

Blindside Deconcentration: Outsourcing, Power Retailers, and Antitrust

Richard M. Steuer

Who would have guessed that deconcentration of the American economy would take hold not by splitting large vertically integrated companies into smaller integrated companies, but by outsourcing layer atop layer of operations to third parties and by ceding market power to major downstream customers?

Yet that is just what is happening, and the potential implications for antitrust analysis are jarring.

It has been widely reported that a procession of companies in the United States have begun outsourcing substantial segments of their operations, including not only such early castoffs as information technology and food service, but logistics, manufacturing and even product design.¹ The specter of the “hollow company”² is not yet ubiquitous in America, but it unmistakably is becoming more common and has been greeted with a mixture of uncertainty and alarm.³

At the same time, considerable attention is being paid to the growing influence of large retailers in the country.⁴ Before the rise of national brands with nationwide advertising, retailers ranging from the fabled general store to Montgomery Ward wielded substantial sway over consumer purchasing decisions.⁵ With the gathering strength of popular nationally-advertised brands throughout the 20th century, retailers lost ground to leading suppliers in the perennial tug-of-war for marketing leadership, with brand names becoming relatively more important. Today, retailers appear to be gaining ground again, with large retailers exercising growing influence over suppliers and creating their own powerful brands.⁶

Both of these phenomena have begun to dilute market power at the supplier level, making the real power of individual suppliers less concentrated than their market shares otherwise might suggest.

■ **Richard M. Steuer** is a partner in the New York office of Mayer, Brown, Rowe & Maw LLP and a Council Member of the ABA Section of Antitrust Law. He is a former Chair of the Antitrust Committee of the Ass’n of the Bar of the City of New York, adjunct professor of antitrust law, and writes often on antitrust law.

¹ See, e.g., Jonathan D. Glater, *Offshore Services Grow in Lean Times*, N.Y. TIMES, Jan. 3, 2004, at C1; Enrico T. Polastro & Sonia Tulcinsky, *Outsourcing Research and Manufacturing—Toward a Redefinition*, American Pharmaceutical Outsourcing (2002); *Despite Market Maturity, IDC Forecasts Logistics BPO Market to Grow 12% to Reach \$276 Billion by 2007*, PR Newswire (Apr. 21, 2003).

² See Joel Popkin and Co., *Securing America’s Future: The Case for a Strong Manufacturing Base* 28 (2003).

³ See Anne Fisher, *If All the Jobs Are Going to India, Should I Move to Bangalore?*, FORTUNE, Jan. 12, 2004, at 146; see also Claire Moore Dickerson, *Virtual Organizations: From Dominance to Opportunism*, N.Z. J. INDUS. REL. 35–46 (June 1998).

⁴ See Steve Lohr, *Questioning the Age of Wal-Mart*, N.Y. TIMES, Dec. 28, 2003, at WK5, col. 4.

⁵ JOSEPH C. PALAMOUNTAIN, *POLITICS OF DISTRIBUTION* 54 (1955).

⁶ See, e.g., Anthony Bianco & Wendy Zellner, *Is Wal-Mart Too Powerful?*, BUSINESS WK., Oct. 6, 2003, at 100.

Concentration's Conventional Wisdom

The conventional wisdom has long been that if parts of the economy become too concentrated, deconcentration would be accomplished through the divestiture of stand-alone businesses and the prohibition of mergers of competitors.⁷ At the height of the “no fault monopolization” movement, proponents of proactive deconcentration advocated horizontal break ups of integrated companies into side-by-side competitors, much like the AT&T divestiture.⁸ More recently, at the remedy phase of the *Microsoft* case, advocates of divestiture insisted on a horizontal break up into multiple integrated companies rather than a vertical break up among different levels of the business.⁹ The rationale, in each instance, was that market power could be more effectively dissipated by breaking a dominant firm into several competing integrated firms standing alongside one another, rather than creating a stack of dominant firms, each with the same market power as before at its own level of production or distribution.

A “hollowed company”

may continue to have

the same market share

as it did before

outsourcing, but does

it have the same

market power?

Rarely did anyone champion the notion of breaking up companies by offloading particular layers of functionality or ceding more decision making to retailers as a means of diluting market power.¹⁰ Yet that is precisely what is happening today. Without any prodding from either government investigations, litigation, or bankruptcy proceedings, company after company voluntarily is restructuring its own vertical integration through outsourcing, and redefining its vertical relationships with suppliers and customers—raising the question of how to factor these phenomena into antitrust analysis.

Outsourcing

Companies never have demonstrated any inclination to initiate deconcentration by spontaneously splitting themselves into competing entities. (Divesting non-core businesses in non-adjacent markets does not count, nor does a break up under pressure, such as AT&T.) However, companies today are rushing to embrace outsourcing as a means of reducing costs, and in the process some may be radically altering their very essence as competitors and their ability to wield the same degree of market power in the future that they did in the past. A “hollowed company” may continue to have the same market share as it did before outsourcing, but does it have the same market power?

⁷ *E.g.*, *Standard Oil Co. v. United States*, 221 U.S. 1, 77–78 (1911); *United States v. Am. Tobacco Co.*, 221 U.S. 106, 187–88 (1911); *United States v. AT&T*, 552 F. Supp. 131, 223 (D.D.C. 1982), *aff'd sub nom*, *Maryland v. United States*, 460 U.S. 1001 (1983); *United States v. IBM*, 86 F.R.D. 504, 505 (S.D.N.Y. 1980). See Nat'l Comm'n for the Review of Antitrust Laws and Procedures, Report to the President and the Attorney General, 121, 158–59 (1979) [hereinafter No-Fault Monopolization Report]; MARK J. GREEN, *THE CLOSED ENTERPRISE SYSTEM* 292, 294 (1972).

⁸ See No-Fault Monopolization Report, *supra* note 7, at 158.

⁹ See Plaintiffs' Memorandum in Support of Proposed Final Judgment at 31–35, *United States v. Microsoft Corp.*, 97 F. Supp. 2d 59 (D.D.C. 2000) (Nos. 98-1232, 1233), available at http://www.usdoj.gov/atr/cases/ms_remediespapers.htm; Remedies Brief of Amici Curiae at 8, 46–56, *United States v. Microsoft Corp.*, 97 F. Supp. 2d 59 (D.D.C. 2000) (Nos. 98-1232, 1233) (advocating for “full divestiture” of Microsoft into three identical companies), available at <http://aei-brookings.org/admin/pdffiles/brief.pdf>; see also Robert E. Litan & William D. Nordhaus, *Effective Structural Relief in U.S. v. Microsoft* (May 2000), available at <http://www.aei-brookings.org/admin/authorpdfs/page.php?id=165>. For the opinion granting conditional approval to the final consent decree between the government and Microsoft, see *United States v. Microsoft Corp.*, 231 F. Supp. 2d 144 (D.D.C. 2002).

¹⁰ There have been exceptions, such as the divestiture of Western Electric by AT&T to create Lucent Technologies. *AT&T*, 552 F. Supp. at 142; see also Robert W. Crandall, *The Failure of Structural Remedies in Sherman Act Monopolization Cases*, 80 *Or. L. Rev.* 109, 181–84 (2001). Also, in vertical merger cases, such as *Ford Motor Co. v. United States*, the remedy sought was to require divestiture of an input source (for sparkplugs and other electronics). 405 U.S. 562, 564–65 (1972) [hereinafter *Ford/Autolite*].

In *General Dynamics*¹¹ the Supreme Court recognized that current market shares teach little about tomorrow's market power where a company's strength is based on advantages that are not sustainable. On the surface, this may appear to have little applicability to the outsourcing phenomenon, because a powerful competitor that cuts costs through outsourcing without diminishing the demand for its products or services is likely to become even more successful. In this respect, the adoption of outsourcing should have no impact on market power analysis.

However, the "hollowing" of companies through outsourcing may have a profound impact on the ease of entry into particular markets and the influence of potential competition.

However, the "hollowing" of companies through outsourcing may have a profound impact on the ease of entry into particular markets and the influence of potential competition.¹² When an appreciable number of companies turn to independent third parties to supply inputs—from routine laundry service for hotels and customer support for catalogue companies, to complex data processing for banks and the design and manufacturing of brakes for automobile makers—there is a greater likelihood of healthy competition arising within expanding markets for supplying those inputs. Specialized suppliers can often furnish inputs at a lower initial cost than otherwise could be achieved, and a proliferation of such suppliers can make such cost savings widely available. This, in turn, should make it easier for outsiders to engage in *de novo* entry into the original market. Essentially, outsourcing is the polar opposite of a vertical acquisition (barring the emergence of exclusivity restrictions, of course, which can prevent suppliers from contracting with more than one company in the same industry). Therefore, just as vertical acquisitions historically have raised concerns about the deterrence of new entry by forcing newcomers to enter at multiple levels of functionality in order to compete against vertically integrated incumbents,¹³ outsourcing should have the opposite effect by allowing newcomers to enjoy cost savings that they would not soon be able to achieve on their own.

For example, if an increasing number of widget makers outsource warranty repair services to third parties on a non-exclusive basis, resulting in a thriving market for widget repair services, it should become easier for a newcomer to enter into the widget-making business because there will be a ready source of warranty repair services available without the need to invest in replicating that part of the business.

Likewise, if there exist an ample number of third parties offering the various layers of inputs needed to put together a widget-manufacturing business itself, potential competition in the widget market would be strengthened even if few other widget makers already were operating. To borrow a term, the "contestability"¹⁴ of the widget market would become greater by the presence of the third-party input suppliers. Of course, the strength of that impact would depend not only on the quality and capacity of those third-party suppliers, but the countervailing importance of such

¹¹ *United States v. Gen. Dynamics Corp.*, 415 U.S. 486, 509 (1974).

¹² This is particularly so in the sense of easing entry by reducing startup costs. Outsourcing would only reduce entry barriers in the longer term in particular circumstances, such as where incumbents continuously could foreclose new entrants from gaining access to the same inputs through other means (such as vertical integration) or where outsourcing provides scale economies that the entrants could not achieve on their own, and where the cost of the outsourced inputs accounts for a substantial share of the cost of the downstream product or service.

¹³ See, e.g., *Ford/Autolite*, 405 U.S. at 571; *Brown Shoe Co. v. United States*, 370 U.S. 294, 323–24 (1962) ("The primary vice of a vertical merger . . . is that, by foreclosing the competitors of either party from a segment of the market otherwise open to them, the arrangement may act as a 'clog on competition.'" (internal citation omitted)). See also U.S. Dep't of Justice Non-Horizontal Merger Guidelines, 49 Fed. Reg. 26,823, 26,834 (June 14, 1984), available at <http://www.usdoj.gov/atr/public/guidelines/2614.htm>.

¹⁴ For further discussion of "contestable markets," see generally Elizabeth E. Bailey & William J. Baumol, *Deregulation and the Theory of Contestable Markets*, 1 YALE J. ON REG. 111 (1984); William J. Baumol, *Contestable Markets: An Uprising in the Theory of Industry Structure*, Address Delivered at the Ninety-Fourth Meeting of the American Economic Association (Dec. 29, 1981), in 72 AM. ECON. REV., 1–15 (1982).

factors as reputation and brand loyalty, which can take time to match, and innovation, which cannot necessarily be outsourced. The potential for third-party input suppliers to dilute the market power of incumbent market leaders will vary from market to market, depending on the nature of the product and the relative importance of these various market forces.

The question will be whether the incumbents really possess as much market power as their current shares might indicate, where readily available outsourcing poses an immediate threat of new competition.

The Merger Guidelines of the Department of Justice and Federal Trade Commission¹⁵ provide a useful template for examining how the presence of outsourcing should impact the measurement of market power. The Guidelines address the ease of entry of potential competitors, asking whether entry would be “timely, likely, and sufficient in its magnitude, character, and scope to deter or counteract the competitive effects of concern.”¹⁶ In making this determination, the Guidelines focus on how long entry would take to achieve, whether entry would be profitable, and whether entry would be sufficient. In examining timeliness, the availability of outsourcing for major components of a new business should make it possible, in many instances, to enter more quickly. In assessing profitability, outsourcing should make initial entry less costly, and therefore potentially more profitable. In analyzing sufficiency, the availability of input suppliers not bound to exclusivity restrictions should open the possibility for multiple entry, bearing in mind the warning in the Guidelines that “[e]ntry may not be sufficient, even though timely and likely, where the constraints on availability of essential assets, due to incumbent control, make it impossible for entry profitably to achieve the necessary level of sales.”¹⁷ In markets in which outsourcing has spawned a cadre of freely available third-party input suppliers, such concerns should be diminished, and it is more likely that entry should be sufficient because it can be achieved more economically than starting from scratch.

It is customary to address concentration and deconcentration in terms of market share, but in a real sense, the more important concept is deconcentration of market power. As the case law and economic literature recognize, market share is only a surrogate for market power,¹⁸ and not always the most accurate indicator.¹⁹ Outsourcing holds the prospect for real tempering of market power even in instances where there is no immediate change in market share, and should be properly accounted for in any modern analysis of market power. This means that in merger analysis, the market power of incumbents may need to be discounted in markets where widespread outsourcing exists, to account for the constraints that outsourcing may place on the ability of the merging parties to raise prices, since new entry will be made easier. Likewise, in monopoly and other cases, the market power of the defendants will need to be evaluated in light of the availability of outsourcing and the likelihood that such availability will give rise to new competitors. In each instance, the question will be whether the incumbents really possess as much market power as their current shares might indicate, where readily available outsourcing poses an immediate threat of new competition.

¹⁵ U.S. Dep’t of Justice and Federal Trade Comm’n, Horizontal Merger Guidelines, 57 Fed. Reg. 41, 552 (1992), available at <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>.

¹⁶ *Id.* § 3.0.

¹⁷ *Id.*

¹⁸ See generally *Tops Mkts., Inc. v. Quality Mkts., Inc.*, 142 F.3d 90, 97 (2d Cir. 1998); *Ball Mem’l Hosp., Inc. v. Mut. Hosp. Ins., Inc.*, 784 F.2d 1325, 1334–35 (7th Cir. 1986); PHILIP AREEDA ET AL., *ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRICIPLES AND THEIR APPLICATION* § 531, at 187 (2d ed. 2002).

¹⁹ See, e.g., *General Dynamics*, 415 U.S. at 498; *Tops Markets*, 142 F.3d at 97; *Ball Memorial*, 784 F.2d at 1335.

The bottom line is that the outsourcing phenomenon may not have as direct an impact on the concentration of market power as would an old-fashioned horizontal divestiture but, in particular instances, it may result in genuine dilution of market power.

Rising Distributor Influence

Deconcentration of market power also can be fostered by the shift of market power from one vertical level of distribution to another. Although there were powerful retailers throughout the 20th century, including Montgomery Ward, Sears, Roebuck, and A&P (which, in antitrust lore, prompted passage of the Robinson-Patman Act almost by itself),²⁰ most of the focus of antitrust market power analysis was on leading manufacturers, such as Standard Oil, American Tobacco, and Microsoft.²¹ While there have been cases involving strong retailers in years past,²² only recently, in cases like *Staples*,²³ *Toys “R” Us*²⁴ and *Cardinal Health*,²⁵ have courts begun to apply a more sophisticated analysis to the market power of large-scale retail chains and other powerful distributors.

The influence of major distributors can take many forms. Large retailers naturally are important customers for manufacturers and, increasingly, have been able to demand that manufacturers assume the expense of such functions as warehousing, inventory control, delivery tracking, and the stocking of shelves and displays (including, in some instances, paying slotting allowances and playing the role of “category captain”²⁶). All of these transfers are themselves forms of outsourcing, except that instead of the manufacturer shifting functions to third parties, retailers are shifting functions to the manufacturer. (The manufacturer, in turn, may itself choose to outsource some of these tasks to third parties.)

Manufacturers need to compete against one another in furnishing these services in order to keep their products on the shelves of major retailers, and whatever market power each manufacturer may possess by virtue of its market share and the strength of its brand often will be offset to some extent by the power of the retailer. The retailer’s relative strength, in turn, is a function of its volume of traffic and the loyalty of its customers within each particular category of products. If a retail chain accounts for a sizable percentage of total retail sales in a category, suppliers may have little choice but to meet its demands. As a consequence, whatever power leading brands once may have had to dictate terms to retailers, today such power is subject to being dissipated by the countervailing power of major retail chains.

²⁰ See PALAMOUNTAIN, *supra* note 5, at 196.

²¹ See *Standard Oil*, 221 U.S. at 30–47; *American Tobacco*, 221 U.S. at 155–74; *Microsoft*, 231 F. Supp. 2d at 150–51.

²² See, e.g., *Great Atl. & Pac. Tea Co. v. FTC*, 440 U.S. 69, 84–85 (1979); *United States v. Topco Assocs., Inc.*, 405 U.S. 596, 612 (1972); *Klor’s, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207, 212–13 (1959).

²³ *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1092–93 (D.D.C. 1997).

²⁴ *Toys “R” Us, Inc. v. FTC*, 221 F.3d 928, 936–37 (7th Cir. 2000).

²⁵ *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34, 52–61 (D.D.C. 1998).

²⁶ Federal Trade Comm’n, *Report on the Federal Trade Commission Workshop on Slotting Allowances and Other Marketing Practices in the Grocery Industry: A Report by Federal Trade Commission Staff* 46–57 (Feb. 2001), available at <http://www.ftc.gov/bc/slotting/index>. See also Federal Trade Commission Staff Study, *Slotting Allowances in the Retail Grocery Industry: Selected Case Studies in Five Product Categories* (Nov. 2003), available at <http://www.ftc.gov/opa/2003/11/slottingallowance.htm>.

²⁷ For a discussion of the market power inherent in brand control, see Spencer Weber Waller, *The Language of Law and the Language of Business*, 52 CASE W. RES. L. REV. 283, 325 (2001) (discussing branding and “brand equity” as potentially the assets most valuable to a company).

Retailers and other distributors also can offset manufacturers' market power by controlling brands themselves.²⁷ This can take several forms. Traditionally, retailers have carried "private label" or "store" brands, which they source from suppliers of their choosing, including, in some instances, the same suppliers that furnish brand name products. This affords retailers the freedom to replace one manufacturer with another (often in a different country) almost seamlessly, without attracting the ire—or even the attention—of consumers, so long as the same quality is maintained. Retailers and other distributors also generally will have the right to strike exclusive arrangements with valued suppliers, to assure that a trusted supplier will not provide comparable products to any competitor.²⁸

The key for the distributor is the ability to control the use of the trademark. Some trademarks have been popularized by retailers, such as Sears' well known "Craftsman" brand. Other widely recognized trademarks have been licensed on an exclusive basis, such as K-Mart's license to use the "Martha Stewart" trademark exclusively for certain products and Target's arrangement with Michael Graves. Some of these brands have become highly popular and have won appreciable consumer loyalty.²⁹ Perhaps the most celebrated illustration of the importance of control over a trademark was the distribution of a food processor made by a French company, Robot-Coupe. The U.S. distributor owned the trademark, "Cuisinart," and when there was a falling out between the two companies the distributor found another supplier in Asia without missing a beat, while Robot-Coupe was left trying to convince puzzled consumers to continue buying its products.³⁰ The rest is history.

In short, where the distributor controls the brand—either by creating it or by holding an exclusive license—the distributor can exert considerable control over manufacturers. (In the case of licensed trademarks, the trademark owner too will need to exercise quality control in order to protect the integrity of its mark, of course, but the licensed distributor still will hold considerable sway over the manufacturers that supply it.) Accordingly, whatever market share such nameless manufacturers enjoy cannot be equated with an equivalent degree of market *power*, since they serve entirely at the pleasure of the distributor that controls the brand. Moreover, even manufacturers of name brand products in the same categories will face added pressure since their ability to negotiate with the retailer will be diminished by the retailer's ability to bring comparable products to market under its own trademarks.

Alternatively, retailers can have branded products created for them exclusively. For example, in *Toys "R" Us*, a large retailer was able to prevail upon leading manufacturers of name brand toys to make varieties of their products exclusively for that chain.³¹ Although the Federal Trade Commission issued a cease and desist order in that case, which was upheld on appeal, the order specifically preserved the right of the retailer to contract for exclusive product varieties from manufacturers.³² More recently, retailers of recorded music have struck exclusive deals to distribute particular albums, such as Best Buy's deal with the Rolling Stones and Target's deal with Bon

²⁸ See, e.g., *Determined Prods., Inc. v. R. Dakin & Co.*, 514 F. Supp. 645, 648 (N.D. Cal. 1979).

²⁹ Constance L. Hays, *Kmart Still Has Martha Stewart, But Wal-Mart Has Its Mainstays*, N.Y. TIMES, Dec. 30, 2003, at C1.

³⁰ See *Cuisinarts, Inc. v. Robot-Coupe Int'l, Corp.*, 509 F. Supp. 1036, 1037–38 (S.D.N.Y. 1981) (detailing the at-odds commercial relationship of the two companies).

³¹ 221 F.3d at 931–32.

³² See *Toys "R" Us, Inc.*, 126 F.T.C. 618, 620 (1998), available at <http://www.ftc.gov/os/1998/10/toysrsinord.htm>.

Jovi.³³ Each of these is an example of a retailer exercising its power to convince a manufacturer to cut a special deal, exposing once again the vulnerability of the manufacturers' market positions in the current retail environment.

The latest source of retailer power is the gift card, which enjoys huge popularity during the Christmas season. Billions of dollars of gift cards go into circulation within a few weeks at the end of the year,³⁴ and to the extent that those cards are redeemable at only one chain (as many are) they place still greater control over consumers' purchasing decisions in the hands of the retailer.

The one trend potentially running counter to the growing power of retail chains has been the rise of Internet retailing.³⁵ To the extent that a manufacturer can achieve nationwide market penetration directly through the Internet, without investment in "bricks and mortar," it can compete against the largest chains and temper the power that those chains otherwise would be able to exercise. However, experience is fast teaching that some products are far better suited to e-commerce than others, and in many categories, e-commerce will have little prospect for making an impact. Moreover, a manufacturer that already depends upon traditional retailers may hesitate to compete against them, since those retailers may respond by choosing to drop or de-emphasize that manufacturer's brand in favor of others.³⁶ Moreover, some of the large chains are themselves already among the most successful e-tailers, and may present the best avenue for capturing Internet sales. For example, such chains as Barnes & Noble and Best Buy make a substantial portion of their sales over the Internet.³⁷

Buyer power has been recognized as a countervailing factor in assessing suppliers' market power,³⁸ but sometimes only grudgingly,³⁹ and rarely in the context of suppliers and distributors.⁴⁰ Nevertheless, to the extent that powerful retailers and other distributors offset the power of man-

³³ Ian Austen, *Big Stores Make Exclusive Deals to Bring in Music Buyers*, N.Y. TIMES, Dec. 29, 2003, at C1.

³⁴ See Tracie Rozhon, *Results Mixed, Stores Await a Final Burst of Shopping*, N.Y. TIMES, Dec. 26, 2003, at C1 ("gift cards . . . now make up \$17 billion of holiday retail spending").

³⁵ See generally Federal Trade Commission Public Workshop, *Possible Anticompetitive Efforts to Restrict Competition on the Internet* (Oct. 2002), available at <http://www.ftc.gov/opp/e-commerce/anticompetitive/index.htm>; Richard M. Steuer, *Retailing on the Internet*, ANTITRUST, Summer 1998, at 50–52.

³⁶ See Ashish Agarwal, *Statutory and Contract Barriers to the Sale of Products Over the Internet* (Nov. 5, 2003) (citing Doug Bartholomew, *E-Commerce Bullies* (Sept. 4, 2000), at industryweek.com, and Robert Atkinson, *The Revenge of the Disintermediated* 14 (Jan. 2001) (report of the Progressive Policy Institute), at <http://www.ppionline.org/documents/disintermediated.pdf>.

³⁷ See, e.g., *Barnes & Noble Raises Bid on Remainder of Internet Unit*, N.Y. TIMES, Jan. 9, 2004, at C3; *Best Buy Offers MusicNow's Download Service*, N.Y. TIMES, Nov. 11, 2003, at C6.

³⁸ See, e.g., *FTC v. Tenet Health Care, Corp.*, 186 F.3d 1045, 1052 (8th Cir. 1999); *United States v. Baker Hughes, Inc.*, 908 F.2d 981, 986 (D.C. Cir. 1990); *Cardinal Health*, 12 F. Supp. 2d at 58 ("Although the courts have not yet found that power buyers alone enable a defendant to overcome the government's presumption of anti-competitiveness, courts have found that the existence of power buyers can be considered in their evaluation of an anti-trust case, . . ."); *United States v. Country Lake Foods*, 754 F. Supp. 669, 674 (D. Minn. 1990); *B.F. Goodrich Co.*, 110 F.T.C. 207 (1988). These cases should be distinguished from cases addressing the exercise of monopsony power, where a dominant buyer purchases less of a good in order to drive the price down. Note that the presence of power buyers also may constitute a structural factor diminishing the likelihood of collusion among suppliers. See, e.g., *E.I. du Pont de Nemours & Co. v. FTC*, 729 F.2d 128 (2d Cir. 1984).

³⁹ See Mary Lou Steptoe, *The Power-Buyer Defense in Merger Cases*, 61 ANTITRUST L.J. 493, 504 (1993) (concluding that speculative evidence of a "power" buyer should not so easily counter government evidence of a merger's probable anticompetitive effect). For a related viewpoint on the problems of excessive buyer power, see Robert Pitofsky, Thoughts on "Leveling the Playing Field" In Health Care Markets, Remarks Before the National Health Lawyers Ass'n Twentieth Annual Program on Antitrust in the Health Care Field (Feb. 13, 1997), available at <http://www.ftc.gov/speeches/pitofsky/nhla.htm>.

⁴⁰ Some exceptions are *Cardinal Health*, 12 F. Supp. 2d at 61, and *Country Lake Foods*, 754 F. Supp. at 674. See also *United States v. Syufy Enters.*, 903 F.2d 659, 663 (9th Cir. 1990).

The key to measuring market power in each instance is to recognize the changing dynamics of the relationships between manufacturers, wholesalers and retailers, and determine where the real power lies.

ufacturers, they are, in a real sense, deconcentrating that power—not by increasing the number of suppliers but by increasing the power on the other side of the negotiating table to pit one supplier against another more aggressively. To map the dynamics of any market, it is necessary to understand not only who is inhabiting that market, but who is in control and by how lopsided a margin. Only then can one determine how much market power each participant really possesses. In cases in which a retailer genuinely has the option of switching suppliers or making a product itself, the balance of power may tend to shift toward the retail side, and suppliers may well have less market power than their present shares would suggest. Likewise, where a retailer is strong enough to insist on being furnished with special products, or where a retailer has access to legions of club members or gift card holders, these are signs that the market power of suppliers may need to be discounted to take this into account. The key to measuring market power in each instance is to recognize the changing dynamics of the relationships between manufacturers, wholesalers and retailers, and determine where the real power lies.

Conclusion

Antitrust's conventional wisdom may have been blindsided by the emergence of outsourcing and power retailers, but the principles of antitrust analysis are up to the job of accounting for them. Although horizontal factors, such as market share and unilateral effects, have become central to understanding the basis of market power, today's vertical factors, such as the availability of outsourcing and the emergence of retailer power, now demand consideration as well. This means that we need a new way of looking at concentration—one that accounts for the limits that these new realities impose on the exercise of market power. The good news is that the guiding principles for assessing the impact of these vertical factors are familiar ones—that market share is not necessarily the same as market power, and that the market power of yesterday is not necessarily the same as the market power of tomorrow. With these principles in mind, factoring the impact of outsourcing and power retailers into market power analysis should be a piece of cake. ●

Interview with Susan Creighton, Director, FTC Bureau of Competition

Editor's Note: In this in-depth and wide-ranging interview with The Antitrust Source, Susan Creighton addresses the key issues currently before her as the Director of the FTC's Bureau of Competition. In addition to outlining her three main priorities, including the Bureau's continued focus on several important litigation matters, Creighton discusses the FTC's present merger enforcement efforts and priorities, as well as significant, non-enforcement policy initiatives.

Susan Creighton was named Director of the FTC's Bureau of Competition in August 2003 after spending the previous two years as Deputy Director. Prior to coming to the FTC, Creighton was a partner with the law firm of Wilson, Sonsini, Goodrich & Rosati, where she specialized in antitrust and intellectual property litigation. Before joining Wilson, Sonsini, Creighton clerked for U.S. Supreme Court Justice Sandra Day O'Connor and for Judge Pamela Ann Rymer of the District Court of the Central District of California. She is a graduate of Harvard University and Stanford Law School.

ANTITRUST SOURCE: Let's start by asking you to tell us something about the priorities you have as Director of the Bureau of Competition and your goals for the coming year.



SUSAN CREIGHTON: I have three priorities. One is to be maintaining and managing our very active litigation agenda. I think a lot of folks are familiar with the Commission's decisions in the *Polygram* and *Schering* cases. We also have four additional matters pending before the Commission and another five cases that are in active litigation before the Administrative Law Judges. Altogether that makes for a total of nine major antitrust cases going right now, which is a huge challenge for our staff. So one priority is to manage these cases and to litigate them well. A second priority, given that challenge, is to handle the increase in the number of HSR filings that we have seen recently. Coming on top of our litigation workload, the increase in merger review poses some challenges. My third priority is to remain focused on making sure that, despite our litigation workload and the increase in Hart-Scott review, we continue to maintain an active and aggressive non-merger agenda.

ANTITRUST SOURCE: What is the interaction, if any, between the Bureaus of Competition and Consumer Protection? Is there any effort to coordinate how the Bureaus work together to achieve the overall goals of the Commission?

SUSAN CREIGHTON: As Chairman Muris, General Counsel Bill Kovacic, and others have stated in speeches during the last couple of years, the missions of the two Bureaus are complementary, and on occasion there may be similar factual issues. For example, in our *Unocal* case, the Bureau of Competition has alleged that Unocal made intentional misrepresentations in connection with

obtaining a monopoly on reformulated gasoline. And obviously factual issues regarding deception are important in many Consumer Protection cases. Generally, though, while the missions of the Bureaus are complementary, our matters still are handled separately.

ANTITRUST SOURCE: You mentioned the uptick in HSR filings and a general sense that merger activity is increasing. What effect does that have on your ability to attract and retain talented people within the FTC? Are people drawn to the FTC when mergers pick up, or back into private practice?

SUSAN CREIGHTON: That's a good question. I think the answer is that it works both ways. In the past few years, hiring by the Agencies was somewhat lower than it had been in the 1990s because we weren't seeing a lot of staff turnover. As a result, there may have been some pent-up demand to join the Agencies, and right now we are certainly seeing a lot of really excellent applicants who would like to join us. At the same time, we're also getting a lot of calls from firms interested in recruiting from among our staff of very talented attorneys. So we're going to be challenged to make this a place where our lawyers want to stay and make their careers.

ANTITRUST SOURCE: You've had some departures from your leadership ranks recently. I'm thinking of Mike Cowie and Robby Robertson, among others. Who is going to fill those leadership roles and will there be an associated reorganization of responsibilities?

SUSAN CREIGHTON: Both Robby Robertson and Mike Cowie initially came here in connection with our increased litigation workload. We realized that we needed to be increasing our ability to litigate through trial several antitrust cases simultaneously. Mike and Robby joined us as part of that effort, and I think from the beginning the expectation was that they would be here for a couple of years. They did a tremendous job helping us build up a team of senior litigation counsel within the Bureau. That team today is led by Mel Orlans, who is a very experienced litigator previously in the General Counsel's office. We have also brought in, more recently, two very talented partners from private firms—Jack Martin from Hunton & Williams, and Tom Brock from Proskauer Rose. Together with Mel, Jack and Tom give us a core of very strong trial lawyers who are able to assist our staff in litigating our pending cases.

ANTITRUST SOURCE: Are those two recent arrivals replacements for Cowie and Robertson or are you still looking to add to your leadership ranks?

SUSAN CREIGHTON: We think we're set for the time being. Before he left, by the way, Mike Cowie had assumed responsibility as Assistant Director of what is now Mergers IV. His position as Assistant Director in Mergers IV has been taken by Chul Pak.

ANTITRUST SOURCE: While we're on the subject of mergers, do you want to comment generally on the Commission's agenda with respect to merger enforcement? Has there been any change in philosophy or focus that you think is worth addressing?

SUSAN CREIGHTON: I think it's a continuation of what Chairman Muris has been describing for the last couple of years, which is a great deal of continuity with the approach taken over the last fifteen years at the Commission.

ANTITRUST SOURCE: When Chairman Muris and former AAG Charles James entered office, they both remarked they thought coordinated effects theories had been inappropriately de-emphasized, and declared their intentions to look more to coordinated effects analysis than had been the case in the recent past. Would you say that the Bureau of Competition is more focused on concentrated industries that pose conditions conducive to coordination? Where does the balance stand now?

SUSAN CREIGHTON: Either unilateral or coordinated effects may be possible in any given case, and I don't think we are predisposed towards one theory more than the other. It's a very fact-dependent analysis that is driven by the circumstances of the case.

ANTITRUST SOURCE: Let's talk about consummated mergers for a minute. In the last couple of years, the FTC has challenged a number of consummated mergers, for example MSC Software and Chicago Bridge, and Aspen Tech lies ahead. Why is there an emphasis on consummated deals?

SUSAN CREIGHTON: To a considerable extent, the focus on consummated deals is an outgrowth of the change in the Hart-Scott filing requirements. It's not something that is really a change in focus so much as there are a lot more deals that we don't get a chance to review before the mergers are consummated. So that accounts to a considerable extent for our focus on consummated mergers. I would put in a different category, though, a challenge that we just filed to a consummated merger of two hospitals in Evanston, Illinois. As you may know, the Agencies have been unsuccessful in the courts in several Hart-Scott challenges to hospital mergers over the last decade. To improve our understanding of this important industry, we undertook a retrospective study to see what actually happened after the fact in a number of hospital mergers. In the case of Evanston, we saw very substantial price increases as a result of the merger. So the Evanston case provides an opportunity to look after the fact at what actually happened in a particular hospital merger. In so doing, potentially we can also inform and improve the antitrust analysis that should be applied when analyzing hospital mergers prospectively as well.

ANTITRUST SOURCE: Do you think that the HSR reporting threshold should be lowered, based on the experiences you've had in looking at non-reportable deals?

SUSAN CREIGHTON: No. I have not seen any systematic difficulties with the higher thresholds. The higher thresholds just mean that we need to be more diligent in the instances of cases that get brought to our attention that, though relatively small, may end up harming consumers.

ANTITRUST SOURCE: Are customer complaints the primary way your attention is drawn to non-reported deals, or is there an independent monitoring program to try to catch them?

SUSAN CREIGHTON: We do both. We do monitor media reports and industry publications; some deals have come to our attention that way. Sometimes we also hear from customers who file a complaint about a merger after the fact.

ANTITRUST SOURCE: Do you feel like you're catching most of the non-reportable deals that raise antitrust concerns or are you simply trying to catch enough of them to create a deterrent effect?

SUSAN CREIGHTON: I suppose it's always hard to know what you don't know. I'm not aware of, nor do I have any reason to believe, that there are any very substantial number of anticompetitive deals going forward that we're not hearing about.

ANTITRUST SOURCE: Let's talk for a minute about innovation markets. In the recent *Genzyme* case, the Commission decided not to challenge a merger that would have been a 2-to-1 in a so-called innovation market. What does this non-enforcement decision by the Commission tell us about the Commission's views of innovation markets?

SUSAN CREIGHTON: I believe that the Chairman's statement in closing that case should provide some guidance to those who are trying to counsel companies that are contemplating the merger of research and development programs. As for the principles articulated in the Chairman's statement in support of closing the transaction, the statement was very careful in pointing out that there is an appropriate role for innovation market analysis and that such analysis has been applied carefully and prudently by the Commission in the past. Most particularly in the pharmaceutical context, where you can identify products that already are in clinical trials and, hence, in the pipeline for approval, innovation market analysis has been used on a number of occasions by the Commission.

The *Genzyme* case, however, involved a very different set of facts. Neither company had a product in clinical trials. Rather, they were both at the early research stage, injecting different solutions into two mice, three mice. In that context, as the Chairman pointed out, and as was articulated very clearly in a Commission staff report in 1996, there is no economic basis—either theoretical or empirical—for concluding a priori that the combination of research and development at an early stage is more likely to be procompetitive or anticompetitive. Rather, whether the merger is likely to have anticompetitive consequences is a very fact-specific inquiry that turns on the circumstances of the particular case. The kinds of presumptions that we apply under the Merger Guidelines in product cases simply aren't appropriate in cases involving such early-stage research.

ANTITRUST SOURCE: You said it is a fact-specific inquiry; let me follow up. Is it objective facts or subjective facts that matter? If you found, for example, that the stage of research of the two merging parties was very preliminary, but that their intentions were to restrain competition by merging, would that matter?

SUSAN CREIGHTON: I'd say the inquiry turns on both the parties' incentives and the parties' ability to execute on those incentives. For example, in cases involving pre-clinical research, competitors don't know who else might be working on similar research or how much of a lead they might have over those rivals. That uncertainty makes it quite risky to slow down your development efforts. Parties that have products in advanced clinical trials, by contrast, have a much clearer idea of their position relative to their competitors, and that knowledge may make it much easier to ascertain whether anticompetitive conduct will induce timely and sufficient entry.

ANTITRUST SOURCE: What about vertical mergers? Is that an area of enforcement interest and, if so, how does it compare to the intensity of interest in horizontal mergers?

SUSAN CREIGHTON: The Commission has brought vertical merger challenges where appropriate in the last couple of years, for example, in the *Cytoc/Digene* case. So where we find that vertical mergers pose a competitive threat, we have and will challenge such mergers.

As far as vertical versus horizontal, I wouldn't characterize it as a question of the intensity of enforcement focus, but rather the likelihood of a vertical merger being anticompetitive compared to a horizontal merger. I think it's widely agreed that a horizontal merger is more likely on average to raise competitive concerns than a vertical merger. As a result, we're going to be challenging, on average, more horizontal mergers. That's not to say there can't be anticompetitive vertical mergers as well.

ANTITRUST SOURCE: Folks at the Commission, including the Chairman, have made remarks about the Commission's practices in regard to electronic discovery and expressed an interest in finding new ways and less burdensome ways to extract information from parties in electronic discovery, especially in merger investigations. Would you give us a progress report on developments at the FTC in this area?

We've been

encouraging parties

to produce electronic

documents, and even

if possible paper

documents that have

been scanned

electronically, and

produce them through

third-party vendors

over the Internet.

SUSAN CREIGHTON: Electronic production is a fact of life. I think that's increasingly how parties are maintaining their information in the ordinary course of business, and we're attempting to be responsive to that in a way that will impose the least burden on companies in complying with Hart-Scott. I think we've been receiving a steadily increasing number of electronic productions, actually in both merger and non-merger cases. Probably the most important recent development is that we've been encouraging parties to produce electronic documents, and even if possible paper documents that have been scanned electronically, and produce them through third-party vendors over the Internet. We've been trying to encourage parties to use this alternative, rather than deliver documents to us on CDs or other similar formats. We've found the Web-based production has been much more efficient and useful and easy for us and the parties involved. There have been a couple of productions that have gone particularly easily, but we're still a long way away from having all the wrinkles ironed out.

ANTITRUST SOURCE: When parties make electronic productions to you, normally they have engaged a vendor that provides them with tools to search the documents and make redactions, classify documents as privileged, and a lot of other things. When the FTC receives a production like that, do you request access to the tools that the parties have used to help you sort and review and de-duplicate the electronic production?

SUSAN CREIGHTON: When parties are providing an electronic production, we require that they provide access to a variety of widely available tools that help us sort and review the documents. We have placed increased emphasis on encouraging parties to produce to us through online sites hosted by third-party vendors (ASPs or Application Service Providers), and in that context, we require access to industry-standard functionalities. The exact nature of those functionalities is a case-by-case issue, and it may not always be the case that we want or need exactly the same tools that the parties use (for example, we don't typically focus on determining whether documents produced to us are privileged). But we need—and require—tools that enable us to review the production effectively and efficiently. The same is true when parties produce electronically to us by giving us the electronic files directly, rather than through an ASP (though lately we have not been encouraging this "direct" production method in merger cases).

We also request some forms of metadata. For example, an issue has come up recently in some electronic productions we've received that directly implicates metadata. Depending on format, when electronic documents are produced, documents that contain date codes will exhibit the date

In general, to the

extent the metadata

is responsive—for

example, it identifies

document authors,

readers, cc's and bcc's,

hidden fields, text,

codes or formulas,

or provides

other important

information—it is

clearly covered by the

second request and

should be produced.

of the production as the document date—not the date on which the document was actually created. That's not much use to us. However, some metadata fields can identify or at least narrow down the actual document creation date (and also provide other useful information, such as that there's a date code in the document!).

ANTITRUST SOURCE: Is it your practice to request metadata, track changes, and all of that for every single document produced, or just selected ones?

SUSAN CREIGHTON: Metadata comes in an enormous variety of forms, so it's difficult to give a simple answer to your question. In general, to the extent the metadata is responsive—for example, it identifies document authors, readers, cc's and bcc's, hidden fields, text, codes or formulas, or provides other important information—it is clearly covered by the second request and should be produced. By the way, this is not really a new requirement; it's always been implicit in the second request. But we have made it explicit to make sure that parties are aware of their obligations on this point. Now, having said that, we are aware that a lot of metadata may not be important or useful, and may be burdensome to produce, so metadata really needs to be handled on a case-by-case basis in discussions with the staff.

ANTITRUST SOURCE: What is the purpose of the current FTC/DOJ hearings on the Merger Guidelines; what have you learned and what do you expect to come out of them?

SUSAN CREIGHTON: The quality of the comments we've received is really excellent. I have not finished going through them; I was able to watch some, but not all, of the sessions. We're still in the process of going through and understanding and thinking about a number of the issues that were raised.

In terms of what we are trying to accomplish, I think there are a couple of things. To begin with, it's important for us to make sure that the Guidelines are as accurate and as useful as possible. Since the 1992 revisions to the Guidelines, the Agencies have not formally solicited comments from the academic community and the Bar about the Guidelines as a whole. The Guidelines are used not just by the Agencies, but also provide a reference point for state enforcement agencies, the enforcement agencies of other countries, and the courts in private litigation. Under those circumstances, we believe that it's our obligation to make sure the Guidelines continue to reflect the most up-to-date economic learning. We also wanted to find out from the Bar which portions of the Guidelines work well at a practical level, as well as which areas may work less well. Finally, the hearings also aid in our effort to make as clear as possible how the Agencies, in fact, are applying the Guidelines, so that businesses can plan accordingly.

ANTITRUST SOURCE: Have you considered revising the Guidelines to reflect more accurately what your actual practice is in respect to merger enforcement?

SUSAN CREIGHTON: I haven't heard all of the comments from the attorneys and economists who testified at the hearings, but if there was an issue that attracted widespread consensus regarding the need for revision, that would be something we would take into consideration.

ANTITRUST SOURCE: Can you identify any areas that have emerged so far in your review where people have indicated a need for revisions to the Guidelines?

SUSAN CREIGHTON: It's still too early. I don't think we even have a complete transcript of all the testimony yet.

ANTITRUST SOURCE: Are there any plans or initiatives being considered or designed to increase the acceptance of the Guidelines by courts?

SUSAN CREIGHTON: I think the Guidelines are pretty widely accepted by the courts. That said, the data released by the Agencies shows that we don't view the HHI thresholds in the Guidelines as the be-all and end-all of antitrust analysis. To the extent the courts potentially place undue emphasis on those HHI thresholds, I would hope the release of our data would be useful and informative to the courts.

ANTITRUST SOURCE: Would you consider it fair game for a party to invoke the Report on Merger Enforcement Statistics to argue against strict application of the Guidelines in a particular case involving the FTC?

SUSAN CREIGHTON: As the report itself reflects, our analysis is not driven by rigid thresholds. So I doubt there would be occasion to use the report very effectively that way.

ANTITRUST SOURCE: Do you have any additional comment on the FTC's objectives in publishing the Report on Merger Enforcement Statistics, other than the idea of greater transparency?

SUSAN CREIGHTON: In addition to transparency, our objective is to enable attorneys to provide useful guidance to their clients in terms of making reasonable business decisions regarding whether to proceed with a particular transaction. I think that for people who are frequent practitioners before the Agencies, the numbers are probably not a big surprise. Even for experienced practitioners, though, the data should provide some additional clarity. For example, if you have a client who tells you that a lot of customers are likely to complain about the transaction, you know that you have some hot documents, and you know that the Agencies are likely to view it as a 3 to 2 merger, you now can provide your client with a more detailed assessment regarding the likelihood the merger will be challenged.

ANTITRUST SOURCE: Are there any other activities that the Commission is undertaking in furtherance of its transparency goals?

SUSAN CREIGHTON: The Commission has made an effort, where appropriate, to issue statements about why it decided not to bring an enforcement action. You mentioned one of those cases, the *Genzyme* case. Another example is the Commission's statement in connection with its decision not to challenge the cruise lines merger, which generated considerable discussion in the Bar a while ago. The Commission also recently issued a short statement about a merger involving some PBMs. I think that those statements can help provide some insight that goes beyond what might be inferred if you only hear from us when we do decide to challenge a transaction.

In addition to closing statements, the Commission also has taken a number of other steps to improve transparency. One of those steps is the issuance of reports that reflect the Commission's analysis on a wide range of subjects, from the updated Oil Merger Study to the Generic Drug Study. Another effort is the Commission's participation in a number of amicus or other advocacy

statements, in which the Commission is able to address a variety of issues that are of concern to the Commission.

ANTITRUST SOURCE: Let's talk a little bit about the non-merger enforcement area. Recent developments in that area would include the *Unocal* decision and the *Rambus* decision. Would you care to comment on *Unocal* and *Rambus*, what they mean for the Commission's enforcement agenda, and what the possible next steps are?

SUSAN CREIGHTON: I can't comment on the *Rambus* case, from which I am recused, beyond observing that there obviously are important issues related to standard setting and monopolization that are raised by the case. So it will provide the Commission with an opportunity to address those issues.

As our pharmaceutical cases and standard-setting cases make clear, we believe that intellectual property sometimes can be misused for anticompetitive purposes.

As for the *Unocal* case, as you know, it is currently on appeal to the Commission from a motion to dismiss. The Administrative Law Judge in *Unocal* dismissed the case both on the ground that the conduct was protected by *Noerr* immunity and on the ground that the Commission lacks jurisdiction in cases that require a determination regarding the scope of the party's patents. Those are both extremely important issues that the Commission will now have an opportunity to address. With respect to *Noerr*, since the case comes before the Commission on a motion to dismiss, all of the facts alleged in the complaint are assumed to be true—namely, that Unocal deliberately engaged in fraud before the California Air Resources Board for the purpose and with the effect of gaining a monopoly in reformulated gasoline, and California consumers will pay an extra \$0.05 or \$0.06 per gallon of gasoline as a result. Unocal's position is that antitrust law can't reach that conduct because Unocal is entitled to perpetrate a fraud on a state agency under *Noerr-Pennington*. That seems to me to be a very important policy question with ramifications that go well beyond the specifics of the *Unocal* case. The Commission has set an expedited briefing and argument schedule, so we may get a decision from the Commission within the relatively near future.

ANTITRUST SOURCE: What would it mean to the Commission's enforcement agenda if the ALJ's ruling were upheld that the FTC doesn't have jurisdiction over IP issues like determining the scope of a patent?

SUSAN CREIGHTON: It is our position that the Administrative Law Judge's position clearly is wrong and is inconsistent with precedents of the Commission itself, including the *American Cyanamid* case, which was affirmed by the Sixth Circuit Court of Appeals. Nonetheless, if the decision were to be affirmed, it would potentially implicate important aspects of our non-merger enforcement agenda. As our pharmaceutical cases and standard-setting cases make clear, we believe that intellectual property sometimes can be misused for anticompetitive purposes. And given the steadily growing significance of intellectual property in many American businesses, we expect that this trend, if anything, is likely only to increase in the future. Accordingly, if such issues were found to fall outside the scope of the Commission's ability to challenge, we believe that this result unquestionably would be bad for consumers.

ANTITRUST SOURCE: Let's turn for a minute to the health care area where the Commission held hearings last year. There's a report in the works as I understand it. Perhaps you might comment on what we can expect from that report and what you thought was notable in the hearings?

SUSAN CREIGHTON: The health care hearings took place over twenty-four days and addressed a large number of issues that we felt merited further investigation, research, and discussion. As we are drafting the report we are continuing to analyze and discuss these issues. I'm afraid that to say anything more at this point would be premature.

ANTITRUST SOURCE: When might we expect the report?

SUSAN CREIGHTON: We're hoping that the report will be out before the end of the summer.

ANTITRUST SOURCE: What is the status of the Commission's enforcement activities in the generic drug cases?

SUSAN CREIGHTON: With respect to branded/generic settlements, the *Schering* case is being appealed, so we are in the process of preparing to defend the Commission's decision in that case. More generally, the Commission's 2002 Generic Drug Study found that branded/generic settlements of the type that have raised antitrust concerns effectively came to an end as soon as the Commission started to bring enforcement actions, back in 1999 or 2000. So these types of settlements may not pose competitive issues as frequently going forward.

In addition to branded/generic settlements, the Bureau also has devoted considerable resources to investigating generic/generic settlements, as well as Orange Book listing cases. In the area of generic/generic settlements, we have already brought one enforcement action that resulted in a consent decree, the *Biovail/Elan* case, and that remains an area we are actively pursuing. In the Orange Book listing context, we obtained a consent order against Bristol-Myers involving allegations that it had improperly listed several patents on the Orange Book. We continue to focus considerable resources investigating the potential late or improper listing of patents in violation of the Hatch-Waxman statute.

ANTITRUST SOURCE: It's obvious from the Commission's enforcement activities in the area of generic drugs and patent litigation settlements that this has been a very high priority. Do you think that the best way to address the competitive concerns that arise from these situations is through enforcement actions in the courts or through legislation designed to fix the weaknesses in the law?

SUSAN CREIGHTON: Whether legislation or enforcement provides a better means of effectively addressing a particular problem depends on the circumstances. Moreover, sometimes they may work well together, as complementary approaches. The Commission's actions with regard to generic drugs provide a good illustration. As I mentioned earlier, as soon as the Commission started bringing enforcement actions against particular branded/generic settlements, we stopped seeing settlements with provisions that raised competitive red flags. Settlements didn't stop; settlements just stopped having these problematic terms. I believe that this striking change in behavior, which is well-documented in the Commission's Generic Drug Study, provides a useful example of how enforcement action sometimes may quickly and effectively change behavior to consumers' benefit.

At the same time, the Commission's Generic Drug Study made a number of recommendations regarding how statutory and regulatory provisions might be amended to reduce competitive issues regarding another important generic drug issue, involving the listing of patents in the Orange Book. These recommendations subsequently were enacted through regulatory changes made by the

FDA and Congressional action that implemented most of the Commission's recommendations. As I mentioned, we have also brought enforcement actions in the Orange Book context, including *Bristol-Meyers*, and we remain concerned regarding the potential for abuse with respect to certain Orange Book listing issues. Many of those issues, however, have been substantially remedied by the regulatory and statutory changes that followed the release of the Generic Drug Study.

ANTITRUST SOURCE: How would you characterize the feedback that you have received on the FTC's Report on Patent Law and Competition? What do you see as the major contributions the Report has made, and where do you see the process going from here?

SUSAN CREIGHTON: Overall, the feedback has been very favorable, and I think that the Report made a major contribution in bringing a competition perspective to bear on policy issues involving intellectual property. For example, the Report highlighted the widespread perception that many patents are issued that are of questionable quality, and outlined why the issuance of questionable patents is of competitive concern and might harm innovation. The Report makes a number of recommendations regarding how the problem might be corrected most efficiently and effectively. Some of those recommendations subsequently have been a matter of vigorous discussion and debate, such as the recommendation that the presumption of patent validity be lowered from a clear and convincing standard to preponderance of the evidence. Another recommendation that has been discussed at length related to tightening the legal standard for proving non-obviousness.

ANTITRUST SOURCE: As you said, one of the recommendations was to weaken the presumption of a patent's validity, if contested. And that has drawn a fair amount of attention from the patent community. Is there any plan at the FTC to advocate or promote changes in the law along those lines?

SUSAN CREIGHTON: There is going to be a conference about the Commission's IP report in April in Berkeley, California, which should provide further opportunity for discussion and debate of these issues. In addition, the National Academy of Sciences has a report that has not yet been released, but it is due out soon, addressing some of these same policy considerations. I wouldn't be surprised if at some point this discussion and debate leads to Congressional hearings, because what is at stake—the fostering of innovation in the American economy—is of tremendous long-term importance.

ANTITRUST SOURCE: Does the Commission, though, have any plans at this point to encourage changes in the patent laws along the lines that it discussed in its initial report?

SUSAN CREIGHTON: Our plan at present is to sponsor further discussion and debate of these issues. The possibility of legislative change ultimately may be an outcome of that process, but I don't expect such legislative change necessarily to be immediate.

ANTITRUST SOURCE: Speaking of reports, the air is heavy with anticipation for the second report. Do you have anything to say about the timing or contents of the second report on IP issues following the hearings?

SUSAN CREIGHTON: We've been working hard with the DOJ but I don't think I can give you any kind of useful guidance regarding the timeframe.

ANTITRUST SOURCE: Do you see a significant prospect in the near future of the IP Guidelines being revised as a result of the intensive study that the FTC and DOJ have given to the IP and antitrust interface at the hearings and in writing the reports?

SUSAN CREIGHTON: I am not aware of any extended testimony at the IP hearings regarding changes that need to be made to the IP Guidelines. So the answer would be no, not at present.

ANTITRUST SOURCE: What would you say have been your principal accomplishments to date as head of the Competition Bureau?

SUSAN CREIGHTON: I think that the principal accomplishments have been mostly internal. Getting our litigation group up and running and providing increased litigation training for our staff have been a major focus of my efforts so far. We also have pushed forward with some additional important initiatives, like the challenge to the Evanston hospital merger and the litigation of matters before the Commission that should provide the Commission with the opportunity to address issues regarding consummated mergers and merger remedies, the scope of state action, *Noerr*, and Section 2.

ANTITRUST SOURCE: Do you have any advice for practitioners dealing with the FTC staff or the Director of the Bureau of Competition based on your insights into what it's like on the inside?

SUSAN CREIGHTON: I have been at the Commission for about two-and-a-half years now, and I continue to be puzzled why some attorneys—maybe not a lot of attorneys, but not a negligible number, either—seem to believe that it works to their client's benefit not to engage staff in efforts to narrow the scope of issues, or the scope of production, or enter into meaningful substantive discussions. Instead, they seem to think that they're better off stonewalling the staff and then raising issues for the first time at the Bureau or Commission level. And I have not yet, in two-and-a-half years, ever seen that redound to the benefit of the client. In my experience, it has uniformly benefited clients when their counsel provided data earlier, engaged in substantive discussions earlier, and resisted the temptation to dump a bunch of documents and data, certify compliance, and then try to rush the Commission. I'm sure there are steps on our part that we can take to make the process better, and I'm committed to making sure that our staff is as transparent as possible in terms of what issues we're focused on and minimizing the burden on the parties. I recognize that it's a reciprocal process. But I would encourage the private bar, for its part, to commit to that process as well, because, as I said, I believe it will ultimately benefit rather than harm your client. ●

The Digital Age at the FTC: Current Issues in Electronic Document Production and Review

D. Bruce Hoffman

Document “discovery”—the search for, production, and review of relevant documents—lies close to the heart of the American legal process, both in terms of its centrality to the resolution of legal issues and in the time and effort it requires. The last decade has seen a sea change in document discovery, from a world in which discovery largely involved the production in paper form of parties’ paper files, to a world in which most documents exist and, increasingly, are produced in electronic form. While this transformation was pioneered in private litigation, the Federal Trade Commission has recently begun to address the challenges presented to antitrust investigation and law enforcement by the rapid shift from hard copy or “analog” documents to a digital world. In this article, I review the recent history of the FTC’s Bureau of Competition’s experiences with electronic document production, provide a synopsis of the Bureau’s current approach to the issue, and discuss some unresolved questions with which we continue to grapple.¹

■
D. Bruce Hoffman is Deputy Director of the Federal Trade Commission’s Bureau of Competition. Previously, Hoffman was the Bureau’s Associate Director for the Regions. The views expressed in this article are the author’s alone, and do not necessarily reflect the views of the Commission or any individual Commissioner. I am grateful to Jack Martin, Eric Edmondson, and all of the staff of the Bureau for the insights and information on which this article is based.

A Brief History of the FTC’s Recent Treatment of Electronic Discovery

Electronic documents and, of course, electronic discovery, have been around for quite some time. In fact, case law dealing with the discovery of electronic documents dates back more than twenty years.² Parties have been producing electronic documents to the FTC for at least that long, whether in the merger review process or in litigation. Until recently, however, the FTC did not distinguish between electronic and paper documents in the production and review process mandated by the Second Request and, in particular, did not usually focus on the issues presented by electronic document production. The Model Second Request, though specifically requiring companies to search and produce electronic files, gave parties the choice either to have those files “printed and produced in hard copy” or, instead, “produced in machine-readable form (provided that Commission representatives determine prior to submission that it would be in a format that allows the agency to use the computer files), together with instructions and all other materials necessary to use or interpret the data.”³ The lack of guidance concerning what constituted a “machine-readable form” of an electronic document that would be acceptable to the investigating staff, combined with other production instructions couched exclusively in terms relevant to

¹ In the interests of space, I focus this discussion on the production of documents by electronic means (particularly in the merger context), rather than on the interesting but complex issue of how parties can properly search for and identify responsive electronic documents (though I comment briefly on some issues related to this point). Also, these comments, within the merger investigation context, are strictly related to the second request process, and are not related to the HSR notification process.

² See, e.g., *National Union Elec. Corp. v. Matsushita Elec. Indus. Co.*, 494 F. Supp. 1257 (E.D. Pa. 1980).

³ Model Second Request, Instruction C, available at <http://www.ftc.gov/bc/modelguide.htm>.

paper,⁴ seems to have resulted in most productions taking place in paper form, even where the producing parties had obtained the documents in electronic form and conducted their document review without reducing the documents to paper.⁵

By early 2002, it had become apparent that the growing volume of electronic documents, the special production and review challenges they posed, and the increased availability (and falling cost) of sophisticated systems for electronic review mandated a fresh look at electronic discovery. As a result, then-Bureau of Competition Director Joe Simons made electronic document production a centerpiece of the issues raised and considered in the merger review process he announced on March 15, 2002.⁶ This process, which involved workshops held at numerous locations across the country and numerous submissions by various interested entities, culminated in the Bureau's December 11, 2002 Statement on Guidelines for Merger Investigations.⁷

In this Statement, the Bureau for the first time explicitly encouraged parties to submit "materials in electronic format rather than in hard copy in response to a second request."⁸ The goals in doing so were two-fold: (1) to reduce the burden of document production and review (for both producing parties and the staff), while maintaining or improving the quality of the information received; and (2) to improve the speed and efficacy of Commission merger investigations. To achieve these goals, the Statement suggested changes in the Model Second Request's instructions, discussed some issues of particular importance at the time (such as the use of term searches to identify responsive documents, and issues associated with so-called backup and archive files), and, perhaps most importantly, encouraged parties to work with investigating staff to make electronic production feasible. The Statement also discussed certain production formats, based on the best information available to the Bureau at the time. Of course, as anyone dealing with digital issues might expect, the landscape in this area has changed rapidly in even the short time that has elapsed since the Statement.

Current Status and Recent Developments

In the wake of the December 2002 Statement, the Bureau has taken a variety of steps to encourage electronic production. For example, though the FTC has not yet finalized a revised Model Second Request, second requests issued after the Statement have typically dealt with electronic production issues more clearly than prior versions. Thus, recent second requests have typically:

- Changed the definition of "documents" to include, specifically, "metadata and other bibliographic or historical data describing or relating to documents created, revised, or distributed on computer systems;"
- Specifically encouraged parties to discuss burden and other issues involved in the search and production of backup and archive materials, and identified options investigating staff will consider to address legitimate concerns;

⁴ See, e.g., Instruction O(2) (requiring documents to be submitted "in sturdy cartons").

⁵ As I discuss below, electronic documents differ from paper printouts of those documents in important respects. These differences, when properly taken into account, can and should significantly influence the decision as to the proper production format.

⁶ FTC Initiates "Best Practices Analysis" for Merger Review Process, available at <http://www.ftc.gov/opa/2002/03/bcfaq.htm>.

⁷ FTC Competition Director Announces Best Practices for Merger Investigations, available at <http://www.ftc.gov/opa/2002/12/mergerguides.htm>.

⁸ *Id.*

- Revised the instruction on production techniques to provide that parties may produce electronic reproductions in lieu of original documents or photocopies, provided, among other things, that the staff approve the production format in advance; and
- Specified that the staff would consider two kinds of production formats: (a) production in a common page-based format, such as .pdf or .tiff, providing images linked to searchable text and made available to the Commission by a secure online Web-based or equivalent hosted facility offering industry standard functionality; or (b) a similar format, except produced on CD or hard drive directly to the Commission in a searchable local database format such as Summation®.⁹

Though the Statement by its terms dealt only with merger investigations, the Bureau has also sought to apply its concepts to document production in nonmerger investigations and in litigation.

The Bureau has subsequently had numerous experiences with electronic production, in a variety of formats, and has hopefully continued to learn from these experiences. Additionally, the technologies continue to advance with great rapidity—and, perhaps less positively, the volume of electronic documents and information created and retained by companies continues to grow, seemingly at an even greater rate. As a result, the Bureau has gradually changed its approach to some of the items discussed above: notably, the format for the production of electronic documents.

Several experiences with document productions in the form of large volumes of images on CDs or hard drives produced directly to staff along with Summation load files have convinced the Bureau that, at least for now, this form of production is not feasible in many merger cases. There are a lot of reasons for this. One, of course, comes down to resources. The FTC is not a computer document production company and, as a result, there are limits on its capacity to handle the logistics of electronic document productions. By necessity, and in the interest of efficiency, the FTC allocates most of its resources and energy to the actual legal and factual analysis of anti-trust issues. It cannot—and probably should not—allocate most or even a large fraction of its resources to handling the mechanics of electronic discovery. In contrast, vendors who provide electronic production services devote all or at least most of their resources to just that, including developing features, setting up and maintaining the Web sites on which the documents are produced, getting documents loaded quickly, and ensuring that access works. Perhaps not surprisingly, the Bureau's experience has been that these vendors (frequently described as "Application Service Providers" or "ASPs") handle electronic production faster and better than it does. Since speed and efficiency are of the essence to all parties in merger investigations, we have recently been reluctant to accept electronic productions (in the second request context) via CD-ROM or hard drive. Instead, the Bureau is generally looking for production through hosted repositories administered by ASPs, and it has modified the language of recent second requests to make this clear.¹⁰

⁹ The actual model text from these early post-Statement second requests stated: "Electronic formats and production methods the Commission representative will consider include, without limitation, production in a common page-based format providing images combined with or linked to searchable text files, with the files provided to the Commission either through a secure online Web-based or equivalent hosted document repository offering industry-standard access, security, and functionality deemed acceptable by the Commission representative in advance, or on an external network appliance or CD-ROM providing the files in a searchable local database format such as Summation® that provides functionalities equivalent to those available on hosted online repositories, and deemed acceptable by the Commission representative in advance."

¹⁰ Specifically, the FTC no longer includes the last phrase of the instruction cited above. The instruction now reads: "Electronic formats and production methods the Commission representative will consider include, without limitation, production in a common page-based format

With that limit, the Bureau remains flexible in terms of the ASPs, formats, and systems that it will accept. In general, of course, these issues are the parties' choices. What matters is that the system will enable the FTC to conduct an efficient and effective investigation.

Good Practices in Electronic Production

As with all merger practice, the general guideline for "good" practice in the context of electronic document production is to be informative and cooperative. In this specific context, because of the relative novelty of electronic production and the many forms it can take, it is particularly important to provide the FTC staff the opportunity to review and analyze the proposed production system in advance so that the producing parties can obtain the staff's approval. As a result, our best experiences so far have been with electronic production that involved parties who took the initiative to discuss the issues with the staff at as early a point in the process as reasonably possible. Typically, these parties have included in the discussions corporate personnel from the information technology department (so as to be able to answer staff's questions about the location, format, and storage and retrieval techniques applicable to the company's electronic documents). Though the parties' lawyers should of course be involved, filtering highly technical information through the lawyers without providing the staff the opportunity for direct contact with technical personnel tends to impede the flow of information, raise costs, and cause delays.

Similarly, the best experiences have often involved parties bringing in representatives of their proposed ASP so that the staff can meet the vendor and receive a hands-on demonstration of the system, along with an informed, accurate discussion of its features, nuances, and limitations.¹¹ This also provides the best opportunity to recognize and alleviate potential problems before they occur. The parties should also provide a "live" trial opportunity, where the staff can actually work with real documents posted on the actual system that will be in use, and should also provide production on a "rolling" basis, rather than producing all of the documents at once. (This is almost always a good idea, but it is particularly important with electronic production because it provides opportunities to identify and correct logistical or technical problems at an early point.)

Some Interesting Issues

The subject of electronic discovery by the FTC often generates strong reactions by some parties and can raise some interesting and challenging issues. Many of those issues will evolve and develop along with both electronic production technologies and the Commission's experience with them.

Do I Have to Produce Electronically? Some parties seem particularly resistant to producing electronically, and sometimes couch the issue as a legal question going to the FTC's power to compel such production. To a large extent, this issue is more illusion than substance. The relevant instruction in the second request does not presently require electronic production, even of documents that exist only in electronic form. Rather, the choice to produce electronically or not is generally left to the parties.

providing images combined with or linked to searchable text files, with the files provided to the Commission through a secure online Web-based or equivalent hosted document repository offering industry-standard access, security, and functionality deemed acceptable by the Commission representative in advance."

¹¹ Needless to say, demonstrating important functionalities to the staff in the approval phase, and then eliminating or limiting access to those functionalities during the production phase, would not be a good practice.

There are, of course, constraints on that choice that may militate toward producing at least electronic documents in an electronic format. First, electronic documents often include important information, frequently described as metadata, that may not appear when the document is printed and produced in hard copy. But some of that information (such as “blind copies” on e-mail, date information, and certain kinds of formulas, hidden text, comments, and others) is plainly responsive to the second request, and so must be produced. In such cases, producing in paper form is likely to be much more difficult than producing in electronic form.

Second, there are some kinds of documents that may not be appropriately produced in paper format alone. One likely example is Excel spreadsheets, which are not really designed to be printed. Just printing a spreadsheet and producing the printed copy omits critical information. In fact, for that precise reason the staff has typically required that spreadsheets, or at least some of them, be produced in their native formats, as reducing them to a page-based format such as .pdf or .tiff often omits much of the same information that disappears when the document is printed.

Finally, parties should seriously consider producing electronically—whether they are legally required to do so or not—for the same reasons that the Bureau is now encouraging electronic production. Electronic production can expedite the review process and allow the review to be more finely honed, allowing the staff more time to focus on substance (which is nearly always in the parties’ interest). And it appears that electronic production may be no more expensive than paper production (or even less), especially when the parties’ internal document review will use an electronic system or when the production will have to be made to more than one government agency.

What About Paper Documents? Parties also often want to know whether they are required to produce paper documents by electronic means. The answer to the preceding question should make this answer obvious: for now, at least, parties are free to produce electronically, and as a result, are free to choose whether or not to include paper documents in the electronic production. However, converting paper documents into electronic form raises a number of technical issues that are beyond the scope of this article but that should be carefully considered. Not the least of these is that because it is considerably more burdensome for the staff to review non-searchable electronic images of documents than it is to review paper, we discourage (and likely would not accept) an electronic production of scanned paper documents unless those documents have been made effectively searchable, such as by having optical character recognition software generate a searchable text file to accompany each image.¹² The cost of doing this, however, seems to be falling, and parties should bear in mind that the advantages described above—combined with the advantage of having all of the relevant documents in one place and one format—may well support the investment.

“Duplicate” Documents, Date Codes, and Other Peculiarities of Electronic Production. Electronic document production does raise a number of issues that are insignificant or irrelevant in old-fashioned paper production. The list of these issues is far too long for this article, but a couple of recent experiences merit some discussion. For example, the second request does not require parties to produce “identical” copies of documents. In the paper world, this was both obvious and largely unimportant: obvious, because whether paper copies are “identical” duplicates or not is apparent from their face (for example, if a document has handwritten notes on it, it is not identical to a copy that does not!), and unimportant because the cost of eliminating all “identical” paper dupli-

¹² For much the same reason, the Commission is unlikely to accept any electronic production that consists of non-searchable images.

cates often exceeds any conceivable benefit of such redaction, requiring as it does a physical inspection of each potential duplicate.

Neither of these things is necessarily true with electronic documents. First, determining whether documents are identical may not be nearly as intuitive or obvious as is true with paper. For example, documents containing date codes—codes that automatically update the document whenever it is accessed—may appear identical on casual inspection, but in fact each copy may be “non-identical” in the sense that each date will change whenever the document is viewed or printed.¹³ Second, many electronic discovery systems offer relatively inexpensive “de-duping,” in which all “identical” copies of an electronic document can be deleted from a company’s production, leaving only one. This process can substantially reduce the volume of a document production, offering benefits to both parties and the FTC. However, parties who choose to de-dupe must be mindful of their obligation to eliminate only truly identical duplicates and to produce bibliographic metadata with the document so that its authorship, distribution, and other pertinent information can be readily ascertained by the staff.

*Parties should resist
any temptation to try
to retain control over
the documents once
they are produced to
the agency via
the vendor . . .*

Another issue unique to electronic production through third-party vendors is the question of control over the produced documents. Obviously, when paper documents are delivered to FTC, they are out of the parties’ control, and the same is true with CDs or hard drives containing electronic documents. However, production through ASPs raises the possibility of the parties retaining some measure of control over the produced documents (such as the ability to add or remove documents after certifying substantial compliance, or to delete documents which may be subject to a claim of privilege and inadvertent production). Parties should resist any temptation to try to retain control over the documents once they are produced to the agency via the vendor, and parties and their vendors should work carefully with the staff to ensure that the applicable agreements provide adequate safeguards against any post-production interference by parties. If the staff cannot be certain that they will have the same degree of control and security over documents produced by electronic means as they would over documents produced by paper, they will rightly reject the production technique.

The Future

As the litigation bar and the courts have long recognized, electronic production is the inevitable future of document discovery. And so it is with document production at the FTC. Though the staggering volume of electronic documents will continue to present challenges, there seems to be no doubt that whatever set of those documents must be searched and then produced will increasingly be searched and produced by electronic means. The FTC is committing considerable resources to ensure that parties employing those electronic means and willing to work in good faith find an informed and receptive audience at the agency. ●

¹³ Producing documents containing date codes presents another challenging issue. Just printing the documents freezes the date at the time of printing, which does not accurately reflect the potentially important fact that the document contains a date code. Loading the document into a document production system may have the same effect. The fact that the document contains a date code—and information such as the date on which the document was actually created, viewed, or printed—can be determined from the metadata, but not necessarily from anything apparent from the document’s face. This underscores the importance of producing metadata.

Brown Bag Program

Spanning the Globe: What Every In-House Counsel at a Multinational Company Needs to Know

An ABA Section of Antitrust Law “Brown Bag” Conference Call, January 23, 2004,
Sponsored by the Corporate Counseling Committee

MODERATOR

Elise Kirban
*International Paper
Company*

PARTICIPANTS



Kenneth Glazer
*The Coca-Cola
Company*



Jonathan Jacobson
*Akin Gump Strauss
Hauer Feld LLP*



Catriona Hatton
Hogan & Hartson LLP



Aimee Imundo
*General Electric
Company*

ELISE KIRBAN: I'm Elise Kirban, your moderator today, and I'd like to welcome you all to the Corporate Counseling Committee's latest virtual brown bag, which we've ambitiously entitled, "Spanning the Globe: What Every In-House Counsel at a Multinational Company Needs to Know." I'd like to introduce you to the four distinguished panelists we have with us today. I'll do that in the order in which they're going to speak. Our first panelist is Ken Glazer, who is the senior competition lawyer at Coca-Cola in Atlanta, where he is responsible for handling competition matters around the world. Prior to joining Coke, Ken practiced antitrust law at Patton Boggs in Washington, DC. He is currently serving as Vice-Chair of the Section of Antitrust Law's Section 2 Committee.

Our next panelist is one of our colleagues in private practice, Jonathan Jacobson, a partner at Akin Gump Strauss Hauer Feld LLP in New York, where he is co-chair of the firm's national antitrust practice. Jon has taken a lead role in many significant antitrust cases over the course of his twenty-seven-year career, including *PepsiCo v. Coca-Cola* (where he indeed did work with Ken), *United States v. VISA USA*, *Eastman Kodak v. Image Technical Services*, and a number of others. Jon is also active in the Antitrust Section, and is currently Editorial Chair for the upcoming revision of the *Antitrust Law Developments*, which is moving into its sixth edition. He is also Co-Chair of the Section's Publications Committee. He has also been appointed to serve as a Commissioner on the Antitrust Modernization Commission and frequently publishes articles and books on a variety of antitrust topics.

Our third panelist is Catriona Hatton, who joins us from the Brussels office of Hogan & Hartson LLP, where she is a partner, a member of the firm's antitrust, competition, and consumer protection group, and managing partner of the Brussels office. Catriona has been practicing EU competition law in Brussels for over fifteen years and has extensive experience advising clients on

both EU and national competition law aspects of mergers, government investigations, and compliance with competition rules that apply to a wide range of commercial agreements. She has represented clients in a variety of industries, including chemicals, pharmaceuticals, media and entertainment, automotive, and energy. She also practices in the area of data protection, which is one of the topics she'll talk about today, advising clients regarding EU-wide compliance with data protection laws and issues relating to the transfer of personal data to countries outside of the EU. Catriona is a UK- and Irish-qualified lawyer and speaks English, Dutch, Italian, French, and Irish.

Our final speaker is Aimee Imundo, who is antitrust counsel for General Electric Company. Aimee is based in GE's corporate offices in Washington, where her practice includes responsibility for counseling, transactions, litigation, investigations, training and compliance—all on a global basis. Prior to joining GE, Aimee practiced law at Arnold & Porter in Washington, where she worked primarily on antitrust litigation and transactions. Aimee has also been active in the Antitrust Section and is a frequent speaker at antitrust law conferences on international, transactional, and compliance-related topics.

As you can see, we have a wealth of knowledge and experience on this panel. And with that, let me turn the program over to Ken, who will get us started.

KEN GLAZER: My topic today is how to manage multinational transactions. We really are in a new world today from what it was ten or fifteen years ago. There is now a huge amount of antitrust law around the world to worry about. There has been a veritable explosion in just the last five or ten years of new antitrust laws—countries enforcing their laws in a new and vigorous way that hadn't been the case before. Depending on who's doing the counting, we now have more than one hundred countries with antitrust laws, and that really does include the biggest, most important countries. And most of those countries have some form of premerger provision. So, the first starting point of my remarks is that antitrust law, and specifically merger law, is now a global phenomenon.

The second starting point is that while it's global, it's still jurisdiction by jurisdiction; there is no world antitrust body. If you have to do a merger filing in one country, filing in another country is not a substitute for that. Of the hundred or so countries that have antitrust laws, about seventy-five have some kind of premerger regime—that means on the same international deal you can have different outcomes—where you can have one country clearing a deal, another country rejecting it or imposing conditions. The most famous recent example of this is the *GE-Honeywell* case. Now when I say that merger law is jurisdiction-by-jurisdiction, the one big exception to that is, of course, the European Union, which now covers fifteen countries, but in May of this year will cover twenty-five countries in Europe, and that is a multinational body. But for deals that fall below the very high EU threshold, you still have to take into account the merger laws of all those individual countries. And I believe all of them, or just about all of those twenty-five countries has its own individual merger law.

So, I'm really going to be Johnny-One-Note on this panel, because my point is, we are in a new world, a world where you have to worry about antitrust law everywhere. I'm going to be making that same point over and over again in different ways. I see three implications for this in the area of deals, especially international deals. First, you have to worry about notification almost everywhere now. (I'll be getting into that in some greater depth.) The second point is that all the substantive antitrust issues that you used to have to worry about just in a limited number of jurisdictions, and especially the United States, fifteen years or so ago, you now have to worry about in a whole lot of places. The third point is now you have to have the right antitrust resources in a whole lot of places, and I'll touch on that briefly at the end.

*We are in a new world,
a world where you have
to worry about antitrust
law everywhere.*

—KEN GLAZER

Turning to the first area, I'm going to spend most of my time on this question of notification and reporting. To repeat, this is a widespread problem now. You have to worry about notification almost everywhere. By my latest count, the number of countries that have some kind of premerger regime is around seventy-five. Just to give you a sense of how that's growing, one of the leading treatises on international mergers is a book by Bill Rowley and Don Baker, and the 2000 edition of that said sixty countries have merger regimes. Today, as I say by my count, we're up to seventy-five. By the way, a good source on this is a very good publication by the Antitrust Section on international competition laws generally. But the key point I would make is, while the books are a good starting point, you cannot rely on any of them because the law is changing so rapidly. You always need to re-check. And that's because you have new countries adopting merger laws for the first time, or antitrust laws of which merger may be a part, for the first time. For example, Coca-Cola had to do its first filing in Morocco last year because of a brand new law there, which went into effect I think at the beginning of last year. India has had an antitrust law for a number of years, but they just revised their antitrust law and it now contains a merger provision. And then, of course, you're constantly having changes to the merger laws, and the European Union has just revised its laws quite extensively. So you can never go by a source that's even only one year old. You should always go back and check. Fortunately, you can now get a lot of this information on the Web and a lot of the agencies now have actually very good Web sites.

But there are now deals where literally dozens of separate jurisdictions have to be reported. This really is a new world we're living in. Going back even as recently as 1988, you really only had to worry in a big way about the United States and just a scattering of a few other countries. Then you had the European Union adopt its merger control regulation in 1989, which went into effect in 1990. And then, as I said, over the last twelve to fourteen years, dozens of new countries have come online with antitrust and merger laws. So, in the case of Coca-Cola, for example, a few years ago, we did a deal where we were buying some of the Cadbury-Schweppes beverage brands around the world and I believe the count was, we had to do at least two dozen merger filings around the world. Just to illustrate the geographical breadth now of these laws, about a week after we announced our Cadbury deal, we got a letter from the Zambian Competition Commission reminding us that they now had an antitrust law with a merger provision that requires a premerger filing. The point is, if you're in a world where you have to worry about a filing in Zambia, there really are not too many other places you don't have to worry about. And that was back in 1998, and that's six years ago and there have been a number of new countries added since then.

I keep talking about notification. Why is notification so important? If you're advising your deal people, your deal lawyers, they have to understand that these notification systems determine the whole timing by which they can complete a deal because the merger laws almost invariably have waiting periods. You have to file and then you have to wait a certain period of time before you are allowed to close. That could take six months or even longer. Your deal team has to take into account that time lag as part of the deal planning process. And it's critical for the antitrust lawyers to be part of that process from the very beginning so that it's understood from the very beginning.

In some countries you run into unusual delays. I mentioned Zambia a minute ago. We also had to file in Zimbabwe on our Cadbury deal. They had a new law and it was so new, in fact, that it was clear that we had to file but they didn't have their premerger form ready. And it wasn't ready for about another nine months. Essentially, we had to sit there and wait for them to get their form ready before we could even begin the process and start the clock rolling on that. And your deal people need to understand that it takes a lot of time to fill out these forms. Some of these forms are quite onerous. Some require a lot of substantive analysis and huge quantities of data. Some of them

require translations of deal documents, and so forth. And your deal people also need to know there are filing fees. Fortunately, most of them are not high, but there are some that are quite steep, even relative to the size of some deals.

So the first thing you have to do in a deal is figure out where it's going to need to be reported, and where there will be some level of agency review. For each of those you have to figure out the timetable. It's hard to generalize across seventy-five different laws. Each one is different and has its own peculiarities. But let me try to just make a couple of general points that apply across the board.

Of the approximately seventy-five countries that have some kind of merger regime, most of those seventy-five are mandatory, that is, if you meet the threshold, if your deal or if the parties are of a certain size, you have to notify. It's not voluntary. But even where premerger reporting is voluntary, in some cases it's what I would call voluntary in theory but mandatory in fact because if it's a deal that has serious or some significant antitrust issues, you really want to file in the first place, even if it wasn't technically required because the agencies can come after you anyway, even if you didn't have to file in advance. In other words, it's going back to the pre-Hart-Scott-Rodino situation in the United States. As a practical matter, in virtually all of those countries, you do need to pre-clear the deal if the deal is the least bit controversial from an antitrust point of view. And that's true even if you have a deal that falls below the threshold. There are many cases in which the prudent and the responsible, sensible thing to do is to notify the agency, even if you fall below the threshold.

The second observation about these premerger laws is that the business people need to understand that the scope of these laws is quite broad. They hear about merger law—they might have this idea that it just applies to a full-scale merger. They need to understand that these laws typically apply to a much wider range of transactions than just full-scale, formal mergers. They apply to all manner of acquisitions of stock, acquisitions of assets, changes of control, many different kinds of joint ventures, and even in some cases the grant or acquisition of an exclusive license. They need to understand that the reporting requirement could and very often does apply to the seller as well as the buyer, so the seller can't necessarily just sit back while the buyer does everything. They also need to understand that the laws often require the parties to take into account any other deals that the same parties might have done with each other within a certain space of time. In other words, they need to understand that they can't do a deal by little incremental steps. Incremental, smaller deals that fall below a reporting threshold may still trigger premerger review if they take place within a certain time period.

The third point I want to make about these merger laws is that each one does have a different threshold for filing and there's no way to generalize. But it sometimes takes a fair amount of time just to figure out whether you have to file. So, again, that time element also needs to be built into the planning process.

A fourth point is that a lot of these premerger laws—something like twenty or twenty-five of them—have what I'll call a triggering event or an early filing deadline. In other words, virtually all the laws say you can't close your deal, you can't consummate the transaction, until you have filed. For example, under the Hart-Scott Act, you don't have a deadline for making a filing; you just can't close your deal until you file and the waiting period has expired. But there are about twenty or twenty-five of them where you actually have to file within a certain number of days of a particular event. Typically, it is the signing of a definitive agreement. That is true, for example, of the European Union and a lot of other countries in Europe. In some cases, though, the filing requirement is triggered by something less than a definitive agreement. So those need to be looked out

for. Some companies have actually been fined in the last couple of years by the Brazilian agency for failure to file on time.

The fifth point I want to make about these laws is that some of them have a surprisingly broad geographical reach. Again, this is another counseling point. Your business people need to know that just because a deal doesn't have an immediate impact in a particular country doesn't mean that no filing is necessary in that country. There are a lot of examples of this. The leading example is the European Union because the way the EU merger control regulation is structured, there are some joint ventures that need to be filed even if the joint venture has no impact whatsoever on the European Union. If you have two companies, each of which has a Community dimension within the meaning of that phrase, and they go off and they do a joint venture in, let's say, Latin America, they will still need to notify in the EU. It seems counter-intuitive, but that's the way it is. One should not assume that there is no filing necessary in country A just because the deal has minimal or even zero impact in country A.

Your worries have

now been

internationalized . . .

—KEN GLAZER

One final point on notification: I've been discussing all this as though notification is a burden and, of course, in some respects it is a great burden, especially if you have to notify in multiple countries. But, there is another way of looking at it, which is that in some cases (this is very true, for example in the EU and in the U.S.) notification does give you a tremendous amount of comfort. If you notify and the waiting period has expired and the deal clears—you have a great degree of comfort that you wouldn't otherwise have had.

Let me just turn quickly to the substantive issues—it's really an obvious point. If you have antitrust laws around the world, or merger laws, you now have to worry about these substantive issues in all those countries, whereas in the past you only had to worry about them in the United States and just a smattering of countries. Your worries have now been internationalized, starting, of course, with just the basic question of whether the deal is doable. So you do have to go through your substantive antitrust analysis. Again, this differs from country to country. Every country has its own distinctive standard, although there are some common elements. A lot of countries focus on the dominance-type of test—they are looking to see whether the merger will result in one firm becoming dominant. A lot of countries look at the structure of the market. You have to look at this for every country where there is some impact and where notification is going to be required. Some of the countries have merger guidelines and obviously those are important to get hold of and study if that country is going to be relevant. But many countries don't have merger guidelines and many don't even have precedents. But the number of precedents is now growing around the world.

In the U.S. we've always, in the past, worried about document creation. What are our business people going to say and write in their documents? In many cases those actually have to be turned over to the FTC or DOJ. You now have to worry about that issue of document creation in 75, 80, 90 countries. You should put into place a confidentiality agreement and make sure that it covers all the countries that are at issue to prevent improper uses of information or improper information flows. You have to worry about gun-jumping issues now, not just in the United States but in quite a few countries now, as well.

And I think you also need to think about the kind of deal points, the kind of provisions that we would put in a deal document, when we have the United States in mind, exclusively. Like a provision that says the deal is subject to regulatory approval. That now needs to be internationalized. You have to think about the nature of the approval you're seeking in the number of countries, not just in the U.S. or Europe. And the various other kinds of provisions—best efforts provisions, required spin-offs and divestitures—your concerns now have been internationalized.

And then, the final area to cover is resources. Given this new world we're living in, you now have to think about having the right resources in each of the countries in which you're going to be facing some kind of regulatory scrutiny. And that means antitrust counsel, perhaps for both sides, and local counsel, perhaps even for both sides of the deal, as you would in a sophisticated jurisdiction. You may need to engage an economist, and even local economists, in various countries. You need to engage your local business people, not just people at headquarters, because they're the ones who know the markets and the impact the deal is going to have on the market. You now need to gather market share and other types of data for dozens of countries. I think that Aimee is going to go into greater depth on this resources point later in the program.

That wraps up what I was going to cover. For internal purposes, I've prepared a checklist on competition law issues that people working on transactions ought to have right there in the forefront. I'm happy to share that checklist with anyone who registers an interest. Send me an e-mail at kglazer@na.ko.com.

ELISE KIRBAN: We'll also post that checklist on the Antitrust Section Corporate Counseling committee's Web site (<http://www.abanet.org/antitrust/committees/counsel/home.html>). Jon, did you have any thoughts or questions or comments for Ken?

JONATHAN JACOBSON: It struck me that one of the particular difficulties might be negotiating risk-shifting provisions. Do you do one for the whole deal? Do you do it country by country? It would seem to me that it requires a really early assessment about the merits. How do you go about that, Ken?

KEN GLAZER: It depends a lot, I think, on the nature of the deal. I think you can distinguish between a very centralized deal, on the one hand, and a decentralized deal. A centralized deal is a merger, for example, or you're buying another company in its entirety. It's harder to break those things down on a country-by-country basis. Contrast it with a decentralized deal. Take, for example, the Coca-Cola/Cadbury deal—it really in a sense was not one deal but multiple deals because we were actually buying the trademarks in each country where those trademarks were registered. And so you had a country-by-country breakdown with respect to those types of provisions.

ELISE KIRBAN: Aimee, as an in-house lawyer, do you have any thoughts, comments, or questions for Ken?

AIMEE IMUNDO: Ken pointed out how long these merger filings can take to put together sometimes. I wonder how you face the tension that I sometimes face, which is: your business people seem to understand when you tell them that this will take a long time and yet they really want to hold back on putting the time and attention into that until the deal is sort of real, which could mean a week before signing. And then how do you manage the fact that the day they sign, they're ready for you to have filed, and want to know what's taking so long? How do you manage that and get people to buy in and actually commit the time to you early on?

KEN GLAZER: The way I deal with that is, you need to let the business people know what you're dealing with and let them know the delays that you might be facing. And warn them that if we don't do x, y, and z, if we don't hire a lawyer in this country now and make a determination or hire a lawyer to start preparing the notification form or whatever it is you need to do, it's going to cause

a delay. I hate to put it this way, but you basically shift that back to the business people. All you can do is let them know what the costs are in terms of time and then, ultimately, it has to be their call as to how they want to handle it. But, clearly, it's critical for the in-house antitrust people to be part of that process from the very earliest stage.

ELISE KIRBAN: And I think it's really an issue of managing expectations, to a large degree. I want to move now to Jon Jacobson, who is going to talk about international coordination in cartel cases.

JONATHAN JACOBSON: I'll be talking, not just about cartel cases, but the inevitable tag-along U.S. class action litigation. We'll find out from the *Empagran* decision exactly how far the international scope of that extends. Many would say that international coordination in this context is an oxymoron, and I'm quite sympathetic to that. But in reality, the need for the best possible coordination really does arise immediately when a potential cartel problem is discovered. Now, typically, inside counsel will learn about a possible cartel problem either from a U.S. grand jury subpoena—that gives you a pretty good clue—or a dawn raid—that gives you a pretty good clue—or with much greater difficulty, internally from sources within the company. Occasionally, you'll also learn of a possible cartel problem when you're dealing with an existing problem in one product line and you then may learn of another problem in a related or different product line. We certainly saw that in the *Lysine* case and in a number of the *Vitamin* cases, as well. In all of these instances, a number of very important decisions must be made very quickly, and counsel must make sure to consider the implications for all major jurisdictions that may be affected.

Often the very first question that must be asked is whether the company should apply for an amnesty. The go/no-go amnesty decision has to be made with great care but also with great speed. Time is of the essence because only the first applicant is eligible, both in the U.S. as well as in other jurisdictions that have amnesty programs. If you arrive second or third or worse, you're too late. You can always seek a reduced fine or other concessions in return for your cooperation, but amnesty as such is out. And that can be a big deal. Amnesty, when granted, means no corporate fine and no prosecution of individuals at the company. There is still civil damages liability, but in this country, the Department of Justice is even proposing legislation for de-trebling of damages for companies that have qualified for amnesty.

Even though the Justice Department and international enforcers have done a very good job in making amnesty a race to see who gets in first, the decision to seek amnesty is a monumental and extraordinarily difficult one. Once an amnesty request has been made, as a practical matter there is no going back. A mistaken decision to seek amnesty can be a nightmare if the client, after all, proves really to be innocent, or if the conduct is not really hard core. And in many cases the facts may at least be ambiguous enough that the right decision is not to seek amnesty but to fight. The key in every case, and it's very difficult, is to get to the real truth and the whole truth quickly and accurately. Outside counsel will certainly be involved, but the role of inside counsel in this process is absolutely critical. Inside counsel needs to identify the people involved, provide access to them, and most importantly gain their trust and do so on a very time-sensitive basis.

If a decision is made to seek amnesty, it's not necessary to convey to the DOJ every detail on day one. The DOJ puts a marker down for an amnesty applicant, holding the company's place in line, so to speak, for a reasonably short period of time after which more complete disclosures will have to be made. The EC has a similar process and allows what it calls a hypothetical application in which the company can apply for amnesty by reciting, on a hypothetical basis, a descriptive list of the evidence it believes it will be able to provide later on. The EC also allows a compa-

*The key in every case,
and it's very difficult,
is to get to the real
truth and the whole
truth quickly and
accurately. Outside
counsel will certainly
be involved, but the
role of inside counsel
in this process is
absolutely critical.*

—JONATHAN JACOBSON

ny to enquire preliminarily as to the availability of amnesty without identifying who the company is, so long as it provides the broad product sector. And the examples used have been chemicals, construction, transportation—broad descriptive categories—to learn if a prior application in those categories has been made. The EC also allows applications to be made orally, which can be very important in maintaining confidentiality and protecting against U.S. civil discovery, as we'll talk about in a minute.

A key point is that if a decision to seek amnesty is made, an approach to the European Commission, the Canadian authorities, and possibly other enforcers should normally be made very soon after the approach to the DOJ—very soon, as in days, and certainly not weeks. Having made the decision to seek U.S. amnesty, it is quite rare that there would be any reason not to seek the same treatment everywhere else that it may be available.

Whether you seek amnesty or not, when a cartel problem is discovered it's important to start assembling the team quickly. Aimee will talk about this process in detail later on, but let me give you a few highlights focused on cartel-like investigations. For companies operating globally, any response to a cartel investigation must at least include counsel from the EC and counsel from Canada. Depending on the company's operations, you may need counsel in Australia, Japan, and several other countries, as well. Moving quickly is important here too, for slightly different reasons. Depending on the jurisdiction, the number of top lawyers, including those who are close to local regulators, may be quite small and you don't want to be shut out by your competitors having gobbled them up. In many cases, you will also want to retain top-flight economists and econometricians, not just in the U.S., as Ken was indicating in the merger context; you may need them in many other countries, as well.

Another issue that arises almost immediately in the process is the scope of the attorney/client privilege. But that's Catriona's topic and she has an excellent presentation on it. I'll leave that for her discussion in a few minutes.

Once the team is assembled, setting up regular communications is essential. There should be at least one live all-hands meeting early on if it can be done, followed by regular—meaning at least weekly—conference calls. You should determine a secure means of e-mail communication. Be very sensitive to the privilege issues you're about to hear about and consider setting up an e-room or other resource in which rights to particular files can be monitored closely to minimize attorney/client privilege and work product issues as you proceed.

Apart from managing privilege questions, another issue that is going to be faced fairly soon is whether public disclosure is required, either under U.S. securities laws or the public disclosure laws of other countries. Typically, a U.S. company will tend to disclose a grand jury subpoena but almost never an amnesty application. Some companies disclose when there's a grant of conditional amnesty; others do not. There are no hard guidelines on this and it depends on the company and its situation and, candidly, on the lawyer giving the advice. Disclosure issues must be analyzed not only from an SEC perspective, but certainly under the disclosure laws of all jurisdictions in which the company's securities are sold. Recognition also has to be made of the fact that if you disclose in one country, you probably ought to disclose in all of them.

Now, we've heard a lot from the enforcers in the U.S. and in Canada and in Europe about how closely they coordinate their investigations. One of the concerns that arises is that if I provide information to an antitrust enforcer here or one overseas, to what extent will that be shared with other enforcers or wind up some time later on in the hands of civil treble-damage plaintiffs here in the U.S.? In most cases, documents and information provided to government enforcers will remain confidential. But this is not necessarily so, and it's quite important to be careful. In terms of the U.S.

grand jury context, information provided to a U.S. grand jury is protected under Rule 6(e) of the Rules of Criminal Procedure absent a court order based on a showing of particularized need, which is difficult to establish. As a matter of both law and practice, the Antitrust Division will not share grand jury information with enforcers from other countries absent express consent from the disclosing party, which is typically given in the amnesty context but almost never in other contexts. Antitrust Division officials will never share grand jury information with civil plaintiffs absent a court order. But there are important caveats.

First, where conditional amnesty has been granted, the company that has applied will typically consent to the sharing of information by the DOJ with enforcers outside the U.S. Frequently, the result of that will be that a lot of information is exchanged about the companies that have not applied for amnesty but, rather, are resisting the investigation. Whether or not you've applied for amnesty, consent to share documents as opposed to oral information should be granted sparingly. The consequences of voluntary disclosure and later treble damage actions can be severe, and we'll talk about that in a minute.

Second, even without consent and even without an amnesty applicant involved, nothing prevents the DOJ from discussing publicly available information with other enforcers. So if there's a news story about a grand jury subpoena that has been received, or there are names of the employees of a particular company in publicly available information like a Web site, there's absolutely nothing to prevent a call from this side of the pond to the other or vice versa saying, "Gee, you ought to check out this news story. It's very interesting." Or, "Gee, you ought to go to this Web site here. There's some interesting information for you to look at."

There are a number of express written cooperation agreements that the U.S. has entered into with the European Commission, with Canada, and many other jurisdictions. (I'll take a moment here to insert a plug for the ABA Antitrust Section's upcoming book, *International Cooperation Agreements Handbook*, which will be available for sale at the Spring Meeting and which covers this issue accurately and in great detail.)

An important fact to recognize about all international cooperation agreements, however, is that they are trumped by domestic non-disclosure laws. So, if as in the case of Rule 6(e) of the Rules of Criminal Procedure, domestic law bars the sharing of information outside the investigating agency, an international cooperation agreement will not open a loophole and allow the disclosure anyway. There's one narrow exception in the case of antitrust mutual assistance agreements, but there's only one such agreement that the U.S. has today and that's with Australia and I am not aware of the exception ever having been invoked.

In addition to the sharing of documents that may be produced particularly here in the U.S., there's an issue that comes up in every global case about documents that are located overseas. Once a criminal investigation has begun, it's important to begin addressing those issues, again, as with almost everything else, very early on. DOJ grand jury subpoenas do not reach documents located outside the U.S. Typically, a DOJ subpoena will be accompanied by a demand to preserve foreign located documents and a reservation of rights to get them. But unless the DOJ proceeds through an MLAT, which is one of the cooperation agreement types, or some other means under which the process of the other country itself is invoked to procure the documents, the documents will not be subject to production in the United States. The DOJ has been trying to streamline and expedite the process of international evidence gathering, most recently, in a speech that Scott Hammond gave in November in Japan arguing for more legislation and other cooperation in international investigations. But as for right now, in any event, it remains quite difficult for the DOJ to get access to documents that are located abroad.

This difficulty in the criminal context should be contrasted with the process in civil cases under the Federal Rules of Civil Procedure. Those rules, which obviously apply in civil, not criminal cases, and apply only after a case has been filed, allow document requests and subpoenas for documents wherever they may be located. The only limitation is that the documents must be in the custody or control of a company over which the court has jurisdiction. And, of course, the request can't be overly burdensome, and must be reasonably relevant. Strangely, if documents located outside the U.S. are ultimately produced to U.S. located parties, like treble damage plaintiffs, they can then be subpoenaed by a grand jury. But timing issues tend to make this point somewhat academic.

Now, an issue that is quite current and unresolved is what happens in the case of voluntary provisions of materials to overseas enforcers. A particular issue that has come up is whether responses to Article 11(3) requests in the European Commission and similar information requests abroad are discoverable in the U.S., including applications made for amnesty or applications made for leniency or even statements made in a candid way to get more favorable treatment from an enforcer. An Article 11(3) request, like some of these other voluntary requests, is technically just a request. There are no penalties for non-compliance. In the case of Article 11(3), it's really a slap in the face of the EC not to respond and, in any event, non-compliance will be met with a Commission order requiring compliance in short order, in any event. Article 11(3) responses include supporting documents, but the key part of the response, and the thing the U.S. treble damage plaintiffs want most, is the narrative that counsel prepares setting forth in some detail the client's version of the facts and the applicable law, which is expected to be candid. These are submissions that treble damages folks in the U.S. are always anxious to get.

To date, I'm aware of only two decisions on the discoverability in the U.S. of Article 11(3) submissions, and the cases conflict. Both decisions are by special masters, not district judges, but they are both available. One is reported on LEXIS and another is on various Web sites. My paper will be posted, as Elise indicated, and if you need the decisions, feel free to consult the paper or contact me.

The first of the two cases I mentioned was *Vitamins*, a January 2002 decision in the District of Columbia. There, the Special Master rejected all the arguments—attorney work product, self-evaluation privilege, and comity—on the grounds that the submissions were voluntary and therefore ought to be produced. With regard to comity in particular, he said that those considerations were real but they were outweighed by the important U.S. interest in disclosure. More recently, in June 2002, in the *Methionine* case in the Northern District of California, the opposite result was reached. There, the Special Master upheld the self-evaluation privilege and upheld the comity argument. And what may have been particularly important in that case, even decisive, was the filing by the European Commission of an amicus brief opposing disclosure. My feeling is that future cases will follow *Methionine* rather than *Vitamins*. But, in any event, the issue has to be top of mind when responding to requests for information from foreign governments.

ELISE KIRBAN: It makes everybody think really long and hard about the complex web of issues you've got to face when you're dealing with something that has potentially massive ramifications for your company. I wanted to ask Aimee, as an in-house lawyer, what's your response to Jon's presentation?

AIMEE IMUNDO: Of course, the multinational that I counsel is the biggest, and the need for speed is something that Jon mentioned in the face of making these decisions about whether to go for-

ward and seek amnesty or not. The analogy with moving a big organization is turning a battleship around, and it's a constant challenge to get people to focus on important things quickly. And I wonder, Jon, how it is that you can rally your clients to really focus quickly enough on these decisions, especially where it's a little bit gray or you've discovered the conduct internally and you haven't gotten a grand jury subpoena?

JONATHAN JACOBSON: With great difficulty. And the larger the company, the greater the level of difficulty. As a general rule I think if you're convinced that amnesty is a real possibility and at least needs to be considered or recommended, it's essential just to grab the general counsel physically and walk with him or into the CEO's office as soon as possible. That can be complicated if the CEO herself is involved. That can make it even more difficult and, in that event, it may be necessary to go to members of the board of directors. But, in my experience, the critical thing is to go straight to the top as soon as possible and get a decision whether to pursue the amnesty course or to do something else and, at a minimum, get a direction to people within the company to cooperate with you to the maximum extent possible. If you don't do that, and you flail about at lower levels, you're going to fail.

ELISE KIRBAN: Catriona, you're over in Europe. Any thoughts?

CATRIONA HATTON: You mentioned that the U.S. domestic rules on non-disclosure might prevent the DOJ or FTC from sending information over to the EU or to some other third country with which they have a cooperation agreement. Is it useful to use domestic rules to try, if it's in the party's interest, to prevent the transfer of the data between the two agencies?

JONATHAN JACOBSON: It depends on whether you cooperate. If you're cooperating, as a practical matter, you can't prevent it and if you try they will view it as not cooperating. How do they get around the non-disclosure laws? I think it goes back to what I was saying. All of the cartel enforcers around the world are bragging of late about how much cooperation there is, so, clearly, they are talking to one another. They're not spelling out chapter and verse how they're doing that consistent with the international non-disclosure laws, but I have no doubt that the enforcers are going to the line and I certainly have no reason to believe they're ever crossing the line, but I'm sure they're going to the line of what they can disclose in terms of what's publicly available within the limits of the national non-disclosure provisions.

ELISE KIRBAN: We're going to now move to Catriona Hatton who's going to talk about privilege and also data privacy issues and how they interplay with this.

CATRIONA HATTON: These are two distinct issues. Obviously, one concerns EU rules on legal privilege and the other the EU data protection rules. But what they do have in common is that those issues are peculiar to Europe, and the rules in this respect often conflict with the rules in the U.S. and elsewhere. Therefore, it's quite difficult to deal with these issues in the international context in which most of us are operating.

First, I'll speak about the question of legal professional privilege and the position of the European Commission on that—in particular, the fact that the European Commission does not consider in-house counsel advice as privileged, which has obvious ramifications for those of you who are practicing in-house and, indeed, for us external counsel as well. And, the first thing on the EU

In practice, all of this means that currently, in order to obtain a privileged opinion for EU Commission purposes, you need written advice from an outside counsel admitted to practice in the EU.

rules on legal professional privilege is that there are no written rules. It's not dealt with by any decision or regulation or directive. The European Commission's position is currently based on a 1982 judgment of the European Court, more than twenty years back, which is known to a lot of people as the *AM&S* judgment. The European Court's decision in that case was clear that communications between external counsel who are qualified in an EU member state and its client are privileged. But in-house counsel communications within the company are not, with the consequence that they could be seized by the European Commission in a dawn raid and can be reviewed by them and used in evidence to prove antitrust infringements.

A subsequent court case clarified that in-house counsel communications which were reporting on external counsel's advice would be privileged. So if you had in-house counsel preparing a memorandum for circulation internally, say, that "Y law firm has advised me of this and the bottom line is such and such," that will be a privileged communication for the European Commission.

Another implication of the *AM&S* judgment is that advice from external counsel—U.S. counsel or other counsel—not admitted to practice in the EU is not privileged. I think all of the debates since *AM&S*—and there's been significant debate in the last twenty years on this question—has really focused on the issue of the lack of in-house counsel privilege and not on the fact that the Commission doesn't recognize privilege for external U.S. counsel's advice. I'm not aware of any cases where the Commission has seized advice from U.S. counsel to its client, but nonetheless it still remains the position of the European Commission that they could, if they so decided, review the advice given to companies by their external U.S. counsel. So, in practice, all of this means that currently, in order to obtain a privileged opinion for EU Commission purposes, you need written advice from an outside counsel admitted to practice in the EU. Now, in practice that will often be a collaborative effort between the outside and in-house counsel, who will have had their own ideas on the issue concerned, but ultimately—and particularly for sensitive issues—the final product should be signed by an outside EU counsel in order to benefit from attorney-client privileged communication status.

—CATRIONA HATTON

I think it's safe to say that there have not been numerous cases where the Commission has relied on an in-house counsel opinion to prove an infringement. But there are a few cases where their published decisions have even quoted the in-house counsel advice as helping to prove the infringement. I'll talk about those in a minute. And there's also the pending case of *Akzo Nobel*, which is currently before the Court of First Instance. I think a lot of people are very anxious to hear the final decision of the court in that case and to see whether there might be some scope for change in the rules.

I mentioned there are two published decisions where the Commission has quoted from in-house counsel's advice. One was *John Deere* and the other was the *London European Sabena* case. They're both a few years back, but in the *John Deere* case, the Commission fined the company €2,000,000 for an export ban. The export ban was expressed in a way that the ban would be applicable provided there was no contrary legal regulation which prevents that kind of a ban. The Commission noted that—this is the Commission's quote—"John Deere's own in-house counsel expressed doubts as to the legitimacy of such a device." The Commission also noted that "Deere and Company knew that such conduct and, in particular the export ban, was contrary to EEC and national competition law. It was advised on this by its in-house counsel. Senior management of Deere and Company in Moline, including a member of the main board, was fully informed."

In *London European Sabena*, back in the late '80s, where the Commission found an abuse of dominant position, again, quoting from the Commission's decision, they said: "The infringement

was committed deliberately and Sabena could not have been unaware that it was infringing the rules of competition: on April 9, 1974, a member of its legal department stated that, in his opinion, its behavior could give rise to penalties imposed by the Commission pursuant to Article 86 (now Article 82).” These are both decisions where the Commission expressly relied on the in-house counsel’s opinion. There will have been other cases where the Commission will seize the in-house counsel’s opinion and maybe not use it or not refer to it in their decisions.

There is now a case before the European Court of First Instance, and I think a lot of people are anxious to see how that will come out in the end because it concerns a dawn raid on Akzo Nobel’s premises in the UK last February. The Commission went in and took documents and e-mails as it usually would, but including e-mails and documents from Akzo’s in-house counsel; Akzo’s in-house counsel is a registered member of the Dutch bar. And Akzo requested that the Commission return the documents. The Commission refused and was using the documents in its investigation of Akzo’s behavior. Akzo then challenged the Commission’s decision before the European Court with respect to the seizure and the reliance on the in-house counsel’s opinions. Akzo first went for interim measures before the Court to prevent the Commission from relying on these documents and the Court granted the interim measure in Akzo’s favor. The Court, significantly, acknowledged in granting the interim measures that the applicant’s arguments “justify raising again the complex question of the circumstances in which written communications with a lawyer employed by an undertaking on a permanent basis may possibly be protected by professional privilege, provided the lawyer is subject to rules of professional conduct equivalent to those imposed on an independent lawyer.” They didn’t go into the details, they didn’t need to on the interim measures case. We are awaiting the final judgment, but unfortunately it may take quite some time. But I think there is some possibility, a little window of opportunity, that there may actually be a change in the rules.

Now, the practical difficulties of trying to manage all of this is that you’ve got very different rules. Obviously, the rules are different from the U.S. rules on in-house professional privilege. But also they differ from certain EU Member States’ rules. So, for example, Ireland, the UK, the Netherlands, Spain, Norway, and some others recognize in-house counsel privilege. That all creates quite a patchwork of laws that are difficult to deal with when you’ve got investigations going on in the EU and the U.S. or EU and parallel investigations by a national member state. You could be faced with a situation where, for example, the EU seeks to rely on in-house counsel opinion delivered by UK counsel, and the UK authority would not have access to the same opinion and could not rely on it. So, here are some practical suggestions pending a change in the current rules:

- On sensitive issues requiring written advice on compliance with EU competition rules, or with national competition rules of EU Member States, it is advisable to work closely with external counsel. This does not mean that you need an opinion from external counsel on every issue of EU competition law, but there will be situations which may involve serious restrictions where it is advisable to have external counsel provide the opinion.
- It is important to ensure that communications are headed appropriately. So, for example, a communication from in-house counsel to the company that repeats or summarizes advice from external counsel should be headed “Privileged Report on Advice Received From External Counsel,” or similar wording.
- Similarly, advice from outside counsel should always be headed with appropriate language (e.g., “Attorney-Client Privileged Communication”) to show that it is privileged and confidential and that it is received from external legal counsel.

*On sensitive issues
requiring written advice
on compliance with
EU competition rules,
or with national
competition rules of
EU Member States,
it is advisable to work
closely with external
counsel.*

—CATRIONA HATTON

The EU rules are

very much in favor of

protecting all personal

information—even

information that on

any sort of reasonable

consideration wouldn't

be considered very

personal.

—CATRIONA HATTON

- The question arises as to how you should treat in-house counsel communications. Since in-house counsel communications to his/her company are considered privileged under national rules of some EU Member States and under U.S. law, and given the pending *Akzo* case, you should continue to label advice from in-house counsel privileged, with an indication that the advice is from in-house counsel. (In the event of a European Commission dawn raid, the Commission will likely review that advice; but, for example, the UK competition authority would not.)

- As to the form in which the advice is provided, you should avoid providing advice in the body of an e-mail or, if you do, always add a header indicating that the content of the e-mail is privileged and confidential. It is preferable to put the advice in an attachment. Request your outside counsel to provide their advice in attached Word or .pdf documents and that they provide appropriate headings for those e-mails.

- With regard to your paper files kept in Europe, hard copies of advice from external counsel should be kept in a separate file and clearly labeled as such. Given the pending *Akzo* case and the fact that some EU Member States recognize the privileged nature of in-house counsel's advice, hard copies of in-house counsel advice held at European premises should also be kept separately and labeled as "In-House Counsel Advice/Privileged."

On the data protection side, that's another thorny issue and, I think, one that may be very difficult to understand from the U.S. perspective because, again, the rules are so different and the EU rules on data privacy are very, very stringent. The EU rules are very much in favor of protecting all personal information—even information that on any sort of reasonable consideration wouldn't be considered very personal. There are quite sweeping rules, which govern any kind of data processing. For example, compiling even a telephone directory with individual's names is processing personal data. Likewise, accessing e-mails is processing personal data. So, that gives rise to certain issues when you're conducting an antitrust audit in the context of a compliance exercise in-house or if you engage an external team to do that, or indeed if you have a request from the U.S. FTC or DOJ for a document production that may involve you going through documents in Europe. There you need to be very careful with regard to protection, particularly of employees' e-mails, particularly the personal e-mails. As a general rule, the employer cannot demand access to computer files and e-mails that the employee has explicitly labeled as personal or private. In principle, those e-mails are protected under local privacy laws even though they are stored on the employer's equipment. There are some exceptions to this. For example, in the event of suspected criminal behavior, there may be reasons to access even the employee's personal e-mails. But because the rules vary from one Member State to another, it's quite a sensitive issue.

So, if you're in a situation where you need to access private personal e-mails of employees, you should seek advice first, or at least consider the issues probably on a national basis before doing that. If an employee has not distinguished—and some employees will not distinguish between those general business e-mails and the personal e-mails—then, in general, you can look at all e-mails, but the employee may challenge that position.

Finally, in carrying out an antitrust audit exercise or document production, you do need to be careful about what information is transferred outside of the EU because the EU data protection authorities generally consider transfers of personal data to the U.S. as illegal unless the receiving company has signed the safe harbor agreement or entered into a model contract or some other fairly limited exceptions. So that's another consideration to be taken into account.

I'm going to give a few practical suggestions as to how to deal with some of these issues when you are doing an antitrust audit or document production. I think it's a good idea to have an inter-

nal document which sets out the scope of the exercise you're carrying out and why you need to review certain employee files or e-mails. The document should show that you have given consideration to the European privacy issues and that you've taken appropriate measures to protect the employee's data as much as possible. For example, the protection measures might be limiting the number of people who review the data strictly to people who really need to see it. If possible, make the data anonymous, so that you don't identify the person from whom the data is coming. And again on the transfer issue, only transfer data outside of the EU where that's really essential.

In dealing with issues on the spot with the employees, you should provide an explanation to the employees concerning the purpose of the review. This may be an on the spot review and they may not have had prior notice but you should provide that sort of explanation to them there and then and you should also explain that you will not be reviewing e-mails that are labeled personal or private. If you have external lawyers who are doing that exercise for you, you need to give them appropriate instructions as to how to treat employees' personal or private e-mails.

Finally, again, because the transfer issue is one of the most sensitive, if the objective of the exercise can be achieved by gathering data in the EU and providing a report back to the U.S. where individuals are not identified in the report, then that's the preferable course. That won't be possible in every instance but where it is, that is the better option. It minimizes the risks. So, that's the myriad of difficult EU rules that you sometimes find yourself having to navigate.

*You would need people
in a hundred different
countries to respond to
the current laws and
you probably need
people in all the other
countries to get ready
for the laws that are
coming.*

—AIMEE IMUNDO

ELISE KIRBAN: Because of time pressures, let's go right to Aimee's presentation.

AIMEE IMUNDO: We have heard about all the things that competition law advisors to international organizations have to worry about. I've been asked to talk about how you staff it. And, I'll say a little bit about GE's model and how that tends to work for us.

The short answer is that it would be really nice to have full-time competition law specialists everywhere. But, nobody can do that. It's just impossible. You would need people in a hundred different countries to respond to the current laws and you probably need people in all the other countries to get ready for the laws that are coming. So, bear in mind that, right from the outset, it's all about compromise and trying to make a blend that's going to work for you. You just cannot have inside antitrust expertise everywhere.

GE works on a specialist model, which means that we concentrate at the corporate level with full-time specialists in certain substantive areas. Antitrust is one, environmental is another, and so on. For antitrust that will be me and a small staff to worry about these things on a global basis. Then, the company also tends to put regional experts on the ground, in Asia and Europe. Those people are going to be pan-regional experts. They're going to have local language expertise, perhaps several languages, but they're not going to be full-time competition law specialists although you're going to have some substantive specialists there if you can. For example, we've got one full-time competition lawyer in Europe now, which is tremendously helpful, but that's the only region where we have one. It would be ideal if we could have a full-time person in each region. We just can't. So, given that, that's where the full-time expertise is concentrated. Then at the business level, that's where the lawyers are closest to the business in those countries. They tend to have a litigation or a deal background or specialized regulatory expertise that might be called for by their particular business. And then, of course, for everything else, you have to rely on outside counsel. I'll say more in a little while about how we use and select outside counsel and how that tends to work for us.

I've already said a little bit about how the substantive specialists work. We don't have an army of antitrust lawyers, and I suspect nobody does. So, at many of your firms it may be just one per-

*Try to designate a
lawyer at each business
to be that business's
"expert" in antitrust
law.*

—AIMEE IMUNDO

son or it may be half a person, or a quarter of a person. But as I said, in addition to the corporate specialist, if we can get somebody at a region level, that's fabulous. We've got one, and then what's left for us is at a business level. Something that we do that I think is very, very helpful and that I would recommend, is to try to designate a lawyer at each business to be that business's "expert" in antitrust law. I put it in quotes because that person probably already has one and a half full-time jobs and so can never be an expert in competition law the way those of us who do it all day, every day can be. But, if a person can be designated, then you could institute what we have, which is a practice group. Then we try to make that person in each of the businesses be a target of update communications, which is going to help them spot issues and flag things and call up to corporate when they need us. The beauty of having one person do that is that that person is going to gain a little expertise just through interacting with you. The same questions will come up within his or her business and that person will be able to handle those questions and not call you all the time. And while, in a perfect world, I would say to everybody "call me anytime," I really don't want that to happen. I don't want everybody calling me at any time because then I could get ten different lawyers from the same business calling with the same question—instead, it's much better to grow a little expertise at the business level. And, luckily, we employ very, very smart lawyers. They get it quickly. Nobody ever calls with a stupid question—it's just that you don't want ten people calling with the same question. Of course, in a massive organization like this one, you actually wind up with a pretty robust practice group that can start trading information or get up to speed on what the corporate resources are in terms of training and let a thousand flowers bloom; but they need to be fed, they need to have a contact point. And then, best of all perhaps, they develop a relationship with the corporate resources, and because they know me, and there's a relationship that always eases the way that these things work, of course.

The role of regional experts really ends up to be coordinating the way that each of the substantive areas are handled or making sure that we're operating in a coordinated way. So I may not know what's happening in terms of licensing law that may affect some of the GE businesses or what's happening on the environmental side of a transaction that I'm working on, but somebody at the regional level is going to be thinking about that. That way I'm using a set of broad experts and it's very, very helpful in terms of coordinating across fields but not so much going down deep into a substantive area.

In the businesses, I would just point out that we have our general counsel, who I think have more of a consistency role across disciplines. Then you have your lawyers right down in the business level at the P&Ls, and it is important that a relationship be developed there because in a pinch, those are the people who know the business people who have the facts that you need. And if there's no relationship there, getting your facts is that much harder—you become almost paralyzed. And it's an opportunity to grow the expertise that you need right there. There are one or two GE businesses that have devoted a lawyer almost full time to antitrust work, although that's really the exception; generally, it's very specialized. So in our appliance business, for example, there is a lawyer who has focused full time on competition work and he has become an expert—I think he probably was before he came here—in distribution and Robinson-Patman and some of the issues that come up uniquely in that kind of business.

That brings us to outside lawyers. Though we've done the best that we can in-house, we're still going to need outside help because we can't be everywhere. We don't have lawyers everywhere. I think it's always the case that it's a bit of a patchwork quilt. You might have a business supported by a lawyer who really supports the business two or three subs up and is located, we hope, on the same continent. I can't say that's always the case.

How do we use outside lawyers, and when do we bring them in, and which ones do we pick? It's all about the outside lawyer developing expertise with the business. We're going to pull people in on big deals that are going to require a full-time person to help coordinate or actually do filings. The person at corporate, like me, may have the job of running the competition aspects of a deal, but even I can't really do that full time without dropping the ball on everything else that this company is worried about. So, to manage an international transaction and all the issues that Ken talked about—all those filings—I'll be the one more or less in charge of delivering the bad news, which is probably always the role for the inside lawyer. I'll be the one telling people how long this is going to be, the expectations, and of course helping you, as outside counsel, work efficiently and helping make sure that we are all coordinated with each other. I tend to work with a series of people, depending on what continent we've got filings in. I may focus on a smaller group to help me coordinate if we wind up with fifteen other people around Europe in Member or Non-Member states that we need to worry about.

In Europe, if there are multiple national filings I will tend to pick one counsel to help me coordinate that. And then, let's say, there are also filings in the the U.S. and Canada; so I may wind up with lead counsel in the U.S., Canada, and then somebody in Europe, and kind of leave it to them to make sure that at least those three lawyers are talking among themselves and with me, and that we get on the same page in terms of market definition, which is probably the most important thing for consistency's sake. We get on the same page on market definition and our methodology for measuring markets, how we're going to talk about the market, and perhaps even most of all, get consistent with what GE has said before in other filings (which sounds so basic and yet is so difficult to do because the lawyers wind up being the institutional memory on all of these things). Then I will leave it to those folks to coordinate on their ten separate national filings in Europe. I'll really rely on one central European lawyer to manage all that as much as possible. They may even draft a template of how the contents of a filing might generally look, sort of outline the way that we're defining the market and overall, how we see trends in that industry. Then, of course, there is the issue of getting the facts and making sure they actually work in that country, but that will be done on a more local basis, usually using a deal lawyer who is on the ground there in that country, at least in the business affected by the transaction.

On compliance matters, we tend to use outside lawyers a fair amount but usually it will be for a very specific mission. It will be because there's a particular area that has come to my attention as needing some attention either in terms of conducting an internal investigation where I'm curious about what's happening in a business or where I've identified an issue of training materials. Then I may ask an outside lawyer to get involved, maybe do some interviews at a business either to learn about its training needs or investigate something that I think needs investigating and then create some materials or, if need be, help me interact with the regulators that might have an interest there.

Of course, we've got to be mindful about privilege issues in that kind of a setting, and that's all the more reason I will rely on outside counsel there. There's just too much specialized knowledge needed about dealing with the regulators in a particular country for us to really have it inside. And I think that means probably nobody can have it inside if we can't.

As far as selecting outside counsel, I think probably like the other inside lawyers listening to this program, I tend to develop a short list and focus on those relationships. Those people will tend to learn the business. Of course, that's a life's work in GE and nobody on the outside can really know all of our businesses—probably nobody on the inside can either. So it's never going to be just one firm, but there is a lot of fluidity, especially if you have deal counsel who are trusted deal counsel

I look for someone with

local relationships

who can get informal

guidance if that's

appropriate, or also

who is familiar enough

with the practice to

be able to operate

where there is not a

developed body of

written law.

—AIMEE IMUNDO

who concentrate on a certain part of the business. I will tend to use those antitrust lawyers a fair amount because I see it as an opportunity to grow the expertise. I'm always looking for opportunities to use new outside counsel on something that's less than a bet-the-company deal the first few times I use them, to gain a little confidence. And there are always conflicts, so you can never concentrate just on one firm.

On a national level I think there's a little bit more fluidity in terms of developing a network. There is a network that we tend to use, but with much less consistency. Especially where it's a developing competition law regime, I really value outside lawyers I can find who, on the one hand, have had some experience working with U.S. clients or at least understand the U.S. business mindset, which helps them communicate with me and helps me in turn communicate expectations up or into the business. But also, I look for someone with local relationships who can get informal guidance if that's appropriate, or also who is familiar enough with the practice to be able to operate where there is not a developed body of written law. I'll give an example of something where we got tremendous help from local counsel I had never used before. It was in an EU applicant state which at that time a couple of years ago had a new merger regime. They had the form, so that was good. We did the form and we were all ready to go—we had the filing fee ready but they didn't have a bank account set up to receive the filing fee. We were just going crazy doing this, and we found a local counsel who could make all the phone calls to sort of help them get that going and find out where we could send our money. I was ready to go there with a suitcase full of cash, but I was advised that that would violate other laws, so we couldn't do that. But that's the kind of thing—there's nothing written about it in the book, so you need somebody on the ground with great local relationships, the language, the practice. I don't think it's possible to have that on the inside, you have to get that from the outside.

For GE—and I'm sure this is true for others—one of the things that makes everything so difficult is that we're not just a multinational organization, we're a multi-organization organization. That means you can acquire things and have businesses all over the world and you're not always operating with the same set of ground rules even when you think you are, as far as even controlling your own businesses or getting them to recognize the structure and how it's there to help them on something that requires some attention. I have sometimes found in some businesses a resistance to drawing in corporate resources. I think there are a couple of rationales behind that. One, is people feel like they can just do it themselves and they don't need to bother anybody and don't want to call attention. Others just feel like "I just want to be helpful, I got this nice Article 11 request from the EU and I want to be helpful so I'm just going to respond to it and send it back." That kind of thing I think happens all the time in multinationals. It's a culture there—a business culture as well as true culture—that always makes it hard. I think part of our job is to bring some real sensitivity to that and help meld the organizations. ●

Further Thoughts on Critical Loss

Michael L. Katz and Carl Shapiro

In a recent issue of *The Antitrust Source*, David Scheffman and Joseph Simons presented their views on critical loss, responding to our earlier article and a closely related article by Daniel P. O'Brien and Abraham L. Wickelgren.¹ In the interest of advancing the debate on the use of critical loss in merger analysis, and to avoid any unnecessary confusion, we take this opportunity to respond to—and correct—Scheffman and Simons.

We and they are both concerned with comparing the Actual Loss and Critical Loss faced by a hypothetical monopolist as part of a market definition exercise. In our earlier article, we showed that high observed margins strongly suggest that the hypothetical monopolist would face a small Actual Loss (i.e., demand would be unresponsive to a price increase). Scheffman and Simons assert that the process by which firms set prices is so complex and poorly understood that any such inference is unwarranted except in very special cases.

As two professors of business strategy who have worked extensively with private clients as well as served in the Antitrust Division of the Department of Justice, we are well aware that firms often take many factors into account in setting prices, and actual pricing is more complex than can be explained fully by any simple model. However, we believe that the application of powerful economic logic combined with a careful examination of the facts in each case can allow us to make considerable headway in defining appropriate relevant markets and avoiding serious mistakes. More specifically:

- Scheffman and Simons fail to appreciate the generality of the analysis that leads to an equilibrium relationship in which high margins indicate low Actual Loss. As we show below, this analysis can readily incorporate strategic reactions by rival suppliers and applies perfectly well to bidding and bargaining situations.
- The analysis is not completely general, of course, and there are situations in which the equilibrium relationship between margins and demand elasticity is more complicated than in the fundamental model. Scheffman and Simons point to the kinked demand model of oligopoly as an example where they claim our methods break down. However, as we show below, the fundamental logic that we developed in our earlier article still applies to that setting. This example illustrates a more general point: it is not enough to say that the world is complicated. Before abandoning fundamental economic logic, one must identify and examine the precise nature of the complexities and study how they affect behavior.

■
Michael L. Katz and Carl Shapiro are at the Haas School of Business, University of California at Berkeley. We thank David Majerus, Steve Salop, and John Woodbury for comments on an earlier version of this paper.

¹ See David T. Scheffman & Joseph J. Simons, *The State of Critical Loss Analysis: Let's Make Sure We Understand the Whole Story*, ANTITRUST SOURCE, Nov. 2003, <http://www.abanet.org/antitrust/source/nov03/scheffman.pdf>; Michael L. Katz & Carl Shapiro, *Critical Loss: Let's Tell the Whole Story*, ANTITRUST, Spring 2003, at 49; Daniel P. O'Brien & Abraham L. Wickelgren, *A Critical Analysis of Critical Loss Analysis*, 71 ANTITRUST L.J. 161 (2003).

- Scheffman and Simons are inconsistent in their treatment of the complexities of actual business behavior. In particular, if they really believe that pricing is so complex that there is little relationship between a firm's pricing and the elasticity of the demand that it faces, then it is rather odd that they would put any stock whatsoever in Critical Loss analysis. After all, of what relevance are Actual Loss and Critical Loss in a world where firms' pricing is heavily based on unspecified, unobserved factors that go well beyond the profitability of current sales?
- Ultimately what matters are competitive effects. A combination of high observed margins and large Diversion Ratios between the merging firms is problematic (but, of course, not conclusive) in terms of competitive effects, and the logic underlying this conclusion is extremely robust. The market definition exercise should use these basic economic principles to structure what is necessarily a fact-intensive inquiry.

In the end, this is not

a debate about the use

of facts versus theory.

It is about how to use

facts and theory

together to understand

markets and

competition.

In the end, this is not a debate about the use of facts versus theory. It is about how to use facts and theory *together* to understand markets and competition. Our fundamental point is that evidence that is alleged to show high margins and a low Actual Loss should be viewed skeptically because it appears inconsistent with premerger profit maximization.

Recognizing a Fundamental Economic Relationship

We described in our article a simple but potentially misleading "Defendants' Story" that makes arguments based on Critical Loss to support a broad market definition. The story goes as follows: With high margins, the Critical Loss is small, and thus a price increase is likely to lead to an Actual Loss greater than the Critical Loss. Because the Actual Loss is greater than the Critical Loss, a hypothetical monopolist would not find it profitable to raise price, and thus the market definition should be broadened. We emphasized in our article that this story is very incomplete because a high margin tends to imply a small *Actual Loss* as well as a small Critical Loss.²

Our analysis builds upon the observation that a profit-maximizing firm with a high margin must expect to gain very little business from lowering its price because, otherwise, the firm would find it profitable to lower price to garner additional unit sales at what would still be a high margin.³ In other words, high margins go hand-in-hand with a supplier's having a perceived demand curve that is unresponsive to price decreases (i.e., demand is relatively inelastic). Absent reason to believe that demand is much more sensitive to price increases than it is to price decreases (i.e., absent a "kink" in demand), demand will be similarly unresponsive to price *increases*. High margins thus suggest a low value for the Actual Loss. Indeed, the firm will choose a price that equates its perceived Actual Loss with its Critical Loss.

This conclusion has very powerful implications for market definition. The market definition exercise involves comparing the Actual Loss and the Critical Loss for a hypothetical monopolist. We have just explained why the Actual Loss for an individual competitor approximately equals the Critical Loss for small price changes. But the Actual Loss for the hypothetical monopolist gener-

² We also outlined a simple approach that uses the Aggregate Diversion Ratio, which is the percentage of the total sales lost by a product when its price rises that are captured by all of the other products in the candidate market. Specifically, we established conditions under which an Aggregate Diversion Ratio greater than the Critical Loss creates a presumption that the candidate product market is in fact a relevant antitrust market.

³ We repeat our earlier warning that one must take care to measure incremental costs properly when computing margins.

ally is smaller than the Actual Loss for an individual competitor. Further study is needed, of course, to see if Actual Loss is less than Critical Loss for, say, a five- or 10-percent price increase by the hypothetical monopolist.⁴

Scheffman and Simons disagree with this application of economic logic. They agree (p. 5) with us that the Actual Loss for the hypothetical monopolist typically will be lower than for an individual competitor. Where they and we part company is with their rejection of the prediction that Actual Loss faced by an individual competitor is approximately equal to Critical Loss in equilibrium.⁵ Instead, they make two claims. First, they assert that the prediction that Actual Loss equals Critical Loss is the consequence of a very particular economic model (i.e., differentiated, static, Bertrand pricing competition). Second, they assert that Actual Loss often is substantially larger than Critical Loss for an individual competitor, which makes it impossible to form strong predictions about the relationship between Actual Loss and Critical Loss for a hypothetical monopolist.

The claims made by Scheffman and Simons indicate a misunderstanding of both economic logic and what we have said. In what follows, we will address each of these claims in turn. First, we will show that the result that an individual competitor will operate where Actual Loss is equal to Critical Loss has much more general applicability than Scheffman and Simons appreciate. Second, we will show that they have overstated the importance of kinks in the demand curve in practice and they have mischaracterized how we would treat evidence of kinks.

Beyond Bertrand: Strategic Behavior, Bargaining, and More

Consider first the disagreement over the generality of the claim that, in equilibrium, a profit-maximizing supplier will operate where the Actual Loss is equal to Critical Loss. This equilibrium relationship can be expressed algebraically by what is known as the Lerner Equation. A supplier's profit margin is defined as the percentage markup of price, P , over incremental cost, C , and is expressed algebraically as

$$M = \frac{P - C}{P}.$$

Profit maximization implies an inverse relationship between the firm's price/cost margin and its perceived elasticity of demand E . That is, profit maximization implies that $M = 1/E$ in equilibrium, which is the Lerner Equation. The elasticity of demand faced by a hypothetical monopolist generally will be lower than the firm-specific elasticity of demand. This is the reason we stated (p. 52) "[w]hen gross margins are large, defense claims that the elasticity of demand is high should be treated with a healthy dose of skepticism."

Scheffman and Simons claim (p. 6) that our analysis here relies on a specific, simple model of pricing:

[T]here are a number of reasons, both theoretical and empirical, as to why these models may not be valid in a given industry setting. This is not a failing of economic theory, it is a failing of models that are too simplistic to capture the reality of the "real world" profit maximization. This is the basis of our broader concern—i.e., does the simple model of pricing . . . accurately reflect actual pricing in the industry being investigated?

⁴ As we showed in our earlier article, the Aggregate Diversion Ratio can be central to that inquiry.

⁵ Scheffman and Simons claim (p. 5) that "the Lerner Equation is not necessarily the result of the assumption of profit maximization; rather, it is the result of the assumption of profit maximization *and* imposition of a simple model that imposes some strong conditions."

Contrary to the assertions of Scheffman and Simons, no particular model of oligopoly pricing is required for the Lerner Equation to apply.⁶ In criticizing use of the Lerner Equation, Scheffman and Simons (p. 6) list a number of factors that affect pricing: “opportunity cost, bargaining leverage, relationships, competition, longer-run considerations, etc.” All of these factors are accounted for in the Lerner Equation properly applied and interpreted.⁷

We believe that the central source of Scheffman and Simons’ confusion is that they fail to appreciate the generality of the Lerner Equation as a statement about the equilibrium behavior of a profit-maximizing firm. The key to seeing the generality is to recognize that the demand curve facing a single firm acting unilaterally accounts for the responses that firm anticipates its rivals will make if it changes its price. The rivals’ responses can come in the form of price changes, quantity changes, product quality changes, or some other competitive variable. Moreover, rivals’ anticipated reactions can be the results of highly complex competitive interactions that take place over time. In other words, the firm-specific demand curve can be viewed as a summary of how an individual supplier perceives its competitive environment. With this understanding and clarification, the Lerner Index indeed reflects nothing more than profit maximization.⁸ Scheffman and Simons accept that antitrust analysis generally proceeds from the assumption of profit maximization. Thus, the lynchpin to their criticism of our work, namely our use of the Lerner Index to infer Actual Loss from observed margins, loses its force.⁹

Whatever label one puts on it, the following logic is clear. When one observes a firm with a high margin, one can infer that—given all of the considerations that the firm has taken into account in making its pricing decision—it believes that lowering its price would not lead to sufficiently greater sales to increase its profits. In other words, the individual competitor perceives relatively inelastic demand if its margin is high.

One way to see just how general is the Lerner Index relationship is to go back to the old price leadership formula.¹⁰ When setting its price, P , the price leader recognizes that rivals will likely respond to higher prices by producing more output. Call R the elasticity of supply of the rivals, K the elasticity of the underlying (standard, market) demand curve, and s the market share of the leader. The price leadership formula tells us that the elasticity of demand facing the price leader,

⁶ As noted in our earlier paper, we do rely on the standard Bertrand pricing model with differentiated products when deriving results based on the Aggregate Diversion Ratio.

⁷ In what follows, we address bargaining leverage, relationships, competition, and long-run situations. Whether or not one uses the methods described our paper, one should be very careful about measuring margins for use in Critical Loss analysis in order properly to account for opportunity cost, long-run considerations, reputation, and other factors. For example, benefits accruing to long-run relationships or the effects of positive impacts on sales of complementary products should be taken into account and will raise measured margins.

⁸ A bit of notation may help some readers appreciate the economic logic. The demand facing an individual competitor can be written as $D(p,r)$ where p is the firm’s price and r is a vector representing the actions of rival suppliers, including their prices. Suppose that the firm expects the actions of its rivals to vary with p according to $r = f(p)$. Then the demand facing the firm can be written as a function solely of p , namely $d(p) = D(p,f(p))$. Using this reduced-form demand curve, the firm maximizes profits using the Lerner Equation $M = 1/E$.

⁹ Scheffman and Simons recognize (p. 6) that their criticism of our approach is based on their view that the Lerner Index depends upon a particular simply model of pricing. “Again, remember that economic theory does tell us that AL is at least as large as CL. Only making some strong additional assumptions can we infer, as do the two papers, that AL is approximately equal to CL, which is the fundamental weakness of the two critiques of CLA.”

¹⁰ William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937 (1981).

E , is given by

$$E = \frac{K + (1 - s)R}{s}.^{11}$$

Profit-maximization then involves setting $M = 1/E$ as usual, following the Lerner Equation relationship. A high elasticity of market demand, K , a high elasticity of rival supply, R , or a small market share, s , all lead to a high firm-specific elasticity of demand facing the price leader, E , and thus a small margin. In other words, the demand curve facing a price leader accounts for changes in supply by rivals if the firm raises (or lowers) its price.

Scheffman and Simons appear to believe that the Lerner Equation fails to apply to markets with bidding or negotiation.¹² Again, they have taken an overly narrow view of the Lerner Equation. Indeed, a simple derivation shows how the Lerner Equation applies when prices are negotiated. In a negotiating situation, ultimately the supplier must form beliefs about how the probability of winning the business varies with its bid or with the floor on what price it is willing to accept. We can denote the supplier's belief about the probability of winning the business as $g(P)$, where g declines with price, P . This function plays the role of the demand curve facing the firm. Expected profits are given by $g(P)(P - C)$, where C is the incremental cost of serving this customer. Maximizing expected profits now leads to the Lerner Equation, where the elasticity of demand reflects the supplier's perceptions that a higher price is more likely to lead to a loss of this customer's business.¹³ We realize this is not the only possible model of bargaining. However, it is a rather general reduced-form approach to bargaining, and it surely reflects the very general point that the profit-maximizing price offered by a seller negotiating with a potential buyer must reflect both the danger of losing the business by refusing to offer a lower price and the margin associated with any such lost business. Moreover, the model is readily extended to cover bidding in auctions as well.

Kinky Economics

Now consider Scheffman and Simons' second objection to the prediction that Actual Loss is equal to Critical Loss in equilibrium. Scheffman and Simons (p. 6) state that "the price elasticity might be significantly different for price increases than for price decreases." In other words, they evidently believe that kinks in the demand curve at premerger prices are common. They go on to say (p. 6):

Thus, kinked demand or cost models are one reason why the Lerner Equation, and therefore the models of the two papers, will not lead to correct results but will nonetheless produce results that are consistent with economic theory. Although we agree with two papers that *theoretical* arguments based on kinks are *ad hoc*, actual behavior by customers and/or competitors may have the effect crudely equivalent to a "kink."

Apart from mentioning markets in which prices are negotiated, Scheffman and Simons appear to argue that kinks are common based on evidence relating price changes to costs changes. They

¹¹ This expression is derived as follows. Call total output X , the leader's output Z , and the rivals' combined output Y . By definition, $Z = X - Y$. Differentiate this equation with respect to P , and then multiply by $-(P/Z)$ to turn the left-hand side into elasticity form. Multiple and divide the dX/dP term on the right-hand side by X , and the dY/dP term on the right-hand side by Y . Then replace X/Z by $1/s$ and Y/Z by $(1 - s)/s$.

¹² Scheffman and Simons assert (p. 7) that "In particular, the 'price' negotiated with a major customer . . . cannot be presumed to result from setting a margin approximating 1.0 divided by the price elasticity of demand of that customer."

¹³ In this negotiation setting, the Aggregate Diversion Ratio corresponds to the *probability* that such lost business will go to other firms in the candidate relevant market.

state (p. 6): “Evidence consistent with the existence of a ‘kink’ is that significant changes in incremental costs do not get translated into changes in prices.” (footnotes omitted) As they point out (footnote 22): “It was this apparent empirical fact that was one of the reasons that led some economists years ago to propose the kinked demand model.”

We agree that evidence regarding the relative movements of costs and prices can be highly informative in a merger investigation. Following our proposed methods, such evidence might be used to overcome a presumption that Actual Loss for a single firm approximately equals Critical Loss. However, as we now explain, application of the classic kinked demand curve model of oligopoly pricing would tend to lead to the conclusion that the products sold by the firms in that oligopoly *do indeed* constitute a relevant market! We do not see how appealing to that theory is likely to support a finding of a broader relevant market.

Under the kinked-demand curve theory of oligopoly, the demand curve facing an *individual competitor* is more elastic for price increases than for price decreases and thus displays a kink at the prevailing, premerger price. The reason the firm-specific demand curve is kinked in this theory is that rivals will respond to any price decrease by the firm in question with their own price cuts, but they will not match or follow price increases.¹⁴ With this oligopolistic behavior, price increases will cause the firm to be pricing above its rivals and thus will lead to sharp losses in sales (since the other firms are assumed to sell reasonably close substitutes), but price decreases will be partially followed or even matched and thus will capture few additional sales. This theory is unlikely to apply in situations where price cuts are very difficult for rivals to detect, since (rapid) detection is necessary for (rapid) matching. Therefore, the theory seems most likely to apply in cases where coordinated behavior is of relatively greater concern. This observation will be important below.

Under the kinked-demand curve theory of oligopoly pricing, then, the relatively elastic demand curve facing the firm in question for price increases is not relevant for the hypothetical monopolist, which would have the power to raise the prices of *all* of the oligopolists. Indeed, the elasticity of the demand curve facing the hypothetical monopolist (i.e., the elasticity of the industry demand curve) is no more elastic than the less elastic side of the kink in the individual firm’s demand curve. There is no kink in the underlying industry demand curve. And the underlying industry demand curve is the one that is relevant for the hypothetical monopolist. The individual firm’s demand curve has a kink at the prevailing price, P , but the market demand curve does not.

Bearing this key point in mind, let us ask how the market definition exercise would proceed in an industry in which pricing was explained by the kinked-demand curve theory of oligopoly.¹⁵

¹⁴ Clearly, this is one rather specific model of oligopoly behavior, and a controversial one at that. In discussing this model, we do not mean to elevate this oligopoly theory above others; we are responding to Scheffman and Simons, who relied on this particular theory. We do note, however, that the demand curve facing the firm under this theory, reflecting as it does the anticipated responses of rivals to any price changes the firm might make, is a good example of the reduced-form demand curve we discussed earlier.

¹⁵ Some readers may find a formal model helpful at this point. Here is a sketch of one such model. Assume (for ease of illustration) that the differentiated oligopolists are symmetrically placed. Suppose that rivals are not expected to change their prices in response to an individual supplier’s price increases, but introduce a variable, θ , that measures the fraction by which rivals are expected to match the individual supplier’s price reductions. In other words, if one firm initiates a \$1 price cut, the other firms are expected follow by cutting their prices by $\$ \theta$. In the polar case where $\theta = 0$, we are back to the Bertrand model of pricing, there is no kink, and our methods apply without the need for any adjustments. In the other polar case, $\theta = 1$, the firm-specific demand curve for price reductions proportionately tracks the industry demand curve, i.e., the demand curve facing the hypothetical monopolist. For any given value of θ between 0 and 1, there can be a premerger kinked-demand curve oligopoly equilibrium for a range of prices bounded below by the competitive (Bertrand equilibrium) price level and bounded above by a highest price level such that no firm would want to lower its price given the partial matching by its rivals. The larger is θ , the higher are prices consistent with equilibrium in this theory. For $\theta = 1$, the range of possible equilibrium prices ranges all the way up to the monopoly (joint profit maximizing) price level.

If price cuts are expected to be matched only loosely by rivals,¹⁶ the kink is relatively mild, and we are back in the standard situation discussed in our original article. Alternatively, if price cuts are expected to be matched closely by rivals, the firms are effectively coordinating their prices prior to the merger. This coordination may be tacit, and quite legal, or it may be express, and in violation of the antitrust laws. Either way, however, it seems to be a reasonable presumption that the firms in the oligopoly collectively have already found it profitable to set prices above competitive levels. Indeed, the point of this theory is that the firms have been able to elevate prices above the non-cooperative level (one-shot Nash equilibrium) by establishing a pattern of behavior in which price cuts are quickly detected and matched. This tells us directly that the firms are engaged in at least some degree of premerger coordination. An important part of the merger inquiry will involve an assessment of whether the merger is likely to increase the danger that such coordination will either continue or become even stronger, moving the industry close to the cartel outcome. This inquiry is likely to focus on the collection of firms that are already coordinating, which suggests a relevant market consisting of those firms. Certainly the presence of successful premerger coordination by a group of oligopolists tends to support the conclusion that the products sold by those firms constitute a relevant market.

Scheffman and Simons also appear to believe that kinks are common in industries in which prices are negotiated rather than simply posted by sellers. We certainly agree that prices in many industries are negotiated, and we have personally been involved in quite a few mergers in industries where prices were negotiated. But we see no reason to believe that kinks are especially common in such industries.

We agree that a kink due to customer behavior would be present if the supplier were negotiating with a customer and the supplier were confident that the customer would pay, say \$100, and also confident that any higher price would lead that customer to pick another supplier. In that situation, the demand curve presented by this customer to this supplier is highly inelastic for prices below \$100, and highly elastic for prices above \$100.¹⁷ We again question how common these situations are in practice. We would consider it unusual in a negotiating situation for the seller to have such a sharp and clear view on how its probability of winning varies with the price it offers, with a sharp kink at \$100. If this relationship is smooth, then so is the expected profit function, and there is no kink.

If the situation above were shown to apply in a particular case, we agree with Scheffman and Simons that a somewhat different analysis would be needed. In this example, the key question for market definition (and competitive effects) would be *why* the customer will pay \$100 but no more to the supplier in question. If the reason is that the customer would switch to another firm in the candidate market, then we know directly that the hypothetical monopolist would find a price increase profitable. The optimal price for the hypothetical monopolist would be (just below) the price at which this customer would shift to some product outside the candidate market. But this inquiry is just a variation on the Aggregate Diversion Ratio analysis we have described. The probability that the customer who walks away from the negotiation when faced with a price greater than \$100 will turn to another firm in the candidate market is precisely our Aggregate Diversion Ratio.

¹⁶ That is, if θ from the previous footnote is relatively low.

¹⁷ The extreme case of this demand is a right-angle demand curve with a kink at the price of \$100 and the quantity associated with the amount of business involved in this particular negotiation.

We are unaware of any reason to believe that customers *generally* will be much more responsive to price increases than to price decreases for small changes in prices. Remember, technically a “kink” requires there to be a discontinuous change in the elasticity of demand facing the firm at the premerger price level. More generally, for the single firm's Actual Loss to be much larger than the Critical Loss for small price increases requires the elasticity of demand facing that firm to rise very sharply with price. So, while we would not rule out such possibilities, we stand by our suggestion that there be a presumption against such a kink, albeit one that is rebuttable based on evidence from the actual market in question.¹⁸

High Margins and Diversion Ratios Create a Narrow-Market Presumption

Especially if the world is complex, it is best to focus on what changes due to a merger. Holding aside efficiencies and more generally how a management team may change the acquired firm's strategy, the big change in terms of competition is the internalization of what had been competition between the two firms. If Firm *A* raises price, a certain percentage of lost sales are captured by Firm *B*. By applying Firm *B*'s margin to these sales, we can estimate the impact on Firm *B*'s profits, which will be accounted for post-merger by the combined entity in setting the prices of Firm *A*'s products. This fundamental economic logic tells us, very generally, that the magnitude of the effect of the merger on price is likely to be greater, the larger is the product of the Diversion Ratio and the Gross Margin. This observation is valid regardless of all the myriad factors that affect the pricing of Firm *A*'s products and do not change due to the merger. The methods described in our earlier article use this logic at the market definition stage of the inquiry.¹⁹ Comparing Aggregate Diversion Ratio to Critical Loss, one finds that higher Diversion Ratios and higher Gross Margins tend to lead to narrower markets.

There Is More to Merger Analysis than Market Definition

We wish to emphasize that our entire analysis was directed at the task of defining relevant markets. This task should not be confused with the assessment of likely competitive effects and efficiencies. Indeed, we are concerned that in horizontal merger cases antitrust litigation sometimes places too much weight on defining relevant markets rather than on assessing the likely competitive effects and efficiencies of a proposed merger. Evidence relevant to assessing competitive effects includes evidence that is typically not part of the market definition exercise as described in the Horizontal Merger Guidelines, such as the ability of small firms to expand production, product repositioning, entry conditions, and efficiencies. It is incorrect for Scheffman and Simons to say (p. 8) of our analysis that “information on incremental margins and evidence consistent with ‘significant’ cross elasticity of demand leads immediately to a (rebuttable) presumption that the merger is likely to be anticompetitive.” The presumption we propose applies only to market definition.

¹⁸ As we pointed out in our earlier article, kinks in the cost curve can be analyzed similarly. Such kinks usually are associated with sharp capacity limits, in which case great care must be taken in properly measuring incremental cost for the purposes of calculating margins. Also, because the market definition exercise involved a non-transitory increase in price, it is appropriate to look at the cost curve over a non-transitory time period, which may well, depending upon the industry, permit increases in capacity to take place, so there would be no kink in the relevant cost curve.

¹⁹ See Carl Shapiro, *Mergers with Differentiated Products*, ANTITRUST, Spring 1996, at 23, for a discussion of how to use this same fundamental logic to structure the inquiry into competitive effects.

Is Critical Loss Analysis Misused?

Finally, we observe that Scheffman and Simons state that

in our experience at the FTC (and outside the FTC), we have rarely seen parties make “serious” claims about market definition based simply on high margins and a corresponding low Critical Loss. In the few instances in which they did so, FTC staff quickly disabused them of the utility of that argument. (p.4)

We are encouraged to hear this, and we hope that the FTC and the DOJ will indeed reject the simple “Defendants’ Story” that we have criticized. Based on our experience, however, we remained concerned that the courts may be susceptible to that story.

We therefore encourage the antitrust community to clarify this point to help courts properly use critical loss analysis in future merger cases. If this debate helps prevent the future misuse of critical loss analysis in litigated merger cases (e.g., by making it much harder for economic experts testifying on behalf of the merging parties to misuse critical loss analysis) we will consider this entire interchange highly productive. ●

Erratum

The formula in note 33 in our article (*Antitrust*, Spring 2003, at 49) giving a starting point for the predicted post-merger price increase is incorrect. We regret this error. With linear demand, the correct formula is given by

$$\frac{MD}{2(1-D)}$$

With constant elasticity demand, the correct formula is given by

$$\frac{MD}{(1-M-D)}$$

Derivations of these formulas are available at <http://faculty.haas.berkeley.edu/shapiro>. A discussion of these formulas can be found in Carl Shapiro, *Mergers with Differentiated Products*, *Antitrust*, Spring 1996, at 23.

The State of Critical Loss Analysis: Reply to Scheffman and Simons

Daniel P. O'Brien and Abraham L. Wickelgren

Scheffman and Simons' (S&S's) principal defense of critical loss analysis (CLA) is that "it is 'just arithmetic' and completely neutral as to the appropriate theoretical model that best explains any real life market."¹ If this characterization were accurate, and if CLA were likely to give the right answer in merger analysis most of the time, we would applaud its use. However, we do not believe that this is the case.

First, CLA involves much more than "just arithmetic." It requires *estimating* margins and demand elasticities using a consistent economic framework. Estimation is highly involved, and a consistent framework is required for the estimates to have meaning. By "consistent framework" we mean an estimation framework that incorporates basic axioms of economics. S&S say that they are not anti-economic theory, but their characterization of CLA as "just arithmetic" leaves significant doubt. If CLA really were "just arithmetic," economics would have *no* role.²

Second, the model-free nature of standard³ CLA that S&S praise so strongly is the heart of the problem with the technique. We fully accept the scientific principle known as "Occam's Razor," which strives for simple theories with the fewest assumptions necessary to explain observed phenomena. However, standard CLA is so model-free that it can generate predictions that are inconsistent with basic economic principles (e.g., optimizing behavior). In short, we think standard CLA takes Occam's Razor much too far. In our view, this has led to erroneous predictions in important merger cases. We also believe it has diverted attention away from the real factors that govern premerger and post-merger pricing incentives.

■
Daniel P. O'Brien and Abraham L. Wickelgren are economists at the U.S. Federal Trade Commission. The views expressed here are our own and do not purport to represent the views of the Federal Trade Commission or any Commissioner. We thank Denis Breen, Dan Hosken, and Mike Vita for helpful comments.

CLA Is More Than "Just Arithmetic"

Scheffman and Simons' three-step approach to implementing CLA is as follows:

1. Estimate the incremental margin and calculate the volume the hypothetical monopolist would have to lose to make the hypothesized price increase unprofitable (the "Critical Loss" or "CL");
2. Separately determine as a factual matter what the Actual Loss in volume is likely to be as a result of the hypothesized price increase (the "Actual Loss" or "AL");

¹ David T. Scheffman & Joseph I. Simons, *The State of Critical Loss Analysis*, Antitrust Source, Nov. 2003, at 2, <http://www.abanet.org/antitrust/source/nov03/scheffman.pdf>.

² The cornerstones of economics are optimizing and equilibrium behavior among firms and consumers. Arithmetic is a tool used to build and support these cornerstones, but it has nothing to do with the cornerstones themselves.

³ By "standard CLA" we mean CLA conducted according to the three-step approach presented by S&S.

3. Compare estimates of Actual Loss with Critical Loss. If the former is larger than the latter, then the market must be expanded.”⁴

Step One requires estimating the premerger incremental margin. Although antitrust analysts often apply simple arithmetic to accounting data to obtain crude estimates of margins, it is well understood that accounting data can yield unreliable estimates of economic margins. The most significant problem is that accounting costs may not reflect actual economic costs. Therefore, a reliable estimate of the economic margin requires a more elaborate analysis. One approach is to use econometric methods to estimate the firm’s cost function using data on output and factor prices. This is seldom done in merger analysis because of time constraints and the cost of assembling and analyzing the appropriate data. What is typically done instead is to check whether margins estimated from accounting data are consistent with other information relevant to the firm’s optimal pricing decision.⁵ For a profit-maximizing firm, relevant information includes evidence about how the firm’s sales would respond to changes in its price. So a careful estimate of the margin, which critical loss analysis requires, involves much more than arithmetic.

Step Two requires estimating the actual loss that would result from a hypothetical price increase. Estimating consumer responses to changes in prices is also a complex undertaking. A variety of information may be relevant, including testimony, business planning documents, survey evidence, and econometric estimates of demand. All of these methods yield imperfect estimates of the actual loss. As a result, regardless of the method used, one should check whether estimates of demand elasticities are consistent with other evidence that provides information about demand elasticities. For a profit-maximizing firm, this includes evidence about the firm’s margin. While the exact relationship between the margin and the elasticity of demand will vary based on the particular theory of oligopoly employed, we know of no economic theory in which firms have positive price-cost margins that are invariant to demand elasticities.⁶ Again, a careful estimate of the actual loss, which critical loss analysis requires, involves much more than arithmetic.

Step Three is the only one of the three steps outlined by S&S that is “just arithmetic.” However, this step requires comparing the actual loss from Step Two with the critical loss from Step One. The quality of the inference one can draw from this comparison is only as good as the quality of the estimates in the first two steps, which both involve much more than arithmetic.

On the Linkage Between Margins and Demand Elasticities

We find it curious that S&S would use the word “separately” in Step Two of their description of critical loss analysis: “Separately [i.e., separately from margin estimation] determine as a factual matter what the Actual Loss in volume is likely to be.” Since there is no economic theory under which a profit-maximizing firm will have a positive margin that is independent of the demand elasticities (actual losses) it faces, the S&S approach of separating margin and demand analysis can, and often does, lead to predictions that are not consistent with any economic theory.

⁴ Scheffman & Simons, *supra* note 1, at 3.

⁵ This consistency check is appropriate even if margins are based on econometric estimates of the firm’s cost function.

⁶ There are economic theories under which a firm may have zero economic margin regardless of the demand elasticity. For example, an upstream firm selling to a downstream monopolist may find it optimal to charge a wholesale price equal to marginal cost and use a fixed fee to collect its profit. In this example, the wholesale price does not depend on the demand elasticity. However, this example is not relevant for the application of CLA to industries in which firms have positive margins.

“One should not increase beyond what is necessary the number of entities required to explain anything.”

—Occam’s Razor

To understand this point, it helps to consider a simple example that illustrates one way that separating margin and demand analysis can lead one astray. Consider a merger between two firms, A and B, which have constant marginal cost, do not face binding capacity constraints, and are unable to coordinate their pricing prior to the merger. Suppose the estimate of the premerger margin for both A and B is 50 percent, and the estimate of the aggregate elasticity of demand for products A and B is 3 at prices within, say, 5 percent of the premerger price. This means that the actual loss in unit sales from a 1 percent increase in the prices of both A and B would be 3 percent. The critical loss for a 1 percent price increase in this case is about 2 percent.⁷ So the application of standard critical loss analysis would suggest that a 1 percent price increase would not be profitable because the estimated actual loss exceeds the estimated critical loss. We have seen critical loss analyses like this numerous times.

The problem with this type of critical loss analysis is that, in this example, the premerger prices of firms A and B exceed the monopoly price. We know this because the monopoly margin is no higher than the inverse of the elasticity, 33 percent, which is less than the premerger margin of 50 percent.⁸ Therefore, firms A and B could increase their premerger profits by cutting price either unilaterally or in concert. This example shows that the critical loss analysis embodied in S&S's three-step approach need not be consistent with profit maximization. This runs counter to their claim that the only assumption required for CLA is "the simple assumption of profit-maximization."

One might argue that this example amounts to a straw man, since we chose the numbers and the assumptions (smooth demand and costs and no premerger coordination)⁹ to illustrate how the prediction from standard CLA may be inconsistent with economic theory. However, we have seen many critical loss analyses that commit this logical error. An example is the critical elasticity analysis conducted by the defendant's experts in the *Swedish Match* case (see the discussion in our original article).¹⁰ A less obvious inconsistency in standard CLA occurs when the cross elasticity (or diversion ratio) between the products of the merging firms is too large for the margin assumed in the CLA analysis to be consistent with profit maximization. We have argued that this inconsistency was present in the critical loss analysis presented by the defendant's expert in the *Poplar Bluff* case (see our original paper).¹¹ We have seen numerous other examples that we are not at liberty to discuss because the information cannot be made public.

⁷ Recall that $Critical\ Loss = (\% Price\ Increase) / (\% Price\ Increase + Margin)$. In this example, the critical loss equals $1 / (1 + 50)$, which is slightly less than 2%.

⁸ Given the assumptions in this example, the optimal premerger margin is $Margin = (Price - Marginal\ Cost) / Price = 1 / Own\ Elasticity\ of\ Demand$.

⁹ We believe these assumptions represent the "normal" case in differentiated products environments. In most of the empirical work that has been done testing oligopoly models, the investigators have not found a reason to allow for kinked demand or costs, suggesting that the assumption of smooth demand and costs is a reasonable approximation in many instances. Coordination tends to be difficult in differentiated product environments. Of course, there are exceptions.

¹⁰ Daniel P. O'Brien & Abraham L. Wickelgren, *A Critical Analysis of Critical Loss Analysis*, 71 ANTITRUST L.J. 161, 182–84. The experts in *Swedish Match* also assumed that demand and costs were smooth and that there was no premerger coordination. In a subsequent article on this issue, one of the *Swedish Match* experts appealed to premerger coordination (see http://www.nera.com/wwt/newsletter_issues/4795.pdf). Specifically, he argued that *Swedish Match*'s "perceived" own elasticity of demand was higher than its actual elasticity because a price reduction was likely to set off a price war. If true, that would indicate that the chewing tobacco firms were engaged in a form of tacit coordination prior to the merger.

¹¹ See O'Brien & Wickelgren, *supra* note 10, at 179–82.

As we noted in our original paper, special conditions,¹² such as kinked demand or costs, or premerger coordination, may in some cases reconcile evidence about margins and the actual loss with rational economic behavior.¹³ S&S also appeal to kinked demand or costs as possible ways to reconcile estimates of margins and the actual loss with rationality. However, they do not offer specifics on the nature of the required kinks, how to evaluate their presence, or what other implications the kinks might have for evaluating the merger.¹⁴ We have seen numerous examples of standard CLA where one of these conditions was required for the reported margins and actual losses to make any sense. However, we have never seen a critical loss analysis in which the presenter appealed to any of these conditions. Our position is that if demand is known to be kinked, then this fact should be incorporated in the oligopoly theory used to evaluate the merger.¹⁵

S&S also suggest that bargaining between the buyer and seller might be sufficient to reconcile evidence of margins and the actual loss with economic theory. The way S&S address this point is illustrative of our problem with their approach. They point out that when firms bargain over prices, margins may not equal the inverse of demand elasticity. However, they go no further than this. They do not attempt to explore how bargaining might affect the margin-elasticity relationship, nor do they examine the implications that negotiated prices might have for CLA. In fact, bargaining does alter the relationship between margins and elasticities, but it typically does not sever the relationship completely, as assumed in standard CLA. This is illustrative of the fundamental problem with CLA: it encourages the mechanical application of a formula based on imprecise estimates without regard to whether the estimates and predictions make sense given the prevailing market institutions.

S&S apparently do not find it important to be explicit about the particular special conditions (e.g., kinks at or coordination on the premerger price) that may be required to reconcile evidence about margins and the actual loss. Instead, they would apparently argue that if some special condition is required to make the evidence consistent, then some special condition “must” actually hold. However, an alternative explanation that is at least as plausible is that the estimates used in the CLA are wrong. S&S seem to believe that kinked demand or costs at the prevailing price, or premerger coordination, or some other unspecified special condition, are more likely occurrences than the mis-estimation of margins or the actual loss (demand elasticity). We do not understand the basis for this belief. As we discussed above, developing estimates of margins and the actual loss are highly involved tasks. Our position, which we stated in our original paper, is as follows: in instances in which special conditions like kinked demand, kinked costs, or premerger coordination on the prevailing price are required to reconcile estimates of margins and the actual loss

“Everything should

be as simple as it is,

but not simpler.”

—Albert Einstein

¹² By “special conditions” we mean conditions that tend not to appear in the initial exposition of oligopoly theory in undergraduate textbooks. For the purposes of this discussion, we include kinked demand, kinked costs, and coordinated behavior in this category.

¹³ It is important to note that an actual kink is required. Smooth, but rapidly changing, demand elasticity does not make this analysis consistent with economic theory because it will still be the case that a small price decrease would increase the profits of the two firms prior to the merger.

¹⁴ The nature of the assumed kink is important. For example, one theory of kinked demand is that the demand facing an individual firm may be more sensitive to price increases than to price reductions because rivals may tend to follow price increases but not price reductions. This theory, originally due to Paul Sweezy, *Demand Under Conditions of Oligopoly*, 4 J. POL. ECON. 568 (1939), is now recognized as a naive form of tacit coordination. See JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 240–44 (1988).

¹⁵ For example, the consultants for the defendants in *Swedish Match* assumed that demand was smooth (not kinked) at prevailing prices in their estimate of the actual loss. This assumption rules out kinked demand as a potential way to reconcile their results. The remaining possible explanations are kinked costs, such as capacity constraints, premerger coordination, or erroneous estimates of the margin or actual loss.

with economic theory, if the parties do not present evidence that one of these conditions is plausible, then one should infer that either their margin or actual loss estimates are very inaccurate.

The Use of Economic Models in Antitrust Analysis

S&S say that the beauty of CLA is that it does not require any assumptions beyond profit maximization. By contrast, they say that our analysis (as well as that of Katz and Shapiro) “depend[s] on the applicability of their (too simplistic, in our view) economic models to the facts of a particular merger and industry.”

We have emphasized the importance of looking at all the evidence and using it to develop a consistent picture of the market. That is, there should at least be a reasonable economic model for which one’s estimates of the market demand elasticity, cross-elasticities, and existing margins are all consistent with profit maximization. Of course, the parties may disagree about what economic model is most appropriate for the industry in question. The great benefit of economic modeling is that it forces the analyst to be explicit about the assumptions driving the analysis. The debate over the appropriate model then boils down to a debate about which assumptions are most appropriate given the prevailing market institutions.

We demonstrated above that in some cases the S&S approach can lead to predictions that are not consistent with profit maximization. In other cases, a great deal of imagination may be required to reconcile estimates of margins and the actual loss with economic theory. We see little beauty in this.

As to the simplicity of the assumptions we used in our critique of standard CLA, we emphasized that the particular oligopoly model chosen was not important for our main points. We noted that standard CLA ignores completely the relationship between margins and elasticities and the role of cross elasticities, and we explained the consequences of these omissions. We noted that the prediction of standard CLA—that mergers are less likely to be anticompetitive when margins are high—is inconsistent with most oligopoly theory. Although we chose the model of differentiated Bertrand competition to make these points, we noted that we could have made them using other widely-used oligopoly models, including that of Cournot competition or that of a dominant firm facing a competitive fringe. Our key points are quite robust.

We agree with S&S that the Bertrand model we employed in our article is relatively simple. When competition takes place on dimensions other than price, or when dynamic considerations play a role, the oligopoly theory used to analyze the merger should account for these factors, if they are significant. However, the S&S characterization of the static Bertrand model as “simplistic” is quite curious given that their CLA completely ignores the margin-elasticity relationship that almost any model of profit-maximizing behavior requires. The Bertrand model, by contrast, assumes rational behavior among competing oligopolists. Its two main building blocks are profit maximization and equilibrium behavior, which are the fundamental building blocks of all of oligopoly theory. The assumption that competition is static (one period) and that firms compete by choosing price (Bertrand) are details that can be changed to correspond to the specific institutions. The main points in our article rely on the two key building blocks, not on the specific assumption of Bertrand competition.

S&S appear to dislike using economic theory to analyze mergers. They say that the Bertrand model is too simplistic for merger analysis, yet they offer no alternative framework for making consistent predictions. They say that they are not anti-economic theory, but their failure to incorporate relationships implied by economic theory into their critical loss analysis leaves significant doubt. Merger analysis is prospective and therefore requires the intellectual discipline imposed by basic

economic reasoning. Standard CLA, as presented by S&S, is not enough to make valid predictions about the effects of mergers on a consistent basis. More structure is required. We think the static Bertrand model does quite well explaining behavior in some environments (e.g., differentiated markets where premerger coordination is unlikely, firms are not capacity constrained, and price is the most important strategic variable). However, it is clear that this model does not fit every situation. If S&S do not like the static Bertrand model for analyzing differentiated products mergers, then they are free to adopt (or develop) an alternative model that fits the market institutions better in a given situation. However, they need to use some economic model in order to make predictions that are consistent with economic theory. Standard CLA does not do this. ●

Book Review:

Law, Economics, and Intellectual Property

William M. Landes & Richard A. Posner

The Economic Structure of Intellectual Property Law

Harvard University Press • 2003

Reviewed by Thomas F. Cotter

George Priest is a law professor at Yale and one of the better-known figures—along with such luminaries as Richard Posner, Ronald Coase, and Guido Calabresi—in the law-and-economics movement. In 1986, Priest published an article in which he lamented that “economists can tell lawyers ultimately very little about how to enforce or interpret the law of intellectual property.” As Priest knew, the principal economic justification for the state’s conferral of exclusive rights upon inventors and authors is the intuition that, absent these rights, rational actors would prefer to copy others’ inventions and works of authorship, rather than to invest in creating and publicizing their own, because copying is often cheaper than creating (or discovering creative works that are worth publishing). Of course, if everyone followed this “free rider” strategy, nothing would ever be created or published; and so rights in intellectual property (IP for short) can be viewed as a sort of correction for a potential market failure.

Critics of IP, however, had long noted the social costs of IP rights, which can in some cases confer market power and limit public access. Some of these critics (including a former Harvard Law School professor named Stephen Breyer) had also noted that inventors, creators, and publishers often are motivated for reasons other than money—and that, even when they are motivated by money, they may have other means (such as simply being the first in the market with a new product) for recouping their fixed costs before the inevitable onslaught of free riders. Finally, while in theory a carefully tailored IP law could balance the social costs and benefits in such a way as to maximize the surplus of the former over the latter—to resolve the “incentive-versus-access” problem in the optimal way—no one has ever devised a method for determining exactly where that optimal balance lies. Given this fundamental, probably insoluble dilemma at the heart of IP law, Priest doubted whether economics would ever have anything meaningful to say about the appropriate scope or duration of IP rights.

Notwithstanding Priest’s doubts, the last fifteen years or so have witnessed an explosion, not only in the importance of IP and IP law to domestic and foreign commerce, but also to the economic analysis of this body of law. (By economic analysis I mean, roughly, the use of microeconomic and industrial organization theory to predict the consequences of legal rules, typically based upon the assumption that actors frequently, though not necessarily always, behave in predictable ways in response to incentives.) Economic theory as it relates to IP law is now a common topic of discussion in the leading law journals. More importantly, economic theory often takes center stage in judicial and even legislative discourse over IP rights, as policy makers grapple to

■
Thomas F. Cotter is a Professor of Law and the Director of the Intellectual Property Program at the University of Florida. Fredric G. Levin, College of Law.

formulate, apply, extend, and adapt legal doctrine to phenomena ranging from Napster to domain name disputes to business methods patents.

The Economic Structure of Intellectual Property Law, a new book by William M. Landes—an economist who holds the Clifton R. Musser Professorship of Law and Economics at the University of Chicago Law School—and Richard A. Posner, the federal judge, former law professor, and now lecturer at the University of Chicago, and prolific author of countless books and articles on a vast range of topics, many of them steeped in the economic analysis of human behavior—comes as a welcome addition to this growing body of literature. The book is based in part on a series of law review articles that Landes and Posner have authored since the late 1980s, but it contains substantial revisions of these works and a considerable amount of new material, including several empirical studies. Landes and Posner acknowledge the intractable nature of the incentive-versus-access problem, but they argue that the problem does not imply, as Priest thought, that economics has nothing useful to say about IP law. In fact, as they demonstrate, there are a variety of ways in which economics can shed much light upon IP doctrine and policy.

The bulk of the book is devoted to copyright and patent law, both of which bodies of law arguably provide much stronger protection today than they did even twenty-five or thirty years ago. Since that time, the copyright term has been extended and copyright rights have proliferated; meanwhile, the Court of Appeals for the Federal Circuit, which since 1982 has heard all appeals in patent infringement cases, appears to most observers to have adopted a more pro-patentee stance than did the regional circuit courts of appeals before it. The impact of these changes upon social welfare is debatable. Because existing works and existing inventions form part of the capital stock from which future works and inventions are derived, strengthening the protection of existing works beyond what is necessary to induce their creation and public dissemination may induce more cost than benefit. Landes and Posner are skeptical—more skeptical than I recall them being in the published articles upon which some of their analysis is based—of the effects of some of these long-term changes, and towards the end of the book they speculate on why, in an era characterized by government deregulation, government largesse in the form of copyright and patent rights has expanded. (They conclude that it's not *all* due to the lobbying of the entertainment industry.) They repeatedly stress—as have others before them, including Thomas Jefferson—that IP is different from real and personal property insofar as (much of) our intellectual creations tend to be, in the absence of legal protection, both nonrivalrous and nonexcludable. In economic parlance, “nonrivalrous” means that many people can enjoy a good at the same time without depleting it; ideas are nonrivalrous but your personal computer is not. “Nonexcludable” means that, once you have disclosed the good to others, you cannot easily prevent their using it; again, ideas tend to be nonexcludable whereas tangible things are not. IP law is one way to make some products of the mind excludable, and hence artificially scarce.

This scarcity can be a huge problem, as when life-saving (but patented) drugs are priced too high for impoverished people to afford them. But it can also have some positive effects, and (importantly) these are not limited to the much-discussed incentives to create and disclose. As Landes and Posner argue, the law-and-economics of property rights *does* have some useful things to say about IP—some examples follow below—even if the fit between IP, on the one hand, and real and personal property, on the other, is not perfect. Nevertheless, IP is different enough from real or personal property that analogies with the latter *can* be harmful, if only because these analogies may lead one to the false conclusion that IP rights should be as robust and resistant to exceptions as are rights under real and personal property law. The fact that exist-

ing IP is an important input into the creation of future IP is an important distinguishing factor, one that occasionally calls for radically different treatment (such as the fair use doctrine in copyright, and analogous though less expansive doctrines in patent and trademark law) from other property regimes.

One way in which economic analysis can prove useful to IP law is to begin with the assumption—an arbitrary one, to be sure, but one has to start somewhere—that the existing scope and duration of IP rights are more or less optimal (or at least, that they are a given), and then try to ascertain whether specific incremental changes in doctrine would lead to better or worse outcomes, as measured by some standard of social welfare. On this basis, for example, Landes and Posner advance a general argument in favor of an expansive reading of copyright's fair use doctrine in some circumstances, such as when a work was not intended by its author for publication. The private correspondence at issue in some well-known copyright cases involving biographies of J.D. Salinger and L. Ron Hubbard is a prime illustration. Even if copyright generally provides an important incentive to create and to publish, it seems doubtful that a rule permitting historians and biographers to quote selectively from unpublished materials on deposit in libraries would have an adverse effect upon those incentives. To the contrary, mindlessly enforcing copyright rights in such a case would actually undermine copyright's purpose of inducing creativity and publication—in this case, the creativity and publication of the biography—with little if any offsetting benefit. In cases like this, even if the copyright incentive is in general optimal, economics may provide us with good reasons to believe that a departure from the norm is warranted.

Second, Landes and Posner recognize that, even aside from whatever incentive effect IP rights may (or may not) have, these rights can have several other effects, some of them beneficial. For example, IP law might reduce a variety of social costs that would be incurred in the absence of IP law. A recurring example is that of "congestion externalities," a cost that society as a whole would bear if too many people (for instance) wanted to make a film version of a particular novel, such that either (1) no one user would find it profitable to undertake the effort, or (2) the resulting multiple efforts would prematurely exhaust the public's interest in the underlying work. This cost may be lower if the copyright system confers upon copyright owners the exclusive right to prepare, or authorize the preparation of, derivative works based upon the copyrighted work. Another cost that IP may help to keep in check is the cost of self-help measures, such as building higher fences or more ingenious methods of encryption. Put another way, IP law may be a lower-cost substitute for some forms of self-help. An illustration is the law of trade secrets. Although trade secret protection may at the margin have some positive effect upon the incentive to invent, it discourages another important policy, public disclosure. Even so, trade secret protection may be socially efficient because it reduces the trade secret owner's need to invest in protective measures, such as impenetrable visual barriers (the famous case of *DuPont v. Christopher*¹ provides an illustration) or restrictive employment policies (such as employing only one's family members, in order to prevent the possibility that a disgruntled employee will disclose your trade secret to a competitor).

A related point is that patent and trade secret law complement each other in several ways. Landes and Posner present a novel argument that, even if patents have little if any positive effect on the rate of invention, they serve an important purpose in facilitating disclosure and licensing that would be more difficult to achieve if only trade secret protection were available.

Landes and Posner

present a novel

argument that, even if

patents have little if

any positive effect on

the rate of invention,

they serve an important

purpose in facilitating

disclosure and

licensing that would

be more difficult to

achieve if only trade

secret protection

were available.

¹ E.I. du Pont de Nemours & Co. v. Christopher, 431 F.2d 1012 (5th Cir. 1970).

On the basis of their theoretical and empirical analyses, Landes and Posner at times suggest some fairly radical proposals—such as a system under which copyrights could be renewed indefinitely for a fee, but otherwise would lapse much sooner than under existing law.

Third, Landes and Posner recognize that, even if the incentive-versus-access problem is insoluble, theoretical and empirical models may be of use in assessing whether the current configuration of these laws is *likely* to affect incentives. The authors' formal economic models will be of most interest to economists, but their empirical studies should be of interest to lawyers and judges too. Among their more interesting findings are the estimated rates of depreciation of various types of intellectual property. (A high depreciation rate for, say, copyrights, would suggest that the value of most copyrights diminishes rapidly, in which case arguments for further extending the copyright term in order to further increase incentives are weakened.) According to Landes and Posner, the depreciation rate for patents and trademarks during the period studied averaged around 6 percent (for patents) and 6.5 percent (for trademarks), while the average for copyrighted works was 8.3 percent, although the rate slowed a bit toward the end of the 20th century. Interestingly, music copyrights have on average depreciated more slowly than have literary and graphic copyrights; but the depreciation rate for music copyrights began to increase in the 1950s and 1960s. Another empirical study suggests, contrary to what theory alone might have predicted, that the U.S. version of "moral rights" as set forth in the Visual Artists Rights Act has had little positive or negative economic impact upon visual artists. And a study of the Federal Circuit, which Landes and Posner will publish separately in a forthcoming issue of the University of Chicago Law Review, is consistent with the hypothesis that that court has been more pro-patent than its predecessor regional circuit courts of appeals.

On the basis of their theoretical and empirical analyses, Landes and Posner at times suggest some fairly radical proposals—such as a system under which copyrights could be renewed indefinitely for a fee, but otherwise would lapse much sooner than under existing law. They argue that such a system would be an improvement over the status quo, which now keeps virtually every writing with even a modicum of originality under copyright for periods of up to a hundred years or more. Under the Landes and Posner proposal, the most valuable works might remain under copyright longer, but (they argue) this may not be as much of a problem as one might think—particularly if, as they recommend, courts interpret the fair use doctrine somewhat more generously than they sometimes do—and it might even have some benefits, to the extent that copyright renewal would confer an ongoing incentive to bring to the public's attention some otherwise long-forgotten works. The proposal is unlikely to go anywhere any time soon, insofar as it would require the United States to pull out of all of the major copyright treaties, including one that is binding upon all members of the World Trade Organization, but it does provide interesting food for thought. Indeed, one of the most valuable things about the book is its constant challenging of the reader's knee-jerk instincts towards either more or less protection for IP.

Probably the least surprising conclusion in the book is that trademark law promotes economic efficiency, meaning (again roughly) that it provides a clear surfeit of social benefits over costs. Trademarks, which protect words and other symbols that identify a unique source or sponsor of a product or service, make it easier for consumers to locate the products they want (in economic terms, they reduce consumer search costs). Imagine how difficult it would be to find the soft drink having the taste you prefer if there were no way to distinguish Coke from Pepsi prior to the point of purchase. At the same time, trademarks would be meaningless unless producers maintained a consistent level of quality in their products, and so a corollary effect of trademark protection is to provide an incentive for producers to invest in quality control.

Much of trademark doctrine can be viewed as consistent with these dual principles of reducing search costs and inducing quality control, at a reasonable administrative cost. For example, in determining whether a firm's commercial use of a word or other symbol infringes another firm's

trademark, courts employ a multifactor test to determine whether a substantial portion of the relevant class of ordinarily prudent purchasers are likely to be confused. Allowing the trademark owner to prevail on a showing of likely, as opposed to actual, confusion trades off one type of risk (that a court may enjoin a use that would not have caused any actual injury) for another, probably greater one (that waiting until confusion has occurred will cause irreparable damage to the trademark owner's reputation). At the same time, the trademark owner cannot prevail if only a small number of unusually gullible consumers would be confused, because in such a case consumers themselves are able to avoid confusion at lower cost than the alleged infringer.

The chapter dealing with antitrust and IP is illuminating, although it probably will be most rewarding for readers who do not already possess some basic understanding of antitrust economics and the new economic theories, such as network effects, that are often at issue in high-tech antitrust litigation such as the *Microsoft* case. Network effects, otherwise known as network externalities or consumption externalities, are said to exist when the value of an asset to a user increases with the number of other users. The telephone is the archetypal example: its value to you is nil unless at least one other person is connected to the network. Operating systems and some application programs arguably exhibit network effects, which means that there may be something of a natural tendency toward monopoly with respect to some "new economy" products—and also a good deal of effort devoted to gaining and maintaining monopoly power.

Landes and Posner do not reveal their views on *Microsoft* itself but do discuss how network effects can render certain claims, such as tying and predatory pricing, more plausible than they often are in the bricks-and-mortar world. Interestingly, they take issue with Robert Bork, who despite his public support for the government's case against Microsoft continues to express disagreement with the Supreme Court's 1922 opinion in *Standard Fashion*,² a case in which the Court held unlawful an exclusive dealing contract that Landes and Posner argue could be viewed as an effort to extend the duration of a monopoly by taking advantage of a type of network externality. They also disagree with Virginia Law School's Professor Edmund Kitch, who has argued that IP rights rarely confer monopoly power. Landes and Posner agree that characterizing all IP rights as monopolies is an exaggeration, but they make a convincing case that many IP rights do confer some degree, albeit minimal in many instances, of market power (often by way of monopolistic competition). They conclude the chapter with a note of caution, however, observing that antitrust enforcement "is not well adapted to deal swiftly and surely with technically complex activities"—an important point, because even if certain anticompetitive activities are more plausible in the new economy, the appropriate response of antitrust enforcers may not be all that obvious. As Landes and Posner also note, however, an adequate discussion of this topic would take them beyond the scope of the book.

Needless to say, not everyone will be convinced by every strand of the authors' analysis. The discussion of trademarks may leave some readers wishing for a more detailed discussion of certain topics, such as the different formulations of the functionality doctrine and their impact on competition among rival brands. There is relatively little about certain "hot" topics, such as peer-to-peer systems for distributing copyrighted music, or the Digital Millennium Copyright Act, or the internationalization of the IP system. A rare gaffe occurs when Landes and Posner assert that in countries which award patents to the first-to-file, as opposed to the first-to-invent—that is to say, in every country other than the United States—the patent applicant has no reason to search the

² *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346 (1922).

unpatented prior art, to see if his invention is preempted. This is not correct, because even in countries that award patents to the first-to-file, unpatented prior art that anticipates or renders obvious the applicant's invention will result in the denial of a patent. In fact, most countries' patent offices will consider a *larger* universe of prior art than does our own. The error, however, is inconsequential to Landes and Posner's broader discussion of patents.

And, of course, some readers will need more convincing than others that IP law needs an infusion of economics—although, *contra* Priest, most IP lawyers and scholars by now probably agree on the usefulness of economic analysis to some degree. A final illustration may be helpful. Some people believe quite strongly that celebrities should have a right to control the commercial use of their names and other indicia of identity in advertising and on products. People who defend this right, which is known as the right of publicity and is recognized in about half of the states, including New York and California, typically do so on the basis of some version of natural-rights theory. People who hate the right of publicity tend to emphasize its potential conflict with other laws, including both copyright and the First Amendment. Landes and Posner, who discuss the right only briefly and in passing, find George Mason Law School Dean Mark Grady's explanation the best—namely, that the right of publicity prevents a congestion externality, in the form of a premature depreciation from overuse of the commercial value of celebrity images from which many people apparently derive some measure of satisfaction. A similar explanation might explain, in part, laws prohibiting the “dilution” (as opposed to infringement) of trademarks and, as above, the copyright right to prepare derivative works. Whether one's natural inclination is to love or hate the right of publicity or antidilution laws for the commonly cited reasons, the possibility that these laws may reduce congestion externalities should form some part of one's overall assessment of the laws' advantages and disadvantages. It is, at the very least, an important consideration.

The preceding example also points to a limitation on the uses of economic analysis. An economic theory that takes as a given consumer preferences, such as the satisfaction in purchasing products endorsed by celebrities or the status signaled by wearing clothes bearing designer trademarks, may well maximize consumer welfare by forbidding unauthorized but nonconfusing uses of celebrity indicia and famous marks. To the extent that one questions the value of the preference, however—perhaps our culture is *too* smitten with celebrity and status for its own good—one might reach an opposite conclusion as to the merits of publicity and antidilution rights. There is, in other words, another fundamental question that economics cannot answer, besides the incentive-versus-access problem, and that is *what* society's goals *should* be. Perhaps on balance the better view is to take existing consumer preferences as a given, rather than having Big Brother impose some vision of the common good; but this is a political and philosophical issue about which economics does not speak. What economics *can* do is to help us in predicting how best to attain our goals, whatever they may be, even if it cannot always provide the final word. Landes and Posner have not provided the final word, as they acknowledge, but their book does provide a masterful analysis of numerous ways in which IP law may advance or impede some of society's most important goals. ●

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: In this edition, we offer two notes. The first critically examines two new papers, both published in the Fall 2003 issue of the *Journal of Economic Perspectives*, that assess the welfare effects of antitrust enforcement. The second note is an extended summary by Paper Trail Editor Bill Page of a paper that he co-authored with John Lopatka. The paper examines the role of judicially-endorsed economic theory in the control of economic expert testimony in antitrust.

Send your comments and suggestions for papers and other works to review to: page@law.ufl.edu or jwoodbury@crai.com.

—WHP & JRW

Papers and Summaries

Robert W. Crandall & Clifford Winston, Does Antitrust Policy Improve Consumer Welfare? Assessing the Evidence, *J. Econ. Perspec.*, Fall 2003, at 3; and Jonathan B. Baker, The Case for Antitrust Enforcement, *J. Econ. Persp.*, Fall 2003, at 27.

These two papers consider the question of whether the “game” of antitrust enforcement has been worth the candle. The Crandall-Winston paper concludes that given the antitrust enforcement track record, the antitrust agencies “would be well advised to prosecute only the most egregious anti-competitive violations.” In sharp contrast, Baker concludes that given his reading of the evidence, “retreating to a minimalist antitrust policy makes no sense. Instead the goal should be to apply sensibly . . . the tools of antitrust enforcement.”

At best, this is a highly skewed point/counterpoint exchange. The Crandall-Winston paper takes the Baker paper on in only one isolated footnote. Baker (who, by way of full disclosure, is also a senior consultant with my employer, CRA), by contrast, peppers his review with a significant number of “counterpoints.” Nonetheless, both papers offer highly readable perspectives on antitrust enforcement. On the strength of the analysis and evidence offered, in this rumble, the belt must go to Baker.

For example, Crandall and Winston use six important monopolization cases brought by the Federal Government—*Standard Oil*, *American Tobacco*, *Alcoa*, *Paramount*, *United Shoe*, and *AT&T*—to illustrate the ineffectiveness of or the harm created by antitrust enforcement. In evaluating *United Shoe*, the paper supposes that if the decree succeeded in reducing machinery prices, it is “highly likely” that shoe manufacturers would have incurred lower machinery expenses as a result. Crandall and Winston conclude that there was no price effect because the value of shoe machinery shipments to the value of shoe shipments was stable between 1954 and 1967. While the paper acknowledges that a combination of lower machinery prices plus a substitution of machines for labor could have generated the same outcome, “no evidence exists to support this conjecture.” Does that mean that the authors sought to find such evidence? Or are they just offering a conjecture on a conjecture? If so, then the evidence can’t distinguish between two competing hypotheses—that the consent decree did or did not have the effect of reducing prices.

With respect to *AT&T*, the authors conclude that the only reason for any pro-consumer divestiture effect was the fact that prior to bringing the 1974 case, the FCC was the chief obstacle to increased long distance competition. This is no doubt true, but not quite the complete story. There are many who have observed that in mid-1970s through 1981, the vertically-integrated AT&T fought at every turn the

FCC's efforts to compel AT&T's provision of equal access by long-distance rivals to the local exchange network. The resulting divestiture of AT&T—and the subsequent and rapid increase in long-distance competition—highlighted the inherent weaknesses of conduct regulation and the pro-consumer role antitrust can play (*Trinko* notwithstanding), even where the remedies are radically structural. In important dimensions, the equal access that followed the divestiture confirmed the predictions of those economists (and lawyers, such as William Baxter) that such access would be difficult if not impossible to attain as long as the regulated AT&T remained integrated into local and long-distance service.

As another example, the Crandall-Winston paper conducts an empirical study of the effects of merger enforcement on the price-cost margins in two-digit SIC industries. The authors conclude that at worst, antitrust enforcement has been generally ineffective and may actually have harmed consumers. But this is the kind of highly aggregated study (are the broad two-digit SIC industries really antitrust markets?) with questionable implications that in part sparked Chicago's successful "new learning" movement in the 1970s, which continues to shape antitrust thought (see *Trinko*, for example). (The Baker paper points out other apparent shortcomings of this approach.)

Most of these points (and others) are made in the Baker paper. As noted above, both papers are well worth the read. One can hope that Crandall and Winston will, in a sequel, address the Baker counter-arguments more completely.

—JRW

John E. Lopatka & William H. Page, *Economic Authority and the Limits of Expertise in Antitrust Cases*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=507542

In this lengthy paper, John Lopatka and I argue that *economic authority*—a body of economic knowledge that appellate courts adopt from the scholarly literature—defines and controls the role of economic expert testimony in antitrust litigation. We offer both positive and normative analyses of the relationship between the two sources of economic knowledge. The following Note is a bit longer than the usual Paper Trail summary because of the length of the paper.

I. Introduction

Recent studies have suggested that interdisciplinary legal scholarship is not influencing courts in most areas of law. For example, few states' courts have adopted explicitly economic theories of common law torts. Empirical surveys have found that the number of citations of law review articles by courts has plunged by almost one-half in the last twenty years—roughly the period in which interdisciplinary scholarship has gained ascendancy. In the same period, however, the federal courts have transformed antitrust law, relying extensively on economically informed legal scholarship. The doctrinal changes have not necessarily taken the form antitrust scholars have proposed, because courts have their own views of the institutional constraints they face. Nevertheless, the scholarly literature has played a major role in the erosion or elimination of rules of per se illegality, the emergence of doctrines of antitrust injury and standing, and in the creation of new standards of sufficiency of evidence. We call the economic ideas that the courts adopt from the scholarly literature "economic authority"—a body of theoretical models and empirical generalizations that courts use to guide the application of the substantive law.

One effect of these changes has been to expand the role of economic expert testimony in antitrust cases. The move to the rule of reason, for example, has required experts to define relevant markets in more cases. And the adoption of explicitly economic tests for practices like

predatory pricing has required experts to gather and analyze data necessary to prove the requisite facts. Nevertheless, bright-line rules still embody economic choices that limit the range of expert opinion that is admissible. At the same time, the courts have maintained and in some instances increased their controls on expert testimony. The *Daubert* trilogy (*Daubert*, *Joiner*, and *Kumho Tire*) has brought the *Daubert* motion to antitrust litigation; now experts must show that their methodologies meet criteria of reliability. Courts also continue to evaluate the substance of expert testimony in the context of motions for summary judgment and for judgment as a matter of law. We argue that economic authority guides all of these inquiries: it defines the role of experts, directly limiting the subjects on which they can testify and the models and methodologies they can use. The paradox of this arrangement is that economic ideas courts have adopted as legislative fact in the common law process without any test of reliability (other than that they appear in the scholarly literature) can trump and constrain economic ideas of experts that must meet criteria of scientific reliability.

II. Models and Fact-Finding

The legal system nominally assigns issues of fact to the jury and issues of law to the court, but this familiar distinction is a gross oversimplification. Juries decide normative issues in applying legal criteria (e.g., “reasonableness”), and those decisions influence the law. Courts, especially in common law areas like antitrust, can also narrow or expand the domain of fact by changing substantive rules and standards of sufficiency. Definition of the domain of fact depends in part on courts’ assessments of the jury’s competence to resolve issues using their common knowledge and common sense.

Expert testimony plays a unique role in this process, because it depends on models and analyses that are far from jurors’ common experience. Jurors are asked to choose between experts whose testimony is in direct conflict. This process may be untrustworthy for many reasons: the testimony may go over the jurors’ heads; the witness may be a plausible charlatan; and even a qualified witness may slant testimony to favor his employer’s positions. Courts recognize these potential shortcomings, and thus have created a gauntlet of constraints through which expert testimony must pass before a jury can consider it: the expert must be qualified; and the testimony must be relevant to an issue in the case, within the expert’s expertise, based on a reliable methodology, and legally sufficient to raise a jury issue.

III. Economic Models and Antitrust Decision Making

Economic expert testimony in antitrust litigation is formally subject to the same controls as other kinds of expertise in other legal contexts. But the application of those controls in antitrust is different because it is guided by economic authority, which courts adopt by judicial notice as legislative fact. Antitrust has always relied on economics, but in the past thirty years it has begun to rely explicitly on the scholarly literature in formulating and applying antitrust rules. The Supreme Court has, for example, adopted Chicago models of resale price maintenance, predatory pricing, tying, and cartels, along with related empirical generalizations. The Court has not, however, relied on the models to adopt rules of per se legality, as some Chicagoans have proposed; instead, it has replaced rules of per se illegality with the rule of reason; narrowed the remaining rules of per se illegality through the characterization inquiry; imposed requirements of antitrust injury and standing; and increased the standards for sufficiency of evidence. These choices affect expert testimony. Expert testimony has become more important with the waning of rules of per se illegality. Nevertheless, the chosen rules and underlying economic models frame and constrain that

testimony. Courts use economic authority to police experts' qualifications, and their testimony's relevance, reliability, and sufficiency.

IV. Judicial Control of Expertise

We examine the role of judicial controls on expertise in the contexts of predatory pricing; market definition and market power; the characterization and proof of horizontal agreements; and damages.

Predatory Pricing. The Court has formulated criteria for predatory pricing that sharply confine expert testimony. In *Matsushita*, expert testimony was insufficient to create a jury issue because the Court found it implausible in light of Chicago School models of predation. In *Brooke Group*, the Court made clear that above-cost pricing is never predatory, thus foreclosing any testimony by economists willing to testify to the contrary. The court of appeals in *American Airlines* recently read *Brooke Group* to require a showing of pricing below some measure of incremental cost—thus rendering insufficient expert testimony applying various measures that included fixed costs.

Market Definition and Market Power. Issues of market definition, as Judge Posner has noted, now involve mainly “questions of fact within a settled framework of economic theory,” i.e., economic authority. Courts directly examine experts' proposed market definitions using this framework. In the recent *Menasha* case, for example, Judge Easterbrook rejected as “economically irrelevant” experts' testimony that “at-shelf coupon dispensers” constituted a separate market, noting that the experts had failed to examine whether the price or quantity of the product varied with those of other promotional services. Market power in antitrust, by contrast, is a term of art that means something different from economic market power. The law's focus on market share and concentration levels as proxies for market power, for example, set important limits on the substance of expert testimony.

The market definition and market power issues in the context of aftermarkets (markets of a durable goods manufacturer for parts and service for its own products) provide an interesting case study of the battle of economic authority in the Supreme Court and the consequences of victory for a theory. In *Image Technical*, Kodak's Chicago-inspired argument was that it could not have market power in its aftermarkets if it did not have market power in the equipment market because any attempt to gouge its equipment customers would have hurt sales in the equipment market. Justice Scalia agreed. But the plaintiffs' brief touted the scholarship of Steve Salop that suggested that information and switching costs might allow exploitation of consumers; the brief added gravitas by announcing that Professor Salop had helped write it. The Court was evidently impressed, citing three of Prof. Salop's articles in the opinion. Those ideas provided the framework for expert testimony on remand.

Cartels: Characterization and Proof of Agreement. The per se illegality of price fixing forecloses expert testimony that naked price fixing is innocuous. But proof of price fixing still may require expertise in characterizing the practice and proving an agreement. Characterization requires the court to evaluate the likely competitive effect of a practice based on the practice's “facial” characteristics—essentially those that are undisputed—in order to determine the degree of “empirical” scrutiny that the practice requires. Thus, the court conducts a kind of preliminary rule-of-reason analysis to determine whether the alleged practice warrants scrutiny under the per se rule, the rule of reason, or something in between. This process may seem paradoxical, but something like it occurs whenever courts apply formal, bright-line rules: the court must go back to the policies underlying the rule to determine whether the rule applies in a particular case.

One example of the role of economic authority in the characterization process is *California Dental Association*, in which the FTC challenged the CDA's restrictions on price and quality adver-

tising. Nominally, the CDA's rule prohibited misleading advertising, but in practice, the association prohibited many forms of discount advertising and any advertising of quality. The FTC offered no expert witnesses in the administrative trial, relying instead on the scholarly literature to show the anticompetitive effects of restrictions on professional advertising. The court of appeals initially held the practices unlawful under a quick look rule of reason analysis, but the Supreme Court, citing the literature on the "lemon effect," found the CDA's arguments in support of its advertising restrictions sufficiently plausible to justify a more searching inquiry. On remand, the court of appeals found that the higher level of scrutiny required the FTC to produce more specific evidence of anticompetitive effect in the California dental market. In effect, the economic authority offered by the FTC was insufficient, in light of the economic authority of the lemon effect, to shift the burden of proof to the CDA.

If there is no direct evidence of an agreement, expert testimony will typically be required to marshal the circumstantial evidence necessary to infer one. "Agreement" in antitrust is another term of art, albeit one informed by the indeterminate economics of oligopoly pricing. The law of collusion contains safeguards designed to prevent juries from too-easily finding rational oligopolists guilty of price fixing. Thus, many courts will not permit an economist to testify to the ultimate issue of whether the evidence justifies an inference of "agreement." If the economist is using the term correctly, the issue is outside of his expertise; if she's using some other definition of agreement, her testimony is irrelevant. Nevertheless, experts can testify to the existence of practices and conditions that might facilitate coordination and to whether those practices make sense for a firm acting independently to adopt. This evidence is subject to widely shared standards of reliability in the selection and analysis of data.

Damages. Probably the most common use of experts in antitrust cases is to prove damages. But economic authority frames this role as well. First, the requirements of antitrust injury and standing define which of the harms that antitrust offenses inflict are compensable. An expert may not testify that the plaintiff has suffered lost profits, if, as in *Brunswick*, the plaintiff lost profits because the alleged practice merely preserved competitors in the market. An expert (in federal court) also may not testify that the plaintiff has paid an overcharge, if, as in *Illinois Brick*, an intermediate purchaser passed on the overcharge to the plaintiff. In both of these cases, the Supreme Court relied on the economics of the practices at issue to shape the domain of factual issues on which experts would be permitted to testify.

Second, the standards of proof allow the court to determine whether the plaintiff has actually suffered the alleged antitrust injury. Here again, economic authority guides the evaluation of the proof. The expert typically gathers data concerning a normative period, then uses statistical methods to project what the experience of the plaintiff would have been, absent the unlawful conduct. The difference between the actual experience in the damage period and the but-for experience is the measure of damages. This process requires a theoretical evaluation of the practice to identify the relevant factors to include in a regression model used to estimate the effects of the violation. Courts police this process by requiring the expert to use an appropriate theoretical model of the alleged practice, to gather reliable data, and to include the appropriate variables in the damage model.

V. Implications

The courts gather economic knowledge from the scholarly literature and use it in the formulation and application of antitrust rules, including those governing expertise. The process by which they acquire this knowledge is subject to none of the requirements of scientific reliability that the court

has imposed on the reception of expert testimony at trial. Nevertheless, it defines the areas in which expertise can be offered, in some instances foreclosing any consideration of economic opinions that are entirely respectable. And in those areas in which it permits or requires expertise, courts rely on their own reading of economic authority to evaluate expert testimony for reliability, relevance, and helpfulness.

Problematic as this may sound, we suggest that economic authority must have primacy if antitrust law is to evolve. Nevertheless, courts should make the process as transparent as possible by identifying the literature on which they are relying, and their own theoretical reasoning. And they should be alert to the possibility that the economic literature may itself be created for litigation and thus be potentially suspect on the same grounds as “hired gun” expert testimony. In determining the role of expertise, courts should take account, first, of the robustness of the economic theories on which they rely and, second, of the institutional context in which litigation occurs.

These factors clarify the roles of Chicago and Post-Chicago economics (PCE) in antitrust. Chicago theories, as we have seen, have had an enormous effect on the evolution of antitrust. Post-Chicago theories have had some notable successes, e.g., in *Image Technical*, but have more often met with resistance. Some have suggested that they are unsuited to antitrust rulemaking because they are either indeterminate or require so many assumptions that they become intractable. Others have suggested that post-Chicago models do not meet *Daubert*'s standards of reliability. We suggest, however, that the characteristics of PCE make it suitable as both economic authority and expert testimony in particular instances. They may be used to challenge proposed rules of per se legality and may generate testable hypotheses of anticompetitive effects in particular cases, as in *Staples*. Moreover, game theoretic analyses may help explain pricing strategies in predatory pricing cases and identify independent motivations for conduct in evaluating evidence of agreement.

VI. Conclusion

Courts gather economic knowledge based on their sense of its explanatory value and of its usefulness in resolving antitrust issues, given the institutional characteristics of the legal system. Courts can use economic authority to impose rules that foreclose factual issues (embodying the knowledge ex ante), or rules that allow the ex post acquisition of the information necessary to identify competitive effects. The latter course typically involves expertise, with all its attendant dangers. Consequently, courts have also relied on economic authority to directly supervise the qualifications, methodologies, and opinions of experts. ●

—WHP