What Is at Stake with Supreme Court Review of United States v. American Express Co.?
Allan L. Sham pine examines the history of the United States v. American Express litigation, as well as the key issues under consideration at this closely watched case pending before the U.S. Supreme Court. This article breaks down the potential legal and business fallout from this case involving two-sided markets in the credit card industry.

Intel: Clarification or Contradiction?
Mark Taylor and Jürgen Schindler discuss the procedural and substantive relevance of the recent Intel decision by the European Court of Justice. The authors examine the ECJ’s contention that the opinion does not overrule existing antitrust case law but rather further clarifies the legal analysis with respect to conditional rebates.

A Call for Greater Consistency in the Failing Firm Defense
Norman A. Armstrong and Christopher C. Yook contend the Merger Guidelines and antitrust case law put forth different standards for companies seeking to meet the “failing firm” defense. As a result, they argue, merging parties face unpredictability and uncertainty when trying to meet the defense before courts and the competition agencies. The authors offer suggested solutions for clarifying this often-thorny area of antitrust law.

Geographic Market Definition in Urban Hospital Mergers: Lessons from the Advocate-NorthShore Litigation
Steven Tenn and Sophia Vandergrift discuss the importance of geographic market definition and identification of the appropriate customers in urban hospital mergers, with an emphasis on the recent FTC v. Advocate Health Care litigation. The authors examine competing approaches to geographic market definition in such cases and analyze why the Seventh Circuit rejected the Elzinga-Hogarty test, while endorsing the hypothetical monopolist test.

A Defense of Using the Hypothetical Monopolist Test in Health Care Provider Mergers
Antara Dutta and Elisa F. Kantor argue that the hypothetical monopolist test, when properly formulated and applied, is an appropriate test for defining the relevant geographic market in health care provider mergers. In particular, the authors respond to an article by Kenneth W. Field, Louis K. Fisher, and William D. Coglianese, who argue that the hypothetical monopolist test is difficult to apply in this context.

Comment on The Flaws in Using the Hypothetical Monopolist Test from the “Payor Perspective” in Health Care Merger Cases, by Field, Fisher, and Coglianese
Dov Rothman and David Toniatti comment on an article by Kenneth W. Field, Louis K. Fisher, and William D. Coglianese concerning application of the hypothetical monopolist test in health care mergers. The authors discuss their position that Field et al.’s approach does not consider how hypothetical monopolization might affect a provider’s walk-away price during negotiations—a consideration they have seen overlooked in analysis of provider mergers.

Interview with Laura Brett, Director, National Advertising Division
Given the important role NAD plays in self-regulating national advertising, Editor Randy Shaheen sat down with Laura Brett, the new NAD director, to get her thoughts on where NAD is now and where it is headed.

Applied Econometrics: When Can an Omitted Variable Invalidate a Regression?
In this first article in our new series explaining complex antitrust economics concepts to lawyers, Hal J. Singer and Kevin W. Caves provide an overview of the concept of omitted variable bias in regression analysis. The article is intended for non-economists and explains the relevant concepts surrounding omitted variable bias and its practical application to real-world antitrust litigation.
What Is at Stake with Supreme Court Review of United States v. American Express Co.?

Allan L. Sham pine

Over the last few decades there has been a great deal of legislation, litigation, and regulation concerning payment cards in the United States and around the world.¹ Anti-steering or non-discrimination rules imposed by Visa, MasterCard, and American Express have been a prominent, recurring issue in these proceedings. Although the specifics of the rules varied among the payment networks, collectively they prevented merchants from treating customers differently depending on the type, brand, or issuer of credit or debit cards. Merchants could not surcharge a purchaser using a particular high-cost payment card, offer a discount to customers who use a lower cost card, encourage or discourage use of particular cards using other strategies, or even provide information about the costs of different payment methods to their retail customers.

History of the Litigation

In October 2010, the U.S. Department of Justice, along with 18 state attorneys general, filed suit against Visa, MasterCard, and American Express.² The complaint alleged that the networks violated the Sherman Act by preventing both the offering of discounts or rewards and the provision of information about the costs to merchants of accepting cards. Preventing those actions was alleged to interfere with price setting at the point of sale.

In brief, the rules were alleged to “insulate the networks from competition by impeding merchants’ ability to encourage competition among payment card brands.”³ The antitrust concern was, in part, that credit cards were relatively high cost payment methods for merchants, but that the network rules prevented merchants from reflecting differences in payment method costs in the prices to consumers. One result of these restrictions allegedly was a cross-subsidy from retail customers using lower cost payment methods (e.g., cash and PIN debit) to the networks’ credit card customers.

Visa and MasterCard settled the case in July 2011, agreeing “to allow merchants to influence their customers’ choice of payment method by offering discounts, incentives, and information to consumers to encourage the use of payment methods that are less costly to the merchants.”⁴

¹ To illustrate how long these issues have been in dispute, see K. Craig Wildfang & Ryan Marth, The Persistence of Antitrust Controversy and Litigation in Credit Card Networks, 73 Antitrust L.J. 675 (2006); Terri Bradford & Fumiko Hayashi, Developments in Interchange Fees in the U.S. and Abroad (Fed. Reserve Bank of Kansas City, Apr. 2008).
³ Schuh et al., supra note 2, at 111.
⁴ Id. at 112.
Federal Reserve Bank economists noted at the time that the DOJ action was relatively late compared to other countries that had previously acted against network rules. American Express, however, did not settle.

The continued presence of American Express’s anti-steering rules has had a general marketwide effect. Its rules prevent merchants from displaying any preference for the brand of payment other than American Express (which has been the most costly brand historically), providing customers with information about how much the use of American Express costs the merchant, or imposing any restrictions or fees that are not imposed equally on other payment methods except for cash and check. The plaintiffs have argued that in practice this means that merchants accepting American Express cannot effectively steer between alternative card brands notwithstanding the relaxation of Visa and MasterCard rules. For example, the continued presence of American Express’s rules was cited by settlement opponents as a barrier to the effectiveness of relief granted under a (since-overturned) settlement of interchange fee litigation against Visa and MasterCard.

The DOJ case against American Express was tried on a rule of reason basis in 2015 before Judge Nicholas Garaufis, who ruled in favor of the plaintiffs. Judge Garaufis found that the relevant product market consisted of general purpose credit and charge card network services; that American Express possessed market power in that market notwithstanding its lesser acceptance by merchants than Visa and MasterCard; and that the anti-steering provisions caused harm to competition and were not otherwise justified.

In 2016, however, the Second Circuit reversed. Judge Richard Wesley wrote that the district court erred in defining the relevant market and should have included credit card services provided to consumers along with services provided to merchants as part of a “two-sided” market. In that broader market, “Plaintiffs bore the burden . . . to prove net harm to Amex consumers as a whole—that is, both cardholders and merchants—by showing that Amex’s nondiscriminatory provisions have reduced the quality or quantity of credit-card purchases.” The Second Circuit concluded that the plaintiffs “failed to carry their burden to prove a § 1 violation.”

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5 Id. at 113–14.
10 Id. at 206–07.
11 Id.
Eleven of the state plaintiffs applied for certiorari, but the DOJ did not. In a surprising turn, the DOJ ultimately filed an amicus brief strongly disagreeing with the Second Circuit decision, but also expressly asking the Supreme Court not to hear the case. The DOJ noted that the Supreme Court “has not squarely considered questions of market-definition or proof of anticompetitive effects in cases involving two-sided platforms as such,” but neither has any other court of appeals, and the Court should wait until such cases appear. Nonetheless, the Supreme Court granted certiorari and the case will proceed.

How to Apply the Rule of Reason
The petitioners asked the Supreme Court to consider several issues. First, they asked for further guidance on the practical operation of the rule of reason. Petitioners noted that the Supreme Court has increasingly required use of the rule of reason, applying it, for example, to reverse payment settlements in FTC v. Actavis, to resale price maintenance in Leegin, and to advertising restrictions in California Dental Association. However, the petitioners argued that the Supreme Court has provided little guidance as to “how the rule of reason should operate in practice” once applied.

Rule of reason analyses can be complicated. Indeed, the rule of reason is applied almost by definition in instances where matters are not clear cut—where there are a variety of factors at play to be balanced. However, even where the broad strokes of how such an analysis should proceed have been sketched out, there can be a great deal of uncertainty as to the specifics of its application. For example, there has been extensive and ongoing debate as to how Actavis should be implemented in practice and who bears what burden of proof and when it will shift. In American Express, the Second Circuit found in effect that the plaintiffs had failed to meet their burden of proof by not addressing a particular form of market definition. That is an astonishing finding—that the plaintiffs had completely ignored a threshold question from the beginning and thus the entire trial and factual record were irrelevant as they failed to grapple with what the Second Circuit characterized as a necessary initial question. Guidance from the Supreme Court on what constitutes a prima facie case in a rule of reason analysis could have far-reaching effects.
Market Definition with Two-Sided Markets

The petitioners have also asked for guidance as to market definition in two-sided markets. The petitioners and amici alike have pointed out that although two-sided markets are not new to antitrust analysis, the Second Circuit’s finding that the plaintiffs must consider the “net” price in a two-sided market is new. One concern expressed by the amici is that not only are there a large number of important industries and firms characterized as two-sided (e.g., Alphabet, Amazon, Facebook, Microsoft, Visa, MasterCard, American Express), but that almost any industry can be characterized as two-sided. If plaintiffs face a more formidable burden of proof in two-sided markets, there could be a strong incentive for defendants to characterize their industries as two-sided.

The question then is whether markets should be defined in a different way in industries characterized as two-sided. The district court focused on competition between the networks and prices to merchants. The Second Circuit stated that it focused on the sum of prices to both merchants and cardholders (although the petitioners have argued that the trail record showed the sum of prices was, in fact, higher, and the Second Circuit did not address whether impacts on non-American Express customers were relevant). Discover’s amicus brief summarized the dispute, noting that the Second Circuit “panel opinion simply substitutes a ‘necessarily affects’ test on product pricing for this Court’s interchangeability standard for market definition.” That is, the Second Circuit has created a new and different market definition test for two-sided markets—one that does not have clear boundaries.

The Supreme Court may address whether two-sided markets are somehow fundamentally different from other markets and whether antitrust analysis must therefore proceed differently. Economists continue to debate this question, and it is clearly unsettled in the legal arena as well. Nonetheless, market definition is a question that goes to the foundation of legal antitrust analysis. While economists have often pointed out that defining markets is primarily a legal exercise, and that a demonstration of anticompetitive harm is sufficient without explicitly defining a market, market definition is a key step in legal antitrust analysis, and can serve as a critical framing tool.

21 See, e.g., Plaintiffs’ Petition, supra note 12, at 19; Brief of Amicus Curiae Southwest Airlines Co. in Support of Petitioners at 8, Ohio v. American Express Co., No. 16-1452 (July 6, 2017) [hereinafter Southwest Brief].

22 See, e.g., Reply Brief, supra note 20, at 7.


24 Reply Brief, supra note 20, at 11.

25 Brief for Discover Financial Services as Amicus Curiae in Support of Petitioners at 7, Ohio v. American Express Co., No. 16-1452 (July 6, 2017) [hereinafter Discover Brief]. See also Plaintiffs’ Petition, supra note 12, at 20 (“Rather than apply the established market-definition test, the Second Circuit adopted a new one. Because the price in the market for merchant services affects the price in the market for cardholder services, the Second Circuit held that the cardholder and merchant markets should be consolidated into a single market for antitrust purposes. It is often the case that pricing in one market affects pricing in another, but that interdependency has never collapsed the two markets into one for antitrust purposes.”) (citation omitted).

26 See, e.g., Dennis Carlton & Ralph Winter, Competition Policy and Regulation in Credit Card Markets: Insights from Single-Sided Market Analysis, 10 COMPETITION POL’Y INT’L 53, 54 (2014) (“It is hard to imagine a wider range of views on the role of prices in any market. . . . Credit card networks are undoubtedly two-sided, but economic analysis of such markets should keep a tighter link to what we know about conventional, one-sided markets than scholars have done to this point.”).

for clarifying the issues for both economists and lawyers. Changing how markets are defined would fundamentally change how an antitrust analysis proceeds.

**Burdens of Proof with Rule of Reason and Two-Sided Markets**

Amici also expressed interest in certain specific applications of the burden of proof and market definition questions. For example, if plaintiffs must consider the “net” two-sided price, which party has the burden of demonstrating whether there is any “off-setting” benefit on the other side? The Second Circuit has indicated that is part of the plaintiffs’ initial burden. Amici have argued that the Court should make clear that any such burden should fall on defendants, as the ones in the best position to undertake the analysis.

The issues go beyond burden of proof, however. If multiple “sides” of a market are considered, how far should that analysis extend? To what extent can benefits to one group of customers be used to offset harm to a different group of customers? For example, one concern about non-discrimination rules is that they may create a cross-subsidy from cash and PIN debit users to credit card users—a harm to the former but a benefit to the latter. Should the effects be netted out? Does it matter if total retail prices are higher as a result? What if output (usage) of credit cards expands because of this cross-subsidy while output (usage) of cash and PIN debate declines? Should total output be considered, or are these separate markets? The breadth of analysis required could significantly expand depending upon the Supreme Court’s guidance.

While it is uncertain what the Supreme Court will focus on, the petitioners and amici have raised many issues that could have a profound impact on the application of rule of reason analysis in antitrust cases generally and the treatment of two-sided industries specifically.


30 See, e.g., Connor Brief, *supra* note 23, at 3 (“Amex, as the proponent of and enforcer of the merchant restraints, is clearly in the best position to understand and quantify any relevant offsetting competitive benefits. Creating a new antitrust standard that requires the victim of a restraint of trade to prove that its harm is not offset by benefits to third parties is not sound policy or economics.”).

31 See, e.g., Southwest Brief, *supra* note 21, at 8.

32 Petitioners claimed that Plaintiffs demonstrated that even net prices were higher even after accounting for rewards. Reply Brief, *supra* note 21, at 11.

Intel: Clarification or Contradiction?

Mark Taylor and Jürgen Schindler

In the short time since it was published, much has already been written about the European Court of Justice’s (ECJ) Intel judgment,¹ both in the mainstream media and specialist antitrust publications. This is no doubt related to Intel’s prominence as a household name, and the sizeable fine involved. Despite the brevity of the judgment, its 25 pages are a rich source of substantive, jurisdictional, and procedural considerations. This article will set out a brief overview of the jurisdictional and procedural issues considered in the judgment, before tackling the heart of the matter—the Commission’s newly emphasized obligation to consider the effects of allegedly anticompetitive conduct.

On September 6, 2017, the Court of Justice of the European Union handed down its long-awaited judgment on Intel’s appeal against a €1.06 billion fine for alleged abuse of a dominant position. The fine—record-breaking at the time it was imposed by the European Commission in 2009²—was first appealed by Intel to the General Court of the European Union.

However, the General Court dismissed Intel’s appeal of its June 12, 2014 judgment,³ prompting Intel to take its case to the ECJ—and resulting in a rare ruling on Article 102 of the Treaty on the Functioning of the European Union from the European Union’s highest court. As a precursor to that ruling, Advocate General Wahl delivered his opinion regarding Intel’s appeal on October 20, 2016.⁴ Although not binding, the opinion supported Intel’s appeal, finding that the Court of Justice should refer the case back to the General Court for a second review.

When the ECJ handed down its judgment almost a year later, it ultimately mirrored AG Wahl’s recommendation. Although not all of Intel’s grounds of appeal were upheld, and there are some important divergences between the ECJ’s judgment and AG Wahl’s opinion, the ECJ overturned the General Court’s judgment and ruled that the case must be referred back to the General Court.

Two aspects to Intel’s conduct have been under examination throughout the proceedings: (1) its granting of certain conditional rebates and (2) “naked restrictions.”⁵ As regards the first type of conduct, Intel awarded four original equipment manufacturers (OEMs) rebates conditional on these OEMs purchasing all or almost all of their x86 CPUs from Intel. The OEMs in question were Dell, Lenovo, HP, and NEC. Intel also granted payments to a European retailer, Media-Saturn-Holding GmbH (MSH), which were conditional upon MSH selling exclusively computers containing Intel’s x86 CPUs. As regards the naked restrictions, Intel granted three OEMs (HP, Acer, and Lenovo) payments, which were conditional upon those OEMs postponing or cancelling the launch of AMD CPU-based products and/or putting restrictions on the distribution of those products.

Jurisdiction

As has been mentioned above, the conduct that the Commission had found abusive in its decision related to agreements between Intel and OEMs located outside the European Economic Area (EEA). Intel argued before the General Court that, because the conduct in question had taken place outside the EEA, or involved agreements with entities located outside the EEA, the conduct did not have an effect on trade between Member States. On that basis, Intel argued, the Commission did not have jurisdiction to apply Article 102 to the conduct in question. The General Court dismissed Intel's arguments in this regard, prompting Intel to appeal the issue to the ECJ—albeit with a much reduced scope, which was narrowed to only “the agreements concluded between Intel and Lenovo in 2006 and 2007.”6

This was an audacious argument—a finding in favor of Intel by the ECJ would have significantly curtailed the Commission's ability to pursue conduct taking place outside the European Union. It seems that audacity was perhaps recognized by Intel given its reduction in the scope of this argument between the written proceedings before the General Court (which related to five OEMs), the oral proceedings (in which Intel restricted the argument to two just OEMs), and its appeal to the ECJ (by which time Intel had narrowed the argument down to just one OEM, Lenovo). Nonetheless, the months between AG Wahl delivering his opinion and the ECJ handing down its judgment must have been an uncomfortable wait for the Commission.

AG Wahl's opinion set out that a premise of competition law in the European Union is that there is “an adequate link to the EU territory, be it in the form of the presence of a subsidiary, or the implementation of anticompetitive conduct within that territory.”7 The link to the territory of the European Union may therefore be a question of either the implementation or the effects of conduct, and the opinion goes on to argue that the “implementation” limb of this test does not only relate to direct sales, but rather that there must be a case-by-case assessment. Perhaps the more interesting question arose as regards the “effects” limb of the test, however. In a globalized economy, conduct of a significant scope anywhere in the world would have at least some effect in the European Union, and AG Wahl recognizes this in the opinion. As a result, he argues, for the “effects” limb of the test for jurisdiction to be met, the conduct must have a “direct (or immediate), substantial and foreseeable anticompetitive effect within the internal market.”

Perhaps unsurprisingly, however, the ECJ held that for effects to be foreseeable, it is enough to “take account of the probable effects of conduct on competition.”8 The ECJ thereby endorsed the qualified effects test that Intel had sought to challenge, making it substantially easier for the Commission to pursue conduct that is carried out outside the European Union than if the ECJ had followed AG Wahl’s proposed restriction of enforcement to scenarios where there is an “adequate link to the EU territory.”9

Procedure

During its investigation, the Commission had carried out an interview with one of the most senior executives of Intel’s largest customer, Dell—referred to in the proceedings as Mr D1. The Commission had, however, failed to record the interview and provide Intel with a record of the meeting.

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While Intel argued that this had infringed its rights of defense, the General Court found that there was a distinction between “formal” and “informal” interviews, and that the Commission’s meeting with Mr D1, being an “informal” interview, was not subject to the same procedural requirements as a “formal” interview.¹⁰

On appeal to the ECJ, it was confirmed that no such distinction exists for the purposes of Article 19(1) of Regulation No 1/2003, which forms the basis for the Commission’s power to carry out such interviews, and that the Commission should indeed have made a record of the interview. However, the ECJ went on to hold that, in order for Intel to have shown that the Commission’s procedural error affected its rights of defense, it would have had to show that “it did not have access to certain exculpatory evidence and, secondly, that it could have used that evidence for its defence.”¹¹

This means that, where the Commission fails in the future to make a record of an interview, an investigated company would need first to establish that the interview took place, and then establish that it contained exculpatory evidence—all without, of course, having a record of the interview. This leaves companies under investigation in the uncomfortable position of presumably relying on rumor and hearsay to uncover the existence of an interview, and then turning to the interviewee (likely a customer, supplier, or competitor) to find out what evidence it gave to the Commission.

**Substance**

Intel’s first ground of appeal, regarding the General Court’s assessment of Intel’s rebates, submitted that the General Court had “erred in law by failing to examine the rebates at issue in the light of all the relevant circumstances.”¹² The General Court identified in its judgment three types of rebates: (1) volume-based rebates, (2) exclusivity rebates, and (3) “fidelity-inducing” rebates. Volume-based rebates are linked to the volume of purchases made from a company that occupies a dominant position on a market, and are generally not viewed as problematic.¹³ Exclusivity rebates are linked to a customer obtaining all or most of its purchases from the company occupying a dominant position,¹⁴ while “fidelity-inducing” rebates are not directly linked to volume or exclusivity of purchases, but may still build fidelity towards the company in a dominant position.¹⁵

In its judgment, the General Court relied on existing case law—in particular, Michelin II¹⁶ and Hoffmann-La Roche¹⁷—to find that a volume-based rebate is generally not problematic under Article 102, but that an exclusivity rebate “constitutes an abuse of a dominant position if there is no objective justification for granting it.”¹⁸ The General Court went on to note that “it is only in the case of rebates falling within the third category [that is, fidelity inducing rebates] that it is necessary to assess all the circumstances, and not in the case of exclusivity rebates falling within the second category.” The General Court’s reasoning for this distinction was that “exclusivity rebates

¹¹ Case C-413/14 P, Intel Corp. v. Comm’n, ECLI:EU:C:2017:632 (CJ Sept. 6, 2017), ¶ 98.
¹² Id. ¶ 31.
¹⁴ Id. ¶ 76.
¹⁵ Id. ¶ 78.
granted by an undertaking in a dominant position are by their very nature capable of restricting competition.”¹⁹

Intel challenged this conclusion, submitting that “all the relevant circumstances” should have been examined before determining whether the rebates in question constituted abusive conduct, since “neither the wording nor the structure of Article 102 suggests that some types of conduct . . . must be treated as inherently anticompetitive.”²⁰

The ECJ seems to have agreed with Intel. “Clarifying” Höffmann-La Roche, as the ECJ termed it,²¹ the ECJ appears to have placed a broad obligation on the Commission to examine the circumstances surrounding the conduct of a company under investigation—irrespective of its form—where the company under investigation submits evidence that its conduct was “not capable of restricting competition.” The ECJ has therefore extended the contextual assessment already used for “fidelity-inducing” rebates to exclusivity rebates. The ECJ emphasized the company’s position on the relevant market, how much of the market was covered by the practice in question, the specifics of the rebates in question (namely the terms on which they are granted, their duration, and amount), as well as whether there has been a strategy to exclude as-efficient competitors, as factors to be taken into consideration when carrying out this assessment.²²

The ECJ added that even beyond these factors, though, the Commission also has to consider whether there may be an objective justification for the rebates, such as where exclusionary effects are outweighed by efficiencies that also benefit the consumer.²³ In addition, the ECJ noted the important role that the as-efficient competitor (AEC) test had played in the Commission’s assessment of the rebates—even though the Commission had emphasized that the very nature of the rebates meant that they were capable of restricting competition.²⁴ By noting the prominence of the AEC test’s role in the Commission’s decision—despite the Commission itself having emphasized that carrying out the test was not necessary given the nature of the rebates, but rather was done only for completeness—the ECJ has underlined the importance of the AEC test in an effects-based analysis.²⁵

A “Clarification” Capable of Causing Confusion?
The ECJ is very clear that it has not overturned existing case law. It acknowledges the ECJ’s previous ruling in Höffmann-La Roche, which stated that a company in a dominant position that uses exclusivity or “fidelity-inducing” rebates is abusing its dominant position under Article 102.²⁶ The General Court had also recognized this ruling, as well as developments in subsequent case law²⁷ according to which it is necessary to assess all the circumstances surrounding the grant of those rebates falling into the third category—that is, “fidelity-inducing” rebates—but that doing so

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¹⁹ Id. ¶¶ 84, 85.
²¹ Id. ¶ 138.
²² Id. ¶¶ 138, 139.
²³ Id. ¶ 140.
²⁴ Id. ¶ 142.
²⁵ Id. ¶¶ 142–147.
²⁶ Id. ¶ 137.
is not necessary in the case of exclusivity rebates.\textsuperscript{28} However, the ECJ\textsuperscript{29} has now clarified that a company under investigation can rebut, on the basis of supporting evidence, the presumption that its conduct is “capable” of restricting competition—and where it does so, the Commission must examine carefully the circumstances around the conduct (as noted above) to determine whether it is indeed capable of such a restriction.\textsuperscript{30} The ECJ’s broad phrasing of this clarification appears to hold the Commission to this standard not only with respect to exclusivity and “fidelity-inducing” rebates, but also for the spectrum of conduct that may be investigated under Article 102.

In turn, this appears to bring Article 102 enforcement more in line with enforcement of Article 101. Where companies engage in one of the behaviors set out in Article 101(1), Article 101(3) provides them with a last line of defense to show that their conduct should not be prohibited. In what seems almost to be a tacit acknowledgment of the imbalances of defenses available to companies under Articles 101 and 102, the possibility of relying on Article 101(3) as a potential defense in conduct involving rebates was actually raised in \textit{Hoffmann-La Roche}. In that judgment, the ECJ remarked that rebates may not be contrary to the objectives of the Common Market where “exceptional circumstances” may make an agreement between companies “permissible” in the context of Article 101(3) (then numbered Article 85(3)).\textsuperscript{31} The ECJ has now provided companies investigated under Article 102 with a similar fallback with a broader application than “exceptional circumstances,” while leaving one important question unanswered: what does capability mean?

**The Meaning of Capability**

The question is of particular interest given the importance that the ECJ places on an effects-based approach, and on an assessment of the broader circumstances of the conduct, in the subsequent paragraphs of its judgment. Going by the meaning of the word, “capable” sets a low threshold that would only require a plausible (perhaps even theoretical) possibility that conduct could restrict competition.

However, it seems questionable that the ECJ intended to set such a low threshold given the judgment’s emphasis on the importance of effects. Conduct that may, in theory, be capable of restricting competition may not necessarily be viewed as such once the surrounding circumstances are taken into account. So, should “capability” be assessed as a theoretical plausibility, or does it need to be considered in conjunction with effects—meaning there would be little distinction between “capable” and “likely”? This is, in essence, a question of degrees of probability.

AG Wahl shared his own thoughts on this question in his opinion: “Certainly, evidence of actual effects does not need to be presented. This is because it is sufficient, in relation to conduct that is presumptively unlawful, that the impugned conduct be capable of restricting competition. Importantly, however, that capability cannot merely be hypothetical or theoretically possible.”\textsuperscript{32} He goes on to remark that “[t]he aim of the assessment of capability is to ascertain whether, in all likelihood, the impugned conduct has an anticompetitive foreclosure effect. For that reason, likelihood must be considerably more than a mere possibility that certain behaviour may restrict competi-

\begin{itemize}
\item \textsuperscript{28} Case T-286/09, Intel Corp. v. Comm’n, ECLI:EU:T:2014:547 (GC June 12, 2014), ¶ 84.
\item \textsuperscript{29} Case C-413/14 P, Intel Corp. v. Comm’n, ECLI:EU:C:2017:632 (CJ Sept. 6, 2017), ¶ 138.
\item \textsuperscript{30} Id. ¶¶ 138, 139.
\item \textsuperscript{31} Case 85/76, Hoffmann-La Roche v. Comm’n, 1979 E.C.R. 00461, ¶ 90.
\item \textsuperscript{32} Case C-413/14 P, Intel Corp. v. Comm’n, ECLI:EU:C:2016:788 (AG Oct. 20, 2016), ¶ 114.
\end{itemize}
tion.”33 His basis is that the threshold for Article 102 to apply to companies cannot be lowered to such an extent that “the degree of likelihood required for ascertaining that the impugned conduct amounts to an abuse of a dominant position was nothing more than the mere theoretical possibility of an exclusionary effect,” otherwise EU competition law would sanction form rather than effects.

AG Wahl’s interpretation of capability is a logical one. Even in a “by object” infringement, the purpose of competition law must be to protect against effects on the relevant market and consumers, rather than to sweepingly prohibit certain types of behaviors even if they cannot affect the market.

**Historic Conduct**

Following AG Wahl’s interpretation would also lead to a pragmatic approach when dealing with wider enforcement questions, such as how to treat historic conduct. Say, for example, that certain potentially anticompetitive conduct has been continuing for a decade before it is investigated by the Commission, but has not resulted in any anticompetitive effects on the market. If that conduct takes a per se anticompetitive form, then it is hard to imagine a situation in which it is not plausible that such conduct has restricted competition on the market over the course of its duration. If capability is taken to mean a theoretical plausibility, then that conduct would be prohibited without the need to show foreclosure effects on the market. The fact that over the course of a decade the conduct has not had any anticompetitive effects would be irrelevant. Such a prohibition would clearly be sanctioning the form, rather than the effect, of conduct.

This was, however, the position taken by the General Court in its *Intel* judgment. The General Court held that “even in the context of an analysis of the circumstances of the case, the Commission must only show that a practice is capable of restricting competition,” and therefore “it follows necessarily from this that the Commission is also not required to prove a causal link between the practices complained of and actual effects on the market.”34

It seems that the ECJ’s judgment means that taking such a position would no longer be tenable where the company under investigation provides evidence that its conduct has not resulted in foreclosure over an extended period of time. If the company does so, then the Commission would have an obligation to look at the circumstances surrounding the conduct—and surely the likelihood in this scenario that conduct has anticompetitive effects cannot be seriously viewed as more than a “mere possibility.” As a result, the conduct would not be cast as anti-competitive and prohibited—which would be the logical outcome, given it has not negatively affected the market over ten years.

**Recycling Continental Can**

The ECJ’s judgment has emphasized the need to take a holistic approach when assessing potentially anticompetitive conduct: not only does the form of the conduct need to be assessed, but also its effects on the market, as well as any potential consumer benefit, such as efficiencies. As the ECJ recognizes in its judgment, the requirement to look at the broader circumstances and effects of conduct is hardly a novel approach (otherwise, it would have been very difficult for the ECJ to have framed its judgment as a “clarification”). However, the ECJ’s judgment does add nuance to the extent to which different effects are to be taken into account.

33 *Id.* ¶ 117 (emphasis added).

In its 1973 judgment in *Continental Can*, the ECJ held that the prohibition in Article 102 (then Article 86) is “not only aimed at practices which may cause damage to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure.” The ECJ, therefore, was evidently concerned not only with protecting consumers from harm, but also ensuring that the market remained structured so as to maintain a competitive environment.

This purpose of Article 102 has been recognized many times since by the courts, not least in the General Court's *Intel* judgment: “It is apparent from the case-law that Article 82 EC is aimed not only at practices which may cause damage to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure,” which refers to *British Airways* in this regard.

The importance of market structure as a consideration was, however, called into question by the wording of the ECJ's *Post Danmark I* judgment, which drew an explicit link between harm to the structure of a market and harm to consumers: “In order to assess the existence of anti-competitive effects . . . it is necessary to consider whether that pricing policy . . . produces an actual or likely exclusionary effect, to the detriment of competition and, thereby, of consumers’ interests.” The implication of the judgment was that conduct can only be abusive if it results in detriment to consumers.

This disregard for the effects of conduct on the market has been somewhat tempered in subsequent case law, notably, *Post Danmark II* and *British Airways*. However, as has been remarked above, the ECJ's *Intel* judgment has emphasized the importance of the AEC test in an effects-based analysis. The AEC test inherently focuses on the effect of conduct on market structure: conduct that excludes a competitor that is as efficient as the dominant company may not harm consumers’ interests but certainly results in a less competitive market. In its *Intel* judgment, the ECJ therefore appears to be re-emphasizing the importance of considering the effects of potentially abusive conduct not only on consumers, but also on the market itself.

**Conclusion**

At first glance, it appeared the “clarification” of existing case law in the ECJ’s *Intel* judgment was the usual euphemism for “contradiction.” Perhaps, in some respects, a better word would be “expansion.” In one fell swoop, the ECJ has taken an established approach to assessing certain types of conduct—namely, “fidelity-enhancing” rebates—and expanded its application to all conduct assessed under Article 102, while also promoting consistency with enforcement under Articles 101 and 101(3). Nonetheless, the judgment certainly leaves room for interpretation—and maneuver—by leaving key questions open.

It is rare for an Article 102 case to be ruled on by the EU’s highest court. While the judgment does provide welcome guidance across a range of substantive, jurisdictional, and procedural matters, it is likely to be a long wait before the ECJ provides further clarification on the questions it has left unanswered.●

A Call for Greater Consistency in the Failing Firm Defense

Norman A. Armstrong Jr. and Christopher C. Yook

Earlier this year, the U.S. District Court for the District of Delaware sided with the Department of Justice’s Antitrust Division (DOJ) and blocked Energy Solutions’ attempted $367 million acquisition of Waste Control Solutions (WCS) following a bench trial. The DOJ alleged that the two companies, if consolidated, would have been the sole provider of certain nuclear waste disposal services in 36 states. The parties attempted to defend the acquisition, in part, through the failing firm defense, presenting evidence that WCS had never generated an operating profit and pointing to a series of investments that had yet to yield expected returns. Adding to the line of cases rejecting the defense, Judge Sue L. Robinson held that WCS failed to show that Energy Solutions was “the only available purchaser” despite prior efforts to solicit bids.¹

The Energy Solutions decision illustrates the challenges of successfully raising the failing firm defense, which is “narrow in scope”² and judged against a “strict legal standard.”³ Although the guidance from the DOJ, the Federal Trade Commission (collectively “the antitrust agencies”), and the courts indicate that the failing firm defense is still viable in theory, Energy Solutions illustrates a critical inconsistency in the application of the failing firm defense. In particular, the antitrust agencies and courts have articulated two different standards regarding the failing firm’s obligation to solicit alternative offers, referred to here as the “alternative purchaser element.” Key court decisions on this issue have held that the acquiring party must be “the only available purchaser”⁴ while the antitrust agencies’ guidance explicitly requires “good-faith efforts to elicit reasonable alternative offers.”⁵ These two different tests⁶ for the alternative purchaser element continue to be inconsistently applied, making it difficult for the merging parties and their advising counsel to realistically rely upon the failing firm defense.

Origins and Objectives of the Failing Firm Defense

The failing firm defense originates in the 1930 Supreme Court decision in International Shoe,⁷ although the conceptual underpinnings can be traced back to a 1917 opinion from the Seventh

⁶ The test articulated in Citizen Publishing is referred to here as “the no alternative purchasers test,” while the test from the Horizontal Merger Guidelines is referred to here as “the good faith efforts test.”
⁷ Int’l Shoe Co. v. FTC, 280 U.S. 291 (1930).
Circuit. In *International Shoe*, the Court concluded that a company’s acquisition of a competitor does not violate Section 7 of the Clayton Act where the target’s resources are “so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure.”

Explaining its rationale for recognizing a defense of a merger that may otherwise be unlawful under Section 7, the Court reasoned that permitting the merger could help avoid shareholder losses, the elimination of jobs, and other public harms threatened by the shutdown. In the 1963 *Philadelphia National Bank* decision, the Supreme Court again intimated that the failing firm defense is concerned with the “public impact” of a failing firm.

In the years following *International Shoe*, the public impact justification has been minimized by the courts and antitrust agencies applying the failing firm defense. Instead, the commonly understood rationale is that a merger between competitors, one of which is a failing firm, “cannot have an adverse effect on competition, because the failing company would disappear as a competitive factor whether or not the merger occurred.” Despite the failing firm defense being recognized before the judiciary and the antitrust agencies, it is “narrow in scope. . . rarely invoked in court or before the Agencies. . . [and] is rarely successful.”

**Inconsistent Approaches to the Alternative Purchaser Element**

There is currently a subtle, but significant, difference in the standards applied to the failing firm defense. Following the *International Shoe* decision, the Supreme Court further articulated the elements of the failing firm defense in *Citizen Publishing*, requiring a showing that: (1) the target faces the “grave probability” of failure; (2) the prospects of reorganization for the failing firm are unlikely; and (3) the acquiring company “is the only available purchaser.”

The DOJ first issued formal guidance regarding the failing firm defense as part of its 1968 Merger Guidelines, which notably moved away from the “only available purchaser” standard. Specifically, the DOJ stated that it would ordinarily not challenge a merger if: “(i) the resources of one of the merging firms are so depleted and its prospects for rehabilitation so remote that the firm faces the clear probability of a business failure, and (ii) good faith efforts by the failing firm have failed to elicit a reasonable offer of acquisition more consistent with the purposes of Section 7 by a firm which intends to keep the failing firm in the market.”

This formulation of the failing firm defense has been incorporated in subsequent iterations of the antitrust agencies’ guidance, including the jointly issued Horizontal Merger Guidelines. Similar to the 1968 Merger Guidelines, the latest version of the Horizontal Merger Guidelines requires that
the failing firm have “made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger.”18 The Horizontal Merger Guidelines additionally state that a reasonable alternative offer is “any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets.”19

These two tests for the alternative purchaser element have been applied inconsistently by the courts. Many courts cite only the Citizen Publishing elements, requiring that the acquiring company be the only alternative purchaser.20 Other cases cite the “good faith efforts” test from the Horizontal Merger Guidelines verbatim.21 A third category of decisions have seemingly mixed the elements of both approaches.22

The choice of test for the alternative purchaser element can heavily impact the outcome of the failing firm defense. For example, the District Court for the District of Columbia considered the defense in the FTC’s challenge of a proposed joint venture between telescope manufacturers Meade Instruments Corporation and Celestron International.23 In considering the FTC’s motion for preliminary injunction, the main issue for the court was whether the defendants had properly established the failing firm defense.24 In its opinion declining to apply the defense, the court first cited the Citizen Publishing elements and the “only available purchaser” test.25 Explaining its reasoning for finding that this test had not been satisfied, the court wrote that “[t]he FTC is not obligated to prove that these companies are immediately ready and willing to purchase Meade. Instead, it is Harbour Group’s burden to show that the Meade-Celestron joint venture is the ‘only’ available alternative.”26 It characterized this burden as “quite heavy” and found that even Meade’s engagement of Merrill Lynch to sell the company was inadequate because the efforts “did not comport with a normal Merrill Lynch exhaustive search.”27

The Energy Solutions Decision

The alleged failing firm in Energy Solutions, Waste Control Specialists, was a relatively recent entrant to the nuclear waste disposal industry, having only entered the market in 2012. At the time of trial, WCS had never generated an operating profit and consistently missed its earnings projections.28 The defendants also presented evidence that the amount of low-level radioactive waste

18 Horizontal Merger Guidelines, supra note 5, ¶ 11.
19 Id. §§ 11, 32.
22 See, e.g., Dr. Pepper/Seven-Up Co. v. FTC, 798 F. Supp. 762, 779 (D.D.C. 1992), rev’d, 991 F.2d 859, 865 (D.C. Cir. 1993) (evaluating efforts of failing firm, but under framework of only available purchaser test); United States v. Pabst Brewing Co., 296 F. Supp. 994, 1003 (E.D. Wis. 1969) (“[T]he defendants must establish . . . there were available no reasonable, possible, or feasible alternatives.”).
24 See id. at *1.
25 See id. at *4–5.
26 Id. at *18.
27 Id. at *12.
generated by nuclear plants steadily decreased in the past decade.\textsuperscript{29} During trial, the CEO of WCS’ parent company publicly announced that WCS would close if the merger was not completed.\textsuperscript{30}

Less than a year after WCS began operations, Energy Solutions, an industry incumbent, made the first of its repeated outreach to WCS to explore a possible acquisition.\textsuperscript{31} Each time, Energy Solutions was rebuffed because “[WCS] wanted more value.”\textsuperscript{32} Instead, WCS engaged investment bank Wunderlich in April 2014 to explore alternative strategic transactions for WCS. By August 2014, the banker’s efforts resulted in nine companies signing a non-disclosure agreement and three companies submitting indications of interest in WCS. Energy Solutions was one of the suitors, and it offered to acquire WCS for $50 million in cash and 30 percent of its stock. WCS opted to negotiate with other parties, none of which resulted in a concrete offer. By January 2015, Energy Solutions considered negotiations with WCS to be “officially dead.”\textsuperscript{33}

Later that spring, Energy Solutions and WCS became embroiled in antitrust litigation against each other, unrelated to the merger challenge. Mediation in that case led to the two companies reviving merger negotiations.\textsuperscript{34} At that time, WCS had been in negotiations with another company that progressed to where the company requested site visits, access to WCS’ data room, and had initiated formal due diligence.\textsuperscript{35} However, WCS never responded to those requests of the potential acquirer and moved forward to negotiate with Energy Solutions.

During the 2015 negotiations, Energy Solutions increased its offer but demanded a 30-day exclusivity period in order to proceed. WCS acceded to Energy Solutions’ exclusivity demands, which included “no talk,” “no give,” and “no shop” provisions that prohibited WCS from negotiating with, providing non-public information to, and soliciting any proposals from any other company.\textsuperscript{36} The merger agreement also did not include a “fiduciary out” clause which, in effect, prohibited WCS’ board from negotiating with other bidders even if they determined that their fiduciary duties required it.\textsuperscript{37} Shortly thereafter, on November 18, 2015, the two parties agreed to the acquisition of WCS by Energy Solutions for $367 million.

Following the DOJ’s complaint to enjoin the merger, Energy Solutions and WCS had indicated that they were mounting a defense along seven different lines. But by the end of the bench trial, the court had dismissed two of those arguments, with the companies abandoning another three. Thus, the court only addressed two arguments in its opinion: whether it was feasible for competitors to enter or expand within the relevant product market, and the failing firm defense. The court rejected the first argument and went on to evaluate the failing firm defense, which it characterized as ‘a ‘choice of evils’ approach where [if successful] ‘the possible threat to competition resulting from an acquisition is deemed preferable to the adverse impact on competition and other losses if the company goes out of business.’”\textsuperscript{38}

\textsuperscript{29} Id.
\textsuperscript{30} See id. at n.11.
\textsuperscript{31} Id. at *37–38.
\textsuperscript{32} Id. at *38.
\textsuperscript{33} Id. at *40.
\textsuperscript{34} See id.
\textsuperscript{35} Id. at *41.
\textsuperscript{36} Id. at *43.
\textsuperscript{37} Id. at *67–68.
\textsuperscript{38} Id. at *65–66.
Alternative Purchasers for the Failing Firm in Energy Solutions. The court’s rejection of the failing firm defense in *Energy Solutions* ultimately hinged upon the alternative purchaser element. In articulating the failing firm defense, Judge Robinson stated that the defendants had the burden to show: “(1) that the resources of [WCS] were ‘so depleted and the prospect of rehabilitation so remote that it faced the grave possibility of a business failure,’ and (2) that there was no other prospective purchaser for it.”39 However, the court then added the Horizontal Merger Guidelines test for the alternative purchaser element, stating that “[f]or *Energy Solutions* to be the only available purchaser, defendants must show that WCS made ‘good faith efforts to elicit reasonable alternative offers.’”40

Ultimately, the court held that WCS had not satisfied the alternative purchaser element. Again, WCS had taken substantial steps to explore a potential sale prior to the ultimate deal with *Energy Solutions*, engaging a banker in April 2014, which yielded three indications of interest from potential acquirers.41 Although WCS later terminated its engagement with the banker, WCS entered into exclusive negotiations with an alternative purchaser in October 2014, which continued through completion of due diligence but did not result in a firm offer.42

Despite the steps taken by WCS to explore alternative purchasers, the court focused on the fact that WCS had agreed to exclusivity with *Energy Solutions* as part of the 2015 negotiations leading to the eventual merger agreement.43 Following the announcement of the merger agreement, WCS was again approached by a number of companies interested in its acquisition, but pursuant to the exclusivity period and other deal protection provisions, WCS did not respond.44 The court stated that WCS had essentially bound itself to a single bidder process in 2015 by entering into an exclusivity agreement with *Energy Solutions*, describing the deal protections as “the legal equivalent of willful blindness.”45

Considering WCS’ multiple efforts to explore a sale46—none of which resulted in a firm offer—it is difficult to see why the court concluded that WCS did not act in good faith to find an alternative purchaser. Indeed, the result is contrary to cases applying the good faith efforts test, where the courts have credited repeated efforts to sell the failing firm to other purchasers.47 Rather, the district court’s rationale in *Energy Solutions* more closely resembles the decisions like *Harbour Group*, applying the stricter no alternative purchasers test that has been described as a “quite heavy” burden to prove.48 Assuming that the no alternative purchasers test had been strictly interpreted in *Energy Solutions*, there were indeed other suitors for WCS, one of which had negotiated all the way through due diligence. Therefore, one explanation for the outcome in *Energy Solutions* is that the district court may have combined the requirements of the two tests.

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39 Id. at *66 (emphasis added).
40 Id. at *66–67 (citing *Dr. Pepper/Seven-Up Co.*, 991 F.2d at 865).
41 See id. at *38–39.
42 See id. at *39–40.
43 Id. at *67.
44 Id.
45 Id. (citing *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, 1999 Del. Ch. LEXIS 202, at *1–2 (Del. Ch. Sept. 27, 1999)).
46 The opinion did note that WCS’ efforts in 2014 involved the sale of a minority equity interest, not for the entire company. See id. at *68.
47 See, e.g., *California v. Sutter Health Sys.*, 84 F. Supp. 2d 1057, 1136–37 (N.D. Cal. 2000) (holding that alternative purchaser Tenet Healthcare Corporation’s “vague expression of interest” did not constitute a reasonable alternative offer, and that therefore the elements of the failing firm defense were satisfied).
Inconsistent Application by the Agencies

Not only have the tests for the alternative purchaser element been inconsistently applied by the courts, there has been varying treatment by the antitrust agencies as well. In 2009, the FTC closed an investigation into Scott & White Healthcare’s consummated merger with King’s Daughters Hospital. In the closing statement, the FTC explained that its decision was based upon the failing firm defense.\(^49\) There was clear evidence that King’s Daughters was indeed in financial trouble prior to the merger, satisfying the first element. As a result, the dispositive issue in the investigation was whether the merging parties sufficiently established the alternative purchaser element. Using the no alternative purchasers test, the FTC said the main question was “whether there was a viable alternative purchaser for King’s Daughters.”\(^50\) Prior to the consummated merger, another health system, Seton Family of Hospitals, had a serious interest in acquiring King’s Daughters but had been unable to complete its diligence. In a somewhat unusual step, the FTC required Scott & White to offer King’s Daughters for sale again to Seton as part of the investigation.\(^51\) Despite the renewed opportunity to purchase King’s Daughters, Seton declined to do so and the FTC permitted the original transaction to move forward, finding that there was no alternative purchaser.\(^52\)

Additionally, in a 2015 blog post providing additional guidance on the failing firm defense, the FTC wrote:

> Critical to our assessment of the issue is whether there is a less problematic acquirer. Yet we have seen cases where the merging parties have done no more than a cursory search for an alternative buyer . . . . The case law is clear that in the context of arguing that an otherwise anticompetitive transaction should proceed because the acquired firm is failing, the merging parties must show that the acquiring company is the only available purchaser.\(^53\)

Notably, this statement appears to mix the two different tests from \textit{Citizen Publishing} and the Horizontal Merger Guidelines.

In another example of the antitrust agencies’ application of the good faith efforts test, on July 12, 2017, the DOJ announced that it was closing its investigation into the proposed acquisition of the Chicago Sun-Times by the owner of the Chicago Tribune.\(^54\) After the execution of the letter of intent and the opening of the DOJ’s investigation, the Chicago-Sun Times initiated a public bidding process, and it was ultimately sold to an alternative buyer as a result. In its statement explaining the closing of the investigation, the DOJ revealed that the failing firm defense had been one of the main issues in the investigation.\(^55\) The DOJ emphasized that it requires a showing of “good faith efforts” to secure alternative offers, and made no reference to the \textit{Citizen Publishing} standard in the closing statement.


\(^{50}\) Id.

\(^{51}\) Id.

\(^{52}\) Id.


\(^{54}\) Closing Statement, Department of Justice Statement on the Closing of Its Investigation into the Possible Acquisition of Chicago Sun-Times by Owner of Chicago Tribune (July 12, 2017), https://www.justice.gov/opa/pr/department-justice-statement-closing-its-investigation-possible-acquisition-chicago-sun-times.

\(^{55}\) Id.
On October 6, 2016, the FTC reached a consent agreement resolving its investigation of Minnesota-based healthcare provider CentraCare’s merger with local physician group St. Cloud Medical Group (SCMG). In its press release announcing the settlement, the FTC explained that SCMG had been struggling financially, lost its final line of credit, and had experienced significant physician attrition.\textsuperscript{56} It appears that the FTC applied the good faith efforts test in the case. The complaint stated that “[a]fter a good-faith, multi-year search,” SCMG had been unable to find another purchaser.\textsuperscript{57} The complaint also noted that SCMG’s search resulted in at least one local provider expressing interest in acquiring some of SCMG’s physicians.\textsuperscript{58}

### A Suggested Solution for Improvement

There is apparent confusion in the interpretation of the alternative purchaser element of the failing firm defense. Some cases apply the \textit{Citizen Publishing} standard of requiring a showing of no alternative purchaser, while other cases use the good faith efforts framework outlined in the Horizontal Merger Guidelines. Such confusion cannot be attributable only to a lag in judicial acceptance of the Horizontal Merger Guidelines, as the guidance has been available since 1968 and the antitrust agencies have also applied it inconsistently. The varying approaches lead to unpredictability for market participants and their advisors alike. For example, it is currently unclear what other bidders will be considered true alternative purchasers—whether the expression of any modicum of interest by another suitor makes the defense unavailable.

With these challenges in mind, the first suggested step is to select and then consistently apply a single standard for the alternative purchaser element. Between the two tests set out in \textit{Citizen Publishing} and the Horizontal Merger Guidelines, the latter is the better option. By focusing on the process, the good faith efforts test allows the decision maker to broadly consider the initiatives by the failing firm to pursue an alternative solution. For example, in \textit{Energy Solutions}, the efforts made by WCS (hiring a banker, soliciting bids, negotiating with several other purchasers, and completing diligence) arguably should have weighed more heavily in the district court’s decision. Also, the formalistic and strict interpretations of the no alternative purchasers test, such as was the case in \textit{Harbour Group Investments},\textsuperscript{59} is too onerous. It is unrealistic to require exhaustive negotiations with every possible suitor; the good faith efforts test is sufficiently flexible to evaluate the validity of the failing firm’s efforts and whether a less competitively harmful transaction was available.

As a second step, the antitrust agencies should provide further guidance as to what is considered a valid good faith effort and also clarify some of the unintended confusion created by previous statements and decisions. The Horizontal Merger Guidelines already define “reasonable alternative offers” as any offer above the liquidation value.\textsuperscript{60} Similarly, more instructive guidance could be provided by the antitrust agencies in the form of enumerating the factors to be considered in evaluating a failing firm’s efforts. Other agencies have also issued guidance as to good faith efforts in other contexts. For example, the Department of Transportation has articulated the


\textsuperscript{58} Id. ¶ 38.


\textsuperscript{60} Horizontal Merger Guidelines, supra note 5, at n.16.
factors that it considers in determining whether the recipient of federal highway funds has made good faith efforts to subcontract with disadvantaged business enterprises. Some suggested factors for the failing firm good faith efforts test could include:

1. The duration of the firm’s search;
2. whether the firm initiated a public sale process;
3. number of solicitations for bids for the firm;
4. whether the failing firm engaged a banker, consultant, or another external service to assist with its search;
5. the terms of the bids obtained by the firm; and
6. evidence of communications with potential purchasers.

The agency guidance could also make clear that the factors will be considered in their totality and that no single factor would be dispositive. The next iteration of the Horizontal Merger Guidelines would appear to be a pragmatic vehicle to convey the new guidance, as when the 1997 revisions provided additional guidance around efficiencies. Alternatively, a jointly issued enforcement policy statement could achieve the same objectives as a standalone initiative.

The guidance could incorporate some of the factors used in previous cases. For example, the fact that Summit Medical Center had searched for a purchaser for three years and engaged Morgan Stanley to assist it were considered in California v. Sutter Health System. In the recent closing statement from the Chicago Sun-Times investigation, the DOJ further explained: “Because [the alternative purchaser element] may not be satisfied by a confidential sale effort, a seller may choose to undertake a public sale process to augment its effort to elicit reasonable alternative offers.” Such insight is helpful for failing firms considering a prospective transaction.

Conclusion

There have been two different approaches to the second element of the failing firm defense—one stating that must be no alternative purchasers, and the other requiring good faith efforts to elicit reasonable offers. The choice between the two standards has real impacts, as the no alternative purchasers test perhaps requires further steps to fully explore all alternatives than does the good faith efforts test. Compounding the issue, the two tests have been applied inconsistently by the courts and the antitrust agencies—sometimes only the first test is applied, sometimes the second, and sometimes a combination of both.

The recent Energy Solutions case illustrates how the two standards can sometimes be confused. Such inconsistency makes the failing firm defense difficult to apply and perhaps obviates its purpose. One solution is to consistently apply the good faith efforts test moving forward, and have clear guidance from the antitrust agencies on the factors it would consider in applying it. Until that happens, however, the failing firm defense may remain an unrealistic idea that parties cannot rely upon.

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61 See C.S. McCrossan Constr., Inc. v. Minn. Dep’t of Transp., 946 F. Supp. 2d 851, 853–54 (D. Minn. 2013) (explaining the Department of Transportation regulations for subcontractor participation as part of federal highway fund grants and explaining guidance regarding good faith efforts to award subcontracts to minority businesses).


63 Id.
Geographic Market Definition in Urban Hospital Mergers: Lessons from the Advocate-NorthShore Litigation

Steven Tenn and Sophia Vandergrift

Geographic market definition has been, and remains today, the key battleground on which hospital merger cases are won or lost. True to this paradigm, geographic market definition was the central issue in the Federal Trade Commission’s recent success in blocking the merger of two Chicago-area health systems: Advocate Health Care Network and NorthShore University Health System.

In FTC v. Advocate Health Care, the FTC and the State of Illinois alleged an 11-hospital geographic market that covered much of Chicago’s northern suburbs. The district court was unconvinced, and denied the FTC’s motion for a preliminary injunction based on its finding that the FTC had failed to prove a relevant geographic market.

The FTC subsequently appealed to the Seventh Circuit. The Seventh Circuit reversed the district court and remanded the case, deeming the district court’s geographic market findings clearly erroneous. In a robust and detailed opinion, the Seventh Circuit took stock of the evolution of hospital merger geographic market analysis. It assessed the tools that have historically been deployed in this analysis, including Elzinga-Hogarty and the hypothetical monopolist test. In its analysis, the court retired the former and solidified the latter. Ultimately, the Seventh Circuit’s Advocate opinion and the litigation upon which it is based provide litigants on both sides of a deal useful guidance about how to effectively define geographic markets in future hospital merger cases.

This article reviews the Advocate litigation, the Seventh Circuit opinion, and the state of hospital merger geographic market definition in the case’s wake. While we focus on geographic market definition, many of the issues we discuss similarly arise in the context of competitive effects analysis. As discussed below, application of the hypothetical monopolist test entails determining whether a hypothetical merger of all suppliers in a given area would lead to significant anticompetitive effects (specifically, a small but significant non-transitory increase in price, otherwise known as a SSNIP). Competitive effects analysis considers a largely analogous situation: would the proposed merger between two specific suppliers lead to significant anticompetitive effects. Given the similarity of these two questions, the qualitative and empirical evidence relied upon in market definition has become increasingly similar to the qualitative and empirical evidence relied upon in competitive effects analysis. Indeed, each side’s market definition and competitive effects analyses in the Advocate-NorthShore litigation were closely related. Thus, while we focus specifically on market definition, many of the points are applicable to competitive effects analysis as well.

1 No. 15 C 11473, 2016 W L 3387163 (N.D. Ill. June 20, 2016).
Overview of Advocate-NorthShore

In September 2014, two prominent Chicago-based health systems—Advocate and NorthShore—announced a merger. With 11 general acute care hospitals, numerous outpatient facilities, and a network of physicians, Advocate is the largest health system in Illinois. Two of Advocate’s general acute care hospitals are in the northern suburbs of Chicago while the others are elsewhere in Illinois and were not at issue in the FTC’s challenge to the transaction. Advocate’s proposed merger partner, NorthShore, has four hospitals, all of which are located in the northern Chicago suburbs. The FTC considered each of NorthShore’s hospitals to be competitively implicated by the merger.

Historically, many proposed hospital mergers challenged by the FTC involved hospitals located in rural, sparsely populated areas. This case differed, as the geography at issue involved one of the country’s largest cities—urban, densely populated Chicago. Beyond the merging parties’ hospitals, the greater Chicago area is home to dozens of other hospitals, including major academic medical centers (AMCs), such as Northwestern Memorial; specialty hospitals, such as those focused on cancer or pediatric treatment; and various community hospitals. Even Chicago’s northern suburbs, where the merging parties’ footprints overlap and, consequently, the FTC’s case focused, are home to several other hospitals.

In December 2015, after an in-depth investigation, the FTC filed a complaint seeking a preliminary injunction in the District Court for Northern District of Illinois. The FTC’s complaint alleged a lessening of competition for the provision of inpatient general acute care hospital services sold to commercial payers (i.e., health insurance providers) in Chicago’s northern suburbs—an area termed the North Shore Area. Over the course of a nearly two-week trial, the district court heard testimony from 15 witnesses, including six experts, four payers, four of the merging parties’ hospital executives, and one third-party hospital. After all of the evidence was presented, the district court found that the FTC had not met its burden with respect to proving the geographic market and ruled for the merging parties.

The Commission appealed the district court’s decision to the Seventh Circuit. The Seventh Circuit reversed and remanded to the district court for reconsideration of the FTC’s motion for a preliminary injunction consistent with its detailed and pointed geographic market findings. In its final decision, the district court reversed its initial position, found for the FTC, and granted a preliminary injunction. Immediately following the decision, Advocate and NorthShore announced they would abandon the proposed merger.

Overview of Hospital Merger Enforcement at the FTC

The Seventh Circuit’s opinion in Advocate considered a long history of hospital merger precedent. This history provides a critical foundation and context for the opinion. Likewise, it goes a long way towards explaining the FTC’s modern approach to geographic market definition in hospital mergers and, specifically, why the FTC approached Advocate as it did.

The FTC has met with varied levels of success over time in litigating hospital mergers. The FTC and the Department of Justice began challenging hospital mergers in the 1980s and early 1990s.

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4 FTC v. Advocate Health Care Network, 841 F.3d 460, 476 (7th Cir. 2016).
During this early era of hospital merger enforcement, the agencies were successful in a number of cases. In these and other early wins, the courts accepted relatively narrow geographic markets.

From 1994 through 2000, however, the FTC and DOJ lost a string of litigated hospital merger challenges, largely on the issue of geographic market definition. In many of these cases, the government’s loss can be attributed to courts finding a broader geographic market than the government alleged. For example, in 1995, the FTC lost its challenge in FTC v. Freeman Hospital Corp., a case in which two of the three hospitals in Joplin, Missouri planned to merge. The FTC proposed a geographic market composed of an area extending 27 miles around Joplin. Defendants, on the other hand, successfully argued the market extended to 50 miles or more. Similarly, in FTC v. Tenet Healthcare Corp., the FTC alleged a geographic market extending 50 miles from Poplar Bluff, Missouri, while the defendants argued a 65-mile market, but the FTC did not prevail. In United States v. Mercy Health Services, the DOJ lost as well, with the court finding that the geographic market could extend as far as 70 to 90 miles.

In finding these broader geographic markets, many courts relied on analyses of patient flow data. One such analysis is known as the Elzinga-Hogarty approach, in which a candidate market is selected and then patient migration in and out is considered. A geographic market is established under the Elzinga-Hogarty test if the candidate market is sufficiently self-contained, i.e., few patients enter or exit the area.

On the heels of these losses, in 2002, the FTC established a merger litigation task force that undertook a retrospective study to review the effects of consummated hospital mergers. Following that effort, and based on its teachings, in 2004, the FTC challenged the Evanston-Highland Park merger (which was consummated in 2000). After a full Part III administrative trial and appeal to the Commission, the Commission upheld the Administrative Law Judge’s decision and ruled for the FTC. Because this case involved a consummated transaction in which actual price effects had already resulted, it allowed the FTC to side-step difficult geographic market issues it had faced in prior cases. In addition, the case allowed the FTC to successfully challenge the Elzinga-Hogarty approach that had hindered the agency in the past. The FTC put the test’s founder and namesake, Dr. Kenneth Elzinga, on the stand to explain the problems with using the Elzinga-Hogarty test to define markets in hospital cases.

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6 See, e.g., Hosp. Corp. of Am. v. FTC, 807 F.2d 1381 (7th Cir. 1986); United States v. Rockford Mem’l Corp., 898 F.2d 1278 (7th Cir. 1990); FTC v. Univ. Health, Inc., 938 F.2d 1206 (11th Cir. 1991).
7 See, e.g., Am. Med. Int’l, Inc., 104 F.T.C. 1 (1984) (the relevant geographic market was San Luis Obispo city and county); FTC v. Univ. Health, Inc., 938 F.2d 1206 (11th Cir. 1991) (the relevant geographic market was limited to Augusta, Georgia).
9 69 F.3d 260 (8th Cir. 1995).
After prevailing in *Evanston*, the FTC went on to win its subsequent hospital merger challenges. These cases include *FTC v. ProMedica*\(^\text{14}\) and *FTC v. OSF*.\(^\text{15}\) The agency also challenged the Inova-Prince William\(^\text{16}\) merger, which the parties abandoned pre-decision, and Phoebe Putney-Palmyra,\(^\text{17}\) which turned largely on state action issues. In *ProMedica* and *OSF*, the mergers took place in the mid-sized cities of Toledo, Ohio and Rockford, Illinois, where it was feasible for the FTC to treat the entire area surrounding the city as a geographic market and still bring a successful case.

Until *Advocate*, the agency had yet to litigate a truly urban hospital merger in which the FTC would potentially have to defend its proposed geographic market against an Elzinga-Hogarty-style analysis. In *Advocate*, the agency was faced with that challenge and, as a result of the agency’s initial district court loss, the Seventh Circuit had an opportunity to weigh in. As a result, the law and economics that underpin modern geographic market definition in the hospital merger context are now clearer.

### Geographic Market Definition: Lessons from *Advocate*

#### The Iterations of the Hypothetical Monopolist Test.

One of the Seventh Circuit’s core holdings relates to the application of the hypothetical monopolist test for geographic market definition. Broadly, the Seventh Circuit explained that “the hypothetical monopolist test [\(\square\)] uses an iterative process, first proposing a region and then using available data to test the likely results of a price increase in that region.”\(^\text{18}\) Put differently, to properly apply the hypothetical monopolist test, one must first identify a potential candidate market and then test whether a monopolist supplier in that candidate market could sustain a SSNIP, i.e., a small but significant non-transitory increase in price (often taken to be a 5 percent price increase), without a sufficient number of customers switching to suppliers outside the hypothetical market such that the SSNIP would not be profitable.

This is the approach the FTC presented at trial. The FTC’s economic expert (and co-author of this article), Dr. Steven Tenn, first identified a candidate market and then employed an economic analysis to determine if it passed the hypothetical monopolist test. In its initial opinion, the district court rejected this approach, finding fault with the criteria applied to select the candidate market. The district court did not proceed to address the FTC’s evidence regarding whether a hypothetical monopolist could extract a price increase. Instead, the court ended its inquiry at the candidate market stage, deeming flaws in the composition of the candidate market fatal to the FTC’s case.

The Seventh Circuit found this to be an error, stating, “The district court criticized [the FTC’s economic expert’s] candidate market but did not mention his results. The court did not explain why it thought that a narrow candidate market would produce incorrect results. . . . We have not found support for that assumption.”\(^\text{19}\) On remand, with the Seventh Circuit’s guidance, the district court reversed course and found the FTC’s application of the hypothetical monopolist test to be sound.

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\(^\text{18}\) *Advocate Health Care Network*, 841 F.3d at 464.

\(^\text{19}\) *Id.* at 473.
The FTC’s methodology for implementation of the hypothetical monopolist test proceeds as follows: The first step of the geographic market analysis is to determine the order in which hospitals are added to the candidate market. The Horizontal Merger Guidelines do not prescribe a specific methodology for how to construct a candidate geographic market. An economist must devise a method that takes account of and incorporates the facts and dynamics that characterize the specific area at issue. In Advocate, the FTC relied on three criteria discussed below that were based on the available qualitative and empirical evidence, along with the competitive concerns raised by that evidence.

The first criterion used to determine the candidate market was to include local hospitals in the candidate market before “destination hospitals.” Destination hospitals include both AMCs and specialty hospitals that, like AMCs, draw from a far broader geography than community hospitals. This criterion was appropriate because the evidence showed that payers assembling provider networks must include hospitals located in the northern suburbs of Chicago to be attractive to employers in the area. Thus, hospitals located in the area were observed competing to fulfill this role for payers. This criterion reflects the local competitive dynamic by adding to the candidate market those hospitals that potentially meet that need before adding hospitals that do not. Importantly, none of the AMCs in Chicago are located in the northern Chicago suburbs. Had there been such an AMC, it would have potentially fulfilled the payers’ need for having local providers in the northern Chicago suburbs and, accordingly, would have been included in the candidate market in the same order as the other local hospitals.

The second criterion used to construct the candidate market was that hospitals that more significantly overlap with the merging parties were included in the candidate market before including hospitals that less significantly overlap with the merging parties. Specifically, hospitals with at least a 2 percent share in the areas from which Advocate’s and NorthShore’s hospitals draw patients were included in the candidate market first.

Finally, the third criterion used to construct the candidate market was that hospitals that overlap with both Advocate and NorthShore were included in the candidate market before including hospitals that overlap with either Advocate or NorthShore, but not both. Like the first two criteria, this criterion stems from the competitive dynamics at issue in the case. Specifically, it reflects the concern that Advocate and NorthShore are close substitutes for patients desiring local treatment in Chicago’s northern suburbs. These patients are likely to live in areas where Advocate and NorthShore overlap, since patients living in areas where only one or neither of the parties attracts patients are unlikely to view Advocate and NorthShore as their first and second choices. If a significant fraction of patients view Advocate and NorthShore as their first and second choices, then economic theory indicates that a combined Advocate-NorthShore would have greater negotiating leverage postmerger since such patients would have to turn to their third best alternative if the combined firm were excluded from the payer’s provider network. The third criterion illuminates this competitive concern by identifying those hospitals that are potentially the next best alternative for patients who view Advocate and NorthShore as their first and second choices.

During the trial, the defendants criticized this approach for inappropriately excluding particular hospitals from the geographic market. But, as discussed above, the criteria employed do not in fact exclude any hospital from the geographic market. Rather, they determine only the order in

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which hospitals are included in the candidate market. Given the nature of the hypothetical monopolist test, this is not merely a semantic issue. As acknowledged by the Seventh Circuit, defining a geographic market is inherently an iterative process in which “[t]he analyst proposes a candidate market, simulates a monopolization of that market, then adjusts the candidate market and reruns the simulation as necessary.”

It follows that, when constructing a candidate market, rather than excluding suppliers, an economist is actually identifying the order in which hospitals ought to be included in the candidate market.

Applying the three criteria identified above resulted in a candidate market containing 11 hospitals. This set includes all four NorthShore hospitals and the two Advocate hospitals located in the northern suburbs of Chicago, plus five other hospitals. After constructing a candidate market, the next step is to “simulate[] a monopolization of that market.” As the Horizontal Merger Guidelines explain, if the hypothetical monopolist could sustain a SSNIP, then the market definition exercise is complete and the candidate market is deemed a relevant geographic market under this methodology. This is so because if a SSNIP would be profitable for the hypothetical monopolist, then competition from sellers outside of the candidate market would not sufficiently constrain the pricing of sellers inside of the candidate market. Thus, those outside sellers should be excluded from the geographic market.

A range of qualitative and empirical evidence was used to determine whether or not the candidate market passed the hypothetical monopolist test. For example, the evidence clearly showed the importance to payers of including hospitals in the northern suburbs in their provider networks and, in particular, the importance of including either Advocate or NorthShore. Further evidence came from empirical analysis of patient discharge data. This analysis showed that patients typically prefer hospitals located near where they live, and view hospitals in the northern suburbs, and Advocate and NorthShore in particular, as close substitutes.

A formal merger simulation analysis was used to complement and reinforce this evidence. Specifically, a merger simulation between all of the hospitals in the candidate market was undertaken to determine whether a hypothetical monopolist of them would find it profitable to impose at least a 5 percent SSNIP. A similar merger simulation between only Advocate and NorthShore was also undertaken to predict the competitive impact of the proposed transaction.

The merger simulation model employed was similar to models that have previously been used in the economics literature, including in research specific to mergers in the hospital industry. The model relies on diversion ratios and margins, which the Horizontal Merger Guidelines identify as being particularly important when evaluating unilateral effects. Additionally, it relies on standard economic theory to predict how these inputs determine the magnitude of the postmerger price change. This merger simulation analysis directly addresses whether a hypothetical monopolist would sustain a SSNIP. As discussed above, this can be assessed, without the use of a formal

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21 Advocate Health Care Network, 841 F.3d at 473.
22 Id.
24 There are, of course, multiple ways of undertaking a merger simulation. For example, one alternative approach that the FTC could have employed was a Price-Willingness to Pay (WTP) regression, which seeks to estimate the relationship between price and a measure of bargaining leverage by predicting the change in price that would occur from the parties’ increased bargaining leverage postmerger. But employing this regression risked raising complicated econometric issues that would have been difficult to resolve in this case and was therefore not the analysis the FTC’s economic expert considered most appropriate.
economic model, based on other qualitative and empirical evidence. Thus, while merger simulation is one way of determining whether a candidate market passes the hypothetical monopolist test, it is not the only possible approach.

**Sensitivity Analysis.** The FTC’s economic expert concluded that the North Shore Area candidate market passed the hypothetical monopolist test. Having established a relevant market, the FTC proceeded to the next analytical phase prescribed by the Horizontal Merger Guidelines: assessing market shares and concentration levels. The FTC found the merger would result in market shares and concentration figures far beyond those the Horizontal Merger Guidelines identify as presumptively “likely to enhance market power.” Specifically, postmerger, the combined firm would have a 59.7 percent market share. With a postmerger HHI of 3943 (an increase of 1782 points above premerger levels), the market would be highly concentrated.

To be conservative in the merging parties’ favor, the FTC’s economic expert also considered a candidate market that additionally included the next most relevant hospitals when evaluating the competitive concern raised by the proposed transaction. He relaxed the second criterion to include hospitals with a 1 percent share in the areas where Advocate and NorthShore attract patients, rather than those with at least a 2 percent share. At the same time, he relaxed the third criterion to include hospitals that overlap with Advocate or NorthShore, but not both. These relaxed criteria led to a candidate market containing 15 hospitals, which he also concluded passed the hypothetical monopolist test. Moreover, the proposed transaction would still result in a “highly concentrated” market under this alternative market delineation and would still meet the presumption of harm under the Horizontal Merger Guidelines.

Additional sensitivity analysis was also undertaken regarding the first criterion, where local hospitals were included in the candidate market before destination hospitals, by considering alternative ways of incorporating the AMCs into the analysis. Treatment of these hospitals is complicated by the fact that they pull in patients from throughout the Chicago metropolitan area. While large AMCs such as Northwestern Memorial and Rush University attract some patients from the northern suburbs, the vast majority of their patients reside in areas where the relevant Advocate and NorthShore hospitals attract few or no patients.

This highlights a well-known limitation associated with defining supplier location-based geographic markets: a bright-line rule is employed where firms are either “in” or “out” of the market. This can be avoided, however, if one measures concentration based on patient location. Two robustness checks were considered where concentration was measured based on patient location. The results were then compared to concentration in the North Shore Area based on hospital location.

The first method measured concentration for patients living in the service area that NorthShore analyzes in the ordinary course. This analysis incorporated all of the patients living in NorthShore’s service area, including those that went to hospitals in other parts of the city.

A hospital-specific concentration measure was also considered, constructed in two steps. First, concentration was measured separately for each ZIP code. Second, the weighted average

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25 Horizontal Merger Guidelines, supra note 20, § 5.3.
26 The distinction between the two approaches is as follows: When calculating concentration based on hospital location, one includes all patients who are admitted to hospitals located in a given area, regardless of where the patient resides. In contrast, when calculating concentration based on patient location, one includes all patients living in a given area, regardless of which hospital they are admitted to. The determination of whether it is most appropriate to measure concentration based on the location of suppliers versus the location of patients is a fact-driven inquiry.
across the ZIP codes was calculated separately for each hospital, based on the number of admissions for a given hospital that were from each ZIP code. This analysis included the entire Chicago area, along with all of its hospitals, but more weight was given to areas where a given hospital attracts more patients.

These patient-based measures of concentration were similar to concentration measured based on hospital location. Including the AMCs in the concentration measures did not alter the main takeaway from the analysis: the proposed merger would substantially increase concentration in an already highly concentrated market.

**Elzinga-Hogarty and Patient Travel Patterns.** As discussed earlier, reliance on the Elzinga-Hogarty approach initially helped the antitrust agencies in their efforts to block hospital mergers. But its use by the merging parties contributed to a series of losses in subsequent hospital merger litigations. Prior courts’ acceptance of Elzinga-Hogarty posed a problem for the FTC when bringing an urban hospital merger case, since Elzinga-Hogarty tended to lead to very wide geographic markets in dense urban areas.

A key takeaway from the Seventh Circuit opinion is that methods for defining the geographic market should evolve along with the associated economics literature and, as a result, the Elzinga-Hogarty approach should no longer be used to define the geographic market. Nonetheless, the Seventh Circuit opinion is quite clear that this conclusion does not undermine the importance of patients’ preferences, as reflected in patient-level data, when defining the geographic market.

The Seventh Circuit opinion highlights what is known as the “silent majority fallacy” in the economics literature. Even if a candidate market has significant patient inflow and outflow, and therefore does not pass the Elzinga-Hogarty test, it may be the case that “a ‘silent majority’ of patients will not travel, enabling anticompetitive price increases.”\(^{27}\) In other words, the Seventh Circuit opinion endorsed a key finding from the economics literature, and a key element of the FTC’s case, that the Elzinga-Hogarty test is inconsistent with the hypothetical monopolist test.\(^{28}\) If a sufficient fraction of patients strongly prefer to be treated in a given area, then a hypothetical monopolist may be able to raise price due to that preference, even if other patients are in fact willing to travel outside the candidate market for treatment. The key issue is whether the hospitals located within a candidate market are sufficiently close substitutes such that the elimination of competition between them would lead to a significant price increase. Elzinga-Hogarty considers hospital substitutability in a very indirect and limited manner, making it an inappropriate methodology for defining the geographic market.

The Seventh Circuit opinion makes clear, however, that patient preferences are still relevant when defining the geographic market. While commercial payers are the direct customer, patient preferences are key since commercial payers care about the demand for their products, which is determined by employer preferences and the preferences of their employees. In Advocate, the evidence clearly demonstrated that having hospitals in the northern Chicago suburbs in a payer’s provider network made their health plans far more attractive to employers located in that area. As a result, a hypothetical monopolist of all hospitals in the North Shore Area would be able to profitably impose a SSNIP and thereby pass the hypothetical monopolist test.

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27 Advocate Health Care Network, 841 F.3d at 470 (citation omitted).
The plaintiffs relied on a number of different approaches to assess patient preferences for receiving local care. It is clear from the Seventh Circuit opinion that analysis of patient travel times was particularly effective. In multiple places in the opinion, the Seventh Circuit cites to travel time analysis to highlight that patients generally prefer to be treated locally. For example, “This case’s record reflects that preference: in the Commission’s proposed market, 80 percent of patients drove to the hospital of their choice in 20 minutes or less.”

Due to this preference for local treatment, the Seventh Circuit concludes that the need for convenience will often imply relatively localized geographic markets—that is, “for the most part hospital services are local.” This conclusion is consistent with the Seventh Circuit’s conclusion that Elzinga-Hogarty is an inappropriate method for defining the geographic market, since that approach will often result in very large geographic markets when applied to urban areas. Thus, the Seventh Circuit’s retirement of Elzinga-Hogarty, while solidifying the importance of patient preferences, is not contradictory, but rather clarifies what factors do, and do not, matter when defining the geographic market.

The Likely Response of Payers to a Price Increase. During the course of the Advocate litigation, the FTC and the defendants diverged on the key issue of whether patients or health insurers should be considered the hospitals’ customers when defining the relevant antitrust market. One of the most important guideposts the Seventh Circuit provided in the Advocate opinion relates to this question. In hospital markets, the Seventh Circuit explained, patients, hospitals, and insurers partake in a two-stage competitive dynamic. This two-stage dynamic is foundational to geographic market definition because it indicates that payers’, rather than patients’, response to a price increase is the relevant inquiry when undertaking the hypothetical monopolist test.

During the trial, the defendants emphasized patients’ alternatives for hospital care and advanced a narrative about how patients would respond if their hospital prices increased by a small but significant amount. One of the defendants’ central themes was that the FTC inappropriately excluded Northwestern Memorial and other area hospitals from its candidate market. The defendants urged the court to look to the “competitive substitutes” outside of the FTC’s proposed market. The defendants posited that because some patients residing in the northern Chicago suburbs sought care at hospitals outside of the North Shore Area, such hospitals would constrain prices postmerger and belonged in the geographic market. This line of reasoning was initially persuasive to the district court. Indeed, at trial, the district court found that patient preference for local hospitals was “equivocal” and that the FTC’s basis for excluding downtown AMCs from the candidate market was circular.

The Seventh Circuit took a different approach. It focused on the likely response of payers to a price increase and, on that basis, affirmed the FTC’s market definition analysis. To arrive at this conclusion, the Seventh Circuit expressly acknowledged that hospital care is purchased in two stages, and thus there are two stages of competition in hospital markets. In the first stage, insurers and hospitals negotiate to determine which hospitals will be included in an insurer’s provider network and at what prices services will be provided. In the second stage of competition, after provider network composition and price have been established, hospitals compete to attract

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29 Advocate Health Care Network, 841 F.3d at 470.
30 Id. at 474 (quoting United States v. Rockford Mem’l Corp., 898 F.2d 1278 (1990)).
31 Advocate Health Care, 2016 WL 3387163, at *4–5.
32 Advocate Health Care Network, 841 F.3d at 465.
patients largely through non-price factors, such as location, quality, and reputation.\textsuperscript{33} Based on this dynamic, the Seventh Circuit explained, “[i]nsured patients are usually not sensitive to retail hospital prices, while insurers respond to both prices and patient preferences.”\textsuperscript{34}

The Seventh Circuit went on to describe how patient price insensitivity affects geographic market definition. It stated that, based on this insensitivity, “[t]he geographic market question is therefore most directly about the likely response of insurers, not patients, to a price increase.”\textsuperscript{35} Following the Seventh Circuit’s holding on this issue, patient insensitivity to hospital price increases should not be ignored when defining the geographic market in hospital mergers.\textsuperscript{36} Advocate teaches that discounting this factor, overlooking the two stages of hospital competition, or failing to view the hypothetical monopolist test through the lens of payers may result in an analysis that is untethered from competitive realities and, consequently, unpersuasive to a court.

**Conclusion**

The Advocate litigation provides significant guidance on how to define geographic markets in future hospital merger cases. The Seventh Circuit found that commercial payers, rather than individual patients, are the relevant customers. Therefore, the geographic market should be delineated based on the likely response to a price increase by commercial payers. Specifically, the Seventh Circuit endorsed the Horizontal Merger Guidelines’ hypothetical monopolist test to define the relevant geographic market, while finding that the Elzinga-Hogarty approach is not an appropriate means of doing so. The latter finding is unsurprising given the court’s treatment of the hypothetical monopolist test, since the Elzinga-Hogarty approach is inconsistent with the hypothetical monopolist test. This conclusion will be particularly important for hospital mergers in urban settings where it is more likely that a candidate market would fail Elzinga-Hogarty despite passing the hypothetical monopolist test.

The Seventh Circuit opinion does not offer precise instruction for how the hypothetical monopolist test should be implemented, i.e., how the candidate market should be constructed and what analysis should be used to determine whether a monopolist of hospitals in that area could profitably increase price by a SSNIP. Nonetheless, it is clear from the Seventh Circuit opinion that the approach used should recognize that commercial payers are the relevant customers, and should be based on the available qualitative and empirical evidence and the competitive concerns raised by that evidence. The method used by the FTC’s economic expert in Advocate to define the geographic market is an example of one such approach.

While the Seventh Circuit’s opinion offers significant guidance on how the geographic market should be defined in hospital merger litigations, we do not believe that it will significantly impact how the FTC evaluates prospective hospital mergers during its merger review process. The key analyses and approaches that the FTC relied upon in Advocate are not new, but have been used by FTC staff for many years. As such, the FTC is likely to assess future urban hospital mergers in much the same way it always has: through a fact-based inquiry that relies on a range of analytical tools to determine whether the proposed transaction is likely to have significant anticompetitive effects.

\textsuperscript{33} Id.

\textsuperscript{34} Id. at 471 (citation omitted).

\textsuperscript{35} Id. (citations and internal quotations omitted).

\textsuperscript{36} Patients’ degree of price sensitivity depends, in part, on the plan design of their health insurance. For example, patients may exhibit a higher degree of price sensitivity in situations where they have higher out-of-pocket costs.
A Defense of Using the Hypothetical Monopolist Test in Health Care Provider Mergers

Antara Dutta and Elisa F. Kantor

Over the last 20 years, federal hospital merger enforcement cases have turned largely on one issue: the proper definition of the relevant geographic market in which to analyze potential anticompetitive effects. Recent history is no exception; in 2016, the Federal Trade Commission initially lost two preliminary injunction actions—one against Pennsylvania hospital systems Penn State Hershey Medical Center and PinnacleHealth System,¹ and one against Chicago-area systems Advocate Health Care Network and NorthShore University HealthSystem²—primarily because the district courts found that the FTC had failed to properly define a relevant geographic market. The courts of appeals reversed both decisions, ruling that the district courts had erred in formulating and applying the Horizontal Merger Guidelines’ hypothetical monopolist test to establish a relevant geographic market.

The FTC won these appeals for good reason. As each court of appeals correctly observed, the hypothetical monopolist test is an appropriate test for analyzing the relevant geographic market, and in applying that test, courts may not rely on arbitrary thresholds of patient flows into and out of specific areas to determine whether a hypothetical monopolist provider could profitably impose a price increase. Rather, because commercial health insurers, or payors, serve as the direct purchasers of health care services from providers, courts must take into account payors’ likely responses to a provider’s attempt to exercise market power. That does not render patients’ preferences for providers irrelevant; to the contrary, payors understand such preferences, and seek to construct networks of local providers that will appeal to a large number of area residents. In defining the relevant geographic markets in the Penn State and Advocate cases, the FTC appropriately applied the hypothetical monopolist test by assessing the substitutability between providers in a payor’s network while recognizing that patient preferences for various area providers play a central role in that determination.

The pivotal part played by geographic market definition in recent hospital merger litigations has renewed the focus on the appropriate methodology for defining such markets in health care provider mergers.³ Some practitioners suggest that the hypothetical monopolist test is unsuitable for analyzing relevant geographic markets in health care provider mergers, and question the application of the test to prices negotiated between payors and providers. Here, we consider such claims and reaffirm that the hypothetical monopolist test, when properly formulated and applied,

² FTC v. Advocate Health Care, No. 15 C 11473, 2016 WL 3387163 (N.D. Ill. June 20, 2016), rev’d, 841 F.3d 460 (7th Cir. 2016).
is an appropriate vehicle for defining relevant geographic markets in provider mergers. In particular, we respond to arguments made in a recent article by Kenneth W. Field, Louis K. Fisher, and William D. Coglianese (Field et al.), who contend that it is difficult to apply the hypothetical monopolist test to define relevant geographic markets in the health care context for a variety of reasons. 4

Background

**Defining Antitrust Markets.** When evaluating whether a proposed merger may be harmful to competition, the antitrust agencies define antitrust geographic and product “markets,” which include the merging parties and may include one or more of the merging parties’ direct competitors. The purpose of market definition is to identify an economically meaningful unit—the “relevant market”—that could be subject to the exercise of market power as a result of the merger. 5 Once such a market is correctly defined, information on the merging parties’ positions within the market and the significance of other competitors in the market can be used to assess the likely competitive impact of a merger.

The primary analytical framework for defining any antitrust market is the “hypothetical monopolist test.” 6 The test poses the following question: could a hypothetical monopolist of all products (or services) within a candidate market profitably impose at least a small but significant and non-transitory increase in price (SSNIP) on at least one product in the market, including at least one product sold by one of the merging firms? If a candidate market passes the test, it qualifies as a relevant antitrust market. That means the group of products inside the candidate market is, in the eyes of customers, sufficiently differentiated from products outside the market and may be analyzed as a relevant economic unit. If the products sold outside the candidate market are close enough substitutes for products inside the candidate market to constrain a price increase by the hypothetical monopolist (i.e., to make such a price increase unprofitable), the candidate market does not pass the test. In that case, the candidate market is too narrow for the purpose of assessing potential anticompetitive effects.

**Payor-Provider Negotiations.** In any merger, one must understand the general framework in which prices are determined to apply the hypothetical monopolist test. In the health care context, payors typically assemble “networks” of various local providers, including hospitals, physicians, and surgical centers. Payors seek to construct high-quality and sufficiently broad networks that can be successfully marketed to area employers and individuals, and create these networks by negotiating individually with providers for network inclusion. In return for inclusion, providers negotiate discounts off their list prices for inpatient, outpatient, and physician services. A payor’s members typically face substantially lower out-of-pocket prices for obtaining care from “in-network” providers as opposed to providers that are “out-of-network.” Accordingly, members are significantly more likely to seek care from an in-network provider.

When bargaining for network inclusion and the rates under which members’ care will be reimbursed, payors and providers each have certain sources of leverage. Providers compete with one another on both price and quality to be included in a payor’s network because inclusion ensures greater access to the payor’s members (i.e., potential patients). A provider’s leverage in negotia-

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6 Id. § 4.1.1.
tions with a payor increases with the degree to which the payor’s network would be less attractive to employers and individuals without the provider. For instance, a provider has greater leverage if it offers popular services that other area providers do not or if there are few other providers located nearby. On the other side of the table, the payor derives leverage from its ability to deprive the provider of patients by excluding the provider from its network. Each side’s leverage in a negotiation thus depends on its ability to substitute away from the other. 7

Geographic Market Definition in Provider Mergers. Applying these concepts, the hypothetical monopolist of providers in a candidate geographic market gains the ability to negotiate higher prices if its bargaining leverage vis-à-vis payors increases sufficiently. Before the hypothetical monopolization, a payor could negotiate individually with the different providers in the candidate market, and could play rival providers off each other in each negotiation. After the hypothetical monopolization, the payor negotiates with a single consolidated entity in the candidate market. Whether the hypothetical monopolist is able to negotiate a SSNIP depends on the extent to which providers outside the candidate market are substitutes for providers inside the market. The application of the hypothetical monopolist test to provider-payor negotiations thus is not fundamentally different from other settings where the test is used to determine the contours of a candidate market.

Implementation of the Test. The agencies and courts commonly use a SSNIP of about 5 percent to define antitrust markets, including geographic markets in health care provider mergers. 8 Whether a hypothetical monopolist provider has the ability to profitably impose such a price increase depends on the specific characteristics of the candidate market at issue. To make that determination, the agencies and the courts typically consider several sources of evidence—for example, patient-level utilization data for area hospitals, business documents of the merging hospitals and their likely competitors, testimony from a variety of market participants including payors and employers, and evidence from past provider-payor negotiations—as well as a range of analytical tools. No single tool or source of evidence is required to demonstrate that a candidate geographic market passes the hypothetical monopolist test. 9

Reaffirming the Use of the Hypothetical Monopolist Test in Provider Mergers
Providers and their advocates, including Field et al., have questioned the appropriateness of implementing the hypothetical monopolist test to define geographic markets by assessing payors’ likely responses to a provider’s attempt to exercise market power. Their skepticism appears to be based, in part, on certain features of health care markets, such as the fact that the prices at issue are determined through negotiations between providers and payors rather than on a “unilateral” basis, as well as the fact that patient preferences largely dictate the value of a provider in a payor’s network. Some practitioners dispute the practical relevance of the bargaining framework that is typically used to analyze the effects of provider consolidation because providers and payors do not always explicitly threaten to walk away from negotiations and because actual exclusion of a provider from a payor’s network is relatively uncommon. Another familiar critique of the hypo-

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7 In addition to bargaining leverage, economic models of bargaining include a “split parameter,” which determines the split of the economic surplus created by the agreement between the buyer and the seller. The split parameter reflects the bargaining skill of each party, which is unrelated to bargaining leverage and unaffected by a merger.


9 See Advocate, 2017 WL 1022015, at *3.
The hypothetical monopolist test is that it does not fully account for the effect of existing leverage on the payor or provider side. Finally, some critics—in particular, Field et al.—cast doubt on the reliability and significance of payor statements regarding a hypothetical monopolist provider’s increased leverage.

While health care markets have certain distinct features that must be considered in the market definition exercise, there is no reason to believe that the hypothetical monopolist test is ill-suited to the analysis of health care provider mergers. Indeed, not all of the concerns listed above are unique to health care. Here, we explain why such concerns either are not directly relevant to the geographic market analysis or are already adequately addressed by the hypothetical monopolist test framework that was used by the FTC to define geographic markets in Penn State, Advocate, and other recently litigated provider mergers.

**The Appropriateness of the Hypothetical Monopolist Test in a Bargaining Framework.**

Field et al. suggest that because providers bargain with payors to arrive at prices—rather than setting prices “unilaterally” and allowing potential buyers to decide whether and how much of the product to purchase—the hypothetical monopolist test is challenging to apply in the health care context.\(^{10}\) But the fact that prices are negotiated does not undermine the validity of using the hypothetical monopolist test in provider mergers. The key component of any relevant market analysis is not whether competition occurs within a posted price, bargaining, or auction framework, but whether hypothetical monopolization increases a seller’s market power sufficiently for it to impose a SSNIP on the relevant purchasers. A firm that acquires market power through the hypothetical monopolization of all sellers in an area will not be restrained from exercising that power simply because it engages in bilateral negotiations with customers; rather, the hypothetical monopolist understands that by reducing the alternatives to which its customers may turn, it gains an advantage in negotiations.\(^{11}\) Evidence from consummated hospital mergers confirms this conclusion, empirically demonstrating that competition between providers is a key determinant of prices and that payors pay higher prices when such competition is lost.\(^{12}\)

The hypothetical monopolist test is routinely and successfully applied to define product and geographic markets in other industries in which prices are negotiated. For example, in their challenge of Sysco Corporation’s proposed merger with US Foods, Inc., the FTC and plaintiff states defined a relevant product market as broadline foodservice distribution sold to “national customers.”\(^{13}\) The customers in that market—which included national hotel chains, foodservice management companies, and group purchasing organizations—typically purchased broadline foodservice distribution services by awarding contracts through requests for proposals or bilateral negotiations.\(^{14}\) The district court accepted the hypothetical monopolist test as a valid method for determining whether broadline foodservice distribution constituted a relevant product market, ask-

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10 Field et al., supra note 4, at 5.

11 See Advocate, 2017 WL 1022015, at *10 (giving weight to an FTC expert’s view that posted-price and bilateral bargaining models “generate identical” price increases).


14 Id. ¶ 4.
ing, “If there was only one broadline food distributor, could it profitably raise price by five percent, or would that price increase result in a substantial number of customers moving enough of their spend to other modes of distribution . . . such that the price increase would become unprofitable?"15 To answer this question, the court considered a range of evidence, including expert economic evidence and customer testimony, and concluded that broadline foodservice distribution to national customers was a relevant product market.16

Similarly, in their recent challenge of Staples, Inc.’s proposed merger with Office Depot, Inc., the FTC and plaintiff states defined the relevant product market as “the sale and distribution of [a cluster of] consumable office supplies to large [business-to-business] customers.”17 The buyers in that product market—large business-to-business customers—procured the relevant products from sellers via formal requests for proposal, auctions, or direct negotiations.18 The parties agreed that the hypothetical monopolist test was the main test used by economists to define a product market,19 and the district court found that the FTC’s economic expert had appropriately applied it.20 Testimony from several customers who stated that they were able to obtain lower prices because of competition between sellers in the proposed market supported the expert’s conclusions.21 As demonstrated by Sysco, Staples, and other similar cases, the fact that sellers engage in bargaining with customers is not an impediment to applying the hypothetical monopolist test.

The Ability to Walk Away. The hypothetical monopolist test remains applicable to health care provider mergers despite the fact that, during negotiations, payors do not always explicitly “threaten” to exclude providers, and providers do not always threaten to walk away from a payor’s network. Such overt threats are unnecessary because each side knows that its leverage in negotiations derives from the extent to which it is able to walk away from the relationship.

During negotiations, an individual payor either explicitly or implicitly plays rival hospitals off each other to obtain better terms, and a provider understands that competition with other providers constrains the prices that it can obtain. Payors have provided direct evidence of this dynamic. For instance, in the FTC’s challenge of Evanston’s consummated merger of Highland Park, a payor testified that before the merger, it “viewed Highland Park as Evanston’s ‘primary alternative,’” and “believed that it could . . . ‘work them off against each other.’”22 Although the payor had “never threatened to drop either Evanston or Highland Park,” it “believed that its ability to do so was understood and that this ability restrained the hospitals’ prices.”23 A second area payor likewise testified that while it did not “overtly” play one hospital off the other during contract negotiations, it was not necessary to explicitly identify alternatives “because most hospitals know their competitors.”24

15 Sysco, 113 F. Supp. 3d at 34.
16 Id. at 43–44.
18 Id. ¶ 43(a).
19 Staples, 190 F. Supp. 3d at 121.
20 Id. at 121–22.
21 Id. at 122.
23 Id.
24 Id. at 407.
The Effect of Hypothetical Monopolization on Bargaining Leverage. Some critics suggest that practitioners may misapply the hypothetical monopolist test by failing to fully account for the role of existing leverage on one or both sides of the bargaining table. For instance, Field et al. caution against attributing the hypothetical monopolist’s “substantial leverage” to monopolization without first determining whether individual providers may already independently wield substantial leverage against payors before monopolization occurs.²⁵ Some advocates also argue before the FTC and the courts that the hypothetical monopolist test does not sufficiently address a payor’s ability to use its existing leverage to thwart a hypothetical monopolist provider’s attempt to raise prices.²⁶

As Field et al. acknowledge, the hypothetical monopolist test must assess the change in relative bargaining leverage resulting from hypothetical monopolization.²⁷ Field et al. also claim that a practical challenge in applying the test is that it may allow one to “rely entirely” on whether the hypothetical monopolist of a candidate market has “substantial leverage” and thus ignore the possibility that individual providers in the market may independently wield significant leverage.²⁸ But it is not common practice to implement the hypothetical monopolist test by merely assessing whether the hypothetical monopolist has “substantial leverage.” Consider a candidate market in which an individual provider already adds significant value to payors’ networks. That provider’s leverage in negotiations with payors may nevertheless be limited due to competition from other providers. By eliminating competition between providers in the candidate market, the hypothetical monopolization may increase the monopolist’s leverage sufficiently to allow it to profitably raise prices by a SSNIP. To make this determination, the antitrust agencies customarily consider the available evidence on substitutability between the relevant providers in area payors’ networks and empirically evaluate the likely effect of hypothetical monopolization on provider leverage.²⁹ Far from considering the hypothetical monopolist’s leverage “in a vacuum,”³⁰ the hypothetical monopolist test, as implemented, focuses on the change in competitive conditions following monopolization of the candidate market to establish whether a SSNIP is likely to result.

Similar reasoning applies when considering whether a payor can exert its existing leverage—or “counter-leverage”³¹—to prevent a hypothetical monopolist from increasing prices by a SSNIP. The hypothetical monopolist test assumes that existing payors already use their available leverage to the fullest extent in negotiations with providers and that this leverage is reflected in prevailing negotiated prices. Following hypothetical monopolization of providers in the candidate market, the provider’s bargaining leverage increases while the payor’s leverage remains the same (i.e., the provider’s relative leverage increases).³² Because payors do not acquire any additional “counter-leverage” as a result of the hypothetical monopolization, the focus of the test is correctly on the effect of the increase in provider leverage. The question, as before, is whether the increase in the provider’s relative leverage is sufficient to allow it to profitably impose a SSNIP.

²⁵ Field et al., supra note 4, at 6–7.
²⁶ See, e.g., Penn State, 838 F.3d at 346.
²⁷ Field et al., supra note 4, at 6.
²⁸ Id. at 6–7.
²⁹ See Penn State, 838 F.3d at 346–46; Advocate, 2017 WL 1022015, at *3–5.
³⁰ Field et al., supra note 4, at 7.
³¹ Id. at 8.
³² See Penn State, 838 F.3d at 346.
Relevance of Payor Testimony. The agencies and the courts consider a variety of evidence when defining relevant geographic markets, including third-party testimony. As the direct buyers of health care services from providers, payors often are a natural—and important—source of such evidence. Yet Field et al. claim that it is difficult to find “probative value” in payor testimony as to the likelihood that a hypothetical monopolist would have sufficient increased leverage to profitably impose a SSNIP because payors cannot reliably “assess the outcome of the bargaining affected by that shift in leverage.”33

Payor testimony is not less reliable or useful in the market definition exercise because payors cannot necessarily predict the precise outcome of a negotiation with the hypothetical monopolist on the other side of the bargaining table. The hypothetical monopolist test does not require such guesswork from payors. Rather, payors can reliably explain the competitive dynamics in a candidate market, which helps to answer the question of whether a hypothetical monopolist of providers in that market could profitably impose a SSNIP.

For instance, payors can describe the extent to which specific providers serve as substitutes in the networks they offer, the impact of the loss of the hypothetical monopolist on their network, and what the payors would do to keep the hypothetical monopolist in-network, including whether they would succumb to the monopolist’s demand for higher reimbursement rates. A payor’s view, based on its experience as a seller of health plan networks in the relevant area, that its network is far less marketable without certain area providers can indicate that the payor would accept a “small but significant” price increase to keep a hypothetical monopolist of those providers in its network.34 Moreover, as the entities that negotiate prices with providers, payors are usually in a good position to testify as to whether the hypothetical monopolization of a candidate market would result in significant loss of competition among providers and thus substantially increase the hypothetical monopolist’s leverage in negotiations.

Field et al. also contend that payors can have “skewed” business incentives when providing testimony about a provider merger, which can render that testimony unreliable.35 Payors certainly may have their own business incentives to complain against or provide support for a merger. For instance, merging providers may secure certain area payors’ support for their proposed merger by agreeing to provide them with favorable pricing or other terms once the merger is consummated. Alternatively, a payor may be unwilling to publicly voice its opposition to a merger because it wants to avoid endangering its business relationship with large area providers. While a payor’s support for, or opposition to, a merger may be informed by particular business incentives, its factual testimony regarding the commercial realities of the market—for example, testimony regarding members’ preferences for particular providers or the feasibility of excluding certain providers from its network—nonetheless can be probative to the application of the hypothetical monopolist test. Payor testimony on these issues is particularly credible when it is broadly consistent with other available evidence.

Accordingly, the agencies’ primary objective in eliciting payor testimony is to understand the market realities relevant to a provider merger. Such testimony is not, as Field et al. intimate, tainted or distorted when it is elicited as part of an agency investigation.36 It similarly would be a mistake to assume that the agencies’ analysis of a merger’s likely impact turns on whether payors

33 Field et al., supra note 4, at 8.
34 Penn State, 838 F.3d at 345–47.
35 Field et al., supra note 4, at 8–9.
36 See id. at 9. Although Field et al. cite to Staples to support this view, id., the district court ultimately found there was no evidence that the FTC’s declarations were ill-gotten. See Staples, 190 F. Supp. 3d at 136 n.14.
express concerns about the merger, although that information certainly can be relevant to an investigation.

Three recent examples from litigated provider mergers demonstrate the importance of payor testimony in defining geographic markets. In *Penn State*, the merging parties signed agreements with two large local payors promising favorable post-acquisition rates in an alleged attempt to “forestall [payor] opposition to the Merger.”37 The U.S. Court of Appeals for the Third Circuit observed that private contracts between the merging parties and payors who support the deal “have no place in the relevant geographic market analysis.”38 At the same time, the Third Circuit recognized that the hypothetical monopolist test must be assessed through the “lens of the insurers,” and relied on testimony by payors who had “repeatedly said that they could not successfully market a plan in the [candidate] area without” the merging parties’ hospitals.39

Similarly, in 2015, the FTC filed suit to block the proposed acquisition of St. Mary’s Medical Center by Cabell Huntington Hospital despite the fact that some payors signed letters of support for the acquisition.40 In so doing, the FTC simultaneously relied on testimony from payors to support its alleged relevant geographic market.41 Payors observed that area members preferred to obtain care locally, and concluded that a health plan that excluded both hospitals in the candidate market would not be marketable to members in the candidate market, even if that plan were significantly less expensive.42 That testimony was corroborated by other evidence indicating that the FTC’s alleged market was a distinct geographic market, including statements from local employers that employees would not purchase a health plan excluding both hospitals in the candidate market;43 data and documents demonstrating patients’ preference for local care;44 and testimony from out-of-area providers that they were not meaningful competitors for patients in the candidate market.45

Finally, in Advocate, the district court on remand cautioned that the payor testimony at issue may need to be taken with a “grain of salt” because it “may . . . be self-serving.” Nonetheless, the court found value in that testimony when defining the geographic market because “the record as a whole support[ed] the view that insurers genuinely believed that a plan that excluded” both merging hospital systems would not be “viable.”46

**Factoring in the “Patient Perspective.”** Field et al. suggest that an alternative to applying the hypothetical monopolist test from the “payor perspective” (i.e., to prices negotiated between

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38. *Penn State*, 838 F.3d at 344.

39. Id. at 342–43.


41. Id. at 10; Letter from Alexis Gilm an, Assistant Director, FTC, to Cynthia Dellinger, Assistant General Counsel, West Virginia Health Care Authority 16 (Apr. 18, 2016) [hereinafter Gilm an April Letter], https://www.ftc.gov/system/files/documents/public_statements/945863/160418virginiahealthcare.pdf.

42. Gilm an April Letter, supra note 41, at 16, Attach. 1 at 11.

43. Id. at 16.


45. Id. ¶ 35; Gilm an April Letter, supra note 41, at 16–19.

providers and payors) is to implement the test from the “patient perspective.” It is not meaningful, however, to frame the hypothetical monopolist test as requiring a choice between the “payor perspective” and the “patient perspective.” Payors and providers understand and internalize patient preferences when they negotiate because patient preferences largely determine a provider’s importance to a payor’s network. By focusing on payor-provider negotiations, the hypothetical monopolist test properly integrates patient preferences into the geographic market analysis.

The antitrust agencies and the courts routinely consider information regarding patient preferences when implementing the hypothetical monopolist test. Data on the travel and utilization patterns of area patients speak directly to the issue of how far patients within a candidate market are willing to travel to obtain specific types of health care services. Such data can help to identify providers that may reasonably act as substitutes for each other in a payor’s network, which is the issue at the core of geographic market definition.

However, the appropriate manner in which to use information on patient preferences in the geographic market analysis has long been the subject of debate. Patient-level travel and utilization data at times have been erroneously used to attempt to predict how patients would respond to a SSNIP (often through the “Elzinga-Hogarty method”). This is an error because such data do not reflect patient responses to prices. Even though a payor may pay significantly different rates to providers in its network, a payor’s members typically face little variation in their out-of-pocket costs as long as they choose an in-network provider. Thus, a patient’s choice of provider usually depends on other factors, such as whether the provider participates in the patient’s health plan network, whether it is located close to the patient’s home or workplace, and the provider’s reputation, quality, and service offerings. While most patients prefer to receive care locally, some patients may choose to travel longer distances to obtain care. But because the decisions by a minority of patients to travel farther away for care usually are explained by circumstances unrelated to the price of care, they say little about the likely responses of the majority of patients to a SSNIP.

Practitioners sometimes suggest that even if patients do not face significant price variation among in-network providers before monopolization occurs, payors can prevent a SSNIP by using tools to make patients more price-sensitive (e.g., tiered or narrow networks, deductibles, and coinsurance). To the extent these claims are relevant to the geographic market analysis, they are rarely substantiated by sufficient evidence to address the question posed by the hypothetical monopolist test: can payors successfully use such tools to prevent the hypothetical monopolist of providers in a candidate market from raising its price by a “small but significant” amount?

Consider, for instance, a payor that responds to a SSNIP by constructing a tiered or narrow network that excludes or disadvantages the monopolist’s hospitals in an effort to steer patients to far-

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47 See, e.g., Field et al., supra note 4, at 10–11. Field et al. do not specify the precise form that the hypothetical monopolist test would take if applied from an alternative “patient perspective.”


49 See, e.g., Gilman April Letter, supra note 41, at 16; Penn State, 838 F.3d at 341.

50 See, e.g., Field et al., supra note 4, at 10; Penn State, 838 F.3d at 22 n.6. “Tiered” networks designate in-network providers into tiers based on the cost and quality of the care they provide, with lower-cost and/or higher-quality providers typically assigned to higher tiers. “Narrow” networks are networks that contain fewer in-network providers and facilities than traditional networks and result in lower premiums for members.
ther-away hospitals outside the candidate market. The payor can only successfully market this alternative network if a sufficient number of area patients that currently prefer the monopolist’s providers are willing to travel to the more distant hospitals, and many patients may remain unwilling to do so. For this reason, the market definition analysis must address whether such tools enable a payor to substitute providers outside the candidate market for the hypothetical monopolist’s providers in its network, not simply whether such tools are theoretically feasible or have been used to contain health care spending for specific patient populations in other settings.

Evidence of a Payor’s Need for Providers. Field et al. suggest that the fact that most hospitals participate in most payors’ networks, as well as the fact that a relatively small number of payors and providers typically operate in an area, lead to a “weakness of data from the payor perspective.”51 According to Field et al., “[T]he absence of direct statistical evidence about payors’ need for certain providers” results in a reliance on “indirect evidence” of patient preferences.52 But this distinction between “direct” and “indirect” evidence is illusory. Payors themselves rely on an understanding of patient preferences when they construct provider networks, giving such patient-level information value in the analysis. A variety of other types of evidence can also demonstrate the importance of specific providers to a payor’s network, such as information on past negotiations between various payors and providers (including details of negotiated rates and other terms), payor testimony, and ordinary-course business documents. A combination of such evidence from relevant market participants is regularly used to define product and geographic markets in other industries, including the FTC’s successful challenges in Sysco and Staples.

The Hypothetical Monopolist Test and Quality Competition. Notwithstanding Field et al.’s criticisms, the hypothetical monopolist test as applied to the likely responses of payors also adequately addresses competitive issues involving provider quality.53 Providers compete with each other on both price and quality, and a provider’s quality and service offerings are important sources of leverage in negotiations with payors. Because it is easier to quantify price effects, the hypothetical monopolist test evaluates the monopolist’s increased market power in terms of its ability to raise prices by a SSNIP.54 But the additional market power can also manifest itself in the form of adverse non-price effects that are commensurate with a SSNIP or higher.

Looking Ahead
The challenges in defining geographic markets in health care provider mergers lie not in the lack of availability of an appropriate analytical framework, but in ensuring its correct application. As recent case law confirms, the hypothetical monopolist test can be applied to payor-provider negotiations to draw appropriate geographic markets in health care provider mergers. The characteristics of the U.S. health care market thus do not prevent the proper implementation of the test.

51 Field et al., supra note 4, at 9.
52 Id. at 10.
53 Id.
54 Horizontal Merger Guidelines, supra note 5, § 4.1.2.
Comment on *The Flaws in Using the Hypothetical Monopolist Test from the “Payor Perspective” in Health Care Merger Cases*, by Field, Fisher, and Coglianese

Dov Rothman and David Toniatti

In a recent article, *The Flaws in Using the Hypothetical Monopolist Test from the “Payor Perspective” in Health Care Merger Cases*, Kenneth Field, Louis Fisher, and William Coglianese (Field et al.) observe that in reviewing mergers of health care providers, courts have concluded that the relevant geographic market should be defined from the perspective of the payor assembling a network of providers for a health plan. Field et al. claim this raises a host of problems when applying the “hypothetical monopolist test” to delineate the relevant geographic market. They argue that applying the hypothetical monopolist test is conceptually straightforward in a setting where sellers post prices and buyers decide whether to pay a seller’s posted price, but more complicated in the health care context because payors (buyers) and providers (sellers) negotiate to set prices for services to patients who are covered by the payors’ plans.

According to Field et al., a key question raised by the hypothetical monopolist test is whether a payor could successfully market a network without any providers in the proposed market area, and if the answer is no, then a hypothetical monopolist of providers in the proposed market area would have substantially greater bargaining leverage and be able to raise prices by a small but significant non-transitory increase in price, or a SSNIP. Field et al. then argue that—in practice—applying the hypothetical monopolist test from the payor perspective has a number of problems. In particular, they argue that determining whether the hypothetical monopolization of a candidate market would result in a significant price increase is more difficult in the health care setting where prices are negotiated rather than posted.

We agree with Field et al. that whether a payor could successfully market a network without any providers in a proposed market area is a key question for assessing the relevant geographic market. We differ with Field et al. with regard to the implications for market definition. If a proposed market area includes the providers that consumers in the area consider to be substitutes such that a payor could not successfully market a network without the providers in the area, we would argue it is likely that the hypothetical monopolization of those providers would result in a SSNIP. We explain below that we believe our different perspective is at least partially driven by Field et al.’s

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framework, which focuses on the impact of hypothetical monopolization on a payor’s walk-away price, but does not consider how hypothetical monopolization might affect a provider’s walk-away price, an omission that we have encountered in analysis of provider mergers.

**Hypothetical Monopolization Affects a Payor’s and a Provider’s Walk-Away Prices**

Two key determinants of a negotiated price are the seller’s and buyer’s walk-away prices. In the health care context, the provider is the seller and the payor is the buyer. The payor’s walk-away price is the price at which the payor would be just as well off with or without an agreement—i.e., it is the highest price the payor would be willing to pay. The provider’s walk-away price is the price at which the provider would be just as well off with or without an agreement—i.e., it is the lowest price the provider would be willing to accept. As Field et al. explain, “[W]henever the [payor]’s maximum price is at least as high as the [provider]’s minimum price, the parties should agree to a price that is somewhere between these two walk-away prices.”

Whether the negotiated price is closer to the payor’s walk-away price or the provider’s walk-away price depends on the relative “bargaining power” of the payor and provider. Bargaining power does not affect the walk-away prices, but it does affect the negotiated price. A payor with more bargaining power will be able to negotiate a (lower) price that is closer to the provider’s walk-away price, and a provider with more bargaining power will be able to negotiate a (higher) price that is closer to the payor’s walk-away price. In a standard bargaining framework, whatever the relative bargaining power of the payor and provider, the hypothetical monopolization of the providers is likely to result in an increase in the negotiated price.

**Effect of Hypothetical Monopolization of Providers on a Payor’s Walk-Away Price.** If a candidate market includes the providers that consumers in the given market area consider to be substitutes, the profit of a payor when it does not reach an agreement with a provider in the candidate market will be lower if the payor also does not reach agreements with the other providers in the candidate market. An implication is that the hypothetical monopolization of the candidate market will cause the payor’s walk-away price to increase. If the candidate market includes all (or nearly all) providers that the consumers consider to be substitutes such that a payor could not market a network without the providers in the candidate market, the payor earns zero profit absent an agreement with the providers, and the payor’s walk-away price is the price at which the payor

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5 Id. at 6.

6 Bargaining power is also sometimes referred to as “bargaining ability” or “bargaining skill.” This concept is distinct from “bargaining leverage,” which relates to the payor’s and provider’s walk-away prices. A provider has more “bargaining leverage” if the payor would earn much less profit without an agreement with the provider. Similarly, a payor has more bargaining leverage if the provider would earn much less profit without an agreement with the payor.

7 A negotiated price may be expressed as a weighted average of the provider’s and payor’s walk-away prices. Suppose \[ Price = \alpha (Provider \ Walk-Away \ Price) + (1-\alpha) (Payor \ Walk-Away \ Price) \], where the parameter \( \alpha \) is the relative bargaining power of the payor. If both the provider’s and payor’s walk-away prices increase by a certain percent, then the negotiated price will increase by the same percent, assuming no change in the bargaining power parameter \( \alpha \).
also earns zero profit with an agreement. This may imply a large increase in the payor’s walk-away price and could lead to a significant increase in the negotiated price.\(^8\)

**Effect of Hypothetical Monopolization of Providers on a Provider’s Walk-Away Price.** If a candidate market includes the providers that consumers in the given market area consider to be substitutes, the profit of a provider in the candidate market when it does not reach an agreement with a payor will be higher if the other providers in the candidate market also do not reach agreements with the payor. An implication is that the hypothetical monopolization of the candidate market will cause the provider’s walk-away price to increase. If a payor could not market a network without the providers in the candidate market, the hypothetical monopolization may cause the provider’s walk-away price to increase significantly and could lead to a significant increase in the negotiated price.

Patient recapture is one reason why the profit of a provider in a candidate market when it does not reach an agreement with a payor may be higher if the other providers in the candidate market also do not reach agreements with the payor. Suppose there are two providers (A and B) in a given area. Suppose also that consumers are happy with a payor’s network as long as one of the two providers is in the payor’s network—i.e., consumers consider the providers to be close substitutes. Prior to the hypothetical monopolization, if A does not participate in the payor’s network, no consumers switch payors to maintain in-network access to A because they are just as happy with B. Likewise, if B does not participate in the payor’s network, no consumers switch payors to maintain in-network access to B because they are just as happy with A. This means that A and B each may lose a lot of patient volume if it does not participate in the payor’s network. After the hypothetical monopolization, if the combined provider A-B does not participate in the payor’s network, many consumers may switch payors to maintain in-network access to A-B because they do not have other alternatives. Alternatively, many consumers may continue to use A or B, but on an out-of-network basis. Either way, post-hypothetical monopolization, if A-B does not participate in the payor’s network, A-B does not lose as much patient volume as A and B would have lost on their own prior to the hypothetical monopolization.\(^9\) As a result, the hypothetical monopolization of providers will result in an increase in the provider’s walk-away price.

**Implications for the Negotiated Price.** In the standard approach Field et al. discuss, the hypothetical monopolization of a candidate market only affects the payor’s walk-away price. Field et al. argue that a significant increase in the payor’s walk-away price does not necessarily imply a significant increase in the negotiated price, because the payor’s walk-away price is just one of several factors that interact to determine the negotiated price.\(^10\) They caution, “It is therefore dif-

\(^8\) Alternatively, if the candidate market excludes providers that consumers in the given market area consider to be substitutes, the profit of a payor when it does not reach an agreement with a provider in the candidate market may not be much lower if it also does not reach agreements with the other providers in the candidate market. An implication is that the hypothetical monopolization of the candidate market may not cause the payor’s walk-away price to increase much. In this case, the candidate market may need to be broadened to include more of the providers that the consumers in the given market area consider to be substitutes.

\(^9\) Alternatively, if the candidate market excludes providers that consumers in the given market area consider to be substitutes, the profit of a provider in the candidate market when it does not reach an agreement with a payor may not be much higher if the other providers in the candidate market also do not reach agreements with the payor. Suppose consumers are just as happy going to a third provider C, but C is not included in the candidate market. After the hypothetical monopolization, the combined provider A-B may still lose roughly the same patient volume it would have lost prior to the hypothetical monopolization if it does not participate in the payor’s network, because consumers will still have the option of seeking care at C. As a result, the hypothetical monopolization may not increase the provider’s walk-away price by much.

\(^10\) Field et al., supra note 1, at 8.
ficult to determine whether negotiated prices would be ‘significantly’ different when a single factor changes ‘significantly’ and the others remain the same.”

Whether or not one agrees with Field et al. about the difficulty of implementing the hypothetical monopolist test in the health care setting, if it can be determined that a proposed market area includes the providers that consumers in the area consider to be substitutes such that a hypothetical monopolization of the proposed market area results in significant increases in both the payor’s and provider’s walk-away prices, it is likely that the hypothetical monopolization would result in a SSNIP. Field et al. correctly note that several factors may affect a negotiated price—the payor’s walk-away price, the provider’s walk-away price, and the relative bargaining power of the payor and provider. What matters for the hypothetical monopolist test are the factors that affect the change in the negotiated price as a result of hypothetical monopolization—the change in the payor’s walk-away price, the change in the provider’s walk-away price, and the relative bargaining power of the payor and provider.

While the effect of a change in the payor’s walk-away price or the provider’s walk-away price on the negotiated price depends on the relative bargaining power of the payor and provider, if a hypothetical monopolization results in significant increases in both the payor’s and provider’s walk-away prices, a SSNIP is likely regardless of the relative bargaining power of the payor and provider.

Conclusion
The definition of the relevant geographic market is widely recognized as a critical issue in the assessment of health care provider mergers. A key question in defining the relevant geographic market is whether a hypothetical monopolist would be able to raise prices by a SSNIP. In considering this question, it is common to focus on the impact of a hypothetical monopolization on a payor’s walk-away price. The Field et al. article is one such example. This misses that a hypothetical monopolization may also affect a provider’s walk-away price. Accounting for the impact on both the payor’s and provider’s walk-away price may be necessary to fully implement the hypothetical monopolist test.

While this article focuses on the implications for market definition, the same reasoning applies to competitive effects analysis. A merger of providers may affect both the payor’s and provider’s walk-away price, and accounting for the impact on each may be necessary to fully model the impact of a provider merger on negotiated prices.

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11 Id. In particular, Field et al. argue that “any given increase in provider leverage [i.e., payor walk-away price] might have a different impact on negotiated price depending on the amount of counter-leverage wielded by a payor.” Id. We interpret this to mean that the negotiated price depends on the relative bargaining power of the payor. As we discuss below, relative bargaining power affects a negotiated price, but may not affect the likelihood that a hypothetical monopolization will result in a significant increase in price if the hypothetical monopolization results in a significant increase in both the payor’s and provider’s walk-away prices.

12 The change in negotiated price will be less sensitive to a change in the payor’s walk-away price when the payor has relatively more bargaining power, and the change in the negotiated price will be less sensitive to a change in the provider’s walk-away price when the provider has relatively more bargaining power.
Interview with Laura Brett, Director, National Advertising Division

Editor’s Note: The Council of Better Business Bureaus operates a number of advertising industry self-regulatory programs, including the National Advertising Division (NAD). Established in 1971, NAD monitors and evaluates the truthfulness of national advertising claims. Competitors can initiate challenges at NAD and NAD can also “self-initiate” so-called monitoring cases. Challenges are quickly briefed and decided, which means that NAD can often decide several hundred cases each year. NAD decisions are made available to the public. Challenges involving companies that decline to participate in the NAD process or decline to abide by NAD’s recommendations are referred to the Federal Trade Commission for possible regulatory action. Earlier this year Andrea Levine, who led NAD for 20 years, stepped down and a new Director was appointed. Given the important role NAD plays in self-regulating national advertising, Randy Shaheen, an editor of The Antitrust Source, sat down with Laura Brett, the new NAD director, on Oct. 25, 2017, to get her thoughts on where NAD is and where it is headed.

THE ANTITRUST SOURCE: Laura, thank you so much for doing this. It’s a pleasure to be here just to chat instead of trying to defend or attack someone else’s advertising.

LAURA BRETT: Thank you for inviting me.

ANTITRUST SOURCE: Can you tell us first a little bit about your background? What led you to NAD? I’ve heard a rumor for example that you once had a budding political career.

LAURA BRETT: I think it is probably overstating it to suggest I had a budding political career. But, yes, I did serve on my local city council, which is in the city of Rye, New York. I served as a councilperson, and then after two years on the council, I was nominated to be the deputy mayor. That’s not an elected position but an appointed position. I served as the deputy mayor for two years.

It was a really interesting role to play because I live in a very engaged community, where the public is really paying attention to what their local city council is doing and what the local issues are. We also had the attention of two printed newspapers and two online newspapers and a fairly active blog. We were in the public eye in spite of being in this relatively small town. I learned a lot, especially that it is important to communicate what you are going to do and act transparently in the way you do it to avoid the suspicion that somehow something underhanded is going on.

I also looked at a lot of really interesting issues that won’t necessarily apply to work I do at NAD, like hiring a new city manager and a new police commissioner. We dealt with allegations of fraud at the golf club. We negotiated union contracts for two of our three municipal unions while I was there.

The interaction with the public and making important decisions in a transparent way were great learning experiences and do give me experience that will help me as Director of the NAD. Additionally, some of that work, particularly as it relates to negotiating and hiring, are experiences
that I can draw upon in this job at NAD, and gives me some management experience that I wouldn’t have had just in my legal career.

Before I came to NAD, I also had my own legal practice and I worked at a large law firm for about eight years. I was a litigator, which means I learned how to get up to speed on various specific legal issues very, very quickly, as I was always a generalist. With each new case there were new issues that you had to learn and become expert in very quickly.

The concept of moving to advertising law, an area I hadn’t had any prior experience with, was not so daunting. It was just part of being a litigator, where you have to learn a new subject matter every time you get a new case. I felt like having a background as a litigator was helpful coming to NAD, and that learning advertising law was like learning any other topic area and didn’t make me fearful about starting here. I’ve really enjoyed learning advertising law, and I really appreciate and respect the precedent that we’ve built over the last 20, 30, 40, really 46 years, of our existence to make sure that our guidance is consistent.

ANTITRUST SOURCE: The litigators in my office always tell me they can learn anything. And so far they’ve proven themselves right. So I have great respect for litigators—the ability to pivot well. You’re recently in charge here. Do you have a vision in terms of what your priorities or goals might be for NAD going forward?

LAURA BRETT: Sure. Our mission here is to ensure that advertising is truthful. And so my goals center around that mission. We’ve done a really good job over the last 46 years of establishing and maintaining our reputation for protecting consumers and making sure that advertising is truthful. My goals are to make sure that we remain committed to that mission and at the same time ensure that we remember that we must be a good resource for business and should be responsive to the business needs of the companies that come here. We would also like to reach more businesses and therefore more consumers.

So let’s talk about those two things separately. First, being a resource to business and being responsive to business needs means that we have to ensure that our process works smoothly. We’re going to do that in two specific ways in the short term and keep our ears open for a better ways to do that in the long term. In the short term, one thing we want to make sure that we are doing is streamlining the way cases are handled at NAD, meaning that every time a challenge comes in, we want to make sure that that challenge gets out quickly and that there is little delay in getting the challenge to the advertiser. Additionally, we want to make sure that the way that the submissions and meetings are scheduled is done both swiftly and transparently.

Our opening letters now set out a response schedule, but we have parties that often ask for extensions, whether it’s the challenger or the advertiser and often both. We know that very often that schedule is going to change. We encourage parties to work out a meeting schedule that works. When that does not happen, we’ve had parties work with Sheryl, our Case Administration Manager, who will remain the first person you talk to when you want an extension and your adversary won’t agree.

But when things get complicated and there is a lot of conflict, we’ve now asked Annie Ugurlayan, who is a 12-plus-years staff attorney at NAD, to step into her role as assistant director and manage a lot of the communications between the parties. She can hold a joint scheduling conference call which can help schedule responses and meetings in a way that’s fair and transparent. Both parties will know why extensions have been granted and will have an opportunity to be heard on whether an extension should or should not be granted. As an aside, the 2015
ABA Report on Advertising Self-Regulation suggested NAD implement a similar process, which would include a joint case management conference between the parties.

We are also going to try to manage cases so that we decrease our time to decision. We've heard complaints over the years that our decisions take too long. While very often that's unavoidable, we want to review the process so that the decisions which are less complex, and can be drafted faster, come out more quickly. In some cases most of the claims have been discontinued by the advertiser, and it's not going to be a lengthy decision. Other times the issues are less complicated. So we are troubleshooting right now trying to figure out better ways to handle some of the simpler cases more quickly. Other decisions are going to take longer because the issues are highly complex and difficult. We want to ensure that we balance the need to issue decisions quickly with the equally important need to evaluate all challenges carefully. All decisions should get the time and attention they deserve.

We are also going to have our ears open for ways we can be a better resource for businesses and what is working and what isn't in the long term. We'll get to that later.

The other goal we have is to reach more consumers and businesses. We would like to speak at upcoming industry conferences. Please invite us. In the past, we limited our speaking because of our limited resources. We have to be cautious because there's always a balance. If we are out speaking at conferences then we are not here writing decisions. But we also want to make sure that we are reaching new audiences.

We are looking at industry trade association conferences, trying to get on the agenda on some of those, and also working with the Council of Better Business Bureaus to figure out ways to reach more businesses.

**ANTITRUST SOURCE:** That ties well into my next question, which is the process that NAD went through with the ABA Antitrust Section working group, where they kicked the tires and gave some recommendations and some thoughts as to how NAD might change some of its operations. The net result was that some of the recommendations were implemented. Did you find that process as an attorney on the staff helpful? Was it on balance, more disruptive, than helpful? What's your sense of looking back now how well it worked?

**LAURA BRETT:** The process was disruptive at the beginning, no question, but it was ultimately productive. NAD was fulfilling its mission, but we can improve and it was helpful to get very specific feedback about how the users of our forum felt we could improve. That report resulted in some meaningful changes to the way we do things. It's something that I still have a copy of. I can pull it out right now if you want me to. And it's something I look to as comprehensive feedback on what's worked and what doesn't work and what we might be able to do better. I think it is a good resource for us in looking at how we can better serve the companies and the lawyers who come through here and use this forum on a regular basis.

**ANTITRUST SOURCE:** And are there things going forward that you think the ABA can do as an institution to further the efforts of NAD?

**LAURA BRETT:** We really do appreciate the work that the ABA does to support self-regulation, and we appreciate the effort that went into the working group report. The working group is something we still look to as a resource. As we consider making additional changes, we may reach out back to the working group for input on how to implement specific changes that were recommended in their report.
ANTITRUST SOURCE: Are you also open to informal critiques and criticism from the business community? Are there ways that the business members can give you a sense of what they think works well and what they think maybe doesn’t work so well?

LAURA BRETT: Sure. I am working to try and get more feedback from the companies that use NAD as well as the lawyers that use NAD. In the near future I would like to schedule meetings with some of the companies that use NAD regularly because I want their feedback. I want to know how NAD works for them and how we could work better for them while we still maintain our independence and our credibility, which are important and essential to what we do. But we also need to understand what about the process is effective and what about the process is ineffective.

I also am trying to meet with some of the attorneys who use this forum regularly for their feedback. To the extent there are attorneys or companies who want to provide feedback to us, I’d really welcome it and I invite people to reach out to me. We can schedule a call, coffee, or a meeting.

ANTITRUST SOURCE: Let’s turn to how the process works. The first thing that might be helpful to know is what the difference is between your role on a specific case versus that of one of the staff attorneys. How does the work get delegated between yourself and the staff attorneys?

LAURA BRETT: The staff attorney who is handling a case is the frontline person who reviews the submissions when they come in and is the lead person on all of the information in that record. I work with every attorney here on every case and provide some guidance and feedback to them about how best to attack the issues that are raised by an individual challenge. The assigned attorney will review any detailed testing that is submitted, the arguments that are made, and our prior cases to make sure that we understand and can be consistent with our prior decision-making when we write our decisions.

I make sure that I meet with those attorneys regularly and especially make sure that I talk to them before our meetings, when we’ll have a detailed discussion about what’s in the record, what we think the issues are, what we think may be the problems with the claims and whether or not they’ve been properly substantiated.

After our meetings with the parties, we continue to meet together to talk about where we think this case is going. I try to serve more as a sounding board than the decision-maker. Staff are ultimately the decision-makers, but I am there to make sure that they evaluate all the issues. Additionally, I try to make sure that our decision-making is consistent because as the person who sees all of the cases that are before NAD, I have a more comprehensive view of the way cases that we are currently handling or have recently decided interplay with one another.

It’s not uncommon for us to have an issue that arises in multiple different challenges and multiple different product categories at the same time. We’ll be looking at puffery for instance and it will be in a couple of different cases. I want to make sure that those decisions don’t conflict with one another and that we anticipate what questions might arise about how we reached a decision in one case as compared to the decision in another case.

ANTITRUST SOURCE: In terms of written advocacy, parties provide written submissions to NAD. What do you think works well, what not so well, and if you can do it without naming names, what are some particularly horrible examples of trying to persuade NAD on an issue?

LAURA BRETT: We get some excellent, written advocacy here, but what makes for a good or bad
submission is the clarity of the submission and whether or not we have sufficient information to make a decision. Some people are excellent writers who submit briefs that illustrate topics in really eloquent ways and that can help. But a short simple brief along with detailed information about the testing provided in support of the claim, can also provide sufficient information to allow us to reach a favorable decision. The brilliance of the writing might not influence the outcome.

What works well is writing that really lays out the issues clearly, the context and the substantiation. What gets in the way of our decision-making is argumentativeness. We see a lot of argumentativeness in submissions to NAD and, I think as lawyers, we often can’t help ourselves. As a former litigator, I can appreciate that the argumentativeness sometimes is not for our benefit, but may be for your client’s benefit. But it can get in the way.

Another difficulty that prevents us from reviewing things thoroughly is when we don’t get enough information from one or both sides—either the challenger or the advertiser has not provided sufficient detail about the testing to substantiate the challenged claims. Often we are provided with conclusory statements about the substantiation in either the parties’ arguments or in an expert affidavit. In order to make a decision we need to review and understand the underlying testing and why it is reliable. When you bring in an expert we appreciate it when the experts lay out why they think the advertising claims are substantiated, walking us through the testing, rather than just being told that the expert believes the claims are substantiated.

**ANTITRUST SOURCE:** What about the meetings? Each side has the opportunity to meet separately with you and the staff attorney. What do you think makes for effective use of that hour or so?

**LAURA BRETT:** A couple of things. Bring your experts. We really want to hear from the technical experts who have weighed in on whether the challenged advertising claims are or are not substantiated. We want to be able to ask that person questions and we want to know the details of the testing. We can’t consider anything at meetings that is outside the record in our ultimate decision, but sometimes we might overlook important information that is in the record and an expert can focus us on that information. Other times, the expert can help us understand details (that are in the record) about how the testing was completed. It’s really important to have the experts there.

The other thing that’s very helpful in meetings is for the advertiser or challenger to help us understand why this claim matters to consumers and businesses. What is the overall context of this advertising claim? Why is this an important claim either for the advertiser to be able to continue to make or for the challenger to see discontinued? The marketing context can often help us understand how to evaluate the claim and the substantiation.

And then finally, the more you can walk us through your substantiation and put the pieces together for us and really lay it out for us, the easier it’s going to be for us to make a decision either way. It benefits parties to walk us through the claims and the substantiation to make it easy for us to reach a decision in your favor. Most of the parties that come through here are very good at arguing their case. Our meetings are very effective, and it helps us crystallize the issues in the case. And a meeting can often influence our thinking about the case. The meetings allow us to dig in to the substantiation, what it is included and what is not included, in a way that often shapes our decision-making.

**ANTITRUST SOURCE:** In terms of who to bring, the experts obviously . . .

**LAURA BRETT:** Right.
ANTITRUST SOURCE: Do you see any benefit one way or the other in terms of bringing other people from the company? Or is it more just their preference?

LAURA BRETT: It really is the company preference about whether or not they want to be here. But I will say it's very unusual for us to have just outside counsel come to our meetings. We almost always have someone from the company. It is not necessary to have someone from the company if they are trying to avoid the time or expense of travel to our offices, but it is really up to the company.

It is helpful for us to have company representatives so that we can ask questions about the larger context of the advertising claims. Company representatives can give us a better understanding of the market and the context of the advertising and why the challenge is before NAD. We now have teleconferencing equipment to help us make sure that we can hear from company representatives and experts, without requiring travel to New York. We have had the teleconferencing equipment for about a year and it has been used fairly often.

ANTITRUST SOURCE: Let's switch gears a little bit. So a typical NAD case is where one company challenges another company. But you also have the ability to bring, what you call monitoring cases, where you reach out and select an advertisement to look at. Do you also do the monitoring as opposed to just hearing competitor challenges?

LAURA BRETT: Monitoring is an important part of our mission. We are going to miss many, many industries in the marketplace if we rely only on competitors challenging each other's advertising. There are industries that don't challenge each other's advertising. And there are lots of industries where the issues that arise with advertising claims aren't necessarily competitor issues, but they are still problematic for consumers. We try to look at advertising in all industries to make sure that advertising claims are not misleading and consumers receive truthful information when they make their purchasing decisions.

We also want to provide guidance to the industry on new advertising issues. In addition, we want to prioritize reviewing claims that are made to vulnerable audiences or are hard for consumers to evaluate themselves. So when we look at monitoring cases, those are the criteria that we line them up against.

We always have to remember that this is self-regulation, and that if there are companies out there that don’t want to play by the rules they are not ideal candidates for self-regulation. Our resources may be better used by reviewing advertising claims from companies that are trying to be truthful but may not know what kinds of substantiation or what business practices are expected when advertising.

ANTITRUST SOURCE: Are there particularly effective monitoring cases that stand out in terms of having that kind of impact?

LAURA BRETT: Sure. One case—I think my favorite monitoring case if I have to pick one—involves a company called eSalon. They made customized hair color products that you could use in your home. I liked this case because it gave us an opportunity to provide guidance. The company was a small company and they were gaining some traction in the marketplace, and had gotten a lot of media attention with articles in InStyle and other magazines. Even The Wall Street Journal carried an article about their approach to this new product. The way that the company was publicizing their media attention ran afoul of a lot of FTC guidance on the use of endorsements.
The company welcomed going through the NAD process, and they were happy to participate. They wanted to learn from us about how to be transparent to consumers in the way that they were marketing their product. Working with the company felt like a collaborative process. We met with the company and they were strong advocates for their product, but they were also eager to understand our guidance and apply it in their advertising going forward. In addition, this case gave us an opportunity to talk a lot about the way advertisers were using social media to promote their products and provide guidance to the industry generally on how best to do that. It was fun.

**ANTITRUST SOURCE:** And as a practitioner, I know that one of the advantages of NAD is you often can reach out and address an issue faster than the FTC.

**LAURA BRETT:** Right.

**ANTITRUST SOURCE:** Are there particular challenges or issues that you think NAD is going to be wrestling with in the coming years?

**LAURA BRETT:** Funding is always a challenge for us, making sure that we have adequate funds to be able to do the job that we do well. That's a consistent challenge and one that we're going to continue to struggle with. But I think new challenges include making sure that we are adaptable because we see advertising changing.

The way advertising is appearing to consumers is changing. We have to make sure that we are prepared to review advertising and the way it is appearing so that we can continue to be a resource for companies and consumers even when advertising is not in traditional formats, like television or print, but appears on multiple screens. We cannot be sure of the ways that advertising is going to change, but we're confident that we're going to need to change and adapt to be a good resource. We want to make sure to meet that challenge so that we continue to be a resource for businesses and consumers.

Another ongoing challenge will be to maintain industry support. Self-regulation doesn’t work without industry support. In order to maintain industry support we must respond to business needs, as well as maintain our reputation for independence and fairness. In addition, we hope to continue to have the support of the FTC so that we remain effective at insuring that advertising to consumers is not misleading.

**ANTITRUST SOURCE:** I saw you got a lot of support from the FTC at the NAD Conference.

**LAURA BRETT:** Yes. We do appreciate the message that they sent at our conference—that self-regulation continues to be important to the FTC, and that industry self-regulation is a really important way to ensure that advertising is truthful. I continue to appreciate the support that we get from the FTC and the relationship we have.

**ANTITRUST SOURCE:** Laura, thank you very much. I really appreciate your taking the time to do this.

**LAURA BRETT:** Thank you for coming in and interviewing me. I appreciate it.
Hal J. Singer and Kevin W. Caves

In his New York Times best seller, Thinking Fast and Slow, Nobel Prize laureate Daniel Kahneman explained that the party in litigation proffering a regression model to a jury was bound to lose. The reason is that regression runs counter to the way we think: Our brains tend to overcompensate when we learn a random fact about a person or thing. Regression tells us that the best predictor is often the mean of the population; hence, the popular phrase “regressing towards the mean.” A prediction can often be improved by deviating from the mean, but only if certain conditions are satisfied.

One such condition is that the regression does not suffer from so-called omitted variable bias. The objective of this article is to illustrate this concept, which frequently comes up during antitrust litigation, for non-economists. We will answer the following questions: What is omitted variable bias? Why is it so important to so many econometric debates? When is it empirically relevant? And how do we deal with it in real-world antitrust litigation?

Omitted Variable Bias: Intuition

As illustrated in Figure 1, the essence of regression analysis is to use variation in $X$ (the independent variable) to explain variation in $Y$ (the dependent variable). We can see in Figure 1 that, when $X$ is above its average, $Y$ also tends to be above its average. Note that we need both forms of variation if we want our regression to make a meaningful prediction.

To illustrate, suppose that $Y$ did not deviate at all from its average, such that all of the blue dots were clustered along the red line. In that case, there is literally nothing a regression can do to improve upon the average: Guessing the average will always predict $Y$ perfectly. Knowledge of $X$ would therefore be irrelevant to predicting $Y$. Conversely, suppose that there is variation in $Y$, but not in $X$. In that case, there would be no hope to use movements in $X$ to predict $Y$, because $X$ does not move at all. Our best guess would revert, once again, to the mean of $Y$.

Intuitively, omitted variable bias occurs when the independent variable (the $X$) that we have included in our model picks up the effect of some other variable that we have omitted from the model. The reason for the bias is that we are attributing effects to $X$ that should be attributed to the omitted variable.

As illustrated in Figure 1, every regression model has one or more omitted variables, simply by virtue of the fact that the regression line does not always perfectly predict $Y$. (As seen below, these “errors” can be either positive or negative.) When an omitted variable is uncorrelated with $X$—for

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1 Daniel Kahneman, Thinking Fast and Slow (2011).
The example also assumes (again naively) that price endogeneity can be ignored here. Although endogeneity (sometimes referred to as “simultaneity”) is an important topic in empirical econometrics, it is outside the scope of this brief article.

Omitted variable bias occurs when the independent variable (the \( X \)) that we have included in our model picks up the effect of some other variable that we have omitted from the model. For example, if the errors come from statistical white noise in the measurement of \( Y \)—then it does not present any problems. But if the omitted variable has an effect on the dependent variable (\( Y \)) and is correlated with the explanatory variable (\( X \)), the regression will mistakenly attribute the effects of the omitted variable to the explanatory variable, resulting in omitted variable bias.

**Direction of Bias Caused by the Omitted Variable**

To make matters more concrete, Figure 2 provides a stylized illustration of data points along a classic demand curve of the type covered in introductory microeconomics courses. Within this stylized example, one can see how a regression line can fit the data. The line that provides the best fit is the one that passes through the three data points. And we can see, simply by eyeballing the data, that the demand curve is indeed downward-sloping: When price goes up, the quantity demanded falls. For example, when the price is $4, the quantity demanded is 75 units; when the price is only $2, the quantity demanded increases to 125 units.

As empirical economists know all too well, real-world data are never this well behaved. Among other things, the example below assumes (naively) that the quantity demanded depends on the price, and only on the price.\(^2\) But elementary economics teaches that the demand curve will tend to shift with changes in income (among other variables).

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\(^2\) The example also assumes (again naively) that price endogeneity can be ignored here. Although endogeneity (sometimes referred to as “simultaneity”) is an important topic in empirical econometrics, it is outside the scope of this brief article.
Let’s examine a slightly more complex example, in which the data points are drawn from different areas, with varying income levels. Figure 3 displays the data:
As seen above, we now have a cluster of data points without the downward-sloping relationship that was so readily discernible in Figure 2. If anything, a naïve interpretation of these data would seem to suggest that the quantity demanded increases when the price goes up. For example, the quantity demanded at a price of just $2 is only 50 units, but when the price increases to $5, the quantity demanded seemingly increases to 125 units. (This is actually possible in theory, in the case of so-called Giffen goods, but these are so rare in practice that the odds that we’ve actually stumbled upon a Giffen good are vanishingly small).

Why do these consumers appear to demand more when the price is higher? The answer is that we have failed to control for a key variable—in this case, income. For any given price level, consumers in lower-income areas will demand less than consumers in higher-income areas. The consumers willing to purchase a quantity of 125 units at a price of $5 are wealthier than those willing to purchase a quantity of 50 units at the much lower price of $2. Figure 4 shows what happens when we include the omitted variable in our analysis, by allowing the demand curve to shift with income, and then fitting separate demand curves to the data points conditional on the income level:

![Figure 4](image)

As seen above, once we control for income, the paradox is resolved: What appeared to be an upward-sloping demand relationship was actually three separate demand curves, corresponding to three groups of consumers with three distinct income levels.

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2 Named after Scottish economist Sir Robert Giffen, a “Giffen good” is a good for which quantity demanded increases as its price increases, rather than falls. Giffen noted that as the price of a food staple like bread rises, the poor can no longer afford to supplement their diet with better foods and must consume more of the staple food.
As the prior example illustrates, omitting a key variable can be detrimental to a regression model, making it impossible to accurately tease out even the most fundamental economic relationships in the data and resulting in biased econometric estimates. The reason that omitting income is so problematic in this example is that income is correlated with price and has a positive effect on quantity demanded: Consumers in higher-income areas tend to pay higher prices, and to purchase larger quantities, than do consumers in lower-income areas. If one fails to control for income, it is easy to mistake this as evidence that higher prices cause consumers to purchase more than they would otherwise, when in fact it is a change in income that leads to higher prices and higher quantity demanded. In this example, omitted variable bias leads us to conclude incorrectly that the demand curve is upward-sloping.

On the other hand, omitting income would not create omitted variable bias if income had no effect on demand or if income were uncorrelated with price (or both). If income were uncorrelated with price, then there would be no danger of attributing changes in quantity demanded caused by changes in income to changes in price. If income had no effect on demand, then movements in income would not cause movements in quantity demanded at all.

The direction of the bias introduced by an omitted variable depends on the sign of the correlation between the omitted variable and the independent variable, as well as the sign of the effect of the omitted variable on the dependent variable. Table 1 summarizes the possible biases introduced by an omitted variable. Whenever the omitted variable is positively correlated with the independent variable and has a positive effect on the dependent variable, the direction of the bias is positive: In the example above, income was positively correlated with price and had a positive effect on quantity demanded, so the direction of the bias was positive (as seen in the first row of Table 1). The positive bias was so severe that the relationship between price and quantity demanded, which should have been negative, was actually pushed into positive territory, implying (counterfactually) that the demand curve was upward-sloping. This positive bias derives from incorrectly attributing the effects of an increase in income to an increase in the price level.

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When the correlations change, so does the direction of the bias. To understand why, suppose next that income has a negative effect on the quantity demanded (as might be the case for inexpensive domestic cars), but that income is still positively correlated with price (as would be the case if higher-income purchasers of domestic cars were more likely to pay sticker price). In contrast to the prior example, higher incomes are now associated with lower quantities (because fewer domestic cars are sold in higher-income areas) but also with higher prices (because domestic cars tend to sell for higher prices in higher-income areas). As seen in Table 1, this means that the direction of the bias is negative.

Figure 5 illustrates these relationships. In contrast to our prior example, higher incomes are now associated with higher prices and lower quantities demanded, instead of higher prices and higher quantities demanded. As seen below, when we control for income, we again trace out three
separate demand curves corresponding to three different income levels, each of which is relatively steep. Had we failed to control for income, we would have traced out a demand curve that is too flat, as illustrated by the dashed red line. A flat demand curve means that the quantity demanded is highly sensitive to movements in price, while a steep demand curve means that the quantity demanded does not change much with the price. In this example, omitted variable bias did not change the sign of the relationship—we still find that quantity is negatively related to price. But the bias makes the relationship too negative: Quantity demanded appears overly sensitive to price when we fail to control for income.

For example, consider what happens to price and quantity demanded when we move from a lower-income area to a higher-income area. Because higher incomes are positively related to prices, prices will increase. And because quantity demanded and income have a negative relationship, the quantity will decrease. If we fail to control for income, we will mistakenly fully attribute the decline in quantity demanded to the increase in price (a movement along the demand curve), which in reality is partially caused by the fact that higher-income consumers are less interested in purchasing domestic cars than lower-income consumers (a shift in the demand curve).

**When Does Omitted Variable Bias Matter, and What Should Be Done About It?**

It is easy to claim, in the abstract, that a regression has failed to account for some unspecified factor. This is because there will always be at least some movements in $Y$ that $X$ cannot fully account for. Omitted variable bias is therefore most effective as a methodological critique when one can (1) identify a plausible candidate for the omitted variable; (2) predict the direction of the bias based on its expected correlation with $X$ and $Y$; and (3) (ideally) demonstrate this effect empirically by controlling for the omitted variable, and showing that the results change substantially.
Consider an example of a horizontal price-fixing conspiracy in which the defendants allegedly entered into an agreement as of a certain date. Suppose that the plaintiffs present a regression indicating that prices increased by 30 percent on average after the start date of the alleged conspiracy, relative to beforehand. An economist for the defense might argue that the plaintiffs’ regression model suffers from omitted variable bias because the plaintiffs’ economist neglected to control for changes in the defendants’ costs that took place around the time of the alleged conspiracy.

Note that the direction of the bias is important here, and depends critically on whether and how the omitted variable (cost) is correlated with the challenged conduct: If costs are positively correlated with the conduct, then the direction of the bias is positive (as seen in the first row of Table 1), implying that the plaintiffs’ model has overstated the effect of the conspiracy on prices. This would imply that the plaintiffs’ regression was mistakenly attributing an observed price increase to the conspiracy, when in fact some or all of the increase was driven by higher costs. But if costs are negatively correlated with the conduct, then the direction of the bias is negative (as seen in the second row of Table 1), implying that the plaintiffs’ model has understated the effect of the conspiracy on prices. (That is, but for falling costs, the conspiracy would have driven prices still higher). Finally, if costs are uncorrelated with the conduct, then omitting them from the regression model does not bias the plaintiffs’ regression model.

The ideal solution would be to obtain cost data from the defendants, so that costs can be directly controlled for in the regression model. If the plaintiffs’ regression still detects a positive and significant effect of the conspiracy on prices, the defense can no longer plausibly argue that the plaintiffs’ estimate of the effect of the conduct is biased (unless some other omitted variable is identified). But if the plaintiffs’ regression no longer shows a significant effect of the conspiracy, then the plaintiffs cannot plausibly prove liability or claim damages based on their regression model. On the other hand, it is possible that suitable cost data are unavailable. (For example, perhaps costs are aggregated in the defendants’ records, with no specific information available for the products at issue.) In this case, other forms of record evidence (e.g., testimony from input suppliers) could be used to investigate the likely direction of the correlation between the omitted variable and the conduct, and thus, the likely direction of the bias.

Claims of omitted variable bias were raised by the defense in In re High-Tech Employee Antitrust Litigation. In that case, the plaintiffs alleged that top executives at some of Silicon Valley’s most prominent companies, including Apple, Google, Intel, and Adobe, conspired to restrict the recruiting and hiring of high-tech workers as a mechanism for suppressing compensation. To quantify this effect, the plaintiffs’ economist used an econometric model in which the dependent variable was real annual employee compensation, and the independent variable was a measure of the challenged conduct, calculated as the proportion of months within a given year during which a given employer was subject to one or more of the anti-solicitation agreements challenged by the plaintiffs. The results of the regression indicated that the compensation paid to class members was negatively related to the challenged conduct.

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4 No. 11-CV-2509 LHK (N.D. Cal.).
5 The regression controlled for a variety of additional factors, including employee age, gender, years at the company, employer revenue, and the number of new hires. See Kevin Caves & Hal Singer, Analyzing High-Tech Employee: The Dos and Don’ts of Proving (and Disproving) Classwide Impact in Wage Suppression Cases, ANTITRUST SOURCE (Feb. 2015), http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/feb15_caves_2_11f.pdf.
The regression also enabled the plaintiffs’ economist to quantify this effect. In particular, the regression yielded a prediction of how much class member compensation would have increased, on average, if each employer had participated in anti-solicitation agreements for zero months (equivalent to eliminating the challenged conduct). This yielded an estimate of aggregate damages—calculated as the difference between what class members were actually paid and the amount that they would have been paid absent the allegedly anticompetitive agreements among employers—of approximately $3 billion.6

The defendants’ economists argued in the abstract that the plaintiffs’ regression model might suffer from omitted variable bias, which “arises when some of the same unmeasured common factors drive both the independent and dependent variables.”7 By invoking omitted variable bias, the defense was asserting that the plaintiffs’ measure of the challenged conduct was correlated with some other variable, which the plaintiffs had omitted from their model, and that it was this omitted variable that was actually causing lower compensation to be paid to class members. As the court observed in its class certification order, the defense had failed to specify what the omitted variable might be, or to explain why excluding it from the model would have biased the plaintiffs’ regression in the matter claimed by defendants.8

Both omissions are important: A plausible omitted variable is, first and foremost, something that affects the dependent variable. In this context, defendants’ experts would have had to offer up some factor that would be expected to have a significant effect on class member compensation, yet was not already controlled for in plaintiffs’ regression model. Second, one would have to be able to plausibly claim that the omitted variable had the correct correlation with the challenged conduct. If the omitted variable were uncorrelated with the conduct, or if the correlation had the wrong sign, then the critique falls apart.

To illustrate, suppose the defense had posited an omitted variable that had a positive effect on class member compensation. In this case, the defense would have had to argue that the omitted variable was negatively correlated with the challenged conduct—so that, as the challenged conduct took effect, the omitted variable would decline, causing class member compensation to fall. If that were the case, then the plaintiffs’ measure of the challenged conduct would have been picking up the effect of the omitted variable, implying that the plaintiffs’ damages estimate was biased upward. Controlling for the omitted variable could have reduced the plaintiffs’ damages estimates, perhaps to zero. Had the defense in High Tech Employee succeeded in demonstrating this empirically, it is not at all clear how the plaintiffs could have prevailed. On the other hand, if the correlation between the conduct and omitted variable were positive, then the omitted variable would simply have made the plaintiffs’ damages estimates conservative, understating the effect of the conduct on class member compensation.

Conversely, if the defense posited an omitted variable that had a negative effect on class member compensation, the defense also would have had to argue that the omitted variable was positively correlated with the conduct—so that, as the challenged conduct took effect, the omitted variable would increase, causing class member compensation to fall. If the correlation

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6 The court agreed that the analysis “was capable of showing that Defendants’ total expenditures on compensation [were] less than they would have been in the absence of anti-solicitation agreements and thus capable of showing classwide damages.” See Order Granting Plaintiffs’ Supplemental Motion for Class Certification at 56, In re High-Tech Employee Antitrust Litig., No. 11-CV-02509 (N.D. Cal. Oct. 24, 2013).
7 Id. at 73.
8 Id. at 74.
between the conduct and omitted variable was negative, this would again imply that the plaintiffs’ regression model had underestimated the true effect of the challenged conduct.

Conclusion
We have explored omitted variable bias, a fundamental regression concept that frequently arises in antitrust litigation. Every regression has omitted some variables. The relevant question is whether the omission generates bias that significantly compromises the reliability of the regression model. For this to happen, it must be the case that the model has failed to control for a variable that affects $Y$ and is correlated with $X$. In litigation, the direction of the bias is often highly relevant (e.g., are damages estimated conservatively, or are they over-stated?). The direction of the bias can be predicted based on how the omitted variable is correlated with the independent variable. Better yet, it can be known with certainty by controlling for the omitted variable.