

# The PRC Antimonopoly Law: Unanswered Questions and Challenges Ahead

**Nathan Bush**

On August 30, 2007, the Standing Committee of the National People's Congress (NPC) adopted China's first comprehensive competition statute, the Antimonopoly Law (AML).<sup>1</sup> Although the final text reflects thirteen years of drafting, it leaves unanswered many basic questions about China's substantive competition rules and antitrust enforcement program. While some outstanding issues should be resolved before the law takes effect on August 1, 2008,<sup>2</sup> uncertainties will doubtless persist.

The key provisions of the AML are surveyed below in light of the political circumstances shaping its drafting and implementation. The final text leaves ample room for Chinese antitrust either to converge with prevailing practices of well-established antitrust jurisdictions or to serve other strategic or industrial policy goals. As with most Chinese laws, the AML's impact depends less on the text itself than on the resources, motives, and clout of the enforcement authorities.

## The AML's Translucent Drafting Process

Several prior Chinese laws touch on antitrust issues, but the relevant provisions are vague, largely toothless, and scattered among multiple laws under different enforcement agencies. A committee drawn from several central government agencies began drafting the AML in 1994, but progress was sporadic. China's accession to the World Trade Organization (WTO) in 2001 reinvigorated the process. In the course of revising domestic laws and dismantling trade barriers to comply with China's WTO commitments, many Chinese officials and scholars "discovered" competition policy as an accepted tool for regulating developed market economies.

The AML's drafting process was far less opaque than most Chinese legislative efforts. Though drafting occurred behind closed doors, "unofficial" drafts circulated frequently. Seminars and formal written comments of these drafts allowed meaningful input from domestic stakeholders and from foreign antitrust scholars, enforcement officials, and private practitioners (including the American Bar Association and the International Bar Association), as well as such multilateral institutions as the World Bank, Organization for Economic Co-operation and Development, and the United Nations Conference on Trade and Development. This dialogue followed the drafting from the ministries to the State Council (China's cabinet) and on to the NPC. Meanwhile, Chinese per-

■ *Nate Bush is a counsel in the Beijing office of O'Melveny & Myers LLP. The views expressed in this article are those of the author and not those of the firm or any of its clients.*

<sup>1</sup> See Antimonopoly Law of the People's Republic of China (promulgated by the Standing Committee of the National People's Congress on Aug. 30, 2007 and effective on Aug. 1, 2008)(AML), available at <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=371229&pdmc=11006>. Unofficial translation by O'Melveny & Myers LLP is appended to this article.

<sup>2</sup> See AML, art. 57.

sonnel were assigned to competition authorities in Europe, and Chinese academics (as well as their students) devoted greater attention to studying antitrust policies worldwide.

Engagement paid off. Successive drafts shed unworkable provisions and drew closer to modern U.S. or EC rules. Provisions importing vestigial or cumbersome foreign practices (such as a scheme of individual exemptions for agreements among competitors and a strong essential facilities doctrine) disappeared, partially in response to foreign commentary. However, several constructive provisions inserted in response to foreign advice were deleted, some potentially mischievous provisions survived, and many key issues were reserved for the enforcement authorities.

The result is a statutory text that can be construed—and stretched in some places—to conform with prevailing international antitrust principles and practices. The AML targets three types of private “monopolistic conduct”: anticompetitive “monopoly agreements,” abuses of dominant market positions, and concentrations that are “likely to eliminate or restrict competition.”<sup>3</sup> Most substantive provisions clearly derive from foreign models (particularly EC and German practices), but many of the nuances and details of foreign doctrines are omitted. While such generality is common in competition statutes (and routine for Chinese laws), it defers many key decisions to implementing regulations, guidelines, judicial interpretations (quasi-legislative pronouncements from higher Chinese courts), and case-by-case enforcement decisions. Thus, it remains to be seen whether the abstract foreign concepts embedded in the law will be applied with imported analytical techniques and judgments.

### The Divergent Purposes of Chinese Antitrust

Whether Chinese competition policy makers embrace prevailing international practices depends, understandably, on whether such foreign practices will achieve their policy goals. Problematically, China’s antitrust priorities remain unsettled.

Article 1 of the AML lists the new law’s aims, ranging from promoting “efficiency” and “consumer interests” to advancing “fair market competition,” “the public interest,” and “the healthy development of the socialist market economy.” Sloganeering aside, Article 1 reflects real disagreement within the Chinese government and academic establishment as to the proper role of the AML. Some recognize modern competition policy as a means of promoting consumer welfare and efficiency through the competitive process. Many reformers also seek to rein in “administrative monopoly,” the anticompetitive misuse of official power by local authorities and sector regulators to protect favored companies. Others embrace the goals of protecting small and medium enterprises from larger competitors. More menacing, perhaps, are frequent calls for the AML to shield domestic enterprises from foreign rivals or to reinforce industrial policies aimed at promoting homegrown innovation, brand-building, and market leadership by Chinese companies. Chinese commentators can point to the competition and industrial policies of various foreign jurisdictions (including the populist periods of U.S. antitrust) to validate each approach. These views resonate in different passages of the law and in different sections of the government. Indeed, the selected excerpts from the NPC Standing Committee’s final discussion of the AML published on the NPC’s official Web site suggest that each of these approaches to competition policy influenced different standing committee members.<sup>4</sup> These competing viewpoints will con-

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<sup>3</sup> See AML, art. 3. Language limiting the AML’s prohibitions to misconduct that “substantially” eliminates or restricts competition appeared throughout an earlier draft, but was deleted. It is unclear whether this principle will be revived during implementation.

tinue to shape the interpretation and enforcement of the AML in years to come. The relative influence of the competing approaches is left unresolved by the final text of the AML and will depend heavily on the allocation of policymaking and enforcement authority.

### The Policy Making and Enforcement Climate

Authority over competition policy is precious bureaucratic turf, and struggles for this turf have erupted along three dimensions: rivalry between central government agencies to become the general antitrust authority, resistance to the central government's efforts to rein in anticompetitive regulatory practices by local and provincial officials with new "administrative monopoly" rules, and efforts by key sector regulators to retain primacy over competition within their jurisdictions. The final text of the AML addresses, but does not clearly resolve, these tensions.

### The Antimonopoly Authority (or Antimonopoly Authorities?)

Three central government agencies have asserted leadership over competition policy: the State Administration of Industry and Commerce (SAIC), the National Development and Reform Commission (NDRC), and the Ministry of Commerce (MOFCOM). Each has its own strengths, constituencies, and agenda. The SAIC issues business licenses and administers various commercial laws, including the Anti-Unfair Competition Law, which includes prohibitions on predatory pricing, tying, and bid rigging.<sup>5</sup> In 2004 the SAIC released a controversial report cataloguing the allegedly anticompetitive practices of leading multinationals engaged in China's domestic markets.<sup>6</sup> Meanwhile, the NDRC, a powerful macroeconomic policy body, supervises enforcement by local price bureaus of the 1997 Price Law, which broadly bars collusion and discriminatory or predatory pricing.<sup>7</sup> In 2003 the NDRC issued the Interim Provisions on Preventing Acts of Price Monopoly, cursory measures that read like an outline of the AML.<sup>8</sup> Though the 2003 initiative was stillborn, the NDRC gained visibility in the antitrust field by actively confronting collusion in the food sector in the summer of 2007. MOFCOM, the leading ministry on international trade and investment issues, has taken the lead in drafting the AML and in reviewing mergers involving foreign parties on "antimonopoly" grounds pursuant to the Regulations on the Mergers & Acquisitions of

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<sup>4</sup> The NPC published selected excerpts of the Aug. 24, 2007, discussion on its official Web site in Chinese. Relevant excerpts (and their corresponding URLs) include: "Antimonopoly Law Draft Basically Mature, Proposed to be Put to a Vote," available at <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=371689&pdmc=110106> (visited Sept. 12, 2007); "Identification of Abuse of Dominant Market Position," available at <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=371690&pdmc=110106>; and "Enhancing Supervision of Mergers and Acquisitions, Preventing Abuse of Administrative Power to Exclude and Restrict Competition," available at <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=371691&pdmc=110106>. Unofficial translations available from the author.

<sup>5</sup> See Anti-Unfair Competition Law of the People's Republic of China (promulgated by the Standing Committee of the National People's Congress on Sept. 2, 1993, and effective Dec. 1, 1993), arts. 11 (predatory pricing), 12 (tying), and 15 (bid rigging), available at <http://tfs.mofcom.gov.cn/aarticle/date/i/s/200503/20050300027909.html>. Translation available by subscription at <http://www.chinalawinfo.com>.

<sup>6</sup> See *Antimonopoly Law to Benefit All*, CHINA DAILY (Jun. 2, 2004), translation available at <http://www1.china.org.cn/English/government/97133.htm> (visited Jun. 17, 2004). The report, entitled *Competition-Restricting Behavior of Multinational Companies in China and Possible Countermeasures*, was issued by the Antimonopoly Division of the Fair Trade Bureau of the SAIC in the SAIC's official publication, *Industry and Commerce Administration*, on March 1, 2004.

<sup>7</sup> See Price Law of the People's Republic of China, (promulgated by the Standing Committee of the National People's Congress on Dec. 29, 1997 and effective May 1, 1998), art. 14.1 (collusion) and 14.2 (predatory pricing), available at [http://www.gov.cn/ziliao/fffg/2005-09/12/content\\_31188.htm](http://www.gov.cn/ziliao/fffg/2005-09/12/content_31188.htm). Translation available by subscription at <http://www.chinalawinfo.com>.

<sup>8</sup> See Interim Provisions on Preventing Acts of Price Monopoly, Order [2003] No. 3 (adopted by the State Planning and Development Commission (SPDC) on June 18, 2003 and effective November 1, 2003), available at [http://www.sdpc.gov.cn/zcfb/zcfbl/zcfbl2003/t20050613\\_6683.htm](http://www.sdpc.gov.cn/zcfb/zcfbl/zcfbl2003/t20050613_6683.htm). Translation available by subscription at <http://www.chinalawinfo.com>. The NDRC was formerly known as the SPDC.

Domestic Enterprises by Foreign Investors, which were provisionally issued in 2003 and revised in 2006.<sup>9</sup>

The NPC sidestepped this controversy through the common Chinese legislative maneuver of charging the State Council with designating the enforcement agency. Article 10 calls for the State Council to designate one or more “antimonopoly authorities of the State Council.”<sup>10</sup> Possible enforcement schemes include: a new independent enforcement authority, likely to draw personnel from various existing agencies; enforcement by a single existing agency; overlapping enforcement authority in different agencies; or enforcement of different provisions by different agencies. The last scenario seems most likely, with MOFCOM continuing to review mergers, the SAIC policing abuses of dominance, and the NDRC’s price bureaus expanding their regulation of cartel activity. Parceling out authority, particularly among rival agencies with separate agendas, raises risks of inconsistent enforcement. Moreover, unless the relationship between the new AML and existing measures is clarified, competing agencies may regulate the same conduct by applying different standards under different rules.

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### Rules Against Administrative Monopoly

Another controversial feature of the enforcement scheme arises from the rules against “administrative monopoly.” Local and provincial authorities routinely act to promote local enterprises or exclude competitors from other regions or countries, and industry regulators are often suspected of favoring certain enterprises (often state-owned) over competitors. Existing measures to combat administrative monopoly have yielded only modest results. While some drafters advocated use of the AML as a new weapon against “administrative monopoly,” others feared policing the bureaucracy would compromise enforcement in the private sector.

In the end, the NPC adopted detailed “administrative monopoly” rules in Chapter V of the AML.<sup>11</sup> These rules apply not to private actors, but to “administrative agencies and organizations empowered by laws or regulations with responsibility for the administration of public affairs.”<sup>12</sup> Article 33 bars several common tactics of local protectionism, such as discriminatory taxes, fees, charges, licensing and inspection requirements, local content requirements, and checkpoints, as well as all “other actions which impede the free flow of products among different regions.” Similarly, Articles 34 and 35 prohibit discrimination against parties from other regions in the public tendering processes and in the approval of new branches or investments. (Chinese law requires most domestic entities to establish branches in the various localities where they do business, so discrimination in approval of new branches is a substantial barrier to entry.) Article 32 prohibits measures compelling the consumption of goods and services from designated providers, and Article 36 prohibits government actors from compelling companies to engage in

<sup>9</sup> See Regulations on the Mergers & Acquisitions of Domestic Enterprises by Foreign Investors (promulgated by the Ministry of Commerce, State-owned Assets Supervision and Administration Commission of the State Council, State Administration of Taxation, SAIC, China Securities Regulatory Commission, and State Administration of Foreign Exchange, Aug. 8, 2006 and effective Sept. 8, 2006) (M&A Rules), arts. 51–54, available at <http://tfs.mofcom.gov.cn/accessory/200612/1164956339653.doc> (visited Oct. 7, 2007). See also Provisional Regulations on the Mergers & Acquisitions of Domestic Enterprises by Foreign Investors (promulgated by the Ministry of Foreign Trade & Economic Cooperation, Mar. 7, 2003 and effective April 12, 2003) (Provisional M&A Rules), arts. 19–22, available at <http://tfs.mofcom.gov.cn/aarticle/date/i/IV/ag/200304/20030400082880.html>. Translation available by subscription at <http://www.chinalawinfo.com>.

<sup>10</sup> See AML, art. 10. The Chinese language does not clearly distinguish singular and plural nouns, so Article 10 allows designation of a single enforcement agency or multiple enforcement agencies.

<sup>11</sup> See AML, arts. 32–37.

<sup>12</sup> See *id.*

monopolistic conduct otherwise prohibited by the AML. Moreover, Article 37 prohibits “abuse of administrative power by” issuing regulations that “eliminate or restrict competition”—a potentially unworkable limitation on administrative power.

Many of these rules, however, simply duplicate existing measures. Moreover, government agencies are responsible for policing their own subordinate departments and offices for violating the AML’s rules against administrative monopoly.<sup>13</sup> As a result, aside from acting as an advocate and watchdog, the antimonopoly authority will lack power to compel compliance by other government agencies.

### State-Dominated and Strategic Industries

To complicate the enforcement climate further, existing industry regulators seek to retain authority over competition within their respective sectors. Indeed, an earlier draft included language that would have granted industry regulators a “right of first refusal” in enforcing the law, authorizing the antimonopoly authorities to step in only when the regulators fail to act. Although this language did not survive, Article 7 calls for special supervision of industries that are “controlled by the state-owned economy and that are critical to the well-being of the national economy and national security” and of sectors involving state-sanctioned exclusive monopolies. The government is to safeguard both the “legitimate activities” of the firms in these industries as well as the “legitimate interests of consumers.” The AML does not identify the sectors carved out for special supervision. Given the prevalence of state ownership in some energy, mining, communications, and manufacturing sectors, Article 7 may, ironically, derail general competition rules in many of the most inefficient sectors of the economy. It may also gut the rules against administrative monopoly in the sectors where they are needed most.

### Antimonopoly Commission

The drafters anticipated the need for interagency policy coordination. Article 9 calls for the establishment of a new “Antimonopoly Commission” to “organize, coordinate, and guide antimonopoly work.” The commission’s functions include research, policy making, coordinating administrative enforcement efforts, and performing other duties assigned by the State Council. The composition of the commission, however, is left to the State Council. Previous drafts of the law suggested that the primary enforcement agencies, key sector regulators, and even “experts” from academia might be included. The Antimonopoly Commission may provide a viable channel for resolving turf disputes—if real political support from higher levels lends credibility and discipline to the process.

The challenges of managing multiple competition authorities are not unique to China. The United States, after all, has two federal antitrust agencies, fifty state attorneys general, and a handful of sector regulators. Mechanisms for resolving jurisdictional disputes in the United States are, however, reasonably transparent and robust (e.g., executive leadership, legislative oversight, and judicial review). The hydraulics of Chinese policy making are far more fluid and opaque, with turf fights often entangled in broader political tussles. Many compelling questions about the AML’s enforcement—from the handicapping of global market leaders to the shielding of vulnerable state-owned enterprises—have not yet been resolved by the government and party leadership. The Antimonopoly Commission might expedite this political process, but it cannot eclipse it. In the long run, the way in which conflicts between the rival antitrust enforcers, sectoral regula-

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<sup>13</sup> See AML, art. 51.

tors, and provincial and local authorities are resolved (or left unresolved) will largely dictate the antitrust agenda in individual cases. In any case, it may be difficult for any government agencies to move forward with the release of implementing regulations and guidelines until the basic enforcement scheme is decided.

### Substantive Provisions

Given the uncertain policymaking and enforcement climate, it is difficult to predict future policy based solely on the final text of the AML. As explained below, the AML incorporates many essential features of prevailing international antitrust practices aimed at promoting consumer welfare while providing ample textual hooks for serving alternate policy goals.

**Market Definition.** Market definition is an implicit first step in applying most of the AML's rules against "monopolistic conduct." Article 12 defines a "relevant market" as the "scope of products and the scope of territory within which undertakings<sup>14</sup> compete with each other within a specific period of time with respect to specific products or services." This captures the basic product and geographic dimensions of market definition under U.S. and EC practice, but it does not necessarily mean that markets will be defined in terms of vulnerability to the exercise of market power using U.S. or EC methods (such as the "hypothetical monopolist" methodology).

**Extraterritoriality.** The AML applies to all "economic activities within the territory of the PRC" and "monopolistic conduct outside the territory of the PRC that has eliminative or restrictive effects on competition in the domestic market of the PRC."<sup>15</sup> It is unclear whether a requirement for "substantial" or "appreciable" effects on China will be read into this standard for extraterritorial jurisdiction.

**Monopoly Agreements.** Chapter II of the AML, inspired by Article 81 of the EC Treaty,<sup>16</sup> prohibits anticompetitive "monopoly agreements" among multiple firms. "Monopoly agreements" are defined to include "agreements, decisions, or other concerted actions that eliminate or restrict competition."<sup>17</sup> Separate articles address horizontal and vertical "monopoly agreements." Article 13 prohibits horizontal agreements "among competing undertakings," specifically including agreements to fix or change prices, limit production or sales volume, divide markets, conduct joint boycotts, or limit the purchase of "new technology or new equipment" or the "development of new technology or products." Article 14 on vertical agreements expressly prohibits two modes of resale price maintenance: specifying resale prices and setting minimum resale prices. In addition, both Article 13 and Article 14 prohibit any other monopoly agreements defined by the enforcement authorities. Though such catch-alls are common in Chinese laws, in the AML they may allow accretion of new principles to keep pace with foreign antitrust trends.

Article 15 allows block exemptions for agreements entered for the purposes of:

- "improving technology, research, and developing new products";
- "improving product quality, reducing costs, enhancing efficiency, unifying product specifications and standards, or implementing specialized division of labor";

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<sup>14</sup> "Undertakings" are defined in Article 12 to include natural persons, juridical persons, and other organizations involved in producing or dealing in goods and services. The relevance of the assets, sales, and activities of affiliates under control of a common "ultimate parent," an element of current MOFCOM practice, remains to be seen.

<sup>15</sup> See AML, art. 2.

<sup>16</sup> See Treaty Establishing the European Community, Feb. 7, 1992, O.J. (C 224) 1 (1992) 1 C.M.L.R. 573 (1992), art. 81.

<sup>17</sup> See AML, art. 13.

- “improving operational efficiency and enhancing competitiveness of small and medium-sized undertakings”;
- “realizing public interests, including, but not limited to, energy conservation, environmental protection, and disaster relief”;
- “alleviating serious decreases in sales volume or distinct production surpluses due to economic depression”;
- “ensuring legitimate interests in foreign trade and foreign economic cooperation”; and
- “other circumstances provided for by laws and the State Council.”

Like Article 81(3) of the EC Treaty, these exemptions are limited to restraints that are intended for the achievement of the exempt objectives, “enable consumers to share fairly” in the benefits of the agreement, and do not “materially restrict competition in the relevant market.”<sup>18</sup> A further requirement under EC practice that the restraints imposed be “indispensable” or necessary to the attainment of the exempt objectives is missing—making the exemptions for crisis cartels, export cartels, and unspecified “public interests” even more worrisome. Without clear blacklisting of hard-core restraints, Article 15 may be used to authorize or forgive gravely anticompetitive conduct.

**Abuse of Dominance.** Chapter III of the AML, modeled on Article 82 of the EC Treaty, addresses abuse of dominance. Article 17 expressly prohibits “undertakings with dominant market positions” from “abusing their dominant market positions.” Dominant market positions are defined as “market positions held by undertakings which are able to control the price, quantity, or other transaction conditions of products in the relevant market or to prevent or affect other undertakings’ entry into the relevant market.”<sup>19</sup>

There are two mechanisms for determining whether or not a firm is dominant. First, dominance may be established through a multi-factor analysis of: the market shares of the dominant firm and its competitors, the dominant firm’s “ability to control” the market, the dominant firm’s financial and technological conditions, barriers to entry, the extent of dependence on the dominant firm by other companies, and “other factors affecting market competition.”<sup>20</sup> Although these factors are vague and somewhat circular, they provide a textual hook for U.S. and EC methods of gauging market power.

Second, dominance may be presumed based solely on the market share of the alleged dominant firm.<sup>21</sup> Any firm with a market share exceeding 50 percent is presumed dominant. Collective dominance is presumed when two undertakings have combined market shares exceeding two-thirds, or three undertakings have combined market shares exceeding three-quarters. A firm with a market share of 10 percent or less will not be deemed dominant, even if the market shares of its largest competitors otherwise trigger presumptions of collective dominance.

Fortunately, the final text confirms that these market-share based presumptions are rebuttable. Recent drafts implied that the presumptions were irrefutable, raising risks that firms might be deemed dominant solely by virtue of high market shares even if they lacked meaningful market power. The final text, however, clarifies that firms that otherwise trigger a presumption of dominance based on market share under Article 19 will not be deemed dominant “if it is proved other-

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<sup>18</sup> See AML, art. 15.

<sup>19</sup> See AML, art. 17.

<sup>20</sup> See AML, art. 18.

<sup>21</sup> See AML, art. 19.

wise.” Alleged dominant firms will have the opportunity—and burden—of demonstrating the lack of market power, presumably using the factors outlined in Article 18.

Article 17 lists illustrative abuses of dominance. Rules against predatory pricing (“selling below cost”), refusals to deal, exclusive dealing, tying, and discrimination are brief, and omit key elements of foreign doctrines. These prohibitions apply only to conduct “without justification”—perhaps inviting “rule of reason” assessment of both the procompetitive and anticompetitive effects of the challenged conduct on a case by case basis. Article 17 also bars dominant firms from “selling products at unfair high prices or buying products at unfair low prices.” Although Article 82(a) of the EC Treaty is similar, Chinese regulators may be more prone than their Brussels counterparts to scrutinize the pricing practices of dominant firms based on intuitions of “fairness” or industrial policy rather than sound economic analysis. Finally, Article 17 also includes a catch-all prohibiting other abuses as defined by the enforcement authorities.

**Review of Concentrations.** Chapter IV outlines a new merger review scheme to replace the skeletal antitrust provisions of the M&A Rules.<sup>22</sup> Although some continuity with current MOFCOM practices is likely, the new merger rules may cure many of their shortcomings. And whereas the existing merger control rules apply only to foreign parties, the AML applies to domestic and foreign parties alike. Although the AML’s merger review scheme is clearly patterned on the European system for review of concentrations, it will be difficult to predict the compliance burden until implementing regulations are released.

Article 20 defines “concentrations” to include mergers of undertakings or acquisitions by one undertaking of control over another undertaking’s “equity or assets” or of “control or capability to exercise decisive influence on other undertakings through contract or other means.”

Article 21 requires the advance reporting of all concentrations that satisfy the notification thresholds set by the State Council and expressly prohibits the consummation of unreported concentrations. The final text, however, does not define the notification thresholds. Earlier drafts contained a battery of alternative thresholds based on the parties’ market shares, assets and income in China and worldwide, and the value of the assets or securities to be acquired through the transaction. Some proposed thresholds deviated from the International Competition Network’s recommended practices by failing to require at least two parties to have a substantial nexus with China and by relying on subjective assessments of market share rather than objective measures such as assets and revenues. (The notification thresholds under the existing merger review rules have been criticized for similar reasons.)

The NPC delegated the task of defining the notification thresholds to the State Council. It remains unclear whether the enforcement authorities will have the power to fine-tune the notification thresholds to exempt transactions that trigger the notification thresholds set by the State Council but nevertheless pose no meaningful risks to competition or consumers in China.

Article 23 outlines basic materials required for a notification, but it leaves the enforcement authority to develop the specific requirements and forms. MOFCOM’s current merger review practices suggest that China will follow the European model. In March 2007, MOFCOM issued Guidelines on Antitrust Filing for Mergers & Acquisitions of Domestic Enterprises by Foreign Investors,<sup>23</sup> which call for parties to provide much of the same information as a European Form CO

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<sup>22</sup> See AML, arts. 20–31.

<sup>23</sup> See Guidelines on Antitrust Filing for Mergers & Acquisitions of Domestic Enterprises by Foreign Investors (issued by the Ministry of Commerce and effective on Mar. 8, 2007), available at <http://tfs.mofcom.gov.cn/aarticle/bb/200704/20070404597464.html>. Translation available by subscription at <http://www.chinalawinfo.com>.

(and in some instances to provide even more data). If these filing requirements survive, acquisitive firms may face high compliance burdens in the future—particularly if the notification thresholds are unduly low or broad.

The AML contemplates a two-stage review process. Upon receipt of a complete notification, the authorities have thirty days to complete a preliminary review.<sup>24</sup> The transaction may proceed if the antimonopoly authority affirmatively approves the transaction or takes no action. If the antimonopoly authority decides to review the transaction further, it must notify the parties in writing before the thirty-day deadline. The review should be completed within ninety days of the decision to conduct a full review.<sup>25</sup> The deadline may be extended up to an additional sixty days with the parties' consent, if the submitted documents are inaccurate or require "further verification" or if "relevant circumstances significantly change" after the initial notification. Thus, the maximum review period is 180 days. The final text is silent on whether these periods refer to business days (as under current antitrust review rules) or calendar days (a more likely view).<sup>26</sup>

Concentrations that may "exclude or restrict competition" are to be blocked or approved subject to restrictive conditions, unless the parties to the transaction "can prove that the positive effects of such concentration on competition obviously outweigh the negative effects" or that "the concentration is in the public interest."<sup>27</sup> Likely competitive effects of concentrations should be evaluated based on: the parties' market shares, the concentration of the relevant market, the effects on "market access and technological progress," the effects on consumers and other relevant enterprises, the "development of the national economy," and "other factors that may affect the market competition" as the enforcement authorities may deem necessary.<sup>28</sup> These provisions may be applied to promote consumer welfare but they may also be applied to serve other industrial policy goals. If the authority prohibits the concentration, it must provide a written explanation of the reasons.<sup>29</sup>

**Intellectual Property.** The antitrust-intellectual property interface remains controversial in the United States and Europe so it is unsurprising that the intersection of China's undernourished intellectual property regime and fledgling antitrust rules will likewise prove controversial. The final text of the AML, however, sheds little light on the authorities' approach to licensing restrictions, patent pools, standard setting, mergers of intellectual property holders, compulsory licensing as a remedy for abusive conduct, and other intellectual property-related antitrust issues. Article 55 simply provides that AML shall not apply to the "exercise of intellectual property rights pursuant to the stipulations in laws and administrative regulations relating to intellectual property" but "shall apply to actions taken . . . to eliminate or restrict competition by abusing intellectual property rights." "Unreasonable" royalties charged by foreign patent holders (particularly in high-tech industries) are a perennial complaint of Chinese industry groups and regulators. Notably, proposed amendments to the Patent Law would explicitly authorize compulsory licensing as a remedy for anticompetitive conduct. If, as some fear, the AML becomes an instrument of industrial policy, licensing practices may be among the early targets. For example, firms deemed "dominant" in a market co-extensive

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<sup>24</sup> See AML, art. 25.

<sup>25</sup> See AML, art. 26.

<sup>26</sup> See AML, art. 25–26.

<sup>27</sup> See AML, art. 28–29.

<sup>28</sup> See AML, art. 27.

<sup>29</sup> See AML, art. 26.

with their intellectual property rights might be threatened with actions for abuse based on their refusal to license or extraction of “unfair high” royalties which the market might otherwise bear. Although specific guidelines on intellectual property issues are expected, they are unlikely to defuse many future controversies over innovation, competition, and industrial policy in China.

**Trade Associations and Farm Cooperatives.** Chinese trade associations have been implicated in a number of recent scandals involving alleged price fixing or market division. In response, the NPC added several last-minute provisions targeting trade associations to the final draft of the AML. Article 11 exhorts industry associations to “strengthen the self-discipline of industries and to lead undertakings within their respective industries to carry out lawful competition and to protect the market competition order.” Article 16 warns that “industry associations shall not organize undertakings within their industries” to violate the rules against monopoly agreements. Article 46 authorizes the antimonopoly enforcement authority to fine trade associations up to RMB 500,000 for engaging in monopolistic conduct and authorizes the social organization registration administration authority to revoke their registrations in “serious” cases. Article 56 exempts certain concerted actions by agricultural enterprises and farmers from the AML.

### Administrative Enforcement and Penalties

The AML will principally be enforced through administrative investigations conducted by the anti-monopoly authorities and the imposition of administrative penalties. Chapter VI grants the anti-monopoly authority substantial investigative powers. Investigations may be initiated based on written complaints including “relevant facts and necessary evidence” from any organization or individual.<sup>30</sup> Chinese civil litigation burdens plaintiffs with the production of relevant evidence with their complaints, though the extent of evidence needed to trigger an investigation remains to be seen. Complainants may, however, remain confidential.<sup>31</sup> The enforcement authority may investigate interested parties and other relevant entities or individuals through on-site inspections (presumably including unannounced “dawn raids”); seizing, copying, or sealing relevant electronic and printed materials; questioning; inquiry into bank accounts; and sealing offices, as necessary.<sup>32</sup> Investigations must be conducted by at least two enforcement officials, written records of the investigation must be maintained, and any commercial secrets disclosed to investigators must be kept confidential.<sup>33</sup> The individuals and entities under investigation are entitled to submit statements and evidence in their defense, and the authorities are to verify any alleged facts, asserted justifications for conduct, and evidence as necessary.<sup>34</sup> If a target of investigation for anticompetitive conduct admits the alleged activities and undertakes to take corrective action within a specified time frame, the authority may suspend the investigation and reduce or waive penalties.<sup>35</sup> If the enforcement authority determines upon investigation that the AML has been violated, it may publish its decision.<sup>36</sup>

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<sup>30</sup> See AML, art. 38.

<sup>31</sup> See AML, art. 38.

<sup>32</sup> See AML, art. 39.

<sup>33</sup> See AML, art. 40–41.

<sup>34</sup> See AML, art. 43.

<sup>35</sup> See AML, art. 45.

<sup>36</sup> See AML, art. 44.

Chapter VII outlines administrative penalties that may be imposed by the antimonopoly authority. Penalties for entering monopoly agreements and abuses of dominance include confiscation of illegal gains, fines of 1 percent to 10 percent of the offenders' total turnover from the preceding year, and orders to cease the offending conduct. The mandatory minimum fines are troubling, particularly since the fines are not limited to turnover from China or from the relevant market. Where concentrations are consummated in violation of the AML, the enforcement authorities may order corrective measures to restore pre-transaction conditions and impose fines up to RMB 500,000.

Inspired by foreign leniency programs, Article 46 provides that participants in monopoly agreements (not limited to horizontal agreements) that report the misconduct and "provide important evidence" to the enforcement authorities may receive reduced penalties or be spared punishment.

### Private Enforcement and Compensation

Though largely neglected in the public debate of the AML, China's judiciary might play a meaningful role in the development of Chinese antitrust. Article 50 opens the door for private judicial enforcement of the AML. It provides that where violations "cause losses to others," the offenders are to "bear civil liabilities according to law"—conventional language used in Chinese legislation to establish a private cause of action in a People's Court. As drafted, Article 50 appears to allow consumers (or competitors) to pursue litigation in Chinese courts and file administrative complaints with the antimonopoly authority simultaneously—raising the risks of inconsistent rulings by the agencies and the courts on the same matter. The Supreme People's Court (SPC) should eventually issue a judicial interpretation of the AML, a quasi-legislative measure guiding lower courts in handling litigation under the new law. Indeed, the SPC might condition private claims on a prior finding by the enforcement authorities that the defendant had violated the AML. The SPC issued a similar interpretation in 2003 conditioning private actions for damages in securities fraud cases on prior determinations of misconduct by the China Securities Regulatory Commission (CSRC) or on prior criminal convictions, and similar requirements appeared in a 2005 draft of the AML.<sup>37</sup> Allowing the antimonopoly authority to act as a gatekeeper for private causes of action may mitigate the risks of inconsistent enforcement. A judicial interpretation might also articulate limitations on standing and damage calculations.

Prospects for adjudication of private antitrust claims raise concerns raise a worrisome question: Are China's courts equipped for antitrust litigation? Chinese plaintiffs seem ready. Sony and Intel have already faced lawsuits in Chinese courts from Chinese plaintiffs asserting antitrust-like claims, and new claimants may emerge after August 1.<sup>38</sup>

### Administrative and Judicial Review

China's judiciary may be involved in reviewing decisions of the antimonopoly authorities. Aggrieved parties may challenge most decisions of the antimonopoly authorities either by apply-

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<sup>37</sup> See Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market, Interpretation [2003] No. 2 (promulgated by the Supreme People's Court on January 9, 2003 and effective February 1, 2003), art. 5, available at <http://www.court.gov.cn/lawdata/explain/civilization/200303200005.htm>. Translation available by subscription at <http://www.chinalawinfo.com>.

<sup>38</sup> See, e.g., *Intel Accused of Monopoly In Beijing Court*, CHINATECHNEWS.COM, Apr. 4, 2005, available at <http://www.chinatechnews.com/2005/04/04/2472-intel-accused-of-monopoly-in-beijing-court/>; see also Roger Parloff, *Sony's China Problem—Will a Lawsuit Against Sony in China Set a Scary Precedent?*, CNNMONEY.COM, Mar. 5, 2007, available at [http://money.cnn.com/magazines/fortune/fortune\\_archive/2007/03/05/8401275/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2007/03/05/8401275/index.htm).

ing for administrative reconsideration (i.e., seeking review by a higher administrative office) or by initiating administrative litigation (i.e., challenging the decision in court). However, any challenge to a decision to prohibit or conditionally approve a concentration must first be brought through administrative reconsideration. Only after a higher administrative organ completes the administrative reconsideration may the aggrieved party resort to the courts through administrative litigation challenging the decision on administrative reconsideration (and, indirectly, the underlying agency decision).<sup>39</sup>

### National Security Review

China's recent initiatives to consider national security when approving foreign investment commanded substantial attention in the domestic and international press. This policy is not new; the 2003 Provisional M&A Rules listed national security as a consideration in the antitrust review of foreign acquisitions of Chinese firms.<sup>40</sup> Responding both to growing unease with penetration of key sectors by foreign investors and to public outrage at the political rebuff of the China National Offshore Oil Corporation's abortive 2005 bid for UNOCAL, the 2006 revisions to the M&A Rules introduced separate requirements for foreign acquisitions of Chinese firms that "result in actual control by the foreign investor" and "involve key industries, have factors imposing or possibly imposing material impact on the economic security of the State, or would result in transfer of actual control in a domestic enterprise which owns any well-known trademarks or Chinese historical brands."<sup>41</sup> MOFCOM, "together with other relevant departments," may act to block, modify or unwind unreported transactions with actual or potential "material impact" on the "economic security of the State." MOFCOM's review procedures remain in flux, and other authorities are rumored to be getting involved in the process.

The AML does not change this situation. Article 31 of the AML provides that where a foreign investor merges with or acquires an enterprise within China or where any other form of concentration "concerns national security," the transaction will be subject to separate review on national security grounds "in accordance with relevant regulations of the State" in addition to the antitrust review under Chapter IV of the AML. Chinese officials have explained that Article 31 simply confirms that the approval of a concentration under the AML would not trump other national security review procedures, much as antitrust clearance of a transaction under the Hart-Scott-Rodino process in the United States does not affect the separate national security review by the Committee on Foreign Investment in the United States.<sup>42</sup> As noted above, Article 7 does not specify the sectors "with a direct bearing on national economic wellbeing and national security" subject to special supervision.

### Implementation Challenges

The good news is that a growing number of Chinese officials and scholars appreciate the complexity of competition policy and the value of experiences from other antitrust jurisdictions. The bad news is that many obstacles to implementing modern competition policies in other transitional economies assume grotesque proportions in China.

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<sup>39</sup> See AML, art. 53.

<sup>40</sup> See Provisional M&A Rules, *supra* note 9, art. 19.

<sup>41</sup> See M&A Rules, *supra* note 9, art. 12.

<sup>42</sup> See generally 50 U.S.C.A. App. § 2170 (2007).

Recruiting and training enough qualified personnel to manage a nationwide antitrust enforcement program—particularly economists specializing in industrial organization—will take time. Snarled regulations and inefficient distribution systems cut many product markets into tiny regional markets, complicating analysis of transactions and practices which, in other markets, might be more straightforward. Simply obtaining accurate data for antitrust analysis may prove difficult—official statistics are notoriously unreliable, and company recordkeeping is often poor, if not fraudulent (to conceal tax evasion). The residual impulse to plan rather than regulate commercial activity remains strong in many government offices, as do the incentives for officials to promote or protect favored enterprises at the expense of consumers. Chinese administrative and judicial traditions do not encourage detailed explanations of decision making, so publication of AML enforcement decisions may provide little prospective guidance for market players—at the risk of chilling activities that would benefit Chinese consumers.

Continued engagement is crucial. Once the antimonopoly authorities have been formally designated, it should be easier for foreign enforcement agencies and intergovernmental agencies to sustain technical assistance programs targeting the right agencies and personnel. Expectations should be realistic—the AML's relevance is likely to vary with the industry, region, and political strength of the parties involved in any given case. It took thirteen years to finalize the AML, and that was the easy part. ●

# Appendix



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## **Anti-Monopoly Law of the People's Republic of China**

*(Adopted by the 29<sup>th</sup> Session of the Standing Committee of the 10<sup>th</sup> National People's Congress on August 30, 2007)*

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## Chapter One General Provisions

Article 1 This law is enacted for the purposes of preventing and prohibiting Monopolistic Conduct, protecting fair market competition, promoting efficiency of economic operation, safeguarding the interests of consumers and the public interests, and promoting the healthy development of the socialist market economy.

Article 2 This law is applicable to Monopolistic Conduct in economic activities within the territory of the People's Republic of China. This law is applicable to Monopolistic Conduct outside the territory of the People's Republic of China that has eliminative or restrictive effects on competition in the domestic market of the People's Republic of China.

Article 3 "Monopolistic Conduct" referred to herein includes:

- (1) conclusion of monopoly agreements by undertakings;
- (2) abuse of dominant market positions by undertakings;
- (3) concentrations of undertakings that have or are likely to have the effect of eliminating or restricting competition.

Article 4 The State shall formulate and implement competition rules suitable for the socialist market economy to improve control of the macro-economy and to strengthen a unified, open, competitive, and orderly market system.

Article 5 Undertakings may implement concentrations in accordance with the law through fair competition and voluntary combination to expand their business scale and to improve their market competitiveness.

Article 6 Undertakings with dominant market positions shall not abuse their dominant market positions to eliminate or restrict competition.

Article 7 With respect to industries that are controlled by the state-owned economy and that are critical to the wellbeing of the national economy and national security, as well as industries in which exclusive operation and exclusive sales are the norm of business in accordance with the law, the State shall protect the lawful business activities of the undertakings in such industries. The State shall regulate and supervise the business activities of such undertakings and regulate the prices of commodities and services provided by such undertakings in accordance with the law so as to protect the interests of the consumers and to promote technological progress.

Undertakings in the industries referred to in the preceding paragraph shall conduct their business in accordance with the law, shall be honest and reputable in their business dealings, and shall maintain strict self-discipline and accept public supervision. They shall not harm the interests of consumers by utilizing their controlling positions or their status as the exclusive provider of certain services or products.

Article 8 Administrative agencies and organizations empowered by laws and regulations to have the function of administrating public affairs shall not abuse their administrative power to eliminate or restrict competition.

Article 9 The State Council shall establish the Anti-Monopoly Commission which shall be responsible for organizing, coordinating, and guiding the anti-monopoly work. The Anti-Monopoly Commission shall perform the following duties:

- (1) to research and formulate competition policies;
- (2) to organize investigations, assess the overall market competition conditions, and publish the assessment reports;
- (3) to formulate and promulgate anti-monopoly guidelines;
- (4) to coordinate the anti-monopoly administrative enforcement work;
- (5) to undertake other duties as designated by the State Council.

The State Council shall stipulate the composition of and the working rules of the Anti-Monopoly Commission.

Article 10 The authority appointed by the State Council to perform the function of anti-monopoly law enforcement (the “Anti-Monopoly Law Enforcement Authority under the State Council”) shall be responsible for the anti-monopoly law enforcement work in accordance with the provisions of this law.

The Anti-Monopoly Law Enforcement Authority under the State Council may, if there is a practical need to do so, delegate to the corresponding agencies of the People’s Governments at the levels of province, autonomous region and municipality directly under the central government responsibilities of the anti-monopoly law enforcement work in accordance with the provisions of this law, if necessary.

Article 11 The trade associations shall strengthen the self-discipline of industries to lead undertakings within their respective industries to carry out lawful competition and to maintain the order of market competition.

Article 12 “Undertakings” referred to herein mean natural persons, legal persons and other organizations that are engaged in manufacturing or otherwise dealing with commodities, or providing services.

“Relevant Market” referred to herein means the scope of commodities and the scope of territory within which the undertakings compete with each other during a specific period of time with respect to specific commodities or services (collectively “commodities”).

## Chapter Two Monopoly Agreements

Article 13 The following Monopoly Agreements among undertakings with competing relationship shall be prohibited:

- (1) fixing or changing the price of commodities;
- (2) limiting the outputs or sales volume of commodities;
- (3) allocating the sales markets or the raw material purchasing markets;
- (4) restricting the purchase of new technology or new equipment or restricting the development of new products;
- (5) jointly boycotting transactions; or
- (6) other Monopoly Agreements determined by the Anti-Monopoly Law Enforcement Authority under the State Council.

“Monopoly Agreements” referred to herein mean agreements, decisions or other concerted conducts that eliminate or restrict competition.

Article 14 Undertakings are prohibited from entering into Monopoly Agreements with their counter-parties that:

- (1) fix the resale price of commodities sold to third parties;
- (2) limit the minimum resale price of commodities sold to third parties; or
- (3) other Monopoly Agreements determined by the Anti-Monopoly Law Enforcement Authority under the State Council.

Article 15 The provisions of Articles 13 and 14 shall not apply to agreements among undertakings if the undertakings can prove that such agreements fall under any of the following:

- (1) for the purpose of improving technology, researching and developing new products;
- (2) for the purpose of improving the product quality, reducing costs, enhancing efficiency, unifying specifications and standards of products, or implementing division of labor based on specialization;
- (3) for the purpose of improving operational efficiency of small and medium-sized undertakings and enhancing their competitiveness;
- (4) for the purpose of achieving public interests, including, but not limited to, energy saving, environmental protection, and disaster relief;

(5) for the purpose of alleviating serious decreases in sales volume or distinctive production surpluses due to economic depression;

(6) for the purpose of safeguarding legitimate interests in foreign trade and foreign economic cooperation;

(7) other circumstances as stipulated by laws and by the State Council.

If any Monopoly Agreements fall into the circumstances set forth in sub-clauses (1) to (5) above so that the provisions of Articles 13 and 14 are not applicable, the relevant undertakings must also prove that the agreement so concluded will not materially restrict competition in the Relevant Market and that the agreement can allow consumers to share the benefits generated therefrom.

Article 16 The trade associations shall not organize undertakings within their industries to engage in Monopolistic Conduct prohibited under this Chapter.

### **Chapter Three Abuse of Dominant Market Position**

Article 17 Undertakings with dominant market positions are prohibited from abusing their dominant market positions by engaging in the following activities:

(1) selling commodities at unfair high prices or buying commodities at unfair low prices;

(2) selling commodities at prices below cost without any justification;

(3) refusing to transact with counter-parties with respect to a transaction without any justification;

(4) restricting, without any justification, their counter-parties to transact with such undertakings exclusively or to transact with other parties designated by such undertakings exclusively;

(5) engaging in tie-in sales of commodities or imposing other unreasonable conditions with respect to transactions without any justification;

(6) applying differential treatments to counter-parties to transactions who have the same qualifications with respect to transaction price and other transaction terms, without any justification;

(7) other activities that are deemed by the Anti-Monopoly Law Enforcement Authority of the State Council as abusing dominant market positions.

“Dominant Market Positions” referred to herein mean the market positions held by undertakings who are able to control the price or quantity of commodities, or other transaction terms in the Relevant Market or to block or affect the entry of other undertakings into the Relevant Market.

Article 18 A finding that certain undertaking has a Dominant Market Position shall be based on the following factors:

(1) the market share of the undertaking in the Relevant Market, and the competition conditions in the Relevant Market;

(2) the ability of the undertaking to control the sales market or the raw material purchasing market;

(3) the financial resources and the technical capacities of the undertaking;

(4) the extent to which other undertakings depend on the subject undertaking with respect to relevant transactions;

(5) the level of difficulty for other undertakings to enter the Relevant Market;

(6) other factors relating to the determination whether the subject undertaking has a Dominant Market Position.

Article 19 Undertakings may be presumed to have a Dominant Market Position if they satisfy any of the following conditions:

(1) the market share of one undertaking in the Relevant Market accounts for 1/2;

(2) the joint market share of two undertakings in the Relevant Market accounts for 2/3; or

(iii) the joint market share of three undertakings in the Relevant Market accounts for 3/4.

In case of circumstances set forth in the sub-clauses (2) and (3) above, if any of such undertakings has a market share less than 1/10, it shall not be presumed to have a Dominant Market Position.

If an undertaking which is presumed to have a Dominant Market Position presents evidences showing otherwise, it shall not be deemed to have a Dominant Market Position.

#### **Chapter Four Concentration of Undertakings**

Article 20 Concentration of undertakings means the following circumstances:

(1) a merger of undertakings;

(2) an acquisition by an undertaking of the control of other undertakings through acquiring equity or assets;

(3) an undertaking, by contracts or other means, acquiring control of other undertakings or the capability to exercise decisive influence on other undertakings.

Article 21 If a concentration of undertakings meets the thresholds for notification as stipulated by the State Council, the relevant undertakings shall file a notification with the Anti-monopoly Law Enforcement Authority under the State Council in advance. Without filing such a notification, the undertakings shall be prohibited from implementing the concentration.

Article 22 Undertakings are permitted not to file any notification with the Anti-Monopoly Law Enforcement Authority under the State Council if their concentration meets any of the following conditions:

(1) one undertaking participating in the concentration owns more than 50% of the voting shares or assets of each of the other participating undertakings;

(2) more than 50% of the voting shares or assets of every undertaking participating in the concentration are owned by a single undertaking that does not participate in the concentration.

Article 23 When undertakings file a notification of concentration with the Anti-Monopoly Law Enforcement Authority under the State Council, they shall submit the following documents and materials:

(1) the notification;

(2) an statement explaining the impact of the concentration upon the competition conditions of the Relevant Market;

(3) the concentration agreement;

(4) the financial and accounting reports of the undertakings participating in the concentration in the preceding fiscal year, which are audited by accountant firms;

(5) other documents and materials required by the Anti-Monopoly Law Enforcement Authority under the State Council.

The notification shall indicate clearly the name, address and business scope of the undertakings participating in the concentration, the proposed date for implementing the concentration and other matters as stipulated by the Anti-Monopoly Law Enforcement Authority under the State Council.

Article 24 If the documents and materials submitted by undertakings are not complete, undertakings shall file supplementary documents and materials within the time limit specified by the Anti-Monopoly Law Enforcement Authority under the State Council. If the undertakings make no supplementary filing within the specified time limit, it shall be deemed that no notification is filed.

Article 25 The Anti-Monopoly Law Enforcement Authority under the State Council shall conduct a preliminary review of the reporting undertakings, decide on whether to initiate further review, and notify the undertakings in writing of its decision within 30 days from the date of receipt of the documents and materials submitted by the undertakings in accordance with Article 23 hereof. The undertakings shall not implement the concentration

before the Anti-Monopoly Law Enforcement Authority under the State Council makes its decision.

The undertakings may implement the concentration if the Anti-monopoly Law Enforcement Authority under the State Council decides not to initiate further review or makes no decision within the time limit.

Article 26 If the Anti-monopoly Law Enforcement Authority under the State Council decides to initiate further review, it shall complete the review within 90 days from the date of the decision, decide whether to prohibit the concentration of the undertakings and notify the undertakings in writing thereof; in case of a decision to prohibit the concentration of undertakings, it shall explain its reasons. Undertakings shall not implement the concentration during the review period.

Under any of the following circumstances, the Anti-monopoly Law Enforcement Authority under the State Council may extend the time limit for the review set forth in the above paragraph by giving a written notice to the undertakings, provided that the extension shall not exceed 60 days at the maximum:

- (1) the undertakings agree to extend the time limit for the review;
- (2) the documents or materials submitted by the undertakings are inaccurate and need further verification; or
- (3) material changes have occurred with respect to relevant circumstances since the undertakings filed the notification.

If the Anti-monopoly Law Enforcement Authority under the State Council makes no decision within the time limit, the undertakings may implement the concentration.

Article 27 The following factors shall be taken into consideration in the review of the concentration by undertakings:

- (1) the market shares of undertakings participating in the concentration in the Relevant Market and their ability to control of the market;
- (2) the degree of concentration in the Relevant Market;
- (3) the effect that the concentration of undertakings may have on market access and technological progress;
- (4) the effect that the concentration of undertakings may have on consumers and other relevant undertakings;
- (5) the effect that the concentration of undertakings may have on the development of the national economy;
- (6) other factors affecting the market competition that the Anti-Monopoly Law Enforcement Authority under the State Council deems relevant shall be taken into consideration.

Article 28 The Anti-Monopoly Law Enforcement Authority under the State Council shall make a decision to prohibit a concentration of undertakings if such concentration has or may have the effect of eliminating or restricting competition. However, the Anti-Monopoly Law Enforcement Authority under the State Council may decide not to prohibit a concentration if the undertakings can prove that the positive effects of such concentration on the competition obviously outweigh its negative effects or that the concentration is in the public interest.

Article 29 If the Anti-Monopoly Law Enforcement Authority under the State Council does not prohibit the concentration of undertakings, it may decide to impose restrictive conditions to reduce the adverse effects the concentration may have on competition.

Article 30 The Anti-Monopoly Law Enforcement Authority under the State Council shall publicize in a timely manner its decisions to prohibit the concentration of undertakings or to impose restrictive conditions on the concentration of undertakings.

Article 31 If the merger with or acquisition of domestic enterprises by foreign investors or other forms of concentration involving foreign investors concerns national security, in addition to the review of concentration of undertakings in accordance with the provisions of this Law, it shall be examined for national security review in accordance with relevant regulations of the State.

## **Chapter Five Abuse of Administrative Power to Eliminate or Restrict Competition**

Article 32 Administrative agencies and organizations empowered by laws and regulations to have the function of administering public affairs shall not abuse their administrative powers to require or require in a disguised form organizations or individuals to deal in, purchase or use the commodities supplied by the undertakings designated by them.

Article 33 Administrative agencies and organizations empowered by laws and regulations to have the function of administering public affairs shall not abuse their administrative powers and take any of the following actions to hinder the free flow of commodities among different regions:

(1) to charge discriminatory fees under separate fee categories or at different rates, or fix discriminatory prices for commodities originated from other regions;

(2) to impose on commodities originated from other regions technical requirements or inspection standards different from those applied to similar local commodities, or cause commodities originated from other regions to be subject to discriminatory technical measures such as duplicate inspection or certification, so as to restrict the entry of commodities originated from other regions into the local markets;

(3) to implement special administrative licensing measures applicable only to commodities originated from other regions, so as to restrict the entry of commodities originated from other regions into the local markets;

(4) to set up checkpoints or take other measures to block the entry of commodities originated from other regions or the flow of local commodities out of the region;

(5) other actions that may impede the free flow of commodities among different regions.

Article 34 Administrative agencies and organizations empowered by laws and regulations to have the function of administrating public affairs shall not abuse their administrative powers to exclude or restrict the participation of undertakings from other regions in local bidding activities by means such as prescribing discriminatory qualification requirements or standards or by not publishing information according to law.

Article 35 Administrative agencies and organizations empowered by laws and regulations to have the function of administrating public affairs shall not abuse their administrative powers to exclude or restrict investment in their region or establishment of branches or subsidiaries in their region by undertakings from other regions, by applying means such as treatment not equal to what local undertakings are entitled to.

Article 36 Administrative agencies and organizations empowered by laws and regulations to have the function of administrating public affairs shall not abuse their administrative powers to compel undertakings to engage in any Monopolistic Conduct set forth hereunder.

Article 37 Administrative agencies shall not abuse their administrative powers to make regulations that contain provisions eliminating or restricting competition.

## **Chapter Six Investigation of Suspected Monopolistic Conduct**

Article 38 The Anti-Monopoly Law Enforcement Authority shall investigate suspected Monopolistic Conducts in accordance with the law.

Any organization or individual shall have the right to report any suspected Monopolistic Conduct to the Anti-Monopoly Law Enforcement Authority. The Anti-Monopoly Law Enforcement Authority shall maintain the confidentiality for the reporting organization or individual.

The Anti-Monopoly Law Enforcement Authority shall conduct necessary investigation if the report is in writing and includes relevant facts and evidence.

Article 39 When conducting investigations of the suspected Monopolistic Conduct, the Anti-Monopoly Law Enforcement Authority may take the following measures:

(1) entering into business premises of the undertaking being investigated or other relevant places for inspection;

(2) questioning the undertakings being investigated, interested parties, and other relevant organizations or individuals, requesting them to clarify the relevant facts and circumstances;

(3) examining or copying relevant documents, agreements, accounting books, business correspondence, electronic data and other materials of the undertakings being investigated, interested parties, and other relevant organizations or individuals;

(4) sealing or seizing relevant evidence;

(5) making inquiries about the bank accounts of the undertakings.

Measures as stipulated in the foregoing paragraph may be implemented only after a written report has been submitted to the principal responsible persons of the Anti-Monopoly Law Enforcement Authority and the relevant approval has been obtained.

Article 40 Investigations of suspected Monopolistic Conduct by the Anti-Monopoly Law Enforcement Authority shall be carried out by at least two enforcement officers and such officers shall present law enforcement certificates.

The enforcement officers shall maintain written records of their inquiries and investigations. Such written records shall be signed by the persons questioned or investigated.

Article 41 The Anti-Monopoly Law Enforcement Authority and its staff shall keep confidential commercial secrets obtained during the course of law enforcement.

Article 42 The undertakings being investigated, interested parties, or other relevant organizations or individuals shall cooperate with the Anti-Monopoly Law Enforcement Authority with respect to the performance of its functions in accordance with the Law and shall not refuse or hinder the investigation by the Anti-Monopoly Law Enforcement Authority.

Article 43 The undertakings being investigated and interested parties shall have the right to state their opinions. The Anti-Monopoly Law Enforcement Authority shall verify the facts, justifications and evidence presented by the undertakings being investigated and interested parties.

Article 44 After investigating and verifying the suspected Monopolistic Conduct, if the Anti-Monopoly Law Enforcement Authority determines that such conduct constitutes Monopolistic Conduct, it shall make a decision in accordance with the law and may publicize the decision to the public.

Article 45 With respect to a suspected Monopolistic Conduct being investigated by the Anti-Monopoly Law Enforcement Authority, if the undertakings being investigated commit themselves to take specific measures within the time limit approved by the Anti-Monopoly Law Enforcement Authority to eliminate the effects of such Monopolistic Conduct, the Anti-Monopoly Law Enforcement Authority may decide to suspend the investigation. The decision to suspend the investigation shall expressly state the specific commitment made by the undertakings being investigated.

If the Anti-Monopoly Law Enforcement Authority decides to suspend the investigation, it shall monitor the undertakings' performance of their commitments. If the

undertakings have fulfilled their commitments, the Anti-Monopoly Law Enforcement Authority may decide to terminate the investigation.

The Anti-Monopoly Law Enforcement Authority shall resume the investigation if one of the following circumstances occurs:

- (1) the undertakings fails to fulfil their commitments;
- (2) material changes have occurred with respect to the facts based on which the decision to suspend the investigation was made;
- (3) the decision to suspend the investigation was made based on incomplete or untrue information provided by the undertakings.

## **Chapter Seven Legal Liabilities**

Article 46 If the undertakings conclude and implement Monopoly Agreements in violation of relevant provisions of this Law, the Anti-Monopoly Law Enforcement Authority shall order the undertakings to stop such illegal act, confiscate their illegal gains and impose fines of more than 1% and less than 10% of their sales in the preceding year; if the Monopoly Agreement has not been implemented, fines of less than RMB500,000 may be imposed.

If the undertakings, on their own initiative, report to the Anti-Monopoly Law Enforcement Authority information concerning the conclusion of Monopoly Agreements and provide important evidence, the Anti-Monopoly Law Enforcement Authority may reduce the penalty imposed or grant exemption from penalty after weighing the relevant circumstances.

If trade associations organize undertakings within their respective industries to conclude Monopoly Agreements in violation of this Law, the Anti-Monopoly Law Enforcement Authority may impose a fine of no more than RMB500,000; if the circumstances are serious, the authority in charge of registration and administration of social organizations may revoke the registration of the trade organizations in accordance with the law.

Article 47 If the undertakings abuse their Dominant Market Positions in violation of relevant provisions of this Law, the Anti-Monopoly Law Enforcement Authority shall order the undertakings to stop such illegal act, confiscate their illegal gains and impose a fine of more than 1% and no less than 10% of their sales in the preceding year.

Article 48 If the undertakings implement the concentration in violation of relevant provisions of this Law, the Anti-Monopoly Law Enforcement Authority under the State Council shall order the undertakings to stop implementing the concentration, dispose of equity or asset within a specified time limit, transfer their business within a specified time limit or take other necessary measures to revert to the condition of the undertakings before the concentration and may impose a fine of no more than RMB500,000.

Article 49 The Anti-Monopoly Law Enforcement Authority shall take into consideration the nature, extent and duration of the illegal act and other factors in

determining the specific amount of the fines set forth in the Articles 46, 47 and 48 of this Law.

Article 50 Undertakings that cause loss to others as a result of their Monopolistic Conduct shall be liable for civil liabilities in accordance with the laws.

Article 51 If administrative agencies and organizations empowered by laws and regulations to have the function of administrating public affairs abuse their administrative power and engage in activities eliminating or restricting competition, their superior authority shall order them to make correction; the chief officer directly responsible and other persons who are directly responsible shall be subject to disciplinary sanctions in accordance with the law. The Anti-Monopoly Law Enforcement Authority may propose to the relevant superior authority as to how to address the issue in accordance with the laws.

If there are other provisions in laws and administrative regulations concerning the regulation of actions eliminating or restricting competition that are taken by administrative agencies and organizations empowered by laws and regulations to have the function of administrating public affairs that abuse their administrative powers, such other provisions shall prevail.

Article 52 If any individual or organization refuses to provide relevant materials or information, or provide false materials or information, or conceal, destroy or remove evidence, or take other action to refuse or hinder the investigation conducted by the Anti-Monopoly Law Enforcement Authority in accordance with the law, the Anti-Monopoly Law Enforcement Authority shall order such individual or organization to make correction. the Anti-Monopoly Law Enforcement Authority may impose a fine of less than RMB20,000 on individuals or a fine of no more than RMB200,000 on organizations; if the circumstances are serious, a fine of more than RMB20,000 and less than RMB100,000 may be imposed on individuals and a fine of more than RMB200,000 and less than RMB1,000,000 on organizations; if any conduct constitutes a criminal offence, the relevant individual or organization shall be prosecuted for criminal liability in accordance with the law.

Article 53 If any individual or organization objects to the decision made by the Anti-Monopoly Law Enforcement Authority in accordance with Articles 28 and 29 hereof, they may first apply for administrative review in accordance with the law; if they object to the decision of the administrative review, they may file an administrative lawsuit in accordance with the law.

If any individual or organization objects to decisions made by the Anti-Monopoly Law Enforcement Authority other than those specified in the preceding paragraph, they may apply for administrative review or file an administrative lawsuit in accordance with the law.

Article 54 Any staff of the Anti-Monopoly Law Enforcement Authority who abuse their powers, fail to fulfil their duties, conduct irregularities for personal gains, or disclose commercial secrets obtained in the course of law enforcement shall be prosecuted for criminal liabilities in accordance with the law if their conducts constitute criminal offences, or shall be subject to disciplinary sanctions in accordance with the law if their conducts do not constitute criminal offences.

## **Chapter Eight Supplementary Provisions**

Article 55 This law shall not apply to Undertakings' conducts that are exercising their intellectual property rights in accordance with the provisions of laws and administrative regulations relating to intellectual property rights. However, this law shall apply to Undertakings' conducts that eliminate or restrict competition by abusing their intellectual property rights.

Article 56 This law shall not apply to the alliance among or concerted actions by farmers and the farmers' economic organizations in connection with the production, processing, sales, transportation, and storage of agricultural products and other business activities related to agricultural products.

Article 57 This law shall become effective as of August 1, 2008.

## Product Markets in Merger Cases: The *Whole Foods* Decision

### Carlton Varner and Heather Cooper

The definition of the relevant market is often the dispositive issue in antitrust merger cases. If the market is defined narrowly, the market shares of the merging parties are often sufficient to make a prima facie showing<sup>1</sup> that the merger violates the antitrust laws. If the market is defined broadly such that the market shares of the merging entities are much smaller, then it is unlikely that the merger will be found unlawful. A decade ago, in *FTC v. Staples, Inc.*,<sup>2</sup> the Federal Trade Commission convinced the U.S. District Court for the District of Columbia that “office supply superstores” constituted a market separate from other mass merchandisers selling identical office supplies and had the merger of Staples and Office Depot enjoined because it substantially increased concentration in what was essentially a three firm market.

This summer the FTC made similar market definition assertions in its challenge to the proposed acquisition of Wild Oats Markets, Inc. by Whole Foods Market, Inc.<sup>3</sup> The FTC contended that Wild Oats and Whole Foods were part of a “premium natural and organic supermarkets” distinct from traditional supermarkets. It asserted that conventional supermarkets do not constrain premium natural and organic supermarkets (PNOS) in nearly the same way that Whole Foods and Wild Oats constrain one another. The FTC cited various attributes of Whole Foods and Wild Oats—that they maintain a unique inventory of products focused mainly on natural and organic products, describe themselves as “Lifestyle Retailers” offering superior service, and cater to distinct customers who are educated and affluent and interested in lifestyle issues<sup>4</sup>—which distinguished them from conventional supermarkets. The FTC also relied on various statements by John Mackey, the Whole Foods CEO, such as that “Safeway and other conventional retailers . . . can’t really effectively focus on Whole Foods Core Customers without abandoning 90 percent of their own customers,”<sup>5</sup> as supporting its PNOS market definition. Since the merging parties were by far the two largest players in this proposed PNOS market, the concentration statistics alone would have made a prima facie showing that the acquisition violates the antitrust laws.<sup>6</sup>

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*Carlton Varner and Heather Cooper are lawyers with Sheppard Mullin in Los Angeles. Carlton Varner is a member of the Editorial Board of The Antitrust Source.*

<sup>1</sup> *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321, 363–65 (1963) (merger that produces a firm controlling an undue percentage share of the relevant market raises an inference that the effect of the contemplated merger is to substantially lessen competition).

<sup>2</sup> 970 F. Supp. 1066 (D.D.C. 1997).

<sup>3</sup> *FTC v. Whole Foods Market, Inc.*, Case No. 07-01021-PLF (D.D.C. filed June 6, 2007), available at <http://www.ftc.gov/os/caselist/0710114/070605complaint.pdf>.

<sup>4</sup> *FTC Corrected Brief on Its Motion for Preliminary Injunction (Public Version)* at 29–47 [FTC Brief], available at <http://www.ftc.gov/os/caselist/0710114/080107corbrief.pdf>.

<sup>5</sup> *Id.* at 4.

<sup>6</sup> *Id.* at 49–51. Apart from Whole Foods and Wild Oats, the only other PNOS identified by the FTC were Earth Fare in southeastern states and New Seasons in Oregon.

*The centrality of pricing evidence . . . is perhaps the main feature that distinguishes Whole Foods from Staples.*

In a ninety-three-page opinion, however, the U.S. District Court for the District of Columbia rejected the FTC's proposed market definition and denied its motion to enjoin the acquisition. *FTC v. Whole Foods, Inc.*, 2007 U.S. Dist. LEXIS 61331 (D.D.C. Aug. 16, 2007) [Opinion]. Based largely on testimony and studies from the defendants' experts, the court found that conventional stores such as Safeway, Delhaize America, Kroger's, and others had "repositioned" themselves to offer more natural and organic products and would operate to constrain Whole Foods in the post-merger market. It found that grocery shoppers are price sensitive and frequently engage in "cross-shopping," i.e., buying various grocery items from different stores in their local areas, and purchasing many, if not the majority, of their items at conventional stores. Opinion at \*25, \*39. Internal, ordinary course documents from Whole Foods also showed that it conducts price checks at conventional stores and has the same prices in areas where there is no Wild Oats store as those areas in which there is a Wild Oats store. As to the unique attributes of PNOS raised by the FTC, the court found they were simply a way to differentiate these stores from their competitors, rather than a basis to conclude there is a separate PNOS market. Opinion at \*26. The court's opinion did not mention or discuss Mr. Mackey's comments, whether on market definition issues or any other subject.<sup>7</sup> The failure of the trial court to do so was cited as error "No. 1(a)" by the FTC in its motion filed with the Court of Appeals for the District of Columbia Circuit asking it to enjoin the merger pending resolution of the appeal.<sup>8</sup> The court of appeals denied the Commission's motion on August 23, 2007.<sup>9</sup>

*Whole Foods* does not break any new ground in terms of legal doctrine, and largely applies settled legal principles to the facts at issue. Nonetheless, several aspects of its opinion will bear on future merger cases. These include:

- the centrality of pricing evidence—which is perhaps the main feature that distinguishes *Whole Foods* from *Staples*;
- the weight courts give (or will not give) to executives' comments, even when relevant and notorious,<sup>10</sup>
- the focus a court will give to "marginal," rather than "core," customers to determine whether customers would switch to conventional stores in the event of a price increase; and
- Distinguishing what is simply marketing differentiation from a truly "separate" market or submarket—or put differently, the proper role of *Brown Shoe's* "practical indicia" in merger analysis.<sup>11</sup>

<sup>7</sup> FTC Brief, *supra* note 4, at 1–2. Mr. Mackey also made a number of statements cited by the FTC as indicating the acquisition was anti-competitive including one that it would allow Whole Foods to avoid "nasty price wars."

<sup>8</sup> *FTC v. Whole Foods Market, Inc.*, D.C. Cir. No. 07-5276, Memorandum of Points and Authorities in Support of Plaintiffs Motion for an Injunction Pending Appeal 2 (Aug. 17, 2007), available at <http://www.ftc.gov/os/caselist/0710114/0710114injpendpub.pdf>.

<sup>9</sup> The court of appeals initially had issued an administrative injunction enjoining the acquisition on August 20, 2007, and directed appellees to file a supplemental brief addressing the eight reversible errors identified by the FTC in its filing. After this response was filed, however, the court of appeals vacated the administrative injunction and denied the FTC's motion in an order dated August 23, 2007, available at <http://www.ftc.gov/os/caselist/0710114/070823wholefoodsorddenyinjuncpendappl.pdf>. That order stated that, although the FTC has raised some questions about the district court's decision, it had not made a strong showing of likelihood of success, in that it had failed "at this stage" to carry its burden to show that the court's findings were clearly erroneous and there were errors of law.

<sup>10</sup> Holman Jenkins, *Business World: Whole Food Fight*, WALL ST. J., June 27, 2007, at 12.

<sup>11</sup> *United States v. Brown Shoe Co.*, 370 U.S. 294 (1962).

## Defining Product Markets

The requirement to define a product market in merger cases derives from Section 7 of the Clayton Act<sup>12</sup> barring mergers which may tend to create a monopoly or substantially lessen competition in any “line of commerce” (product market) in “any section of the country” (geographic market). More than forty years ago, in *Brown Shoe v. United States*, the Supreme Court stated that “[T]he ‘outer boundaries’” of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it.<sup>13</sup> Within this broader market, said the Court, there may also be “well-defined submarkets” which themselves constitute product markets for antitrust purposes.<sup>14</sup> Such markets may be determined by examining certain “practical indicia,” such as “industry or public recognition of the submarket as a separate economic entity, the product’s peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.” Applying these principles to the case before it, the Court held that men’s, women’s, and children’s shoes were separate markets, but rejected “finer” markets based on further age/sex distinctions. It thus became apparent early on that market definition issues would be very fact-specific. Important factors would include economic testimony regarding cross-elasticity of demand and real-world evidence about how the merging parties view their own market position and competition.

The submarket criteria from *Brown Shoe* initially caused some courts to find submarkets to exist within broader relevant markets or find separate markets based on the *Brown Shoe* criteria alone, without analyzing cross-elasticity of demand issues.<sup>15</sup> In recent years, however, courts have increasingly recognized that, as stated by the *Brown Shoe* Court itself, these criteria are simply “practical indicia” to be used as part of the analysis of substitutability and cross-elasticity of demand issues.<sup>16</sup>

The DOJ/FTC Horizontal Merger Guidelines<sup>17</sup> do not specifically mention submarkets. They focus, instead, on how customers will respond to price increases. The Merger Guidelines provide that the agencies’ merger analysis should begin with each product sold by each merging firm and ask what would happen if a hypothetical monopolist imposed a “small but significant and nontransitory increase in price” (SSNIP).<sup>18</sup> If, in response to that price increase, the reduction in sales would be large enough that a hypothetical monopolist would not find it profitable to impose such an increase, then the agency will add to the product group the product that is the next best substitute. This process is repeated until the appropriate group of products has been identified. The Merger Guidelines state that the SSNIP will normally be 5 percent but may be less

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<sup>12</sup> 15 U.S.C. § 18.

<sup>13</sup> 370 U.S. at 325.

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

<sup>15</sup> See ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 378–80 (6th ed. 2007). The Supreme Court has not addressed merger issues since *United States v. General Dynamics*, 415 U.S. 486 (1974).

<sup>16</sup> H.J. Inc v. ITT, 867 F.2d. 1531, 1540 (8th Cir. 1989); Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210 (D.C. Cir. 1986); FTC v. Arch Coal, Inc., 329 F. Supp. 2d. 109, 119–20 (D.D.C. 2004); *United States v. Oracle, Inc.*, 331 F. Supp. 2d. 1098, 1119 (N.D. Cal. 2004).

<sup>17</sup> U.S. Dep’t of Justice and Fed. Trade Comm’n, 1992 Horizontal Merger Guidelines (1992, rev. 1997), available at <http://www.ftc.gov/bc/docs/horizmer.shtm> [Merger Guidelines].

<sup>18</sup> *Id.* § 1.11 “Product Market Definition.” The SSNIP test has been criticized as impractical in that there would never be adequate data to make such calculations. Robert G. Harris & Thomas M. Jorde, *Market Definition in the Merger Guidelines: Implications for Antitrust Enforcement*, 71 CAL. L. REV. 464, 481 (1983).

in some markets. Many courts apply the SSNIP test from the Merger Guidelines to determine the relevant product market in merger cases.<sup>19</sup>

### Retail Product Market Definition and the Road to *Whole Foods*

Decisions prior to *Staples* involving grocery store mergers or issues similar to *Whole Foods* reached varying conclusions as to the appropriate product market, some with little or no analysis. In *California v. American Stores Co.*,<sup>20</sup> which involved a merger of two grocery supermarket chains, the lower court defined the market as full-line grocery stores with more than 10,000 square feet. It specifically excluded “mom and pop” stores, convenience stores and non-grocery stores, such as department stores, service stations, and drug stores. This was based on evidence that the merging parties themselves, as well as shoppers, did not view them as competition.<sup>21</sup> In contrast, in *Thurman Industries, Inc. v. Pay ‘N Pak Stores, Inc.*,<sup>22</sup> the Ninth Circuit concluded that home centers were not a separate market from specialty retail stores with more limited, but similar, product offerings. According to the Ninth Circuit, the defendant presented “overwhelming evidence” that for any given product sold at a home center, the identical product is also available for purchase at several specialty stores and there is significant consumer sensitivity to price fluctuations.<sup>23</sup> While several of the *Brown Shoe* indicia pointed to home centers as a submarket, such indicia were inadequate to offset the fact that price reductions by specialty stores would lure customers from home centers.<sup>24</sup> *Bon-Ton Stores, Inc. v. May Department Stores Co.*<sup>25</sup> found, based on the *Brown Shoe* “qualitative” indicia and internal company documents, that “traditional department stores” were a separate market from a marketplace encompassing retailers in general.

In *FTC v. Staples, Inc.*, the court found the FTC made a “compelling showing” that a small but significant increase in Staples’ prices would not cause a significant number of consumers to turn to non-superstore alternatives to purchase consumable office supplies. This evidence consisted of showing that Staples’ prices in the geographic markets where it is the only office superstore were 13 percent higher than those markets in which it had competition from Office Depot or OfficeMax. Likewise, Office Depot prices were “well over” 5 percent higher in markets where it had no competition from other office superstores. The logical conclusion from such evidence was that consumers did not switch to Wal-Mart, Target, or Best Buy or other non-office superstore alternatives when prices were increased. Other evidence showed that Staples or Office Depot do lower their prices when faced with entry by another office superstore, but not other retailers. This pricing evidence was supported by the *Brown Shoe* “practical indicia,” such as distinct customers and industry or public recognition of the submarket as a separate economic entity. The court itself made trips to the stores from which it concluded that office superstores are in fact “very different

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<sup>19</sup> *Arch Coal*, 329 F. Supp. 2d at 120; *Oracle*, 331 F. Supp. 2d at 1111–12; *United States v. SunGard Data Sys.*, 172 F. Supp. 2d 172, 190 (D.D.C. 2001).

<sup>20</sup> 697 F. Supp. 1125 (C.D. Cal. 1988), *aff’d in part and rev’d in part on other grounds* 872 F.2d 837 (9th Cir. 1989) *rev’d on other grounds* 495 U.S. 271 (1990).

<sup>21</sup> *Id.* at 1129. In its decision in *American Stores*, the Ninth Circuit stated that, were it to independently review the product market definition, it may reach a different conclusion than the lower court. 872 F. 2d at 841.

<sup>22</sup> 875 F.2d. 1369 (9th Cir. 1989).

<sup>23</sup> *Id.* at 1374.

<sup>24</sup> *Id.* at 1376.

<sup>25</sup> 881 F. Supp. 860 (W.D.N.Y. 1994). *See also* *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704 (7th Cir. 1979) (relevant market was drive-thru photo processing based in customer perception of greater convenience and service than walk in stores).

in appearance, physical size, format . . . etc.” Likewise, internal documents of defendants showed that they focused mainly on competition from other office superstores and used the phrase “office superstore industry” in strategic planning documents.<sup>26</sup>

Building on *Staples*, the FTC challenged Whole Foods’ acquisition of Wild Oats on the grounds that, since Whole Foods and Wild Oats were close substitutes in various local markets, their merger would facilitate unilateral price increases. Indeed, the FTC’s brief in support of the injunction argued that Whole Foods decided to acquire Wild Oats only after concluding that its “systematic destruction” through competition would require too much time, expense, and uncertainty. Whole Foods planned to close thirty Wild Oats stores after the acquisition, and the purchase price included a premium to take Wild Oats off the table for other potential purchasers. According to material cited by the FTC, Whole Foods’ CEO Mackey told his Board that buying Wild Oats would avoid “nasty price wars”<sup>27</sup> in several areas and forever eliminate the possibility of Kroger’s or Safeway using their brand value to launch a competing natural/organic chain.

The FTC’s product market evidence in *Whole Foods* focused mainly on such statements and internal documents. Unlike *Staples*, however, the FTC did not offer evidence that PNOS stores had higher prices in areas with no competitive overlap, but instead pointed to evidence that Whole Foods’ margins were lower in markets when there was a Wild Oats.<sup>28</sup> The pricing evidence offered by the FTC’s expert focused on the effect that entry by PNOS stores have on the sales and operating margins of defendants.<sup>29</sup> It showed that entry by Whole Foods near a Wild Oats had a greater negative effect on Wild Oats than entry by other stores.<sup>30</sup> There were apparently no Wild Oats entries in Whole Foods areas.<sup>31</sup> The FTC also emphasized that PNOS stores have much higher operating margins than conventional stores, and thus their customers must be insensitive to price increases.<sup>32</sup>

### The Trial Court’s Ruling in *Whole Foods*

The district court opinion focused mainly on the ability of conventional stores to constrain the pricing of the post-merger Whole Foods. Relying principally on the testimony of the defendant’s experts, particularly economist David T. Scheffman, the court found that Whole Foods would not be able to sustain a price increase in a properly defined product market.<sup>33</sup> In getting there, the trial court accepted Dr. Scheffman’s view that the SSNIP/hypothetical monopolist test under the Merger Guidelines focused on marginal consumers. Opinion at 15. Marginal consumers, according to Dr. Scheffman, could switch in response to a SSNIP in any one of three ways—by reducing their purchases at one store and substituting another, by switching a shopping trip from one market to

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<sup>26</sup> *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1078–79 (D.D.C. 1997).

<sup>27</sup> *FTC Brief*, *supra* note 4, at 1. The public versions of the briefs of both parties redact some evidentiary material, such as the volume of sales Whole Foods expected to obtain from Wild Oats stores to be closed after the acquisition.

<sup>28</sup> *Id.* at 22–24.

<sup>29</sup> *Id.* at 26.

<sup>30</sup> *Id.* at 26–29.

<sup>31</sup> *Id.* at 22–28.

<sup>32</sup> *Id.* at 21.

<sup>33</sup> In addition to Dr. Scheffman, Whole Foods also provided testimony and studies from a “food marketing” expert, Dr. John L. Stanton, which focused on store formats and operations of numerous conventional grocery store chains, and Ms. Kellyanne Conway, a polling expert who conducted survey to support Dr. Scheffman’s report. Based on testimony by an FTC expert that Ms. Conway’s survey was flawed, the court gave it no weight or consideration. Opinion, *FTC v. Whole Foods, Inc.*, 2007 U.S. Dist. LEXIS 61331 at \*10–\*11 (Aug. 16, 2007).

another, or simply by changing retailers. According to Dr. Scheffman, supermarkets make their pricing, quality and service decisions in ways designed to attract these marginal consumers, and cannot survive by catering solely to core customers. Scheffman performed a Critical Loss Analysis<sup>34</sup> using both a 5 percent and 1 percent SSNIP, and concluded that actual loss would substantially exceed critical loss at either level of price increase. Opinion at 16–17. Since there was no evidence in the record to determine cross-elasticity of demand between PNOS and conventional stores, Dr. Scheffman based his critical loss analysis on market studies he reviewed, showing: (1) grocery shoppers are price sensitive; (2) Whole Foods and Wild Oats customers shift purchases between PNOS and other supermarkets and can do so “costlessly”; (3) most Whole Foods and Wild Oats shoppers frequently shop at other grocery stores; (4) other supermarkets compete vigorously for Whole Foods and Wild Oats customers; and (5) Whole Foods (and Wild Oats to a lesser degree) regularly price check other supermarkets to gauge their pricing and product assortments. Opinion at \*17.

Other data from Dr. Scheffman showed that, when Whole Foods opened a store in a new local area, it captured substantial sales from local conventional supermarkets. *Id.* at 18. The court found this persuasive. While the study by the FTC expert showed that entry by Whole Foods into an area where a Wild Oats store already existed reduced the Wild Oats sales more than the conventional ones, “[t]he Court is unwilling to accept the assumption that effects of Wild Oats from Whole Foods’ entries provide a mirror from which predictions can reliably be made about the effects on Whole Foods from Wild Oats’ future exits if this transaction occurs.” *Id.* at \*19. The court then summarized the “credible evidence” regarding the marketplace as follows:

The problem is that “what’s going on in the marketplace,” according to the credible evidence before the Court, is that (1) Wild Oats prices are higher than Whole Foods prices where the two companies compete, (2) Whole Foods prices are essentially the same at all of its stores in a region, regardless of whether there is a Wild Oats store nearby, and (3) when Whole Foods does enter a new market where Wild Oats operates Whole Foods takes most of its business from other retailers, not from Wild Oats. Furthermore, the market studies and other evidence show that Whole Foods competes vigorously with other supermarkets to retain the business of its many marginal customers.

*Id.* at \*20.

Dr. Scheffman’s studies also showed that Whole Foods and Wild Oats shoppers frequently shop at conventional markets, and purchase the majority of natural and organic products sold in the United States from conventional rather than PNOS markets. *Id.* at \*26–\*27. According to the court, such “cross-shopping” shows that the “fundamental problem” with the FTC’s product market is that post-merger many customers could and would shift their purchases of natural and organic foods to conventional markets if Whole Foods increased prices. Finally, Whole Foods internally projected retaining only one-third of Wild Oats’ volume of business after the merger, with two-thirds going elsewhere. Quoting defense counsel, the court asked, if two-thirds of the volume was expected to go elsewhere, then “what kind of monopoly is this?” *Id.* at \*31.

The district court also rejected the FTC’s “product differentiation” argument, relying on another defense witness, Dr. John L. Stanton, a food marketing expert. Differentiation, said the court, is the primary method a supermarket uses to lure customers, and it can include such things as low prices, ethnic appeal, and any number of other steps stores may take to stand out. While a typi-

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<sup>34</sup> “Critical loss” is the point at which lost sales would wipe out any gains from a price increase. *Id.* at \*16; *Tenet Healthcare v. FTC*, 186 F. 3d 1045, 1050 (8th Cir. 1999).

cal Whole Foods store is mission-driven, with an emphasis on a healthy lifestyle and environmental responsibility, it also carries all the “traditional categories” of products associated with supermarkets. *Id.* at \*21. As the demand for natural and organic products has skyrocketed in recent years, conventional supermarkets are refocusing and repositioning their formats to offer an increased selection of natural and organic foods. *Id.* at \*22–\*23. The court concluded that the FTC’s differentiation argument does not really address the key issue on market definition, which is “would customers switch” in response to a price increase, but simply reflects the different ways stores choose to compete with one another. *Id.* at \*23.

### Impact of *Whole Foods* on Product Market Issues

The *Whole Foods* opinion is necessarily fact-specific and in that sense has little impact on product market jurisprudence. The court’s emphasis on objective data, through the SSNIP analysis and otherwise, is also consistent with recent trends in merger decisions. Three aspects of the *Whole Foods* opinion still stand out.

***The Elephant in the Room—CEO Mackey’s Remarks.*** The court did not discuss the statements made by Whole Foods’ CEO John Mackey, and what they showed as to Whole Foods’ subjective intentions. Prior to and during this merger litigation, Mackey made a number of comments from which it could be inferred that his company’s acquisition of Wild Oats was anticompetitive and/or that the PNOS market suggested by the FTC was correct.<sup>35</sup> Such comments included ones that buying Wild Oats would eliminate a competitor, prevent “price wars,” end “forever, or almost forever” the possibility of the conventional stores like Safeway buying an existing chain to compete with Whole Foods, and that such conventional stores would never abandon their customer base to compete in the PNOS market.

In one sense the court’s silence concerning the statements is surprising. The statements were a major focus of the FTC’s case, and statements by senior executives as to the nature of the market and competition are relevant in merger cases under the *Brown Shoe* “industry and public recognition” indicia and otherwise.<sup>36</sup> Nonetheless, such evidence is seldom dispositive on its own: as described by Judge Easterbrook in *A.A. Poultry Farms v. Rose Acre Farms*<sup>37</sup> such comments may merely reflect “. . . a desire to extinguish one’s rivals . . . entirely consistent with, often the motive behind, competition.”<sup>38</sup> Their evidentiary value is especially weak if inconsistent with more objective, economic evidence.

In *United States v. Oracle, Inc.*,<sup>39</sup> for example, the government cited internal documents of Oracle and PeopleSoft stating they were each other’s “closest competitors,” and an Oracle doc-

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<sup>35</sup> FTC Brief, *supra* note 4, at 1–2. In addition to ordinary course documents like presentations to his Board of Directors, Mackey had a blog on the Whole Foods Web site and also posted comments on Internet sites under such pseudonyms as Rahodeb (an anagram of his wife’s first name).

<sup>36</sup> *United States v. Hammermill Paper Co.*, 429 F. Supp. 1271, 1287 n. 48 (W.D. Penn. 1977) 4A PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW § 964(c) (2d ed. 2002) (stating that intent evidence in a merger case may be probative in determining whether the market has been defined too broadly); John Harkrider, *Proving Anticompetitive Impact: Moving Past Merger Guidelines Presumptions*, 2005 COLUM. BUS. L. REV. 317, 334 (2005) (stating that “great weight” should be given to evidence reflecting the views of senior management about the transaction). Item 4(c) of the HSR Report form specifically seeks documents prepared by and for the purpose of analyzing the acquisition with respect to markets, market shares and competition, and these are often quite important in analyzing the competitive effect of a merger.

<sup>37</sup> 881 F.2d 1396 (7th Cir. 1989).

<sup>38</sup> *Id.* at 1402.

<sup>39</sup> 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

ument stating that “PeopleSoft” is our “Number 1 competitor.” The court, however, found such evidence to be inconsistent with other evidence and discounted it.<sup>40</sup> Judge Vaughn Walker in *Oracle* also found the customer testimony on the product market issue “unhelpful.”<sup>41</sup> It is only when, as in *Staples* itself, markets described in public statements of senior executives or internal planning documents are consistent with economic facts, that they form the basis of market definition.

Either way, the court’s failure to address Mackey’s comments shows how little weight will be given such evidence.

**Core vs. Marginal Customers.** The second issue is how (or with respect to which customers) to measure SSNIPs under the Merger Guidelines. The FTC argued that the SSNIP analysis should be made with respect to “core” customers, who are not price sensitive and have decided that natural and organic is important. It criticized Dr. Scheffman’s Critical Loss Analysis for focusing mainly on marginal customers. The Court rejected this argument due in large part to the heavy degree of cross-shopping, i.e., most Whole Foods customers buy a majority of their items at conventional stores, already frequent the store(s) to which they would switch in the event of a price increase, and those conventional stores already sell over 60 percent of the natural and organic items sold. In essence, it concluded there were many more marginal than core customers, and the market definition issue should focus on this larger group.

Section 1.11 of the Merger Guidelines relating to the general standards for product market definition does not specify whether to focus on core or marginal buyers. It simply states that the issue is whether “buyers” will shift their purchases to another product in the event of a price increase. In *United States v. SunGard Data Systems*,<sup>42</sup> the court discussed this issue in the context of a merger of computer disaster recovery services. It described the critical question under the Merger Guidelines as being whether the hypothetical monopolist can profitably raise price, and “there must be a significant number of customers that will not switch to a substitute product in response to a SSNIP . . . .”<sup>43</sup> The *SunGard* court states that this “significant” or “substantial” group of customers should be one that is “representative” of the entire client base for the product.<sup>44</sup> The *SunGard* court then goes on to conclude that, even though some segments of customers either could not or would not switch among various computer disaster recovery systems, it could not conclude that the sampling was either large enough or representative enough such that the narrow market sought by the FTC was appropriate under the SSNIP analysis.

The SSNIP analysis probably will not work to define a product market accurately if limited to either core or marginal customers. Core customers almost by definition will not switch, producing

*It is only when, as in Staples itself, markets described in public statements of senior executives or internal planning documents are consistent with economic facts, that they form the basis of market definition.*

<sup>40</sup> *Id.* at 1165–67.

<sup>41</sup> *Id.* at 1131. The *Oracle* court also stated that customer preferences should not make a market, and the issue is not what customers like or prefer, but what they could do if the merged firm raised prices. *Id.* at 1131–35.

<sup>42</sup> 172 F. Supp. 2d 172 (D.D.C. 2001).

<sup>43</sup> *Id.* at 190; FTC v. R.R. Donnelley & Sons Co., 1990-2 Trade Cas. (CCH) ¶ 69,239 (D.D.C. 1990) (stating that customer testimony from isolated segments of market do not make for a separate product market). See also FTC v. Arch Coal, 329 F. Supp. 2d. (D.D.C. 2004), 109, 119–20 (stating that a “considerable number” of customers should switch if there is a SSNIP for the products to be in the same market).

<sup>44</sup> 172 F. Supp. at 190–92. FTC v. Cardinal Health, Inc., 12 F. Supp. 2d. 34, 48–50 (D.D.C. 1998) (prescription drug wholesalers are separate product market even though some customers could perform this service themselves since “majority” do not); Malcolm B. Coate & Armando E. Rodriguez, *Pitfalls in Merger Analysis: The Dirty Dozen*, 30 N.M.L. Rev. 227, 235 (2000) (stating that the fact that a majority of customers will not switch is generally not relevant as long as a sufficient number of customers will switch in the event of a price increase).

an unrealistically narrow market.<sup>45</sup> Conversely, a focus on marginal customers will expand the market and distort the competitive impact of the merger. The issue is not really whether customers are core or marginal, but whether enough customers would switch in response to a SSNIP.

In *Whole Foods*, however, the marginal customer was also the “representative” customer. According to the evidence deemed persuasive by the trial court, most customers who shop at Whole Foods or Wild Oats also shop at a conventional store and are buying an increasing amount of natural and organic items from those stores. The FTC is likely correct to assert there is a core customer who insists on buying natural and organic items exclusively at a Wild Oats or Whole Foods store—the “affluent lifestyle” customer identified by the FTC. It was not, however, proper to use such customers for the SSNIP analysis here, or other analyses measuring customer response to price increases. Such customers comprise a small minority of PNOS shoppers, and their affluence alone makes them unresponsive to price increases such that they have little need for the protections of the antitrust laws.

***Differentiation as a Basis for a Product Market.*** The third interesting aspect of the opinion in *Whole Foods* is what it teaches about *Brown Shoe’s* “practical indicia.” The *Whole Foods* court concluded that the unique aspects of PNOS upon which the FTC relied as a basis for a separate market were in fact just marketing strategies. Some of the facts cited by the FTC, however, such as size and format of stores, and the greater variety of premium and natural SKUs, were cited by the *Staples* court<sup>46</sup> as a basis for the separate office superstore market. They are in the *Brown Shoe* “laundry list” of factors to consider in determining submarkets. Some courts have found separate product markets based on the quality and features of the products,<sup>47</sup> but other courts shy away from separate markets based on subjective differentiation facts alone.<sup>48</sup> The basic message from the *Whole Foods* decision is that the non-economic *Brown Shoe* criteria cannot be the basis for a separate market where the pricing evidence shows that customers will likely switch to other products in the event of a price increase.

In order to determine the proper role for the *Brown Shoe* submarket practical indicia in defining product markets, it is necessary to recognize that such indicia fall into three broad categories. The first category includes those for distinct prices, sensitivity to price changes, and distinct customers. These indicia would be subsumed in any cross-elasticity analysis, including the SSNIP test from the Merger Guidelines. The second category includes unique production facilities and specialized vendors. As in *Whole Foods*, these indicia simply will not be present in many cases. The third category includes industry and public recognition of the proposed market as a separate economic entity and the product’s peculiar characteristics and uses. These factors are essentially non-economic in nature and should not be used to create a separate market unless that market is also consistent with the economic data. Standing alone they are, as the *Whole Foods* opinion notes, simply marketing strategies.

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<sup>45</sup> A “core” customer analysis was used in *Bon-Ton Stores, Inc. v. May Dep’t Stores*, 881 F. Supp. 860, 824 (W.D.N.Y. 1994), to conclude that department stores were a separate market. The core customer was one who tends to shop exclusively for women’s clothes at department stores.

<sup>46</sup> *FTC v. Staples, Inc.*, 970 F. Supp. 1066,1078 (D.D.C. 1997).

<sup>47</sup> *United States v. Gillette Co.*, 828 F. Supp. 78 (D.D.C. 1993) (premium writing instruments is separate market).

<sup>48</sup> *H.J. Inc. v. ITT*, 867 F.2d 1531, 1539 (8th Cir. 1989); *In re Super Premium Ice Cream Distribution Antitrust Litig.*, 691 F. Supp. 1262, 1268 (N.D. Cal. 1988) (all grades of ice cream compete against one another and plaintiffs failed to show that differences, such as physical or price, have any antitrust significance).

The logical way to define the product market in antitrust cases is, as recognized by many courts, essentially a three-step process. The first step is to limit the market to sellers or producers that have functionally interchangeable products. The next step is the analysis of how consumers would react to a price increase. This is where the “rubber meets the road” most often. In *Staples*, consumers did not flee to Target or Wal-Mart for their pens and pencils even though Staples and Office Depot had higher prices for those items. The third step in the analysis is examination of the non-economic *Brown Shoe* indicia, such as peculiar characteristics and industry recognition.

In *Whole Foods*, defendants convinced the court that, due to the substantial overlap in customers between conventional and PNOS, customers would, and already do, switch to conventionals if Whole Foods raised its prices. On the non-economic factors, the court found the evidence at least mixed or favoring the defendants, for example the evidence that many conventional stores had also switched to the “lifestyle” mode, and the industry recognition factor was blurring. As such, it was able to easily discount the *Brown Shoe* non-economic factors and characterize them as simply marketing strategies rather than a basis for a separate market.

Apart from the facts of *Whole Foods*, non-economic indicia should seldom result in a separate market where there is functional interchangeability and cross-elasticity of demand. This would distort the competitive analysis away from the fundamental consumer welfare paradigm and focus on issues unrelated to whether the merger at issue promotes or impedes competition. Where consumers could and would switch to good substitutes in the event of a price increase, the fact that the industry may characterize a market as separate, or the products in it as having “peculiar” uses, should not be used to create a separate market.

### Conclusion

The basic problem with the FTC’s position in *Whole Foods* was that it lacked the pricing evidence it had in *Staples*, which showed that customers did not go elsewhere if the office superstores increased their prices. *Whole Foods* is an attempt by the FTC to persuade a court that if you take a CEO’s statements about a merger and stir it in with evidence showing the existence of several “practical indicia” from *Brown Shoe*, the resulting mixture should trump objective evidence about how customers would react in the event of a price increase. It was not successful, and the court’s decision underscores the dominant influence of economic evidence in merger cases today. ●

# Too Hot to Handle: Internal Party Documents in *Whole Foods* And Other Modern Merger Challenges

**Darren S. Tucker & Kevin L. Yingling**

Documents are an essential part of any government merger investigation or trial. Indeed, the significance of documents in antitrust cases is underscored by the primacy that 4(c) documents are given by antitrust regulators during the initial Hart-Scott-Rodino waiting period and the substantial document requests accompanying a second request investigation. Some antitrust practitioners likely recall the days of searching through company warehouses to respond to a government subpoena or request for documents. Today, although the initial searches are more likely performed by information technology personnel, the volume of documentary material has expanded almost exponentially. The costs and burdens of analyzing these materials for both the merging parties and the government have always been substantial and only appear to be increasing, although some recent reforms have been beneficial. With all of the time and money expended on producing and reviewing documents, it seems only reasonable to wonder what exactly will be proved with all of this paper. Of course, the critical question is what the courts make of all this.

In the recent *Whole Foods* preliminary injunction hearing, documentary evidence played a particularly prominent role in the government's case. The FTC relied on a large number of documents, including several with colorful statements from Whole Foods' CEO John Mackey. The court nevertheless disregarded most of the FTC's documentary evidence without explanation, leaving practitioners to wonder what role, if any, documents can play in merger challenges.

## Types of Business Documents

Broadly speaking, there are two categories of documents at issue in a government merger challenge: ordinary course of business documents and merger-related documents. Ordinary course of business documents can be thought to exist along a continuum from transactional documents to subjective analytical materials. Important merger-related documents are almost exclusively subjective because they are predictive in nature. The antitrust agencies can obtain all of these types of documents through a combination of the Hart-Scott-Rodino filing, voluntary requests, administrative subpoenas, and, if the case goes to trial, requests for production under Federal Rule of Civil Procedure 34.

Documentary evidence assists antitrust investigators in formulating their overall view of competition in the marketplace and can play a significant part in their decision whether to sue to block a merger. Courts have also relied on the internal documents of merging parties to help determine if a merger violates Section 7 of the Clayton Act. However, judges in the past two decades generally have shown greater skepticism toward certain kinds of documents and have avoided basing decisions on them.

■ **Darren S. Tucker and Kevin L. Yingling** are attorneys at O'Melveny & Myers LLP in Washington, D.C. Darren Tucker is a member of the editorial board of The Antitrust Source. O'Melveny represented third-party intervenors Wal-Mart and Trader Joe's in the *Whole Foods* preliminary injunction action discussed in this article. The views expressed in this article are those of the authors and not of O'Melveny & Myers LLP or any of its clients.

There appears to be nearly universal acceptance that transactional and other quantitative business records are useful in proving or disproving that a merger may substantially lessen competition.

**Business Records.** There appears to be nearly universal acceptance that transactional and other quantitative business records are useful in proving or disproving that a merger may substantially lessen competition.<sup>1</sup> Even commentators who have expressed skepticism about the merits of relying on other types of documents in merger review acknowledge the importance of business records in understanding the relevant antitrust market and potential competitive effects.<sup>2</sup> Examples of these types of documents include win/loss reports, customer lists, pricing records, sales records, responses to requests for proposals, and sales contracts. These documents reflect the competitive significance of the company in selling its products and may indicate other competitors in the market and the extent of competition between the merging firms. The data points from these documents may be incorporated by economists into merger models to predict the likely competitive effects of a transaction. Although the information in these documents is likely to be reliable, it is not infallible.<sup>3</sup> After all, they were created by humans.

**Analytical Ordinary Course of Business Documents.** Courts and regulators have also frequently relied on more subjective documents drafted by the merging parties in the ordinary course of business because they are written in response to the day-to-day workings of the marketplace, not with an eye toward gaining regulatory approval of a merger.

Analytical business documents have played a significant role in several merger cases premised on unilateral effects theories. In *FTC v. Staples*, the court relied heavily on ordinary course of business documents that showed competition was most robust among office supply superstores and not other retail formats.<sup>4</sup> The district judge found that in “document after document, the parties refer to, discuss, and make business decisions based upon the assumption that ‘competition’ refers to other office superstores only.”<sup>5</sup> In *FTC v. Swedish Match*, the court rejected outright the conflicting testimony from the FTC’s and the defendants’ expert economists about the relevant market.<sup>6</sup> Instead, the judge turned, in part, to the “internal documents of Swedish Match and National,” which showed that “price-based substitution between loose leaf and moist

<sup>1</sup> See, e.g., *United States v. Syufy Enters.*, 903 F.2d 659, 669–70 (9th Cir. 1990) (“The documentary evidence bears out this testimony. Syufy has at all times paid license fees far in excess of the national average . . . .”); *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1166–67 (N.D. Cal. 2004) (discussing quarterly “win/loss analysis” documents and stating that “these documents arguably negate a showing of localized competition between Oracle and PeopleSoft more than they support such a finding.”); *United States v. SunGard Data Sys., Inc.*, 172 F. Supp. 2d 172, 188 (D.D.C. 2001) (citing to defendants’ data regarding substantial losses to products outside the government’s proposed relevant market); *FTC v. Freeman Hosp.*, 911 F. Supp. 1213, 1225 (W.D. Mo. 1995) (finding the acquired hospital Oak Hill “less competitively significant” because “[a]ccording to internal monthly operating statistics regularly compiled by Freeman and Oak Hill, . . . Oak Hill’s private pay percentage of its patient census has steadily declined”); *United States v. Baker Hughes Inc.*, 731 F. Supp. 3, 9 (D.D.C. 1990) (discussing internal analysis of bid results), *aff’d*, 908 F.2d 981 (D.C. Cir. 1990); *United States v. Ivaco, Inc.*, 704 F. Supp. 1409, 1415 (W.D. Mich. 1989) (“Internal corporate documents disclosed substantial and continuous price competition . . . indicating that the firms’ pricing policies were responsive to their competitors’ behavior.”).

<sup>2</sup> See John Harkrider, *Proving Anticompetitive Impact: Moving Past Merger Guidelines Presumptions*, 2005 Col. Bus. L. Rev. 317, 343 (2005) (“In making this argument [against using documents written by low-level management or salespeople], I wish to exclude transactional documents such as sales call reports. These documents frequently include valuable data concerning how firms respond to competition and can provide valuable input to bidding models and natural experiments.”).

<sup>3</sup> INTERNATIONAL COMPETITION NETWORK, MERGER WORKING GROUP, INVESTIGATIVE TECHNIQUES SUBGROUP, A PRIVATE SECTOR PERSPECTIVE ON TOOLS AND TECHNIQUES USED IN MERGER INVESTIGATIONS 12 (2004) (“Even the ‘raw data’ from documents may not be quite as objective and useful as one might think.”).

<sup>4</sup> *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).

<sup>5</sup> *Id.* at 1079.

<sup>6</sup> *FTC v. Swedish Match*, 131 F. Supp. 2d 151 (D.D.C. 2000).

snuff is generally lacking.”<sup>7</sup> The court held that the market was limited to loose leaf chewing tobacco. Throughout its opinion, the court cited several contemporaneous documents created by the parties, including market surveys and internal presentations and memoranda, as well as public SEC filings and annual reports.

Analytical business documents have also been featured in coordinated effects cases. For example, the district judge in *FTC v. Cardinal Health* listed the merging companies’ internal documents as one of three reasons for finding collusive anticompetitive effects likely after the merger.<sup>8</sup> During the trial, the Commission offered “internal documents from each of the Defendants discussing the existence of excess capacity in the market and its adverse effects on Defendants’ sell margins.”<sup>9</sup> These internal documents included market analyses and strategy documents as well as documents evaluating the proposed mergers in the industry.

Reliance on ordinary course documents is not limited to the government. Defendants have also prevailed against the government by pointing to these documents. Most recently, in *FTC v. Foster* the district court relied, in part, on the companies’ internal documents in finding that there were a number of other competitors in the market.<sup>10</sup> The court also found that the merging firms’ “business records . . . confirm that barriers to entering the northern New Mexico market do not place other firms at a significant competitive disadvantage.”<sup>11</sup> In *United States v. SunGard*, the court relied on internal company documents stating that internal solutions, which the government sought to exclude from the relevant product market, were a competitive alternative.<sup>12</sup> The judge discounted the government’s evidence from the defendants’ business documents as ambiguous and insufficient to satisfy its burden of proof.<sup>13</sup>

Although documents created in the ordinary course of business provide an attractive source of information on the marketplace, there are several difficulties that may cause these documents to be unreliable. One is that the business people who create these documents are not antitrust economists or attorneys and are, therefore, likely to describe conduct and outcomes in ways that are not cognizable in a merger analysis. This problem is particularly nettlesome because business people often use terminology similar to antitrust parlance (e.g., market, entry barriers, dominance), but without the same legal meaning. Indeed, as commentators have admonished numerous times (and the antitrust agencies explicitly recognize), business people often use the term

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<sup>7</sup> *Id.* at 162.

<sup>8</sup> *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34, 63 (D.D.C. 1998) (“The FTC at trial showed, through Defendants’ own internal documents and public statements, that they perceived that the excess capacity currently in the marketplace was the primary factor fueling so called ‘irrational’ pricing.”).

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

<sup>10</sup> *FTC v. Foster*, No. CIV 07-352, 2007 WL 1793441 (D.N.M. May 29, 2007).

<sup>11</sup> *Id.* at \*24.

<sup>12</sup> *United States v. SunGard Data Sys., Inc.*, 172 F. Supp. 2d 172, 187–88 (D.D.C. 2001) (quoting a SunGard document that stated “Our primary competitor across all product lines is the Internal Solution” and a Comdisco document that claimed “Our largest competitor remains the internal solution.”).

<sup>13</sup> *See id.* at 189 (“Although plaintiff points to several documents . . . to argue that the cost of an internal hot site is exponentially higher than that of shared hot site services, some of these exhibits do not differentiate between internal high availability and an internal hot site.”). In discussing a SunGard document (Exhibit 58) that stated that internal solutions were more expensive than shared hot sites “by a factor between 5 and 15,” the court held that “the government’s reliance on its Exhibit 58 is insufficient evidence.” *Id.*

“market” for business segments that are not antitrust markets.<sup>14</sup> More fundamental is the problem that the authors of these documents may simply be wrong in their analysis.<sup>15</sup>

**Merger-Related Documents.** Merger-related documents are created by companies in connection with a specific transaction and would not have otherwise been prepared. High-level merger evaluation documents are typically provided to the agencies with the pre-merger notification filing. These documents are the agencies’ first look at the companies’ internal thinking and may, therefore, disproportionately color their view of the transaction.<sup>16</sup>

The most controversial use of parties’ internal merger documents is reliance on so-called hot or intent documents. As defined by the FTC, a hot document is one that “predicts that the merger will produce an adverse price or non-price effect on competition.”<sup>17</sup> Intent documents “disclose the purpose or intent of the acquiring or acquired firm in effecting a merger.”<sup>18</sup>

*The most controversial use of parties’ internal merger documents is reliance on so-called hot or intent documents.*

Over-reliance on this type of evidence by investigators and judges is properly criticized on several fronts. First, these documents may reflect merely business bravado rather than a calculated assessment of the post-merger market place. The leading antitrust treatise has questioned the weight that should be given to statements that “may have been made by an overly exuberant acquisition proponent within the firm who had little or nothing to go on.”<sup>19</sup> Second, the statements may have been written by lower-level employees with no decision-making authority for the company. Finally, the language itself may be ambiguous or not relevant to the market at issue. Courts should, therefore, carefully probe for these concerns before crediting hot or intent documents.

Nevertheless, thoughtful, reasoned, and unambiguous predictions about the anticompetitive effects of a merger by high-level decision makers are entitled to some weight. Areeda’s treatise states that “evidence of anticompetitive intent cannot be disregarded, as it is clearly pertinent to the basic issue in any horizontal merger case.”<sup>20</sup> One practitioner asserts that a “form of credible evidence is high-level strategic documents predicting the merger’s impact on competition. An Item 4(c) document stating that the purpose of the transaction is to eliminate a competitor and increase price is highly probative.”<sup>21</sup> Even commentators who are hostile to most documentary evidence have “hastened to note that evidence of corporate managers’ beliefs, intentions, perceptions or motivations regarding their line of business could be relevant, as a legal matter, to merger analysis.”<sup>22</sup> The defendants’ economic expert in *Whole Foods*, while serving at the FTC,

<sup>14</sup> U.S. Dep’t of Justice & Federal Trade Comm’n, Commentary on the Horizontal Merger Guidelines 11 (2006) (“The Agencies are careful, however, not to assume that a ‘market’ identified for business purposes is the same as a relevant market defined in the context of a merger analysis.”), available at <http://www.usdoj.gov/atr/public/guidelines/215247.htm>.

<sup>15</sup> Geoffrey A. Manne & E. Marcellus Williamson, *Hot Docs vs. Cold Economics: The Use and Misuse of Business Documents in Antitrust Enforcement and Adjudication*, 47 ARIZ. L. REV. 609, 619–20 (2005) (“Business people are boundedly rational. They make mistakes; they focus on idiosyncratic things; they are limited in their capacity to collect and process information; and they take actions knowing that they do not have perfect information and that the decision is risky.”).

<sup>16</sup> See Scott A. Sher, *Documents Kill: The Importance of a Company’s Everyday Business Documents in the Antitrust Merger Review Process*, MERGERS & ACQUISITIONS ADVISOR 6 (Feb. 2002) (“The antitrust agencies attribute great significance to Item 4(c) documents; in fact, these documents provide the agencies with the only true ‘inside’ look at a merger during the initial review process—all other information available to the government is found within the public domain.”).

<sup>17</sup> Federal Trade Comm’n, Horizontal Merger Investigation Data, Fiscal Years 1996–2005 at 5 n.18 (2007).

<sup>18</sup> 4A PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 964a (2d ed. 2006).

<sup>19</sup> *Id.* ¶ 964c.

<sup>20</sup> *Id.* ¶ 964a.

<sup>21</sup> Harkrider, *supra* note 2, at 336–37.

<sup>22</sup> Manne & Williamson, *supra* note 15, at 650.

recognized that in “some cases, there are ‘hot’ documents that indicate that the authors of the documents see an anticompetitive potential in the proposed transaction. Of course, such documents can be extremely important in merger investigations and in litigation.”<sup>23</sup>

In analyzing purportedly hot documents, the courts have been quick to dispense with unreliable statements. In *United States v. Baker Hughes*, the district court dismissed in a footnote the government’s hot document, which predicted the merger would permit the acquirer to “‘manipulate the market more effectively’ and gain ‘more flexibility in price setting,’” by finding that the document related to a geographic market not at issue in the litigation.<sup>24</sup> Likewise, in finding for the FTC, the court of appeals in *FTC v. University Health* explicitly did not rely on a document that claimed that the merger would “[r]educe competition.”<sup>25</sup> The judge in *United States v. Oracle* sardonically dismissed as mere “spice”<sup>26</sup> the Justice Department’s reliance on a 2002 report by Oracle’s Co-President when he was an analyst with Morgan Stanley that stated “the back office applications market for global companies is dominated by an oligopoly comprised of SAP, PeopleSoft, and Oracle.”<sup>27</sup> Although this was not a merger-related document, it does illustrate the courts’ suspicion toward provocative documents generally.

In most other modern cases, the courts ignore the government’s anticompetitive intent documents, even when the government wins. For instance, the opinions in *Staples* and *Swedish Match* both fail to make any mention of the hot or motive documents cited by the FTC. In *Heinz*, the circuit court made only an oblique reference to anticompetitive merger documents, while the district court does not mention the evidence at all.<sup>28</sup>

Regulators appear to place greater weight on merger hot documents than the courts. Between the FTC’s fiscal years 1996–2005, the FTC challenged 88 percent of mergers where the investigation found hot documents.<sup>29</sup> This compared with an enforcement rate of 64 percent in investigations with no hot documents.<sup>30</sup> Although the presence of hot documents is not as significant as complaining customers or high concentration, they do raise the risk of an agency challenge by a non-trivial amount.

Moreover, the FTC and the DOJ have frequently highlighted provocative documents in their efforts to enjoin a transaction. In *Staples*, the FTC wrote in its court filings that “eliminating competition is a primary motivation for the deal” before citing to several confidential Staples’ documents allegedly showing anticompetitive motive.<sup>31</sup> In suing to block the acquisition of Intuit by

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<sup>23</sup> David Scheffman, Dir. FTC Bureau of Econ., Sources of Information and Evidence in Merger Investigations, Address Before the Association of the Bar of the City of New York (June 14, 2002), available at <http://www.ftc.gov/speeches/other/scheffmanabanybar.pdf>.

<sup>24</sup> *United States v. Baker Hughes Inc.*, 731 F. Supp. 3, 12 n.8 (D.D.C. 1990), *aff’d*, 908 F.2d 981 (D.C. Cir. 1990).

<sup>25</sup> *FTC v. University Health, Inc.*, 938 F.2d 1206, 1220 n.27 (11th Cir. 1991). The district court had found the document ambiguous. *See id.*

<sup>26</sup> *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1125 (N.D. Cal. 2004) (noting there were a “plethora of exhibits” with “some of these . . . for spice (e.g., Ex P2290)”).

<sup>27</sup> Plaintiffs’ Proposed Findings of Fact at 47, 84, *United States v. Oracle Corp.*, No. C04-0807 (N.D. Cal. July 8, 2004) (citing plaintiffs’ document P2290).

<sup>28</sup> *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 717 (D.C. Cir. 2001) (“Heinz’s own documents recognize the wholesale competition and anticipate that the merger will end it.”), *rev’g* 116 F. Supp. 2d 190 (D.D.C. 2000).

<sup>29</sup> Federal Trade Comm’n, Horizontal Merger Investigation Data, Fiscal Years 1996–2005 tbl. 5.1 (2007) (22 of 25 matters).

<sup>30</sup> *Id.* tbl. 5.2 (95 of 149 matters).

<sup>31</sup> Plaintiff’s Memorandum of Points and Authorities in Support of Motions for Temporary Restraining Order and Preliminary Injunction at 13, *FTC v. Staples, Inc.*, No. 97-0701 (D.D.C. filed Apr. 10, 1997). The brief also argued that “[a]nticompetitive motive as shown here [in these Staples’ documents] is highly probative of the likely effect of the proposed merger on competition.” *Id.* at 13 n.13.

Microsoft in the personal finance software market, the DOJ quoted from a memorandum written by Intuit's Chairman that the merger would "eliminat[e] 'a bloody share war'" and "'enrich[ ] the terms of trade we can negotiate with [customers].'"<sup>32</sup> The DOJ also cited in its complaint a document from a Microsoft manager stating that without the merger, customers "'are in a stronger position to play us off against each other. As a combination, we would be dominant.'"<sup>33</sup> In *United States v. First Data*, the complaint alleged that "[a]n internal merger planning document acknowledged the likely effect of First Data's acquisition of Concord on pricing . . . : the '[c]ombination of [the merging parties] allows FDC [First Data Corp.] more leeway to set market pricing.'"<sup>34</sup> Most recently, as discussed below, the FTC relied to a significant degree on several hot documents in its case against the Whole Foods merger.

The Commission has also relied on hot documents in administrative adjudication. Recently, the FTC Commissioners found in *Evanston Northwestern Healthcare Corp.* that the documentary evidence, as well as econometric analysis, demonstrated that price increases after the merger were attributable to the consummated merger.<sup>35</sup> In pre-merger documents, records from board meetings between the merging parties' board members and medical staff leaders state that Evanston representatives saw the merger as a chance to not "'compete with self' in covered zip codes (e.g., 60% to 70% market shares)."<sup>36</sup> The President and CEO of Highland Park wrote: "Everybody progresses to see the community benefit that would be derived as well as the economic benefit of not being out there doing battle with one another in what will be a common battle ground if you want to call it that."<sup>37</sup>

The Commissioners found that the "documents are probative because they reflect the merging parties' unvarnished contemporaneous analyses of the parties' market positions by their most senior officials. The statements are not simple bravado or unsubstantiated hyperbole from middle managers or sales representatives."<sup>38</sup> The FTC acknowledged that the parties' argument that intent documents do not prove a Section 7 violation was correct. However, the Commission found that the "documents are probative not because they reflect the desire of [the parties' CEOs], but because they contain the informed analysis of experienced executives about when, why, and how the transaction would enable the merged hospitals to increase prices."<sup>39</sup>

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<sup>32</sup> Complaint at 3, *United States v. Microsoft Corp.*, No. 3:95-CV-01393 (N.D. Ca. Apr. 27, 1995), available at <http://www.usdoj.gov/atr/cases/f0100/0184.htm>.

<sup>33</sup> *Id.* at 3–4.

<sup>34</sup> Complaint at 14, *United States v. First Data Corp.*, No. 1:03CV2169 (Oct. 23, 2003), available at <http://www.usdoj.gov/atr/cases/f201400/201400.pdf>.

<sup>35</sup> *Evanston Northwestern Healthcare Corp.*, FTC Docket No. 9315 (Aug. 6, 2007) (opinion of the Commission), available at <http://www.ftc.gov/os/adjpro/d9315/070806opinion.pdf>.

<sup>36</sup> *Id.* at 65.

<sup>37</sup> *Id.* at 15. The CEO concluded by stating "it would be real tough for any of the Fortune 40 companies in this area whose CEOs either use this place [Highland Park] or that place [Evanston Hospital and Glenbrook] to walk from Evanston, Highland Park, Glenbrook and 1700 of their doctors." *Id.*

<sup>38</sup> *Id.* at 66.

<sup>39</sup> *Id.* at 66. Other Commission decisions have relied on some arguably ambiguous hot merger documents. See *Chicago Bridge & Iron Co.*, FTC Docket No. 9300 (Jan. 6, 2005) (opinion of the Commission) ("Respondents' own strategic planning documents predicted that the merged firm would 'dominate' the relevant markets."), available at <http://www.ftc.gov/os/adjpro/d9300/050106opionpublicrecordversion9300.pdf>.

### The Whole Foods Case

On February 21, 2007, Whole Foods and Wild Oats entered into a merger agreement, under which Whole Foods would acquire Wild Oats. Both companies operated high-end supermarkets with an emphasis on organic and perishable products. Following a pre-merger review, the FTC filed a complaint on June 6, 2007, in the U.S. District Court for the District of Columbia alleging that Whole Foods' acquisition of Wild Oats would substantially lessen competition for premium natural and organic supermarkets in twenty-one markets.

High-level merger-related documents were at the forefront of the FTC's preliminary injunction action against Whole Foods' acquisition of Wild Oats. The companies' ordinary course of business documents also proved to be a critical battleground between the litigants in shaping the court's assessment of the relevant market and competitive effects. Even the expert economists relied substantially on internal documents in forming their opinions. Surprisingly, the district court did not mention the bulk of the FTC's documentary evidence and seemed to rely heavily on the defendants' expert to interpret the evidence.

**The FTC's Use of Documentary Evidence.** The FTC's complaint was notable for its many colorful quotations from Whole Foods' documents, particularly those of CEO John Mackey.<sup>40</sup> For example, Mackey advised a member of his board that

By buying [Wild Oats] we will . . . avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm [Whole Foods'] gross margins and profitability. By buying [Wild Oats] . . . we eliminate forever the possibility of Kroger, Super Value, or Safeway using their brand equity to launch a competing national natural/organic food chain rival to us. . . . [Wild Oats] may not be able to defeat us but they can still hurt us . . . [Wild Oats] is the only existing company that has the brand and number of stores to be a meaningful springboard for another player to get into this space. Eliminating them means eliminating this threat forever, or almost forever.<sup>41</sup>

The complaint also quoted from other Mackey documents describing the features that differentiated Whole Foods from conventional retailers and noted that conventional retailers' sales of organic products had "never hurt Whole Foods."<sup>42</sup>

In its pre-trial brief, the FTC revealed that Mackey had posted anonymous messages on Internet financial message boards critical of Wild Oats. The Commission cited one posting that suggested significant head-to-head competition between Whole Foods and Wild Oats: "Whole Foods is systematically destroying their viability as a business—market by market, city by city."<sup>43</sup>

Yet, for all the attention on Mackey's hot documents, the FTC actually had far more compelling documentary evidence that supported its merger analysis. The FTC offered several types of documents that suggested that premium natural and organic supermarkets were a distinct relevant

<sup>40</sup> The complaint was also notable for the fact that the FTC's alleged relevant product market differed from prior grocery store mergers. Instead of an all supermarkets product market, as in prior supermarket enforcement actions, here the FTC alleged a market limited to premium natural and organic supermarkets.

The FTC also deviated from its all supermarkets product market in a settled case involving the acquisition of supermarkets in Puerto Rico. Wal-Mart Stores, Inc., FTC Docket No. C-4066 (Nov. 21, 2002) (complaint), available at <http://www.ftc.gov/os/2002/11/walmartamigocomp.pdf>. In that case, the FTC alleged a product market consisting of supermarkets, supercenters, and club stores, such as Sam's Club and Costco.

<sup>41</sup> Complaint at 1–2, FTC v. Whole Foods Market, Inc., No. 07-1021 (D.D.C. June 6, 2007), available at <http://www.ftc.gov/os/caselist/0710114/070605complaint.pdf>.

<sup>42</sup> *Id.* at 9.

<sup>43</sup> Plaintiff Federal Trade Commission's Corrected Brief on Its Motion for Preliminary Injunction at 6, FTC v. Whole Foods Market, Inc., No. 07-1021 (D.D.C. Aug. 1, 2007), available at <http://www.ftc.gov/os/caselist/0710114/080107corbrief.pdf>.

High-level merger-related documents were at the forefront of the FTC's preliminary injunction action against Whole Foods' acquisition of Wild Oats.

product market.<sup>44</sup> The Commission cited documents describing differences between stores in its alleged relevant product market from other types of supermarkets. For instance, the parties' documents described their emphasis on high-quality perishables, avoidance of products with synthetic additives, and creating a "lifestyle" retail environment. Wild Oats documents prepared in the ordinary course of business indicated that the opening of a competing premium natural and organic supermarket—particularly Whole Foods—resulted in substantially greater revenue attrition than entry by other types of supermarkets. Similarly, the FTC pointed to Whole Foods' documents indicating that the company was uniquely concerned about new store openings by Wild Oats and Earth Fare (another premium organic supermarket). The FTC also cited several documents authored by Mr. Mackey indicating his belief that traditional supermarkets, even those offering organic products, do not constrain the pricing of Whole Foods.

As evidence of its relevant geographic market, FTC relied on the defendants' site reports, which typically focused on customers within a three-to-six-mile distance of proposed new stores.

To establish unilateral competitive effects from the merger, the FTC offered a wide array of internal documents kept in the ordinary course of business by Whole Foods and Wild Oats. One group of documents indicated that in local markets where only one of the merging parties had a store, that company was viewed by both parties as having a "monopoly" and able to charge higher prices. Some company documents referred to these areas as "cash cows" and "non-competitive." Other business documents indicated that Wild Oats viewed Whole Foods as its primary competitor and that it viewed competition from natural and organic food stores as distinct from traditional grocery stores.

The FTC was also able to cite to ordinary course of business documents describing the reaction of one merging party to the entry of the other in a local market. For example, as part of its 2007 budgeting process, Wild Oats estimated that the vast majority of its revenue losses were attributable to new Whole Foods stores. According to other documents, Whole Foods and Wild Oats responded to entry by the other by cutting prices, remodeling stores, and increasing in-store services. Similar competitive reactions did not occur in response to conventional supermarkets, according to the FTC.

Wild Oats also created "Competitive Intrusion Plans" and other planning documents that suggested uniquely robust competition with Whole Foods. These exhibits described Wild Oats' strategy for competing against nearby and soon-to-be-opened Whole Foods stores, plans to open new stores, and plans to reduce prices and improve service to better compete against Whole Foods. The FTC asserted that no other competitor commanded this level of attention in Wild Oats' strategic documents and that these plans had begun to bear fruit by late 2006.

In addition to the bombastic statements from Whole Foods' CEO and the legion of ordinary course of business documents from both merging grocers, the FTC also relied on merger-related materials. The deal valuation workbooks, audaciously called "Project Goldmine," estimated the revenues that Whole Foods expected to capture after closing each Wild Oats store.<sup>45</sup> The FTC

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<sup>44</sup> Given that the FTC was seeking to prove a unilateral effects theory of competitive harm, there was substantial overlap in the documents it presented to prove the relevant product market and competitive effects.

<sup>45</sup> The FTC indicated in its post-trial brief that the Goldmine estimate exceeded 33% and that other documents estimated at least a 45% revenue capture rate. The Goldmine documents indicated that these diversions could be largely maintained for over ten years. *See* Plaintiff Federal Trade Commission's Proposed Findings of Fact ¶ 334, *FTC v. Whole Foods Market, Inc.*, No. 07-1021 (Aug. 3, 2007). On Whole Foods' Web site, John Mackey claims that this capture rate may be as high as 50%. John Mackey's Blog: Whole Foods Market, Wild Oats, and The Federal Trade Commission, [http://www.wholefoodsmarket.com/blogs/jm/archives/2007/06/whole\\_foods\\_mark.html](http://www.wholefoodsmarket.com/blogs/jm/archives/2007/06/whole_foods_mark.html) (last visited

argued that these diversion estimates were high enough to establish that the two stores were in their own product market.

### **Whole Foods' Response.**

1. REASONS TO DISCOUNT THE FTC'S DOCUMENTARY EVIDENCE. The defendants asserted that the FTC's documentary evidence had little bearing on the relevant issues. They argued that documents indicating a company official's intent, such as the "nasty price wars" document, are not reliable evidence on which to gauge the competitive effects of a merger. While agreeing that "[b]usiness documents revealing the parties' and their competitors' actions in the marketplace can significantly inform the antitrust analysis of a merger," the defendants pointed to the D.C. Circuit's *Baker Hughes* decision and Areeda's treatise as authority that subjective, predictive testimony by company official should be given little, if any, weight.<sup>46</sup> Intent evidence is unreliable, claimed the defendants, because company officials are not familiar with all of the workings of the marketplace (or even their own company), the officials may boast or exaggerate their intentions, and such statements can be easily misinterpreted.

The Project Goldmine and Competitive Intrusion documents, argued the defendants, had no relevance to product market definition. Rather, the documents indicated only that shoppers at either Wild Oats or Whole Foods tended to regard the other store as their next best substitute. According to the defendants, the FTC was masquerading a unilateral effects analysis as a product market analysis, and the documents gave no indication of what customers would do in response to a SSNIP by the merged company. These documents, like the Mackey statements, were nothing more than a "side show."<sup>47</sup>

Finally, the defendants argued that the "cash cow" and similar documents were selective excerpts from the defendants' documents and were unreliable. Quoting from Areeda, the defendants explained that "a businessperson often uses colorful and combative vocabulary far removed from the lawyer's linguistic niceties."<sup>48</sup> Reliance on a small number of colorful documents was not a substitute for conducting a proper econometric analysis.

2. THE DEFENDANTS' DOCUMENTARY EVIDENCE. The defendants also relied on documentary evidence—albeit to a lesser degree than the FTC—to support their case. Defendants pointed in particular to ordinary course of business documents indicating company officials' concerns regarding competition from conventional supermarkets. Whole Foods was particularly concerned about traditional supermarkets, such as Safeway and Delhaize, remodeling and repositioning their stores and offering more perishables and natural foods. Whole Foods also pointed to contemporaneous documents indicating that Whole Foods and traditional supermarkets cross-check their prices. In addition, defendants offered market research studies conducted in the ordinary course of business showing widespread cross-shopping, i.e., the same consumers who shop at Whole Foods and Wild Oats also shop at traditional supermarkets and frequently purchase the same types of products.

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Sept. 26, 2007) ("[W]e believe approximately 50% of the volume their store does will transfer to our store, with the other 50% migrating to our other competitors (these estimates are based on our past experience with similar situations).")

<sup>46</sup> Joint Memorandum of Points and Authorities of Whole Foods Market, Inc. and Wild Oats Markets, Inc. in Opposition to Motion for a Preliminary Injunction at 68–69, *FTC v. Whole Foods Market, Inc.*, No. 07-1021 (D.D.C. July 20, 2007).

<sup>47</sup> Transcript of Motion Hearing at 18, 21–22 (Volume II), *FTC v. Whole Foods Market, Inc.*, No. 07-1021 (D.D.C. Aug. 1, 2007).

<sup>48</sup> Joint Reply Memorandum of Points and Authorities of Whole Foods Market, Inc. and Wild Oats Markets, Inc. in Opposition to Motion for a Preliminary Injunction at 9, *FTC v. Whole Foods Market, Inc.*, No. 07-1021 (D.D.C. Aug. 1, 2007) (quoting 7 PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* § 1506 (2d ed. 2003)).

Defendants, like the FTC, claimed that site analyses could help determine the geographic market. Whole Foods' claimed that these documents did not support the FTC's one-size-fits-all approach, but rather indicated that the reach of each Whole Foods store varied based on a number of different factors and was far from uniform.<sup>49</sup>

**The Decision and Appeal.** On August 16, 2007, the district court denied the FTC's request for a preliminary injunction.<sup>50</sup> In reaching its decision, the court relied heavily on the testimony of the defendants' economist, David Scheffman, as well as declarations submitted by the defendants. The opinion largely ignored the company documents cited by the FTC, including the Mackey documents trumpeted in the FTC's complaint and briefs.

On August 17, 2007, the FTC filed an emergency motion for an injunction pending appeal from the Court of Appeals for the D.C. Circuit. In its brief, the FTC explained that the district court had "utterly ignored the bulk of the Commission's case, including clear and authoritative statements by the principals that the rationale for the transaction is to eliminate competition."<sup>51</sup> The Commission argued that it was reversible error to assign "no weight to contemporaneous, high-level statements and strategic documents authored by senior executives, describing their view of the market realities and of the effect of the merger."<sup>52</sup>

On August 23, 2007, the court of appeals denied the FTC's motion, explaining: "Although the FTC has raised some questions about the district court's decision, it has failed to make a 'strong showing that it is likely to prevail on the merits of its appeal.' The FTC must show that the district court, in denying the preliminary injunction, abused its discretion by making clearly erroneous factual findings or errors of law. At this stage, the FTC has failed to meet that burden."<sup>53</sup> With the injunction dissolved, the parties closed the transaction on August 28, 2007.

**Analysis of the Whole Foods Decision.** As noted, the FTC's documentary evidence received virtually no attention in the district court's opinion. Nowhere does the opinion discuss or even mention the "nasty price wars" document, Mackey's Internet postings, the "cash cow" documents, or the Competitive Intrusion documents. Given that these documents constituted a primary source of the FTC's evidence on market definition and competitive effects, the court's failure even to acknowledge them is surprising and a significant shortcoming in the court's analysis. The FTC was undoubtedly correct that the court had "ignored the bulk of the Commission's case."

There are several possible reasons why the court disregarded nearly all of the FTC's documentary evidence. One possible explanation is that the court viewed documentary evidence in a merger case as generally irrelevant or not sufficiently probative. Support for this interpretation is found in the court's substantial reliance on the testimony of defendants' expert economist and declarations by the defendants' officers to define the product market and analyze the competitive effects.

This reading of the case, however, discounts a number of considerations. First, the district court's opinion states several times that documentary evidence is relevant. The judge wrote that

... the FTC's  
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Nowhere does the  
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mention the "nasty  
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postings, the "cash  
cow" documents, or the  
Competitive Intrusion  
documents.

<sup>49</sup> Joint Reply Memorandum of Points and Authorities of Whole Foods Market, Inc. and Wild Oats Markets, Inc. in Opposition to Motion for a Preliminary Injunction at 18–19, FTC v. Whole Foods Market, Inc., No. 07-1021 (D.D.C. Aug. 1, 2007).

<sup>50</sup> For a summary of the district court's opinion, see Carlton Varner & Heather Cooper, *Product Markets in Merger Cases: The Whole Foods Decision*, ANTITRUST SOURCE, Oct. 2007, <http://www.abanet.org/antitrust/at-source/07/10/Oct07-Varner.pdf>.

<sup>51</sup> Emergency Motion for the Federal Trade Commission for an Injunction Pending Trial at 2, FTC v. Whole Foods Market, Inc., No. 07-5276 (Aug. 17, 2007), available at <http://www.ftc.gov/os/caselist/0710114/0710114emergmot.pdf>.

<sup>52</sup> *Id.* at 13 (citing *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962)).

<sup>53</sup> Order, FTC v. Whole Foods Market, Inc., No. 07-5276 (D.C. Cir. Aug. 23, 2007) (per curiam).

the declarations submitted by the defendants “are entitled to little weight to the extent that they are ‘in conflict with contemporaneous documents.’”<sup>54</sup> Second, the court noted the importance of *Brown Shoe’s* “practical indicia”<sup>55</sup> to help courts “ensure that the market definition comports with business reality.”<sup>56</sup> Third, and most important, the court did, in fact, rely on a number of documents, particularly for market definition. The court cited Whole Foods documents discussing an increase in competition from traditional supermarkets, the prevalence of cross-shopping by consumers at other supermarkets, and the impact of conventional supermarkets when opening a new store. Perhaps most significant, the court relied to a substantial degree on defendants’ site location reports to determine the geographic market.

A second possible explanation for the court’s approach to documentary evidence is that the court only considered ordinary course of business documents as proper evidence. This view would account for the court’s acceptance of the defendants’ documentary evidence and rejection of the FTC’s intent evidence (since these were merger-specific) and Mackey’s Internet postings (since these were not prepared as part of his duties as CEO). There is direct support in the opinion for this interpretation. The court described several documents on which it relied as “prepared in the ordinary course of business.”<sup>57</sup> Other documents cited by the court—such as historical market studies, site reports, and old e-mails—also clearly fall into the category of ordinary course documents.

There are two problems with this reading of the case, however. The first is that some of the documents the court described as being prepared “in the ordinary course of business” were actually documents prepared in connection with the transaction. For example, the court relied on the merger-related Goldmine documents, which were prepared by Whole Foods’ bankers for the purpose of evaluating the Wild Oats transaction. But even putting aside the merger-related documents, we are still left with the question of why the court did not address the FTC’s other documentary evidence. The colorful Mackey documents were only a small part of the FTC’s case. The FTC also relied on dozens of ordinary course of business documents. The court’s failure to discuss these documents strongly suggests that the deciding factor was something other than whether a document was prepared in the ordinary course.

Our view is that the court’s overall treatment of documentary evidence is generally consistent with other recent merger cases. Judges have tended to ignore entirely or discount substantially intent documents submitted by the government that forecast anticompetitive effects. Instead, courts have relied on ordinary course of business documents that support their view of the economic theory of the case and discredited problematic documents that suggested the opposite result or did not otherwise fit the theory.

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<sup>54</sup> *FTC v. Whole Foods Markets, Inc.*, No. 07-1021, slip op. at 2–3 n.4 (D.D.C. Aug. 16, 2007) (quoting *United States v. Gypsum Co.*, 333 U.S. 364, 396 (1948)). However, defendants’ declarations to the court were not tested by the crucible of cross examination at trial. *Cf. United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1139–42 (N.D. Cal. 2004) (discussing the cross examination of the government’s witness, Philip Wilmington, an EVP at PeopleSoft and finding that since he “was not aware of what PeopleSoft’s own documents reveal about Lawson as a competitor . . . the court finds Wilmington’s testimony concerning Lawson’s absence from the up-market largely incredible”). The judge in *Whole Foods* did not permit time for the examination of non-expert witnesses.

<sup>55</sup> *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962).

<sup>56</sup> *Whole Foods*, slip op. at 9. The court went on to conclude that these indicia did not support the FTC’s market definition. *See id.* at 61.

<sup>57</sup> *Id.* at 41 (“Whole Foods’ internal documents, prepared in the ordinary course of business, indicate that Whole Foods believes it faces ‘eroding product differentiation’ as other supermarkets continue to stock many of the same products that Whole Foods offers.”); *id.* at 60 (“Whole Foods created documents in the ordinary course of business documenting the proportion of Wild Oats current sales that might transfer to Whole Foods after the merger.”).

The *Whole Foods* court's failure to discuss the FTC's extensive documentary evidence (with the exception of the Goldmine documents) probably reflects the considerable time pressure facing the court more than anything else. As the court itself noted, "[t]his lawsuit has been litigated on a very fast track," with fact and expert discovery completed within forty-two days of the filing of the complaint, briefs filed within the next seven days, and a two-day hearing beginning six days later.<sup>58</sup> Only fifteen days after the hearing, on August 16, 2007, the court issued its ninety-three page opinion. Such a compressed schedule was needed, according to the court, "to provide the losing side . . . sufficient time to proceed promptly to the court of appeals for a decision before the consummation of the proposed merger, scheduled for August 31, 2007."<sup>59</sup> Typical of Section 7 hearings, the factual record was extensive.<sup>60</sup>

Given the time pressure under which the court was operating, it appears that the court relied on the parties' economic experts to help it comb through the mountain of evidence in the case. This result is not surprising given the economic nature of merger analysis, but it was almost a foregone conclusion since the judge chose not to hear from any fact witnesses at trial. Ironically, because the economic data was not rich enough to permit sophisticated analysis, the economists for both sides relied extensively on non-quantitative evidence, including internal company documents. In the end, the court found defendants' expert Dr. Scheffman more compelling than the FTC's expert, Dr. Murphy, and, therefore, came to largely adopt Dr. Scheffman's interpretation of the documents. For example, in his critical loss analysis, Dr. Scheffman did not calculate the "actual loss" through econometric means, but estimated the actual loss by reviewing the defendants' market study documents. The court accepted Dr. Scheffman's interpretation of these documents and others.

### Conclusion

Not long ago, many viewed the *Arch Coal*<sup>61</sup> and *Oracle* decisions as portending a diminished role for customer evidence in merger litigation. Similarly, we would not be surprised to see the *Whole Foods* decision read to suggest a lesser significance for documents at trial, particularly for hot and intent documents. This view would seem to be misguided.

In the last two decades, courts have paid scant attention to motive and hot documents in merger litigation. Practitioners should take comfort in knowing that a "smoking gun" document is unlikely to be the leading cause of an enforcement action and even less likely to be a deciding factor in a judicial decision. The *Whole Foods* case reaffirms that even highly inflammatory documents will not be automatically accepted at face value by the courts. At the same time, the *Whole Foods* decision reinforces the importance of ordinary course of business documents. The court relied primarily on these documents to determine the geographic market and supported its product market and competitive effects analysis with numerous cites to the defendants' documents. Moreover, the opinion commends this type of evidence on several occasions.

*The Whole Foods case reaffirms that even highly inflammatory documents will not be automatically accepted at face value by the courts. At the same time, the Whole Foods decision reinforces the importance of ordinary course of business documents.*

<sup>58</sup> *Whole Foods*, slip op. at 2; see also *id.* at 3 ("Unfortunately, the Court, too, has had to act under severe time constraints (and with fewer resources than counsel has had) in evaluating the evidence and arguments, reaching its decision and attempting quickly to articulate that decision in a reasonably thorough and comprehensible opinion."). Another hearing for injunctive relief with similar time constraints was the *SunGard* case. See *United States v. SunGard Data Sys., Inc.*, 172 F. Supp. 2d 172, 192 n.24 (D.D.C. 2001) ("There is no question that time pressures may have prevented any thorough analysis of the many customers that will be affected by the proposed acquisition.").

<sup>59</sup> *Whole Foods*, slip op. at 3.

<sup>60</sup> The record included 35 deposition transcripts, 16 declarations, 5 expert reports, 1511 exhibits, 2 days of testimony, and closing arguments. See *id.* at 2–3.

<sup>61</sup> *FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109 (D.D.C. 2004).

Although the *Whole Foods* court's treatment of documents in general was not that far afield from other modern merger cases, it does seem to raise the specter of a more troubling phenomenon: the willingness of courts to delegate fact finding to expert economists rather than wrestling with the diverse facts and complex theories themselves. In *Whole Foods*, the court did not even acknowledge the bulk of the FTC's documentary evidence and excluded at the outset all fact witnesses from testifying at trial. No one doubts that economics should be the animating principle in antitrust law and the important role of an economist to explain that framework at trial. Unfortunately, when confronted by burgeoning caseloads and other constraints, courts may be inclined to forgo the arduous task of independently squaring the facts with the economic theory and, instead, permit whichever economist appears more credible to sift through the evidence for them. Although this may function as a serviceable shortcut, it may reduce merger cases to simply picking the more polished expert. ●

# Why *Twombly* Does Not (and Should Not) Apply to Hard-Core Cartels

**William J. Blechman**

In *Bell Atlantic v. Twombly*,<sup>1</sup> the U.S. Supreme Court ruled that putative class plaintiffs' allegations of exclusively parallel conduct by major telecommunication providers did not state a conspiracy claim under Section 1 of the Sherman Act,<sup>2</sup> because an unlawful agreement could not "plausibly" be inferred from those allegations. Extending this ruling to a hard-core cartel is not justified based on the facts and nature of the claim in *Twombly* and would be unsound public policy. The existence of a hard-core cartel is typically concealed, and a government prosecution of cartel activities does not necessarily reveal the full scope and operation of the cartel. If *Twombly* is applied to hard-core cartels, then it will likely have an unintended chilling effect on private cartel enforcement and further injure cartel victims.

## What Is a Hard-Core Cartel?

A hard-core cartel is the supreme evil of antitrust.<sup>3</sup> It has no procompetitive justification and, by definition, operates in secret. Such a cartel consists of a relatively small number of firms engaged in a horizontal agreement not to compete through any of a variety of mechanisms, including fixing, maintaining, or stabilizing prices; restricting output; rigging bids; or allocating territories or customers.<sup>4</sup> There is no "plausible" efficiency justification for such a cartel and, as a result, antitrust law treats cartel conduct as a per se violation of Section 1 of the Sherman Act.<sup>5</sup>

The duration of a hard-core cartel varies from case to case, as does its profitability.<sup>6</sup> Hard-core cartels have cost customers and consumers billions of dollars in overcharges.<sup>7</sup> Cartels remain

■ **William J. Blechman** is a partner at Kenny Nachwalter P.A., where he concentrates on plaintiff's antitrust law. He has been involved in civil direct actions against many global cartels on behalf of large public and private companies in the United States and Europe. He gratefully acknowledges the editorial assistance of Scott E. Perwin, Douglas H. Patton, and James Almon.

<sup>1</sup> 127 S. Ct. 1955 (2007).

<sup>2</sup> 15 U.S.C. § 1.

<sup>3</sup> See *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 408 (2004); ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), NEW INITIATIVES, OLD PROBLEMS: A REPORT ON IMPLEMENTING THE HARD CORE CARTEL RECOMMENDATION AND IMPROVING CO-OPERATION 11 (2000), available at <http://www.oecd.org/dataoecd/39/63/2752129.pdf> [hereinafter HARD CORE CARTELS] ("hard core cartels . . . [are] the most egregious violations of competition law"). One competition regulator described them as "cancers on the open market economy. . . . They cause serious harm to our economies and consumers [and] . . . undermine the competitiveness of the industry involved, because they eliminate the pressure from competition to innovate and achieve cost efficiencies."). Mario Monti, *Why Should We Be Concerned with Cartels and Collusive Behaviour?*, in FIGHTING CARTELS—WHY AND HOW? 14, 14 (Swedish Competition Authority ed., 2001), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/00/295&format=HTML&aged=0&language=EN&guiLanguage=en>; see also U.S. Dep't of Justice and Fed. Trade Comm'n, Antitrust Guidelines for Collaborations Among Competitors § 3.2 (Apr. 2000), available at <http://ftc.gov/os/2000/04/ftcdojguidelines.pdf>.

<sup>4</sup> See generally ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 81–90 (6th ed. 2007).

<sup>5</sup> See *United States v. Topco Assocs.*, 405 U.S. 596, 607–08 (1972) (collecting cases); *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 223 (1940).

<sup>6</sup> See Margaret Levenstein & Valerie Suslow, *Contemporary International Cartels and Developing Countries: Economic Effects and Implications for Competition Policy*, 71 ANTITRUST L.J. 801, 802, 805 (2004).

<sup>7</sup> See HARD CORE CARTELS, *supra* note 3, at 13, 16, 23, 24, 44 n.2.

widespread in the global economy, including in the United States. Most of these cartels go undetected for reasons discussed below.<sup>8</sup>

### *Twombly*

The plaintiffs in *Twombly* were two customers of their local telephone company. Their complaint, on behalf of a putative class of nearly all subscribers of local telephone and high-speed Internet services in the contiguous United States, alleged that the major incumbent local exchange carriers had conspired for seven years not to compete with each other for local customers outside their respective market areas. As a result of this alleged conspiracy, the plaintiffs maintained that they were unable to obtain, or had to pay more for, service from incumbent providers.

In support of this claimed conspiracy, the complaint alleged parallel anticompetitive practices by the defendants, including impeding rivals' ability to obtain local exchange access through unfair agreements, inferior communications, overcharging and other billing practices. The complaint also contained "a few stray statements" of an agreement by defendants to stay out of each other's markets,<sup>9</sup> but made no mention of the "specific time, place or person involved in the alleged conspiracies."<sup>10</sup> Despite the occasional reference in the complaint to an unlawful agreement, "[t]he nub of the complaint . . . is [defendants'] parallel behavior."<sup>11</sup>

The Supreme Court held that the plaintiffs' allegations of parallel conduct failed to state a claim for relief under Section 1 because the complaint did not contain sufficient facts to support plausibly the inference of a conspiracy as distinct from identical, but independent, action.<sup>12</sup>

The Court could have relied on *Theatre Enterprises, Inc. v. Paramount Film Distributing Corp.*,<sup>13</sup> to rule that parallel conduct, without more, is not actionable under Section 1, and plaintiffs therefore did not state a claim for relief. Instead, however, the Court used the *Twombly* appeal to rule, first, that, in a parallel conduct case, a plaintiff cannot satisfy Rule 8(a) of the Federal Rules of Civil Procedure merely by alleging parallel conduct and then adding a conclusory allegation of "conspiracy;" and, second, to retire the fifty-year standard originated in *Conley v. Gibson*,<sup>14</sup> that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."<sup>15</sup>

*Twombly* perhaps can be understood given its context. The appeal presented a very broad putative class that provided a platform to condemn antitrust class action lawsuits and the lawyers who bring them.<sup>16</sup> That animus is undoubtedly connected, at least in part, to the billions of dollars

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<sup>8</sup> See Ann-Christin Nykvist, *Introduction*, in *FIGHTING CARTELS*, *supra* note 3, at 11 ("[I]t would be naive to believe that companies in general, which operate today in a more international environment than ever before, would obey strictly the anti-trust rules in one particular country and not in others"); Robert H. Lande, *Why Antitrust Damage Levels Should Be Raised*, 16 *LOY. CONSUMER L. REV.* 329, 336 n.24 (2004); Peter G. Bryant & E. Woodrow Eckard, *Price Fixing: The Probability of Getting Caught*, 73 *REV. ECON. & STAT.* 531 (1991).

<sup>9</sup> *Twombly*, 127 S. Ct. at 1970.

<sup>10</sup> *Id.* at 1970 n.10.

<sup>11</sup> *Id.* at 1970–71.

<sup>12</sup> *Id.* 1965–66; *see also id.* at 1961.

<sup>13</sup> 346 U.S. 537 (1954).

<sup>14</sup> 355 U.S. 41 (1957).

<sup>15</sup> *Id.* at 45–46.

<sup>16</sup> *See, e.g.*, Brief of the Chamber of Commerce of the United States of America et al. as Amici Curiae in Support of Petitioners, at 21, *Bell Atlantic v. Twombly*, 127 S. Ct. 1955 (No. 05-1126), 2006 WL 2474076; Brief of Mastercard International Inc. and Visa U.S.A. Inc. as Amici Curiae in Support of Petitioners at 21–22 & n.8, *Bell Atlantic v. Twombly*, 127 S. Ct. 1955 (2007) (No. 05-1126), 2006 WL 2474077; Brief

that corporations have paid to defend and settle private antitrust actions.<sup>17</sup> These facts and circumstances notwithstanding, as the dissent in *Twombly* points out, “there is no reason to throw the baby out with the bathwater” by dismissing an antitrust complaint alleging an actual agreement among competitors in a hard-core cartel.<sup>18</sup>

### ***Twombly* Did Not Involve a Hard-Core Cartel**

*Twombly* did not involve allegations of a hard-core conspiracy. The decision, by its terms, applies only to a Section 1 claim based on parallel behavior giving rise to an inference of an alleged anti-competitive agreement. The majority opinion goes out of its way to state several times that *Twombly* only presents a circumstantial conspiracy case. In one passage, Justice Souter, writing for the majority, states that the “complaint leaves no doubt that plaintiffs rest their § 1 claim on descriptions of parallel conduct and not on any independent allegation of actual agreement among the [defendants].”<sup>19</sup>

Despite the Court’s express and clear limitation on *Twombly*’s application, arguments are now appearing that language in *Twombly*, and a footnote in particular,<sup>20</sup> apply not only to a circumstantial antitrust case based on parallel conduct but to a hard-core conspiracy case as well. Defendants now contend that even the latter case should be dismissed if the allegations of a “contract, combination, or conspiracy, in restraint of trade” are conclusory and the complaint lacks specific allegations of who met with whom, where and when.<sup>21</sup>

The logical implication of this position is that no hard-core cartel victim should be able to sue absent more detailed information about the conspiracy as revealed, if at all, in a guilty plea or

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of the American Petroleum Institute as Amicus Curiae Supporting Petitioners at 7, *Twombly*, 127 S. Ct. 1955 (No. 05-1126), 2006 WL 2474078; Brief of Amici Curiae Legal Scholars in Support of Petitioners at 16–17, *Twombly*, 127 S. Ct. 1955 (No. 05-1126), 2006 WL 2474080.

<sup>17</sup> The exact amount of those payments is not publicly known because defense costs and direct (as opposed to class) action settlements are typically not reported. See generally John M. Connor & Robert H. Lande, *How High Do Cartels Raise Prices? Implications for Optimal Cartel Fines*, 80 TUL. L. REV. 513 (2005) (current Sentencing Commission presumption that cartels overcharge on average by 10% is much too low). One inexact and conservative barometer of the amount corporations have paid to settle their civil damage exposure in cartel cases alone is the dollar amount they have paid in fines after pleading guilty to conspiring to fix prices. According to the U.S. Department of Justice, those corporations paying criminal fines of \$10 million or more have paid a total of \$3.778 billion as of August 1, 2007. See U.S. Dep’t of Justice, Antitrust Division, Sherman Act Violations Yielding a Corporate Fine of \$10 Million or More, <http://www.usdoj.gov/atr/public/criminal/225540.htm>. By operation of law, all of that money went to the United States as opposed to the private victims of the cartels.

<sup>18</sup> *Twombly*, 127 S. Ct. at 197 n.13 (Stevens, J. dissenting).

<sup>19</sup> *Id.* at 1970.

<sup>20</sup> *Id.* at 1970 n.10, which reads as follows:

If the complaint had not explained that the claim of agreement rested on the parallel conduct described, we doubt that the complaint’s references to an agreement among the [incumbent local exchange carriers] would have given the notice required by Rule 8. Apart from identifying a seven-year span in which the § 1 violations were supposed to have occurred (i.e., “[b]eginning at least as early as February 6, 1996, and continuing to the present”), the pleadings mentioned no specific time, place, or person involved in the alleged conspiracies. This lack of notice contrasts sharply with the model form for pleading negligence, Form 9, which the dissent says exemplifies the kind of “bare allegation” that survives a motion to dismiss. Whereas the model form alleges that the defendant struck the plaintiff with his car while plaintiff was crossing a particular highway at a specified date and time, the complaint here furnishes no clue as to which of the four [incumbent local exchange carriers] (much less which of their employees) supposedly agreed, or when and where the illicit agreement took place. A defendant wishing to prepare an answer in the simple fact pattern laid out in Form 9 would know what to answer; a defendant seeking to respond to plaintiffs’ conclusory allegations in the § 1 context would have little idea where to begin.

<sup>21</sup> See, e.g., *In re Elevator Antitrust Litig.*, Docket No. 06-3128-CV, 2007 WL 2471805, at \*2 (2d Cir. Sept. 4, 2007); Defendants’ Notice of Supplemental Authority re: Amended Motion to Dismiss, *In re Methyl Methacrylate (MMA) Antitrust Litig.*, No. 06-MDL-1768 (E.D. Pa. Sept. 6, 2007); see also *In re Insurance Brokerage Antitrust Litig.*, MDL Docket No. 1663, Civ. No. 04-5184 (GEB), 2007 WL 2533989, at \*18–\*19 (D.N.J. Aug. 31, 2007).

other (unlikely) public disclosure. The mantra of hard-core cartel participants would now appear to be “catch me if you can—and post-*Twombly* you cannot.”

### A Hard-Core Cartel Operates in Secret

Reading *Twombly* to require a plaintiff to allege the details of a hard-core cartel ignores the realities of how such a conspiracy operates. An unlawful cartel often operates in secret. The U.S. Department of Justice (DOJ) has explained that “it is very difficult to detect cartel behavior or, once discovered, to compile sufficient evidence to successfully prosecute cartel members in court.”<sup>22</sup> This difficulty exists because the very nature of cartels is to operate in ways that are undisclosed, difficult to track, and thus difficult to prove.

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For example, a cartel’s participants generally destroy incriminating documents. They may keep documents evidencing the conspiracy in their personal computer or even at their homes. They use falsified expense reports to conceal their movements or the people with whom they are meeting. They meet outside their corporate offices in places that make detection difficult, such as a hotel or conference room, an out-of-town restaurant, or an airport. Trade associations can provide a convenient “cover” for them to be together, as in the acid cartel,<sup>23</sup> and when meeting in person, many participants often avoid making a written record that details their pricing, market share and allocation deliberations.<sup>24</sup> In their internal communications and writings with each other, they use fake names and code words and prominent reminders on incriminating documents to “destroy after reading” or words to that effect. Cartel participants may communicate with each other using public telephones and public facsimile machines, and they typically confine knowledge of the cartel’s existence to a small circle of people. They mislead customers by informing them that price increases are the result of increases in raw material costs or supply and demand conditions. And they mislead law enforcement about the existence of the cartel.

Two cartel cases demonstrate the lengths to which conspirators will go to conceal their conduct. In the conspiracy relating to vitamins, two senior executives of F. Hoffmann-LaRoche Ltd. who were obligated to cooperate with the DOJ in connection with Roche’s guilty plea in the citric acid cartel, rehearsed lies they would tell the DOJ when questioned about a vitamins conspiracy. In those interviews, they falsely stated to the DOJ that there was no vitamins conspiracy, that Roche did not participate in such a cartel or in competitor communications not to compete on the sale of vitamins, and that they were unaware of any meetings or conversations between Roche and other vitamin manufacturers relating to a vitamins price-fixing conspiracy. In fact, both Roche executives knew at the time that they and others at the company had regularly communicated and met on at least a quarterly basis for years with competitors and discussed and agreed to fix prices, and to allocate volumes of and customers for certain vitamins manufactured by Roche.<sup>25</sup>

<sup>22</sup> Gerald F. Masoudi, Deputy Ass’t Att’y Gen., Antitrust Div., U.S. Dep’t of Justice, Antitrust Division, Cartel Enforcement in the United States (and Beyond), Address to Budapest Cartel Conference 6 (Feb. 16, 2007), available at <http://www.usdoj.gov/atr/public/speeches/221868.pdf>; see generally Scott D. Hammond, Deputy Ass’t Att’y Gen., Antitrust Div., U.S. Dep’t of Justice, Caught in the Act: Inside an International Cartel, Address Before OECD Competition Committee Public Prosecutors Program 2–5, 8 (Oct. 18, 2005), available at <http://www.usdoj.gov/atr/public/speeches/212266.pdf>.

<sup>23</sup> See e.g., *United States v. Andreas*, 216 F.3d 645, 652, 657 (7th Cir. 2000) (trade association formed to help cover up global citric acid cartel); see generally Christopher R. Leslie, *Trust, Distrust, and Antitrust*, 82 TEX. L. REV. 515, 587–90 (2004); 13 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 2112 (2d ed. 2005).

<sup>24</sup> In a distinct minority of cases, participants took contemporaneous notes apparently because their corporate culture required them to report the cartel developments to their superiors.

<sup>25</sup> See Plea Agreement ¶ 5, *United States v. Sommer*, Criminal No. 3:99-CR-201-R (N.D. Tex. filed May 20, 1999).

*Given the realities of how a cartel secretly operates, it is “mind boggling” to think that an antitrust plaintiff can reasonably be expected to know, before discovery, and particularly without government prosecution and/or public admission by a cartel member, about the details of a cartel’s operations.*

In the cartel relating to carbon products, one co-conspirator attempted to conceal the existence of the conspiracy by falsely characterizing competitor communications as legitimate business meetings in response to law enforcement questions. He then sought to coordinate co-conspirators’ stories by circulating a script to them revealing what he had told the DOJ about the competitor contacts. To avoid leaving a paper trail, he reminded the others to destroy not only the script after reading it but also any other documents relating to or reflecting their competitor communications.<sup>26</sup>

A cartel can and does maintain discipline to ensure secrecy, to enforce the unlawful agreement, and to deter members from abandoning the conspiracy. It typically does this through the threat or practice of retaliation against a member who does not abide by the agreement. Such retaliation can take the form of stealing market share, increasing prices of or cutting off raw materials supplied to a co-conspirator, or increasing output to drive prices lower for a time to inflict some measure of pain on those wavering in their allegiance to the cartel. Absolute discipline is not an essential element of a cartel, although it helps to maintain secrecy. Cheating may affect the impact and sometimes the duration of the conspiracy, not its existence. If cheating occurs, then cartel members realize supracompetitive pricing for whatever time period, short or long, that the collusion allowed.

A cartel also remains concealed because of the enormous costs to its members if it is exposed. Under U.S. antitrust law, cartel members (excluding the amnesty recipient) are subject to criminal fines, and individuals are also subject to imprisonment.<sup>27</sup> Firms and people also are jointly and severally liable under civil antitrust law for treble damages caused by the conspiracy. A company that receives amnesty from the United States may avoid these criminal and civil consequences, provided it complies with the requirements of the Antitrust Criminal Penalty Enhancement and Reform Act of 2004.<sup>28</sup> Still, depending upon a firm’s volume of commerce involved in the conspiracy, its civil exposure for actual damages can be enormous. There also is a cost to the amnesty recipient in a global cartel case in terms of proceedings and potential additional fines in foreign jurisdictions.

Given the realities of how a cartel secretly operates, it is “mind boggling”<sup>29</sup> to think that an antitrust plaintiff can reasonably be expected to know, before discovery, and particularly without government prosecution and/or public admission by a cartel member, about the details of a cartel’s operations. Yet this is precisely what defendants have begun to argue, even in hard-core cartel cases, in *Twombly*’s aftermath.<sup>30</sup>

### Reining in *Twombly*

Advocates claiming a broader interpretation of *Twombly* would prevent a civil cartel case from going forward absent a successful government prosecution or (an unlikely) public disclosure of the existence of a conspiracy and the details of its operation. But such an outcome is unsound policy that will lead to less cartel enforcement and deterrence.

That the DOJ decides not to prosecute firms for participating in an unlawful conspiracy does not mean they did not conspire. The government may choose not to prosecute a cartel for any of a number of reasons. For example, the evidence may not meet the “reasonable doubt” standard

<sup>26</sup> See Plea Agreement ¶¶ 5, 6, *United States v. Morganite, Inc.*, Criminal No. 02-733 (E.D. Pa. filed Nov. 4, 2002).

<sup>27</sup> The Antitrust Division has eliminated the no-jail plea agreement and “now insists on jail sentences for all defendants—domestic and foreign.” Masoudi, *supra* note 22, at 5.

<sup>28</sup> Pub. L. No. 108-237, title II §§ 212–13, 118 Stat. 665, 666–667 (codified as 15 U.S.C. § 1 notes).

<sup>29</sup> *Twombly*, 127 S. Ct. at 1984 (Stevens, J., dissenting).

<sup>30</sup> See *supra* note 21.

imposed by criminal law or the DOJ's own guidelines about the nature, quality, or quantity of proof; private antitrust enforcement may be considered sufficient to hold conspirators accountable without criminal proceedings; the DOJ may defer to foreign enforcement agencies that also have jurisdiction over the conduct; or the DOJ may not have the resources or manpower.<sup>31</sup>

Even when the DOJ does prosecute a cartel, the full scope of the conspiracy may not be revealed. A guilty plea merely reflects the minimum parameters of a conspiracy.<sup>32</sup> To counter this reasoning, defense lawyers might argue that surely a firm will admit to all cartel conduct when pleading guilty to avoid an even harsher penalty later if additional incriminating facts are revealed. The DOJ's prosecution of Stolt-Nielsen S.A. in connection with the parcel tanker conspiracy is a case in point.<sup>33</sup> But firms negotiating with the government do their own cost-benefit analysis in deciding what to reveal. Further, the same evidentiary issues, limited resources, and amnesty assistance<sup>34</sup> that control what cases the government prosecutes in the first instance also inform the DOJ's judgment about the acceptable scope of a guilty plea. Thus, once a firm admits to a technical criminal violation, the products and time period covered by the plea are often negotiable terms of the contract.<sup>35</sup>

The full scope of a cartel may not be revealed even when a foreign government commences an enforcement proceeding. Consider the European Commission (EC), which, next to the DOJ, has had the most active government cartel enforcement. Previously, firms subject to an EC cartel investigation voluntarily prepared written submissions setting forth their positions and detailing conduct within the scope of the investigation, including, on occasion, who met with whom, where, when, and what they discussed. However, in response to rulings by a few U.S. courts that those submissions were discoverable in civil antitrust cases, the EC amended its regulations in 2002 and thereafter to provide for oral submissions and to protect from disclosure written submissions that a company prepared and produced exclusively for the EC's investigation.<sup>36</sup>

There remains an exception to the EC's regulations for a firm's pre-existing documents (e.g., records seized in an EC raid), which the EC acknowledges remain discoverable in civil cases in

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<sup>31</sup> See U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL §§ 9-27.220–250 (2007), available at [http://www.usdoj.gov/usao/eousa/foia\\_reading\\_room/usam/title9/27mcrm.htm](http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/27mcrm.htm) [hereinafter UNITED STATES ATTORNEYS' MANUAL]; see generally Scott D. Hammond, Deputy Ass't Att'y Gen., Antitrust Div., U.S. Dep't of Justice, The U.S. Model of Negotiated Plea Agreements: A Good Deal with Benefits for All, Address Before OECD Competition Committee at 5 & nn. 9–10 (Oct. 17, 2006), available at <http://www.usdoj.gov/atr/public/speeches/219332.pdf>; Masoudi, *supra* note 22, at 1; cf. Scot J. Paltrow, *Budget Crunch Hits U.S. Attorneys' Offices*, WALL ST. J., Aug. 31, 2007, at A1.

<sup>32</sup> See *In re Vitamins Antitrust Litig.*, No. Misc. 99-197 (TFH), 2000 WL 1475705, at \*11 (D.D.C. May 9, 2000) (“[T]he Court rejects the notion that the guilty pleas . . . foreclose a broader conspiracy. Guilty pleas are negotiated instruments which take into account not only the culpability of the accused but the Justice Department's resources and other cases requiring the government's attention.”).

<sup>33</sup> See Indictment, *United States v. Stolt-Nielsen, S.A.*, Criminal Action No. 06-CR-466(B WK) (E.D. Pa. filed Sept. 6, 2006).

<sup>34</sup> Although the government may seize an enormous volume of documents from targets pursuant to grand jury subpoenas, most of them may never even be read as prosecutors make their cases based on cooperation from amnesty applicants and their witnesses and still other co-conspirators who may subsequently plead guilty and also cooperate.

<sup>35</sup> See UNITED STATES ATTORNEYS' MANUAL, *supra* note 31, § 9-27.400(B) cmt. (“readily provable charges” may be dropped or bargained a way “because the United States Attorney's Office is particularly overburdened, the case would be time-consuming to try, and proceeding to trial would significantly reduce the number of cases disposed of by the office.”); cf. Hammond, *Negotiated Plea Agreements*, *supra* note 31, at 7 & n.22.

<sup>36</sup> See Commission Notice on Immunity from Fines and Reductions of Fines in Cartel Cases No. 2006/C 298/11, ¶¶ 32–34, 40, 2006 O.J. (C 298) 17, 21–22 (Dec. 8, 2006), [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c\\_298/c\\_29820061208en00170022.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c_298/c_29820061208en00170022.pdf); Commission Notice on Immunity from Fines and Reduction of Fines in Cartel Cases No. 2002/C 45/03, ¶¶ 32–33 (Feb. 19, 2002), [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/c\\_04520020219en00030005.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/c_04520020219en00030005.pdf).

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U.S. courts.<sup>37</sup> However, even these records only tell a part of the conspiracy story as they usually are focused on European conduct, while most cartels are global in character.<sup>38</sup> Moreover, defendants in civil antitrust cases in the United States attempt to block private plaintiffs from obtaining their EC records in discovery as they slice-and-dice the conspiracy to marginalize and distort its scope or effect.<sup>39</sup> Some federal courts have properly been unsympathetic with that tactic because a defendant's pre-existing EC documents, like its grand jury records, reveal only a portion of how the cartel operated.<sup>40</sup>

Because of the limits on government enforcement actions, fewer unlawful conspiracies would be exposed, or their full scope revealed, if a civil case either had to await the completion of a government prosecution or was effectively confined in the pleadings and discovery to the four corners of the government's case. While cartel victims wait for the outcome of a government investigation and/or prosecution, they may be denied justice. The United States has a five-year statute of limitations on criminal antitrust violations. The EC may investigate a cartel for at least that long. During that time, documents may disappear, and witnesses may become unavailable, their memories may fade, or they may no longer be subject to a firm's control for purposes of producing witnesses to testify.<sup>41</sup>

The genius of the U.S. legal system is that it allows private parties to remedy wrongs, hold tortfeasors accountable, and deter future violations without government action. Congress intended no less in enacting the Sherman and Clayton Acts, which by their terms or through statutory construction allow a private litigant to recover treble damages and attorney's fees and costs if it prevails, hold defendants jointly and severally liable without a right to contribution, and deprive defendants of a pass-on defense. As the Supreme Court explained in *Radovich v. National Football League*, "Congress itself has placed the private antitrust litigant in a most favorable position."<sup>42</sup> A pleading rule that ignores the realities of a hard-core cartel and handicaps a victim's right to seek relief is plainly inconsistent with that legislative intent. Courts "should not add requirements

<sup>37</sup> See Directorate General for Competition, European Commission, Submission to the Antitrust Modernization Commission at 1, 6, 9 (Apr. 4, 2006), [http://www.amc.gov/public\\_studies\\_fr28902/international\\_pdf/060406\\_DGComp\\_Intl.pdf](http://www.amc.gov/public_studies_fr28902/international_pdf/060406_DGComp_Intl.pdf) [hereinafter EC Submission].

<sup>38</sup> "International cartels ignore national borders and we find increasingly that cartels are global in scope. Industry and commerce expand on a world-wide basis, so do cartels." Monti, *supra* note 3, at 20. "In forty-five of the fifty-four instances in which the Antitrust Division has secured a corporate fine of \$10 million or greater, the corporate defendants were foreign-based. These numbers reflect the fact that the typical international cartel likely consists of a U.S. company and three or four of its competitors that are market leaders in Europe, Asia and throughout the world." Masoudi, *supra* note 22, at 2-3. In its submission to the United States Antitrust Modernization Commission, the EC observed that "[e]xperience has shown that any international cartel of significance is likely to affect the United States as well as Europe. EC Submission, *supra* note 37, at 8. A firm's pre-existing EC records thus provide an important piece of the puzzle in understanding how a global cartel operated.

<sup>39</sup> In *Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690 (1962), the Supreme Court ruled in an antitrust case that "plaintiffs should be given the full benefit of their proof without tightly compartmentalizing the various factual components and wiping the slate clean after scrutiny of each. . . . [T]he character and effect of a conspiracy are not to be judged by dismembering it and viewing its separate parts, but only by looking at it as a 'whole.'" *Id.* at 699.

<sup>40</sup> See, e.g., *In re Plastic Additives Antitrust Litig.*, No. Civ. A. 03-2038, 2004 WL 2743591, at \*14 (E.D. Pa. Nov. 29, 2004); *In re Automotive Refinishing Paint Antitrust Litig.*, MDL Docket No. 1426, 2004 U.S. Dist. LEXIS 29160, at \*14-\*17 (E.D. Pa. Oct. 29, 2004); *In re Vitamins Antitrust Litig.*, No. 99-197TFH, 2001 WL 1049433, at \*11, \*13 (D.D.C. June 20, 2001); see generally ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 1243-44 (6th ed. 2007).

<sup>41</sup> See *In re Scrap Metal Antitrust Litig.*, No. 1:02-CV-0844, 2002 WL 31988168, at \*5 (N.D. Ohio Nov. 7, 2002); *In re Mid-Atlantic Toyota Antitrust Litig.*, 92 F.R.D. 358, 359 (D. Md. 1981).

<sup>42</sup> 352 U.S. 445, 454 (1957).

to burden the private litigant beyond what is specifically set forth by Congress in th[e] [antitrust] laws.”<sup>43</sup>

### What Does *Twombly* Mean for Pleading a Hard-Core Cartel Case?

Because a cartel usually operates in secret, its details remain obscured when subject to Government investigation, and its full scope is not revealed even after a government prosecution, a plaintiff alleging a hard-core conspiracy claim usually cannot reasonably be expected to know the details of the cartel absent discovery.<sup>44</sup> The Supreme Court got it right long ago when it stated that “in antitrust cases” the “proof is largely in the hands of the alleged conspirators.”<sup>45</sup>

*Twombly* states that there is not a heightened pleading standard for an antitrust case.<sup>46</sup> That said, if the case is to be read to avoid both a pleading nullity (i.e., a pleading standard that usually cannot reasonably be satisfied) and an implied prohibition against a private right of action against a hard-core cartel absent a successful criminal prosecution or other (unlikely) public disclosure of the conspiracy, then the decision cannot mean that to survive a Rule 12 motion a private plaintiff must allege that which it is not reasonably likely to know at the time its claim accrued. A contrary construction of the decision would have a chilling effect on private cartel enforcement—which runs counter to congressional intent in enacting the Sherman and Clayton Acts—and would mean that some not insubstantial number of unlawful conspiracies will go undetected and their full scope concealed because the DOJ does not prosecute every hard-core cartel and, when it does, the full scope of the conspiracy may not be charged. The stakes for customers and consumers victimized by hard-core cartels are high because the DOJ reports that there are approximately 130 sitting grand juries investigating suspected cartel activity, of which almost one-half involve suspected international cartels.<sup>47</sup>

How, then, to read *Twombly* with respect to a hard-core cartel case? For starters, the *Twombly* majority should be taken at its word when it states that there is “no doubt” that the plaintiffs’ case was based on parallel, circumstantial conduct as opposed to an actual agreement. As such, *Twombly* is distinguishable on its facts from, and does not apply to, a hard-core conspiracy case that contains allegations of an unlawful agreement independent of parallel behavior. A hard-core cartel, unlike the alleged agreement in *Twombly* that the putative class circumstantially inferred from parallel conduct, has no legitimate legal explanation. A plaintiff pleading a cartel claim should use care to make this distinction explicit in its complaint.

Assuming for purposes of analysis only that *Twombly* applies even to a hard-core cartel case, and to reconcile the decision with the unique circumstances presented in such a conspiracy, a plaintiff should allege in its complaint the names of firms that conspired; the approximate time period of the conspiracy; the product(s) covered by the cartel; the characteristics of the product and industry that make them susceptible to cartelization; the elements of the unlawful agreement;

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<sup>43</sup> *Id.*

<sup>44</sup> See *Mary Ann Pensiero, Inc. v. Lingle*, 847 F.2d 90, 95 (3d Cir. 1988) (“Proving a conspiracy is usually difficult and often impossible without resort to discovery procedures.”) (citing *Poller v. CBS*, 368 U.S. 464, 473 (1962)), cited in *In re Auto. Refinishing Paint Antitrust Litig.*, No. MDL 1426, 2004 U.S. Dist. Lexis 29160, at \*9 (E.D. Pa. Oct. 29, 2004).

<sup>45</sup> *Hosp. Bldg. Co. v. Trustees of Rex Hosp.*, 425 U.S. 738, 746 (1976).

<sup>46</sup> 127 S. Ct. at 1973–74.

<sup>47</sup> See Masoudi, *supra* note 22, at 2; U.S. DEP’T OF JUSTICE, ANTITRUST DIVISION, WORKLOAD STATISTICS FY 1997–2006, <http://www.usdoj.gov/atr/public/workstats.pdf> (reporting inter alia on criminal investigations and cases, including grand jury investigations initiated, terminated, and pending).

available facts, which, at least upon information and belief, plausibly explain how the conspirators implemented the agreement (e.g., an explication or examples of the price changes, rigged bids, allocation or supply restraint); the geographic market(s) covered by the conspiracy; the connection between the conspirators' anticompetitive conduct and a domestic effect of the conspiracy giving rise to plaintiff's Section 1 claim; and how the conspirators concealed the cartel from detection.<sup>48</sup> In evaluating the legal sufficiency of such allegations, a court should be realistic about and sensitive to the fact that a hard-core cartel is per se unlawful and is rarely publicized in advance of a criminal prosecution. Even then, government enforcement agencies (to protect an ongoing investigation or honor confidences) or the conspirators themselves (to minimize risk exposure) often intentionally obscure its details from view by private litigants.

These allegations put defendants on notice of the legal claim, the time, place, and companies involved in the conspiracy (although *Twombly* mentions these characteristics in the disjunctive, not the conjunctive), and explain how conspirators' fraudulent concealment prevents a plaintiff from knowing more facts about a cartel's operation at the start of a case. Moreover, the allegations about the product and industry characteristics, coupled with an explanation or examples of how the conspiracy may have operated, provide context to explain "plausibly" how the conspirators were able to cartelize the market causing injury and damage to plaintiffs. Numerous cases and economic textbooks recognize the unremarkable principle that firms with sufficient market concentration that sell a commodity product can effectively conspire not to compete by increasing, maintaining, or stabilizing price, rigging bids, allocating territories or customers, or restricting supply.<sup>49</sup>

These proposed pleading recommendations properly balance the realities and limitations of the interplay between government and private cartel enforcement, prudential concerns about emasculating the effectiveness of private attorneys general suing under the U.S. antitrust laws, the per se illegal character of a hard-core cartel, the realities of what is reasonably knowable by an antitrust plaintiff at the outset of a civil cartel case, and *Twombly's* reading of "plausibility" and notice requirements into Federal Rule of Civil Procedure 12.

Following the Supreme Court's *Twombly* decision, the notoriously business-friendly *Wall Street Journal* Editorial Page declared that the case represents a victory "for consumers and capitalists against self-styled 'consumer advocates' and their tort bar funders."<sup>50</sup> Are there abuses in the antitrust litigation process? Unfortunately, yes (on both sides). Does *Twombly* present an extreme set of facts and circumstances that may invite skepticism about the class action approach in that case? Yes. But *Twombly* is no victory for companies and consumers overcharged as a result of a hard-core cartel. Reading the decision to apply to a Section 1 claim against such a conspiracy means that suppliers who have cheated their customers and consumers may not be held accountable, or fully accountable, for that conduct. Surely no champion of capitalism would approve of that result. ●

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<sup>48</sup> These allegations are not intended to be exhaustive of all allegations to be included in a Section 1 claim.

<sup>49</sup> See, e.g., DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 122–54 (4th ed. 2005); F.M. SCHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 235–74 (3d ed. 1990).

<sup>50</sup> *Justice Souter's Revelation*, Editorial, *WALL ST. J.*, May 23, 2007, at A16.

## The Reach of *Leegin*: Will the States Resuscitate *Dr. Miles*?

M. Russell Wofford, Jr. and Kristen C. Limarzi

*Leegin Creative Leather Products, Inc. v. PSKS, Inc.*,<sup>1</sup> in which the Supreme Court ended per se treatment of minimum resale price agreements in favor of a rule of reason analysis, no longer qualifies as breaking news. While the Court's opinion undoubtedly offers companies greater flexibility to impose minimum resale price maintenance programs under federal law,<sup>2</sup> thoughtful commentators have noted that the continuing uncertainty about the states'<sup>3</sup> treatment of minimum resale price maintenance could slow the business response to *Leegin*.<sup>4</sup>

Businesses have good reason for moving cautiously. Although relatively few private plaintiffs have brought minimum resale price maintenance cases under state law,<sup>5</sup> many of the same features of federal antitrust law that encourage civil litigation have state law equivalents. Every state empowers its attorney general to enforce its state antitrust laws through civil actions.<sup>6</sup> Fifty-one U.S. jurisdictions permit private actions under their antitrust statutes.<sup>7</sup> Forty-seven of those fifty-one jurisdictions allow for the recovery of enhanced damages,<sup>8</sup> and forty provide for the automatic recovery of reasonable attorney's fees.<sup>9</sup> Although in practice nearly all states have looked to federal law in crafting their own antitrust jurisprudence, we know from experience with *Illinois Brick*'s<sup>10</sup> ban on indirect-purchaser suits that states can reject federal precedent—particularly where they

■ **Russ Wofford** is a partner in the Atlanta office of King & Spalding LLP, and **Kristen Limarzi** is an associate in the firm's Washington, D.C. office. The authors wish to thank Andrea C. Clarke, Asha C. Jennings, and Scott E. Zweigel for their assistance. The views expressed herein are the authors' and not those of King & Spalding or its clients.

<sup>1</sup> 127 S. Ct. 2705 (2007).

<sup>2</sup> *Leegin*, of course, does not render minimum resale price agreements per se legal under federal law. A recently filed class action alleges that *Leegin*'s conduct violates the Sherman Act under the rule of reason. Complaint, Spahr v. *Leegin Creative Leather Prods., Inc.*, No. 2:07-CV-00187 (E.D. Tenn. May 15, 2007).

<sup>3</sup> Unless otherwise designated, this article includes the District of Columbia, the Commonwealth of Puerto Rico and the territories of the U.S. Virgin Islands and Guam in its description of "state" antitrust issues.

<sup>4</sup> See Beth L. Fancsali & Paul Olszowka, *How Wide Did the Supreme Court Open the Door to Minimum Resale Pricing?*, 15 ANDREWS ANTITRUST LITIG. REP. No. 6 Sept. 6, 2007; Maria L. Fiala & Scott A. Westrich, *Leegin Creative Leather Products: What Does the New Rule of Reason Standard Mean for Resale Price Maintenance Claims*, ANTITRUST SOURCE, Aug. 2007, <http://www.abanet.org/antitrust/antitrustsource/07/08/Aug07-Westrich8-6f.pdf>; Theodore C. Whitehouse, David K. Park & Emma-Ann L. Deacon, *Minimum Resale Price Restraints Need Extra Attention*, COMPETITION LAW 360, July 23, 2007, <http://competition.law360.com/Secure/ViewArticle.aspx?id=30372>.

<sup>5</sup> Our research has uncovered fewer than 30 reported state-court decisions on resale price maintenance.

<sup>6</sup> Only Connecticut, North Dakota, and Washington do not also provide for criminal antitrust enforcement.

<sup>7</sup> See, e.g., MD. CODE ANN., COM. LAW § 11-209(b)(2)(i) (2000 & Supp. 2007); S.C. CODE ANN. § 39-5-140(a) (Law. Co-op. 1985 & Supp. 2002); TEX. BUS. & COM. CODE ANN. § 15.21(a)(1) (Vernon 2002).

<sup>8</sup> The great majority of states provide, like the Clayton Act, for automatic treble damages. See, e.g., CONN. GEN. STAT. § 35-35 (2005); 79 OKLA. STAT. ANN., tit. 79, § 205(A)(1) (West 2002). A few others require a showing of wilful, flagrant, or per se violations of the statute. See, e.g., MICH. COMP. LAWS ANN. § 445.778 Sec. 8(2) (West 2002); N.H. REV. STAT. ANN. § 356:11 (2002 & Supp. 2007).

<sup>9</sup> See, e.g., HAWAII REV. STAT. § 480-13(a)(1) (2002 & Supp. 2006); MINN. STAT. § 325D.57 (2004).

<sup>10</sup> *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977).

believe that consumer welfare is at stake. *Leegin's* requirement that federal courts analyze resale price maintenance under the rule of reason could therefore shift the battleground from federal to state law.

Differences between state and federal statutory language, state court precedent on vertical minimum resale price agreements, and the varying degrees of deference that states give to federal antitrust precedent all suggest that—despite *Leegin*—minimum resale price agreements may remain per se illegal in at least some states. Predicting which states will reject *Leegin's* approach is difficult, but states representing some of the largest economies in the country appear to number among those most likely to retain the *Dr. Miles* rule. Until test cases compel these states to decide what rule they will apply, any business considering a minimum resale price agreement must weigh carefully the benefits of that action against the risks of starring in what could become a cautionary tale.

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### What We Already Know

Predictions about the states' reactions to *Leegin* can rely on more than mere guesswork. We know, for example, that thirty-seven states argued as amici in *Leegin* to retain the *Dr. Miles* rule.<sup>11</sup> We also know that forty-eight states typically defer to federal precedent when interpreting their own state antitrust laws, consistent with a statute or judicial precedent that either mandates or suggests that deference.<sup>12</sup> While virtually all states have looked to federal law in developing their antitrust jurisprudence, the language of many state statutes differs from the Sherman Act; in some cases, in ways that could suggest a legislative intent to hold vertical agreements on minimum resale prices per se illegal. We also know that courts in at least a dozen states have issued opinions addressing vertical minimum resale price maintenance under state law<sup>13</sup>—with one requiring the rule of reason as a matter of state law even before *Leegin*.<sup>14</sup> Finally, we know that a few states have almost no antitrust jurisprudence at all.<sup>15</sup>

### How Can We Predict a State's Response to *Leegin*?

States are, of course, free to legislate a state-law repeal of *Leegin*, preserving by statute per se treatment of minimum resale price agreements. Businesses will have warning of these legislative changes, however, and if statutory repeals of *Illinois Brick* are any guide, amendments may take years.<sup>16</sup> Of more immediate concern is state courts' ability to depart from *Leegin* before any legislative repeal, in response to a challenge to a particular minimum resale price agreement. The likelihood of this development in any given state could depend upon several factors: amicus par-

<sup>11</sup> See Brief for the States of New York, Alaska, Arkansas, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Utah, Vermont, Washington, West Virginia, and Wyoming as Amici Curiae Supporting Respondent, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007) (No. 06-480), 2007 WL 621851.

<sup>12</sup> See, e.g., *Berghausen v. Microsoft Corp.*, 765 N.E.2d 592, 594 (Ind. Ct. App. 2002); *Rozema v. Marshfield Clinic*, 977 F. Supp. 1362, 1374 (W.D. Wis. 1997).

<sup>13</sup> See *infra* notes 34–36.

<sup>14</sup> See *People ex rel. Scott v. Convenient Food Mart, Inc.*, 315 N.E.2d 124, 131–34 (Ill. App. Ct. 1974); see also *Nichols Motorcycle Supply Inc. v. Dunlop Tire Corp.*, 913 F. Supp. 1088, 1128–29 (N.D. Ill. 1995).

<sup>15</sup> For example, Georgia and Pennsylvania have no general civil antitrust statute similar to the Sherman Act.

<sup>16</sup> See, e.g., NEV. REV. STAT. § 598A.210 (amended 1999).

ticipation in *Leegin*, state-court precedent on resale price maintenance, the language of a state's antitrust statute, and the degree of deference a state accords federal antitrust precedent.

**Amicus Participation in *Leegin*.** In highlighting the uncertainty of state responses to *Leegin*, some commentators have noted that thirty-seven states unsuccessfully argued as amici to retain the per se rule.<sup>17</sup> Amicus opposition may not, however, foreshadow a state's response to *Leegin* as much as one might think.

First, the decision to appear as an amicus rests with the state attorney general.<sup>18</sup> It does not necessarily reflect the views of the state legislatures or courts—the only two bodies empowered to establish or change state law on minimum resale price maintenance. (Illinois' Attorney General, in fact, urged the retention of the *Dr. Miles* rule as a *Leegin* amicus despite state-law precedent requiring the rule of reason.<sup>19</sup>) If amicus participation indicates an attorney general's preference for the *Dr. Miles* rule, one might expect those same attorneys general to be more aggressive in bringing civil suits challenging minimum resale price agreements, or filing amici briefs urging state courts to continue to regard them as per se unlawful, or even lobbying the state legislature to repeal *Leegin*. Amicus participation does not, however, indicate whether a state attorney general is likely to succeed in those efforts.

Moreover, amicus participation might not indicate an interest or ability to pursue per se treatment of minimum resale price agreements following *Leegin*. Thirty-four of the thirty-seven amicus states have statutes or judicial opinions that express some preference to follow federal authority when interpreting their own antitrust statute.<sup>20</sup> Amicus participation could therefore suggest an attorney general's recognition, or at least expectation, that her state's courts will likely follow the federal rule, whatever that rule turns out to be.<sup>21</sup>

Conversely, a decision by a state's attorney general not to participate as a *Leegin* amicus says little about how that state will treat resale price maintenance in the future. Where the statutory language indicates that minimum resale price agreements could remain per se unlawful, an attorney general might have concluded that *Leegin* would have little impact on her enforcement options regardless of how the Supreme Court decided it. Other attorneys general might not have partici-

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<sup>17</sup> See, e.g., Fiala & Westrich, *supra* note 4, at 2; Carole E. Handler & G. Michael Halfenger, *Licensees and Intellectual Property Owners Affected by Supreme Court Abandoning Century-Old Per Se Rule Against Resale Price Maintenance*, 9 E-COMMERCE L. REP. No. 8, Aug. 2007, at 7.

<sup>18</sup> See NAAG Antitrust Task Force, Protocol for State Consideration of Whether to Participate as Amicus Curiae or Engage in Competition Advocacy (Feb. 14, 2005), available at [http://www.naag.org/assets/files/pdf/at-amicus\\_protocol.pdf](http://www.naag.org/assets/files/pdf/at-amicus_protocol.pdf).

<sup>19</sup> See *supra* notes 11, 14.

<sup>20</sup> See, e.g., FLA. STAT. § 542.16 (2002); 740 ILL. COMP. STAT. ANN. 10/11 (West 2002); MO. REV. STAT. § 416.141 (2007); N.J. STAT. ANN. § 56:9-18 (West 2001); N.M. STAT. ANN. § 57-1-15 (LexisNexis 2000); UTAH CODE ANN. § 76-10-926 (2002); *Orr v. Beamon*, 77 F. Supp. 2d 1208, 1212 (D. Kan. 1999), *aff'd*, 4 Fed. Appx. 647 (10th Cir. 2001); *State v. Alpine Air Prods., Inc.*, 490 N.W.2d 888, 894 (Minn. Ct. App. 1992), *aff'd*, 500 N.W.2d. 788 (Minn. 1993).

<sup>21</sup> For example, under Connecticut law, state courts are required by statute to follow federal antitrust precedent when applying state law. See CONN. GEN. STAT. § 35-44b. Following *Leegin*, Connecticut Attorney General Richard Blumenthal said that the Supreme Court's decision "eliminates a vital antitrust protection." See Press Release, Attorney General Statement on High Court Ruling Ending Century-Old Antitrust Protection (June 28, 2007), available at <http://www.ct.gov/ag/cwp/view.asp?A=2788&Q=385328>. Although he promised that his office would "monitor the marketplace, and take action to protect consumers, if necessary," he did not suggest that Connecticut law allowed for per se treatment despite the *Leegin* decision, and his promise to "still take action" against minimum resale price agreements could suggest that, at least in his view, the *Leegin* decision limits his enforcement options. *Id.* (emphasis added). Florida's attorney general may have been similarly motivated. In a recent teleconference conducted by the ABA Section of Antitrust Law, Liz Leeds, Assistant Attorney General in the Antitrust Section of the Florida Attorney General's Office, acknowledged that Florida courts were likely to follow the Supreme Court's decision in *Leegin* in applying Florida's own antitrust statute. See *State Antitrust Enforcement After Leegin: The Enforcers Speak*, ABA Section of Antitrust Law (Sept. 25, 2007), audio available at <http://www.abanet.org/antitrust/at-bb/audio/07/09-07.shtml>.

pated because they agreed with the federal enforcement authorities that the Supreme Court should overturn the *Dr. Miles* rule.<sup>22</sup> Finally, an attorney general's absence from the amicus brief might just indicate a lack of interest in the issue altogether.

**Amicus Participation in Illinois Brick and Khan.** Apart from what amicus participation might say about the attorney general's position on minimum resale price agreements, two earlier cases illustrate the difficulty in relying on amicus participation as an indicator of what state courts or legislatures are likely to do.

Forty-nine states participated in *Illinois Brick*, arguing that indirect purchasers should have standing to recover damages under federal antitrust law: forty-eight as amici, and Illinois as a party.<sup>23</sup> After the Supreme Court rejected that view, thirty-six of those states (and the District of Columbia, which did not participate in *Illinois Brick*) provided for some right of action on behalf of indirect purchasers, either through their legislatures or the courts.<sup>24</sup>

Noting that thirty-six of the forty-nine participating states took action after *Illinois Brick*, however, may distort the magnitude of those states' disagreement with the decision. Only twenty-one of those states rejected *Illinois Brick* entirely by allowing for private rights of action by indirect purchasers under state law.<sup>25</sup> The remaining fifteen states repealed *Illinois Brick* only to allow indirect purchaser suits brought by the state attorney general<sup>26</sup>—a more limited divergence from the Supreme Court's decision. Of the original forty-nine state participants, therefore, a clear majority (twenty-eight) either took no action to repeal *Illinois Brick*, or limited its repeal to suits by the state attorney general. Only twenty-one of forty-nine states rejected *Illinois Brick* outright and preserved damages actions for indirect purchasers.<sup>27</sup> Although *Illinois Brick* repealers arguably represent the most significant contemporary conflict between federal and state antitrust policy,<sup>28</sup> amicus participation in that case did not clearly foreshadow a state's ultimate position on private indirect-purchaser suits.

Closer in subject matter to *Leegin*, thirty-four states and territories appeared as amici in *State Oil Co. v. Khan*, arguing that maximum resale price agreements should remain per se illegal under federal law.<sup>29</sup> After the Supreme Court held otherwise,<sup>30</sup> commentators speculated that the states

*Of the 49 states participating in Illinois Brick, only 21 later preserved damages actions by indirect purchasers under state law.*

<sup>22</sup> Brief for the United States as Amicus Curiae Supporting Petitioner, *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007) (No. 06-480), 2007 WL 173650.

<sup>23</sup> See Brief for the States of Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming, Commonwealths of Pennsylvania and Virginia and the National Association of Attorneys General as Amici Curiae, *Illinois Brick Co. v. Illinois*, 97 S. Ct. 2061 (1977) (No. 76-404), 1977 WL 189564; Brief of State of California Through Its Attorney General, *Evelle J. Younger Amicus Curiae, Illinois Brick Co. v. Illinois*, 97 S. Ct. 2061 (1977) (No. 76-404), 1977 WL 189565.

<sup>24</sup> See ANTITRUST MODERNIZATION COMMISSION, REPORT AND RECOMMENDATIONS 269 (Apr. 2007) [hereinafter AMC REPORT], available at [http://www.amc.gov/report\\_recommendation/toc.htm](http://www.amc.gov/report_recommendation/toc.htm).

<sup>25</sup> The District of Columbia also repealed the *Illinois Brick* ban on private suits by indirect purchasers. See 740 ILL. COMP. STAT. § 10/7(2); D.C. CODE ANN., ch. 45, § 28-4509 (2007).

<sup>26</sup> See, e.g., IDAHO CODE ANN. § 48-108(2) (2007); R.I. GEN. LAWS § 6-36-12(g) (2007).

<sup>27</sup> Admittedly, as noted below, several of these states represent a significant portion of the U.S. economy.

<sup>28</sup> See, e.g., AMC REPORT, *supra* note 24, at 265–83.

<sup>29</sup> Brief of Thirty-Three States and the Territory of Guam in Support of Respondents, *State Oil Co. v. Khan*, 522 U.S. 3 (1997) (No. 96-871), 1997 WL 221797.

<sup>30</sup> *Khan*, 522 U.S. at 22.

might not follow the decision.<sup>31</sup> We have found no reported decisions by state courts rejecting the *Khan* rule, however, and several courts have followed the decision in construing state laws.<sup>32</sup> State opposition to the *Leegin* decision, however, may be stronger than in *Khan* because *Leegin*—which poses a greater perceived threat of immediate price increases to the public—may more clearly implicate a state’s consumer protection policies.<sup>33</sup>

Although the states’ amicus brief in *Leegin* might imply that at least thirty-seven state attorneys general believe that minimum resale price agreements should be per se unlawful, wishing does not necessarily make it so.

**State Judicial Precedent on Resale Price Maintenance.** During *Dr. Miles’* ninety-six-year tenure, at least a dozen state courts addressed minimum resale price agreements under their state law. The majority relied on federal authority in holding them per se unlawful<sup>34</sup>—sometimes even where the state statutes appeared to limit per se treatment to horizontal agreements.<sup>35</sup> A few state courts, however, have relied on state statutory language or other non-federal authority to reach the same conclusion.<sup>36</sup> Although the state-court decisions that relied on *Dr. Miles* are now less persuasive, the cases that relied on other grounds provide an arguably undiminished basis to continue to hold minimum resale price agreements per se unlawful.

**State Statutory Language.** In the absence of clear judicial precedent, one might, of course, do something obvious: look at what the state antitrust statute says.

A minority of states address minimum resale price maintenance specifically.<sup>37</sup> Montana law, for example, prohibits a person from “enter[ing] into an agreement which binds any person not to . . . sell . . . article of commerce below a common or standard figure,”<sup>38</sup> and New York law specifically declares resale price maintenance agreements void.<sup>39</sup>

Although 34 states

appeared as

unsuccessful amici in

*Khan*, none rejected

the *Khan* rule.

<sup>31</sup> See, e.g., Robert T. Joseph, *Vertical Maximum Price Fixing After State Oil Company v. Khan*, 17 FRANCHISE L.J. 73, 88 (1998).

<sup>32</sup> See, e.g., *FF Orthotics, Inc. v. Paul*, No. D044226, 2006 WL 1980270, at \*5 (Cal. Ct. App. July 17, 2006) (not for publication) (applying California law); *Lubbock Beverage Co v. Miller Brewing Co.*, No. Civ. A. 5:01-CV-124-C, 2002 WL 31011266, at \*10 (N.D. Tex. June 4, 2002) (not for publication) (applying Texas law).

<sup>33</sup> See Brief of Thirty-Three States and the Territory of Guam, *supra* note 29, at \*17 (arguing that maximum resale price maintenance agreements should remain per se unlawful because they could disguise minimum resale price maintenance agreements).

<sup>34</sup> See, e.g., *State v. Lawn King, Inc.*, 417 A.2d 1025, 1035 (N.J. 1980); *Indep. Milk Producers Co-op v. Stoffel*, 298 N.W.2d 102, 104–06 (Wis. Ct. App. 1980).

<sup>35</sup> See *State v. Alpine Air Prods., Inc.*, 490 N.W.2d 888, 893–95 (Minn. Ct. App. 1992).

<sup>36</sup> See, e.g., *McCall Co. v. O’Neil*, 25 Ohio Dec. 591, 1914 WL 1669 (Ohio Com. Pl. Nov. 12, 1914) (holding agreements on resale prices void under Ohio antitrust statute); *State v. Miles Labs., Inc.*, 282 S.W.2d 564 (Mo. 1955) (finding vertical and horizontal price fixing agreements equally unlawful under prior version of the Missouri antitrust statute based upon legislative history of the act); *Ford Motor Co. v. State*, 175 S.W.2d 230, 233 (Tex. 1943) (“It is a violation of our anti-trust laws for one party to enter into a contract with another party, whereby it is agreed that goods or products . . . shall be resold at fixed or agreed prices . . .”) (citing state cases); Only in Illinois have courts used the rule of reason to analyze minimum resale price maintenance agreements. See *supra* note 14.

<sup>37</sup> In addition to state statutes that may address resale price agreements generally, a number of states have industry-specific statutes that govern such agreements with respect to particular products. See, e.g., FLA. STAT. ANN. § 526.307(1) (West 2007) (prohibits fixing of retail prices for motor fuel); N.Y. GEN. BUS. LAW § 370-f (McKinney 2007) (same); KAN. STAT. ANN. § 41-701(f) (2007) (prohibits fixing of resale prices of liquor or beer).

<sup>38</sup> See MONT. CODE ANN. § 30-14-205(h) (2002).

<sup>39</sup> See N.Y. GEN. BUS. LAW § 369-a (McKinney 2003) (“Any contract provision that purports to restrain a vendee of a commodity from reselling such commodity at less than the price stipulated by the vendor or producer shall not be enforceable or actionable at law.”). New Jersey law is similar. See N.J. STAT. ANN. § 56:4-1.1 (West 2001) (“Any contract provision that purports to restrain a vendee of a commodity from reselling such commodity at less than the price stipulated by the vendor or producer shall not be enforceable or actionable at law.”).

Other state statutes go beyond the Sherman Act's general prohibition against unreasonable restraints, but without specifically addressing minimum resale price agreements. New Hampshire and West Virginia, for example, both prohibit contracts "fixing, controlling or maintaining" prices.<sup>40</sup> These statutes do not indicate whether the prohibition extends to vertical as well as horizontal agreements, or whether the courts should analyze such contracts under a per se or rule of reason analysis. State courts could nevertheless consider these departures from the federal statutory language as an opportunity to treat vertical minimum resale price agreements differently as well.

**Deference to Federal Precedent.** Regardless of the language of state antitrust statutes, statutory or judicial admonitions to follow federal antitrust precedent could constrain a state court's ability to reject *Leegin*. As noted above, legislatures or courts in forty-eight states and territories have expressed some preference to follow federal antitrust precedent when interpreting their state statutes. For some, like Michigan, the instruction appears to be mandatory and directly on point: courts "shall give[] due deference to interpretations given by the federal courts to comparable antitrust statutes, including, without limitations, the doctrine of per se violations and the rule of reason."<sup>41</sup> Elsewhere, as in the District of Columbia, courts "may use as a guide interpretations given by federal courts to comparable antitrust statutes."<sup>42</sup> In North Carolina, at least one court regards federal precedent "instructive only insofar as it reflects common law."<sup>43</sup> While these differences defy easy categorization, in *Leegin's* wake these state courts may face a stark choice: follow a state policy to protect residents from minimum resale price agreements or follow federal antitrust precedent in the interest of a national norm.

States could resolve this dilemma by legislating around it. Seventeen of the eighteen states that repealed *Illinois Brick* by statute did so in the face of statutes or case law urging deference to federal precedent.

Although long-standing admonitions to follow federal antitrust precedent will likely constrain state courts more than state legislatures, *Illinois Brick's* legacy demonstrates that determined state courts can reason around a policy to follow federal law—whether mandatory or not. The Iowa Supreme Court, for example, repealed *Illinois Brick* despite statutory language that required deference to federal precedent, interpreting that requirement to apply to prohibited conduct, but not to standing.<sup>44</sup> The Arizona Supreme Court drew the same distinction, but also relied on statutory language that courts "may use as a guide interpretations given by the federal courts to comparable federal antitrust statutes."<sup>45</sup> Finding that the requirement to follow federal law was merely permissive, the Arizona court stated that it could "simply decline[] to follow *Illinois Brick's* guidance [because] the [statute's] plain language . . . would allow an indirect purchaser suit."<sup>46</sup> One North Carolina court felt free not to follow *Illinois Brick*, despite prior rulings that federal precedent

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<sup>40</sup> N.H. REV. STAT. ANN. § 356:2 (2002); W. VA. CODE § 47-18-3(b)(1)(A) (2002).

<sup>41</sup> MICH. COMP. LAWS ANN. § 445.784 §14(2) (West 2002) (emphasis added).

<sup>42</sup> D.C. CODE § 28-4515 (2001) (emphasis added).

<sup>43</sup> *United Roasters, Inc. v. Colgate-Palmolive Co.*, 485 F. Supp. 1041, 1047–48 n.1 (E.D.N.C. 1979).

<sup>44</sup> *Comes v. Microsoft Corp.*, 646 N.W.2d 440, 445–46 (Iowa 2002).

<sup>45</sup> ARIZ. REV. STAT. ANN. § 44-1412 (2002) (emphasis added); *Bunker's Glass Co. v. Pilkington, PLC*, 75 P.3d 99, 102–06 (Ariz. 2003).

<sup>46</sup> *Bunker's Glass Co.*, 75 P.3d at 103.

should be “persuasive” in construing the state statute,<sup>47</sup> because only the federal precedent in effect at the time the statute was passed in 1969 was relevant.<sup>48</sup>

As the response to *Illinois Brick* shows, statutory requirements or judicial admonitions to follow federal law will not necessarily prevent state courts from rejecting a precedent with which they disagree. The states’ responses to *Leegin* may well vary, but no one should assume that a mandatory—much less a discretionary—policy to adhere to federal precedent ensures a rule of reason regime in any particular state.

### Proceed with Caution

Many states offer conflicting signals about their post-*Leegin* treatment of minimum resale price agreements. Several, however, emerge as among the riskiest for businesses considering such agreements.

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**California.** California’s antitrust statute, the Cartwright Act, specifically prohibits agreements to fix prices or set minimum prices for the sale of any product,<sup>49</sup> and California courts construing this statute have applied a per se rule to minimum resale price agreements.<sup>50</sup> Although California courts have previously cited federal authority to support this rule, California law does not mandate that courts look to federal precedent in interpreting the Cartwright Act. In fact, that state’s Supreme Court has held that the Cartwright Act was not modeled on the Sherman Act, and that federal precedent, while helpful, is “not directly probative.”<sup>51</sup> California did not participate as an amicus in *Leegin*.

The statutory language prohibiting certain price agreements and local courts’ relative freedom to depart from federal precedent suggest considerable risk that minimum resale price agreements may continue to receive per se treatment in California.

**New York.** New York law declares minimum resale price agreements unenforceable,<sup>52</sup> and courts applying state law, known as the Donnelly Act, have employed a per se analysis.<sup>53</sup> No statute requires consistency with federal antitrust law, and New York courts have expressed some reservation about using federal precedent to interpret the Donnelly Act.<sup>54</sup> New York was the lead party in the states’ amicus brief.<sup>55</sup> As with California, New York may remain in the per se camp on minimum resale price agreements.

<sup>47</sup> See, e.g., *Madison Cablevision, Inc. v. City of Morganton*, 386 S.E.2d 200, 213 (N.C. 1989).

<sup>48</sup> *Hyde v. Abbott Labs., Inc.*, 473 S.E.2d 680, 683–86 (N.C. Ct. App. 1996).

<sup>49</sup> CAL. BUS. & PROF. CODE § 16720(d) & (e) (West 1997 & Supp. 2007).

<sup>50</sup> See *Miland v. Burckle*, 572 P.2d 1142, 1147 (Cal. 1978); *Chavez v. Whirlpool Corp.*, 93 Cal. App. 4th 363, 369 (Cal. Ct. App. 2001).

<sup>51</sup> See *State ex rel. Van de Kamp v. Texaco, Inc.*, 762 P.2d 385, 395 (Cal. 1988); see also *Morrison v. Viacom, Inc.*, 66 Cal. App. 4th 534, 541 n.2 (Cal. Ct. App. 1998).

<sup>52</sup> N.Y. GEN. BUS. LAW § 369-a (McKinney 2003).

<sup>53</sup> See, e.g., *George C. Miller Brick Co. v. Stark Ceramics, Inc.*, 2 A.D.3d 1341, 1343, 770 N.Y.S.2d 235 (N.Y. App.Div. 4th Dept. 2003).

<sup>54</sup> See, e.g., *People v. Roth*, 420 N.E.2d 929, 930 (N.Y. 1981) (“the ruling of a Federal court interpreting a Federal Statute has no direct bearing upon a State court’s analysis of an analogous provision enacted by the State Legislature”); *State v. Mobil Oil Corp.*, 344 N.E.2d 357, 359 (N.Y. 1976) (“undoubtedly the sweep of Donnelly may be broader than that of Sherman”). Cf. *Anheuser-Busch, Inc. v. Abrams*, 520 N.E.2d 535, 539 (N.Y. 1988) (“the Donnelly Act . . . should generally be construed in light of Federal precedent and given a different interpretation only where State policy, differences in the statutory language or the legislative history justify such a result”).

<sup>55</sup> Moreover, although not speaking in his official capacity, the NY State Attorney General’s Director of Litigation for the Antitrust Bureau has stated that “people need to be reminded that there is already state antitrust law on minimum RPM,” citing to the New York statutory provision that declares such agreements unenforceable. Posting of Robert Hubbard, to AT-CONVERSATION@MAIL.ABANET.ORG (July 13, 2007).

**New Jersey.** New Jersey law declares resale price agreements unenforceable.<sup>56</sup> Although required to “construe [state law] in harmony with ruling judicial interpretations of comparable Federal antitrust statutes,”<sup>57</sup> at least one court has refused to look to federal authority where the statutory language deviates from the Sherman Act.<sup>58</sup> New Jersey’s divergent statutory language could provide a basis for a state court to depart from *Leegin* and retain the per se rule.

## Conclusion

Unfortunately for many businesses, the states that appear most hostile to *Leegin* are also some of the most important to the U.S. economy. Nearly 65 million people live in New York, New Jersey, and California—more than 21 percent of the U.S. population.<sup>59</sup> Retail sales in those states totaled more than \$639 billion in 2002, almost 20 percent of the national total.<sup>60</sup> Regardless of how other states respond to *Leegin*, the desire to avoid liability in these economically important states could drive business policy on resale price maintenance.

Has *Leegin*’s importance been overstated? Only a series of test cases will reveal which states will acquiesce to the decision, as they did with *State Oil v. Khan*, and which will reject the ruling, as many did with *Illinois Brick*. Until then, businesses may be wise to consider the rumors of *Dr. Miles*’ demise to be greatly exaggerated. ●

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<sup>56</sup> N.J. STAT. ANN. § 56:4-1.1 (West 2001) (“Any contract provision that purports to restrain a vendee of a commodity from reselling such commodity at less than the price stipulated by the vendor or producer shall not be enforceable or actionable at law.”).

<sup>57</sup> N.J. STAT. ANN. § 56:9-18 (West 2001).

<sup>58</sup> See *Kimmelman v. Henkels & McCoy, Inc.*, 506 A.2d 381, 386–87 (N.J. Super. Ct. App. Div. 1986). In other pre-*Leegin* cases, New Jersey courts have cited to federal precedent in declaring vertical price restraints per se illegal. See *State v. Lawn King, Inc.*, 417 A.2d 1025, 1032–33 (N.J. 1980); *EZ Sockets, Inc. v. Brighton-Best Socket Screw Mfg. Inc.*, 704 A.2d 1364, 1367 (N.J. Super. Ct. Ch. Div. 1996), *aff’d*, 704 A.2d 1309 (N.J. Super. Ct. App. Div. 1997).

<sup>59</sup> See U.S. Census Bureau, State and County QuickFacts, <http://quickfacts.census.gov/qfd/>.

<sup>60</sup> *Id.*

## Some Reflections on Corporate Criminal Responsibility

**Editor's Note:** This article is extracted from Judge Kaplan's remarks made on the occasion of the presentation to him of the Stanley H. Fuld Award by the Commercial and Federal Litigation Section of the N.Y. State Bar Association on January 24, 2007. We are indebted to Judge Kaplan for his permission to publish these interesting and timely remarks.

### Lewis A. Kaplan

Over the course of my career, we have seen a sea change in the use of criminal law in the business world.<sup>1</sup> When I was a little younger than I am now, government dealt with business misconduct principally by regulation and civil litigation. When there were criminal investigations, they typically proceeded in what by now is an old-fashioned way. The government got a tip or a cooperating witness. Grand jury subpoenas went out. Witnesses were turned or immunized. Cases were built. Sometimes indictments were returned. Even where corporations or other business entities were indicted, the potential consequences of conviction usually were such that mounting a defense was a feasible course of action.

That has changed. For a variety of reasons that are familiar to many of you, the return of an indictment against many public companies and other prominent organizations would threaten their very existence, regardless of whether they were guilty. In those cases, defending against criminal charges is not a viable option. The entity in such a case has little choice—it must make a deal with the government that avoids a criminal prosecution. This frequently means waiving the attorney-client privilege, firing employees whom prosecutors regard as culpable, paying large fines, and often accepting major changes to the manner in which the entity does business. We thus have moved, in some cases and in some degree, from a system in which prosecutors prosecuted and courts and juries decided guilt or innocence to a system in which prosecutors as a practical matter threaten business entities with unbearable extrajudicial consequences and thus exact acquiescence in the government's demands.

This is made possible by the conjunction of two principles. The first is the proposition that a corporation is a legal person and thus capable of committing a crime. The second is the fact that a corporation, however large, is guilty of a crime if even a single agent commits a prohibited act with the requisite mental state as long as that act was intended to benefit the corporation and was directly related to the performance of the kind of duties the agent had the general authority to perform.<sup>2</sup>

These principles, neither of which is self evident, have not been with us from the beginning of time. Blackstone said that corporations are incapable in their corporate capacities of committing crimes, although their members may be criminally liable in their individual capacities.<sup>3</sup> Never-

■  
The Honorable **Lewis A. Kaplan** is a U.S. District Court Judge for the Southern District of New York.  
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<sup>1</sup> See generally Leonard Orland, *The Transformation of Corporation Criminal Law*, 1 BROOK. J. CORP., FIN. & COM. L. 45 (2006).

<sup>2</sup> See LEONARD B. SAND ET AL., MODERN FEDERAL JURY INSTRUCTIONS, Instruction 2-7.

<sup>3</sup> 1 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 464 (1765).

theless, these principles have been with us for a very long time. The Supreme Court accepted the constitutionality of imputing criminal responsibility to corporations on agency principles in 1909.<sup>4</sup> The concept of the corporation as a legal person is older than that. Thus, the environment in which corporate criminal liability became a matter of black letter law was very different from today. Certainly the Supreme Court, when it upheld the *respondeat superior* theory of criminal liability ninety-eight years ago, could not have conceived of anything like the *Arthur Andersen* case. It is, I suggest, time for an objective consideration of whether any change is warranted in present circumstances.

Let me begin with some disclaimers. First, these remarks are not about any pending case or any case that recently was dismissed.

Second, I have no more sympathy for corporate or white collar crime than for any other variety. When people commit crimes, they should be punished, regardless of whether their collars are white or blue. Moreover, crimes committed by white collar criminals out of a studied calculation of likely costs and benefits of engaging in the criminal behavior perhaps are especially reprehensible.

Third, I am not squeamish about the fact that the criminal process often, and quite appropriately, presents defendants and prospective defendants with choices between unpalatable alternatives. That is what happens whenever a criminal defendant accepts a plea bargain, and plea bargaining is not the only circumstance in which it occurs. But it is important to recognize that corporations and other business organizations are different than individuals and that the difference is relevant to the extent to which they should be treated in exactly the same way.

Although corporations are regarded by the law as persons, they are not persons in the same sense as those of us who live and breathe. They are collections of individuals and, often, other organizations that are bound together by complex webs of contracts and legal rights and duties. At a minimum, these collections include stockholders, directors, officers, and employees.

One consequence of this difference between corporations and individuals is that a criminal conviction of a corporation does not punish the wrongdoers. It punishes the stockholders and, in some cases, other corporate constituents. These groups bear the consequences regardless of whether they have any culpability. You don't have to look any further than the thousands of innocent former partners and employees of Arthur Andersen to see what I mean. But there are other, perhaps less obvious, examples. In the Adelphia scandal, to mention one, the bankrupt company, as part of a deal to avoid indictment, agreed to pay \$715 million to a government-established restitution fund. This deprived the bankruptcy estate of a vast sum that otherwise would have been distributed in accordance with the priorities applicable in bankruptcy. Some creditors were disadvantaged for the benefit of ultimate beneficiaries of the government's fund. While there was no error in the bankruptcy court's approval of the settlement with the government,<sup>5</sup> the case illustrates the point that criminal prosecutions of corporations may injure innocent constituencies even more remote than stockholders and employees.

I do not question the application of conventional agency principles in the civil context. When the constituents of a corporation or business entity join together in a collective effort to make a profit, it seems entirely fair to require that the entity compensate anyone whom its actions injure,

<sup>4</sup> N.Y. Central and Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909).

<sup>5</sup> Ad Hoc Adelphia Trade Claims Comm. v. Adelphia Commc'ns Corp., 337 B.R. 475 (S.D.N.Y.), *appeal dismissed as moot sub nom. In re Adelphia Commc'ns Corp.*, Nos. 06-1417-BK, 06-1738-BK, 2006 WL 3826700 (2d Cir. Dec. 26, 2006).

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just as it is entirely fair to require that the entity pay its debts. Such compensation is a part of the collective enterprise.

The criminal side may, and I emphasize the word “may,” be different. Most say that the criminal law serves a number of purposes. Criminal convictions afford an institutionalized means of exacting retribution. The punishment deters others from engaging in similar offenses. In some cases, as where an individual is imprisoned, it disables the offender from committing other crimes. So let us consider corporate criminal liability in terms of these purposes.

The first question is whether convicting corporations of crimes serves the purpose of institutionalizing vengeance. Certainly one can understand that punishing living and breathing criminals for their misdeeds satisfies the basic human desire to see the guilty pay for their crimes. Indeed, criminal law developed in part to avoid private vengeance by satisfying that desire. But that doesn’t seem to be much of a concern where the offender is a legal entity that is a “person” only in a metaphorical sense. And I wonder whether people who are victims of crimes committed by agents of a corporation feel better when the corporation is convicted of a crime than they would feel if the guilty individuals alone were convicted.

The case for corporate criminal liability appears differently when viewed from the standpoint of general deterrence. The empirical question is whether a board of directors or corporate managers would be more likely to ensure that subordinates conduct themselves in accordance with law if the company were subject to criminal conviction than they would be if the company could not be prosecuted criminally. It is an interesting question to which I do not pretend to have the answer. There is an arguable case, however, for the proposition that corporate criminal liability may have a deterrent effect on other companies, but I’m not sure it is something that is so obvious as to be taken on faith.

Specific deterrence is yet another matter. I wonder whether convicting a corporation of a crime has much effect, one way or the other, on the question whether it will engage in wrongdoing in the future unless, of course, the effect is to put it out of business. Certainly conviction of corporate agents who committed the wrongdoing would take them out of the picture quite effectively regardless of whether the corporation is prosecuted.

These are only some of the relevant considerations, and I quickly concede that I have only scratched the surface of a very complicated subject. I confess also that I do not have a view as to whether any change in the current state of the law would be advisable. I do suggest, however, that this is an appropriate subject for consideration, particularly in light of the devastating consequences of potential criminal liability that we first have seen only recently. ●

# Paper Trail: Working Papers and Recent Scholarship

**Editor's Note:** In this edition, we look at a very recent paper by Herbert Hovenkamp that analyzes the differences between the U.S. and EC standards governing dominant firm conduct. Send your comments and suggestions for papers to review to: [page@law.ufl.edu](mailto:page@law.ufl.edu) or [jwoodbury@crai.com](mailto:jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

## Recent Papers

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**Herbert Hovenkamp, The Legal Periphery of Dominant Firm Conduct (U. Iowa Legal Studies Research Paper No. 07-21, Sept. 1, 2007), <http://ssrn.com/abstract=1014426>**

In this paper, Herbert Hovenkamp explores two areas of potential liability for single-firm exclusionary conduct—attempts to monopolize and “leverage” of monopoly power from one market to another. He characterizes these grounds of liability as “peripheral” to the core focus of the law on dominant firms’ actions that maintain existing monopoly power within a single market. Because these areas pose more than the usual number of textual and theoretical challenges for plaintiffs, however, they provide a useful basis on which to compare and contrast the approaches of European and American law to single-firm conduct.

Hovenkamp begins by observing, as the Supreme Court did in *Copperweld*,<sup>1</sup> that single-firm conduct is generally less suspicious than concerted conduct. One “needs a great deal of theory and analysis to identify the circumstances under which [unilateral] practices are anticompetitive, with the knowledge that they very likely are anticompetitive in only a small proportion of cases.” (p.2) Of that small proportion, most cases will involve dominant firm conduct that harms rivals in the same market in which the firm has monopoly power. Only a fraction of anticompetitive cases will involve “peripheral” grounds, either an attempt to monopolize a market in which the defendant does not yet have monopoly power or an effort to leverage existing monopoly power into an adjacent competitive market. Yet these latter grounds for liability, Hovenkamp notes, are of growing importance as firms expand into multiple markets in the global economy.

**Attempts.** Hovenkamp points out that Section 2 of the Sherman Act specifically prohibits both monopolization and attempts to monopolize while Article 82 of the EC Treaty condemns only abuse of a dominant position, without separately proscribing attempted abuse. Hovenkamp traces the American attempt offense to Section 2’s origins as a criminal statute. He also suggests that U.S. law proscribes attempts because of its preference for preserving competitive market structures rather than regulating noncompetitive ones. Punishing attempts to monopolize may prevent the creation of a dominant position that would require more supervision. European law, by contrast, may be more content to regulate dominant positions when they emerge. EC law, for example, regulates excessive pricing, while U.S. law recognizes that a firm has a right to charge what the traffic will bear.

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<sup>1</sup> *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 767–69 (1984).

That said, however, Hovenkamp concludes that, in practice, the attempt offense does not significantly distinguish U.S. from EC law. At one time, some lower federal courts had endorsed the Ninth Circuit's holding in *Lessig*<sup>2</sup> that a plaintiff could establish an illegal attempt by showing that the defendant had a specific intent to monopolize, even if the plaintiff failed to show that the defendant had an objective probability of achieving a monopoly. In *Spectrum Sports*,<sup>3</sup> however, the Supreme Court made clear that the attempt offense requires the plaintiff to prove that the defendant's actions have a dangerous probability of success. In practice, this element requires proof that the defendant has a market share within striking distance of monopoly. Hovenkamp argues, however, that this requirement is not that far from EC law, which treats market shares of 40 percent or even lower as "dominant." Under EC law, a firm with a 50 percent share could face liability for abuse, even if its conduct only *maintained* that share; under U.S. law, in contrast, a 50 percent firm would be liable for attempt to monopolize only if its conduct threatened substantially to *increase* its share. Both systems, however, recognize that lower market shares make some conduct, like predatory pricing, less likely to be successful.

**Leveraging.** Hovenkamp then turns to the issue of "leveraging" monopoly power in one market in order to gain an advantage in another market. He first notes that the language of Article 82 seems more naturally to encompass such an offense. Section 2 prohibits only some form of "monopolization," a word that does not easily cover acts that merely confer a competitive advantage. Moreover, recent Supreme Court decisions, such as *Spectrum Sports* and *Trinko*,<sup>4</sup> have confirmed that, to establish a leveraging claim, a plaintiff must prove a dangerous probability of monopolizing the second market. Article 82, on the other hand, proscribes "abuse" of dominance, a word that could plausibly encompass many actions far short of monopolization, including leveraging. Hovenkamp illustrates this distinction with a hypothetical based on the EC and U.S. *Microsoft* cases:

Suppose that at one point in history there was a highly competitive market for computer solitaire games, which people could purchase and install on their computers. Now Microsoft, with a near monopoly in its Windows operating system, incorporates a pretty good solitaire game into the program and includes it in the price. So now everyone who purchases a copy of Windows, whether standalone or as part of a computer system, obtains a copy of MS solitaire. If solitaire games were perfectly fungible Microsoft would wipe out the independent market for solitaire games. However, there is in fact considerable product differentiation among solitaire games. As a result, Microsoft's bundling cuts the volume of solitaire games sold by perhaps 40% or even more, but firms do keep on selling them. (p.14)

Hovenkamp suggests that, "if Microsoft accomplished this bundling by means of a contract it would very likely be actionable tying under U.S. law" (*id.*) as an illegal tying arrangement under Section 1 of the Sherman Act but "if Microsoft accomplishes its solitaire bundling simply by including that game's code within the code for the Windows operating system, then U.S. law treats the conduct as unilateral" (pp. 14–15) and the plaintiff would have to prove monopoly maintenance in the operating system market or a dangerous probability of monopolization of the game market. Hovenkamp suggests that EC law would require a "lesser showing" of an effect on the solitaire market to establish that the technological bundle violated Article 82. This difference, he reasons, "explains the differing approaches in the U.S. and EU actions against Microsoft." (p.15) The EC

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<sup>2</sup> *Lessig v. Tidewater Oil Co.*, 327 F.2d 459 (9th Cir. 1964).

<sup>3</sup> *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 459–60 (1993).

<sup>4</sup> *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 415 n.4 (2004).

focused on effects of Microsoft's bundling on the media player market, while the U.S. case focused on effects in the operating system market, particularly its role in preventing the browser from evolving into a rival platform.<sup>5</sup>

Hovenkamp goes on to suggest that U.S. antitrust law has been "overly aggressive" (p.17) in condemning leverage in the context of tying but incongruously less so in cases that cannot easily be characterized as ties. He also notes, however, that "antitrust policy in the United States over the last three decades has been heavily influenced by the Chicago School critique of the 'classical' leverage theory." (p.18) The classical theory was that a firm could earn two monopoly profits by tying the sale of a monopolized good to the sale of a complementary good that is sold in a competitive market. Chicago analysts showed, however, that, where the goods are used in fixed proportions, the monopolist could fully exploit its monopoly without the tie. It *could* monopolize the tied product market, but it had no real incentive to do so. This result makes leveraging claims less plausible.

Hovenkamp correctly notes, however, that later theories have shown that the Chicago critique was overstated, and that, in narrowly defined circumstances, a monopolist could use tying for various monopolistic ends. Hovenkamp again cites *Microsoft*, whose

bundling of Internet Explorer with Windows was manifestly not a mechanism by which Microsoft hoped to earn two monopoly profits, one on Windows and one on Internet Explorer. Rather, it was a way of ensuring that the platform market would not become competitive as technology permitted an evolution toward web-based rather than workstation-based programs and multi-platform communications capabilities that threatened to make Windows won among many platforms. (p.19)<sup>6</sup>

Hovenkamp concludes that, while there are some linguistic differences between the U.S. and EC standards governing dominant firm conduct, those differences are less important in practice than they might appear. We may have occasion to revisit this conclusion in the wake of the decision of the European Court of First Instance in the European *Microsoft* case. ●

—WHP

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<sup>5</sup> Hovenkamp's discussion of this hypothetical is somewhat confusing. The government in the U.S. case alleged that Microsoft's bundling of the browser with Windows constituted both monopolization of the operating system market in violation of Section 2 and tying in violation of Section 1. Judge Jackson held the tie illegal under the per se rule, but the D.C. Circuit reversed on this issue, holding that, at least in a case involving integration of platform software, a rule of reason analysis was more appropriate. *United States v. Microsoft Corp.*, 253 F.3d 34, 84–95 (D.C. Cir. 2001). (As a Catch-22, the court of appeals required the government on remand of the Section 1 claim to prove an anti-competitive effect in the browser market but forbade the government from proving that a browser market exists. *Id.* at 95. The government, not surprisingly, dropped the tying claim after remand.) But the court of appeals did *not* hold that Section 1 was inapplicable simply because the tie was accomplished by technological bundling. After all, even technological tying involves a contract. Thus, in Hovenkamp's hypothetical, the solitaire bundling would certainly constitute a tie of separate products under Section 1. Whether it would fall under the per se rule is less clear, but if it were analyzed under the rule of reason, the issue of legality should not (in principle) differ materially from an analysis under Section 2.

<sup>6</sup> This is an accurate statement of the U.S. government's theory of liability in *Microsoft*, and it won the day. Nevertheless, it is not clear that the theory of liability is supported by a plausible economic theory. The best theory proposed to support the government's case is presented in Dennis W. Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND. J. ECON. 194 (2002). John Lopatka and I suggest that the theory's conditions are not satisfied by the findings in the government case. See WILLIAM H. PAGE & JOHN LOPATKA, *THE MICROSOFT CASE: ANTITRUST, HIGH TECHNOLOGY, AND CONSUMER WELFARE* 156–62 (2007).

## Book Review

# Core Topics in Competition Economics

Michael D. Whinston

**Lectures on Antitrust Economics**

MIT Press • 2006

### Reviewed by Tasneem Chipty

Michael Whinston is the Robert E. and Emily H. King Professor of Business Institutions in the economics department at Northwestern University and is a prolific writer on a broad range of topics in industrial organization. In his book, *Lectures on Antitrust Economics*, Professor Whinston presents a lucid discussion of several core topics in competition economics: price fixing, horizontal mergers, and exclusionary behavior. The book synthesizes a number of theoretical and empirical papers, and includes a historical overview of the intellectual debate on each topic. It provides a coherent summary of important concepts, modeling techniques, and empirical strategies available to students of antitrust economics. Professor Whinston is careful to close each topic with a discussion of the strengths and weaknesses of the state of the literature. In a number of places, he identifies areas ripe for research and recommends areas that are worth pursuing.

The book would make a worthwhile read for both antitrust consulting economists and antitrust attorneys. The reader should note that the tone of the book is somewhat mixed—ranging from casual to technical (with equations and first order conditions to motivate various results). In addition, Whinston assumes familiarity with various analytical tools, including interpreting regression results and setting up and solving basic theoretical models. However, the depth of the discussion and the insights offered along the way will make this book worthwhile for even the less technically proficient reader.

Chapter 1 presents an overview of U.S. antitrust policy. Whinston begins with a description of the federal antitrust laws and the motivation behind the laws—i.e., the tension between the total surplus standard and the consumer surplus standard. He talks about the need for courts to interpret the provisions of the laws and the differences between rule of reason and per se standards. He also talks about the three sanctions available as remedies: criminal penalties, equitable relief (requiring cessation of the bad act), and monetary damages. Missing from this discussion, at least explicitly, is the notion that the antitrust laws are intended to police abuse of market power, though there is nothing wrong with a firm's being big or having market power, at least legitimately acquired market power (e.g., by being more efficient or more innovative). Also missing from the discussion is the notion that market power is necessary but not sufficient to establish antitrust liability and that any action by a firm with market power—whether it is price fixing, a breach of contract, or a creative selling strategy—could, in principle, become the subject of an antitrust inquiry.

Chapter 2 presents a discussion of price fixing—focusing on explicit coordination among firms for the purpose of raising prices. Whinston provides a discussion of the per se treatment of price fixing, explaining that it is “really nothing more than an application of optimal statistical decision making,” (p. 18) intended to minimize the costs of administering antitrust policy. He goes through the theory of price fixing, evidence of the effects of price fixing, and detecting price fixing.

■ **Dr. Tasneem Chipty**, a Vice President at CRA International, is an expert in the area of competition economics and econometrics.

On the theory of price fixing, Professor Whinston describes the coordination problem, some game-theoretic modeling, and a description of some experimental studies. He points out that in many of the models, allowing collusion may actually improve welfare by enhancing productive efficiency. He concludes with the observation that “[i]t is in some sense paradoxical that the least controversial area of antitrust is perhaps the one in which the basis of the policy in economic theory is the weakest.” (p. 26)

On evidence of the effects of price fixing, Professor Whinston looks to the empirical literature to see if there is any evidence that price-fixing enforcement leads to significant reductions in prices. He presents a summary of over ten different empirical papers, along with a discussion about the inherent difficulties in interpreting their results. Taking the results on their face, Professor Whinston concludes that the evidence is “somewhat mixed,” (p. 38) with some studies finding no change in price levels after antitrust prosecution and other studies finding substantial overcharges associated with episodes of price fixing.

On detecting price fixing, Professor Whinston explains that short of direct documentary evidence of meetings to set prices (or even with such documentary evidence), one might turn to two types of evidence: structural evidence and behavior evidence. Structural evidence refers to a consideration of the structural factors that might affect the likelihood that firms in the industry engage in price fixing. These include things like the level of concentration in the industry, the observability of firms’ prices, the lumpiness of demand, and capacity levels—all of which affect the potential benefits and expected costs associated with collusion. In this context, Professor Whinston describes the seminal 1974 work of George Hay and Daniel Kelley, discussing various structural factors and their relative importance in sixty-two price-fixing cases brought by the Department of Justice from 1963 to 1972. Behavioral evidence refers to studies of actual practices to determine whether they are more likely to have been generated from collusive or competitive behavior. These efforts, as Professor Whinston rightly explains, are very difficult, and fraught with issues of interpretation.

Professor Whinston ends his discussion of price fixing with a consideration of tacit collusion, in which he revisits an old policy question of whether an express agreement should be required in order for firms to be found guilty of a Sherman Act violation. Here, he explains the inherent limitations in accurately detecting episodes of tacit collusion, as well as the dangers of pursuing strong structural remedies or monetary penalties in cases involving allegations of tacit collusion. In particular, Whinston notes that sanctions may have an effect on ex ante incentives, whereby firms shy away from cost reductions or product innovations that may result in higher profit margins.

Chapter 3 presents a discussion of horizontal mergers. Professor Whinston provides a thoughtful overview of both the theoretical and empirical literature evaluating the effects of mergers as well as the techniques available for analysis. The theoretical discussion includes a description of the “Williamson Trade-Off,” which was one of the first insights (even though not quite right, as explained by Professor Whinston) stressing the importance of evaluating the efficiency effects of mergers. He describes at some length Joseph Farrell and Carl Shapiro’s model of mergers in the context of Cournot competition. He then catalogs a host of important issues that need to be considered in any responsible merger analysis, including: that firms engage in dynamic, not static, decision making; whether the good in question is a durable or non-durable; the effects of entry; and the role of multi-market contact.

Professor Whinston then turns to the U.S. Merger Guidelines and presents a discussion of market definition and consideration of other market factors, including substitution patterns within the market, substitution patterns between products in and out of the market, capacity limitations, ease

of entry, and procompetitive justifications. While he does not say so explicitly, some of his discussion suggests correctly that the definition of the market need not be hard and fast—that it should serve more as a guide. He notes, for example, that consideration of the substitution patterns between products in and out of the market is itself one way of “softening the edges of the previous determination of the relevant market.” (p. 82) Missing from this discussion is that the concept of market definition and the associated techniques can also provide guidance in evaluating whether firm behavior (such as exclusive dealing) could be a violation of the antitrust laws, apart from evaluating the antitrust risk associated with a particular merger.

In the next section, Professor Whinston provides a thoughtful overview of the empirical methods that have been used to define markets and to evaluate both the potential and actual effects of mergers. This overview includes discussion of demand estimation, issues of instrumentation, multistage budgeting, evidence of the effect of increasing concentration on prices, merger simulation (given information about demand and cost functions), residual demand estimation, event study approaches, and studying the effects of mergers after the fact (prices, efficiencies). For each of these topics, Whinston provides practical guidance on market definition, a discussion of associated empirical studies, and insightful commentary on the relative advantages and disadvantages of each of those studies. He does not discuss the empirical approach of bid analysis, which is an analysis of company bid data that shows when, where, and how often merging parties compete directly with each other. This type of analysis has been used successfully in a handful of recent mergers in both the United States and the European Union.<sup>1</sup>

Chapter 4 presents a discussion of exclusionary contracts. The discussion is one of the most understandable and comprehensive theoretical discussions I have ever seen on the strategic use and value of exclusive contracts. Professor Whinston begins with a discussion of the original Chicago view that engaging in exclusive contracts cannot be a profitable strategy. He then turns to a class of richer models that show that reasonable variations of the Chicago model can make exclusive contracts a profitable strategy for excluding rivals. Students of economics will find that the model designs used by Professor Whinston, which allow him to focus on a particular dimension of the problem, are themselves pedagogically useful. However, this discussion is also more technically demanding; while the motivation and conclusions are just as straightforward as in the rest of the book, the analytical arguments are harder to follow. Finally, Whinston describes the various procompetitive justifications for exclusive contracts, chief among which is the protection of investments. In contrast to his discussion of horizontal issues, Whinston is silent on practical guidance for antitrust strategy. ●

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<sup>1</sup> See, e.g., Case No. COMP/M.4214, Alcatel/Lucent Technologies (July 24, 2006), available at [http://ec.europa.eu/comm/competition/mergers/cases/decisions/m4214\\_20060724\\_20310\\_en.pdf](http://ec.europa.eu/comm/competition/mergers/cases/decisions/m4214_20060724_20310_en.pdf); Case No. COMP/M.4003, Ericsson/Marconi (Dec. 20, 2005), available at [http://ec.europa.eu/comm/competition/mergers/cases/decisions/m4003\\_20051220\\_20310\\_en.pdf](http://ec.europa.eu/comm/competition/mergers/cases/decisions/m4003_20051220_20310_en.pdf).