richard Posner, and Professors Donald Turner and Phillip Areeda, brought these ideas to the forefront of modern antitrust analysis during the 1970s and early 1980s. Collectively, their work demonstrated that all of antitrust analysis could be viewed “through the lens of price theory.”⁷ Indeed, while behavioral economics is frequently presented as a counter to the “Chicago School” of antitrust analysis, that characterization is a red herring: as FTC Commissioner William Kovacic has explained, members of the “Post-Chicago School” as well as the “Harvard School” (including Areeda, Turner, and Justice Stephen Breyer) have also played key roles in importing the assumption of rationality into antitrust law.⁸ As a result, from the Sherman Act, to the Clayton Act, to the recently revised draft merger guidelines,⁹ the neoclassical assumption of the rational profit-maximizer permeates modern antitrust law.¹⁰

Behavioral economics attacks the rational profit-maximizer assumption head on by assuming that humans have cognitive limitations that prevent them from processing information perfectly and maximizing their utility. Drawing on insights from cognitive psychology, neuroscience, and sociology, the behavioral economics literature has observed that humans systematically (as opposed to randomly) deviate from rationality by displaying bounded rationality, bounded willpower, and bounded self-interest.¹¹

Bounded rationality refers to the insight that individuals exhibit systematic biases in their decision making which lead them to use rules of thumb (or, in behavioral economics parlance, “heuristics”) and other decision-making shortcuts to simplify decision making.¹² For example, the “availability heuristic” teaches that humans judge the frequency of an event based on their recollection of the same or similar events. Thus, people are more likely to conclude that they will be in a car accident if they have recently witnessed one. Similarly, the “endowment effect” refers to the fact

⁵ Michael A. Salinger, *Behavioral Economics, Consumer Protection, and Antitrust*, COMPETITION POLICY INT’L, Spring 2010, at 67 (noting that “economic analysis necessarily relies on simplifying assumptions that sacrifice realism for tractability” and that the “rationality assumption plays so prominently in the literature because it is tractable . . . and yields some quite accurate predictions”).

⁶ Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925, 928 (1970).

⁷ *Id.*; ROBERT H. BORK, *THE ANTITRUST PARADOX* (1978); RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* (1976).

⁸ Kovacic, *supra* note 4, at 80 (noting that the Harvard School “had as much to do as Chicago with creating many of the widely-observed presumptions and precautions that disfavor intervention by U.S. courts and enforcement agencies”).

⁹ U.S. Dep’t of Justice & Fed. Trade Comm’n, *Horizontal Merger Guidelines: For Public Comment* (Apr. 20, 2010), available at <http://www.ftc.gov/os/2010/04/100420hmg.pdf> [hereinafter Proposed Merger Guidelines].

¹⁰ See Amanda P. Reeves & Maurice E. Stucke, *Behavioral Antitrust* 19–27 (U. Tenn. Legal Studies Research Paper No. 106, Apr. 24, 2010), available at <http://ssrn.com/abstract=1582720>; Leslie, *supra* note 1, at 265–74.

¹¹ Christine Jolls, Cass R. Sunstein & Richard H. Thaler, *A Behavioral Approach to Law and Economics*, in *BEHAVIORAL LAW AND ECONOMICS* (2000) (describing bounded rationality, bounded willpower, and bounded self-interest).

¹² Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in *JUDGMENT UNDER UNCERTAINTY* 3, 11 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982).

that humans place a higher value on objects they own than on objects that they do not own.¹³ So, for example, an individual who owns an object requires a greater payment to part with that object than he would be willing to pay to purchase the identical object. Likewise, “framing effects” refer to the way a choice is framed—a choice that is cast as a “sure gain” or an “avoidable loss” alters the way humans make decisions.

Bounded willpower refers to the perhaps unsurprising insight that individuals make decisions (skipping exercise, overspending, smoking) that are not in their long-term self-interest. People who recognize their bounded willpower will often take steps to counteract it by, for example, keeping tempting food out of the house, having automatic 401(k) deductions, or only carrying cash.

Bounded self-interest refers to the fact that an individual’s self-interest is “bounded” more broadly than neoclassical economics assumes: in many market settings, people care about being treated fairly but also want other people (who are behaving fairly) to be treated fairly. Thus, if given the choice, individuals will accept a lower salary so that a co-worker is not fired, will donate a kidney to a stranger, and will pay higher taxes so that others can benefit.

Relative to neoclassical economics, which has its origins in the 19th century,¹⁴ the fundamental insights of behavioral economics are comparatively new. Nobel Laureate Herbert Simon first introduced the idea of “bounded rationality” in the 1950s.¹⁵ It was not until nearly two decades later, however, that behavioral economics as a subfield of economics began to take off, following the publication of Nobel Prize winner Daniel Kahneman and Amos Tversky’s landmark papers that concretely identified three heuristics and supplied an alternative model to rational choice theory (which they termed “prospect theory”) based on their behavioral insights.¹⁶ During the 1990s, legal scholars began to apply behavioral economics to different areas of the law resulting in numerous law reviews, books, and academic conferences on the topic. More recent events in the mainstream media have only heightened interest in behavioral economics, including:

- the 2008 collapse of the financial markets, which has been characterized by many (including Alan Greenspan and Richard Posner) as further evidence that unregulated human decision making will not always lead the market to optimal outcomes;¹⁷
- a spate of bestselling books discussing behavioral economics;¹⁸
- a rancorous debate over the role behavioral economics should play in a new Consumer Financial Protection Agency; and
- President Obama’s decision to install leading behavioral law and economics scholar Cass Sunstein as the OMB’s Administrator of the Office of Information and Regulatory Affairs

¹³ RICHARD H. THALER, *THE WINNER’S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* 63 (1992); Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1327 tbl.1 (1990) (summarizing studies).

¹⁴ GEOFFREY M. HODGSON, *ECONOMICS AND EVOLUTION: BRINGING LIFE BACK INTO ECONOMICS* 99–108 (1996).

¹⁵ Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99 (1955).

¹⁶ Tversky & Kahneman, *supra* note 12; Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979).

¹⁷ Kara Scannell & Sudeep Reddy, *Greenspan Admits Errors to Hostile House Panel*, WALL ST. J., Oct. 24, 2008, at A1, available at <http://online.wsj.com/article/SB122476545437862295.html>; RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* (2009).

¹⁸ *See, e.g.*, JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET* (2009); GEORGE A. AKERLOF & ROBERT J. SHILLER, *ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM* (2009); DAN ARIELY, *PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS* (2008); RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008).

(“the Regulatory Czar”) along with his direction to OMB to “clarify the role of the behavioral sciences in formulating regulatory policy.”¹⁹

In short, there are now discussions of behavioral economics in virtually every substantive legal area, and the behavioral economics scholarship shows no signs of slowing down.²⁰

Unanswered Questions for Behavioral Antitrust

Behavioral economics has thus far remained on the sidelines when it comes to U.S. antitrust analysis. In part this is due to the relative infancy of behavioral economics as a field: behavioral antitrust scholars have not yet provided a clear roadmap that advocates or decision makers can easily follow. But there may be other complicating factors as well that are unique to antitrust. I now turn to four of those factors.

1. Is behavioral antitrust viable in the absence of an organizing principle? Its imperfections notwithstanding, there is widespread agreement that one of the virtues of neoclassical economics has been its ability to supply an organizing principle in the form of the assumption that humans behave rationally. This organizing principle, in turn, plays a critical role in the common-law process through which antitrust law is made, by supplying standards for judges to apply and thereby preventing antitrust law from being wholly discretionary and unpredictable. Any economic theory that seeks to supplant neoclassical economics therefore bears the burden of offering an alternative organizing principle (or, alternatively, explaining why one is not needed). The main critique of behavioral economics, thus far, has been that it is not susceptible to an organizing principle or limiting principles relating to the behavior of market participants.²¹ As Cass Sunstein himself has acknowledged, there is some truth in that critique.²² While an organizing principle may eventually emerge, that has not happened yet.

The absence of an organizing principle will likely prevent behavioral economics from reshaping antitrust law in the way neoclassical economics was able to do over the last forty years. This is in large part due to the common-law nature of antitrust law. When judges issue antitrust decisions, they make law based on a single case that can have far-reaching results across industries. As a result, observations that humans behave “predictably irrationally” in certain discrete circumstances do not offer a clear tool for deciding cases that must establish broad rules across sectors of the economy, such as whether conduct qualifies as exclusionary or an agreement is anticompetitive.

Nevertheless, while the absence of an organizing principle (at least for now) may limit the ability of behavioral economics to effect across-the-board doctrinal changes in antitrust, this does not mean that there will not be any role for behavioral antitrust going forward. Doctrinally, it may still be possible for behavioral economics to play a role in certain fact-specific contexts. Two examples are illustrative.

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¹⁹ Press Release, White House, Memorandum for the Heads of Executive Departments and Agencies (Jan. 30, 2009), available at <http://www.whitehouse.gov/the-press-office/presidential-memorandum-regarding-regulatory-review>.

²⁰ Ginsburg, *supra* note 2, at 94 (noting that the volume of law review articles mentioning behavioral economics doubled from 548 during 2000–2004 to 917 during 2005–2009).

²¹ See, e.g., Salinger, *supra* note 5, at 66, 77–79; Ginsburg, *supra* note 2, at 97.

²² Cass R. Sunstein, *Introduction*, in BEHAVIORAL LAW AND ECONOMICS 1, 9 (Cass R. Sunstein ed., 2000) (noting that “an enormous amount remains to be done” in the development of behavioral economics, including determining whether “behavioral economics [can] generate a unitary theory of behavior” or whether behavioral economics is “too ad hoc and unruly to generate predictions in the legal context”).

First, behavioral economics could affect merger review.²³ To understand why, it is helpful to think about why behavioral economics has been able to make inroads in the consumer protection literature and regulatory law more generally. Because behavioral economics is interested in identifying the exception to the rule (i.e., the circumstances in which humans behave irrationally), it applies best where it is possible to test a default rule repeatedly and understand how individuals will react to that default rule. Consumer protection law is largely regulatory, meaning rules and regulations are adopted after detailed proceedings that focus on a discrete issue, such as what a particular disclosure should require. Behavioral economics has likely proven useful in these rule-making settings because its discrete, fact-specific insights align with the discrete and fact-specific nature of regulatory decision making.

Merger review is the closest antitrust decision makers come to engaging in a traditional regulatory process: expert agencies make decisions that are highly fact-specific; the conclusions in the form of closing statements and/or a consent decree are case-specific and do not constitute binding precedent; and the review of the proposed merger is done *ex ante* rather than *ex post*.²⁴ Moreover, while economic modeling plays an important role in market definition and in predicting whether a merger will have anticompetitive effects, the agencies also have the benefit of a vast factual record, including investigational hearings of the parties, interviews with customers and competitors, and documents from the parties. The agencies' decisions during the merger review process are therefore akin to non-precedential fact-bound rulings.

It may be the case that in most mergers, firms engage in rational profit-maximizing behavior as neoclassical economics predicts. But occasionally (the "one off" case, perhaps), predictive models that require complex inferences in the face of imperfect information may tell a different story from what the parties' documents and testimony actually suggest. In these cases, rather than ignoring these facts because they are inconsistent with neoclassical theory (which assumes that irrational conduct will be canceled out) or proceeding with a particular result by shoehorning it into neoclassical theory (by saying, for example, that the party is acting consistently with its own incentives even if others similarly situated would not have the same view of their incentives), the agencies with their knowledge of how industry participants normally behave and their teams of economists may be able to explain the parties' conduct by drawing on their insights from behavioral economics literature.²⁵ The 2010 revised Merger Guidelines place a greater emphasis on the types and sources of evidence that the agencies will consider in evaluating a proposed transaction's anticompetitive effects.²⁶ As Commissioner J. Thomas Rosch has observed, a move to look more

²³ See Stucke, *Behavioral Economists*, *supra* note 3 (discussing application of behavioral economics to merger review).

²⁴ ANTITRUST MODERNIZATION COMMISSION, REPORT AND RECOMMENDATIONS 51 (2007), available at http://govinfo.library.unt.edu/amc/report_recommendation/chapter1.pdf (noting that merger enforcement "has shifted in emphasis from a litigation-based system focused on judicial review of consummated deals to an administrative regime in which [FTC and DOJ] review mergers above a certain size prior to consummation"); Spencer Weber Waller, *Prosecution by Regulation: The Changing Nature of Antitrust Enforcement*, 77 OR. L. REV. 1383, 1400 (1998) (discussing the move of antitrust from a prosecutorial to a regulatory model and claiming that with regard to HSR merger review, "regulation and administrative law-making have replaced the courts as the source for the creation and enforcement of antitrust law"); Harry First, *Is Antitrust "Law"?*, ANTITRUST, Fall 1995, at 9–12 (discussing the shift in antitrust law from a legal culture to a "bureaucratic regulatory culture").

²⁵ Indeed, as suggested elsewhere, this may explain the concurring statements of now Chairman Leibowitz and Commissioner Rosch in conjunction with the FTC's decision to vote out a complaint in the *Ovation* case. See Reeves & Stucke, *supra* note 10, at 59–61.

²⁶ Proposed Merger Guidelines, *supra* note 9.

carefully at the factual record could open the door to a more detailed analysis of the parties' incentives, intentions, and behavioral biases.²⁷

Second, if the FTC were to (1) move toward applying sectoral-specific tests in its administrative decisions (i.e., liability standards that respond to unique concerns in certain industries, such as the high up-front costs present in the high-tech and pharmaceutical industries), or (2) engage in rulemaking, behavioral economics could play a role in the formation of those more context-driven tests. The idea of sectoral-specific tests may initially seem far fetched, but it is a common practice at the European Commission²⁸ and, to some extent, the United States already engages in sectoral-specific analyses insofar as the mergers and conduct of certain regulated industries—such as telecommunications and transportation—are already reviewed by specialized agencies like the Federal Communications Commission and the Federal Energy and Regulatory Commission. Moreover, the FTC's interest in applying an "inherently suspect" analysis to declare certain practices presumptively illegal,²⁹ could potentially open the door for the FTC to incorporate behavioral insights into its findings that recurring conduct in certain sectors is subject to a truncated rule of reason.

Likewise, although antitrust rulemaking may also seem unlikely (given that the FTC generally does not possess rulemaking authority for competition issues), the FTC recently completed such a rulemaking where, pursuant to a statutory mandate, it defined and prohibited "market manipulation" in wholesale petroleum markets.³⁰ Moreover, one can imagine certain recurring issues that do not comfortably fit within traditional Sherman or Clayton Act doctrine due to the overlay of a competing regulatory regime that may also be fodder for future rulemaking. The debate over the legality of pay-for-delay patent-infringement settlements is one such area. As Scott Hemphill has suggested, in the pay-for-delay settlement context, the federal courts lack the aggregate information (the various categories of such settlements, the costs, their frequency, etc.) needed to enact the optimal standard.³¹ In this case, commentators have suggested that rather than litigating whether settlement agreements are anticompetitive under Section 1, the FTC should instead consider promulgating a rule to identify the circumstances under which a settlement would be illegal.³² In so doing, the Commission would have the benefit of bringing its expertise on the practice of pay-for-delay settlements to bear more generally on the legal question of under what cir-

²⁷ Commissioner J. Thomas Rosch, *Managing Irrationality: Some Observations on Behavioral Economics and the Creation of the Consumer Financial Protection Agency*, Remarks Before the Conference on Regulation of Consumer Financial Products 9 (Jan. 6, 2010), available at <http://www.ftc.gov/speeches/rosch/100106financial-products.pdf>.

²⁸ Commissioner J. Thomas Rosch, *The EC's Pharmaceutical Sector Inquiry Preliminary Report—Wading into the Thicket of the Antitrust/Intellectual Property Law Overlap*, Remarks Before the Innsbruck Symposium on Innovation and Competition Law 2–7 (Feb. 26, 2009), available at <http://www.ftc.gov/speeches/rosch/090226innsbruck.pdf> (discussing EC's practice of conducting sectoral specific studies).

²⁹ See, e.g., *Realcomp II Ltd.*, FTC Docket No. 9320, 2009 FTC LEXIS 250, at *39 (Oct. 30, 2009), available at <http://www.ftc.gov/os/adjpro/d9320/091102realcompopinion.pdf> (finding certain practices of multistate listing service were "inherently suspect" and that the plaintiff did not come forward with evidence to carry its burden and explain why those practices should be legal); see generally Geoffrey D. Oliver, *Of Tenors, Real Estate Brokers and Golf Clubs: A Quick Look at Truncated Rule of Reason Analysis*, ANTITRUST, Spring 2010, at 40 (providing overview of "inherently suspect" analysis).

³⁰ 16 C.F.R. § 317 (2009). The FTC conducted the rulemaking pursuant to a Congressional delegation of authority in the Energy Independence and Security Act of 2007, 42 U.S.C. §§ 17301–17386.

³¹ C. Scott Hemphill, *An Aggregate Approach to Antitrust: Using New Data and Rulemaking to Preserve Drug Competition*, 109 COLUM. L. REV. 629, 631 (2009).

³² *Id.*

cumstances those settlements should be illegal. The insights from behavioral economics could come into play to the extent the rulemaking process yielded behavioral insights that were uniquely relevant to the issue being considered.

In short, if the FTC evaluates recurring discrete issues and makes law in those contexts (either through a rulemaking or a Part 3 administrative decision), the opportunity may arise for the agencies to apply behavioral insights that make sense in those discrete areas.

2. Can behavioral economics be useful in analyzing firm behavior? Behavioral economics provides important insights on individual decision making, but whether those insights apply to the behavior of firms remains a mostly unexplored question. Although it is likely true that the individuals who make up firms are prone to behavioral biases, it is far less clear whether these individual biases matter for antitrust law or whether, as modern antitrust analysis assumes, rational behavior cancels out irrational behavior, therefore obviating the need to account for irrational individual conduct in the analysis of firm behavior.³³

Behavioral finance scholars thus far have identified two behavioral traits that may be particularly relevant in analyzing and predicting firm behavior: (1) overconfidence bias, which as its title implies, is the tendency of individuals to overstate their likelihood of success while underestimating their vulnerability to certain risks; and (2) “self-serving” bias, which is the idea that when individuals receive information, they process it in a way that is consistent with their own preconceived notions (including overconfidence).³⁴ Scholars have suggested that these biases may explain the conduct that led to the accounting scandals at Enron and elsewhere, arguing that executives overestimated the likelihood that their fraudulent schemes would succeed and/or underestimated the likelihood that the government would uncover their fraud.³⁵

These behavioral biases may also have implications for analyzing the conduct of firms in the antitrust realm. In the merger review context, empirical evidence showing that these biases tend to exist in CEOs or other high-level executives in charge of making decisions about product development, entry into new markets, or the success of a merger could be probative of whether a merger is likely to have anticompetitive effects.³⁶ Further evidence of these biases could allow the agencies in merger review or merger litigation, for example, to rebut a showing of possible entry by demonstrating that (1) as an empirical matter, there is evidence that corporate executives tend to overestimate their success of product development or entry; and (2) the factual record showed that the decision makers at issue had exhibited this pattern of behavior.

Likewise, these biases could also inform criminal leniency programs by explaining why— notwithstanding knowledge of the possibility of jail time and large corporate fines—individuals might nevertheless enter into price-fixing agreements. Behavioral economics may be able to offer insights as to why in certain circumstances (a particular term of service at a company, experience

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³³ HERBERT HOVENKAMP, *THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION* 134 (2005) (suggesting that the “entire antitrust enterprise is dedicated to the proposition that business firms behave rationally”).

³⁴ Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091–95 (2000) (discussing overconfidence and self-serving biases).

³⁵ William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1283 (2002).

³⁶ Experimental economists Colin Camerer and Dan Lovallo have shown that this optimism bias carries over to entry decision making. Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999); see also Avishalom Tor, *The Fable of Entry: Bounded Rationality, Market Discipline, and Legal Policy*, 101 MICH. L. REV. 482, 505 (2002) (discussing overconfidence in the context of analyzing entry); Mark Armstrong & Steffen Huck, *Behavioral Economics as Applied to Firms: A Primer*, COMPETITION POLICY INT’L, Spring 2010, at 26–28 (discussing prevalence of over-optimism in CEOs and entrepreneurs).

as a CEO or other management position, familiarity with one's competitors, lack of familiarity with the frequency of criminal cartel prosecutions), these individuals underestimate their chance of getting caught. This could lead corporations to complement their antitrust training not only with evidence of *what* happens when one gets caught, but a component that focuses on the *likelihood* of getting caught. Indeed, precisely because behavioral economics is oriented toward identifying anomalous *individual* conduct, its greatest use to antitrust over the long run might be in helping identify the circumstances in which individuals are predisposed to enter into cartels.³⁷

Although most of the work on behavioral biases in firms has been in the behavioral finance realm (where the concern is typically with whether decision makers are acting contrary to their fiduciary duties), scholars have recently begun to identify other less sinister behavioral traits that could have antitrust implications for firms.³⁸ For example, although a fundamental tenet of profit-maximizing behavior is that fixed and sunk costs should not play a role in the setting of price, experimental work has shown that managers often do include fixed and sunk costs in setting prices.³⁹ This could mean that mergers that allegedly generate efficiencies based on a reduction in fixed costs could have greater benefits for consumers (in the form of lower prices), than is superficially apparent. Of course, it may be that the agencies already scrutinize efficiencies at this level of detail, in which case the behavioral economics literature could simply provide a greater theoretical foundation to support efficiencies-based claims.

More generally, these and other insights into ways in which firms do not always engage in profit-maximizing behavior could lead to more factual scrutiny in close cases (involving conduct or mergers) and less of a willingness to assume rational profit-maximizing behavior is always at work. However, for behavioral economics to play a bigger role in antitrust analysis going forward, more work needs to be done oriented toward the theory of the firm.

3. Which decision makers, if any, are qualified to make the hard decision about when (if ever) to apply behavioral economics? A recurring criticism of behavioral economics is that behavioral economics is too amorphous to apply and merely provides a mechanism for decision makers to ground paternalistic policies in post-hoc rationalizations masquerading as economic theory. This has led some to suggest that if the point of behavioral economics is to show how unpredictable and arbitrary human decision making is, then why are decision makers (who are themselves flawed and susceptible to their own biases) any better situated to make the hard decisions that govern human decision making.⁴⁰ The answer to this question will likely turn on who makes the decision to apply behavioral economics, and on what basis.

As to who should make the decision to apply behavioral economics, Judge Ginsburg and Derek Moore suggest in a recent article that, in its current form, behavioral economics is not well

³⁷ Maurice E. Stucke, *Am I a Price Fixer? A Behavioral Economics Analysis of Cartels*, in CRIMINALISING CARTELS: A CRITICAL INTERDISCIPLINARY STUDY OF AN INTERNATIONAL REGULATORY MOVEMENT (Caron Beaton-Wells & Ariel Ezrachi eds., forthcoming 2010) (discussing situational factors that may influence cartel formation).

³⁸ For a detailed discussion of the issues associated with behavioral economics in the context of antitrust law and firm behavior, see Armstrong & Huck, *supra* note 36.

³⁹ *Id.* at 28–30 (discussing accounting anomalies that may be attributable to behavioral biases and explaining how these anomalies could affect merger review).

⁴⁰ See, e.g., Richard A. Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 23, 2009, at A15, available at <http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html> ("Behavioral economists are right to point to the limitations of human cognition. But if they have the same cognitive limitations as consumers, should they be designing systems of consumer protection?").

sued to application by the courts, which “are constitutionally adverse to broad principles, whether drawn from neoclassical or from behavioral economics” and instead are “inclined to make circumscribed decisions that narrowly answer the question whether a particular practice is impermissible in a specific context”⁴¹ As a result, they conclude, “[t]he executive and legislature are better suited and more likely than the judiciary to incorporate the teachings of [behavioral economics]—if they are persuasive—into policy prescriptions.”⁴² Indeed, the Supreme Court’s recent refusal in *Jones v. Harris*⁴³ to enter the economics fray in a case with behavioral economics undertones underscores this view. There, in reversing the Seventh Circuit, the Court refused to side with either Judge Easterbrook (who took the view that markets were self-correcting and that investors did not need additional protections beyond disclosure) or Judge Posner (who disputed that view), reasoning that such a decision “is a matter for Congress, not the courts.”⁴⁴

These observations may suggest that behavioral economics is too messy for the courts to apply in antitrust and elsewhere. But they may also suggest that, while behavioral economics is not yet positioned to provide sufficient guidance for federal court opinions, it is ripe for the DOJ Antitrust Division and FTC to consider exploring. The combination of the agencies’ specialized expertise and their ability to engage in regulatory and administrative processes (including HSR merger review, detailed factual investigations before bringing suit, and, in the case of the FTC, administrative litigation and policy studies) uniquely position the agencies substantively and procedurally to engage in the hard decisions about whether behavioral economics should affect antitrust analysis. In contrast to federal courts, which engage in a case-by-case analysis, the agencies can gain substantive familiarity with an industry and assess whether a particular default rule is accurate. Similarly, in contrast to private actors (i.e., think tanks and special interest groups), the agencies have the procedural ability to subpoena documents, compel testimony, and make rulings. These features, which enable the agencies to bring their institutional expertise to bear on an in-depth review of a particular industry or recurring practice, could help avert the criticism that resorting to “behavioral antitrust” is simply playing politics with economics.

As to the “when,” behavioral economics is unlikely to play any significant role in the agencies’ work unless and until more empirical work is done to suggest that the insights from behavioral economics as applied to antitrust are sufficiently reliable. As the interest in the behavioral economics and behavioral antitrust fields grows in graduate economic programs, legal academia, and at the agencies, that work may follow.

⁴¹ Ginsburg, *supra* note 2, at 97.

⁴² *Id.* at 98.

⁴³ *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1426, 1431 (2010). *Jones* concerned the standard that governs whether a mutual fund investment adviser breached the “fiduciary duty [to investors] with respect to the receipt of compensation for services.” Rejecting the balancing test required by the seminal decision in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), Judge Easterbrook wrote that so long as a mutual fund investment adviser discloses all of the pertinent facts and does not otherwise hinder the fund’s directors from negotiating a favorable price, the investment adviser has complied with his/her fiduciary obligations. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632–34 (7th Cir. 2008) (reasoning that a free market dynamic “create[s] a competitive pressure” that generally keeps fees low and faulting *Gartenberg* on the ground that it “relies too little on markets”). Dissenting from a 5–5 decision denying rehearing en banc, Judge Posner argued that the panel’s decision was based “mainly on an economic analysis that is ripe for reexamination” because there are “growing indications” that boards of directors lack the incentives to police compensation and, instead, consistent with their own personal self-interest (many directors are CEOs of their own companies) are inclined to support lax oversight. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008).

⁴⁴ *Jones*, 130 S. Ct. at 1431.

Rather than thinking of behavioral economics as a stark alternative to neoclassical economics, it may be the case that a more complete antitrust analysis might eventually accommodate both approaches.

4. Do decision makers have to adopt a particular view about the goals of antitrust law to make behavioral economics useful? Perhaps the most important question for behavioral economics if it is to make any inroads in antitrust common law is how its observations—which at this point remain overwhelmingly directed towards consumer behavior—comport with the much debated topic of the proper goals of antitrust.⁴⁵ The standard for measuring whether conduct harms or is likely to harm competition under the federal antitrust laws is, of course, not statutorily defined and, depending on one’s view, Judge Bork’s *Antitrust Paradox* either added a much-needed element of order or further complicated the debate when it explained that the goal of antitrust should be to promote “consumer welfare.” For now at least, the Supreme Court appears to have settled on an understanding that the antitrust laws promote “consumer welfare” as distinct from an allocative-efficiency or total-welfare standard.⁴⁶ To the extent that behavioral antitrust is able to link deficiencies in human decision making to tangible anticompetitive effects (most likely by showing that flawed decision making by firms can have anticompetitive effects), behavioral antitrust may be able to meet this standard. But the jury is still out.

Alternatively, it may be that as insights from behavioral economics evolve and provide more clarity into human decision making, a greater case can be made that antitrust should apply a “consumer choice” framework.⁴⁷ Under this standard, the optimal level of consumer choice (and thus the optimal amount of competition) occurs in “the state of affairs where the consumer has the power to define his or her own wants and the ability to satisfy these wants at competitive prices.”⁴⁸ It is not hard to see how a behavioral antitrust analysis comfortably dovetails with such an objective: if the goal of antitrust law is to maximize individuals’ ability to have choices among competitively priced products, then an economic analysis that focuses on maximizing the ability of humans to make optimal decisions in light of human constraints will be informative. In short, the more antitrust law adopts a paradigm that uses informed consumers (i.e., the demand side) as the barometer for whether the market is competitive, the more likely there will be an effective role for behavioral antitrust.

Conclusion

A common assumption is that neoclassical economics and behavioral economics are polar opposites, with the former predicated on a world where humans behave perfectly and the latter predicated on a world of organized chaos. The popular media’s characterization of both economic theories (neoclassical economics having played a significant role in the financial meltdown and behavioral economics supplying the left-wing’s paternalistic response) has only further entrenched the perception that these two theories are inherently at odds.

⁴⁵ See Barak Y. Orbach, *The Antitrust Consumer Welfare Paradox* 7 (Arizona Legal Studies Discussion Paper No. 10-07, Feb. 16, 2010), available at <http://ssrn.com/abstract=1553226> (discussing disagreement over the meaning of the consumer welfare standard and noting that “*The Antitrust Paradox* ended the debate over the goals of antitrust laws and opened a new debate over the meaning of the term ‘consumer welfare’”).

⁴⁶ See *NCAA v. Bd. of Regents of Univ. of Okla.*, 468 U.S. 85 (1984) (articulating consumer welfare standard); *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993) (distinguishing between consumer welfare and total welfare and clarifying that antitrust applies a consumer welfare standard).

⁴⁷ See, e.g., Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65 (1982); Robert H. Lande, *Consumer Choice as the Ultimate Goal of Antitrust*, 62 U. PITT. L. REV. 503 (2001) [hereinafter *Consumer Choice*]; Neil W. Averitt & Robert H. Lande, *Using the “Consumer Choice” Approach to Antitrust Law*, 74 ANTITRUST L.J. 175 (2007).

⁴⁸ Lande, *Consumer Choice*, *supra* note 47, at 503.

The perception here, however, need not become the reality. Rather than thinking of behavioral economics as a stark alternative to neoclassical economics, it may be the case that a more complete antitrust analysis might eventually accommodate both approaches. Neoclassical economics does not actually assume that humans always behave in perfectly rational ways—only that perfectly rational conduct cancels out irrational conduct. What behavioral economics may ultimately best provide is an important layer of nuance to antitrust analysis by exposing the occasional instances where this assumption does not hold up.

The doctrinal challenge for behavioral economics is achieving that end without completely upending the predictability that the neoclassical assumption of rationality provides. Absent an organizing principle, behavioral economics may be most useful to antitrust in non-lawmaking contexts that draw on the agencies' specialized expertise, such as merger review and in better understanding the behavior of criminal cartel members. As to Sherman and Clayton Act litigation, it is simply too soon to tell how behavioral economics might play a concrete role not only in assessing liability, but in articulating clear rules and standards that can govern future cases. That work is yet to be done. ●

Behavioral Economics: Implications for Antitrust Practitioners

Elizabeth M. Bailey

For antitrust practitioners, there are two familiar behavioral assumptions used in the economic models that underlie antitrust analyses: consumers maximize their utility, which non-economists call “happiness,” and firms maximize their profits. Both of these assumptions are wrong, at least to some extent, in the sense that there are many apparent real-world counterexamples.

With respect to consumers, we can all think of a time we did something out of a sense of fairness rather than out of an attempt to maximize our own self-interested utility (or happiness). For example, most people, at one time or another, have hesitated to be the one to take the last slice of pie, no matter how much we wanted it ourselves, out of a sense of fairness to others (i.e., did everyone else already get a piece?). With respect to firms, there are an increasing number of firms focused on balancing profit maximization with a sense of corporate social responsibility, which may be at odds with the notion of strict profit maximization.¹

Understanding how consumers, and to a much lesser degree firms, depart from the standard assumptions underlying these economic models is the focus of a field of economics research called “behavioral economics.”² The objective of this line of research is to understand how to modify unrealistic assumptions about individual and firm decision-making behaviors in order to make economic models more realistic.

While behavioral economics is a robust field in finance,³ behavioral economics is much less developed in the field of industrial organization, the field most closely related to antitrust.⁴ For an antitrust practitioner, understanding how well actual individual decision-making behavior lines up with that assumed in standard economic models makes good sense because antitrust uses economic models for a variety of tasks. Economic models are used in the merger context, among other things, to predict the effect of a merger on post-transaction prices. In the non-merger antitrust context, economic models are often used to assess certain single-firm conduct using tests

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¹ The popular business concept of the “triple bottom line,” in which a firm’s objective is to strike a balance between people, the planet, and their profits, is one example of such a business strategy.

² In 2002, the Nobel Prize was awarded to Daniel Kahneman for his contributions to behavioral economics; in 2007, the Federal Trade Commission held a conference on contributions of behavioral economics to consumer protection (information on the conference is available at <http://www.ftc.gov/be/consumerbehavior/docs/agenda.shtml>); and, in 2009, the Supreme Court heard arguments in *Jones v. Harris Associates*, 130 S. Ct. 1418 (2010), which pitted, in part, the Chicago School against Behavioralists before a Seventh Circuit Court of Appeals panel.

³ For a good overview of the behavioral finance literature, see Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in HANDBOOK OF THE ECONOMICS OF FINANCE 1051–21 (George Constantinides, Milton Harris, and René Stulz eds., 2003).

⁴ For a summary of the state of research in behavioral industrial organization, see Glenn Ellison, *Bounded Rationality in Industrial Organization*, in 2 ADVANCES IN ECONOMICS AND ECONOMETRICS: THEORY AND APPLICATIONS 142–74 (Richard Blundell, Whitney Newey, and Torsten Persson eds., 2006), available at <http://econ-www.mit.edu/files/904>.

related to profitability, such as the “no economic sense” test and the “profit sacrifice” test. While it is of interest whether the assumptions underlying the economic models are realistic, it is not necessary for these assumptions to hold perfectly for the standard model to provide valuable predictions of economic outcomes. In many settings, the standard model may work very well. For this reason, behavioral economics is not about throwing out the standard paradigm for how consumers and producers make decisions and replacing it with a different paradigm. Rather, the likely contribution of behavioral economics to antitrust is to make improvements in economic outcomes and policy decisions around the edges.⁵

To warrant a universal change in the economic models used for antitrust analysis, counterexamples to those predicted by the standard frameworks must be pervasive and have an economically meaningful effect on outcomes with respect to prices and/or consumer surplus. At this stage, such a change is not warranted because there is no evidence to date of consistent and persistent deviations in real-world settings. However, to the extent that it can be documented that consumers exhibit non-standard decision making in particular industries using relevant facts and data, there should be a willingness on the part of private parties, government agencies, and the courts to consider alternate economic models should there be sufficient data to support the use of such an alternate framework.

... behavioral economics is not about throwing out the standard paradigm for how consumers and producers make decisions and replacing it with a different paradigm.

The Standard Individual Decision-Making Framework

Understanding how individuals make decisions is a fundamental issue in economics. For example, how do consumers choose between purchasing Cheerios, Raisin Bran, or neither of the two? And among the different varieties of Cheerios, how do consumers choose between Honey Nut, MultiGrain, Frosted, or Yogurt Burst? The answers to these questions are fundamental because insight into how consumers make choices and the way in which consumers prefer certain product attributes (e.g., sweetness) to another (e.g., fiber) provides information about the demand curve for each of these types of breakfast cereals.

The standard economic model of individual decision-making behavior assumes that consumers make choices to maximize a utility function, using all of the information available to them, and that they fully, and rationally, process that information. In this framework, an individual cares only about her own level of payoffs, is agnostic about how the decision is framed, and has preferences that are consistent across time. Mathematically, individual i at time $t=0$ is assumed to make a choice, $x \in X$, that maximizes his or her expected utility, subject to a probability distribution, $p(s)$, of his or her beliefs about the possible states of the world $s \in S$:

$$\text{Max}_{x \in X} \sum_{s \in S} p(s) U(x|s).$$

Behavioral economics is the research agenda that considers deviations to this standard framework. One question that behavioral economics raises about the standard consumer decision-making framework is whether consumer preferences, $U(x|s)$, are modeled realistically in the

⁵ Behavioral economics has made a similar contribution to the field of finance. For example, while behavioral economics is able to explain some anomalies with the “efficient market hypothesis,” it is nevertheless the case that “opportunities for easy profits are rare.” See RICHARD BREALEY & STEWART MEYERS, PRINCIPLES OF CORPORATE FINANCE 333–36 (5th ed. 1996).

standard framework.⁶ By consumer preferences, an economist simply means how consumers value a product or service. For example, is it realistic to assume that individuals care only about themselves? Similarly, is it realistic to assume individuals care only about the absolute level of utility they receive?

Carefully designed laboratory-style experiments suggest that consumers can deviate from the standard model of individual decision making. There is also a growing body of non-laboratory empirical research that attempts to tease out the ways in which consumers deviate from the standard model of individual decision making in real-world settings, outside the carefully designed laboratory setting. Non-laboratory style evidence is important because antitrust analyses require one to bring real-world evidence to the table that is fact-specific to the product, market, and conduct at issue. While the standard model of individual decision-making behavior may work very well in many situations, the empirical research discussed below suggests that, in certain settings, there may be room to improve the standard model.

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Consumer Preferences as “Referenced-Based” and Incorporating “Fairness”

Standard economic models consider individuals to be purely self-interested, caring only about the absolute level of utility they receive. For example, the standard framework assumes individuals receive the same utility from receiving \$100 regardless of whether they had previously received \$0 (an increase of \$100) or previously received \$200 (a decrease of \$100). In addition, the standard model assumes that individuals receive the same utility from \$100 irrespective of how much others received.

Of course, in the real world, almost everyone can imagine getting a raise of \$10,000 and feeling very different about that \$10,000 raise, depending on whether they had previous received raises of only \$1,000 or previously received raises of \$50,000. In the real world, one can also imagine feeling very differently about that \$10,000 raise, depending on whether everyone else got the same raise as you did or whether everyone else got a raise three times larger than yours.

One way in which the modeling of consumer preferences has been modified in order to capture more realistic notions of such consumer preferences is to model preferences as “reference based.” Reference-based preferences are designed to capture the idea that consumers may care about changes as opposed to just the absolute level. This incorporates the observation in experimental settings that people dislike losing things much more than they like gaining things. When consumers dislike losing things more than they like gaining things, behavioral economics calls this “loss aversion.” Prospect theory, developed by Daniel Kahneman and Amos Tversky, provides an alternative framework for modeling individual decision-making behavior when individuals exhibit loss aversion.⁷ While consumers exhibit loss aversion in experimental settings,⁸ only recently has

⁶ Two other broad categories of questions raised about the standard individual decision-making framework are: (1) whether consumers form their beliefs, $p(s)$, rationally (for example, do consumers instead tend to be overconfident); and (2) whether the decision-making criteria, $\text{Max} \sum p(s)U(x|s)$, is being modeled realistically in the standard framework (for example, do consumers instead tend to have limited ability to pay attention to complex information). For a summary of the many ways in which behavioral economics considers modifications to the standard individual decision-making framework, see Matthew Rabin, *A Perspective on Psychology and Economics*, 46 EUR. ECON. REV. 657–85 (2002).

⁷ Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 49 ECONOMETRICA 263–91 (1979).

⁸ A frequently described example of loss aversion in an experimental setting involves coffee mugs. Individuals randomly assigned a free coffee mug were found to be willing to sell their coffee mug at prices substantially higher than the prices individuals who were not given a coffee mug were willing to pay. The explanation given for the observed behavior is that those who had a coffee mug in hand perceived a bigger loss to losing the coffee mug than the gain perceived by those who did not have a coffee mug in hand. See Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325–48 (1990).

research provided evidence of some individuals exhibiting loss aversion in certain real-world settings, including the housing market, the stock market, in bike messenger services, and the New Jersey police in contract negotiations.⁹

A second way in which the modeling of consumer preferences has been modified to capture more realistic notions of consumer preferences is to model preferences as having a social dimension rather than purely self-interest. Social preferences encompass several ways in which individuals may not be purely self-interested. One such way incorporates the notion of “fairness.” Matthew Rabin developed an alternative framework for modeling individual decision-making behavior when individuals care about fairness.¹⁰ Preferences that incorporate fairness may recognize that individuals care about how resources are allocated. In addition, preferences that incorporate fairness may recognize that individuals care about the reasons why an individual or firm takes an action, and thus allows for the possibility of individuals retaliating against behavior perceived as unfair.

In the experimental setting, it has been shown that some individuals exhibit a sense of fairness in their preferences, rather than strictly self-interested behavior.¹¹ Recent research has provided evidence of some individuals exhibiting fairness in their behavior in certain real-world settings, such as retaliation by unionized tire manufacturer workers in response to perceived unfair behavior by management.¹²

Implications for Antitrust Analyses

Modifications to standard consumer decision-making behavior, such as consumers who exhibit referenced-based preferences or preferences that incorporate fairness, can lead to interesting implications for how the economic analysis of a potential merger proceeds.¹³

For example, suppose the facts and data in a particular relevant market suggest that some consumers care much more about price increases than price decreases for the particular product or service at issue. In this situation, some consumers exhibit reference-based preferences. Referenced-based preferences can give rise to a demand curve with a kink in it at current prices. In other words, the demand curve is more elastic for price increases (above the kink) than for price decreases (below the kink). While certain economic analyses typically rely on a demand curve that is smooth, reference-based preferences can result in a kinked demand curve. The kinked demand curve can have meaningful implications for how an economic analysis proceeds if a substantial fraction of customers make decisions using referenced-based preferences and there is a substantial difference in how consumers behave in response to a price increase compared to a price decrease. One implication of a demand curve with a meaningful kink at current prices is that the Lerner Equation, which is used in mergers for a critical loss analysis, will not hold.¹⁴ As a result,

⁹ See Stefano DellaVigna, *Psychology and Economics: Evidence from the Field*, 47 J. ECON. LIT. 315–72 (2009).

¹⁰ Matthew Rabin, *Incorporating Fairness into Game Theory and Economics*, 83 AM. ECON. REV. 1281–1302 (1993).

¹¹ See DellaVigna, *supra* note 9 (describing the dictator experiment in which individuals given a lump sum of money are found to share that money with others rather than keep all the money for themselves).

¹² *See id.*

¹³ As a general matter, however, modifications to consumer decision-making behavior should have little effect on how an antitrust analysis proceeds because antitrust analyses are firmly grounded in a fact-specific understanding of how consumers behave in a particular market.

¹⁴ The Lerner Equation is an equilibrium relationship which states that a profit-maximizing firm will choose price such that the firm's percentage mark-up of price over incremental cost is equal to the own-price elasticity of demand faced by the firm.

reference-based preferences could affect certain analyses, such as a critical loss analysis.

Before employing an economic model that relies on a kinked demand curve, however, the analysis should be grounded in the specific facts for the specific product at issue. In the case of assuming referenced-based preferences, it makes sense to establish the fraction of customers making decisions using referenced-based preferences, whether there is a substantial difference in how consumers behave in response to a price increase compared to a price decrease, and whether the kink is located at current prices.

Consumer preferences that incorporate fairness also can lead to interesting implications for the economic analysis of mergers. In particular, preferences that incorporate fairness have the potential to discipline the exercise of market power post-merger. For example, suppose the facts and data related to a specific market suggest that consumers do not make decisions based on pure self-interest, but rather make decisions incorporating a sense of fairness. If it can be shown that consumers would consider the exercise of market power post-merger to be an unfair reason to raise price (a fair reason to raise price may be one related to cost increases), then consumers may refuse to buy the product post-merger even if buying the product would be worth it to them in the framework of purely self-interested decision making.¹⁵

The theory of harm laid out by Commissioner J. Thomas Rosch in his concurring statement in a case the Federal Trade Commission brought against Ovation Pharmaceuticals in December 2008 is a theory of harm that can be framed in the context of consumers having preferences that incorporate fairness.¹⁶ The FTC had challenged Ovation's acquisition of the rights to NeoProfen from Abbott Laboratories in January 2006 as a two-to-one merger in a product market defined as drugs used to treat heart defects in infants. While no apparent horizontal overlap or vertical concern existed when Ovation acquired from Merck its first drug used to treat heart defects in premature babies, Indocin, Commissioner Rosch alleged that "there is reason to believe that Merck's sale of Indocin to Ovation had the effect of enabling Ovation to exercise monopoly power in its pricing of Indocin, which Merck could not profitably do."¹⁷ Commissioner Rosch suggests that if Merck had sold Indocin at the monopoly price, its reputation would be sufficiently damaged such that it would lose sales on the other products in its large product portfolio. Underlying this statement is an assumption about consumer preferences and individual decision-making behavior. In particular, if consumers perceive the monopoly price for a drug used to treat heart defects in premature babies to be unfair, these consumers could retaliate by refusing to buy other products in Merck's large product portfolio even if buying those products would be worth it to them when considered in the framework of purely self-interested decision making.

To support the theory of firm behavior underlying Commissioner Rosch's analysis, fact-specific information and data that consumers behave in such a way is required. Important information to collect and develop includes whether purchasers would know that Merck was charging a

¹⁵ In the purely self-interested context, a consumer would consider it "worth it" to purchase if their willingness to pay was greater than the product's price.

¹⁶ See Concurring Statement of J. Thomas Rosch, Ovation Pharmaceuticals, Inc., FTC File No. 081-0156 (2008), available at <http://www.ftc.gov/os/caselist/0810156/081216ovationroschstmt.pdf>. Another interesting context in which to consider the effect of fairness is in the context of firm decision-making behavior. One such example is the so-called "good guys" defense. When asked why the parties to a proposed transaction would not be able to raise prices post-transaction, business people are often known to respond because we are "good guys." It would be an interesting exercise to empirically test to what extent a sense of fairness on the part of business people results in exercisable market power not being exercised to its fullest extent out of a sense of fairness.

¹⁷ *Id.* at 1.

monopoly price for Indocin; whether purchasers would know which other products were part of Merck's product portfolio; and whether there were a substantial number of customers who purchase a wide variety of products from Merck's product portfolio. A difficult, but important, empirical exercise would be to document the likelihood that purchasers would behave in a way consistent with preferences that incorporate "fairness," namely choosing not to purchase even if their willingness to pay for other products in Merck's portfolio exceeds the prices charged by Merck for those products.

Firms modifying

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The implications for

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Non-Standard Producer Decision-Making Behavior

As mentioned earlier, behavioral economics primarily focuses on how consumers may deviate from the standard model of individual decision making, not how firms may deviate from the standard model of firm decision making. Behavioral economics, as it relates to firms, often assumes firms are rational profit-maximizing entities, focusing instead on how firms modify their behavior to take advantage of the ways in which consumers deviate from the standard model.¹⁸ Firms modifying their behavior to take advantage of consumer behavior may have implications for consumer protection activities designed to protect consumers from unfair or deceptive practices. The implications for antitrust, however, are much less clear.

Two arguments are usually raised for continuing to treat a firm as a rational, profit-maximizing entity.¹⁹ First, firms may have access to a wide array of consultants and advisors who can assist in information processing and making optimal pricing decisions. Second, firms which stray from profit maximization are unlikely to survive in the long-run due to competition. It certainly makes sense that at any point in time a firm may make a mistake, thereby deviating from profit-maximizing behavior or by having short-run objectives to maximize revenue or market share rather than maximizing profits. However, consistent with the continued reliance on firms behaving as profit maximizers in the economic literature, there is little research that provides evidence suggesting that firms deviate from profit-maximizing behavior in a systematic or persistent way. Rather, anecdotal evidence on deviations appear to be related to non-systematic mistakes or to a firm targeting an interim goal related to revenues or market share that evolves over time to profit maximization.

One possible precedent for the antitrust agencies being open to considering systematic non-profit maximizing behavior on the part of a firm is former FTC Chairman Muris's 2004 closing statement in the FTC's investigation into Genzyme Corporation's acquisition of Novazyme Pharmaceuticals.²⁰ Genzyme and Novazyme were two firms conducting early studies into a treatment for Pompe disease, a rare and usually fatal genetic disorder that affects infants and children. Given that both firms had treatments in the pipeline, the FTC's investigation focused on the likelihood that the transaction would lessen the pace of innovation and R&D into the development of a treatment for Pompe disease or otherwise dampen the incentive to race to be the first firm to market a treatment for Pompe disease. The FTC's closing statement suggests that a manager's personal interests may deter a firm from otherwise engaging in a profit-maximizing strategy. In particular, the FTC noted that the structure of the Genzyme/Novazyme transaction "strongly suggest[ed]" that the transaction would not dampen incentives to develop a treatment because the manager placed

¹⁸ See DellaVigna, *supra* note 9.

¹⁹ See ROBERT PINDYCK & DANIEL RUBINFELD, MICROECONOMICS 264–65 (2009); *see also* DellaVigna, *supra* note 9.

²⁰ See Statement of Chairman Timothy J. Muris in the Matter of Genzyme Corporation/Novazyme Pharmaceuticals, Inc., FTC File No. 021-0026 (2004), available at <http://www.ftc.gov/opa/2004/01/genzyme.shtm>.

in charge of the Pompe disease research program post-transaction had two children afflicted with Pompe disease.²¹

While not described in the closing statement to the Genzyme/Novazyme transaction, there is an alternate behavioral explanation for why Genzyme/Novazyme would have no incentive to dampen innovation related to Pompe disease post-transaction that does not rely on non-profit-maximizing behavior. The argument is similar to that used to explain Merck's pricing decisions with respect to Indocin. In particular, given Genzyme's portfolio of other medical and biotechnology products, Genzyme/Novazyme may have found it profit-maximizing to not slow the pace of R&D for a treatment for Pompe disease post-transaction because, if it did, purchasers would consider such a strategy unfair, leading them to reduce their purchases of other products in Genzyme's portfolio in response. As discussed above, how sensible such a behavioral explanation is depends on the particular facts at hand. In this instance, the viability of such a behavioral explanation rests on key questions, such as whether purchasers would know that Genzyme/Novazyme slowed down the pace of innovation; whether purchasers would know which other products were part of Genzyme's portfolio; and whether substantial numbers of customers purchase a wide variety of products from Genzyme's portfolio.

Conclusion

Just as one would not conclude switching costs are high in one industry because switching costs are high in an unrelated industry, the same should be true for modifications to the standard frameworks for individual decision making and firm decision making. Antitrust analyses are fact-specific, and the facts related to the industry at hand must accord with the assumptions about how individuals make decisions in that industry and how firms make decisions in that industry. If it can be shown using the relevant facts and data for the specific product or service at issue that consumers care much more about price increases than price decreases in a systematic and persistent way, then it makes sense to consider an alternate framework, such as a kinked demand curve. Similarly, if it can be shown using the relevant facts and data for the specific product or service at issue that a firm (or firms) deviates from standard profit-maximizing behavior in a systematic and persistent way, then it makes sense to consider an appropriate alternate framework of firm decision making for evaluating the competitive concern at hand.

Absent fact-specific evidence of systematic and persistent deviations, it makes sense to rely on the standard frameworks for consumer and firm decision-making behaviors as the default economic model. The standard frameworks are familiar frameworks, tractable frameworks, and, absent evidence to the contrary, appear to describe consumer and firm behavior well. It would be an unfortunate turn in how antitrust analyses are conducted if behavioral economics became a means to justify making any ad hoc, unsupported assumption on decision-making behavior to fit with one's agenda. Rather, it makes good sense for private parties, government agencies, and the courts to incorporate alternate economic models based on behavioral economics framework when the facts and data in the specific issue at hand merit the use of an alternate analytical framework. ●

²¹ *Id.* at 15.

Unilateral Effects with Differentiated Consumer Products: A Response to Scheffman and Simons

Gregory J. Werden

In the April 2010 issue of *The Antitrust Source*, David Scheffman and Joseph Simons identify what they view as a serious flaw in the standard analysis for assessing likely unilateral effects from mergers involving differentiated consumer products.¹ They target the assumption that demand curves are smooth.² Their thesis is that this assumption is critical to the prediction of price increases following the merger of competing brands, yet this assumption is empirically unsupported.

Scheffman and Simons contend that the demand curve for a particular brand is likely to exhibit a sharp kink at the profit-maximizing price,³ with the quantity demanded significantly more responsive to a small price increase than to a small price decrease. With this sort of kinked demand, they argue, the merger of competing brands might not affect prices.

The kink is hypothesized to derive from the psychology of retail shoppers and the resulting asymmetry in their reactions to price changes. Inspired by the work of psychologists, marketing scientists maintain that shoppers compare prices to internal and external reference values,⁴ and they react positively to a price below its reference value and negatively to a price above its reference value. Scheffman and Simons go much further, arguing that the asymmetry in consumer responses to price changes gives rise to a sharp kink in the demand curves faced by manufacturers of consumer products.

For the purposes of this comment, I accept that many shoppers react asymmetrically to price changes, but I presume nothing about the significance of the asymmetry,⁵ and I explain below why the asymmetry does not imply a sharp kink in the demand curves faced by manufacturers of consumer products.⁶ I also explain that, despite the asymmetry, the standard analysis of unilateral effects provides critical tools that should be used by agencies and courts when assessing proposed mergers involving differentiated consumer products.

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¹ David Scheffman & Joseph Simons, *Unilateral Effects for Differentiated Products: Theory, Assumptions, and Research*, ANTITRUST SOURCE, Apr. 2010, <http://www.abanet.org/antitrust/at-source/10/04/Apr10-Scheffman4-14f.pdf>.

² For a presentation of the standard analysis, see Gregory J. Werden, *Unilateral Competitive Effects of Horizontal Mergers I: Basic Concepts and Models*, in 2 ABA SECTION OF ANTITRUST LAW, ISSUES IN COMPETITION LAW AND POLICY 1319 (Wayne Dale Collins ed., 2008).

³ A “kink” is an abrupt change in the slope of a curve; a “sharp kink” is a change in slope that occurs at a single point.

⁴ See, e.g., Tridib Mazumdar, S.P. Raj & Indrajit Sinha, *Reference Price Research: Review and Propositions*, J. MARKETING, Oct. 2005, at 84; Ronald W. Niedrich, Subhash Sharma & Douglas H. Wedell, *Reference Price and Price Perceptions: A Comparison of Alternative Models*, 28 J. CONSUMER RES. 339 (2001).

⁵ Empirical research finds small differences between the demand elasticities for price increases and those for price decreases. See Sangkil Moon, Gary J. Russell & Sri Devi Duvvuri, *Profiling the Reference Price Consumer*, 82 J. RETAILING 1, 7–8 (2006).

⁶ Because the psychology of retail shoppers is relevant only to consumer goods, I consider only mergers involving such goods, and I understand Scheffman and Simons to have done likewise.

The Smooth Demand Assumption

The standard analysis of unilateral effects with differentiated consumer products assumes smooth demand curves at the brand level. Scheffman and Simons assert that this assumption “is not likely to be factually justified,”⁷ citing evidence that retail shoppers react asymmetrically to price changes. They reason that a demand curve cannot be smooth if it reflects asymmetric reactions to price changes, but that reasoning is faulty.

Formal theory of consumer behavior with asymmetric reactions does predict kinked demand curves for individual consumers.⁸ Empirical evidence, however, indicates that individuals’ demand curves do not actually exhibit sharp kinks at prevailing prices. Rather than a sharp kink, empirical research finds “a region of price insensitivity for small increments around a reference price [so] a price change may not be noticed.”⁹

More importantly, the demand curves of individual consumers do not matter. The seller of the brand of a differentiated product maximizes its profits with respect to the aggregate demand of all consumers. With inevitable consumer heterogeneity, sharp kinks in individual demand curves are consistent with a smooth aggregate demand curve at the brand level.¹⁰

Economists sometimes posit that each consumer purchases one unit of a product or none. In this model, the demand curve of an individual consumer has the sharpest possible kink at her “reservation price,” the highest price she is willing to pay. Yet the aggregate demand curve is smooth if the population of consumers is characterized by a continuous distribution of reservation prices, which is reasonable to assume when the market has both many, and heterogeneous, consumers.

Brand level demand also can be smooth if individual demand curves are kinked due to asymmetric price reactions. Different shoppers have different information, and they process it differently,¹¹ so they have a range of reference prices.¹² Indeed, marketing scientists investigating reference prices typically use a choice model that assumes shopper heterogeneity described by a continuous distribution.¹³

A brand level demand curve does not have a sharp kink if the distribution of reference prices is continuous, but it still could be concave, thus exhibiting a proportionately greater quantity response to a discrete price increase than to a discrete price decrease. With smooth, concave demand, asymmetric aggregate price reaction is observed for discrete price changes, yet it does not exist for the infinitesimal price changes involved in the calculus of profit maximization. Hence,

⁷ Scheffman & Simons, *supra* note 1, at 2.

⁸ See Daniel S. Putler, *Incorporating Reference Price Effects into a Theory of Consumer Choice*, 11 *MARKETING SCI.* 287, 295 (1992).

⁹ Gurumurthy Kalyanaram & Russell S. Winer, *Empirical Generalizations from Reference Price Research*, 14 *MARKETING SCI.* G161, G167 (1995). Kalyanaram and Winer rely on Gurumurthy Kalyanaram & John D. C. Little, *An Empirical Analysis of Latitude of Price Acceptance in Consumer Package Goods*, 21 *J. CONSUMER RES.* 408 (1994). Kalyanaram and Little estimate what they term “latitudes of price acceptance” of 8¢ for sweetened drinks and 10¢ for unsweetened drinks, with both categories of drinks having median prices of a bit more than a dollar. *Id.* at 415–16.

¹⁰ See, e.g., ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, *MICROECONOMIC THEORY* 122–23 (1995).

¹¹ See, e.g., Donald R. Lichtenstein, Peter H. Bloch & William C. Black, *Correlates of Price Acceptability*, 15 *J. CONSUMER RES.* 243 (1988); Moon et al., *supra* note 5.

¹² See, e.g., David R. Bell & James M. Lattin, *Looking for Loss Aversion in Scanner Panel Data: The Confounding Effect of Price Response Heterogeneity*, 19 *MARKETING SCI.* 185 (2000) (finding significant heterogeneity in reference prices); Lakshman Krishnamurthi, Tridib Mazumdar & S.P. Raj, *Asymmetric Response to Price in Consumer Brand Choice and Purchase Quantity Decisions*, 19 *J. CONSUMER RES.* 387 (1992) (identifying different customer types and finding that they respond differently to price changes); Moon et al., *supra* note 5 (same).

¹³ See, e.g., Kalyanaram & Little, *supra* note 9, at 410–11; Moon et al., *supra* note 5, at 2–3; Putler, *supra* note 8, at 296–98.

a concave brand level demand curve reflecting asymmetric price reactions can be differentiable at every point.¹⁴

Economists are eager to consider any demand scenario presented in the real world, but smooth demand curves provide an arbitrarily close approximation to whatever the real world presents. For example, output is discrete in the real world, but a continuous demand curve provides a sufficiently close approximation. A smooth demand curve can reflect asymmetric price reactions, so there is no reason to assume a sharp kink.

Scheffman and Simons argue that rivals' responses to price changes also provide a reason to believe there is a sharp kink in brand level demand curves. This argument, however, has fatal flaws.

First and foremost, Scheffman and Simons mistakenly focus on "residual" demand curves. In fact, standard analysis of unilateral effects analysis with differentiated consumer products uses ordinary "Marshallian" demand curves. Marshallian demand curves are constructed under the assumption that all other prices are held constant, while residual demand curves incorporate responsive price changes by rivals. Nearly all economic analysis is performed using Marshallian demand curves.

Second, within the context of the economic model used to analyze unilateral effects with differentiated consumer products,¹⁵ the only potential cause of asymmetric price responses by the merged firm's rivals is that their demand curves have sharp kinks, yet there is no reason to suppose sharp kinks in those demand curves (as discussed above). Profit maximization with respect to smooth demand curves does not produce asymmetric responses to one competitor's price changes by other competitors.

Third, if rivals did not respond to price increases, the implication would not be that the merged firm faces a sharply kinked demand curve. Rather, the implication would be that the analysis of unilateral effects is very simple. Without rivals' responses, the analysis of unilateral effects converges with the analysis of market delineation. Price responses are assumed away when applying the hypothetical monopolist test, and the relevant market is delineated even with differentiated consumer products.

Finally, Scheffman and Simons attribute excessive importance to the merged firm's rivals. Standard analysis of unilateral effects with differentiated consumer products does account for the responses of rivals. Nevertheless, price increases by non-merging rivals normally make a small contribution to the post-merger, market-wide, average increase in price.¹⁶

If demand is smooth, and there is no general reason to believe otherwise, the predictions of standard analysis remain valid. When a merger brings competing brands of a differentiated product under common ownership and control, competition between them is eliminated. To whatever extent either brand had constrained the pricing of the other, that constraint is lifted, so the product's price increases (absent offsetting effects from the merger). Moreover, when useful in the process of

¹⁴ Marketing scientists posited, and estimated, brand level demand curves with asymmetric aggregate price response and found a substantial range of prices within which there is no aggregate asymmetry. See Koen Pauwels, Shuba Srinivasan & Philip Hans Franses, *When Do Price Thresholds Matter in Retail Categories?*, 26 *MARKETING SCI.* 83 (2007).

¹⁵ Scheffman and Simons allude to the kinked oligopoly demand curve, which relates to coordinated effects. Scheffman & Simons, *supra* note 1, at 7–8. Although coordinated effects could be a distinct reason for post-merger price increases, I consider only unilateral effects but note that the concept of kinked oligopoly demand curve has vocal detractors. See George J. Stigler, *The Literature of Economics: The Case of the Kinked Oligopoly Demand Curve*, 16 *ECON. INQUIRY* 185 (1978).

¹⁶ See, e.g., Gregory J. Werden & Luke M. Froeb, *The Effects of Mergers in Differentiated Products Industries: Logit Demand and Merger Policy*, 10 *J.L. ECON. & ORG.* 407, 413, 418 (1994).

predicting likely price increases, the elasticity of demand for a relevant product can be inferred from the product's price-cost margin (and vice versa). For a differentiated consumer product (sold by a single-product firm) the price-cost margin can be expected to be roughly equal to the reciprocal of its elasticity of demand.

The Scheffman-Simons Example

Scheffman and Simons also argue that a merger could eliminate significant competition between two brands, yet not lead to price increases, because neither brand actually constrained the pricing of the other. They present an example in which each merging brand faces competition from an excellent substitute (not controlled by the merger partner) at prevailing prices, so a small price increase would cause a large reduction in sales. They nominate private label products as candidates for the excellent substitutes.¹⁷

Scheffman and Simons do not claim this example finds support in empirical research on competition between private labels and major brands. Nor do they present the example as a necessary implication of asymmetric consumer reactions to price changes. Scheffman and Simons do, however, observe that this example is impossible if brand level demand curves are smooth.¹⁸ With smooth demand, competition between merging brands necessarily affects their profit-maximizing prices, and the standard analysis correctly identifies the importance of that competition.

Contrary to the apparent suggestion of Scheffman and Simons, the government should not be required to address their example. If the key pricing consideration for the merging firms were the prospect of massive substitution to an existing product of a non-merging firm, their documents should vividly portray that fact. The failure of the merging firms to trumpet such documents (or comparable evidence) is proof enough that an existing excellent substitute sold by a non-merging firm is not the key consideration in pricing.

Significant competition between merging and non-merging brands, while very common, is far from sufficient to make the Scheffman and Simons example relevant. With heterogeneous consumer preferences, a merging brand faces competition from many substitutes, as econometric studies invariably find. The standard analysis of mergers with differentiated products accounts for competition with all of the substitutes.

Finally, if the facts of a particular case did match up with the Scheffman and Simons example, the standard analysis still could be applied, although not with calculus. The economic model used to predict unilateral effects applies with any demand and cost curves.¹⁹ If calculus cannot be used, it is simple to compute the merged firms' profits at thousands of price combinations, then plot those profits against the prices. Similar analysis sometimes is necessary in market delimitation, for example, if a hypothetical monopolist would shut down discrete blocks of productive capacity.²⁰

¹⁷ Scheffman & Simons, *supra* note 1, at 2–3 & n.8.

¹⁸ *Id.* at 2–3.

¹⁹ Scheffman and Simons also argue that cost curves might not be smooth. *Id.* at 5. That is both true and empirically relevant, but I am not aware of a single example in a merger case involving differentiated consumer products.

²⁰ See Gregory J. Werden, *Beyond Critical Loss: Tailored Application of the Hypothetical Monopolist Test*, 4 COMPETITION L.J. 69 (2005). The analysis can reveal that a hypothetical monopolist would impose a large price increase even if a small price increase is unprofitable.

Unilateral Effects with Asymmetric Consumer Reactions

Contrary to the contention of Scheffman and Simons, asymmetric reactions to price changes are not likely to be of significance in the assessment of the likely unilateral effects of a differentiated products merger. As an empirical matter, shopper psychology does not prevent price increases for consumer products when changes in the economic environment alter the profit-maximizing level of prices. Shopper psychology might affect precisely how price increases are implemented, but antitrust law should not be concerned with such details.

As an empirical matter, shopper psychology does not prevent price increases for consumer products when changes in the economic environment alter the profit-maximizing level of prices.

At the outset, it must be appreciated that marketing science finds that the impact of shopper psychology is negligible in the long term,²¹ and that is just what Scheffman and Simons implicitly assume. They explicitly assume that pre-merger prices are at profit-maximizing levels,²² yet today's prices could be at profit-maximizing levels only if they had changed in the past following changes in the economic environment. Cost shocks, new product introductions, and mergers all cause the profit-maximizing prices to change.

Shopper psychology might well affect how retail prices are adjusted with changes in the economic environment, but the empirical evidence clearly indicates that retail prices are adjusted when costs change.²³ And contrary to the apparent implication of asymmetric reactions to price changes, empirical research typically finds that prices respond to cost increases more rapidly than to cost decreases.²⁴ Moreover, a recent study found that supermarkets frequently impose small price increases that likely are not cost related.²⁵

What marketing science actually teaches is that manufacturers should account for shopper psychology in deciding exactly how to increase prices.²⁶ According to an authority on which Scheffman and Simons rely, the “[a]symmetric price response effect suggests that retailers and manufacturers have to devise careful strategies while raising the price of a brand. One approach may be to raise price in small increments so that consumers can be forced to adapt to higher reference prices.”²⁷

If need be, a manufacturer of consumer products also has other ways to deal with shopper psychology in implementing a post-merger price increase. It can, for example, reduce the amount of product contained in standard package sizes or it can reduce the frequency or extent of temporary price promotions. It also could increase average revenue per unit without affecting retail prices. Slotting allowances or other fixed fees are common in transactions between manufactur-

²¹ See Gadi Fibich, Arieh Gavious & Oded Lowengart, *The Dynamics of Price Elasticity of Demand in the Presence of Reference Price Effects*, 33 J. ACAD. MARKETING SCI. 66 (2005).

²² Scheffman & Simons, *supra* note 1, at 5.

²³ See David Besanko, Jean-Pierre Dubé & Sachin Gupta, *Own-Brand and Cross-Brand Retail Pass-Through*, 24 MARKETING SCI. 123 (2005) (estimating retailer pass-through rates for cost changes).

²⁴ See, e.g., Sam Peltzman, *Prices Rise Faster than They Fall*, 108 J. POL. ECON. 466 (2000); John Geweke, Report to the FTC, Issues in the “Rockets and Feathers” Gasoline Price Literature (Mar. 16, 2004), available at <http://www.ftc.gov/bc/gasconf/comments2/gewecke2.pdf>.

²⁵ Haipeng (Allan) Chen, Daniel Levy, Sourav Ray & Mark Bergen, *Asymmetric Price Adjustment in the Small*, 55 J. MONETARY ECON. 728 (2008).

²⁶ Marketing science also explores the effect of asymmetric consumer reactions on pricing dynamics. See Gadi Fibich, Arieh Gavious & Oded Lowengart, *Optimal Price Promotion in the Presence of Asymmetric Reference-Price Effects*, 28 MANAGERIAL & DECISION ECON. 569 (2007).

²⁷ Kalyanaram & Winer, *supra* note 9, at G167.

Any presumption of significant anti-competitive effects from the merger of competing sellers of differentiated consumer products arises, not from economic theory, but rather from the demonstration that a proposed merger eliminates an important competitive force.

ers and retailers. A merged manufacturer might adjust only the fixed fee and not affect retail prices.²⁸ The FTC successfully argued just that in the baby food case.²⁹

For all of the foregoing reasons, asymmetric reactions to price changes should not be of concern in assessing the likely unilateral effects of a merger involving differentiated consumer products. Whatever impact the asymmetry might have, it is not of antitrust significance.

Conclusions

Shoppers might react asymmetrically to price changes, but that does not imply that brand level demand curves have sharp kinks. Nor do the teachings of marketing science on asymmetric reactions by shoppers undermine the utility of the basic insights and tools provided by economic theory for assessing the likely competitive effects of differentiated consumer products mergers.

Scheffman and Simons react to what they characterize as a proposal to presume anticompetitive effects on the basis of economic theory.³⁰ That characterization, however, distorts the roles played by theory and evidence. Any presumption of significant anticompetitive effects from the merger of competing sellers of differentiated consumer products arises, not from economic theory, but rather from the demonstration that a proposed merger eliminates an important competitive force. That elimination is a substantial lessening of competition in violation of Section 7.

The test of a theory is whether it predicts, and the best evidence indicates that mergers of competing manufacturers of differentiated consumer products have led to increases in the retail prices of their products over the short term.³¹ More such evidence is welcome, and it could prove valuable in evaluating methods for predicting unilateral merger effects, but for now the weight of evidence is that the prediction of Scheffman and Simons—that mergers of competing brands of differentiated consumers products do not lead to price increases—is not borne out. ●

²⁸ For an analysis of mergers allowing for such effects, see Luke Froeb, Steve Tschantz & Gregory J. Werden, *Vertical Restraints and the Effects of Upstream Horizontal Mergers*, in *THE POLITICAL ECONOMY OF ANTITRUST* 369 (Vivek Ghosal & Johann Stennek eds., 2007).

²⁹ See *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 718–19 (D.C. Cir. 2001).

³⁰ Scheffman & Simons, *supra* note 1, at 1 & n.4.

³¹ See Orley Ashenfelter & Daniel S. Hosken, *The Effect of Mergers on Consumer Prices: Evidence from Five Selected Case Studies*, J.L. & ECON. (forthcoming), available at <http://ssrn.com/abstract=1106585>.

Paper Trail: Working Papers and Recent Scholarship

Editor's Note: *The Supreme Court's decision in American Needle on the future of single entity treatment for affiliated firms invites serious reflection. Professor Hovenkamp examines the decision, and Editor Bill Page comments. Send suggestions for papers to review to: page@law.ufl.edu or jwoodbury@crai.com.*

—WILLIAM H. PAGE AND JOHN R. WOODBURY

Recent Papers

Herbert Hovenkamp, *American Needle and the Boundaries of the Firm in Antitrust Law*

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616625

In this paper, Professor Herbert Hovenkamp of the University of Iowa examines how the Supreme Court's decision in *American Needle*¹ affects the law governing whether a group of firms should be treated as a single entity incapable of conspiring under Section 1. He agrees with the Court that, apart from a handful of extreme cases that warrant per se illegality or that pose no risk of exclusionary or exclusive activity, cases involving affiliated firms should be judged under the rule of reason.

NFL teams are separately incorporated, but, since 1963, have licensed their IP rights through a joint venture, NFL Properties (NFLP). More recently, NFLP granted an exclusive license to Reebok to use the team logos on hats. That decision cut off *American Needle*, which sued, alleging that the NFL's action was a horizontal refusal to deal. The lower federal courts held that, at least in the licensing of logos, the NFL teams were a single entity.² The Supreme Court, in an opinion by retiring Justice John Paul Stevens, reversed and remanded for analysis of the arrangement under the rule of reason.

Hovenkamp points out that the single entity category is important because it creates a kind of safe harbor for a range of benign conduct. But the stakes are high in defining the category. If, for example, the NFL is a single entity, its unilateral refusals to deal are almost certainly lawful and any vertical exclusive contracts it forms would be subject to a relatively lenient rule of reason inquiry focusing on market share and exclusionary effect. If the NFL teams are separate, then the refusal to deal is concerted and could be judged under either the per se rule or some version of the rule of reason, depending upon the specifics of the restraint.

In *American Needle*, the Court read its decisions on this question to establish that economic substance, not corporate or other form, should govern whether a group of actors is a single entity or "separate decisionmakers" with separate interests. The Court held long ago in *Sealy* that an incorporated joint venture of separate manufacturers that assigned exclusive territories was not

¹ *American Needle, Inc. v. NFL*, No. 08-661, 2010 WL 2025207 (U.S. May 24, 2010).

² *American Needle, Inc. v. NFL*, 538 F.3d 736, 740 (7th Cir. 2008), *aff'd* 496 F. Supp. 2d 941, 533 F. Supp. 2d 7901 (N.D. Ill. 2007).

a single entity because it was just a shell that carried out the joint decisions of its individual owners.³ In *Copperweld*,⁴ by contrast, the Court held that a manufacturer and its wholly owned and separately incorporated subsidiaries functioned as a single enterprise.

NFL teams, according to the Court, had “separate corporate consciousness[es]” and actually or potentially competed “to attract fans, for gate receipts and for contracts with managerial and playing personnel” as well to sell products under their individually owned logos. This conclusion followed, even though the teams act through NFLP, a separate corporation that distributes revenues among the teams, because the teams remain separate entities with rival interests that at least potentially compete in the licensing of their own IP. A cartel is still a cartel even if it appoints a joint selling agent. True, there are aspects of the NFL that require joint action, but these can be considered in a rule of reason inquiry under Section 1.

Hovenkamp questions whether the single entity issue was of great practical importance in *American Needle*'s challenge to the exclusive contract between NFLP and Reebok. That vertical agreement, he notes, was undoubtedly between separate entities; whether it was an illegal exclusionary practice would depend upon the extent to which it foreclosed competitors of Reebok from a properly defined downstream market. The single-entity issue becomes more important in determining whether the alleged conduct is a concerted refusal to deal or a cartel. In *American Needle*, the rule of reason inquiry (as opposed to per se legality) was appropriate mainly because of the danger of collusion in the licensing process rather than exclusion in downstream markets. The horizontal agreement “facilitates collusion rather than independent bidding for licenses” of team logos, which are “by nature exclusive to each team.” Hovenkamp suggests that “[t]here is no obvious reason why a group of football teams should be permitted to cartelize the licensing of their marks any more than a group of competing restaurants should be, and if a procompetitive rationale should emerge, the rule of reason should be quite sufficient to handle it.” For example, the NFL's refusal to admit a team from the USFL was held lawful even though it was concerted.⁵ The concern with collusion should determine the nature of the rule of reason inquiry, including the validity of any defenses offered in support of the restraint.

The Court emphasized that, on remand, the “necessity of cooperation” should be one factor in the rule of reason analysis. Hovenkamp asks whether the Court means that the cooperation must be necessary for the individual restraint to succeed or for the joint venture as a whole to succeed. Although the teams must cooperate to schedule the season, there is no similar imperative for marketing their individual IP rights. Does the necessity of cooperation to form a league carry over to the IP context, or should the latter be viewed separately? Does the answer depend on the extent of the nexus between the two?

The Court emphasized, in determining that the rule of reason should apply, that the IP rights at issue in the case were team logos owned by the teams individually. That would imply that the NFL's decisions about the NFL's own trademark would be unilateral. Hovenkamp suggests, however, that virtually all of the league's licensing decisions should be viewed as concerted and subject to the appropriate degree of scrutiny under the rule of reason. In both *Sealy*⁶ and *Topco*,⁷ for example,

³ *United States v. Sealy, Inc.*, 388 U.S. 350 (1967).

⁴ *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984).

⁵ *Mid-South Grizzlies v. NFL*, 720 F.2d 772 (3d Cir. 1983).

⁶ 388 U.S. 350 (1967).

⁷ *United States v. Topco Assocs.*, 405 U.S. 596 (1972).

the Court properly treated an association's use of its common trademark as concerted action, although it wrongly applied the per se rule. The rule of reason would also be appropriate if the NFL's research arm were to develop and patent a new product, although, Hovenkamp notes, joint action might be more justifiable in that case than in the trademark case "because excessive licensing by one firm could dissipate the value of the patent to other firms."

Under *Copperweld*, separately incorporated firms owned by a common parent are a single entity, but most courts hold that separately incorporated franchises contractually related to their franchisor are separate entities, even if they are created solely to promote the business of the franchisor. Thus, the decision of McDonald's itself, say, to run a national advertising campaign, is unilateral, but joint actions of McDonald's franchisees are concerted. If McDonald's "imposed" resale price maintenance, the restraint would entail a vertical agreement even though the restraint was an "exercise[] of the franchisor's own property rights rather than those of individual franchisees, and "even though the only purpose for incorporating a particular MacDonal'd's franchisee is to serve as part of the MacDonal'd's franchise." Like the franchisees, Hovenkamp notes, NFL teams

are independently owned businesses with separate economic interests that do not necessarily coincide with those of the venture as a whole. Most critically, the individual teams have incentives to behave as competitors vis-à-vis one another, while the organization may have incentives to maximize joint profits by behaving as a cartel. This conclusion also has a flip side: the individual members may have an incentive to free ride on the investment of other members, while the organization has an interest that each member do its part. These concerns can be particularly relevant to the subject of intellectual property licensing.

For joint ventures, Hovenkamp argues, the extremes of per se illegality and single-entity status (virtual per se legality) are only rarely appropriate. The former course is appropriate for "naked conduct that is not integral to the delivery of the joint venturer's product." The latter course is only appropriate where the venture "is conducting its own business rather than being involved in the separate business of its individual team members." According to Hovenkamp, *American Needle* implicitly denies single-entity status to Visa and Mastercard joint ventures and local real estate boards, all of which "have structures that tend to be looser than that of the NFL, permitting more individualized business decision making by separate members." This conclusion follows regardless of corporate form, so long as the constituent firms retain individual business operations, as in *Sealy*, and do not fully align corporate interests, as in *Copperweld*. The decision also denies single-entity status to relationships between franchisors and franchisees, between patent owners and their licensees, and between a hospital and its physician-officers, where the officers retain individual competing practices.

American Needle is, however, consistent with *Dagher*,⁸ which granted single-entity status to a "joint venture of two oil producers that produced, sold, and priced gasoline from a common facility" under the producers' separate brands. The key distinction between the cases was that the joint venture participants in *Dagher* "ceased all of their separate operations in the western United States and made sales of gasoline only through the venture."

Hovenkamp suggests that *Chicago Professional Sports*,⁹ which held that the NBA was a single entity, may still have some validity. In that case, Judge Easterbrook held that the NBA was a single entity, at least for some purposes, because, unlike the NCAA, it creates its constituent

⁸ *Texaco, Inc. v. Dagher*, 547 U.S. 1 (2006).

⁹ *Chicago Prof'l Sports Ltd. P'ship v. NBA*, 95 F.3d 593 (7th Cir. 1996).

teams solely to produce basketball games, even though the teams retain distinct ownership. He noted, however, that

[s]ports are sufficiently diverse that it is essential to investigate their organization and ask *Copperweld's* functional question one league at a time—and perhaps one facet of a league at a time, for we do not rule out the possibility that an organization such as the NBA is best understood as one firm when selling broadcast rights to a network in competition with a thousand other producers of entertainment, but is best understood as a joint venture when curtailing competition for players who have few other market opportunities.¹⁰

For Judge Easterbrook, a contractual provision between the NBA and NBC that limited the number of games the Chicago Bulls could broadcast on WGN was not a concerted action of the league's members. This restraint was different from *American Needle* because the Bulls' side contracts at least potentially affected the ability of the league to maximize profit. Nevertheless, Hovenkamp argues, the same NBA issue should now be resolved under the rule of reason: "while there was more essential integration in the *Chicago Professional Sports* situation, there was not so much more as to render individualized competition impossible or make it harmful, particularly given the NBA's ability to charge licensing fees for side contracts." Rule of reason analysis allows the Court to weigh these concerns, while single-entity treatment makes them per se legal. ●

—WHP

¹⁰ *Id.* at 600 (emphasis added).