

My Summer Vacation at the European Commission

Jonathan B. Baker

Among the more than 100 jurisdictions with active competition policy regimes today, the United States has the distinction of starting first, creating the most extensive set of judicial precedents, and possessing the largest and most experienced enforcement institutions. Antitrust institutions in the United States have long stood at the summit on any scale of international prestige and influence in the competition policy field. Yet any such ranking would also undoubtedly indicate that during the last decade or so, the antitrust institutions of the European Union have grown in size and sophistication to the point where they are comparably respected and as influential as their U.S. counterparts. In recent years, as competition policy has spread throughout the world, nations newly adopting antitrust enforcement have been more likely to emulate Europe than the United States.

I had an unusual opportunity to observe antitrust enforcement in this other leading jurisdiction during the past summer when I was invited to visit the major European competition policy agency, the Competition Directorate of the European Commission (DG-Comp), in Brussels. My frame of reference comes largely from my past positions at the two federal antitrust agencies in the United States, the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice (DOJ). I was not at DG-Comp for long, and only had a chance to follow directly a small fraction of agency activity, focusing on merger review and guidelines drafting. But I also spoke with many people holding a wide range of positions throughout the organization and with a number of outside lawyers who practice before DG-Comp. My primary interest was the role of economic analysis in merger review.

At DG-Comp, I saw much that I recognized from my U.S. enforcement experience. The agency has a large and energetic professional staff. The members of the staff are bright and hardworking, with high morale. A decision-making meeting among senior officials reminded me in some respects of a meeting of the FTC. EU Commissioner Neelie Kroes, the political official in sole charge of DG-Comp, was joined at the conference table by senior agency administrators (the rough equivalents of the Director, Deputy Director, and Associate Director of the FTC's Bureau of Competition), the case or project team, personal advisors in her Cabinet (something like an FTC Commissioner's attorney advisors, but with greater line authority), a representative of the European Commission's Legal Service (who played a role resembling that of the FTC's General Counsel) and the Chief Economist (roughly comparable to the Director of the FTC's Bureau of Economics). In one non-case policy discussion, the Commissioner and her advisors paid attention to protecting collegial relations with the Commissioners in charge of other Directorates in a manner that reminded me not so much of the FTC, but more of the way senior officials in White House agencies like the Council of Economic Advisers, where I once worked, prepare for interagency working group meetings.

■ **Jonathan B. Baker** is Professor of Law, Washington College of Law, American University. He is indebted to Svend Albaek, Andrew Gavil, Randolph Tritell, and Stephen A. Ryan for comments.

Merger Enforcement

I was particularly interested in comparing merger enforcement at DG-Comp with what I recall from my service at the FTC and DOJ. As in the United States, merger investigations at DG-Comp focus on the welfare of consumers, and economic analysis is taken seriously. The European equivalent of the U.S. Horizontal Merger Guidelines sets forth a careful, economic approach to merger analysis that closely resembles the U.S. approach. In both jurisdictions, the merger guidelines help agency staff frame their investigations and help the merging parties shape their submissions. On the whole, DG-Comp undertakes merger review in a way that is comparable to how the U.S. enforcement agencies operate.

Yet differences in the outcome of merger reviews across the jurisdictions have been a particular focus of recent controversy. In 1997, while I was Director of the FTC's Bureau of Economics, the FTC declined to challenge Boeing's acquisition of rival aircraft manufacturer McDonnell Douglas, while the European Commission allowed the same transaction to proceed only on condition that Boeing modify long-term exclusive contracts with three major airlines.

That merger review was conducted against the backdrop of a highly politicized competition for customers between Boeing, a U.S. firm, and Airbus, a European manufacturer, in the commercial aircraft market. The differences in outcome between the two regimes in that case may plausibly be explained by the subtle distinction between lessening of competition (the concern under U.S. law) and abuse of a dominant position (then the concern in merger review under EU law), combined with greater worry in Europe about the harmful potential of exclusionary vertical practices. Some commentators nevertheless cynically suggested that the competition authorities in the two jurisdictions were each protecting the interests of their national champion, a consideration that I do not ever recall being discussed in antitrust decision making during my governmental experience.

A more consequential spat arose in 2001, when the European Commission opposed General Electric's acquisition of Honeywell shortly after the same transaction had been cleared in the United States by the DOJ. With remarkable frankness, senior U.S. antitrust officials publicly questioned whether the competitive effects theory relied upon by DG-Comp in that case made economic sense. Critics also suggested that the European competition policy system is too solicitous to the concerns of complaining rivals at the expense of protecting customers and consumers, insufficiently attentive to procompetitive efficiencies, and too willing to pursue industrial policy goals rather than trusting that market outcomes will promote social welfare. European and U.S. competition law and enforcement policy also differ to some extent outside the merger area, particularly with respect to the evaluation of exclusionary conduct allegations involving vertical agreements or the practices of dominant firms. In these areas, U.S. courts and enforcers appear generally less inclined to challenge such conduct as anticompetitive and more inclined to credit efficiency justifications than are their European counterparts.

Many U.S. commentators historically preferred the U.S. enforcement system and its outcomes to what they saw in the EU. In their view, the United States was more committed to basing enforcement decisions on the economic analysis of a merger's effects and more skeptical about the validity of complaints by rivals. Whatever the merits of such concerns in the past, any such differences are disappearing in merger analysis today. In both jurisdictions, the focus of merger analysis is now squarely on identifying harm to consumers. In 2004, Europe adopted a new merger regulation that prohibited mergers creating a significant impediment to effective competition,¹

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¹ Council Regulation (EC) No. 139/2004 of 20 January 2004 on the Control of Concentrations Between Undertakings, 2004 O.J. (L 24) 1 (EC Merger Regulation).

a standard similar to the substantial lessening of competition test employed in U.S. law. The preamble to the regulation, which noted the procompetitive potential of efficiencies from merger, decisively rejected an older view that efficiencies could harm competition, much as modern merger rulings by U.S. appellate courts have not followed U.S. Supreme Court precedents from the 1960s that could similarly be read to treat efficiencies from merger as an offense, not a defense. The new merger regulation has conferred legitimacy on the modern emphasis at DG-Comp on reviewing transactions for their effects, not their form, focusing on developing a coherent economic theory of the case, and treating efficiencies as a defense.

The new merger regulation followed several reforms in the bureaucratic structure of DG-Comp, including the appointment of a Chief Competition Economist and the establishment of an internal scrutiny panel to provide peer review in major cases. In addition, the Merger Task Force was formally disbanded, with merger review staff allocated to units within divisions assigned to broad industry sectors, although the merger units also continue to work together under the supervision of the Deputy Director-General for Mergers through what is called the Merger Network.

The enforcement culture in Europe has changed as well. The one time I observed internal advocacy of an efficiency offense at DG-Comp, it came from outside the Merger Network, and the merger staff on the case recoiled in horror. Moreover, the Chief Economist has already established himself as a significant player in agency deliberations. His team is staffed by serious and talented Ph.D economists, and it operates like a nascent Economic Analysis Group (at the DOJ Antitrust Division) or Bureau of Economics (at the FTC). But the Chief Economist's team will probably need to triple in size before it can systematically play a role comparable to what agency economics groups do in the United States. (Other good economists with doctoral degrees work at DG-Comp, but their position outside an economics group, reporting to non-economists, likely reduces their effectiveness in making economic arguments. Other DG-Comp staffers have some economics training and an economic orientation, much like some attorneys in the U.S. agencies, but they seem more effective in advancing economic thinking when their ideas are validated by the economics group.)

Alternative Enforcement Models

The most important difference between the enforcement agencies is not in their relative commitment to economic analysis but in the institutional demands of their respective legal systems. Antitrust enforcement in the United States is built upon an adversarial model. At the end of the process, if the agency has concerns about a merger or other firm conduct that the firms involved dispute, the agency cannot insist upon its view without proving the likelihood of harm to competition to a district court judge (or to the Commissioners of the FTC acting as though they were a district court). As a result, the conversation in the agencies, law firms, and courts about firm conduct routinely centers around the development of, and comparison between, two competing stories: a "bad-guy" story of why the practice or transaction might harm competition and a "good-guy" story about why it might enhance competition or create efficiencies.

This comparison between theories can be implicit, existing unarticulated in the minds of investigators, or it can become an explicit contest, as when litigation arises. Advocates for firms under investigation use White Papers and presentations to promote a procompetitive story and undermine anticompetitive alternatives. Agency investigators, working with facts unavailable to the firms, refine both stories, and at times come up with better procompetitive theories than those of the outside advocates. The availability of alternative theories helps shape the development of evidence at the U.S. agencies—even when the prospects of litigation are remote, as in most merg-

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er reviews, by focusing attention on the possible facts that would discriminate between the pro-competitive and anticompetitive interpretations.

Antitrust enforcement in the European Union is not based on an adversarial model but is built instead upon an administrative model, more consistent with the civil law tradition of continental Europe. DG-Comp investigates and enforces as a neutral expert body, acting in U.S. terms both as prosecutor and judge. Particularly when undertaking a sectoral inquiry or enforcing the European prohibition on the abuse of a dominant position, the agency may tend to view itself as having an ongoing regulatory relationship with industry—not as a price regulator, but as a watchdog over market structure and competitor access to networks, inputs, and customers. Under such circumstances, only one story would naturally be on the table in the minds of investigators: an anti-competitive theory, to be proved or disproved. Agency investigation would focus on assembling and evaluating the elements of this theory. Consistent with this view, internal advocacy of an alternative theory seemed counter to the DG-Comp culture in the merger investigations I observed. Some alternative theory may (perhaps must) lurk in the background, but the focus of the internal conversation—even early in a merger investigation, before tentative conclusions had been reached—was on refining and evaluating the bad-guy story, not on testing it against a good-guy story.

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The European approach has a number of advantages. European antitrust institutions may provide more guidance to firms seeking to comply with the antitrust laws than do their U.S. counterparts. A single enforcement agency led largely by career officials can perhaps establish and adhere to precedents more readily than occurs in the decentralized U.S. system of multiple enforcers and multiple courts (notwithstanding that the concept of establishing and following precedent is not central to civil law). Moreover, an agency that does not expect to prove its case in an adversarial judicial proceeding can afford to be more transparent than one always conscious of protecting its legal position. In the merger context, transparency in the European Union is abetted by the requirement that DG-Comp affirmatively decide the case one way or the other and publish its findings and reasons and by the requirement that European enforcers provide the merging parties with a written statement of objections, laying out their preliminary concerns, with time to permit the parties to reply before a final decision is made. By contrast, the U.S. agencies need only explain their decisions when they choose to challenge a case, and in the United States, a decision not to prosecute is left to agency discretion and is not appealable. In addition, enforcement agency culture differs as to internal transparency between the European Union and the United States. The DG-Comp leadership routinely shares with its staff more information about management issues and the decision-making process in individual cases handled by other teams than is shared by its U.S. counterparts.

On the other hand, the adversarial model likely encourages developing and testing of evidence in a way that the administrative model does not. A case team at a U.S. enforcement agency envisioning the possibility of merger litigation is forced to focus on developing admissible evidence and probing for infirmities in the evidence supporting both the good-guy and bad-guy story that could be exposed during cross-examination. The agency will assemble documents, data, and testimony, and likely integrate that evidence through the testimony of an expert economist, who will be subject to cross-examination by the merging parties and scrutiny by the judge. A U.S. case team knows that it will bear the burden of proof in court and that it must establish anticompetitive effects by a preponderance of the evidence. Consequently, documentary requests are extensive. Documents are not simply read; their interpretation is confirmed through deposition testimony. Affidavits are not taken at face value. All too often, experienced agency staff have observed that

in affidavit wars—the occasional back and forth in which agency staff and the parties develop competing affidavits from witnesses at the same firm (or even from the same witness)—statements that initially seem clear become qualified to the point where they say nothing or come close to supporting the opposite position. When econometric evidence is important, the construction of data sets is reviewed in detail and the conclusions derived from data analyses are thoroughly tested for robustness. Even in the common situation in which the prospects of litigation are remote, investigative teams with litigation experience cannot help but think about evidence in this way, though they do not pursue testing of evidence with the same intensity as they employ when a court date is on the horizon.

A case team at DG-Comp also interviews witnesses and reviews documents and data. However, relatively more of the record in Europe comes from responses to questionnaires sent to the merging firms, rivals, and customers—sources closer to affidavits than depositions when translated into U.S. terms. My impression is that DG-Comp case teams do not feel subject to the same pressure to test and support their conclusions as do their U.S. counterparts, and may not go to the same lengths in uncovering and analyzing evidence. A flurry of decisions of Europe's Court of First Instance (CFI) during 2002 criticized DG-Comp conclusions in merger investigations as insufficiently grounded in an evidentiary record, putting pressure on the European agency to review its approach to issues of proof.² (The CFI undertakes the initial review when European Commission decisions are challenged; ultimate review is by the European Court of Justice.) Although these decisions have increased the care with which evidence is discussed while decisions are drafted, they do not appear to have altered fundamentally how case teams uncover and evaluate evidence.

Suggestions for the U.S. Agencies

The powerful incentives for developing and testing evidence created by the adversarial approach of the United States may at times lead to wasted resources. The extensive evidentiary production in the typical second request, supplied by the merging parties at great expense and substantial loss of executive time, is largely chaff and not wheat. Certainly, in retrospect, much appears wasted. But whether it is possible to screen out the valuable nuggets and leave behind less valuable material without first creating a large evidentiary production for agency sifting is far from clear, and is the subject of ongoing conversations between the enforcement agencies and the defense bar. In addition, much of the massive effort involved in trial preparation on both sides of the case has little social value, notwithstanding its litigation benefit to the parties.

DG-Comp's experience with evaluating mergers using the responses to questionnaires suggests a model that the U.S. enforcement agencies could test for reaching decisions with less burden to the parties after a second request has been issued. The agencies might experiment with encouraging merging firms initially to answer only a set of interrogatories (along with any other voluntary production the firms wish to supply). The agency could make a commitment to decide within a short period following receipt of those answers whether to close the investigation or to insist upon full compliance with the second request. Based on the DG-Comp experience, it may turn out that a significant fraction of investigations can be closed based on such limited information.

² *Airtours plc v. Commission*, [2002] E.C.R. II-2585 (Ct. First Instance 2002); *Cases T-310/01 & T-77/02, Schneider Elec. SA v. Commission*, [2002] E.C.R. II-4071 (Ct. First Instance 2002); *Tetra Laval BV v. Commission*, [2002] E.C.R. II-4381 (Ct. First Instance 2002), *aff'd*, *Cases C-12/03 P & C-13/03 P* (Eur. Ct. Justice Feb. 15, 2005), available at <http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:62003J0013:EN:HTML>.

The adversarial process also demands and, at times, creates advocates at all stages of the process and potentially among all participants. Once open-minded investigators shift in their minds to partisan advocacy, they may harden their position and lose their detachment, making it in some respects more difficult for decision makers to have a clear view of the facts and issues. By contrast, the administrative approach may encourage a more open-minded investigation throughout the process. This problem is mitigated in the U.S. agencies to some extent by the presence of multiple layers of review, which brings in new, dispassionate analysts at later stages of the investigation. The European example suggests the importance of protecting the bureaucratic independence of evaluation committees in the U.S. enforcement agencies.

Suggestions for DG-Comp

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My suspicion, based on limited observations, is that DG-Comp could benefit from increasing its effort to develop and test evidence. One possibility for encouraging this result in the merger area would be to introduce more adversarial elements into the review process. There has long been one such element: the ability of merging firms, along with the parties to potentially adverse decisions involving agreements or monopolization, to obtain a hearing at DG-Comp. Recently, however, some merging firms have declined to seek such a hearing, apparently on the view that hearings may benefit third-party complainants more than the merging parties. The reforms of the past few years—particularly the creation of the Chief Economist's role and team and the introduction of internal scrutiny panels—have also added some adversarial aspects to the administrative process. But further steps could be taken.

DG-Comp could push its internal process even more in an adversarial direction by creating in every serious (Phase II) merger investigation a small advocacy team charged with both laying out the evidence in support of a procompetitive interpretation of firm conduct and highlighting where the evidence supporting the anticompetitive theory is weak. The internal scrutiny panel, as part of its own case review, could then hold what would amount to an oral argument between the case team and the internal advocates for the merger, without witnesses, but emphasizing reference to the material in the case file, in order to sharpen the internal focus on collecting and testing evidence.

In the European system, this kind of informal mini-trial would more appropriately be held within DG-Comp than left for judicial review at the Court of First Instance. Notwithstanding the agency's recent court losses, it is hard to see how external judicial review could systematically test DG-Comp's evidence given the way the European system is now set up. Unlike a U.S. District Court, the Court of First Instance has no serious institutional capability to collect or test evidence beyond review of the file developed by DG-Comp. The European court's rules do not allow for discovery, rulings on admissibility of evidence, cross examination, or the like. When translated into U.S. terms, judicial review in the European Union appears to be closer to appellate review than to district court review. Even in its recent decisions critical of DG-Comp, the Court of First Instance at least arguably seems to be acting within the range of what U.S. appeals courts do when they review facts under a clearly erroneous standard while undertaking de novo review of the law. Although, the CFI's Chief Judge has called for a more robust review of the facts in his court,³ it is hard to see how this system could evolve into U.S.-style judicial review without fundamentally changing its character.

³ Bo Vesterdorf, *Standard of Proof in Merger Cases: Reflections in the Light of Recent Case Law of the Community Courts*, 1 EUR. COMP. J. 3 (2005).

In theory, DG-Comp could also encourage itself to devote greater attention to evidence by empowering the merging parties to do more to challenge the agency's theory and frame an alternative during the merger review process. One possibility relates to procompetitive benefits. The parties to any merger likely to draw scrutiny in the United States routinely set forth a procompetitive explanation for their transaction (or at least a competitively benign one like tax savings) at the time of notification—not because they necessarily expect to win on an efficiency defense, but to prevent the agency from inferring an anticompetitive motive from the absence of a rationale and to frame for the agency a good-guy story of the transaction. By contrast, merging parties in the EU appear reluctant to detail any procompetitive benefits they foresee, notwithstanding the requirement on Europe's Form CO (the initial premerger notification filing) that they describe the "economic rationale" for the deal. The merging firms appear to fear that the DG-Comp staff would interpret such a pitch as a signal that the parties view their transaction as potentially raising serious competitive problems absent the efficiencies, and they may also have a lingering concern that efficiencies would be viewed as anticompetitive. This reluctance could perhaps be overcome if the DG-Comp staff would routinely seek clarification when the parties merely cite unspecified synergies or otherwise choose not to explain in more than a cursory manner why their merger is procompetitive or benign.

In addition, the merging parties could be encouraged to challenge DG-Comp's conjectures as to evidence in an early stage, in order to focus the agency on identifying where it needs to develop evidentiary support. DG-Comp already has instituted some institutional mechanisms to promote this end, including a "State of Play" meeting with the merging parties and a procedure for obtaining merging firm comment on key documents obtained from third parties. Still, merging firms appear reluctant to address potential anticompetitive theories before learning what concerns DG-Comp, for fear of directing the agency to competitive concerns that it would not otherwise investigate.

Advice for Merging Firms

How should merging firms and their attorneys and economists navigate within the European system? Notwithstanding the administrative nature of DG-Comp review, outside advocates can help shape the initial expectations of agency staff toward favoring the deal and help support that outcome by supplying evidence to favor a procompetitive theory of the case or undermine an anticompetitive one. Such evidence will get a hearing within an agency increasingly attuned to effects, economics, and efficiencies, and pressured by its reviewing court on evidence.

One practical suggestion is already employed to some extent by outside counsel: on any potentially controversial deal, use Form CO to frame and support an alternative to the anticompetitive story DG-Comp is likely to investigate. The response to the questions in Form CO can be prefaced by a mini-White Paper, laying out an integrated alternative theory of the transaction, providing evidence for it, and referring to later responses to specific questions as appropriate. The merging parties should not hesitate to set forth a procompetitive or benign explanation for the transaction up front, as the benefits from shaping the initial expectations of DG-Comp staff today likely outweigh any lingering concerns that the agency would take the wrong message or identify an efficiency offense. A clear statement of anticipated efficiencies may also discourage the staff from pursuing remedies that would undermine the procompetitive benefits of the deal and make no practical business sense for the parties.

The parties should also seek to undermine an anticompetitive theory early in the investigation by using the answer to Form CO to present evidence on issues that the merging firms must

address or defenses that the agency would expect the firms to be in the best position to address if they were important. Unlike the practice in the United States, merging firms in Europe are required to define the antitrust markets in which they participate. The merging firms should support their market definition with evidence of the likely patterns of buyer substitution that underlies it. To the extent counsel can work with friendly customers in advance to buttress that position, in preparation for customer interviews by DG-Comp staff, that too could be helpful. There is also little downside to the merging parties today in providing evidence in an initial filing as to ease of entry (or repositioning) and efficiencies. These are often areas of inquiry where it would be helpful to counteract the views of complaining rivals.

The more difficult tactical question is how far the merging firms should go initially in addressing possible theories of adverse competitive effect. If an obvious theory that DG-Comp would pursue involves the unilateral effect of loss of localized competition among sellers of differentiated products, that theory should be countered up front because the evidence involved is likely the same buyer substitution considerations as would be adduced in support of the parties' market definition. But the firms may wish to wait before addressing competitive effects theories involving coordination or exclusion until hearing how they are framed by agency staff, to avoid wasting their own effort on theories deemed implausible by enforcers and avoid suggesting avenues of investigation to agency staff. Whether or not competitive effects are addressed early, outside counsel who choose to make economic arguments from the start should work with economists on framing and testing them, much the way DG-Comp increasingly does internally. By making a sophisticated economic argument, the parties can encourage the early and in-depth involvement of the Chief Economist's team in the analysis of their transaction.

This advice is on the whole similar to the way counsel for merging firms deal with the antitrust enforcement agencies in the United States. That should not be a surprise. After all, as European antitrust enforcement has grown in sophistication, its approach to merger analysis has increasingly come to resemble the way mergers are reviewed in the United States. With the growth in cooperation between agencies in the review of transatlantic mergers, and the extensive dialogue among enforcement agencies worldwide through institutions like the International Competition Network (ICN) and the Organization for Economic Cooperation and Development (OECD), this trend toward convergence seems likely to continue. ●

There's No Tying in Baseball: On *Illinois Tool* and the Presumption of Market Power in Patent Tying Cases

Kevin D. McDonald

As is so often the case in life, proper analysis of the issues raised by *Illinois Tool Works v. Independent Ink*,¹ now pending before the Supreme Court, is aided immeasurably by thinking about baseball.

The question presented in *Illinois Tool* is whether, in a claim based on unlawful tying under Section 1 of the Sherman Act, the existence of a patent on the tying product raises a presumption that the patent holder has market power. The facts of the case, moreover, frame that question in historically classical terms: Illinois Tool licenses a patented printhead for applying barcodes to packages as they move on an assembly line. To use the invention, however, the licensee must agree to buy its ink from Illinois Tool as well. In other words, Illinois Tool “ties” the use of the patented invention to the sale of its unpatented ink.² I call this arrangement “historically” classical because the history of tying law has provided many examples of similar ties, in which a machine or other invention (the “tying” product) requiring a staple product as an input (such as ink, or paper, or salt) was sold on condition that the input (the “tied” product) be purchased as well. In fact, the Supreme Court first decided a case in which a patented mimeograph machine was tied to the sale of ink—and found the tie perfectly legal—in 1912.³

It may not surprise you to learn that Illinois Tool’s patented printhead, while undoubtedly a swell invention, is not the only means of affixing a barcode to a box of cereal. Other processes compete directly, and the plaintiff made no effort to plead or prove that Illinois Tool had actual market power in any market for the tying product. Nor will purchasers of ink for designer fountain pens, ink-jet printers, or thousands of other uses be surprised to learn that Illinois Tool’s license requirement has not yet allowed it to corner the market on a staple product like ink. Indeed, these obvious facts led the district court to dismiss all of the plaintiff’s antitrust claims, and they led the Court of Appeals for the Federal Circuit to affirm with respect to the plaintiff’s claim for monopolization under Section 2 of the Sherman Act.

But the Federal Circuit reversed the dismissal of the tying claim under Section 1 of the Sherman Act on the ground that the existence of a patent alone raises a presumption of market power that the patentee has the burden of disproving. The Federal Circuit did not claim that there was any

■ **Kevin D. McDonald** is a partner in Jones Day’s Washington Office. He was the principal author of the ABA’s amicus briefs in *Illinois Tool*, available at www.abanet.org/antitrust under “Recent Comments (and other Reports).” The views stated here are his own.

¹ *Independent Ink, Inc. v. Illinois Tool Works, Inc.*, 396 F.3d 1342 (Fed. Cir. 2005), cert. granted, No. 04-1329 (U.S.).

² I simplify the facts somewhat (e.g., the licensor of the invention is Illinois Tool’s subsidiary, Trident, Inc.) but not in ways important to the question presented in the Supreme Court.

³ *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912).

basis in fact or legal policy for such a presumption—only that the presumption was mandated by prior Supreme Court cases by which it (the Federal Circuit) was bound. It relied, in particular, on the following statement in Justice Goldberg’s opinion for the Court in *United States v. Loew’s Inc.*: “The requisite economic power is presumed when the tying product is patented or copyrighted. *International Salt Co. v. United States*, 332 U.S. 392; *United States v. Paramount Pictures, Inc.*, 334 U.S. 131.”⁴ In light of this pronouncement by the Supreme Court, the Federal Circuit delivered a lecture to the defendants about the limits of appellate power:

Even where a Supreme Court precedent contains many “infirmities” and rests upon “wobbly, moth-eaten foundations,” it remains the “Court’s prerogative alone to overrule one of its precedents. *State Oil Co. v. Khan*, 522 U.S. 3, 20, 118 S. Ct. 275, 284, 139 L.Ed. 2d 199 (1997) We conclude that the Supreme Court has held that there is a presumption of market power in patent tying cases, and we are obliged to follow the Supreme Court’s direction in this respect. The time may have come to abandon the doctrine, but it is up to the Congress or the Supreme Court to make this judgment.⁵

The Federal Circuit did not claim that there was any basis in fact or legal policy for such a presumption—only that the presumption was mandated by prior Supreme Court cases . . .

The citation to *State Oil v. Khan* in that passage is significant because *Khan* was a case in which the Supreme Court did overrule one of its antitrust precedents, and I believe the Federal Circuit was analogizing its position here to that of the Seventh Circuit in *Khan*. In that case, Judge Posner wrote an opinion for the Seventh Circuit bluntly explaining that the Supreme Court’s long-established rule outlawing maximum vertical price fixing (e.g., where a manufacturer tells its distributors they must charge less than a given price) was never justified economically because (among other reasons) low prices are good for consumers. Notwithstanding the lack of support for the rule, however, Judge Posner acknowledged that the Supreme Court’s decision in *Albrecht v. Herald*⁶ clearly made such maximum pricing provisions per se illegal, and (quite correctly) concluded that the circuit court was powerless to hold otherwise until *Albrecht* was overruled. (The Supreme Court promptly granted certiorari in *Khan* and overruled *Albrecht*, relying expressly on, and quoting at extended length from, Judge Posner’s opinion.⁷) Because the Federal Circuit did not actually face Judge Posner’s dilemma of applying a bad rule or disregarding binding precedent, I argue below that any attempted analogy to *Khan* is inapt.

Besides, I have a better one. Baseball, as all antitrust lawyers acknowledge with mild discomfort, is “exempt” from the antitrust laws. Precisely how baseball came to be exempt is a fascinating story in itself—one that I have explored at length elsewhere⁸—and it provides a nearly perfect parallel to the progression that has led at least some courts (e.g., the Federal Circuit here) to apply the presumption of market power to patents.

Both the presumption (of market power) and the exemption (for baseball) evolved to their current state in the law through three essential steps. First, each doctrine traces its roots to an old Supreme Court opinion written by a Justice who, while still revered for his towering intellect, reached a result that seems plainly anachronistic to modern eyes. Second, when each of those cases was revisited by the Court years later, it was, shall we say, “reinterpreted.” That is, the original cases were declared to turn on rationales that neither one even mentioned. (It is striking that

⁴ *Loew’s*, 371 U.S. 38, 45 (1962).

⁵ *Independent Ink, Inc. v. Illinois Tool Works, Inc.*, 396 F.3d 1342, 1351 (Fed. Cir. 2005).

⁶ *Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

⁷ *Khan*, 522 U.S. at 15–16.

⁸ Kevin D. McDonald, *Antitrust and Baseball: Stealing Holmes*, 1998 J. SUP. CT. HISTORY (V.II) 88 [hereinafter *Stealing Holmes*].

the patent case never used the word “presumption,” just as the baseball case never used the word “exemption.”) Finally, in each case, a third interpretation took the fabricated rationale to its (il)logical extreme and made it (or tried to make it) immutable. Thus, both the presumption and the exemption survive even though—and this may be their closest parallel—no serious person contends that they have any basis in fact.

Why, one may ask, is it useful to draw this analogy in any detail for purposes of discussing *Illinois Tool*? The question is a fair one. While the analogy is compelling in my view, it is not likely to be discussed at any length in the Supreme Court. That is because the Court considers the baseball cases to be, well, an embarrassment. The last time that an antitrust litigant argued for the preservation of an outmoded antitrust rule by invoking baseball, Justice O’Connor gave this icy response:

If anyone really thinks that the existence of a patent itself confers market power, they have never produced any evidence of it.

[T]hose decisions are clearly inapposite, having to do with the antitrust exemption for professional baseball, which this Court has described as “an aberration . . . rest[ing] on a recognition and an acceptance of baseball’s unique characteristics and needs,” *id.*, at 282, 92 S. Ct. 2099, at 2112. In the context of this case, we infer little meaning from the fact that Congress has not reacted legislatively to [remedy the problem].⁹

The Respondent in *Illinois Tool* therefore should not make the tactical mistake of basing its argument on the baseball exemption, an argument that would go something like this: “Mr. Chief Justice, and may it please the Court, I believe my position is amply supported by the application of stare decisis in the baseball cases. I realize that the Court has repeatedly labeled them ‘an aberration,’ but I think it meant that in a subtly affectionate way.” No fewer than eleven briefs were filed in support of the Petitioners in *Illinois Tool*, and only one made any reference to the baseball cases. (The Petitioners cited them in a brief footnote, quoted the “aberration” language, and moved on—lest they be accused of shooting fish in a barrel.¹⁰) And, while the Respondent’s brief has not been filed at this writing, neither the Respondent in its opposition to certiorari nor the Federal Circuit below made any reference to the baseball cases.

So why should we refer to them? For two reasons. The first is that no significant issue besides stare decisis seems to be in dispute in *Illinois Tool*. If anyone *really* thinks that the existence of a patent itself confers market power, they have never produced any evidence of it. Rather, the empirical evidence that does exist shows that the overwhelming majority of patents do not.¹¹ Both federal enforcement agencies have rejected the presumption of market power in their enforcement guidelines,¹² and the academic commentary is (as far as I can tell) unanimous that the presumption is unwise.¹³ In *Illinois Tool* itself, the United States has filed an amicus brief urging reversal that lists lawyers from the Department of Justice, the Federal Trade Commission, and the Patent & Trademark Office. The American Bar Association, representing over 400,000 lawyers who seldom agree on much, has also filed amicus briefs urging the Court to grant certiorari and to reverse. Even the Federal Circuit has acknowledged in non-tying cases that “a patent does not of itself

⁹ *Khan*, 522 U.S. at 19 (quoting *Flood v. Kuhn*, 407 U.S. 258, 282 (1972)).

¹⁰ Brief For The Petitioners at 40 n.14, *Illinois Tool Works Inc. v. Independent Ink, Inc.*, No. 04-1329, 2005 WL 1864122, (U.S. Aug. 4, 2005).

¹¹ *Id.* at 24–26.

¹² U.S. Dep’t of Justice & Federal Trade Comm’n, Antitrust Guidelines for the Licensing of Intellectual Property §§ 2.2 & 5.3 (1995), available at <http://www.usdoj.gov/atr/public/guidelines/0558.pdf>.

¹³ *Id.* at 37–39.

establish a presumption of market power in the antitrust sense.”¹⁴ Thus, no basis for affirmance is obvious—or has been advanced by any party or court—*other than* the doctrine of stare decisis. As arguably the most pristine example of stare decisis in the Court’s history, the baseball cases underscore the dangers of preserving a doctrine that cannot be supported as a matter of economic reality.

The second reason for thinking about baseball here relates to the nature of stare decisis itself. For the Court has never allowed the doctrine to bind it simply through blind obedience—as “an inexorable command.”¹⁵ There must be some reason for the Court to repeat a mistake beyond the fact that the mistake was made before. In the baseball cases, that reason was the principle of “subsequent Congressional inaction”—the notion that, once a court has interpreted a statute a certain way (however incorrectly), the court should wait for the legislature to correct the mistake, rather than to overrule its own precedent.

In recent years, the Court has shown increasing skepticism toward the principle of subsequent Congressional inaction, which Justice Scalia has labeled a “canard.”¹⁶ Yet it is the sole reason why we have a baseball exemption today. And if we discover at the end of the next Supreme Court term that we still have a presumption of market power, the same principle will undoubtedly be the cause. Thus, the history of the baseball exemption is instructive because it demonstrates the folly of expecting Congress to rectify the Court’s own mistakes. Have you ever heard of the Curt Flood Act of 1998? Precisely the point.

The Baseball Exemption: Stealing Holmes

The Court finds the baseball exemption embarrassing, and rightfully so. With each and every game broadcast across state lines and farther, no one seriously disputes the game’s impact on interstate commerce—not today anyway. The question was a closer one in 1922, when Oliver Wendell Holmes, Junior, and his brethren first considered the issue in a case styled *Federal Baseball Club of Baltimore v. National League of Professional Baseball Clubs*.¹⁷ That was long before radio, television, minor league organizations, and many of the other common indicia of the modern game. Yet, somehow, all those things have changed while baseball remains exempt. How did Holmes’s decision become immutable? As noted above, the process had three principal steps.

Step One: Federal Baseball. The dispute in *Federal Baseball* arose from the creation of a third “major” league in 1913, which was called—as if to emphasize its interstate character—the Federal League. A group of wealthy businessmen re-christened their existing minor league “major,” quickly erected eight new ball parks, touched off a bidding war for most star players (Tris Speaker was paid the unearthly sum of \$18,000 to stay with the Red Sox), and competed with reasonable success for two seasons. In 1915, the so-called Peace Agreement with major league baseball put an end to the Federal League, by assuming its debts and acquiring its best assets (including the friendly confines of Wrigley Field). The Federal League’s Baltimore franchise, however, was excluded from the deal and swiftly brought an antitrust suit. The result was *Federal Baseball*.

¹⁴ *Abbott Labs. v. Brennan*, 952 F.2d 1346, 1354 (Fed. Cir. 1991).

¹⁵ *Khan*, 522 U.S. at 20 (quoting *Payne*, 501 U.S. 808 at 828).

¹⁶ *Johnson v. Transportation Agency*, 480 U.S. 616, 672 (1987) (Scalia, J., dissenting (“vindication by congressional inaction is a canard”).

¹⁷ 259 U.S. 200 (1922).

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Over the years, Holmes's opinion has been mocked and vilified with inspired rhetoric. Justice Douglas in *Flood v. Kuhn* would label it "a derelict in the stream of the law."¹⁸ That, moreover, was but a tepid imitation of an earlier attack by the bombastic Judge Jerome Frank, who called it "an impotent zombi."¹⁹ Judge Frank went on to analogize baseball's reserve clause to slavery and to label those who defended it "totalitarian minded."²⁰

On its face, Holmes's brief and unanimous opinion hardly seems to merit such calumny. Contrary to the myth that he found baseball to be a sport rather than a business, he referred to organized baseball as a "business" on five separate occasions in two and one-half pages.²¹ He noted that the "constant" interstate travel of the clubs was "provided for, controlled and disciplined by the [leagues]."²² He even emphasized that "to attain for these exhibitions the great popularity they have achieved, competitions must be arranged between clubs from different cities and States."²³ Yet the analysis he employed in 1922—the same one employed by both parties in their arguments—was whether the interstate aspects of the business were essential to its character or merely "incidental." For Holmes, Brandeis, Taft, and the rest, the answer was easy: "The business is giving exhibitions of baseball, which are purely state affairs."²⁴ In other words, the game itself was the "essential thing." When it was played in 1922, only local fans partook. No interstate transaction occurred, as it soon would by virtue of radio broadcasts. For the Court, the interstate transport of players and equipment before and after the game was "a mere incident."²⁵ That rationale seems simple enough, and it has this virtue: Whether or not you agree with the Court's conclusion, the result under such an "incidental effects" test will change as soon as the facts do. If the advent of radio and television convert the "essential thing" into an interstate transaction, then the Sherman Act clearly applies.

So why doesn't it apply today? A partial explanation is that one aspect of Holmes's opinion has been widely misunderstood. After declaring the interstate aspects of the business "incidental," Holmes wrote that "the exhibition, although made for money would not be called trade or commerce in the commonly accepted use of those words That which in its consummation is not commerce does not become commerce among the States because the transportation that we have mentioned takes place."²⁶ Today, the notion that pure services, whether sports or law or medicine, should not be viewed as commerce has been rejected by later Supreme Court cases. But some have read Holmes's passage to mean that, because baseball is a service, it can never be commerce and, hence, never be covered by the Sherman Act.

But that was plainly not what Holmes said or meant. In observing that the game itself was not "commerce," Holmes was merely responding to an alternative argument that the *Federal Baseball* plaintiff had made. Although the plaintiff agreed that the baseball game itself was not commerce,

¹⁸ *Flood v. Kuhn*, 407 U.S. 258, 286 (1972).

¹⁹ *Gardella v. Chandler*, 172 F.2d 402, 409 (2d Cir. 1949).

²⁰ *Id.* at 409–10.

²¹ 259 U.S. at 207–09.

²² *Id.* at 208.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 209.

²⁶ *Id.*

it argued that any travel across state lines would convert what is not commerce (even a person, to use the plaintiff's example) into interstate commerce. Holmes was simply rejecting that syllogism—declaring in his typically epigrammatic way that what is not commerce is not commerce. But that point did not change the incidental effects test. If the facts showed that the interstate aspects of the “business” were more than incidental (as the facts would over the next 25 years), the antitrust laws should apply.

To prove that this reading of *Federal Baseball* is correct, consider three points. First, if the “personal effort” involved in baseball (or any other service) can never be subject to the Sherman Act, then why did Holmes bother us with the whole incidental effects analysis? That test would be rendered irrelevant by the erroneous reading of *Federal Baseball*. Yet Holmes not only included it, but placed it *first* in the opinion. It was not in Holmes's nature to come to the point so indirectly. He was not wasting our time.

Second, Holmes proved that a business based on services could pass the incidental effects test (at least in theory) the very next term, when he decided *Hart v. B.F. Keith Vaudeville Exchange*.²⁷ *Hart* involved an interstate vaudeville circuit, in which local exhibitions were presented in a manner legally indistinguishable from *Federal Baseball*. Yet the lower court had dismissed the complaint outright, not giving the plaintiff a chance to prove that the interstate travel involved in that business was more than “incidental.” Holmes, writing again for a unanimous Court, reversed. Notwithstanding “the *Baseball Club Case*,” which had come to the Court after a full trial, “it may be that what in general is incidental in some instances may rise to a magnitude that it requires that it be considered independently.”²⁸ Thus, the plaintiff in the vaudeville case could, if the evidence were strong enough, prevail under the Sherman Act—even though the actors on a stage are engaged in “personal effort” in precisely the same sense as baseball players.

A third compelling reason for reading *Federal Baseball* as I do is that Learned Hand did so, too. Hand sat on the Southern District of New York when *Federal Baseball* was decided, but he was elevated to the Second Circuit the next year, in time to hear the appeal from the vaudeville case after it was tried on remand from the Supreme Court.²⁹ Because he remained on the Second Circuit for nearly 40 years, Hand was also present when, a quarter of a century later, another antitrust case was filed by a former New York Giant outfielder named Danny Gardella. Gardella had been suspended, along with several others, for jumping briefly to the “Mexican League,” which had begun offering enormous salaries to major leaguers shortly after World War II.

In 1949, Learned Hand's analysis in *Gardella* of the Sherman Act's application to baseball was straightforward, combining elements of both *Federal Baseball* and the vaudeville case: Broadcasting made modern baseball the equivalent of “a ‘ball park’ where a state line ran between the diamond and grandstand.”³⁰ The interstate aspects were no longer “merely incidents” but “part of the business itself.”³¹ Indeed, “the players are the actors, the radio listeners and the television spectators are the audiences.”³² Hand thus recognized, as later judges would not, that whether

²⁷ 262 U.S. 271 (1923).

²⁸ *Id.* at 273–74.

²⁹ *Hart v. B.F. Keith Vaudeville Exch.*, 12 F.2d 341 (2d Cir. 1926).

³⁰ *Gardella v. Chandler*, 172 F.2d at 407.

³¹ *Id.*

³² *Id.* at 408.

the baseball exhibition itself was considered “commerce” or not, the interstate aspects of the “business,” if more than incidental, would cause it to fall under the Sherman Act. Thus, he applied precisely the same analysis as Holmes and, presented with vastly different facts, reached a predictably different result.

Step Two: Toolson. Danny Gardella’s victory in the Second Circuit had several immediate consequences. First, Baseball Commissioner “Happy” Chandler was inspired to “temper [j]ustice with mercy” and declared amnesty for all of the banned Mexican leaguers.³³ He also quickly settled with Gardella because, as he later acknowledged, “the lawyers thought we could not win the *Gardella* case.”³⁴

In addition, the legal scrutiny of baseball’s reserve clause intensified as new plaintiffs rushed to court and Congress took up the subject in earnest. In Congress, several bills were introduced in the early 1950s to grant an exemption from the antitrust laws to baseball, but none was passed. In the courts, the lawsuit of George Earl Toolson, a minor leaguer in the Yankees organization who objected to a demotion, made it to the Supreme Court.

The lower court in *Toolson* had framed the controlling issue as “whether the game of baseball is ‘trade or commerce’ within the meaning of the Anti-Trust Acts.”³⁵ The court thus read *Federal Baseball* differently than Learned Hand, to mean that baseball could never be subject to the Sherman Act (thus making the “incidental effects” test irrelevant). The Supreme Court had the option of either accepting the Hand analysis or squarely facing the “commerce” point, which plainly could not survive the more expansive definition of “commerce” in the Court’s modern decisions.

The *Toolson* Court did neither. Instead, it affirmed the dismissal in a per curiam opinion of one paragraph. The Toolson opinion declared that baseball had developed “for thirty years . . . on the understanding that it was not subject to existing antitrust legislation,” and that, if there are antitrust “evils” in baseball, the remedy “should be by legislation.” The Court then concluded with this final, stunning sentence:

Without re-examination of the underlying issues, the judgments below are affirmed on the authority of *Federal Baseball Club of Baltimore v. National League of Professional Baseball Clubs*, *supra*, so far as that decision determines that Congress had no intention of including the business of baseball within the scope of the federal antitrust laws.³⁶

With that baseless assertion, the baseball exemption was born. As we have seen, *Federal Baseball* said nothing about the Congress of 1890 intentionally *excluding* baseball from the Sherman Act. It is as if the majority in *Toolson* imagined Senator Sherman announcing that “today we enact the Magna Carta of the working class so that all American business will respect the right of consumers to free and open competition . . . that is, um, except for organized baseball, of course.” Indeed, what did it mean to affirm *Federal Baseball* “so far as that decision determines that Congress had no intention of including . . . baseball within the . . . antitrust laws,” when *Federal Baseball* said no such thing? As one commentator dryly noted at the time, “*Toolson* would then seem to reaffirm nothing.”³⁷

³³ Dan A. Abramson, *Baseball & the Court*, 4 *Constitution*, Fall 1992, at 74 (Fall 1992).

³⁴ G. Edward White, *Creating the National Pastime: Baseball Transforms Itself, 1903–1953*, 295 (1996).

³⁵ *Toolson v. New York Yankees*, 101 F. Supp. 93, 94–95 (S.D. Cal. 1951).

³⁶ *Toolson v. New York Yankees*, 346 U.S. 356, 357 (1953).

³⁷ Note, *Recent Cases*, 105 U. Pa. L. Rev. 110, 112–13 n.24 (1956).

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Because the idea of baseball having an express exemption from the Sherman Act was so silly, the last sentence of *Toolson* made no impression on the lower courts. Rather, they construed the Court's failure to overrule *Federal Baseball* as evidence that the antitrust laws would not apply to any business legally indistinguishable from baseball. The Supreme Court, therefore, was forced to take several cases in the ensuing terms to make it clear that defendants in such businesses as entertainment and professional boxing *would* be subject to the Sherman Act.³⁸ The process reached its low point when the Ninth Circuit considered whether professional football was exempt. Groping for a principled distinction between the Court's decisions involving baseball and boxing, and unable to fathom an express exemption for baseball, the circuit court had this epiphany: The Sherman Act exempts all *team* sports, such as baseball and football, but not *individual* sports, such as boxing.³⁹ (Honestly.)

At this point, the Supreme Court decided to speak bluntly. The baseball exemption, the Court acknowledged in *Radovich v. National Football League*, is "unrealistic, inconsistent, [and] illogical." Yet it survives purely as a matter of stare decisis. The distinction between baseball and other sports is the existence of *Federal Baseball* and nothing more: "No other business claiming the coverage of those cases has such an adjudication."⁴⁰

With *Radovich*, the baseball exemption was complete. And the reasoning of Holmes in *Federal Baseball* had been abandoned completely. It no longer mattered how broadcasting affected the interstate nature of the game, or how the term "commerce" was defined. *Toolson* gave baseball an express exemption based on an invented Congressional "intention." By claiming that its new rationale was actually part of Holmes's original decision, the Court was able to preserve the exemption while still acknowledging its (i.e., Holmes's) "mistake."

Step Three: Flood. The Court's final step in redefining *Federal Baseball* would be to make the mistake uncorrectable. That came in the Court's 1972 decision in *Flood v. Kuhn*.⁴¹

When the St. Louis Cardinals attempted to trade Curt Flood to the Philadelphia Phillies, he simply refused. His antitrust assault on the reserve clause quickly made its way to the Supreme Court, which granted certiorari "to look once again at this troublesome and unusual situation."⁴² Mr. Flood may have realized that he was in trouble when Justice Blackmun's opinion began with a paean to baseball's "colorful days," including a list of *eighty-eight* of his favorite old-time ballplayers. At the end of the list, the Justice wrote, without apparent irony: "The list seems endless."⁴³

Flood reaffirmed the baseball exemption on the ground that any solution to the problem created by *Federal Baseball* should come from Congress, not the Court. Justice Blackmun gave three principal reasons: First, Congress had considered the issue of baseball's antitrust exemption several times, but had passed no law. Thus, by its "positive inaction," Congress has "clearly evinced a desire not to disapprove" of *Federal Baseball*.⁴⁴ Second, "since 1922 baseball . . . has been allowed to develop and expand unhindered by federal legislative action."⁴⁵ Given this

³⁸ *United States v. Shubert*, 348 U.S. 222 (1955); *United States v. Int'l Boxing Club of N.Y., Inc.*, 348 U.S. 236 (1955).

³⁹ *Radovich v. National Football League*, 352 U.S. 445, 447 (1957).

⁴⁰ *Id.* at 452.

⁴¹ 407 U.S. 258 (1972).

⁴² *Id.* at 269.

⁴³ *Id.* at 263. Only two other Justices joined in this part of the opinion.

⁴⁴ *Id.* at 283–84.

⁴⁵ *Id.* at 283.

reliance, there would be inevitable “retroactivity problems” if there were “a judicial overturning of *Federal Baseball*.”⁴⁶ Third, the rule of *Federal Baseball* may be “an anomaly” and “an aberration,” but it is “an established one . . . that has been with us now for half a century.”⁴⁷ To overrule it now, would require “withdrawing from the conclusion as to congressional intent made in *Toolson*.”⁴⁸

We have already seen how weak these arguments are. First, we may defer for the moment the reasons why Congress’s “positive inaction” is an oxymoron that deserves little respect in the best of cases—there are simply too many independent reasons why Congress may fail to act. Because in *Flood*, the principle plainly cut the other way: Congress had repeatedly failed to enact an exemption, not failed to “disapprove” it.

Second, baseball’s alleged reliance on an antitrust exemption is also a myth. As noted, the Commissioner of Baseball told Congress in 1951 (after *Gardella*, but before *Toolson*) that his lawyers told him he could not prevail in *Gardella*.⁴⁹ A baseball historian writing in 1950 also concluded that “[i]n three quarters of a century, the validity of the reserve clause has sometimes been affirmed in court, but usually it has been denied. The issue is not yet settled”⁵⁰

Finally, any attempt to give the “aberrant” baseball exemption a 50-year pedigree does not persuade. Holmes’s opinion neither used the word exemption nor turned on Congressional intent. Nor did he imply that his rationale would apply differently to other sports. Thus, the baseball exemption—while factually and historically groundless in 1953—did not become an “aberration” until later cases made it clear that the same faulty reasoning would not apply to boxing (1955) or football (1957). The *Flood* opinion unwittingly concedes that its time frame is actually far shorter when it refers to “withdrawing from the conclusion as to congressional intent made in *Toolson*.”⁵¹

Perhaps recognizing the shakiness of these arguments, the *Flood* Court took refuge in the same technique that guided the *Toolson* Court: Blame Holmes. Thus, the last sentence of *Flood* offers an assertion equally as unrooted in reality as the last sentence in *Toolson*: “And what the Court said in *Federal Baseball* in 1922 and what it said in *Toolson* in 1953, we say again here in 1972: the remedy, if any is indicated, is for congressional, and not judicial, action.”⁵²

So, *Federal Baseball* was rewritten yet again. Just as *Toolson* blamed Holmes for a problem (an express statutory exemption) that he did not create, *Flood* blamed him for insisting on a solution (Congressional action) that he did not mention. Indeed, it is ironic that Holmes is deemed to have invoked Congressional action, because his actual rationale (the incidental effects test) would imply that Congress did not have the power to regulate a business with only an incidental impact on interstate commerce.⁵³

⁴⁶ *Id.*

⁴⁷ *Id.* at 282.

⁴⁸ *Id.* at 284.

⁴⁹ See *supra* note 34; McDonald, *Stealing Holmes*, *supra* note 8, at 121.

⁵⁰ LEE ALLEN, 100 YEARS OF BASEBALL at 72 (1950).

⁵¹ *Flood*, 407 U.S. at 284.

⁵² *Id.* at 285.

⁵³ Holmes derived his incidental effects test from *Hooper v. California*, 155 U.S. 648 (1895), which noted that “[i]f the power to regulate interstate commerce applied to all the incidents to which said commerce might give rise . . . that power would embrace the entire sphere of mercantile activity.” *Id.* at 655. If the power to regulate interstate commerce did not extend to baseball in 1922, Congress would have no authority to “correct” *Federal Baseball* as long as its effect on that commerce were “incidental.”

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Thus, we see the conclusion of the three-step process that has brought us the baseball exemption. The result is a principle of antitrust law that is (1) indefensible as a matter of fact or policy, and (2) an embarrassment to the Court. Can history repeat itself?

The Presumption of Market Power: Not “Common Knowledge”

In *Illinois Tool*, the Supreme Court will decide whether the existence of a patent alone implies that the defendant has market power in a patent tying case. No one really thinks this is true as a matter of fact. Nonetheless, the Federal Circuit concluded that the Supreme Court has already so held: “In *United States v. Loew’s*, 371 U.S. 38 (1962), relying on *International Salt*, the Court made clear that, where the tying product is patented or copyrighted, market power may be presumed rather than proven.”⁵⁴

In briefs before the Supreme Court, the American Bar Association and others have pointed out that the Federal Circuit has misread these cases. *International Salt* gave no consideration whatsoever to the question of power in the tying product. And the “presumption” of power applied in *Loew’s* was not a presumption of market power at all, but a “presumption of uniqueness” that the *Loew’s* Court took pains to distinguish from a presumption of actual market power. The Court’s subsequent decisions imposing the modern requirement of genuine market power over the tying product, moreover, have rendered the original presumption of *Loew’s* obsolete. As a result, the conclusion of Justice O’Connor in her concurrence in *Jefferson Parish Hosp. Dist. No. 2 v. Hyde* remains true: “Nor does any presumption of market power find support in our prior cases.”⁵⁵

So, how did the Federal Circuit get it wrong? By following three essential steps . . .

Step One: International Salt. In arguing that the presumption of market power can be found in the Supreme Court’s cases, the Federal Circuit repeatedly cited *International Salt* along with *Loew’s*. It asserted, for example, that the Supreme Court has “consistently reaffirmed the holdings of *International Salt* and *Loew’s* that no proof of market power is necessary,”⁵⁶ even though *International Salt* contains no consideration or discussion of any “presumption” at all. *International Salt* was so important to the Federal Circuit because it involved a tying product that was patented, just as *Illinois Tool* does, whereas the tying product in *Loew’s* was copyrighted. While that difference should not be important here, the Federal Circuit would not have had a direct Supreme Court holding to “dictate” its result in a patent case without *International Salt*. As we shall see, *International Salt* (like *Federal Baseball*) has been freely reinterpreted over the last 60 years. To place its original holding in context, however, requires that we go back even further.

Nearly 100 years ago, the Supreme Court rejected an attack on a tying arrangement strikingly similar to the one at issue in *Illinois Tool*—in which a patented mimeograph machine was licensed on the condition that the licensee purchase the ink from the patent holder.⁵⁷ The patentee had argued, even then, that the tying arrangement was a form of metering, by which the licensor “is merely insuring to himself a royalty based upon the output of the machine.”⁵⁸ In other words, by pricing the invention (plus ink) in a way that allowed the inventor to charge more to those who used it more intensively, the inventor could both make more money and sell more machines. Today, most

⁵⁴ 396 F.3d at 1348.

⁵⁵ 466 U.S. 2, 38 n.7 (1984).

⁵⁶ 396 F.3d at 1348.

⁵⁷ *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912).

⁵⁸ *Id.* at 65.

commentators would agree that such ties are “nearly always procompetitive.”⁵⁹ In 1912, however, the majority approved the tie only over the blistering dissent of Chief Justice White, who complained that the use of a tie allowed the patent holder “to bring within the claims of his patent things which are not embraced therein, thus . . . to multiply monopolies at the will of an interested party.”⁶⁰ This was an early and forceful articulation of what many have called the “patent leveraging fallacy”—the now discredited idea that a tying arrangement allowed a patentee to convert its patent “monopoly” into two monopolies.⁶¹

Five years later, in *Motion Picture Patents Co. v. Universal Film Mfg. Co.*,⁶² the views of Chief Justice White prevailed, and *Henry v. A.B. Dick* was overruled. This time, Justice Holmes dissented:

Armed with the leveraging fallacy, the Court then

The supposed contravention of public interest sometimes is stated as an attempt to extend the patent law to unpatented articles, which of course it is not, and more accurately as a possible domination to be established by such means. *But the domination is one only to the extent of the desire for the [patented] tea pot or film feeder, and if the owner prefers to keep the pot or the feeder unless you will buy his tea or films, I cannot see in allowing him the right to do so anything more than an ordinary incidence of ownership . . .*⁶³

embarked on a period

As Ward Bowman has noted, Holmes’s conclusion on this point “was never rebutted by the majority.”⁶⁴

of self-described

Armed with the leveraging fallacy, the Court then embarked on a period of self-described “hostility” to tying arrangements, which lasted over 30 years.⁶⁵ The rhetorical high point of that hostility came when Justice Frankfurter announced that “Tying agreements serve hardly any purpose beyond the suppression of competition”⁶⁶—a sentence that would be repeated in every tying case to come before the Supreme Court until the 1970s. Justice Frankfurter continued that “only the prospect of reducing competition would persuade a seller to adopt such a contract and only his control of the supply of the tying device . . . could induce a buyer to enter one.”⁶⁷ These conclusions are known to be indefensible as a matter of economic reality today, when a wide variety of consumer benefits flowing from tying are recognized both in theory and in practice.⁶⁸

“hostility” to tying

arrangements, which

lasted over 30 years.

⁵⁹ HERBERT HOVENKAMP, MARK A. JANIS & MARK LEMLEY, IP AND ANTITRUST § 21.2 at 21-12; Frank H. Easterbrook, *Intellectual Property Is Still Property*, 13 HARV. J.L. & PUB. POL’Y 108, 112 (1990) (describing this form of price discrimination through tying as achieving “the best of both worlds”).

⁶⁰ *Henry v. A.B. Dick Co.*, 224 U.S. at 53.

⁶¹ WARD BOWMAN, JR., PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL 154 (1973). Thanks to the tireless efforts of Professor Bowman and others, the patent leveraging fallacy has been abandoned in the Court’s modern decisions, *see, e.g.*, *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 36 (1984) (O’Connor, J., concurring) (“The existence of a tied product normally does not increase the profit that the seller with market power can extract from sales of the tying product.”) (emphasis omitted), and is routinely rejected by the commentators: “Tying cannot enable a patentee to attain a double monopoly profit by tying unpatented goods.” HOVENKAMP ET AL., *supra* note 59, § 21.3b, at 21-20. *See also Hyde*, 466 U.S. at 36 (concurrence describing this view as “easily demonstrated and widely accepted”).

⁶² 243 U.S. 502 (1917).

⁶³ *Id.* at 520 (emphasis added).

⁶⁴ BOWMAN, *supra* note 61, at 157.

⁶⁵ *See Loew’s*, 371 U.S. at 46.

⁶⁶ *Standard Oil of Cal. v. United States*, 337 U.S. 293, 305 (1949).

⁶⁷ *Id.* at 306.

⁶⁸ Brief for Petitioners, *supra* note 10, at 27–31 (collecting authorities).

For purposes of ties involving intellectual property, the period of “hostility” culminated in the Court’s 1947 decision in *International Salt Co. v. United States*,⁶⁹ where the tying product was patented, and its 1948 decision in *United States v. Paramount Pictures, Inc.*,⁷⁰ where the tying product was copyrighted. Both opinions were straightforward in condemning the ties before them, relying expressly on the leveraging theory as their rationale.⁷¹ Of particular note here, neither case addressed, even obliquely, whether the owner of the patents or copyrighted products had economic power of any kind, much less real market power in the sense of power over price.

The *International Salt* opinion, in particular, focused exclusively on the effects of the tie on the market for the *tied* product. Justice Robert Jackson wrote for the Court that the tie would be condemned as long as the “volume of business” affected in the tied product was not “insignificant or insubstantial.”⁷² The principal competitive evils identified were (1) the tendency of the tie “to foreclose competitors from” access to sales of the tied product, and (2) the restriction of consumer “choice” in purchasing the tied product.⁷³ For Justice Jackson, the only purpose in considering the tying product at all was to point out that the existence of International Salt’s “patents afford no immunity from the anti-trust laws.”⁷⁴ That is far different than saying that patent ties are somehow *more* suspect than other ties—something that Justice Jackson never did say in *International Salt*. To read *International Salt* as the Federal Circuit did in *Illinois Tool*, therefore, would require the discovery of a new rationale.

Step Two: Loew’s. The first case to consider any concept of power in the tying market came five years later in *Times-Picayune Publishing Co. v. United States*.⁷⁵ There, the Court refused to condemn as an illegal tie a newspaper’s requirement that ads be run in both its morning and afternoon papers. The Court’s 5–4 opinion described the Sherman Act’s prohibition on tying as confined to cases where “the seller enjoys a monopolistic position in the market for the ‘tying’ product.”⁷⁶ Because the defendant had no power in the relevant market for advertising, the tying claim was rejected. By introducing the concept of “power” in the tying product, the *Times-Picayune* opinion planted a seed that would eventually undermine the per se rule against tying.

But it would take a *very* long time. A principal reason for the delay was that, in a series of subsequent decisions, the Court insisted that the definition of the “power” sufficient to satisfy this test was not actual *market* power, but something far broader. The first was *Northern Pacific Railway Co. v. United States*,⁷⁷ in which the tying product was the “exclusive” landholdings of certain railroads along the right-of-way. Justice Black made clear that the suggestion in *Times-Picayune* that the defendant have a “monopolistic position” would not be taken literally:

⁶⁹ 332 U.S. 392 (1947).

⁷⁰ 334 U.S. 131 (1948).

⁷¹ *Int’l Salt*, 332 U.S. at 395–96 (“But the patents confer no right to restrain use of, or trade in, unpatented salt.”); *Paramount Pictures*, 334 U.S. at 158 (“Where a high quality film greatly desired is licensed only if an inferior one is taken, the latter borrows quality from the former and strengthens its monopoly by drawing on the other.”).

⁷² 332 U.S. at 396.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ 345 U.S. 594 (1953).

⁷⁶ *Id.* at 608.

⁷⁷ 356 U.S. 1 (1958).

While there is some language in the *Times-Picayune* opinion which speaks of “monopoly power” or “dominance” over the tying product as a necessary precondition for application of the rule of *per se* unreasonableness to tying arrangements, we do not construe this general language as requiring anything more than sufficient economic power to impose an appreciable restraint on free competition in the tied product⁷⁸

That power could be found in a tying case “regardless of the source from which the power is derived and whether the power takes the form of a monopoly or not.”⁷⁹ Indeed, that definition of power was so broad that it could be inferred from the simple fact of the tying arrangement itself: “The very existence of this host of tying arrangements is itself compelling evidence of the defendant’s great power”⁸⁰

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As the defendants in *Northern Pacific* argued unsuccessfully that real market power was now the test, they tried to distinguish *International Salt*, which had not required proof of power, by asserting that the existence of the patent made the difference. Justice Black disagreed: “In arriving at its decision in *International Salt* the Court placed no reliance on the fact that a patent was involved nor did it give the slightest intimation that the outcome would have been any different if that had not been the case. If anything, the Court held the challenged tying arrangements unlawful *despite* the fact that the tying item was patented, not because of it.”⁸¹

For the Court in *Northern Pacific*, the result in *International Salt* was compelling evidence that the requisite power was *not* true market power—if that were the test, a patent alone clearly would not meet it: “Of course *it is common knowledge* that a patent does not always confer a monopoly over a particular commodity. Often the patent is limited to a unique form or improvement of the product and the economic power resulting from the patent privileges is slight.”⁸²

Four years later, the Court’s decision in *Loew’s* continued the process of defining down the concept of “power” in the tying market. Indeed, the *Loew’s* Court could not have been clearer that its definition of the “requisite economic power” was *not* “some power to control price,” and thus not actual market power in its modern sense:

Market dominance—some power to control price and to exclude competition—is by no means the only test of whether the seller has the requisite economic power. Even absent a showing of market dominance, the crucial economic power may be inferred from the tying product’s desirability to consumers or from uniqueness in its attributes.⁸³

The Court continued in a footnote that a finding of “economic power . . . on the basis of either uniqueness or consumer appeal . . . does not necessitate a demonstration of market power.”⁸⁴

No matter how this concept of power was defined, however, the question for the Court in *Loew’s* was how to apply its prior decisions involving intellectual property, because those decisions clearly did not address the question of tying product power at all. Justice Goldberg solved the problem with his often-repeated declaration that “[t]he requisite economic power is presumed

⁷⁸ *Id.* at 11.

⁷⁹ *Id.*

⁸⁰ *Id.* at 7–8.

⁸¹ *Id.* at 9.

⁸² *Id.* at 10 n.8 (emphasis added).

⁸³ 371 U.S. at 45 (footnote omitted).

⁸⁴ *Id.* at 45 n.4.

when the tying product is patented or copyrighted,” citing both *International Salt* and *Paramount Pictures*.⁸⁵

While neither case he cited spoke of any “presumption,” one can argue that a “presumption of uniqueness” for intellectual property—while of little or no relevance to competition policy—has some basis in logic. A patent is awarded only to inventions that are both novel and not obvious,⁸⁶ and thus distinctive by their very nature. A presumption of uniqueness thus follows by definition, because “one of the objectives of the patent laws is to reward uniqueness.”⁸⁷ A copyrighted work, moreover, is literally unique, as the law protects only the original item itself.⁸⁸ Thus, the *Loew’s* Court also found that the holding of *Paramount Pictures* fit comfortably into the presumption, for “[a] copyrighted feature film does not lose its legal or economic uniqueness because it is shown on a television rather than a movie screen.”⁸⁹

After *Loew’s*, therefore, the per se condemnation of patent tying in *International Salt* had a new rationale: Instead of reading the opinion as the unqualified per se condemnation of all tying agreements that it was, the Court would read into *International Salt* the new concept of power in the tying market, but define the concept so broadly that the power could be “presumed” in every patent case. That change alone, however, was not sufficient to create the presumption of market power that was applied by the Federal Circuit in *Illinois Tool*. To reach that result, an additional step remained.

Step Three: Illinois Tool. As a result of *Northern Pacific* and *Loew’s*, the per se rule against patent tying of *International Salt* was changed in form, but not yet in substance. Lip service would be paid to the concept of “economic power,” but the power required was some measure of distinctiveness so broad and vague that no product could flunk the test. That attitude reached its high-water mark in 1969 in the first *Fortner* decision, where Justice Black wrote that seller financing of new homes by U.S. Steel could be attacked as a tie-in, provided the plaintiff could prove that the financing had distinctive or uniquely attractive aspects.⁹⁰ (He set forth numerous suggestions as to how such uniqueness might be shown at trial.) As one treatise has remarked of *Fortner I*, “[a]ll of this seems quite incomprehensible to anyone with even minimal knowledge of the credit market and with manufacturer self-provision of financing.”⁹¹

Eight years later, however, the same case came back to the Court, and its decision in *Fortner II* fundamentally altered the law of tying. The plaintiff had prevailed at trial based on a finding that U.S. Steel’s financing was “unique,” employing several of the indicia suggested by Justice Black.⁹² This time, however, the Court rejected these findings as insufficient to establish the power requirement for tying.

⁸⁵ *Id.* at 45.

⁸⁶ *E.g.*, *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 535 U.S. 722, 736 (2002) (citing 35 U.S.C. §§ 101–103 (1994 ed. and Supp. V)).

⁸⁷ *Loew’s*, 371 U.S. at 46.

⁸⁸ *Bleistein v. Donaldson Lithographing Co.*, 188 U.S. 239, 250 (1903) (Holmes, J.) (“Personality always contains something unique. . . . [Even] a very modest grade of art has in it something irreducible, which is one man’s alone. That something he may copyright . . .”).

⁸⁹ *Loew’s*, 371 U.S. at 48.

⁹⁰ *Fortner Enters., Inc. v. United States Steel Corp.*, 394 U.S. 495 (1969).

⁹¹ HOVENKAMP ET AL., *supra* note 59, § 21.4 at 21–61 (Supp. 2005).

⁹² *See United States Steel Corp. v. Fortner Enters., Inc.*, 429 U.S. 610, 614–16 (1977).

The *Fortner II* Court explained that “uniqueness” was relevant to the question of tying product power only to the extent that it reflected “whether the seller has the power, within the market for the tying product, to raise prices or to require purchasers to accept burdensome terms that could not be exacted in a completely competitive market.”⁹³ The Court acknowledged that a commentator on *Fortner I* had “correctly analyzed the burden of proof” when he stated that “[it is] clear that market power in the sense of power over price must still exist.”⁹⁴ In this way, the definition of the “requisite” power in the tying product was changed fundamentally from the approach of *Northern Pacific* and *Loew’s*. Whereas in *Loew’s* true market power was simply one means of showing the requisite “uniqueness,” now “uniqueness” was relevant only as a means of showing real power over price. Because what the plaintiff in *Fortner II* labeled “uniqueness” did not relate to actual market power, the plaintiff lost.

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The requirement of true market power was cemented by the Court’s 1984 decision in *Hyde*, which rejected a tying claim because a 30-percent market share was too small to show market power, despite evidence that the surgical services involved were “unique” in other senses. *Hyde* put the final nail in the uniqueness coffin with these words: “While these factors may generate ‘market power’ in some abstract sense, they do not generate the kind of market power that justifies condemnation of tying.”⁹⁵ The holdings in *Fortner II* and *Hyde* thus could not be squared with the statement in *Loew’s* that “the mere presence of competing substitutes for the tying product” is insufficient to defeat a tying claim.⁹⁶

The necessary question after *Hyde* was what was to become of the “presumption” for intellectual property articulated in *Loew’s*. By redefining the “requisite power” in a tying case to mean true market power, *Fortner II* and *Hyde* had stripped the *Loew’s* presumption of its utility: a presumption of uniqueness does not mean much when uniqueness is no longer enough to show even a potentially harmful tie.

The lower courts have answered the question in two principal ways, both of which are referenced in Judge Easterbrook’s pithy description of the law in this area: “The tying doctrine was linked to market power in *Hyde*, and although some lower courts missed the message and continued to hold that copyrights and patents are monopolies, most got on board.”⁹⁷ In fact, only three months after *Hyde*, the Ninth Circuit “missed the message” of market power altogether and applied the *Loew’s* presumption to copyrighted software.⁹⁸ Within two years, however, both the Sixth and Seventh Circuits had rejected that view, refusing to apply a presumption of real market power.⁹⁹ The majority of other courts have continued to reject the presumption, although the Federal Circuit’s decision has done much to even the score, in light of its exclusive jurisdiction over patent cases.¹⁰⁰

⁹³ *Id.* at 620 (footnote omitted).

⁹⁴ *Id.* at 620 n.13.

⁹⁵ 466 U.S. at 27 (footnote omitted).

⁹⁶ *Loew’s*, 371 U.S. at 49.

⁹⁷ Easterbrook, *supra* note 59, at 113.

⁹⁸ *Digidyne Corp. v. Data Gen. Corp.*, 734 F.2d 1336 (9th Cir. 1984).

⁹⁹ *Will v. Comprehensive Accounting Corp.*, 776 F.2d 665 (7th Cir. 1985); *A.I. Root Co. v. Computer Dynamics, Inc.*, 806 F.2d 673 (6th Cir. 1986).

¹⁰⁰ *See* 28 U.S.C. § 1295(a). The Federal Circuit has also stated that “Federal Circuit law governs all antitrust claims premised on the abuse of a patent right.” *Unitherm Food Sys., Inc. v. Swift-Eckrich, Inc.*, *cert. granted on other grounds*, 125 S. Ct. 1396 (Feb. 28, 2005) (No. 04-597).

The minority of courts that have applied the presumption have, knowingly or otherwise, engaged in the third step of the process required to preserve the factually baseless presumption of market power: They have redefined the “presumption” of *Loew’s* to be a presumption of *market power* rather than the “presumption of uniqueness” that it claimed to be. This is hardly a small step. We have seen that *International Salt* said nothing about presumptions or market power, and *Loew’s* hotly denied that the presumption of uniqueness could ever be confused with a presumption of actual market power.¹⁰¹ Indeed, when the defendants in *Northern Securities* argued that the patent in *International Salt* was the equivalent of real market power, Justice Black responded that it was “common knowledge” that patents do not by themselves convey such power.¹⁰² How have these courts failed to notice?

The minority of courts that have applied the presumption have . . . redefined the “presumption” of Loew’s to be a presumption of market power rather than the “presumption of uniqueness” that it claimed to be.

The explanation is dicta. Even as the Supreme Court introduced the concept of genuine market power in *Fortner II* and *Hyde*, the majority opinions (both written, coincidentally, by Justice Stevens) strained to give the appearance of citing every tying case in the Court’s history with approval. Thus, the principal ground for the Federal Circuit’s conclusion that the “holdings” of *International Salt* and *Loew’s* had been “reaffirmed” was this statement in *Hyde*: “For example, if the Government has granted the seller a patent or similar monopoly over a product, it is fair to presume that the inability to buy the product elsewhere gives the seller market power. *United States v. Loew’s*, 371 U.S. at 45–47.”¹⁰³ After quoting that passage from *Hyde*, the Federal Circuit declared that “we are obliged to follow such clearly articulated Supreme Court dicta.”¹⁰⁴

Really? I thought it was a matter of definition that “[s]tare decisis does not attach to such parts of the opinion of a court as are mere dicta.”¹⁰⁵ The law’s caution in applying dicta is abundantly justified here, where the only authority cited by the *Hyde* majority was *Loew’s* itself,¹⁰⁶ including the very page in *Loew’s* stating that a tying claim “does not necessitate a demonstration of market power”¹⁰⁷ The *Hyde* opinion’s remark about patents was immediately challenged, moreover, by the four concurring members of the Court, who characterized the presumption of market power in patent cases as a “common misconception.”¹⁰⁸ And when the Ninth Circuit relied on *Loew’s* to apply a presumption of market power in *Digidyne*, Justices White and Blackmun, both members of the *Hyde* majority, dissented from the Court’s refusal to grant certiorari, describing the Ninth Circuit decision as “suspect on several grounds.”¹⁰⁹

Moreover, because dicta does not result from “full application of the judicial mind to the precise question,”¹¹⁰ embracing it leads to unintended consequences. One of the ironies of the cases following *Hyde* is that the Supreme Court’s effort to expand the range of legality under the antitrust laws for beneficial ties in all areas (by redefining the required “power” as market power)

¹⁰¹ *Loew’s*, 371 U.S. at 45 & n.4.

¹⁰² *Northern Securities*, 356 U.S. at 10 n.8.

¹⁰³ *Hyde*, 466 U.S. at 16.

¹⁰⁴ *Independent Ink*, 396 F.3d at 1351.

¹⁰⁵ *BALLENTINE’S LAW DICTIONARY* 346 (3d. ed. 1969).

¹⁰⁶ *See Hyde*, 466 U.S. at 16 (citing 371 U.S. at 45–47).

¹⁰⁷ *Loew’s*, 371 U.S. at 45 n.4.

¹⁰⁸ 466 U.S. at 37 n.7 (O’Connor, J., concurring).

¹⁰⁹ *Data Gen. Corp. v. Digidyne Corp.*, 473 U.S. 908, 909 (1985) (White, J., dissenting from denial of cert.) (urging review to determine “what effect should be given to the existence of a copyright . . . in determining market power”).

¹¹⁰ *Carroll v. Carroll*, 57 U.S. 275. 14 L. Ed. 936 (1853).

has inadvertently narrowed the scope of legality for ties involving intellectual property. By also redefining the *Loew's* “presumption” to be one of market power, courts like the Federal Circuit have taken what was designed to be an additional burden for the claimant (who must prove real market power) and turned it into a burden for the intellectual property defendant (for whom real market power is presumed). It should take more than dicta to achieve such a contradictory result.

I noted at the outset that the attempt to analogize the Federal Circuit’s opinion to that of Judge Posner in *State Oil v. Khan* was unpersuasive. In *Khan*, Judge Posner faced a clearly stated and undisputed rule of the Supreme Court that maximum price fixing was always illegal. There was no split among the lower courts as to whether the rule even existed, as there is in *Illinois Tool*. On the issue of market power, therefore, the Supreme Court’s opinion in *Loew's* can only become the binding authority that Judge Posner faced in *Khan* if it is misread—and misread to mean the opposite of what it says. Judge Posner, moreover, explained in detail why the rule itself was contrary to the goals of antitrust because (like the presumption of market power) it hurt consumers. He thus provided a roadmap for reversal of his own opinion, which the Supreme Court followed closely. The Federal Circuit, by contrast, did not explain the baselessness of the presumption as a matter of economic reality, nor even comment on the absurdity of its conclusion that the plaintiff’s Section 2 claim should be dismissed (for the failure to allege market power) while its Section 1 claim survived (due to a presumption of market power).¹¹¹ Rather, the Federal Circuit seemed content to create a new body of “patent tying law”—which is to be governed in its entirety by Federal Circuit precedent.¹¹²

In sum, the Federal Circuit's decision in Illinois Tool was not an otherwise laudable bow to the limits of its own power. It was error.

In sum, the Federal Circuit’s decision in *Illinois Tool* was not an otherwise laudable bow to the limits of its own power. It was error. And by saddling *International Salt* with yet a second rationale (1) never contemplated by that Court and (2) inconsistent with *Loew's*, it took as its model *Flood v. Kuhn*, not *State Oil v. Khan*.

Congressional Inaction: If It Looks Like A Duck . . .

Having followed the three-step development of both the exemption for baseball and the presumption of market power, we may now complete the analogy.

- (1) In both cases, those who claim to be bound by the doctrine trace that obligation to a venerable Supreme Court decision, even though one (*Federal Baseball*) said nothing about exemptions and the other (*International Salt*) said nothing about presumptions.
- (2) In both cases, that original holding was based on a rationale—“incidental effects” in *Federal Baseball* and the pristine per se rule against tying in *International Salt*—that are now inconsistent with later antitrust jurisprudence.
- (3) Yet in both cases, when the Court revisited the issue, it chose not to overrule the first decision or to distinguish it as based on an early and incomplete legal doctrine, but instead invented a new rationale of dubious factual and legal merit.
- (4) In baseball, the notion in *Toolson* that the Congress of 1890 actually intended a specific exemption for baseball was so absurd that the lower courts ignored it for years; in patent tying, the “presumption of uniqueness” in *Loew's* was economically pointless and circular to boot.

¹¹¹ The Federal Circuit did not even acknowledge its numerous statements in non-tying cases that “[a] patent alone does not demonstrate market power.” *In re Independent Serv. Orgs. Antitrust Litig.*, 203 F.2d 1322, 1325 (Fed. Cir. 2000).

¹¹² See *Independent Ink v. Illinois Tool*, 396 F.3d at 1346 (“We conclude that the antitrust consequences of patent tying likewise is a question governed by our law.”).

(5) Finally, both doctrines required a third step to make them complete, and one tinged with irony. The insistence in *Flood* that Holmes had demanded a Congressional solution to the baseball exemption was probably the opposite of the truth; his “incidental effects” rationale was derived from the perceived *limits* on Congress’s power to regulate interstate commerce. And the transformation by the Federal Circuit of the presumption of *Loew’s* into a presumption of *market power* is remarkable given the express rejection of that proposition in *Loew’s* itself.

The Supreme Court has been invited to take the same third step in *Illinois Tool*. If it affirms, it will sustain an antitrust doctrine equally unrooted in economic reality, and equally disrespected, as the baseball exemption.

And the baseball exemption has one final, painful lesson to teach us—that expecting Congress to correct the Supreme Court’s mistakes is simply chimerical. I am not referring merely to the theoretical weaknesses of reliance on Congressional inaction, which are profound. There are myriad potential reasons why Congress fails to enact legislation, and there is no sound argument that a later Congress’s “intention” in failing to act has any relation to the intention of the prior Congress that passed the statute. Since Justice Scalia labeled the argument a “canard” in the 1980s, the Court has observed with increasing frequency that “Congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction, including the inference that the existing legislation already incorporated the offered change.”¹¹³

As *Illinois Tool* demonstrates, moreover, there is the vexing problem of just what Congressional inaction *is*. In 1988, Congress acted to amend the patent statute by removing any presumption of market power when an alleged infringer asserts patent “misuse” based on tying as a defense.¹¹⁴ (Misuse is an equitable defense to infringement that some courts historically viewed as easier to prove than an antitrust violation.¹¹⁵) Because, as Professor Hovenkamp has noted, “it would be irrational for Congress to immunize patent ties from Patent Act liability only to have them condemned under the [antitrust laws],”¹¹⁶ some have argued that Congress’s amendment of the patent statute impliedly repealed the antitrust laws from supporting the contrary results.¹¹⁷

Notwithstanding this argument, however, the rejoinder of the Respondent in *Illinois Tool* has been that Congress’s failure to amend the antitrust laws at the same time shows that this “irrational” result was precisely what Congress intended.¹¹⁸ Even the Federal Circuit found it “noteworthy that Congress has declined to require a showing of market power for affirmative patent tying claims.”¹¹⁹ Yet Congress’ failure to amend the highly general proscriptions of the antitrust

¹¹³ *United States v. Craft*, 535 U.S. 274, 287 (2002) (quotation omitted). See *Alexander v. Sandoval*, 532 U.S. 275, 292 (2001) (“it is impossible to assert with any degree of assurance that Congressional failure to act represent affirmative Congressional approval of the Court’s statutory interpretation”).

¹¹⁴ Patent Misuse Reform Act of 1988, Pub. L. 100-703, 102 Stat. 4676 (codified at 35 U.S.C. § 271(d)(5)).

¹¹⁵ See HOVENKAMP ET AL., *supra* note 59, § 4.2e6, at 4-36 (2005 Supp.). Most courts have abandoned the notion that there is or should be any difference between the standards for misuse and affirmative antitrust claims. See, e.g., *USM Corp. v. SPS Technologies, Inc.*, 694 F.2d 505, 511-14 (7th Cir. 1982).

¹¹⁶ *Id.*

¹¹⁷ See Brief of New York Intellectual Property Law Association as Amicus Curiae in Support of Petitioners at 12-24, *Illinois Tool Works Inc. v. Independent Ink, Inc.*, No. 04-1329 (U.S.) (Aug. 4, 2005).

¹¹⁸ Respondent’s Brief In Opposition to Petition for Certiorari at 1-5, *Illinois Tool Works Inc. v. Independent Ink, Inc.*, No. 04-1329 (U.S.) (May 5, 2005).

laws is far more likely to have resulted from the view, as expressed by an Assistant Attorney General for Antitrust to a later Congress, that the presumption had been *rejected* by most courts and that the Ninth Circuit's contrary decision in *Digidyne* was a "relic."¹²⁰ I do not expect the Court to reach the argument of implied repeal in *Illinois Tool*, because it does not need to. But the simple fact that the same Congressional events have been argued both ways demonstrates how unrigorous the doctrine is in application.

Beyond these theoretical flaws, however, the baseball exemption shows us what to expect in practical terms when we leave it to Congress to address and remedy the problem. The first thing is that it may take a while. When it decided *Toolson* in 1953, the Court knew that Congress had the baseball exemption under active consideration, yet no "remedy" ensued. When the Court decided *Flood* in 1972, therefore, Chief Justice Burger's concurring opinion gave Congress this stern command: "[I]t is time the Congress acted to solve the problem."¹²¹ And so Congress did act, a mere 26 years later, when it passed "The Curt Flood Act of 1998."

If you have not heard of this statute, do not despair. As far as I can tell, it has never been invoked, for reasons which will be obvious presently. Nonetheless it was announced with great fanfare when passed, with all the usual shibboleths: "The legislation reverses . . . an 'aberrant' 1922 Supreme Court decision that exempted baseball labor relations from antitrust laws on the grounds that it is a game and not a business."¹²² In point of fact, the statute by its terms does not "reverse" *Federal Baseball*, nor does it have any other practical effect in exposing baseball to antitrust liability.

Rather than simply declaring that all commercial activity is subject to the antitrust laws unless expressly exempted, the statute adds a new Section 27 to the Clayton Act comprising over 1200 words and 18 separate subsections. The limitations in the bill are reflected in its own description of its purpose:

It is the purpose of this legislation to state that major league baseball players are covered under the antitrust laws (i.e., that major league baseball players will have the same rights under the antitrust laws as do other professional athletes, e.g., football and basketball players), along with a provision that makes it clear that the passage of this Act does not change the application of the antitrust laws in any other context or with respect to any other person or entity.¹²³

In other words, a major league ballplayer can now sue under the antitrust laws, but the "exemption" is undisturbed with respect to issues such as team relocation, league expansion, and broadcasting. And we do mean that only *major* leaguers can sue. The Act goes to nearly comical lengths of definition and loophole plugging to ensure that hapless minor leaguers will not be included. Thus, the Act purports to lift the exemption for Curt Flood himself, but all others—whether a dissenting owner, a competitive league, or even our bush-league pal, George Earl Toolson—are out of luck.

¹¹⁹ 396 F.3d at 1349 n.7.

¹²⁰ *Intellectual Property Antitrust Protection Act of 1995: Hearings on H.R. 2674 Before the Comm. on the Judiciary*, House of Reps., 104th Cong., 2d Sess. at 16–18 (1996) (testimony of Assistant Attorney General Joel Klein).

¹²¹ *Flood v. Kuhn*, 407 U.S. at 286.

¹²² *Congress Votes Baseball Bill*, N.Y. TIMES, Oct. 8, 1998, at D4.

¹²³ P.L. 105-297, § 2.

And even Curt Flood could not sue successfully under the Act, as long as he was a member of the players' union. The restraints on current players are part of the collective bargaining agreement (CBA), and there is a separate antitrust exemption under the labor laws that protects the owners from claims based on the CBA.¹²⁴ For any player to make use of the Curt Flood Act, therefore, the union would have to be decertified before he could sue. Decertification is no small thing, and it is a decision controlled entirely by the union. It has not happened yet.¹²⁵

As a result, the Curt Flood Act of 1998 could be a poster child for the proposition that a subsequent Congress should *not* be entrusted to repair judicial mistakes in statutory construction. Far from removing the antitrust exemption, it works a small repeal of only arguable utility for those who need protection the least (the major leaguers already protected by the CBA). It does not even "reverse" the decision in *Federal Baseball*, because the plaintiff there was a club in a rival league, not a major league player. All that this statute really does (besides throwing the players' union a bone that they would use only as an act of desperation) is to render the nonsensical holding of *Toolson* stranger yet, as Congress announces that a judicially created exemption will apply to some ballplayers, but not to others.

The Curt Flood Act of 1998 notwithstanding, the antitrust exemption remains, in all important respects, intact. There's still no tying in baseball.

Conclusion

I find the baseball cases compelling here because, in order to "reaffirm" and follow its prior precedent, the Court had to recast and bend those holdings until they were unrecognizable. So it is that, in *Illinois Tool*, the Court could only "reaffirm" a presumption of actual market power by discovering it in a case (*Loew's*) that expressly denied its existence. Simply describing the baseball cases, one hopes, makes it seem inconceivable that the Supreme Court could again misapply stare decisis so grotesquely. Yet it happened once. And there would appear to be no theory other than stare decisis, and no excuse other than Congressional inaction, if it happens in *Illinois Tool*.

But take heart. The Court has made clear that stare decisis applies to holdings, not "clearly articulated . . . dicta," and the holdings of *International Salt* and *Loew's* do not begin to bear the weight that the Federal Circuit has placed upon them. So I am predicting reversal. If I am wrong, I will always suspect it was because the Court failed to keep its mind on the game. ●

. . . the Curt Flood Act of 1998 could be a poster child for the proposition that a subsequent Congress should not be entrusted to repair judicial mistakes in statutory construction.

¹²⁴ See, e.g., *Brown v. Pro Football, Inc.*, 518 U.S. 231, 250 (1996).

¹²⁵ I have found no case in which a major leaguer has brought suit under the Act, even to have it dismissed under the labor exemption. In the words of one court considering the impact of the Curt Flood Act of 1998, "[n]othing of substance has changed since Flood." *Major League Baseball v. Butterworth*, 181 F. Supp. 2d 1316, 1331 (N.D. Fla. 2000); *id.* n.16.

United States v. Hynix Semiconductor, Inc.: **Opening the Door to the Inability-to-Pay Defense?**

James H. Mutchnik and Christopher T. Casamassima

In the high-stakes world of criminal antitrust, practitioners are always watching the U.S. Department of Justice's Antitrust Division for cues about what they should or should not do the next time they have to walk through the Division's door to try to cut the best possible deal for their clients. In May of this year the Division secured the third-largest fine in antitrust history when Hynix Semiconductor Inc. pleaded guilty to fixing the prices of DRAM computer chips and agreed to pay \$185 million.

The Hynix plea arose out of the Division's long-running investigation of the DRAM industry, and is the second huge-dollar guilty plea of a computer chip manufacturer to come out of the investigation. The other guilty plea—by Infineon Technologies AG—led to the fourth-largest criminal antitrust fine ever.

With such high stakes involved, the Division was well aware that all eyes in the criminal antitrust bar would be on it. Given that, the Division—as it always is—was cognizant of the precedent its plea agreements create for future negotiations. After all, the Division itself profits from transparency because it knows that if defense counsel can trust that their clients will do better by cooperating early, then it is more likely that they will advise their clients to do so. Indeed, the Division has acknowledged that transparency is one of the three most important factors in an effective enforcement regime, the other two being the threat of severe sanctions and fear of detection.¹

With the spotlight shining that much brighter in the higher profile cases like DRAM, this is all the more true. That is why the Division's actions in the DRAM investigation could signal lessons about the current mindset of the Division—specifically what factors it will and will not consider in negotiating a plea.

Have there been any lessons for practitioners from the DRAM prosecution so far? Perhaps. The terms of the Hynix plea may indicate that the Division is willing to use with greater frequency the "inability to pay" section of the Federal Sentencing Guidelines to reduce a defendant's fine below the ordinary recommended Guideline fine. It would be helpful, however, for future cases if the Division better articulated its thinking.

■
James H. Mutchnik,
a partner in Kirkland
& Ellis LLP's Chicago
office, focuses on
antitrust and white-
collar criminal defense.

**Christopher T.
Casamassima** is an
associate in the firm's
Los Angeles office and
focuses on antitrust
and business litigation.
The authors and their
firm did not represent
Hynix Semiconductor
Inc., but were involved
in the representation of
another company
involved in the DRAM
investigation.

¹ "The third and final hallmark of an effective Amnesty Program is the need for transparency to the greatest degree possible throughout the enforcement program. Self-reporting and cooperation from offenders have been essential to our ability to detect and prosecute cartel activity. Cooperation from violators, in turn, has been dependent upon our readiness to provide transparency throughout our anti-cartel enforcement program so that a company can predict with a high degree of certainty how it will be treated if it reports the conduct and what the consequences will be if it does not." Scott D. Hammond, Deputy Assistant Attorney General, U.S. Dep't of Justice Antitrust Division, Cornerstones of an Effective Leniency Program, Remarks Presented Before the ICN Workshop on Leniency Programs in Sydney, Australia at 9 (Nov. 22–23, 2004), available at <http://www.usdoj.gov/atr/public/speeches/206611.htm>.

Specifically, in imposing Hynix's gigantic, but still significantly decreased, fine, the Division chose to eschew its long-preferred practice of justifying a decreased fine based on the defendant's cooperation. Instead, the Division stated that it had reduced Hynix's fine due to its inability to pay the full amount of its fine as calculated under the Federal Sentencing Guidelines.² Using the inability-to-pay provision of the Guidelines would make sense if Hynix clearly met existing requirements for qualifying for such a reduction. But there's the rub: publicly available information suggests that, by the time of its plea, Hynix did not look like a company that needed this particular special break, especially given that it would have gotten a substantial discount anyway based on its cooperation with the Division's investigation. So the Division must have seen an unarticulated "something" that led it to accept the "inability-to-pay" reduction. It would be helpful for the Division to state what that "something" was. Meanwhile, other defendants and their counsel should try to say "me too."

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Prior Application of the "Inability-to-Pay" Criterion

The Federal Sentencing Guidelines impose a stringent test on corporations or other organizations seeking an inability to-pay-discount. Section 8, Part C of the Guidelines provides for the imposition of fines on organizations. Section 8C3.3 is entitled "Reduction of a Fine Based on Inability to Pay" and its subsection (a) states that a "court shall reduce the fine below that otherwise required . . . to the extent that imposition of such fine would impair its ability to make restitution to victims."³ Subsection (b) allows—but does not require—a court to decrease a fine below the minimum fine, "if the court finds that the organization is not able and, even with the use of a reasonable installment schedule, is not likely to become able to pay the minimum fine [calculated under the Guidelines]. *Provided, that the reduction under this subsection shall not be more than necessary to avoid substantially jeopardizing the continued viability of the organization.*"⁴

Section 8C3.3's Application Note explains that "an organization is not able to pay the minimum fine if, even with an installment schedule under § 8C3.2 (Payment of the Fine—Organizations), the payment of that fine would substantially jeopardize the continued existence of the organization." Consequently, for an entity to qualify for a reduced fine based on its "Inability to Pay," it must prove that the payment of the fine would put its continued existence in jeopardy or affect its ability to make restitution to the victims of the crime.

Case law interpreting the inability-to-pay discount seems to actually tighten the requirements. The Third Circuit, for example, has held that in evaluating the inability-to-pay question, "[t]he sentencing court must take account of the corporate defendant's financial resources, putting the burden on the defendant to produce relevant materials, before setting a fine that *may consume all of the defendant's assets.*"⁵

² United States v. Hynix Semiconductor, Inc., No. CR 05-249 PJH (N.D. Cal.) Plea Agreement ¶ 10, at 5–6 (Apr. 20, 2005) ("[t]he United States agrees that, based on Defendant's ongoing cooperation, the United States would have moved the court for a downward departure . . . , but for the fact that the amount of the fine that the United States would have recommended . . . would still have exceeded Defendant's ability to pay. The parties further agree that the recommended fine is appropriate . . . due to the inability of the Defendant to make restitution to victims and pay a fine greater than that recommended without substantially jeopardizing its continued viability.")

³ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8C3.3(a) (Nov. 2004) [GUIDELINES MANUAL].

⁴ *Id.* § 8C3.3(b) (emphasis added).

⁵ United States v. Nathan, 188 F. 3d 190, 213 (3d Cir. 1999) (emphasis added).

In *United States v. Eureka Laboratories, Inc.*,⁶ the Ninth Circuit went so far as to hold that:

Guideline Section 8C3.3 does not prohibit a court from imposing a fine that jeopardizes an organization's continued viability. It permits, but does not require, a court in such circumstances and in its discretion, to reduce the fine. The only time a reduction is mandated under section 8C3.3 is if the fine imposed, without reduction, would impair the defendant's ability to make restitution to victims. See USSG § 8C3.3(a). Thus, even if the district court's fine would completely bankrupt [Eureka], neither section 8C3.3(a) nor section 8C3.3(b) precluded the court from imposing such a fine so long as the fine did not impair [Eureka's] ability to make restitution. It did not.

The bottom line is that qualifying for an inability-to-pay discount is not easy. And the Division has historically put defendants to the task of clearing these legal hurdles, rarely accepting defendants' claims of inability to pay.

Hynix Did Not Fit the Traditional “Inability-to-Pay” Criteria

What about Hynix? It should have been in really bad shape, i.e., its “continued viability” in jeopardy, to get the discount.⁷ Was it?

At first glance, Hynix might have appeared to be a reasonable candidate for the discount. Hynix has long been in serious financial trouble; in fact, it has been controlled by creditors since 2001. There has long been speculation that, in the latter part of 2001, Hynix's competitors initiated a “price war” to try and force Hynix to go under. Following this, it was widely reported that a competitor in the DRAM industry (Micron) all but acquired Hynix in 2002, reaching an agreement in principle, only to see the transaction crater at the eleventh hour.⁸ After the Hynix-Micron deal fell through, Hynix needed a \$4 billion bail-out in December 2002.⁹ Had the plea agreement been reached in 2002, Hynix was an obvious candidate for the inability-to-pay discount.

However, more recently, Hynix has turned the corner in a big way; so much so that Hynix reported operating profit for the fourth quarter of 2004 of roughly \$420 million and capital surplus of approximately \$500 million.¹⁰ Hynix's operating profit in the first quarter of 2005 was about \$320 million.¹¹ Leading market research analysts report Hynix is aggressively expanding its capital expenditures, and Hynix's own Web site confirms this, reporting that Hynix is spending \$250 million in 2005—as an initial investment—on a new factory in China.¹² After Hynix's fine became public, Hynix assured investors in public statements that not only did the \$185 million fine not threaten its existence (a goal of the inability-to-pay discount) but would not even hurt its bottom line.¹³ And most recently, Hynix reported that it was a year ahead of schedule in paying off its creditors.¹⁴

⁶ 103 F. 3d 908, 912 (9th Cir. 1996).

⁷ GUIDELINES MANUAL, *supra* note 3, §8 C3.3(b).

⁸ See *Hynix Creditor Claims Major Progress in Micron Talks*, THE REGISTER, Mar. 19, 2002, available at http://www.theregister.co.uk/2002/03/19/hynix_creditor_claims_major_progress/; *Hynix Ditches Micron Rescue Deal*, BBC NEWS, Apr. 30, 2002, available at <http://news.bbc.co.uk/1/hi/business/1959309.stm>.

⁹ See *Rescue Plan for Chip Giant Hynix*, BBC NEWS, Dec. 30, 2002, available at <http://news.bbc.co.uk/1/hi/business/2614585.stm>.

¹⁰ See *Hynix Financial Info*, at http://www.hynix.com/eng/04_jr/03_financial/financial_01.jsp.

¹¹ See *Hynix Semiconductor Inc. Reports the Results for the First Quarter of FY 2005*, May 4, 2005, at http://www.hynix.com/allnews/eng/preng_readA.jsp?NEWS_DATE=2005-05-04:13:07:05&CurrentPageNo=1&SearchKind=4&SearchWord=&SELECT_DATE=

¹² See Hynix Press Release (Apr. 28, 2005), at http://www.hynix.com/allnews/eng/preng_readC.jsp?NEWS_DATE=2005-05-03:16:05:46.

¹³ See *Hynix Says It Can Pay Fine and Still Meet Bottom Line*, TAIPEI TIMES, Apr. 23, 2005, at 11, available at <http://www.taipetimes.com/News/worldbiz/archives/2005/04/23/2003251657>.

¹⁴ See *Hynix Pays Its Debts a Year Early*, BBC NEWS, July 12, 2005, at <http://news.bbc.co.uk/1/go/pr/fr/-/1/hi/business/4674245.stm>.

What Explains the Deal?

Why, then, would the Division nevertheless extend this unusual discount to Hynix? Could it be as simple as \$185 million was just the number that got the deal done and the Division and Hynix used “inability to pay” to justify that number even though it could not have been normally justified using traditional cooperation discounts alone? Is the Division now ready to use an inability-to-pay discount to get fines to a place where defendants can realistically afford them, even if the defendant could not meet the seemingly stringent inability-to-pay requirements? The Division could have eased Hynix’s payments by back-loading a small portion of the fine or providing a discount (albeit a lesser discount) based on Hynix’s relatively early cooperation in the investigation. This makes it appear that the Division could have used “inability to pay” simply as a way for the two sides to bridge final gaps in their negotiations after they were already close to terms. By using “inability to pay” for Hynix, which had been at least a superficially valid candidate for such a discount, maybe the Division believes it can keep the *cooperation* discount low for other “second-in” cooperators, who lacked Hynix’s earlier financial troubles.

If nothing else, the Hynix plea signals that the Division might be more flexible and tolerant of creative solutions to reduce financial burdens on slow-poke defendants.

Consider the circumstances more closely: Hynix agreed to pay \$185 million over five years. The Division agreed to accept an initial payment from Hynix of only \$10 million. And even better for Hynix, the fine is interest-free. Suffice it to say that a low down-payment and interest-free financing is not how the Division has typically done business in the past. Focusing on the actual fine amount, it appears that the inability-to-pay discount was worth about \$16 million, or approximately 8 percent, off the fine. We reached that number by first looking at Hynix’s Joint Sentencing Memorandum.¹⁵ Hynix’s all-important “volume of affected commerce” was \$839 million. Under the Guidelines, that translated into a minimum fine of \$268.5 million.¹⁶ Assuming that Hynix would have otherwise received a “standard” third-in cooperator’s discount of 25 percent, its fine would have been \$201 million.

Would that \$16 million—spread out over five years and interest-free—really have jeopardized the continued existence of a company that has hundreds of millions in cash and is set to spend \$250 million on an initial payment of a business venture in China? Given today’s low interest rates—and yes, the rate is fixed as of the date of the first payment on a fine—would the imposition of interest have broken Hynix’s bank or challenged its continued viability? Would it have jeopardized Hynix’s China expansion plans or put a dent in its profit projections? We do not think so.

Lessons for the Next Defendant

Because the Division is not required, nor did it volunteer, to explain its reasoning for cutting the deal with Hynix, what does this all mean? We offer these suggestions:

If nothing else, the Hynix plea signals that the Division might be more flexible and tolerant of creative solutions to reduce financial burdens on slow-poke defendants. After all, each additional cooperator helps the Division’s efforts to put the squeeze on the remaining conspirators. Perhaps, Hynix got the \$185 million deal done playing the “inability-to-pay” card because the Division did not want to offer any greater substantial assistance discount percentage, fearing that it will negatively impact their fine negotiating position in other matters. Maybe this new-found flex-

¹⁵ United States v. Hynix Semiconductor, Inc., No. CR 05-249 PJH (N.D. Cal.), Joint Sentencing Memorandum at 5 (May 4, 2005).

¹⁶ *Id.*

ibility is just an outgrowth of *Booker*¹⁷ and *Blakely*¹⁸ and the Guidelines' new quasi-advisory status under those cases.

Certainly defense attorneys should all take the time and effort to review their clients' financial statements, loan covenants, and future/projected cash flow to analyze—under the Hynix “standard”—whether there is an inability-to-pay opportunity, even a marginal one. Maybe there is even a new role for the financial analyst in Division cases. Clouding your client's financial picture may just have a silver lining. If nothing else, counsel should work hard to estimate “worst-case” civil damage exposure as a way to see if the Division is willing to take a haircut on its fine, such as it appears to have done with Hynix.

Given the primacy the Division places on transparency in its sentencing regime and assuming that there is, in fact, a message sent with the Hynix “inability-to-pay” sentence, the Hynix plea must be interpreted as a sign that the Division will listen, and apparently listen hard, to an inability-to-pay argument. But is the door only open a crack? Is this a sign that the Division is going to be more flexible in other areas too?

Whatever the answers to those questions, it is possible to take away the impression that the Division is willing to cut deals that make room for the conspirators who see the sense in cooperating a little later than the lucky criminal who beats everyone else to the Division's door. Over time, case-by-case prodding of the Division, or a fuller public statement of the Division's reasoning, will flesh out the answers to these questions. In the meantime, take out your calculator and look at it through your crystal ball—do you see your client's “inability to pay,” even just a little bit? ●

¹⁷ *United States v. Booker*, 125 S. Ct. 738 (2005).

¹⁸ *Blakely v. Washington*, 542 U.S. 296 (2004).

The Filed Rate Doctrine as Applied to Alleged Manipulation in the Wholesale Natural Gas Market: A Defense Perspective

Joshua D. Lichtman and Carlos R. Rainer

Application of the filed rate doctrine to antitrust suits brought by plaintiffs challenging the reasonableness of rates raises a number of important questions in litigation involving wholesale electricity and natural gas transactions. In this article, we analyze, from a defense perspective, how courts have evaluated preclusion arguments advanced by defendants under the filed rate doctrine, with a specific focus on application of the doctrine in natural gas litigation.

The filed rate doctrine is a judicially created rule that prevents collateral attacks on rates that are filed with and/or regulated by state and federal agencies. Principally, the doctrine forbids judicial rate-setting by courts and is applied to preserve the regulatory jurisdiction that is vested in state and federal agencies on matters pertaining to the regulation of rates.

The doctrine has been invoked by defendants to preclude state and federal antitrust litigation relating to wholesale electricity and natural gas rates. Both the Federal Power Act (FPA) and Natural Gas Act (NGA) grant exclusive jurisdiction to the Federal Energy Regulatory Commission (FERC) to ensure that wholesale electricity and natural gas rates are “just and reasonable.” The FPA and NGA vest FERC with sole authority to determine if wholesale rates are just and reasonable. In light of FERC’s exclusive jurisdiction, defendants often plead the filed rate doctrine as a bar to antitrust lawsuits alleging manipulation of wholesale electricity and natural gas rates.

One important question raised in applying the filed rate doctrine in natural gas litigation is whether the doctrine should be relevant when rates are not actually “filed” with FERC but rather are approved under a market-based rate regime established by FERC. On the natural gas side, some plaintiffs have argued that there is insufficient regulatory oversight by FERC under the NGA, and as such, contend that the filed rate doctrine should not apply to preclude antitrust claims challenging wholesale natural gas rates. On the electricity side, defendants have argued and courts have uniformly held that the filed rate doctrine bars antitrust litigation over wholesale electricity rates despite FERC’s transition to a market-based rate regime.

Overview

The 2000–2001 California energy crisis spawned two waves of litigation. The first involved claims (primarily asserted by California state agencies and private plaintiffs, including industrial and individual consumers) that generators and traders of electricity had manipulated the wholesale electricity market, either on their own or collusively.¹ After it became apparent that a factor in the

■ **Joshua D. Lichtman** is a partner with Fulbright & Jaworski L.L.P. in Los Angeles. **Carlos R. Rainer** is a senior associate in Fulbright’s Houston office. Fulbright & Jaworski represents one of the defendants in certain of the recent cases discussed in this article.

¹ A more detailed examination of the application of the filed rate doctrine to the electricity cases arising from the 2000–2001 California energy crisis is found in Rufus W. Oliver III & David M. Rodi, *The Filed Rate Defense: A Regulatory Doctrine Survives The Restructuring Of The Electricity Industry*, ENERGY ANTITRUST NEWS, Winter 2004, at 3.

increase of wholesale electricity prices in California was a rise in the wholesale price of natural gas, used to fire many of the plants generating electricity for use in California,² a second wave of litigation was filed in numerous federal courts and California state courts based on allegations that many of those same marketers had colluded to manipulate the natural gas market.

At the trial court level, the electricity cases have largely been resolved. The FPA requires that wholesale electricity prices be “just and reasonable” and delegates to FERC the authority to make such determinations. Trial courts uniformly have held civil actions alleging either state or federal claims for damages based on the alleged manipulation of the wholesale electricity market barred because the FPA preempts state law claims and/or because the filed rate doctrine bars all of the asserted damage claims, as only FERC may determine what a “just and reasonable” price for electricity would have been absent the alleged misconduct.³

Many of the electricity cases have also been decided at the intermediate appellate court level, with several panels of the Ninth Circuit Court of Appeals holding civil actions seeking to recover for alleged “overcharges” on wholesale electricity purchases barred by federal preemption and/or the filed rate doctrine, with the only avenue for recovery being an administrative complaint to FERC.⁴ The natural gas cases have not yet resulted in any significant decisions at the appellate level in either federal or state court. Separate federal district courts have, however, decided motions to dismiss antitrust claims based upon preemption and filed rate doctrine arguments arising from the NGA. One case, *E&J Gallo Winery v. Encana Energy Services, Inc. (Gallo)*,⁵ denied the motion to dismiss, and two others, *In re Western States Wholesale Natural Gas Antitrust Litigation (Texas-Ohio)*⁶ and *Sierra Pacific Resources v. El Paso Corporation (Sierra Pacific)*,⁷ granted motions to dismiss.

The state trial courts to address the issue have reached conflicting decisions: in *In Re: Natural Gas Antitrust Cases I, II, III and IV*,⁸ the court denied the California procedural equivalent of motions to dismiss brought on filed rate doctrine/preemption grounds. In contrast, in *Phelps Dodge Corp v. El Paso Corp.*,⁹ the court granted a motion to dismiss, finding the plaintiff’s antitrust claims preempted because the claims depended on the allegation that the defendants charged unreasonable rates for natural gas, a matter committed solely to FERC’s jurisdiction.

² See, e.g., Amendments to Blanket Sales Certificates, 18 C.F.R. § 284.288.

³ On June 14, 2005, U.S. Bankruptcy Judge Arthur Gonzalez held that the State of California’s state law claims based on Enron’s alleged “gaming” of the wholesale electricity market in 2000–2001 were barred by federal preemption and the filed rate doctrine. *In Re Enron Corp.*, No. 01B16034 (AJG), 2005 Bankr. LEXIS 1065 (S.D.N.Y. 2005).

⁴ California *ex. rel.* Lockyer v. Dynegy, Inc., 375 F.3d 831 (9th Cir. 2004), *cert. denied*, 125 S. Ct. 1836 (2005); Public Util. Dist. No. 1 of Snohomish County v. Dynegy Power Mktg., Inc., 384 F.3d 756 (9th Cir. 2004), *cert. denied*, 2005 U.S. LEXIS 5184 (June 27, 2005) (*Snohomish*); Public Util. Dist. No. 1 of Grays Harbor v. Idacorp Inc., 379 F.3d 641 (9th Cir. 2004) (*Grays Harbor*); California *ex rel.* Lockyer v. Transcanada Power, L.P., 110 Fed. App. 839 (9th Cir. 2004); T&E Pastorino Nursery v. Duke Energy Trading & Mktg., 123 Fed. App. 813 (9th Cir. 2005) (*Pastorino*).

⁵ No. CV F 03-5412 AWILJO (E.D. Cal. May 14, 2004).

⁶ 368 F. Supp. 2d 1110 (D. Nev. 2005).

⁷ No. CV-S-03-0414-JCM-RJJ (D. Nev. Dec. 8, 2004).

⁸ San Diego Superior Court Case Nos. JCCP 4221, 4224, 4226, 4228, (May 4, 2005 and June 29, 2005).

⁹ Maricopa County Superior Court Case No. CV 2004-00281 (Aug. 23, 2005).

FERC's Exclusive Jurisdiction to Ensure "Just and Reasonable" Wholesale Electricity and Natural Gas Rates: A Transition to Market-Based Rates

FERC has exclusive regulatory jurisdiction over matters pertaining to interstate sales of wholesale electricity and natural gas under the FPA and NGA. The FPA grants FERC exclusive jurisdiction to regulate interstate wholesale electricity sales and ensure the prices charged are "just and reasonable."¹⁰ Just as does the FPA, the NGA requires that all rates charged for the wholesale sale and transportation of natural gas must be "just and reasonable," and the NGA vests "the authority to decide whether the rates are reasonable . . . solely in the [FERC]."¹¹ When FERC has jurisdiction, "the states cannot have jurisdiction over the same subject."¹²

In recent years, FERC has adopted a market-based rate scheme authorizing the wholesale sales of electricity and natural gas at negotiated, market-based rates. Specifically, FERC has shifted from a regulatory scheme requiring advance "filing" of specific rates for wholesale electricity sales to one permitting sellers to charge negotiated, "market-based" rates once FERC has determined that the entity lacks "market power" (e.g., the ability to "significantly influence price in the market by withholding service and excluding competitors for a significant period of time") and on the condition that the seller file quarterly reports of the rates actually charged.¹³ Numerous courts have held that FERC's shift to a market-based rate regime is authorized under the FPA.¹⁴

Similarly, Congress has enacted several statutes reflecting that the federal government has also "occupied the field of matters relating to wholesale sales and transportation of natural gas in interstate commerce,"¹⁵ the NGA,¹⁶ the Natural Gas Policy Act of 1978 (NGPA),¹⁷ and the Wellhead Decontrol Act of 1989.¹⁸ The U.S. Supreme Court has held the Congressional occupation of the field is "complete" and reflects a Congressional intent to provide uniform and comprehensive regulation of the natural gas wholesale market, exclusively under federal law.¹⁹ And, as with the electricity market, regulation of the wholesale natural gas market has shifted in recent years to permit natural gas transactions to be conducted at market-based rates.

As distinct from the electricity market, the changes in the regulation of the natural gas market have occurred partly through legislation and partly through administrative rules and orders promulgated by FERC. First, Congress enacted the NGPA and the Natural Gas Wellhead Decontrol Act of 1989, which repealed Sections 3311–3320 of the NGPA.²⁰ Congress thereby eliminated price

FERC has adopted a market-based rate scheme authorizing the wholesale sales of electricity and natural gas at negotiated, market-based rates.

¹⁰ 16 U.S.C. §§ 824(b), (d); *Entergy La., Inc. v. Louisiana Public Serv. Comm'n*, 539 U.S. 39, 41 (2003); *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1011 (9th Cir. 2004) (*Lockyer v. FERC*).

¹¹ 15 U.S.C. §§ 717(b) and c(a); *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 300–01 (1988); *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 (1981); *United Distrib. Cos. v. FERC*, 88 F.3d 1105, 1161–63 (D.C. Cir. 1996); *Texas-Ohio*, 368 F. Supp. 2d at 1114.

¹² *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 377 (1988) (Scalia, J. concurring).

¹³ *E.g., Lockyer v. FERC*, 383 F.3d at 1012–13; *Snohomish*, 384 F.3d at 760–61.

¹⁴ *E.g., Lockyer v. FERC*, 383 F.3d at 1012–13; *Snohomish*, 384 F.3d at 760–61; *Grays Harbor*, 379 F.3d at 649.

¹⁵ *Schneidewind*, 485 U.S. at 305; *Exxon v. Eagerton*, 462 U.S. 176, 184 (1983).

¹⁶ 15 U.S.C. § 717 et. seq.

¹⁷ 15 U.S.C. § 3301 et. seq.

¹⁸ 101 P.L. 60, 103 Stat. 157.

¹⁹ *Schneidewind*, 485 U.S. at 299–300, 310.

²⁰ *Texaco Inc. v. Duhe*, 274 F.3d 911, 916 n.5 (5th Cir. 2001).

controls as to “first sales” of natural gas, although that term was defined to *exclude* interstate wholesale sales by any natural gas pipeline, any distribution company, or any affiliate thereof.²¹ Moreover, the NGPA does not create a regulatory vacuum that would allow direct or indirect challenges to the prices of interstate “first sales” in civil lawsuits; rather, it constitutes a Congressional determination that such sales are not subject to price regulation at all, given the Congressional intent to “occupy the field of wholesale sales of natural gas in interstate commerce.”²² The Supreme Court has explained:

To the extent that Congress denied FERC the power to regulate affirmatively particular aspects of the first sale of gas, it did so because it wanted to leave determination of supply and first-sale price to the market. “[A] federal decision to forgo regulation in a given area may imply an authoritative federal determination that the area is best left *unregulated*, and in that event would have as much preemptive force as a decision *to regulate*.”²³

As part of its regulatory jurisdiction, and in part as a response to the California energy crisis of 2000–2001, FERC implemented market conduct rules aimed at preventing abusive or anticompetitive conduct.

Second, in various orders promulgated starting in 1992, FERC loosened regulatory control of other aspects of the sale and transportation of wholesale natural gas. Chiefly, in 1993, FERC issued “blanket certificates” authorizing “sales for resale at negotiated rates in interstate commerce” of any natural gas subject to FERC’s jurisdiction under the NGA.²⁴ In granting natural gas wholesalers authority to sell at market-based rates, FERC reasoned that such “light-handed regulation” would be sufficient to ensure that rates for gas sales would remain reasonable, based on FERC’s finding that “adequate divertible gas supplies exist in all pipeline markets.”²⁵ Thus, while FERC required an individualized showing of lack of market power before granting an electricity wholesaler market-rate approval, FERC effectively made such a determination on an industry-wide basis for the natural gas market, resulting in the issuance of blanket certificates allowing all natural gas wholesalers to transact at market-based rates. Therefore, much like the electricity market, by the late 1990s, sellers of wholesale natural gas were authorized to enter into bilateral transactions at market-based rates, without needing to submit those rates directly to FERC for prospective approval and “filing,” but subject to FERC’s ultimate regulatory jurisdiction to ensure that the rates charged were “just and reasonable” as required under the NGA.²⁶

As part of its regulatory jurisdiction, and in part as a response to the California energy crisis of 2000–2001, FERC implemented market conduct rules aimed at preventing abusive or anticompetitive conduct. Specifically, in 2003 FERC issued Order No. 644, amending the blanket marketing certificates to incorporate FERC’s Code of Conduct regulations and thereby expressly prohibit a broad range of objectionable conduct by market-based rate sellers, including collusive conduct aimed at fixing prices or manipulating market conditions.²⁷ FERC’s market conduct rules

²¹ 15 U.S.C. § 3301(21)(B); *see* Reporting of Natural Gas Sales to the California Market, 96 F.E.R.C. ¶ 61,119, 61,463, 2001 FERC LEXIS 1802 (2001); Amendments to Blanket Sales Certificate, 105 F.E.R.C. ¶ 61,217, at ¶ 15, 2003 FERC LEXIS 2276 (2003) (Order No. 644); In the Matter of Amendments to Blanket Sales Certificates, 107 F.E.R.C. ¶ 61,174, at ¶ 28, 2004 FERC LEXIS 1022 (F.E.R.C. 2004).

²² *Exxon Corp. v. Eagerton*, 462 U.S. at 184; *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Board of Miss.*, 474 U.S. 409, 421–22 (1986) (*Transcontinental*).

²³ *Transcontinental*, 474 U.S. at 422 (quoting *Arkansas Elec. Coop. Corp. v. Arkansas Public Serv. Comm’n*, 461 U.S. 375, 384 (1983)).

²⁴ 18 C.F.R. § 284.402.

²⁵ *United Distrib.*, 88 F.3d at 1125–26 (citing 18 C.F.R. §§ 284.281–284.288).

²⁶ 15 U.S.C. §§ 717(c) and (d).

²⁷ 18 C.F.R. § 284.403.

make plain FERC's authority and intention to take action against blanket marketing certificate holders who violate the Commission's rules, including authority to order "disgorgement of unjust profits," "suspension or revocation" of sales authority under FERC's blanket marketing certificates, and "other appropriate non-monetary remedies."²⁸

The FPA and the NGA are "substantially identical" and, thus, "there is an established practice of citing interchangeably decisions interpreting the pertinent sections of the two statutes."²⁹ Some authorities suggest that, as a result of the statutory and regulatory changes since the late 1970s, case law may no longer be cited interchangeably when dealing with the NGA, as distinct from the FPA.³⁰ However, FERC has stated that a "blanket [gas] certificate has the same legal effect as the market based rate authority granted to sellers in the wholesale electric market."³¹ Thus, it appears that FERC continues to believe that decisions concerning regulation of natural gas under the NGA and electricity under the FPA remain essentially interchangeable.

The Related Defenses of Federal Preemption and Filed Rate Doctrine and Their Preclusive Effect on Antitrust Claims

The federal preemption doctrine and filed rate doctrine are closely related in that they both operate to protect the exclusive jurisdiction vested in a federal agency. The NGA vests sole authority in FERC to ensure that wholesale natural gas rates are just and reasonable and to the extent state laws, including state antitrust law, purport to challenge or regulate transactions that are within FERC's exclusive jurisdiction under the NGA, they are preempted. As with federal preemption doctrine, the filed rate doctrine similarly operates to preserve FERC's exclusive jurisdiction to regulate wholesale natural gas rates by precluding suits, including antitrust suits, that challenge wholesale natural gas rates.

With respect to interstate wholesale sales of natural gas, the U.S. Supreme Court has made it clear that:

No court may substitute its own judgment on reasonableness for the judgment of [FERC]. The authority to decide whether the rates are reasonable is vested by § 4 of the [Natural Gas Act] solely in [FERC], and 'the right to a reasonable rate is the right to the rate which [FERC] files or fixes. Congress here has granted exclusive authority over rate regulation to [FERC].³²

FERC's determination of the reasonable rate is subject to review by the appropriate U.S. Court of Appeals, but the standard of review is deferential.³³ Thus, federal law preempts the application of state laws or regulations which would effectively change the prices of transactions within FERC's jurisdiction.³⁴

²⁸ 18 C.F.R. § 284.403(d).

²⁹ *Grays Harbor*, 379 F.3d at 649 n.8; *Lockyer v. Dynegy*, 375 F.3d at 842 n.8; *Hall*, 453 U.S. at 578 n.7.

³⁰ *Gallo*, Memorandum Order and Opinion Denying Defendants' Motion to Dismiss All Claims and Denying Motion to Strike, at 13–14 (E.D. Cal. May 14, 2004).

³¹ *Reliant Energy Serv., Inc.*, Order Approving Stipulation and Consent Agreement, 105 F.E.R.C. ¶ 61,008, at ¶ 29, 2003 FERC LEXIS 1958 (F.E.R.C. 2003).

³² *Hall*, 453 U.S. at 577, 580.

³³ *Lockyer v. FERC*, 383 F.3d 1006, at 1012. See *City of Seattle v. FERC*, 923 F.2d 713, 715 (9th Cir. 1991).

³⁴ *Lockyer v. Dynegy, Inc.*, 375 F.3d at 850 n.17 (citing *N. Natural Gas Co. v. State Corp. Comm'n*, 372 U.S. 84, 91 (1963) ("The federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas or for state regulations which would indirectly achieve the same result.")).

The filed rate doctrine is closely related to preemption; its “essential purpose . . . is to protect the jurisdiction of a regulatory body that Congress has designated to determine whether rates charged, such as those in the natural gas market, are just and reasonable.”³⁵ The doctrine precludes marketers from charging rates different from those filed with or fixed by FERC.³⁶ Thus, “[a]t its most basic, the filed rate doctrine provides that state law, and some federal law . . . [e.g., antitrust law], may not be used to invalidate a filed rate nor to assume a rate would be charged other than the rate adopted by the federal agency in question.”³⁷ The doctrine applies to rates charged by “interstate operators over whom federal agencies have exclusive power to set rates.”³⁸ Accordingly, the filed rate doctrine bars claims for damages dependent upon a hypothetical determination of the rates that would have been charged in a market subject to federal regulation, absent the alleged misconduct.³⁹ At its core, the filed rate doctrine prevents district courts from second-guessing agency rate-making decisions:

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This principle “prevents more than judicial rate-setting; it precludes any judicial action which undermines agency rate-making authority.” Thus, even if a claim does not directly attack the filed rate, an award of damages to the customer that would, in effect, result in a judicial determination of the reasonableness of that rate is prohibited under the filed rate doctrine.⁴⁰

If applicable, the filed rate doctrine bars civil antitrust damage claims, whether asserted under state or federal law.⁴¹ For example, in *Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*, plaintiffs alleged that the defendants, motor carriers engaged in the transportation of freight between the United States and Canada, had conspired to fix prices in violation of the Sherman Act.⁴² Because the defendants’ rates had been filed with the Interstate Commerce Commission, the Supreme Court found “the question presented is whether carriers are subject to treble-damages liability in a private antitrust action” for the alleged misconduct.⁴³ The Supreme Court squarely answered that question in the negative, reaffirming that the filed rate doctrine continues to bar private antitrust damage claims arising from filed tariffs.⁴⁴ The Supreme Court was careful, however, to explain that the filed rate doctrine did *not* provide a broad “immunity” from antitrust law because the defendants remained “subject to scrutiny under the antitrust laws by the Government and to possible criminal sanctions or equitable relief.”⁴⁵

³⁵ *Texas-Ohio*, 368 F. Supp. 2d at 1116; see *Grays Harbor*, 379 F.3d at 650 (the doctrine “is grounded in an agency’s exclusive rate-setting authority.”).

³⁶ *Hall*, 453 U.S. at 573, 577; *AT&T v. Central Office Tel., Inc.*, 524 U.S. 214, 222 (1986); *Lockyer v. FERC*, 383 F.3d at 1012.

³⁷ *Lockyer v. Dynegy*, 375 F.3d at 852–53; *Transmission Agency v. Sierra Pac. Power Co.*, 295 F.3d 918, 929 (9th Cir. 2002) (citing *County of Stanislaus v. Pac. Gas & Elec. Co.*, 114 F.3d 858, 862–63 (9th Cir. 1997)) (*Stanislaus*).

³⁸ *Transmission Agency*, 295 F.3d at 929.

³⁹ *Texas-Ohio*, 368 F. Supp. 2d at 1114–15.

⁴⁰ *Hill v. BellSouth Telecomms., Inc.*, 364 F.3d 1308, 1317 (11th Cir. 2004) (citation omitted).

⁴¹ *Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 416–17, 422 (1986) (*Square D*); *Stanislaus*, 114 F.3d at 862–63 (citing *Hall*, 453 U.S. at 580); see also *Lockyer v. Dynegy, Inc.*, 375 F.3d at 852–853; *Texas-Ohio*, 368 F. Supp. 2d at 1116; *California ex rel. Lockyer v. Mirant Corp.*, 266 F. Supp. 2d 1046, 1057 (N.D. Cal. 2003).

⁴² 476 U.S. at 410–12.

⁴³ *Id.* at 410.

⁴⁴ *Id.* at 418–22.

⁴⁵ *Id.* at 422.

Application of Filed Rate Doctrine/Federal Preemption to Manipulation Claims Pertaining to the 2000–2001 California Energy Crisis

The decisions in *Gallo*, *Texas-Ohio*, and *Sierra Pacific* raise significant questions pertaining to the propriety of applying federal preemption and filed rate arguments to preclude antitrust claims challenging wholesale natural gas rates when the rates are not directly filed with FERC but rather are authorized under a market-based rate scheme. The court in *Gallo* refused to apply the filed rate doctrine, in part, due to the lack of a specific rate filing with FERC. Conversely, the *Texas-Ohio* and *Sierra-Pacific* courts appear to have recognized that application of federal preemption and the filed rate doctrine is driven by the scope of jurisdiction granted to FERC to ensure just and reasonable rates rather than the specific regulatory mechanisms employed by FERC to achieve that result.

The complaints in each of *Gallo*, *Texas-Ohio*, and *Sierra Pacific* allege substantially similar misconduct, as do the various California state court cases pending as *In Re: Natural Gas Antitrust Cases I, II, III, and IV*. In particular, all of those cases allege that the defendants conspired to increase and/or fix the price of natural gas in violation of the Sherman Act, California's antitrust statute, the Cartwright Act,⁴⁶ and/or the California Unfair Competition Law.⁴⁷ Defendants are alleged to have carried out this purported conspiracy primarily by (1) reporting false price and volume information to the publishers of natural gas prices indexes that are used to establish the prices of certain natural gas transactions, and (2) participating in so-called "wash" trades, in which defendants would buy and sell the same volumes to one another at the same price, resulting in no net change of ownership or economic risk, but allegedly causing prices to increase due to the illusion of increased demand for natural gas and/or a collusive exchange of price information.⁴⁸ In each case, the defendants contend that the plaintiffs' antitrust and other claims were barred by federal preemption and/or the filed rate doctrine.

In *Texas-Ohio* and *Sierra Pacific*, the district courts found the claims barred because the alleged conduct concerned wholesale natural gas transactions within FERC's jurisdiction and, in particular, because the plaintiffs' damage claims would have required the court or jury to usurp FERC's function of determining whether the prices charged for the wholesale natural gas transactions at issue were "just and reasonable."⁴⁹ In *Gallo*, the court found that the filed rate doctrine did not apply, on the alternative grounds that (1) the plaintiff's allegations concerned retail, not wholesale sales, (2) resolution of the plaintiff's damage claims would not necessarily require a determination of whether the prices charged were "just and reasonable," which the court acknowledged remained within FERC's exclusive jurisdiction, and (3) there was no "filed rate" because FERC had granted blanket certificates to sell natural gas at market rates and, as distinct from its regulation of wholesale electricity sales, FERC did not make a prospective, company-specific, finding of lack of market power nor did it require the retrospective quarterly filing of rates that was required for electricity sales.⁵⁰

⁴⁶ Cal. Bus. & Prof. Code § 16720.

⁴⁷ Cal. Bus. & Prof. Code § 17200.

⁴⁸ *E.g.*, *Texas-Ohio*, 368 F. Supp. 2d at 1113.

⁴⁹ *Texas-Ohio*, 368 F. Supp. 2d at 1114–17; *Sierra Pacific*, Order Granting Motions to Dismiss, at 1 (D. Nev. Dec. 8, 2004).

⁵⁰ *Gallo*, Memorandum Order and Opinion Denying Defendants' Motion to Dismiss All Claims and Denying Motion to Strike, at 9–17 (E.D. Cal. May 14, 2004).

These cases pose several common issues and arguments relating to the filed rate doctrine and federal preemption for the various trial courts to address. First, there appears to be no significant dispute that the transition of regulation of wholesale natural gas transactions to a market-based regime overseen by FERC is authorized by the NGA.⁵¹

The next issue is whether the filed rate doctrine applies only if FERC has reviewed, and approved, a set “rate” which was then “filed” with FERC and available for public inspection. Numerous courts have held not only that the NGA and FPA permit FERC to establish a market-based regulatory scheme, under which market participants negotiate rates for their individual transactions under FERC’s oversight, but also that the filed rate doctrine applies to the prices established by this system.⁵² For example, the *Grays Harbor* court held that, “while market-based rates may not have historically been the type of rate envisioned by the filed rate doctrine, we conclude that they do not fall outside of the purview of the doctrine.”⁵³ Similarly, in *Energy Louisiana Inc. v. Louisiana Public Service Commission*, the Supreme Court held that the filed rate doctrine barred state courts and agencies from assuming a rate different from one set under the federal regime, even though FERC did not actually set the rate but delegated that authority to a third party subject to federal regulation.⁵⁴ The Fifth Circuit has also recently indicated its acceptance of the view that the filed-rate doctrine applies to market-based rates, holding in *Texas Commercial Energy v. TXU Energy, Inc.* that the plaintiff’s state and federal antitrust claims arising from the defendant’s alleged manipulation of short-term energy markets were barred even though the Public Utility Commission of Texas permitted sales at market rates.⁵⁵

The plaintiffs in the pending natural gas cases argue that the Ninth Circuit electricity market decisions, such as *Snohomish*, *Grays Harbor*, and *Lockyer v. Dynegy*, do not apply to claims alleging manipulation of the natural gas market because of alleged differences in the level of FERC’s regulation of the electricity market and the natural gas market. In particular, the plaintiffs argue that the filed rate doctrine should not apply to alleged misconduct in the wholesale natural gas market because that market has been “deregulated” by the NGPA and FERC has issued “blanket certifications” permitting the sale of natural gas at market rates. Specifically, the plaintiffs point to the statement in *Snohomish* that “the fundamental question in this case is whether, under the market-based system of setting wholesale electricity rates, FERC is doing enough regulation to justify federal preemption of state laws” and the court’s conclusion that FERC’s continuing control of the electricity market through its requirements of (1) an individual determination of lack of market power prior to granting market-rate authority, and (2) retrospective filing of rates on a quarterly basis, was “enough regulation” to justify preemption.⁵⁶

The *Texas-Ohio* court rejected the plaintiffs’ argument that the filed rate doctrine is triggered only by the actual filing and approval of rates by the relevant federal regulatory body.⁵⁷ The court

⁵¹ *Lockyer v. FERC*, 383 F.3d at 1012–13; see *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993).

⁵² *Grays Harbor*, 379 F.3d at 651–52; *Snohomish*, 384 F.3d at 760–61; *Town of Norwood v. New England Power Co.*, 202 F.3d 408, 419 (1st Cir. 2000).

⁵³ 379 F.3d at 651–52.

⁵⁴ 539 U.S. at 49–50.

⁵⁵ *Texas Commercial Energy v. TXU Energy, Inc.*, 413 F.3d 503, 508–10 (5th Cir. 2005).

⁵⁶ *Snohomish*, 384 F.3d at 760–61. The plaintiffs similarly assert that the result in *Grays Harbor* depended upon FERC’s “continuing oversight” of the rates charged for wholesale electricity to ensure that prices are just and reasonable.

⁵⁷ *Texas-Ohio*, 368 F. Supp. 2d at 1115–16.

held that *Stanislaus* did not limit application of the filed rate doctrine only to cases where FERC had prospectively reviewed and approved the allegedly manipulated wholesale prices.⁵⁸ Furthermore, the *Texas-Ohio* court concluded that the filed rate doctrine applied irrespective of the fact that FERC had moved to a market-based regulation system under which it no longer directly reviewed and approved on a prospective basis the terms of each transaction:

The essential purpose of the filed rate doctrine is to protect the jurisdiction of a regulatory body that Congress has designated to determine whether rates charged, such as those in the natural gas market, are just and reasonable. Under the Natural Gas Act, FERC retains statutory authority over wholesale natural gas prices and therefore the filed rate doctrine applies even though FERC, in exercising its authority, chose to move toward a market-based system.⁵⁹

... the Texas-Ohio court concluded that the filed rate doctrine applied irrespective of the fact that FERC had moved to a market-based regulation system under which it no longer directly reviewed and approved on a prospective basis the terms of each transaction . . .

The court noted that, even though FERC had not required advance filing of the specific rates at issue, it (1) retained plenary jurisdiction over wholesale sales of natural gas in interstate commerce under the NGA; (2) remained vested with the statutory authority to ensure the rates for such transactions are just and reasonable; (3) has the sole authority under Section 4 of the NGA to determine whether the rates charged are just and reasonable; and (4) has initiated a regulatory investigation of the alleged false reporting and wash trading conduct upon which plaintiffs' claims are based.⁶⁰

Similarly, in *Sierra-Pacific*, another district court judge dismissed claims alleging the defendants conspired to manipulate the price of natural gas through unlawful wash trades and false price reports to index publishers, even though the alleged misconduct occurred with respect to privately negotiated natural gas transactions and the rates had not expressly been filed with FERC.⁶¹ The plaintiffs argued that FERC's regulation of the wholesale natural gas market had become too light-handed to justify application of the filed rate doctrine to bar the relief sought, which would have required a determination of the difference between the prices actually charged to the plaintiffs and the prices that purportedly would have been charged absent the alleged misconduct. The court rejected this argument, holding that FERC's regulatory authority and manner of regulation had been unchanged since the Ninth Circuit's decision of *Stanislaus* in 1993 and, as a result, the filed rate doctrine barred all of the plaintiffs' claims.

In denying the motion to dismiss in *Gallo*, the court applied a narrower interpretation of the filed rate doctrine, holding that it required, literally, that the "rate" be "filed."⁶² The court acknowledged that "there is no doubt that the filed rate doctrine bars both federal and state claims against actors who 'game the system' in the context of wholesale trades . . ." ⁶³ Nonetheless, the court regarded the question of whether the filed rate doctrine applied in circumstances "where the wholesale rates are no longer filed but are determined by the market itself, and are subject to retrospective FERC review" to be one of first impression. The court then ruled that the filed rate doc-

⁵⁸ *Id.*

⁵⁹ *Id.* at 1116.

⁶⁰ *Id.* at 1115–17 (citations omitted).

⁶¹ *Sierra Pacific*, Order Granting Defendants' Motion to Dismiss, at 1.

⁶² *Gallo*, Memorandum Order and Opinion Denying Defendants' Motion to Dismiss All Claims and Denying Motion to Strike, at 15 ("In other words, the filed rate doctrine is essentially a rule of jurisdiction whose applicability is circumscribed by both the congressionally-mandated jurisdiction of the regulatory agency and the occurrence of the triggering event of filing a rate or tariff.").

⁶³ *Id.* at 9.

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trine did not apply where the specific rates were not filed with FERC.⁶⁴ In particular, the court interpreted *Stanislaus*, which applied the filed rate doctrine to bar antitrust claims concerning natural gas prices, to have been dependent upon the fact that FERC had explicitly reviewed and approved the transactions at issue.⁶⁵

In addition, the *Gallo* court distinguished the then-district court decision in *Snohomish* because it arose from the electricity market and questioned whether the reasoning of *Snohomish* could apply to alleged manipulation in the natural gas market in light of developing differences in the regulatory structures applicable to electricity and natural gas markets.⁶⁶ Because the *Gallo* order was issued before the Ninth Circuit's decisions in *Snohomish*, *Grays Harbor*, *Lockyer v. Dynegy*, and *Lockyer v. FERC*—all of which held that FERC's market-based rate approval under the FPA did constitute a "filed" rate sufficient to trigger application of the filed rate doctrine—it is questionable whether the court would decide the *Gallo* motion to dismiss in the same way today. The *Texas-Ohio* court dismissed the plaintiff's claims for manipulation of the natural gas market (despite being well aware of the differences in the manner in which FERC exercised regulatory oversight of the electricity and natural gas industries) and, in fact, specifically held that the differences in the regulatory regimes did not preclude application of the filed rate doctrine to bar plaintiff's claims.⁶⁷

Although the Ninth Circuit likely will have to reconcile any perceived differences between the rulings in *Texas-Ohio* and *Gallo*, the decision in *Texas-Ohio* arguably is a more consistent application of relevant Supreme Court precedent than the decision in *Gallo*, which seemed to regard the absence of the prospective filing of a specific tariff and direct regulation of wholesale natural gas prices by FERC as dispositive. Specifically, the Supreme Court and appellate authorities make clear that the purpose of preemption and the filed rate doctrine is to protect the supremacy of federal law and the regulatory jurisdiction of FERC—both in instances where FERC has responsibility to determine the reasonableness of rates and in instances where Congress has determined that there is to be no regulation at all, either by FERC or by state law.⁶⁸ In particular, with respect to wholesale natural gas markets, state law claims are preempted regardless of whether FERC is or is not actively regulating the conduct at issue because Congress established a comprehensive federal regulatory scheme.⁶⁹

Although the NGPA is often described as having "deregulated" wholesale natural gas transactions, the statute is better understood as reflecting a Congressional intent to shift from a system under which FERC directly regulated rates to one in which FERC's role is to "oversee a national market price regulatory scheme."⁷⁰ Thus, the NGPA "does not constitute a federal retreat from a comprehensive gas policy" and should not be construed as leaving the market "unregulated" or creating a regulatory vacuum that could be filled by state law.⁷¹ In rejecting the argument

⁶⁴ *Id.* at 12–15.

⁶⁵ *Id.* at 12–13.

⁶⁶ *Id.* at 13–14.

⁶⁷ *Texas-Ohio*, 368 F. Supp. 2d at 1117.

⁶⁸ *E.g.*, *Schneidewind*, 485 U.S. at 300–01, 305; *Miss. Power & Light*, 487 U.S. at 371; *Hall*, 453 U.S. at 577–78.

⁶⁹ *See Transcontinental*, 474 U.S. at 422.

⁷⁰ *Transcontinental*, 474 U.S. at 415, 421.

⁷¹ *See id.* at 421.

that the “deregulation” of the natural gas market under the NGPA allowed for application of state law in *Transcontinental*, the Supreme Court reiterated that “a federal decision to forgo regulation in a given area may imply an authoritative federal determination that the area is best left unregulated, and in that event would have as much pre-emptive force as a decision to regulate.”⁷² The question, thus, is

not whether FERC has affirmative regulatory power . . . but whether Congress, in revising a comprehensive federal regulatory scheme to give market forces a more significant role in determining the supply, the demand, and the price of natural gas, intended to give the States the power it had denied FERC. The answer to the latter question must be in the negative.⁷³

Also, because the filed rate doctrine protects the jurisdiction of the appropriate federal regulatory authority to determine the reasonableness of the rates at issue, and the applicable federal law precludes charging anything but the “reasonable” rate, the filed rate doctrine must bar any claim that would require damages to be calculated based upon the determination of a hypothetical different rate than the one actually charged.⁷⁴ While the *Grays Harbor* ruling was in the context of electricity rather than natural gas, the *Texas-Ohio* court applied the same rationale to hold that the filed rate doctrine barred both state and federal antitrust claims for manipulation of the wholesale natural gas market.⁷⁵ Specifically, the court concluded that “[t]he determination of damages as requested by *Texas-Ohio* would require this Court to speculate upon what rates would have been charged in the natural gas market absent Defendants’ alleged misconduct by assuming a hypothetical rate.” This speculation, the court found, was prohibited because it would “undermine the congressional scheme of uniform rate regulation” by “usurping a function that Congress explicitly has assigned to FERC”—determining “what a just or reasonable rate would have been.”⁷⁶ The court concluded: “Under the Natural Gas Act, FERC retains statutory authority over wholesale natural gas prices and therefore the filed rate doctrine applies even though FERC, in exercising its authority, chose to move toward a market-based system.”⁷⁷

Impact of Blanket Marketing Certificates on FERC’s Regulatory Authority Under the NGA

Some natural gas plaintiffs have urged that the filed rate doctrine should not apply in light of FERC’s elimination of rate-filing requirements through its issuance of blanket marketing certificates allowing market participants to charge unfiled, privately negotiated rates. This argument has proved unavailing to plaintiffs in the electricity cases and should prove equally unavailing to natural gas plaintiffs.

With respect to the current wave of natural gas cases, FERC has always had authority to regulate the alleged misconduct upon which the claims in *Texas-Ohio*, *Gallo*, *Sierra Pacific*, and *In Re Natural Gas Antitrust Cases I, II, III and IV* are primarily based: false reporting of prices to the index publishers and wash trading. As noted above, FERC has recently promulgated regulations

⁷² *Id.* at 422 (quoting *Arkansas Elec. Coop. Corp.*, 461 U.S. at 384).

⁷³ *Id.* at 422; *Puerto Rico Dep’t of Consumer Affairs v. Isla Petroleum Corp.*, 485 U.S. 495, 502–03 (1988).

⁷⁴ *E.g.*, *Grays Harbor*, 379 F.3d at 650–51; *Stanislaus*, 114 F.3d at 863; *Texas-Ohio*, 368 F. Supp. 2d at 1115–16.

⁷⁵ *Texas-Ohio*, 368 F. Supp. 2d at 1115–17.

⁷⁶ *Id.* at 1115–16 (citing *Grays Harbor*, 379 F.3d at 651–52; *Arkansas La. Gas*, 453 U.S. at 579, 582; *Stanislaus*, 114 F.3d at 863).

⁷⁷ *Texas-Ohio*, 368 F. Supp. 2d at 1116.

that explicitly target the primary alleged misconduct in these cases.⁷⁸ The FERC regulations also expressly provide for various remedies, including disgorgement of unjust profits.⁷⁹

Although the regulations were issued after, and as a response to, the 2000–2001 California energy crisis, for purposes of the preemption and filed rate doctrine defenses, the critical point is that FERC always had jurisdiction to issue such regulations under the pre-existing statutory scheme—Congress did not have to grant any new statutory authorization to FERC in order to enable FERC to issue regulations expressly precluding false reporting to the index publishers and wash trading. Because regulation of the alleged misconduct in these cases was always within FERC’s jurisdiction under the NGA and because the Supreme Court has repeatedly held that where FERC has jurisdiction, such jurisdiction is exclusive, the plaintiffs’ claims in the current wave of natural gas cases should all be found preempted and barred by the filed rate doctrine.

Moreover, the better-reasoned view is that FERC was “regulating” the wholesale natural gas market in a manner sufficient to justify application of the preemption and filed rate doctrine defenses and FERC’s regulation of natural gas is not substantially distinguishable from its regulation of the electricity market. Proponents of the opposite view assert that the wholesale natural gas market is “unregulated” (as opposed to the still-regulated electricity market) because of FERC’s practice of issuing blanket certificates authorizing wholesale natural gas sales at market rates to all entities subject to FERC’s jurisdiction under the NGA.⁸⁰ However, in determining to grant natural gas wholesalers authority to sell at market-based rates, FERC reasoned that such “light-handed regulation” would be sufficient to ensure that rates for gas sales would remain reasonable because of FERC’s finding that “adequate divertible gas supplies exist in all pipeline markets.”⁸¹

Thus, although FERC required an individualized showing of lack of market power before granting an electricity wholesaler market-rate approval, FERC effectively made such a determination on *an industry-wide basis* for the natural gas market, resulting in the issuance of blanket certificates allowing all natural gas wholesalers to transact at market-based rates. Logically then, the blanket certificates issued under the NGA should be accorded the same weight for purposes of application of the preemption and filed rate defenses as are the market-based rate approvals issued by FERC under the FPA to electricity sellers. FERC itself has expressly held that a “blanket [gas] certificate has the same legal effect as the market based rate authority granted to sellers in the wholesale electric market.”⁸²

In addition, notwithstanding the absence of specific quarterly rate filing requirements, FERC also has always had statutory jurisdiction to remedy wrongs of the nature alleged. For example, FERC can address allegations of unjust and unreasonable rates:

Whenever the Commission . . . shall find that any rate, charge, or classification demanded, observed, charged or collected . . . in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission . . . is unjust [or] unreasonable . . . , the Commission shall determine the just and reasonable rate . . . and shall fix the same by order.⁸³

⁷⁸ Order No. 644.

⁷⁹ *Id.*

⁸⁰ 18 C.F.R. § 284.402.

⁸¹ *United Distrib.*, 88 F.3d at 1125–26 (citing 18 C.F.R. §§ 284.281–284.288).

⁸² *Reliant Energy Serv., Inc.*, Order Approving Stipulation and Consent Agreement, 105 FERC ¶ 61,008, at ¶ 29 (2003).

⁸³ 15 U.S.C. § 717d(a).

Any person can initiate a complaint with FERC.⁸⁴ In addition, FERC has stated that “the original grant of certificate authority to make jurisdictional sales of natural gas implicitly prohibited acts which would manipulate the competitive market for natural gas”; i.e., that FERC always had jurisdiction over such alleged misconduct.⁸⁵ Thus, claims that manipulation of the market-rate authority under the blanket marketing certificates resulted in unjust and unreasonable natural gas prices have always been remediable through FERC’s pre-existing administrative complaint mechanism.

For example, in *Enron Power Marketing, Inc. Order Revoking Market-Based Rate Authorities and Terminating Blanket Marketing Certificates*, FERC terminated the blanket natural gas marketing certificates of various affiliates of Enron found to have engaged in wash trades.⁸⁶ In so doing, FERC noted that, notwithstanding the issuance of the blanket marketing certifications, FERC had reserved authority to “monitor the operation of the market through the complaint process” and did not grant “gas marketers *carte blanche* to engage in any form of conduct in connection with their jurisdictional sales for resale no matter how deceptive, trusting solely in the market to cure any problems”⁸⁷ With respect to the available remedies, FERC stated that issuance of a blanket certificate “does not entitle the certificate holder to charge rates that are unjust and unreasonable under the NGA,” that the NGA affords “consumers a complete, permanent and effective bond of protection from excessive rates and charges,” and that FERC “has discretion to implement remedies when it finds conduct that has violated its policies or regulations,” which necessarily includes the action of terminating the marketing certificates.⁸⁸

Finally, in certain of the cases, the plaintiffs also argue that the filed rate doctrine does not apply if the claimants are retail purchasers, because their grievances concern not the wholesale transactions that were directly the subject of the allegedly manipulative conduct (wash trades and false reports) but, rather, the damages allegedly suffered when the higher, manipulated, wholesale prices were passed through as higher retail prices. The *Gallo* court accepted this argument, concluding that the filed rate doctrine did not apply because the transactions giving rise to the plaintiff’s claimed damages were the retail purchases by Gallo, irrespective of whether the alleged overcharges at that level were simply being passed-through from the wholesale level at which the allegedly manipulative conduct had occurred.⁸⁹ In contrast, however, the Ninth Circuit in *Pastorino* reached a different conclusion with respect to claims related to California retail electricity prices. The court reasoned that, even though the transactions giving rise to damages were the retail sales, the claims were still preempted because the *conduct that formed the basis for the claims* had occurred within the wholesale market subject to FERC’s exclusive jurisdiction.⁹⁰ Specifically, *Pastorino* held that “[t]his court cannot apply state law to Defendants’ conduct in the wholesale

⁸⁴ See 18 C.F.R. § 385.206.

⁸⁵ In the Matter of Amendments to Blanket Sales Certificates, 107 F.E.R.C. ¶ 61,174, ¶ 12, 2004 FERC LEXIS 1022 (May 19, 2004).

⁸⁶ 103 FERC ¶ 61,343, at ¶¶ 69–72, and n.52, 2003 FERC LEXIS 1212 (2003).

⁸⁷ *Id.* ¶ 69.

⁸⁸ *Id.* ¶¶ 70, 72 & n.52 (citing *Atlantic Refining Co. v. Public Serv. Comm’n of N.Y.*, 360 U.S. 378, 388 (1959)). See *Lockyer v. FERC*, 383 F.3d at 1016 (citations omitted) (“the power to order retroactive refunds when a company’s non-compliance has been so egregious that it eviscerates the tariff is inherent in FERC’s authority to approve a market-based tariff in the first instance. . . . In fact, if no retroactive refunds were legally available, then the refund mechanism under a market-based tariff would be illusory. Parties aggrieved by the illegal rate would have no FERC remedy, and the filed rate doctrine would preclude a direct action against the offending seller.”)

⁸⁹ *Gallo*, Memorandum Order And Opinion Denying Defendants’ Motion to Dismiss All Claims And Denying Motion To Strike, at 9–10.

⁹⁰ *Pastorino*, 2005 U.S. App. LEXIS 3315, at *8.

energy market, an area regulated exclusively by the federal government, simply because it adversely impacted retail prices.”⁹¹ So too, in *Stanislaus*, the court dismissed antitrust claims of retail natural gas consumers, holding that their effort to recover for alleged overcharges was “precisely what the filed rate doctrine prohibits.”⁹²

Key Questions for Courts to Answer

The resolution of these issues may turn on several key questions to be answered by the appellate courts:

- Is the market-based rate system adopted by FERC in the 1990s for wholesale interstate natural gas transactions sufficiently similar to FERC’s oversight of the wholesale electricity market to justify application of the filed rate doctrine?
- Does Congress’s so-called deregulation of certain aspects of the wholesale natural gas market through the NGPA and the Wellhead Decontrol Act reflect Congressional intent to permit state law to regulate aspects of the wholesale natural gas market not directly regulated by FERC or, instead, does Congress’s action reflect a federal decision, with preemptive effect, to leave the market regulated only by market forces?
- Are the scope of the filed rate doctrine and federal preemption of state law driven by the scope of regulatory jurisdiction granted to FERC or by the nature and extent of FERC’s actual regulation and oversight of matters within its jurisdiction?
- If FERC’s jurisdiction is limited to determining the reasonableness of wholesale rates, does the filed rate doctrine preclude claims asserted by retail consumers that allege misconduct in the wholesale market caused allegedly unreasonable prices to be passed through or charged at the retail level? ●

⁹¹ *Id.*

⁹² *Stanislaus*, 114 F.3d at 863.

Book Review

Bargaining in the Shadow of Regulation

Jim Rossi

Regulatory Bargaining and Public Law

Cambridge University Press • 2005

Reviewed by Joseph P. Tomain

“A—always, B—be, C—closing. Always be closing.”

In *The Politics*, Aristotle wrote that “man is a political animal.” In the movie version of his play, *Glengarry Glen Ross*, David Mamet went Aristotle one better and defined man as a bargaining animal. Why, then, should it be any different with our relations with government? Jim Rossi’s answer, like Mamet’s, is that there is no difference—we are always closing; we are always bargaining.

In his new book, *Regulatory Bargaining and Public Law*, Professor Rossi explores contemporary administrative law through what he calls “government relations bargaining” as he examines the relationship between regulator and regulatee.¹ Professor Rossi argues that the relationship between regulator and regulatee is one in which the terms are open and not fixed. Consequently, bargaining takes place throughout the relationship, and he uses an “incomplete contracts analysis”² to explain that phenomenon. He then applies comparative institutional analysis to help us understand the choices available to best order society. Should, for example, the electric industry be left unregulated or regulated by fixed or market-based rates? Comparative institutional analysis, then, allows policy makers to compare regulatory schemes. In brief, as we move to a new regulatory order, we must assess new roles for the several institutions engaged in economic regulation, including an expanded role for courts reviewing antitrust claims.

The nature of political bargaining depends upon the form of government intervention in a market. What is generally called the “free market” is in reality a system of regulation that relies on common law rules of property, tort, and contract enforced by courts. Command-and-control regulation of the sort that governed network industries for most of the 20th century by setting prices and profits is another institutional design we may choose as a social ordering mechanism. Professor Rossi uses government relations bargaining as a means to compare one institutional regime against another. If we have a clearer picture of the political process, he argues, then we will have a better understanding of the role of administrative agencies and we will be better able to design the regulatory state,³ including the role of antitrust regulation.

Based on my initial review of this book for the Cambridge University Press prior to its publication and my rereading of the book for this review, I believe that *Regulatory Bargaining and Public*

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Joseph P. Tomain is
Dean Emeritus and the
Wilbert and Helen
Ziegler Professor of Law,
University of Cincinnati
College of Law.

¹ JIM ROSSI, *REGULATORY BARGAINING AND PUBLIC LAW* iv (2005).

² *Id.* at 13.

³ *Id.* at 3.

Law will prove beneficial to scholars and practitioners of law, economics, and political science because it provides a valuable approach to understanding administrative law generally and economic regulation more particularly.

Professor Rossi examines network industries, especially the deregulation of the electric industry. He writes that “deregulation challenges policy makers and courts to reevaluate many of the traditional public law doctrines that frame the process for defining and implementing the rules in competitive markets.”⁴ *Regulatory Bargaining and Public Law* delivers on that promise.

Professor Rossi aptly titles his book *Regulatory Bargaining* as opposed to “regulatory contract.” The idea of continuous bargaining is central to the analysis and argument of the book, while the idea of contract is used more metaphorically than legalistically. The relationship between regulator and regulatee differs from private contractual relationships, even long-term bilateral contracts to which regulation has been compared in the past, because contract rules and remedies do not fit the regulator-regulatee relationship.

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It is useful to examine bargaining between regulator-regulatee in three stages—pre-regulation, regulation, and regulatory transition. In the pre-regulation stage, bargaining takes place between the industry and federal and state legislatures and is bounded by a set of political norms. During pre-regulation, the initial concerns are about whether and how to regulate. Most often, a legislature establishes general goals and describes a set of broad terms to be filled in and implemented by an Executive branch agency. During the regulation stage, the bargaining shifts to the agency and is then conducted mostly with individual firms, rather than with the industry as a whole. The scope of bargaining is narrowed from the broadly political to legal rules and regulations established by the legislature and developed by the agency. Finally, during periods of regulatory transition, the scope of bargaining widens again, as firms and industries negotiate with legislators and agencies over both political and legal issues.

In many ways, periods of regulatory transition are most challenging. Transitions can occur incrementally or suddenly, and can be triggered by many factors, including regulatory failure and technological, political, or economic change. During such periods, the relationship between regulator and regulatee can be terminated by complete deregulation or restructured through reform. Today, for example, we often say that the electric industry is in a period of deregulation, but it is more accurate to say that the regulator-regulatee relationship is being restructured or re-regulated. What is most challenging about periods of regulatory transition is that technological, political, and economic changes occur against an established background of rules, regulations, and bureaucratic thinking.

In describing the bargaining relationship between regulator and regulatee during periods of pre-regulation and transition, I have used the word “political.” Perhaps a better phrase, and one which Professor Rossi uses, is constitutional order. When an industry or a firm is negotiating during those periods, political claims are bounded by the requirements of the U.S. Constitution, including the Commerce Clause, the Takings Clause, the Contract Clause, and federalism. Professor Rossi’s book is an excellent chart for these public law waters.

In Part I, Professor Rossi uses the example of the electric industry and describes the pre-regulation phase at the beginning of the 20th century. He argues that the technology of the time favored vertical integration. Industry corporate structure together with the economic theory of natural monopoly combined to form the bargain or regulatory compact between industry and gov-

⁴ *Id.* at viii–ix.

ernment. Professor Rossi is indifferent as to whether or not this compact was the result of capture or public interest or whether it was driven by Samuel Insull (public utilities financier and co-founder of the company that became General Electric), or state governments interested in consumer protection. Regardless, the regulatory compact resulted in a remarkably stable regime of cost-of-service regulation.⁵ For most of the 20th century, producers enjoyed profits, consumers enjoyed reliable service at a reasonable cost, and regulators enjoyed the relative absence of political headaches. All of this was accomplished with acceptable levels of cross-subsidization, which promoted universal service. As the economy expanded, so did energy production and rates to all consumers stayed at acceptable and, in some instances, declining levels. Regulatory stability cracked in the waning decades of the 20th century as rising prices caused the traditional regulatory compact to be scrutinized.

If the regulatory phase is a period of stability, then regulatory transition is a period of instability. During the regulatory phase, the terms of the regulatory contract were defined by regulatory law, not by constitutional politics. Consequently, an electric utility or customer needed only to look at the filed tariff or in Title 18 of the Code of Federal Regulations or in Part 2 of the Federal Power Act of 1935 to understand the terms of the regulatory bargain. During regulatory transition, parties are not bound by the constraints of regulatory law and bargaining takes place within the ambit of constitutional politics or public law. Because public law is broad and unsettled, a period of transition is not only unstable but may be inefficient as regulation becomes less transparent and both regulators and regulatees become less accountable. It is also the case that during regulatory transition, the number of federal-state conflicts increases as regulators at both levels of government try to find their way in the dark.⁶

The instability in network industries that began in the late 1960s was driven by several factors. In the electric industry, traditional cost-of-service regulation had reached the end of its useful life as marginal costs out-paced average costs resulting in notable rate hikes. At the same time, the traditional rate formula encouraged (maybe even required) continuing investment by utility shareholders resulting in excess generating capacity. High rates and overcapacity combined to increase political pressure on regulators. In the natural gas industry, traditional rate regulation resulted in a dual natural gas market noted for shortages and gross inefficiency. In the telecommunications industries, rapid technological advances have caused unprecedented levels of investment and competition.

In each instance, new network entrants put pressure on the regulatory environment to reform its old ways, as consumers, in each industry, wanted access to cheaper products. In the electric industry, once thought to be the most inelastic of industries, new entrants came to market through the stimulus of the Public Utility Regulatory Policies Act of 1978. In the natural gas industry, the Natural Gas Policy Act of 1978 addressed the dual market and began deregulation. In the telecommunications industry, the judicial break-up of AT&T under the Modified Final Judgment also signaled a more congenial invitation to new competitors. In short, regulatory transition came about because of economic, technological, and bipartisan political and legal changes.

Given the legal, political, economic, and technological incentives to change the existing regulatory relationship, the question then became: What should the future regulatory relationship look

⁵ See, e.g., LEONARD S. HYMAN, ANDREW S. HYMAN & ROBERT C. HYMAN, *AMERICA'S ELECTRIC UTILITIES: PAST, PRESENT, AND FUTURE* chs. 17–18 (2005).

⁶ Rossi, *supra* note 1, at 61–70.

like? As Professor Rossi notes, the period of regulatory transition in which we currently find ourselves is unsettling. As competition increases and as government lightens its regulatory hand, regulators must shift their focus. Instead of regulating prices and output as they did under traditional cost-of-service regulation, regulators must now focus on access, particularly where transmission bottlenecks exist, and on increased competition, particularly as new providers seek market entry.⁷ New entrants bring conflicts with and claims by incumbents. More about the incumbents' claims for compensation later.

The most significant challenge for the electric industry is the continued provision of reliable service at a reasonable cost.⁸ Deregulation proponents argue that less government regulation has resulted in extraordinary efficiency gains, and they point to the deregulation of the telecommunications industry as their primary example. Professor Rossi, for good reason, is skeptical of the general claim that deregulation lowers costs. Airline deregulation has increased city-pair flights, but service has declined and prices at hubs have increased. Electricity deregulation is stalled after a crisis in California, a historic blackout, and the collapse of Enron. And, while it is the case that there have been efficiency gains in telephony, my cable bill has not decreased nor has my cable service improved.

Regardless of the successes of telecommunications deregulation, that industry is only a loose analogy for the electric industry. Efficiency gains in telecommunications are the result of interconnectivity⁹ or network effects. A two-way communications network becomes more valuable as more subscribers are connected to it, because subscribers can communicate with more people. Similar gains from interconnectivity are lacking in the electric industry. Competition is also hampered in the electric industry because it continues to be subject to a natural monopoly in transmission.¹⁰ For now, the telecommunications analogy does not hold for electricity even though the electric industry can become more competitive and decentralized to the extent that distributed generation provides greater service at reasonable cost.¹¹

Regulatory Bargaining and Public Law concludes Part I with a challenge: In the deregulatory world of increased competition, can the electric industry continue to provide universal service at reasonable costs? That is the challenge that Professor Rossi's book helps to analyze.

In Part II, Professor Rossi applies his government relations bargaining analysis to deregulation. Chapter 5 addresses the test case for the regulatory transition in the electric industry—stranded costs. Rossi focuses on the concept of “deregulatory takings,” which he defines as a “novel term used to describe potential legal claims against the government requiring financial liability for deregulatory policies that upset the settled expectations of private firms.”¹² In this regard, he criticizes, as he has done elsewhere, Sidak's and Spulber's leading treatise on the topic.¹³ Rossi argues that Sidak and Spulber too narrowly construe the concept of the regulatory contract and try to push common law contract doctrine into a public law box. The result, according to Rossi, is

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⁷ *Id.* at 54.

⁸ *Id.* at 73.

⁹ *Id.* at 77.

¹⁰ *Id.* at 76–82.

¹¹ *Id.* at 89–90.

¹² *Id.* at 95.

¹³ J. GREGORY SIDAK & DANIEL F. SPULBER, DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES (1997).

that the Sidak and Spulber analysis is forced, overly legalistic, and ultimately unlikely to receive judicial approval. Professor Rossi's critique is a strong one, and his discussion of deregulatory takings demonstrates the value of his government relations bargaining approach.

Although Professor Rossi says that the deregulatory taking is a "novel legal claim,"¹⁴ I am not so sure. While it is the case that no court has recognized a cause of action for a deregulatory taking of network industry property, the argument that such a legal right exists has been a powerful and successful one. Even though no court has made an award on that basis, neither has a court disagreed with Justice Oliver Wendell Holmes's dictum that "if regulation goes too far it will be recognized as a taking."¹⁵ As Professor Rossi notes, federal and state legislatures have in fact accepted the idea of deregulatory takings by allowing for the recovery of stranded costs.¹⁶ Utilities have not filed takings cases because they have negotiated for and have received compensation from government.

While it is the case that no court has recognized a cause of action for a deregulatory taking of network industry property, the argument that such a legal right exists has been a powerful and successful one.

Regardless of the ad hoc and unsettled nature of takings jurisprudence (and the inapplicability of land use precedents to regulatory transitions), legislators and regulators appear to know a legitimate claim for compensation when they see one. The incumbent utility that invests capital in compliance with government commands should have a legitimate claim for compensation when a change in those commands significantly reduces or destroys the value of investments made in reliance. Naturally, there will be significant disagreement about what constitutes the extent of those investments. Nevertheless, a utility that builds a power plant in reliance on an obligation to serve and then has that power plant rendered useless can and has received just compensation by way of agency and legislative action rather than by judicial award. Stranded costs so awarded maintain the constitutional order of things without turning deregulatory takings into a "constitutional or contractually protected entitlement."¹⁷

Professor Rossi's analysis of deregulatory takings is instructive for legal doctrine. Where Sidak and Spulber argue that such takings analysis should be construed legalistically leading to an entitlement to compensation, Rossi argues that an incomplete contracts approach creates a "presumption against compensation for regulatory transitions that can be rebutted only with proof of a clear statement in the initial regulatory instrument that is specific to a firm, not industry wide."¹⁸ Thus, Rossi demonstrates that there is more than one way to read a contract—regulatory or otherwise. Read narrowly, the regulatory contract would result in compensation for a limited number of devaluations. Read broadly, the default rules used to fill in the gaps of the regulatory contract are broad constitutional prescriptions, such as the Takings Clause.¹⁹ Rossi accepts the contracts analogy, but only so far. He prefers to question the broader political implications of any particular legal rule.

Professor Rossi has written extensively on the issue of regulatory tariffs under a de-regulatory regime and, in Chapter 6, he provides several important insights. During the period of traditional regulation, the filed rate doctrine governed the relationship between the utility and the agency, binding customers and competitors alike. When disagreements arose, the Federal Energy

¹⁴ Rossi, *supra* note 1, at 104.

¹⁵ *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922).

¹⁶ Rossi, *supra* note 1, at 100–05.

¹⁷ *Id.* at 105.

¹⁸ *Id.* at 120.

¹⁹ *Id.* at 121.

Regulatory Commission (FERC) would examine the filed tariff for resolution and, on appeal, courts deferred to FERC's interpretations. More to the point, traditional tariffs were very specific regarding rates and other service terms and the enabling statute was very specific on how those rates could be challenged. During regulatory transition, however, the emphasis on market-based rates means that such specificity in the filed tariff is lacking. Consequently, disagreements on rates are more open to question. Now the problem is: Who decides? Does the tariff continue to control with corresponding judicial deference? Or, should courts have more leeway to construe the relationship between the agency and the utility? Professor Rossi's response is that in a "deregulatory environment [there should be] a more nuanced role for courts in considering antitrust, tort, and contracts claims against firms that have also made private tariff filings with regulators."²⁰

One wonders whether or not courts should have an even more expansive role than the one that Professor Rossi describes. Professor Rossi's prescription allows a broader latitude for third-party claims in courts. One might also argue that in the deregulatory environment, courts ought to also have more latitude in interpreting tariffs and applying default terms given the open-endedness of rate and service issues. If utilities are required to perform to a market standard, then there must be some mechanism to adjudicate the contours and limits of markets. Administrative agencies should be given the first opportunity to address market limitations, but then courts should not be required to defer as routinely as they have had to under traditional regulation. As Professor Rossi acknowledges, "if tariffs and other regulatory filings are understood as a type of incomplete bargain, courts should approach incompleteness in enforcement with extreme caution before entirely dispensing with judicial consideration of the merits of anti-trust, tort, and contracts claims."²¹ Further, the courts should also examine the terms of the tariff and be willing to fill in the gaps rather than defer to agencies or send the matter back to the political process. Professor Rossi does argue for a loosening of the filed rate doctrine.²² Yet, I would argue that courts must have a larger role precisely because of the incompleteness of the relationship not only for antitrust, contract, and tort claims, but for missing or ambiguous or incomplete tariff terms as well.²³

Deregulation of the electric industry is having several effects that Professor Rossi notes. The terms of the regulatory bargain are less certain than under the traditional tariff. The regulatory authority of state and federal regulators is less stable. There are new entrants in the industry, and the industry is experimenting with new technologies. All of these factors have an effect on industry structure and all affect antitrust claims. Professor Rossi's argument is that courts must be less deferential in antitrust matters of price squeeze,²⁴ state action immunity,²⁵ and federal preemption. Antitrust claims will also increase as the industry experiences consolidation. As FERC continues to move the industry into regional transmission organization, utility mergers and consolidations will become more and more financially attractive.²⁶ Consolidation, in turn, raises the possibility of anticompetitive activity, and the benign indifference toward antitrust claims exhibited by courts

²⁰ *Id.* at 131.

²¹ *Id.* at 147.

²² *Id.* at 153–58.

²³ *See, e.g.*, *S. Cal. Edison v. FERC*, 415 F.3d 17 (D.C. Cir. 2005) (D.C. Circuit rejects FERC's interpretation of a tariff in favor of its own "plain" reading).

²⁴ Rossi, *supra* note 1, at 137–40.

²⁵ *Id.* at 188–95.

²⁶ *See, e.g.*, Richard Cudahy, *Consolidation: Key to the Future?*, 143 PUB. UTIL. FORT., Aug. 2005, at 15.

in the past because of the heavily regulated nature of the electric industry must be re-examined.

In Chapters 7 and 8, Professor Rossi explores federalism conflicts. He notes that conflicts are more likely to arise during regulatory transition as jurisdictional relationships and needs are more uncertain and more complex. To the extent that technological change and the desire for efficient markets drive the electric industry to regional transmission, the bright line between federal wholesale regulation and state retail regulation becomes blurred if not obliterated. In the electric industry, the problem of uncertain legal and regulatory authority of state and federal regulators is especially problematic for the national transmission grid, which remains woefully underfinanced and yet essential for the health of the industry.²⁷ Again, regulatory transition is occurring against a backdrop of nearly a century of traditional regulation, and utilities are comfortable interacting with state regulators and have familiarity with state legislatures. Consequently, utilities will continue to press for their competitive advantages in friendly fora, resisting efforts to regionalize when it is unprofitable to do so. To the extent, then, that states attempt to protect their local utilities, dormant Commerce Clause conflicts arise²⁸ and will continue to do so until clear jurisdictional rules are established either by legislatures or FERC with judicial approval.

... benign indifference toward antitrust claims exhibited by courts in the past because of the heavily regulated nature of the electric industry must be re-examined.

FERC has been pressing for regional markets for several years now, arguing that competitive interstate markets are more likely to be efficient than local ones and less likely to erect barriers to trade.²⁹ The physical reality is that the transmission grid needs to be improved and expanded and states should not stand in the way of setting and regulating that grid.³⁰ Self-interest and history being what they are, states are not rushing to yield political power to the federal government on a voluntary basis, and Congress and FERC have demonstrated their reluctance to settle this matter with a heavy hand. Under the Commerce Clause, clearly Congress can legislate widely to regulate the entire electric industry. Politically, however, it is not feasible to ignore the historic role that state regulators have played in the regulation of the electric industry. While the federal reluctance to override state regulation is understandable, it is not necessarily efficient. Jurisdictional gaps will occur and it is inevitable that courts will be called upon to clarify gaps or overlaps in regulation.³¹ In an ideal world, “cooperative” or “coordinated” federalism can smooth out these bumps, but that is a world in which we do not currently live.³² Here I part ways with Professor Rossi’s prescriptions for the future of network regulation.

In matters of federalism conflicts, Professor Rossi favors a default rule by which courts would adopt a presumption *against* federal preemption in favor of state and local regulatory action.³³ As I understand Professor Rossi’s proposal, state and local officials would be authorized to pursue federal goals, particularly in the *absence* of congressional *action*. His hope then would be to encourage or force coordinated federalism “in industries in transition, such as electric power, judicially led coordinated federalism could replace judicial line drawing between the federal government and the states—which often leads to regulatory impasse—with a more cooperative pursuit

²⁷ See James J. Hoecker & Stephen Angle, *Grid Investment & Restructuring: Two Challenges, One Solution*, 142 PUB. UTIL. FORT., Aug. 2005, at 34.

²⁸ Rossi, *supra* note 1, at 175–88.

²⁹ *Id.* at 206.

³⁰ *Id.* at 207.

³¹ *Id.* at 213.

³² Rossi, *supra* note 1, at 214–21.

³³ *Id.* at 229.

of national goals.”³⁴ While Professor Rossi recognizes objections to placing more power in the hands of state and local regulators, I am not sure that his arguments against federal preemption are persuasive because as the electricity market consolidates, federal regulation should increase and preempt conflicting state regulations.³⁵ The argument that more chefs make better soup is not convincing.

Professor Rossi concludes by saying that his political process approach, particularly with the aid of government relations bargaining analysis, helps us better understand the nature of government regulation, particularly in an era of deregulation. He more specifically argues that the “incomplete contracts approach to regulation provides a different focus for regulatory law than competing accounts.”³⁶

Regulatory Bargaining and Public Law does provide a different focus than the competing public interest and public choice approaches by steering a middle way through both. Rossi does not, for example, condemn rent-seeking among the parties to the bargaining relationship.³⁷ He does advocate a wider view of the whole political process for understanding administrative law in general, and deregulation in particular.³⁸ He does not see the bargaining relationship as too narrowly wed to progressive politics³⁹ and instead prefers to advance an agenda of collaborative federalism.⁴⁰ While these broader theoretical ambitions are advanced in the book, the strength of *Regulatory Bargaining and Public Law* resides in Professor Rossi’s expert analysis of how existing public law doctrine must be assessed during this period of regulatory transition or deregulation. As doctrine is assessed through his analysis, we are also led to assess the role of the several political institutions operating in the regulatory state. This assessment requires us to examine each branch of government and leads to at least one conclusion—regulation is a continuous matter of political and legal bargaining. As such, all actors in the regulatory drama must “A–always; B–be; C–closing. Always Be Closing.” ●

³⁴ *Id.*

³⁵ *Id.* at 229–32.

³⁶ *Id.* at 234.

³⁷ *Id.* at 236.

³⁸ *Id.* at 235–36.

³⁹ *Id.* at 236.

⁴⁰ *Id.* at 237.

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: This issue's Paper Trail offers a discussion of the appropriate use of bidding analysis in antitrust and a paper that finds yet another flaw in Chicago's single-monopoly profit theory. Fortunately, the authors of the latter are from Chicago—after all, only Nixon could go to China. As usual, if you have any comments, questions, or suggestions please e-mail them to Bill Page (page@law.ufl.edu) or John Woodbury (jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

Recent Papers

Paul Klemperer, Bidding Markets, UK Competition Commission (June 2005),
<http://www.nuff.ox.ac.uk/users/klemperer/biddingmarkets.pdf>

When mergers occur in markets in which a customer purchases goods or services through a formal or (more likely) informal bidding process, economists start thinking in terms of auction models to evaluate the likely competitive effects. For example, bidding for shelf space or sports rights or broadcast program rights certainly fit this general mold, even though there may be no formal auction process. Occasionally, the evaluating economist or lawyer or agency may presume that because any firm can enter such a bidding contest, “ordinary” competitive issues (such as the competitive significance of current market shares) may be less important in these bid markets.¹ Indeed, there is a substantial body of literature on evaluating distinctions between “posted-price” markets and bid market and the implications of those distinctions for evaluating antitrust harm.²

The Klemperer paper, by contrast, argues that in many if not most cases, the antitrust analysis that should be used for (e.g.) a merger in a bidding market or evaluating tacit collusion³ is the same as what which would apply in a posted price market. Put differently, the paper explains why the differences between the two types of markets for antitrust analysis have been overdrawn. The paper offers a generally smooth cruise towards comparing and contrasting bidding markets with what the author calls “ordinary markets” where prices are posted by the supplier.

The paper describes its goal as correcting three flawed perceptions about bidding markets: “the ‘consultants’ fallacy’ that ‘market power is impossible,’ the ‘academics’ fallacy’ that (often)

¹ FTC and U.S. Department of Justice Horizontal Merger Guidelines n.34 (1992, revised 1997), available at <http://www.ftc.gov/bc/docs/horizmer.htm>, note that when sellers bid for work, a merger between the lowest and second-lowest cost sellers can result in higher prices to the buyer, without any collusion. The Guidelines further observe that in identifying the opportunities of entrants to take sales from a newly merged incumbent, “in a bidding market where all bidders are on equal footing, the market share of incumbents will contract as a result of entry.” *Id.* n.34.

² See, e.g., Robert C. Marshall & Michael J. Meurer, *Bidder Collusion and Antitrust Law: Refining the Analysis of Price Fixing to Account for the Special Features of Auction Markets*, 72 ANTITRUST L.J. 83 (2004).

³ This is in contrast to overt collusion as addressed in the Marshall and Meurer article.

'market power does not matter,' and the 'regulators' fallacy' that 'intervention against pernicious market power is unnecessary,' in markets characterized by auctions or bidding processes."⁴

The paper explains the reasons why the three perceptions are incorrect. It begins by describing the necessary conditions for a bidding market to generate competitive results (a winner-take-all contest, "lumpiness" (each bidding event is large relative to a bidder's revenue), no lock-in for subsequent bidding, and sometimes easy entry). Having described the conditions under which bidding is likely to generate the competitive outcome, even when the number of actual bidders is small, it becomes immediately obvious that most bidding markets do not fit that mold. For example, customer lock-in (switching costs) may be important for defense contracts, telecom systems, or software. The practices in these industries raise the same kind of antitrust concerns that arise in "ordinary" markets. When entry is difficult or the auction is neither lumpy nor winner-take-all, the evaluation of the likelihood of collusion is no different in bidding markets than in other markets. However, Klemperer notes that in many "ordinary" markets, collusion may be difficult because the would-be colluders lack a common enough "vocabulary" to reach and maintain an agreement. Klemperer gives examples illustrating how, in more formal bidding markets, i.e., those with explicit and detailed bidding rules, the bid-taker may have inadvertently provided that vocabulary to the bidders to facilitate collusion.

The paper also considers how the information available to the bidders—common values or private values—can affect the likelihood of collusion (or unilateral action), how that information interacts with the type of formal or informal bidding mechanism (ascending "public outcry" auction or sealed-bid), and how to design the bidding rules to reduce the likelihood of anticompetitive outcomes. For example, the paper notes that a common defense of joint bidding in common values auctions (roughly, ones in which the ex post value (but not the ex ante value) of the auctioned good is the same for all bidders) is that the joint bidders have more information and so will be more aggressive bidders. Such arrangements, however, can also foster collusion.⁵

Overall, the paper is generally an easy read, although there are explanations that are too abbreviated and the paper could have benefitted from a more careful organization. Even so, the paper is easy to recommend, particularly given our reliance on formal or informal bidding models to evaluate collusion, exclusion, and mergers.

Dennis W. Carlton and Michael Waldman, Tying, Upgrades, and Switching Costs in Durable-Goods Markets, National Bureau of Economic Research (Working Paper 11407, June 2005), <http://www.nber.org/papers/W11407> *

In response to claims that tying was anticompetitive, the early Chicago School countered with the now familiar single-monopoly profit theory: If a monopolist of A also sold a complementary product B, the most it could obtain from tying the sale of B to the sale of A was the monopoly profit from

⁴ Being a consulting economist, it should be noted that not all consultants fall prey to the "consultants' fallacy." More generally, this paper is pitched to a European audience where, judging from Klemperer's description, these fallacies are (apparently) committed on a more regular basis than (it seems to me) they are in the U.S.

⁵ Using experimental techniques, one recent paper finds that the competition-reducing effects of joint bidding outweighs the possible efficiencies from joint bidding. Vlad Mares & Mikhail Shor, Industry Concentration in Common Values Auctions: Theory and Evidence, Olin School of Business (Washington University) and Owen Graduate School of Management (Vanderbilt University) (Working Paper 2003), available at <http://www2.owen.vanderbilt.edu/mike.shor/Research/AuctionsCV/CVAuction.pdf>.

* Ed. note: A \$5 fee may be charged to download this paper.

A. Tying could not increase the profits of the monopolist, and indeed, could generate lower profits if an alternative supplier of B was more efficient in the production of the B than the monopolist.

Numerous papers have provided other models where the single-monopoly profit theory is not the complete story.⁶ Among these is the 2002 paper by Carlton and Waldman that demonstrates that tying can be a profitable strategy to protect a monopoly in the tying good or to extend the firm's monopoly power to new, nascent markets.⁷ The analysis of that paper could explain why Microsoft would want to bundle Windows with Microsoft's browser, Internet Explorer. Because it was possible that other browsers could evolve into an operating system that would rival Windows, the bundling could have increased the costs of browser entry and thereby acted to protect the Windows monopoly.

In their 2005 paper, Carlton and Waldman note that their model of anticompetitive tying in the earlier paper cannot explain why it would be profitable for Microsoft to tie the purchase of applications to Windows, when those applications would not threaten the Windows monopoly. As long as the Windows operating system is essential for running those applications, the single-monopoly profit theory would suggest that tying is unnecessary and in fact may generate lower profits than if there were no tie.

The key insight of the paper is recognizing the durability of the tying good (the Windows operating systems in the example above). Suppose that there are two periods. In the first period, the monopolist sells A as well as an application B. The consumer uses A to run applications in both periods, but buys A only in the first period. Another firm produces and sells a superior application B* in the first period as well. In the first period, the monopolist prices A to extract the full monopoly profits in that period from the sale of A—the single monopoly profit theory holds.

But suppose in the second period that the A monopolist and the other applications supplier provide an upgrade to B and B*, respectively. The A monopolist can capture its return to the B upgrade but not the B* upgrade. By allowing the producer of B* to sell to consumers in the first period, the monopolist cannot capture any profits from B* upgrade—those profits are earned by the supplier of B* in the second period. Thus, the possibility of subsequent upgrade profits provides an incentive to the monopolist of A to tie the initial application to the sale of A, even if the rival applications are superior to those of the monopolist and pose no threat to the A monopoly. The paper then extends this model to leasing, demonstrating that if the durable good can be leased, the tie is not necessary.

While this paper does by necessity have a number of technical discussions, it is very good at providing the intuition behind the derivations (many of the more extensive of which are relegated to an appendix). This is worth the read. ●

—JRW

⁶ See, for example, the classic paper by Michael Whinston, *Tying, Foreclosure, and Exclusion*, 80 AM. ECON. REV. 837 (1990).

⁷ Dennis Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. ECON. 194 (2002).