

Brown Bag Program

Perspectives on Merger Divestitures When There Is No Business Unit to Divest

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BILLY VIDGOR: Antitrust remedies, generally, and merger remedies, in particular, have become the subject of significant debate recently. Last year, the ABA Section of Antitrust Law had an extensive program on merger remedies. The European Union announced preferred ways to negotiate merger remedies. Most recently, the Bureau of Competition of the Federal Trade Commission issued its Statement on Negotiating Remedies.¹

The debate, while hot, is not new. Starting in 1976, Congress passed the Hart-Scott-Rodino Act to give the federal antitrust agencies a fair opportunity to challenge a merger prior to consummation and to preserve an ability to obtain an effective remedy. The concern then, and today, is how the court or an antitrust agency might effectively unscramble the eggs after a merger is consummated. This issue is persistent in analyzing merger remedies. Shortly after the Hart-Scott-Rodino Act was passed, the agencies did not regularly negotiate settlements, but over time they have negotiated divestitures rather than challenge transactions. Today, the norm in merger practice involves negotiating merger remedies to preserve the efficiencies of mergers while also restoring competition.

In the mid-1990s, the FTC studied the effectiveness of past merger consent orders and concluded that its policy was not sufficiently effective. So, the agency adopted a policy that preferred the divestiture of stand-alone businesses and a buyer up-front. However, there are situations

¹ FEDERAL TRADE COMM'N, BUREAU OF COMPETITION, STATEMENT OF THE FTC'S BUREAU OF COMPETITION ON NEGOTIATING MERGER REMEDIES, available at <http://www.ftc.gov/bc/bestpractices/bestpractices030401.htm>.

where firms must divest businesses that are integrated within larger entities that share significant production, distribution, and marketing resources. In such circumstances, the remedy requires segregating otherwise integrated companies—a so-called mix-and-match divestiture. This brings us full circle because mix-and-match divestitures require the agencies and parties to unscramble the eggs.

The FTC's recently issued statement demonstrates a continuing evolution in merger remedies. The statement reveals the agency's added flexibility as to when and how the agency will consider stand-alone divestitures versus a mix-and-match divestiture. Our expert panel today will discuss merger remedy analysis and give us some insight on how to walk our way through the divestiture of a mix-and-match set of assets.

Speaking today is **Kristin Adrian**, Senior Vice President, General Counsel of North America for Nestlé USA, Inc. Kristin has been involved with many mergers, two of which have raised significant remedy issues—the Nestlé/Dreyer's and the Nestlé/Ralston Purina transactions.² Kristin will share her thoughts on how merging parties address merger remedy issues.

Frank Bonvino is the Senior Vice President, General Counsel and Secretary of International Multifoods Corporation. International Multifoods was the buyer of the assets divested in connection with the General Mills/Pillsbury merger.³ Frank put together a forceful and persuasive team that convinced the agency to take one of the most complicated divestitures and accept that divestiture. As a matter of full disclosure, I recommended against that divestiture. So Frank can show me how I'm wrong.

Finally, **Mike Cowie** is the Assistant Director for the FTC Bureau of Competition. Mike has responsibility for FTC merger enforcement in the retail, food, and beverage industries, and for merger enforcement in the health care sector. Some of the more notable merger investigations that Mike has directed are Vlastic/Claussen (pickles), Nestlé/Dreyer's (ice cream), Kroger/Raley's (supermarkets), and Quest Diagnostics/Unilab (clinical labs). With that, let me ask Mike to start us off and give us some perspective on where we are in the merger remedy area.

MIKE COWIE: I don't speak for the Commission but will try to provide some perspective. As you know our Chairman, Tim Muris, has emphasized transparency in merger enforcement policy, both on the merits and on remedies. Since Tim Muris became Chairman we have issued two relatively detailed policy statements to clarify FTC policy in this area. One of those is the April 2003 statement of the FTC's Bureau of Competition on Negotiating Remedies.⁴ This is a twenty-page analysis that came out of our merger best practices initiative. Dan Ducore of the compliance division had a substantial role in the preparation of that statement. That's a source for information on the FTC policy in this area.

² Nestle Holdings, Inc. (*Nestlé/Dreyer's*), FTC Docket No. C-4082 (June 25, 2003) (Analysis of Proposed Consent Order to Aid Public Comment), available at <http://www.ftc.gov/os/2003/06/dreyeranalysis.htm>; Nestle Holdings, Inc. (*Nestlé/Ralston Purina*), FTC Docket No. C-4028 (Dec. 11, 2001) (Analysis of Proposed Consent Order to Aid Public Comment), available at <http://www.ftc.gov/os/2001/12/nestleanalysis.pdf>.

³ General Mills, Inc. (*General Mills/Pillsbury*), FTC File No. 001-0213 (Oct. 23, 2001), available at <http://www.ftc.gov/os/caselist/0010213.htm>.

⁴ BUREAU OF COMPETITION STATEMENT ON NEGOTIATING MERGER REMEDIES, *supra* note 1.

⁵ FEDERAL TRADE COMM'N, BUREAU OF COMPETITION, FREQUENTLY ASKED QUESTIONS ABOUT MERGER CONSENT ORDER PROVISIONS, available at <http://www.ftc.gov/bc/mergerfaq.htm>.

Another public statement intended to provide for transparency in this area is the March 2002 statement entitled “Frequently Asked Questions About Merger Consent Order Provisions.”⁵ This is ten-page analysis also available on the website. I would encourage anyone interested in the process to study those two documents. They both provide guidance in going forward with divestiture transactions or negotiations.

Before discussing the nature of the policy or the preference, I want to mention a few other publicly available pieces of information. We also have the 1999 study of the Commission’s divestiture process.⁶ This is a thirty-nine-page document that analyzes FTC consent orders from 1990 to 1994. Another publicly available document is a September 2002 United States General Accounting Office Report to Congress on FTC divestitures in retail markets.⁷ This is a 131-page analysis of FTC consent orders from 1990 to 2000 in four industries: grocery stores, drug stores, funeral services, and gas stations. Those are some of the publicly available sources for guidance.

What do these policy statements say about the FTC practice with respect to mix-and-match remedies? In general, they express a relatively strong bias against them.

I don’t mean to suggest that simply by releasing reports with lots of pages of information we necessarily have a crystal-clear policy, but I do think these publications add a lot of guidance. The one other source I want to mention is the public filings on individual cases. So, in addition to these policy statements, one can learn further about the FTC practices by looking at consent orders for investigated matters.

What do these policy statements say about the FTC practice with respect to mix-and-match remedies? In general, they express a relatively strong bias against them. The reasoning is that the market place, rather than FTC lawyers or FTC economists, is better suited to evaluate whether a set of assets can comprise a viable competitor. Again, if you have a stand-alone business functioning in the market place, we have a lot more confidence that the business unit can function as a competitor. When a mix-and-match of assets is proposed, that forces us to evaluate something that we may be less equipped to evaluate compared to the market place. Those policy statements express a relatively strong bias against mix-and-matches, but there is no per se rule against them. We have retained some flexibility to consider things as they arise in particular circumstances.

—MIKE COWIE

One thing I want to mention about mix-and-matches that I think is important to the business community is that it may affect the timing of getting your deal done. There has been an effort to speed up the merger process here, both in conducting the core second-request investigation and in evaluating remedies. We continue to try to make this process less burdensome and more efficient. If you look empirically at mix-and-match remedies, I think you will see that they take longer to accomplish than other remedies.

The General Mills/Pillsbury merger, which Billy Vigdor and Frank Bonvino were involved with, took a considerable period of time to complete.⁸ From the time the deal was announced to the announcement of the proposed consent order, about sixteen months passed. Another one from a few years ago that had a complicated remedy was Dow/Union Carbide.⁹ That also took about

⁶ FEDERAL TRADE COMM’N, BUREAU OF COMPETITION, A STUDY OF THE COMMISSION’S DIVESTITURE PROCESS (1999), available at <http://www.ftc.gov/os/1999/08/divestiture.pdf>.

⁷ GENERAL ACCOUNTING OFFICE, PUB NO. GAO-02-793, REPORT TO CONGRESSIONAL REQUESTERS, FEDERAL TRADE COMMISSION: STUDY NEEDED TO ASSESS THE EFFECTS OF RECENT DIVESTITURES ON COMPETITION IN RETAIL MARKETS (2002), available at <http://www.gao.gov/new.items/d02793.pdf>.

⁸ *General Mills/Pillsbury*, supra note 3.

⁹ The Dow Chem. Co. (*Dow/Union Carbide*), FTC Docket No. C-3999 (Feb. 5, 2001) (Analysis of Proposed Consent Order to Aid Public Comment), available at <http://www.ftc.gov/os/2001/02/dowunionana.pdf>.

sixteen months from the time the deal was announced to the announcement of the proposed consent order. Now, the Nestlé/Dryer's deal, in which Kristen Adrian was involved, took about eleven months from the announcement of the deal to the announcement of the consent order. Eleven months is not necessarily a model. We would like to do things faster. There are a lot of variables that affect the timing, not just the nature of the remedy. But, it does seem that mix-and-match remedies take longer to complete in part because they are more complicated to analyze on our end.

One other issue I wanted to touch upon that is relevant to mix-and-matches and other remedy issues is: What is the role of the FTC in overseeing, or supervising, the sale of the relevant assets? What should we expect of the merging parties in how they go about shopping the relevant assets?

A trade association in the retail industry, the National Grocers Association, submitted public comments to us in connection with our merger best practice initiatives. One of the things the National Grocers Association stated is that the FTC should do a better job in ensuring that the shopping of the assets is more public.¹⁰ And, in fact, the National Grocers Association advocated that we adopt a rule in which the merging parties would have to provide notice to the trade to publicize the fact that they were shopping the assets. The National Grocers Association reasoned that smaller businesses often do not learn that the assets were available until after the consent order is made public. They stated that the smaller businesses are at a disadvantage relative to larger chains that make more attractive divestiture buyers to the merging parties.

We have not adopted that proposed rule—providing notice to the trade. Instead, if you look at our April 2003 statement, we expressly recognized that the merging parties have some freedom in how they want to shop the assets they're putting together. Possibilities include putting together an offering memorandum by an investment banker that may seek competitive bids; direct negotiations between merging parties and a selected buyer; or an auction. In conducting our investigation we will often ask, "How did you shop it?" But we have not gone so far as to compel merging parties to provide public notice to the industry as advocated by the National Grocers Association.

Finally, before we switch over to Kristin Adrian of Nestlé, I want to mention one other issue that is always on our mind in mix-and-match and other complicated remedy situations. We do always have to consider the prospects of litigation. I know there have been some complaints in the past by the business community and the antitrust bar about the absence of effective judicial review in Europe. People have stated in the past that when the European Commission makes a decision it takes so long to get a judicial review of that decision that there is no effective review. I think there have been changes in that area. I'm not an EC expert, but I do know that there is at least the perception that there is limited judicial review of EC decisions.

That is clearly not the case here. In the remedy area, in particular, we have seen district courts behave very permissively on what is admissible in a preliminary injunction case. In *FTC v. Libbey*, the evidence related to the proposed fix was admissible.¹¹ The district court there considered all the evidence on the proposed fix. Likewise, in *U.S. v. Franklin Electric*, a district court in Wisconsin also considered the evidence concerning the proposed remedy.¹² I think what that means for FTC

¹⁰ NATIONAL GROCERS ASS'N, SUBMISSION OF THE NATIONAL GROCERS ASSOCIATION TO THE FEDERAL TRADE COMMISSION REGARDING MERGER ENFORCEMENT AND REMEDIES (2002), available at <http://www.ftc.gov/bc/bestpractices/021023nga.pdf>.

¹¹ *FTC v. Libbey, Inc.*, 211 F. Supp. 2d 34 (D.D.C. 2002), available at <http://www.ftc.gov/os/2002/04/ftclibbey.htm>.

¹² *U.S. v. Franklin Elec.*, 130 F. Supp. 2d 1025 (D. Wis. 2000), available at <http://www.usdoj.gov/atr/cases/f6400/6483.htm>.

staff is that, when we have a proposed remedy, we obviously have to pause before cavalierly dismissing it as inadequate. We have to ask ourselves “how would an independent judge evaluate this? How would this look to a district court?” That’s something *Libbey* and *Franklin Electric* require us to do.

Kristin, I know you’ve been through two substantial FTC second-request investigations in the past three years. I would appreciate hearing how you saw the process, including any constructive criticism on how the FTC handled those investigations.

KRISTIN ADRIAN: As a general background, I am not a specialist in antitrust matters. Two-and-a-half years ago in January of 2001, when we signed the transaction for the \$12 billion acquisition of Ralston Purina, it would have been very helpful for Nestlé if we had the statement on negotiating merger remedies that was published in April of this year. Although our outside counsel certainly knew all of the FTC’s policies and communicated them to us at various points in the transaction, I would have preferred access early in the process to something that was in writing and that was fairly comprehensive. I think that the FTC statement is well done and the information in the statement is certainly consistent with my two experiences. I appreciate the progress that has been made. I just wish the statement had been issued a few years ago. I assume that what’s going to happen now is that outside counsel will make it a matter of practice to call these documents to their clients’ attention early in the process. This should benefit everyone.

Just for background, on the Nestlé/Ralston Purina transaction, we ended up divesting the Meow Mix brand and one other small brand of dry cat food to an institutional investor. We signed that deal in January 2001, and closed in December 2001.¹³ Compared to the General Mills/Pillsbury deal, this seems very quick, but to my client, it did not seem quick. In that case the Meow Mix business was not a stand-alone business. There were no dedicated manufacturing facilities and no dedicated sales force. However, the assets divested did all come from the Ralston Purina side of the deal.

The Nestlé/Dreyer’s divestiture was much more of mix-and-match because it involved Dreyer’s brands and Nestlé’s distribution assets.¹⁴ Unlike Ralston Purina, it involved key assets from both parties to the underlying merger. This divestiture involved a strategic buyer as opposed to an institutional buyer.

When I visualize the issues in a transaction of this type, I think of it as three points of a triangle. At each point you have someone with differing interests. In order to get the deal done, you need to find that common point in the triangle where everyone is willing to live. It’s a struggle to find the point that works for everyone. It’s very frustrating from the in-house perspective because one’s client wants a lot more certainty than is possible in such a transaction. I think that no matter what improvements happen in the process, there will never be as much certainty at the beginning of a transaction as clients are going to want.

From the in-house perspective, it often feels like we’re hanging on to the reports from our outside counsel as to what the FTC staff said at a certain meeting, or didn’t say, and what it means that they did or did not say something. It’s like reading tea leaves. At the same time, the company continues paying outside counsel significant fees and producing volumes of documents while trying to get the transaction done. Meanwhile management is questioning why it’s taking so long.

¹³ *Nestlé/Ralston Purina*, *supra* note 2.

¹⁴ *Nestlé/Dreyer’s*, *supra* note 2.

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—KRISTIN ADRIAN

I think all of this points to the fact that having a good relationship between the inside counsel and the outside counsel is critical. I've spent a significant amount of time over the last two-and-a-half years talking with my outside antitrust counsel. It's very important that the relationship be a good one. It's also important that the outside counsel have good communication skills so that when he or she is dealing with the staff, no time is wasted on misunderstandings along the way. And, finally, when there's a merger remedy required, usually three sets of antitrust counsel are involved—the primary buyer, the primary seller, and the divestiture buyer. The communication among that group of counsel is also critical.

Once it's clear that a divestiture is going to be required, it's helpful to engage investment bankers, to prepare an offering memo, and to market the proposed package to both institutional and strategic buyers, and not just the most likely buyer. The fact that the divestiture seller, the company that was in the position Nestlé was in, has multiple options and not just one viable divestiture buyer should help to keep the buyer a little bit more honest and less likely to take complete advantage of the situation.

I also think going through a more formal process of trying to sell and market the business will help. Management is going to find the purchase price shockingly low. In order to really believe that it wasn't possible to get a higher price in this do-or-die type of sale, it helps that you've gone through what would be a normal process in any other situation. In the end, having marketed the business being divested should help in dealing with the FTC. As you go through that process of locating a buyer and negotiating the terms of the divestiture package, keep in mind that you will likely need to review the process with the FTC staff.

It's wise to adjust management's expectation as to the time that it will take to negotiate the divestiture and the terms of the decision and order. Divestitures in this context really bear little resemblance to a standard M&A deal. There are many more people involved. In a typical transaction, you have transactional lawyers for the buyer and the seller, and in-house counsel involved—and that's about it. In one of these transactions, the divestiture buyer and the divestiture seller will each have antitrust and transaction counsel, the other party in the primary transaction will have its counsel involved, and the FTC staff will be involved. The amount of time to communicate with all these additional parties obviously adds a significant degree of complexity even if the policies of the government are clear from the outset. Even when the staff is ready to proceed to approve a transaction subject to a divestiture, there remains a question of whether or not the FTC Commissioners themselves will agree with the position of staff. In our Meow Mix divestiture, we got to the 11th hour and there was a surprise condition thrown in by one of the Commissioners. So, it's never done until it's done.

You may want to negotiate the divestiture agreements to a fairly final stage with multiple buyers assuming more than one party is interested. Once you've gone through negotiations with more than one buyer, you are likely to be in a better position to analyze which overall package is the best package to put forward to the staff.

One variable to consider is how closely you want to work with the staff during the negotiations with the buyers, or whether you want to keep your options fairly close to your vest. Perhaps the government would prefer buyer A, but you may not be sure that you can reach a deal that is acceptable with buyer A. Maybe, ultimately, buyer B is a better fit. So, my inclination would be to try to get the transaction fairly close to the position where you're ready to sign it before you present it to the FTC staff, while recognizing that changes may still be required.

Finally, clients need to be informed as they negotiate the primary merger agreement and the best-efforts clause in that contract, how likely it is that there will be an antitrust issue. At the time

the parties are negotiating the primary deal, there will be so many other pressing issues to be negotiated and resolved that the parties may be inclined to dismiss the likelihood of antitrust issues. From the standpoint of valuing the deal, our clients need to have an understanding of the full consequences of the likely antitrust issues—especially, the potential worst scenario consequences.

In closing, I'd like to suggest that outside counsel develop an overall strategy to deal with the antitrust issues early on and review that strategy so that the client has a clear understanding of what might be needed to complete its deal. The strategy is probably going to need to change, maybe many times. Still, this will help to educate clients who are not familiar with the FTC's processes.

I would be very interested in hearing from Frank as a divestiture buyer because my sense from having talked to him previously is that it's much more fun to be in the buyer's position in one of these transactions.

FRANK BONVINO: I'm going to try to give a little bit of our experience as a divestiture buyer in this kind of a situation. I don't specialize in antitrust. Basically, the closest I ever came to the FTC staff before this deal was to ask a staff person for an early termination on a Hart-Scott-Rodino Act notification. When we went into this transaction, it was an eye-opening experience.

Let me start with giving you some background about International Multifoods Corporation. I'll take you back to calendar year 2000. This was just prior to the Multifoods acquisition of the Pillsbury desserts and specialty products business.¹⁵ Multifoods was then and still is a public company listed on the NYSE. At that time, it had revenues of about \$2.5 billion. Its business portfolio consisted of, in the United States, a \$250 million food-service manufacturing business, which included an assortment of fresh and frozen baked goods for in-store bakeries, chains, and other industrial-type users. In addition to this manufacturing business, Multifoods also operated in the United States a nationwide food-service distribution business, which included the sale and distribution of third-party branded and non-branded foods and other products to customers such as limited-menu restaurants, food chains, and vending machine operators. This distribution business accounted for about \$1.8 billion of sales revenue.

In Canada, Multifoods' Canadian subsidiary, Robin Hood, operated a consumer package retail business with sales in U.S. dollars of a little more than \$200 million, with mostly number one and number two positions in the categories in which Robin Hood competed. It also operated a commercial business with sales of flour and other grain-based products to commercial bakeries and distributors and similar type customers.

¹⁵ A majority of Commissioners did not vote to authorize a complaint challenging the underlying merger or to authorize a consent order covering the divestiture of the Pillsbury business to Multifoods. Some of the background concerning the General Mills/Pillsbury merger and the divestiture is set forth in statements of individual commissioners. See *General Mills/Pillsbury*, *supra* note 3. As to the underlying competitive concerns raised by the merger, according to one of the Commissioner statements, the merger would have significantly increased concentration in eight already highly-concentrated product markets: cake mixes, ready-to-spread frosting, family flour, cookie mixes, brownie mixes, quick bread mixes, pancake mixes, and potato mixes. General Mills/Pillsbury, FTC File No. 001-0213 (Oct. 23, 2001) (Statement of Commissioner Mozelle W. Thompson), available at <http://www.ftc.gov/os/2001/10/gmstmthomp.htm>. Some of these overlaps would arise from the combination of products sold under General Mills' Betty Crocker trademark with those sold under Pillsbury's Doughboy trademark. General Mills/Pillsbury, FTC File No. 001-0213 (Oct. 23, 2001) (Statement of Commissioner Sheila F. Anthony) ("Products bearing these symbols command leading shares in virtually every product category in which the two companies compete."), available at <http://www.ftc.gov/os/2001/10/gmstmtant.htm>.

In calendar year 2000—this is important, too, because the staff took some exception to this—Robin Hood was the exclusive licensee of Duncan Hines cake mixes and related products. As many of you know, Duncan Hines is a national player in these products. Robin Hood actually manufactured, marketed, and sold these products in Canada along with its own cake mix products sold under the Robin Hood label. This gave Robin Hood an overall number three position in Canada in this category. This arrangement raised some concern with staff members, although after many hours of discussion, I think we finally convinced the staff that the aggregate sales revenue and earnings from this Canadian cake mix business were immaterial. This relationship has ended in June of this year.

Multifoods and its predecessor companies have been in business for 110 years. The company, formerly known as International Milling, was in the 1960s the largest flour milling company in the world. In the 1960s, 70s and 80s, the company was also in consumer package goods—mostly regional brands. The company, in the mid-80s, decided to change strategic focus and sold its consumer package brands to focus on food-service manufacturing and food-service distribution. So, in calendar year 2000, just prior to our involvement with the FTC, Multifoods did not have a consumer package infrastructure in the United States. It had one in Canada. But, what Multifoods did have was a heritage, as I mentioned, in grain-based products. We had a CEO who came to us from Kellogg's, after five years at Kellogg's, who had a deep knowledge and real passion for consumer brands, and also senior management that was very partial to manufacturing and not particularly fond of the low margin food-service distribution business. When the opportunity to purchase the Pillsbury desserts specialty products business came to us, we were very interested.

General Mills and Diageo, PLC, the parent company of Pillsbury, announced in July 2000 that General Mills would acquire Pillsbury. Both parties were quick to acknowledge the overlap of the Pillsbury dessert and specialty products sold and marketed under the Pillsbury Barrelhead and the Doughboy trademarks, and the General Mills desserts and specialty products sold and marketed under the Betty Crocker trademark. The FTC staff took the position that General Mills and Diageo had to find and produce an up-front buyer as a condition to the staff's willingness to recommend approval of the transaction to the Commission. So General Mills and Pillsbury went out and sought buyers and Multifoods was ultimately selected.

Given Multifoods grain-based heritage, its consumer experience in the past and in Canada, its desire to re-enter the United States, its ability to obtain the necessary financing to do the deal, and the absence of an overlap with the desserts and specialty products business being divested, each of the parties—General Mills, Diageo, and Multifoods—had good reason to believe that the staff would determine that Multifoods was an acceptable buyer. To make a long story short, Multifoods and General Mills signed a sale and purchase agreement in early February 2001.

We had our first meeting with staff in January 2001—about two-and-a-half weeks before the agreement was signed. This meeting gave Multifoods' senior management an opportunity to introduce the company to the staff, and, quite frankly, sell the staff on Multifoods as an acceptable buyer. As an aside, Billy Vidgor will remember this, that first meeting started in the mid-afternoon and we assumed that the meeting would last until about 5:30. It lasted until 9:30 that evening. That meeting was particularly instructive for us. The staff did not pull any punches in expressing their concerns about the mix-and-match nature of the transaction and made it very clear to us that the parties had better come up with a plan to resolve these concerns.

The staff expressed three main concerns at that meeting. They were manufacturing, split trademark, and viability of Multifoods—principally because of infrastructure issues. Let me discuss the

manufacturing issue first. Pillsbury cake mix and ready-to-spread frosting products were made at Pillsbury's plant in Murfreesboro, Tennessee. This is the same plant in which refrigerated and frozen dough products were made. That plant was primarily built for the manufacture of frozen and refrigerated products, so it didn't make any commercial sense to the parties to include the Murfreesboro plant in the divestiture package. General Mills manufactured Betty Crocker cake mix in its plant located in Toledo, Ohio. The parties proposed to flip-flop the manufacturing locations, which meant that General Mills' Toledo plant would have to be converted from a Betty Crocker cake mix manufacturing facility to a Pillsbury cake mix and ready-to-spread frosting facility. This is significant because the manufacture of the ready-to-spread frosting product is far more difficult than the manufacture of cake mix products.

During the conversion process it would be necessary for General Mills to co-pack (or contract pack) Pillsbury products for Multifoods at the Murfreesboro, Tennessee plant until such time that the Toledo plant was converted and able to make the Pillsbury products. General Mills had the obligation, and was charged with completing the conversion of the Toledo plant. The parties had agreed that all of the Pillsbury products to be manufactured in the Toledo plant would have to be manufactured at a cost and quality level at least equal to, or better than, those products that were manufactured by Pillsbury at the Murfreesboro plant. And General Mills agreed that the converted Toledo plant would have a manufacturing capacity of at least equal to or better than the Murfreesboro plant with respect to these products.

The engineers on both sides spent a lot of time on this and estimated that it would take at least a year to complete the conversion of the plant for Multifoods. In fact, it took several months longer.

The split trademark was another big issue. Most of you probably know something about that because it received a lot of publicity during the investigation. The use of the Pillsbury Barrelhead and the Pillsbury Doughboy trademarks needed to be shared by General Mills and Multifoods. Essentially this would allow use of the trademark by Multifoods in the interior of the traditional supermarket, and by General Mills around the outside for its frozen and refrigerated products. This presented a real issue for the staff to deal with—that is, one competitor licensing another competitor with respect to similar product categories in the same trade channel.

The infrastructure was another issue very high on the list of concerns expressed by the staff. Other than the core group of about nineteen people dedicated by Pillsbury to the dessert and specialty products business, the services necessary to support this business were furnished by a central corporate group and other business groups scattered throughout the Pillsbury organization. Multifoods was required to come up with an infrastructure in order to be viable. It had to create a supply chain, a management information system, distribution, sales, marketing, research and development, and other administrative functions to support the business. The parties estimated that it would take about a year to transition the most difficult of these functions, particularly the management information system. In all, the parties would have to transition about fifty separate administrative and operational functions from General Mills to Multifoods.

As you can see, for good reason, there was concern expressed by the staff about the length of time of the transition functions and whether or not the parties could pull this off. We had some real concerns to overcome to get the staff comfortable with recommending the deal. In essence, the staff wanted to make sure that the whole of the business was being divested so that the business being divested would have most of the assets, properties, rights, and flexibilities that it had when it was part of Pillsbury.

Here's how that worked out. With respect to the Toledo plant, General Mills decided to move its cake mix and cereal operations (it had its cereal operations in that facility as well) to other loca-

tions and to sell Multifoods the entire facility to avoid a shared facility—something the staff expressed concern about. Also, instead of moving all of the machinery and equipment related to the divested business from Pillsbury's Murfreesboro plant to the Toledo plant to be purchased by Multifoods, General Mills agreed to install new machinery in Toledo. This avoided the complexities of moving the machinery—another concern expressed by the staff.

Multifoods and General Mills worked out several transition-services agreements, most notably a co-pack agreement under which General Mills would manufacture the products Multifoods needed for its business on a guaranteed cost basis until such time as the Toledo plant was converted and made ready to manufacture the same products. We also worked out a conversion agreement under which General Mills would convert the Toledo plant. Each of these agreements contained confidentiality obligations and adequate firewall protections. In addition, the staff had recommended and the parties agreed that a monitoring trustee be appointed to oversee and in effect control the co-pack and conversion operations to assure compliance.

Kristin mentioned the timing issues. Well, the staff spent a lot of time, perhaps more than any of the parties expected or wanted, to understand these mix-and-match issues. In a perverse way, the time taken by the staff was enormously helpful. The extra time gave us an opportunity to fully vet the proposed acquisition and line up the new business infrastructure. I have to add, as more time went by the deal got a lot better for us. The extra time certainly was a huge factor in our ability to successfully transition the business.

On the negative side of the timing issue, we had to extend a bank underwriting commitment for eleven months. This is an extremely long time for an underwriting commitment and posed a significant additional cost to us. This is something we didn't expect that we would have to do. However, on the other side of it, we got lucky because during the time delay interest rates dropped ten or eleven times.

We also had to contend with anxious investors and prospective employees wondering if we'd ever get this thing done. The time delay had a negative effect on the operating performance of the divested business because it just didn't get the attention it would have otherwise gotten had it been turned over to us sooner.

With respect to the manufacturing issue, we were confident that the plan that both parties' engineers proposed would work, simply because General Mills had world-class engineering talent and resources to complete the Toledo plant conversion. Unfortunately, our confidence—that is, the parties'—wasn't exactly shared by all the staff members.

With respect to the trademark, the staff expressed a lot of concern with the split trademark. In particular, the staff expressed concern that somehow General Mills would use the Pillsbury Barrelhead and the Doughboy in a way that could be detrimental to Multifoods' use of the same trademarks in connection with the products exclusively licensed to it. So far we have not seen any evidence of this kind of activity from General Mills.

The parties negotiated a trademark agreement that is very unusual. Multifoods was granted a royalty-free trademark license automatically renewable every twenty years, with exclusivity in certain product categories. This license provided flexibility that is not commonly seen in trademark license agreements. Again, the staff deserves a lot of credit for its input into this subject because it was the staff's view all along that Multifoods should have as much flexibility in its use of licensed trademarks as Pillsbury had while the desserts and specialty products business was part of the Pillsbury company.

With respect to transitional services, Multifoods and General Mills negotiated several agreements relating to transitional services, complete with confidentiality and firewall provisions that

would enable Multifoods to bring the business in and establish the infrastructure, while at the same time keeping the parties separate with respect to proprietary information. Also the parties agreed to a hold-separate agreement with respect to a portion of the Murfreesboro plant until certification by the monitoring trustee.

BILLY VIDGOR: I appreciate the positive view on which you spin the FTC staff's objections. Mike, you said that a lot of times it takes longer to review a mix-and-match than a stand-alone business. But, when you get down to it, what criteria are you using to build your confidence that a mix-and-match would work?

We look at the elements of the business that supplies the overlapping product or service. Is the management there? Do you have a credible management team with experience in this particular area?

—MIKE COWIE

MIKE COWIE: We look at the elements of the business that supplies the overlapping product or service. Is the management there? Do you have a credible management team with experience in this particular area? In Nestlé/Dreyer's, that was an important factor weighing in favor of accepting the remedy because the divestiture buyer had significant, credible management experience in the industry.¹⁶ So, management expertise is an element.

Manufacturing may be an important element depending on the market of concern. That was obviously a source of some contention in General Mills/Pillsbury. In Nestlé/Dreyer's the divestiture buyer had significant manufacturing capabilities as well as management experience.¹⁷ Management, manufacturing, and distribution capabilities may be important in evaluating a divestiture buyer. In other industries, especially pharmaceuticals, intellectual property may become important as well. There's no secret formula for evaluating divestiture buyers—it requires looking at the elements of the business in the area of concern, keeping in mind what the underlying theory of anticompetitive harm is.

BILLY VIDGOR: Kristin, without going into the specifics, what do you recommend the merging parties look for when they're looking for a divestiture candidate?

KRISTIN ADRIAN: First and foremost is somebody who's going to be acceptable to the FTC. In addition, assuming they're acceptable to the FTC, you want to make certain that they're not going to have any other conditions that would give them a right to walk from the deal, such as a financing condition or some other out. Certainty that the deal will close is very important. In addition, you're looking at how quickly the parties can sever the ties and how quickly the buyer can become truly independent.

MIKE COWIE: Kristin reminded me of the issue of financial condition. That can be a key element as well. Does the divestiture buyer have the financial condition sufficient to replace one of the merging parties going forward? Frank, I think that was an issue in General Mills/Pillsbury. One of the

¹⁶ Nestlé/Dreyer's, FTC Docket No. C-4082 (June 25, 2003) (Concurring Statement of Commissioner Sheila F. Anthony) ("CoolBrands is a qualified buyer whose management team has significant experience in the ice cream business."), available at <http://www.ftc.gov/os/2003/06/dreyeranthonystatement.htm>.

¹⁷ *Id.* ("CoolBrands has existing manufacturing capacity and expertise . . .").

Commissioners referred to Diageo providing credit or a line of credit in order to mitigate that concern.¹⁸

FRANK BONVINO: When we went out to finance the deal, we got an underwriting commitment in a very short period of time, which is unusual. But as part of that underwriting commitment, there was a high-yield piece of the debt. And in those days, the interest rates were fairly significant. The market was very tight all around with respect to financing. The seller on the underlying merger, Diageo, agreed to guarantee the high-yield piece so that we could trade off of Diageo's balance sheet, which reduced the interest rates enormously. And that was very helpful to us. We could have certainly done the deal otherwise, and I think we've produced enough information during our many meetings on this subject to support that.

BILLY VIDGOR: Mike when you're vetting the divestiture buyer, what are some of the tools you use, and what are some of the things you think people should bring to you?

MIKE COWIE: As I mentioned earlier, the underlying problem with the mix-and-match is that we're trying to substitute for the market place in evaluating whether the assets constitute a stand-alone business—so we do try to get as close to the market place as we can. One way we do that is by asking significant customers how they would interface with this business; we do talk to customers and others in the industry to help us understand whether this is likely to work.

BILLY VIDGOR: Kristin, what did you use to persuade the staff that the divestiture buyer should be accepted in Nestlé/Dreyer's?

KRISTIN ADRIAN: Obviously, in part it's up to the buyer to do some of that convincing. One thing we did was to work very closely with economists who were very helpful in providing some of the necessary information.

MIKE COWIE: I have a follow up on Kristin's comment about the use of economists, which is an important one. We at the FTC have tried to improve our accounting and financial analysis capability, and we do have a somewhat growing staff of accountants, as well as economists. This enhances communication with the management of the divestiture buyer and others.

FRANK BONVINO: On the General Mills/Pillsbury matter, face-to-face meetings with the senior management and staff was critical because Multifoods had to establish credibility. Mike, you've mentioned in your comments that one of the concerns you have is a credible management. We did bring in a number of engineers and investment bankers, to cover every issue that was thrown at us. We prepared white papers for the staff to study what we were proposing.

¹⁸ See *General Mills/Pillsbury*, FTC File No. 001-0213 (Oct. 23, 2001) (Statement of Commissioners Orson Swindle and Thomas B. Leary) ("In order to further enhance the financial strength of Multifoods, Pillsbury's parent company, Diageo, will guarantee up to \$200 million long-term debt of Multifoods to finance the purchase, with a commitment that Diageo will not directly or indirectly influence Multifoods's business decisions. Further, General Mills and Diageo will put \$10 million in escrow that could be used to finance a direct sales force"), available at <http://www.ftc.gov/os/2001/10/gmstmtswinleary.htm>.

We wanted to, first of all, establish that the company had manufacturing ability, even though we didn't have the infrastructure in the United States. We had an infrastructure in Canada, and could duplicate it here without any problem. We believed the company would reinvigorate these Pillsbury deserts and specialty products that we felt had been somewhat neglected, that we would be a formidable competitor, and that we had the financial resources and the flexibility to do this. So, those are the kinds of things that we time and time again, in the many meetings and visits that we had with the staff, tried to get across.

BILLY VIDGOR: I wasn't in on the Dreyer's deal, but I would ask—just how much risk was the FTC willing to take on a mix-and-match? Have they thought about it? Is there a standard?

MIKE COWIE: I am certainly unable to quantify but, in general, the risk tolerance is relatively low. You have seen in the last few years the Commission has brought some consummated merger cases, but obviously those are much more complicated in dealing with remedies. So in evaluating a premerger deal, there's a general recognition that now is the time to remedy the anticompetitive problem.

BILLY VIDGOR: Frank, how is your business working now that some time has passed?

*The more complex the
mix-and-match,
the longer the
investigation is going
to take . . .*

—FRANK BONVINO

FRANK BONVINO: The matter went to the Commission in October 2001, about sixteen months after General Mills and Diageo announced their deal. The Commission voted 2–2, so the deal went forward, and it went forward in October 2001 without a consent decree. Chairman Muris had recused himself. So now, twenty months later, I'm pleased to say that this divestiture has worked extremely well for us. During the first twelve months following the closing, we sold the food-service distribution business. So the company now is exclusively focused on its manufacturing business. The Toledo plant was converted. It did take a little longer than we had expected, but it was converted, and it's fully operating and functioning very well.

We started our management information system on time, without any glitches, and within budget. So I'm happy to report that. The marketing, the sales, the distribution, the supply chain, the research and development—all of those organizations were put in place and are fully functioning. In the first year we introduced forty new or improved products in this category. Just as a comparison, in the year prior to the divestiture, Pillsbury had introduced less than five. In the second year, this year, we will introduce (and this is public) fifty new or improved products. Our sales distribution—what I mean by that is the consumer-packaged products that are on the shelf of the supermarket—has increased 12 percent nationally since we acquired the business. That's, I'm told, very significant. And our consumer take-away, as measured by Nielsen, has been extremely good, probably better than we expected.

We reduced our debt by \$255 million from the sale proceeds of the distribution business and from cash flow generated from the business. So our financial position has improved dramatically.

If I can take a minute, I'd like to talk about some of the conclusions to draw from our experience. As Kristin said in her opening comments, if your client has a mix-and-match issue then the client's expectations need to be set realistically. The more complex the mix-and-match, the longer the investigation is going to take—Mike has said that as well. So, your client needs to assess at the outset whether the prize is worth the time and effort. In our case, we felt that the prize was worth the effort. We had negotiated a very favorable purchase price, and we made a commitment to see the matter through to the end.

Despite the mix-and-match challenges that I described, everybody in this deal worked very

hard, including the staff, to come up with answers and remedies to the issues presented by the staff. The staff's input was critical to us because we received an asset package that allows us to be a strong competitor. In our case the parties had a plan, and had the talent and the resources to execute and complete the remedy. The staff didn't entirely agree with that, but we knew we could do this. And, based on the results twenty months later, we believe that the divestiture not only restored competition, but actually enhanced competition in these product categories. The bakery aisle has been reinvigorated as a result of more innovation by us and by our competitors. In the end, the consumers win because they get more product choice and competitive prices.

MIKE COWIE: I'm glad to hear that this has been a success for your company. I was wondering if you could comment on the extent to which your client has replaced Pillsbury as a pricing force, in terms of providing pricing pressure on General Mills or engaging in trade promotions directed at General Mills.

FRANK BONVINO: I can't speak to where they're directed. We have other competitors. We're a very strong force. In this kind of business, trade spending—that is money spent at the trade level—is really how you promote these products, not by consumer advertising and consumer pull-through. So, I believe that we have increased trade spending from the levels that Pillsbury was trade spending before we bought the business.

LISTENER QUESTION: Mike, this is a question directed to you. If you have a mix-and-match situation, would it influence the Commission's decision positively if the divesting party brings multiple potential buyers or bidders for the assets?

MIKE COWIE: So you're saying you would present to the staff or the Commission a menu of potential divestiture buyers?

QUESTIONER: Right, does it give you confidence when you have that much interest? If we're trying to figure out what does the market think about this mix-and-match group, does it give you more confidence that you've got a lot of people interested?

MIKE COWIE: Having more ready and willing buyers improves the likelihood that the staff will find a buyer with the characteristics that we think are needed. It could inject some delay just in evaluating multiple buyers.

BILLY VIDGOR: There's a part of the investigation that focuses on competitive effects and then there's a part focusing on remedy. How do you turn from one to the other, or do you try to do this in parallel?

KRISTIN ADRIAN: If you know for certain that a remedy is going to be needed and that it's clear from the outset, that's one thing. If there is real hope that one won't be needed, I don't think that you would begin to discuss a remedy while you were still discussing the merits. It seems to me if you start to discuss the remedy, you've conceded the fact that one is needed.

MIKE COWIE: The government obviously differs from the private plaintiff—we're less likely to compromise just for the sake of compromise. It's obviously important for us, in meeting our statutory

obligations to enforce the antitrust laws in a principled way, to reach an institutional judgment that there is an underlying antitrust problem. So, we really have to get consensus here on the nature of the underlying antitrust problem before getting too far ahead on the remedy. And that might mean that we're unwilling to accept the remedy because we're uncertain that there's an underlying problem. It also may mean we need to understand whether the remedy is commensurate with the problem. So, the one thought I would add is, from our perspective, we really have to reach some understanding of the problem before getting too far along on remedy.

KRISTIN ADRIAN: So, in other words, it's probably not practical to hope that you can dual-track the two big tasks that need to be done and shorten the time frame.

MIKE COWIE: It may be difficult. There are some markets where the Commission has expertise from looking at them in the past. It may be that we can reach a principled judgment on the underlying problem relatively quickly based on experience. But, in the absence of that condition, we do have to spend the needed time to understand whether there's a problem. The staff is not going to recommend a remedy without showing our management and the Commission first that there's a problem.

BILLY VIDGOR: Any recommendations on how to narrow the issues? Frank, you had effectively every issue on the table. Are there ways of actually getting things resolved or identifying the ones that aren't issues so that you can focus on the ones that are hot?

FRANK BONVINO: The most productive way that we found was to deal with them on a rolling basis, in other words, take them one at a time and work them through to a conclusion. Because if you don't do that, then you've got bouncing balls all over the place and you never get anywhere. Psychologically, it's a lot better for the parties to do it that way because then you can feel that you're making real progress. I don't know how else to do it.

KRISTIN ADRIAN: Now I know why it took sixteen months. But I think Frank makes a very valid point that affects client counseling and expectations. If you have something tangible—say one down, ten to go, two down, nine to go—it looks like you are making progress. However, my experience has been more that you're juggling balls all along the way.

BILLY VIDGOR: How do you present these issues to a judge—whether you are advocating a settlement or opposing it?

KRISTIN ADRIAN: If you think that you have proposed a very viable fix, and you have been through all of the analyses and have all the supporting data, then depending upon various external factors, you might want to roll the dice and you might feel confident going into court. And I suspect the FTC would feel equally confident, because you wouldn't have reached that point unless you were both convinced that your position was correct.

MIKE COWIE: I would just add one dynamic. In a mix-and-match situation, in contemplating litigation, you're always going to have someone like Frank, or someone like CoolBrands on the ice cream merger, in court under oath saying, "We can compete. Here's our business plan, and we have the expertise to do it." That puts the government in a position of appearing to second-guess

business people in the trenches. That's a litigation concern. How is the court going to perceive that dynamic when you have a divestiture buyer saying, "I can do it, believe me. I've been in the industry for twenty years?"

KRISTIN ADRIAN: If they're very convincing in their presentation, then that has to be a serious issue that the FTC has to consider.

MIKE COWIE: In the *Libbey* case the FTC was able to show that the divestiture buyer was going to be dependent on a necessary input from Colombia, which had been essentially undergoing civil war at the time—at a higher price than the incumbents.¹⁹ In other words, the FTC could show empirically that the divestiture buyer was at a measurable disadvantage in obtaining an essential input. So that was a relatively clean way of showing that the divestiture buyer was inadequate and the FTC did not appear to be second-guessing the management capabilities or the sales capabilities of the divestiture buyer. So, there are ways the FTC can litigate that issue effectively. ●

¹⁹ FTC v. Libbey, Inc., 211 F. Supp. 2d 34 (D.D.C. 2002), available at <http://www.ftc.gov/os/2002/04/ftclibbey.htm>.

Interview with

Makan Delrahim, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice

Editor's Note: *The Department of Justice has appointed a multi-dimensional individual to fill a multi-faceted Antitrust Division position. Makan Delrahim, the Antitrust Division's new Deputy Assistant Attorney General responsible for international, policy, and appellate matters, holds degrees both in law and biotechnology and is qualified to practice before the U.S. Patent and Trademark Office. He was in private practice with Patton Boggs, L.L.P. and worked for the National Institutes of Health's Office of Technology Transfer. He also served as Deputy Director for Intellectual Property at the U.S. Trade Representative's Office.*



Makan Delrahim

This background, plus his most recent work as the Staff Director and Chief Counsel of the Senate Judiciary Committee (where he reported to Chairman Orrin Hatch), should make Delrahim well-equipped to implement the Division's initiatives involving international and intellectual property issues.

Although appointed only just this past July, Delrahim already has a wide-ranging portfolio, focusing on the review and evaluation of issues at the intersection of antitrust law and intellectual property rights—including possible revisions to the Intellectual Property Guidelines—and the advancement of global coordination and antitrust enforcement activities through the International Competition Network, where he chairs the Merger Working Group.

The Antitrust Source conducted this interview on October 20, 2003.

ANTITRUST SOURCE: It has been about three months since you became the Deputy Assistant Attorney General responsible for International, Policy, and Appellate matters. Before your arrival, I believe those areas were overseen by three different people. Can you tell us why the three roles have been combined and describe how you view your responsibilities in the front office?

MAKAN DELRAHIM: Most recently, there was a Deputy for International matters, Bill Kolasky, and I believe that the Policy and the Appellate sections reported directly to the Assistant Attorney General. And in different administrations, different organizational models were in place. I know that when Diane Wood, now a sitting Judge, was here in the early nineties, she oversaw both the International and the Appellate matters. So I think the exact responsibilities vary with who is in the AAG job. As far as why these responsibilities were consolidated, my recent experience here shows me that it makes a lot of sense in ways that weren't apparent even to me when I first got into the job. You see, on the Appellate side, there are matters that are right at the cutting edge of antitrust law that our folks in the Appellate section are the experts on. They know all the issues that are being litigated and what is being considered at the Circuit level. For example, you are aware of the recent Ninth Circuit and the D.C. Circuit's cases interpreting the Foreign Trade Antitrust Improvements Act, relating to international jurisdiction. That is an area where the wrong interpretation of this Act could actually hurt our criminal enforcement efforts. There are real policy issues as new case law develops. And our joint staff meetings allow for our Policy folks, as well as our Appellate folks, to work with each other, to discuss

different issues that might be fit for a policy advocacy or a legislative change in certain areas that would enhance our efforts at the Division. I should also add that I had a personal interest in both appellate and international matters, and given my background, having me oversee the Policy section was probably a natural fit—coming from Capitol Hill and dealing with legislation and antitrust policy.

ANTITRUST SOURCE: You mention your background in Congress. Will you be dealing with legislation before Congress concerning antitrust issues in your new role?

DELRAHIM: I will be. I'll be dealing both with policy development, as well as legislation. As you know, there is some antitrust legislation pending in Congress currently, and some initiatives at the Division that pre-date me, dealing with criminal penalties and enhancing our criminal enforcement program. I will be working further on other policy matters, including competition advocacy at various agencies, in my new role.

ANTITRUST SOURCE: What would you list as your top priorities in each of the three areas for which you are responsible now?

DELRAHIM: In the International area, as you know, my predecessors, Bill Kolasky and before him Doug Melamed, kicked off the ICN here and I know that Hew Pate has an interest in making sure that ICN does continue to develop. There have been a lot of gains. It's amazing what we have achieved for an organization that is only about two years old. Charles James and others around the world deserve a lot of credit here. There are already best practices for foreign antitrust enforcement bodies and various analytical papers that have been circulated amongst the different participating governments, and there are a lot of benefits that come out of that. And, if you look at other international organizations as a benchmark, I think the ICN's accomplishments have been unmatched in the past. I would like to continue pushing those efforts in the ICN, trying to get convergence where we can on both the administrative side of merger reviews and where possible, convergence on antitrust analysis and theory. Trying to break down administrative barriers for mergers that touch on multiple jurisdictions would create real efficiencies and certainty for businesses and consumers. I will also focus significant attention to the issue of Competition and Trade. That has become a significant issue as part of the WTO discussions and I think it is a critically important area, and one on which not enough attention has been focused on it.

On the Policy front, we are going to redouble our efforts in the area of intellectual property. This is an area of personal interest to me, as a patent and copyright lawyer. We have, as you know, the intellectual property-antitrust joint hearings that were held last year with the FTC, and there will be a joint report on our findings forthcoming later this year.

On the Appellate matters, in addition to supporting the Division's enforcement cases, we will actively be looking for opportunities to file amicus briefs in certain cases where we think the antitrust policy implications are significant. Again, pre-dating me, the Division filed an amicus brief in the *Trinko* case on an issue that had significant impact on Section 2 analysis and that filing was in a matter that was a purely private action.

ANTITRUST SOURCE: You mentioned the joint DOJ/FTC report on the antitrust and IP hearings held last year. When should we expect that report to issue and what does the Division hope to accomplish with it?

DELRAHIM: The joint report should be coming out later this year. We are working through drafts right now and I think our two agencies are making significant progress. The report is not intended as an enforcement guideline, but is intended to provide a compilation of the recent views and thinking with respect to various issues implicated in antitrust analysis where IP is involved, whether it is in a merger context, in a licensing transaction, or unilateral conduct. There will be two reports, as I think had been anticipated: one that deals with Patent Law and Competition—that was something primarily undertaken by the FTC.* And, as I mentioned, the joint report by the DOJ and FTC will relate to issues in the area where antitrust and intellectual property laws intersect.

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ANTITRUST SOURCE: You said the report on the relationship between IP and antitrust would consist of a compilation of views. Is that all it will be, or will it also offer guidance?

DELRAHIM: I think the report will be designed to guide antitrust practitioners and enforcers—as well as intellectual property holders—on various issues that may arise with the enforcement of antitrust laws and certain practices relating involving intellectual property. It is a synopsis of the various papers and views presented, and it will include some conclusions relating to where the two agencies' enforcement objectives might be. So it should be helpful. It's not going to be exactly like the 1995 IP Guidelines, but more of an analysis of where the law is. We are currently considering updating the 1995 Guidelines and improving them with the understandings gained through the recent hearings as well as eight years of experience since the Guidelines were last revised.

ANTITRUST SOURCE: You've anticipated where I was going, and that is to ask you whether the antitrust and intellectual property hearings or anything else on your radar screen indicate to you that the IP Guidelines ought to be updated or revised.

DELRAHIM: We're discussing that, and a formal decision has not yet been made. We are looking at the Guidelines right now. We do anticipate that some updates to the Guidelines are appropriate. I don't know if the guidance will be changed, and we have not looked at that closely, but one of the things we're examining is how the law has developed and if it warrants a change in the guidance. One thing we do know is that over the last eight years, there has been substantial case law that has developed that could fill in the skeletons of the hypotheticals in the IP Guidelines. I should say, though, that I think the IP Guidelines themselves, by and large, have withstood the test of time over the last eight years. But to the extent we can supplement them with some of the case law we've seen from the Federal Circuit and other areas, as well as advances in technology and that experience we've had in some of those cases, they perhaps could use updating.

Editor's Note: On October 28, 2003, after this interview was conducted, the FTC issued its report, *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy*, available at <http://www.ftc.gov/os/2003/10/innovationrpt.pdf>. Makan Delrahim provided *The Antitrust Source* with the following comment on the report:

I think the FTC's recommendation of the creation of a Liaison Panel between the FTC, the DOJ, and the PTO to permit the exchange of policy views on important issues as they arise is something all three agencies can benefit from. A formal or informal tri-agency panel between the PTO and the antitrust enforcers would allow for greater appreciation of IP policy for the antitrust agencies and similarly greater appreciation of competition impact of IP for the PTO. It could also be a basis for the exchange of views on determining patent validity questions that may arise in enforcement actions or in the merger context.

ANTITRUST SOURCE: What is the timing on the decision whether or not to update the Intellectual Property Guidelines and, assuming a decision is made to update them, when could we look forward to seeing the new guidelines?

We hope that the increased dialogue on the intersection of IP and antitrust with our foreign antitrust partners would help develop a workable and efficient regime to provide for certainty of rights and increase the incentives to innovate . . .

DELRAHIM: The decision will be made after the IP report is issued. There's not a specific date for the issuance of the joint report from the hearings, but I have discussed it with Hew and with Chairman Tim Muris and Susan Creighton of the FTC. As far as when it would be completed, if we do decide to move forward, it will probably be a one-year project, given that we already have the hearings as a foundation. We'll likely get comments from outside practitioners and folks interested in the issues and get the benefit of various experiences to update the report.

ANTITRUST SOURCE: Are there any other intellectual property initiatives that are in the works or that we are likely to see from the Division in the next few years?

DELRAHIM: I would like to focus on the international aspects of intellectual property issues arising in antitrust enforcement. You will see an increased focus on bilateral consultations relating to IP. In fact, you may be aware that over the past year, we've had an intellectual property working group with our European counterparts where we've had six or seven very productive meetings and/or video conferences to exchange our different views with respect to the intersection of antitrust and intellectual property. We hope to expand that relationship not only with the EC, but also with other countries and antitrust authorities. We have recently invited the Japanese Fair Trade Commission and the Taiwanese to establish similar IP working groups. Many would agree that this area is really the cutting edge of antitrust development. It is critical in our new global economy where there is an increased reliance on intellectual property rights and where these rights have become truly global through various treaty obligations and agreements. We hope that the increased dialogue on the intersection of IP and antitrust with our foreign antitrust partners would help develop a workable and efficient regime to provide for certainty of rights and increase the incentives to innovate, whether in the health care field or electronics or with creative works, such as music and motion pictures.

ANTITRUST SOURCE: Is the work with the foreign counterparts in the IP working group likely to affect the content of any updates to the IP Guidelines?

DELRAHIM: I don't know at this time. If we see that there's an area where our understanding is advanced through our dialogues with our foreign counterparts, that could certainly find its way into the report, but given that we have not had many of these discussions, it's hard to predict. We have looked at the recent proposed European Regulation, called the Technology Transfer Block Exemptions—or TTBE—which is their version of IP Guidelines, and right now we're reflecting on the changes they have proposed. I think the recent European regulation relating to intellectual property is a good example of the common good that comes from some of the bilateral discussions we've had. The recent changes are a significant improvement from the EU's past approach, although there may remain some areas where our approach differs significantly from theirs. Those regulations are scheduled to take effect in May 2004, and we hope to discuss this further with the Commission in the coming months. We might express some of our views to Commissioner Monti and Director General Lowe next month when they are here for our annual bilateral discussions.

ANTITRUST SOURCE: You mentioned the case law since the IP Guidelines were issued. Evidenced in that case law is a struggle that the courts are having about how to strike the balance between antitrust enforcement and enforcement and preservation of intellectual property rights. While both sets of laws are designed, at least in part, to promote innovation, they go about that task in ways that are sometimes in tension with each other. What are your thoughts about that issue and where do you believe it's appropriate to draw the line?

DELRAHIM: I really don't believe there is much tension. There's some perceived tension by practitioners and commentators. I don't see much tension either with policy or in the law right now. In my view, they both are intended to promote a competitive marketplace for new ideas and incentives for research, and both have as their ultimate goal benefits to consumers. The intellectual property laws—particularly, the patent laws and copyright laws—provide that incentive for you to bring something new to the consumer and in exchange you get a certain limited right to enjoy exclusivity for that. And then after that period, everybody is free to exploit that for the benefit of the consumers, and often the product becomes a commodity. The antitrust laws, as you know, are ultimately to protect the competitive marketplace which, again helps the consumer. So, I may have just made two statements that are very obvious, but I don't see much conflict between the two. Some people view intellectual property law as protecting monopolies, but as our forefathers in the Constitution anticipated, it's an exchange that we are making as a society with those creators and inventors—in exchange for a limited period of market position in the legal sense. And as you well know, that is not necessarily a monopoly in the product market/economic sense, which is what antitrust is concerned with. For example, one company might have a patent on an ulcer medication, but that doesn't mean another company cannot have a patent on another ulcer medication, and you have two competitors in the same market for the market of ulcer drugs. In short, the fact that the IP laws provide the incentive to innovate means they actually help provide an incentive to have more and better competition among existing products.

ANTITRUST SOURCE: A couple of years ago, you were quoted in a technology industry publication saying that it may be time for a “new injection of technical expertise into antitrust law, just as there was an injection of economic analysis into antitrust law in recent decades.” Is that your view and, if so, would you rank “technical expertise” as high as economics in terms of its importance for antitrust analysis?

DELRAHIM: I remember that quote. I don't know if I rank one higher than the other. I think they are both very important in developing the proper approach to antitrust enforcement. Of course, economic analysis helped guide and shape antitrust jurisprudence as we know it today. Through the works of the Chicago school, Judges Posner and Easterbrook, and Bill Baxter, among others, economics helped show whether or not certain practices that might be literal violations of the black letter law were in fact procompetitive and pro-consumer. Before that, enforcers took actions to prevent practices and ended up actually hurting consumers. So, it was more or less the injection of economics that helped show the true market impact of various activities that helped prove that case and change jurisprudence in the area. I think the consumers, the markets, and all the antitrust enforcers involved have benefited from that evolution; otherwise, we'd be stuck with a two-line statute under the Sherman Act saying that anything that restricts competition is against the law. With respect to the infusion of technical understanding, I really mean we need to fully appreciate how certain business activities—certain marketing activities or other practices relating

to high-technology—work in the real world. And if you do have a full appreciation of the impact on markets and consumers by understanding the technology itself, you come to a better conclusion of what is or should be illegal under antitrust laws. You have certain technologies, whether in the computer technology field or in pharmaceuticals, that will have different market implications than just regular widgets. So my comments were really to emphasize that if the law somehow restricts procompetitive behavior or allows anticompetitive behavior because we apply old economy understanding to new-economy technology challenges, we may inadvertently hurt consumers.

ANTITRUST SOURCE: What is the Antitrust Division doing to promote the use of technical expertise in antitrust analysis?

DELRAHIM: I am too new here to comment on that intelligently right now. But I do know that in various cases, experts, and not just economic experts, are consulted. Also, the most recent reorganization of the Division just last year was done to enable the Division to best take advantage of different expertise within it. We have a networks and technology section. In the *Microsoft* case, for example, it wasn't just lawyers and economists, there were all sorts of computer experts who were consulted, and I presume that in other merger cases, and even in agriculture, experts in those markets are used regularly, pre-dating my comments several years ago in the technology industry journal you mentioned. I should add that it is not just adding people with certain backgrounds, it is looking at antitrust analysis and asking, "That makes sense for the widgets market, but does the analysis make sense for the same practice in this new high-tech market?"

[[If the law somehow restricts procompetitive behavior or allows anticompetitive behavior because we apply old economy understanding to new-economy technology challenges, we may inadvertently hurt consumers.

ANTITRUST SOURCE: Let's shift gears a little bit. Earlier you alluded to legislation pending in Congress about proposed enhancements to antitrust criminal penalties. Can you tell us what the Division's view of that legislation is?

DELRAHIM: Yes, and I would refer you to Hew Pate's speech at the ABA Conference in San Francisco this past August [<http://www.usdoj.gov/atr/public/speeches/201241.htm>]. Hew did discuss that the Antitrust Division believes it is time to rethink some of the criminal penalties, as well as the jail sentences, and consider improvements that have been developed here to the amnesty program that could benefit the Division's criminal enforcement activities. There's a lot of evidence, both anecdotally and otherwise, that shows that members of an illegal cartel would be more willing to come forth and turn themselves and the cartel in if they had some assurances that they would not be subject to treble damages in a private action. Right now, some cartels continue to live on, partly because one member who otherwise would be willing to come forward, does not, out of fear of follow-on treble damages actions. The proposal that has been put forward would, I think, benefit consumers and significantly benefit the enforcement against cartels.

ANTITRUST SOURCE: Has the Division taken a position as to this particular legislation, other than Hew Pate's remarks last August?

DELRAHIM: No, I know a legislative proposal has been forwarded over for the clearance process within the administration, but we do not have an official comment other than what Hew Pate's comments said. We have provided technical assistance to staff members of the House and Senate Judiciary Committees who are considering various aspects of the legislation, including some changes to the laws relating to standard-setting organizations.

ANTITRUST SOURCE: Would it be fair to say that the Division favors enhancing criminal penalties for antitrust violations?

DELRAHIM: I think it would be fair to say that the Division certainly wouldn't oppose such a change if Congress made it.

ANTITRUST SOURCE: There is also legislation in Congress concerning protections for standard-setting organizations and activities. What is the Division's view of that proposed law?

DELRAHIM: I don't know if we have officially commented on that, but based on the latest versions of the legislation that we have reviewed, we believe the legislation could provide some consumer benefits in the limited area of standard setting. I think it could help the standard-setting organizations that are more actively engaged in some cooperative limited-purpose activity, and I don't see the Division opposing that legislation that is currently pending before the Senate. And it's already passed the House, I believe with an overwhelming bi-partisan vote.

ANTITRUST SOURCE: In connection with appellate advocacy, you said earlier that the Division looks for opportunities to file amicus briefs where it thinks it's important enough to warrant it. One of those places was the *Trinko* case. I believe that the Division may be providing input to a brief in the *LePage's* case and, of course, there is *American Airlines*. All of these cases concern Section 2 enforcement. My question is, does the Division have a unified philosophy of Section 2 enforcement and, if so, what is it and how can we look forward to it being expressed?

DELRAHIM: The same test that the Division put forth in the *Microsoft* case, in *American Airlines*, and in *Trinko* were consistent, and that is whether or not the conduct had a business justification other than excluding the competitor. That would be the same test, and it pre-dated Hew Pate's and Charles James' administrations of the Antitrust Division, and it's the same test we've applied and anticipate to continue to apply in similar Section 2 cases.

ANTITRUST SOURCE: Let's turn to the International Competition Network. Are we likely to see concrete proposals emerge from the work of the ICN?

DELRAHIM: I think so. I've been pleasantly surprised by the benefits we've seen. I am pleased to say that I recently became the Chair of its Merger Working Group, a position most recently held by my colleague here, Debbie Majoras. By the progress the ICN has made, you know, the best practices they were able to put forward is something that I think we are seeing many more countries look to and develop. I think I saw today a report that the Brazilian government has agreed to certain changes in its merger law and to adopt the best practices of the ICN. That's a concrete example for us to gauge the accomplishments of the ICN. And we just came back from the OECD, where the various member countries, as well as several observers who were there, discussed the role and progress of the ICN. The ICN members met in France last week, and it was very helpful. ICN is plugging away as a virtual organization—we are now solidifying our plans for the next ICN meeting in Korea early next year. We have seen best practices for investigative techniques in merger enforcement and for notices to parties. I am excited by what it can accomplish in the future.

ANTITRUST SOURCE: In recent years there have been some very public debates between the Justice Department and the EU regarding the application of certain merger theories, the chief example of which is the GE/Honeywell merger. Do you think that this form of debate is helpful, in terms of harmonizing rules or theories, or in solidifying the relationship between the two enforcers?

DELRAHIM: I think it is helpful, both bilaterally and in these types of multilateral forums. From what I can see, I don't think we've had a stronger relationship with the European Commission than we have now. I think part of that could have been a result of the discussions and the debates that started with the Honeywell/GE merger, but that has continued. There's a lot of cooperation on various enforcement actions and discussions of how we should proceed in the approach to antitrust law. The technology transfer regulation I mentioned earlier is another example. They've actually asked for our comments as part of that IP working group, and we'll be providing that, and I think that only shows that the discussions have had a good benefit. Commissioner Monti and DG Phillip Lowe are going to be in town for our bilaterals next week and at the Fordham Conference in New York later this week. There are going to be opportunities when Hew and I and others at the Division will get to meet and solidify our relationship over the coming weeks, and I hope that will continue.

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ANTITRUST SOURCE: In your view, is the trend still toward convergence or are we in a time now in which international actors are emphasizing differences in their philosophies?

DELRAHIM: So far it's still toward convergence. And as new countries are adopting new laws, I think they are benefitting from a lot of these discussions. You know, of course, there are some areas in which different members of the international community will have different approaches, but that's not any different from the difference of ideas here in the United States, when different judges will hear the same case but decide it in different ways. So, I think we'll always have some areas of disagreement, no matter what the area of the law is. But overall, we're still moving toward convergence. And we hope that we'll be able to achieve administrative convergence for enforcement sooner than substantive convergence. That's probably easier to accomplish than getting agreement on a substantive approach to antitrust law.

ANTITRUST SOURCE: Substantively, what would you say are the top two or three areas of significant difference between U.S. antitrust philosophy and that of the EU?

DELRAHIM: The one area I think most people can point to is our differing approach to Section 2-type practices, whether it's pricing or non-pricing practices. The EU takes a view that with a particular level of market position, there are certain practices you can engage in and some you cannot. And right now in the United States, that approach is different. Our approach to market share is that it is a starting benchmark, that other factors come into play, such as the strength of the dominant power and whether there will be competitors coming in. It's not as rigid. And the EU's approach is different—there are some absolutes when you have a certain market share, regardless of your ability to maintain that. I should also mention that the two jurisdictions approach some areas of antitrust IP differently, such as the unilateral practices of IP holders. We don't have a rule here in the U.S. that a unilateral refusal to license valid intellectual property, by itself, is a violation of the antitrust laws. The rule in the EU might be different, which is why we are closely monitoring the development of the recent *IMS Health* case.

ANTITRUST SOURCE: In your view, is there a difference between the U.S. and EU approach to merger analysis?

DELRAHIM: I think the GE/Honeywell case highlighted a major difference between the two countries in their approach to mergers. The Court of First Instance in Europe, where the Commission's decisions are appealed to, has reversed the Commission several times in the recent past on some of its merger enforcement actions. The GE/Honeywell case is being appealed, and we'll see where it goes. But so far, I think, we have moved much closer on our approach to merger analysis, and it's probably due to the experience in that case and our efforts to build a better understanding and cooperative relationship with the European Commission.

ANTITRUST SOURCE: There was a concern expressed by the Division in its amicus brief that the *Empagran* decision could lead to a reduction in amnesty applications. Has it had that effect?

DELRAHIM: It's always tough to evaluate such things with respect to criminal enforcement and amnesty. I'll leave that to our Deputy in charge of criminal enforcement, Jim Griffin. But, intuitively, you can't guess how many cartels are out there that have not come forward; you can't really do a survey out there, asking "Hey are you violating the antitrust laws and would you have, had this case gone the other way?"

Just last week at the OECD, this *Empagran* matter became a big issue that a number of other countries raised. They were concerned. That raises a concern with respect to international cartel enforcement, as well, where countries are afraid to share information out of fear that activities that occur wholly on their soil, that don't even involve a U.S. plaintiff, could now be subject to U.S. treble damage private actions by a plaintiff from a foreign country. This one has caused many countries some discomfort. One official was telling me that if the *Empagran* decision stands, it is tantamount to a usurpation of legislative sovereignty by the U.S. courts. He basically said that if his country has not seen fit to provide treble damages against conduct by defendants in his country by a plaintiff in his country, this case will now decide that for them, and the U.S. courts and laws would be the welcoming host for such activity. As you know that issue is being litigated now. The D.C. Circuit in its 4-3 decision interpreted it a certain way, and now it will likely be up for appeal to the Supreme Court. My guess would be that given there's a clear conflict now with the Fifth and Second Circuits, they likely will take it on *cert* and try to resolve it. But I think that's an issue not only for the Division, but for policy makers on Capitol Hill to look at and consider because now you have, as I said, the specific fact of the *Empagran* case highlighting the problem that it could cause with respect to criminal cartel enforcement.

ANTITRUST SOURCE: What is the Division's view about the split in authority over the FTAIA?

DELRAHIM: The Division filed an amicus in the D.C. Circuit, so I would refer you to that. As you know, we filed on the side that ultimately did not prevail at the D.C. Circuit en banc, but the Division has not filed an amicus for *cert* at the Supreme Court at this time. We also have the Ninth Circuit case, better known as the *Tomato Seeds* case, which involves another aspect of the FTAIA. We have argued that case and are awaiting a ruling by the Ninth Circuit.

ANTITRUST SOURCE: Is the Division contemplating urging legislation in that regard?

DELRAHIM: No, not at this time. That's one of the things we'll look at, particularly given the impact of this line of cases on our criminal enforcement efforts and also on our relations with foreign antitrust bodies. But whether the split in authority is fixed by the Supreme Court or by legislation, the Division will welcome it.

ANTITRUST SOURCE: Recently, arbitrage firms have hired lawyers to try to influence the outcome of merger investigations involving public companies. These arbitrage firms have a significant financial interest in whether or not a deal goes through, having wagered very large sums of money based on the "spread" between the announced deal price and the target's actual stock price. The arbs hire lawyers who locate parties (e.g., customers) to represent before the agencies to present arguments against the deal. The arbs pay the fees of the lawyers and experts, and the agencies are never informed that the arguments they are hearing are being sponsored by arbitrageurs with a large financial stake in blocking the deal. In the Division's view, does this raise any ethical issues, or does it otherwise cause any concern about the integrity of the merger review process?

DELRAHIM: I have not been in the arbitrage business, but I would guess that it is probably a practice that has been going on for some time. Having come from the legislative branch of government, where you are faced constantly by front organizations, such as the Association to Promote this or that, or the Council to Better X or Z, I would be surprised if anyone is easily fooled by the true motives of such groups, who do have a Constitutionally protected right to petition the government. The Division is always looking for credible evidence of the impact of a merger or about a questioned practice by parties. In my personal view, which is not necessarily the Division's view, I don't think it really matters if those customers' plane tickets were paid for by an arbitrage firm or group associated with them, so long as the customers are legitimate and credible. If the information is true, and the customers or witnesses are legitimate, there really is no concern. We hear from parties on different sides of a case or merger all the time. On the other hand, however, I would think that if someone was trying to influence the merger review process by providing sham witnesses or impact evidence, that would be something that would raise serious concerns and would probably instigate the filing of charges, whether under our fraud statutes or under antitrust laws, depending on the facts of the case and the parties involved. ●

The State of Critical Loss Analysis: Let's Make Sure We Understand the Whole Story

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Over the past several years, what has come to be known as Critical Loss Analysis (CLA) has played an increasingly important role in antitrust. However, recent articles by prominent antitrust economists, Michael Katz and Carl Shapiro, and Daniel O'Brien and Abraham Wickelgren (two papers), appear to question the validity of that role.¹ We believe that these critiques of CLA might be misread as to its basic utility and applicability. Our goal here is to put Critical Loss Analysis in context. The significance and generality of CLA lies in its ease of practical application and from the fact that it is merely "arithmetic" based on the assumption that a rational firm will not change price unless it expects, as a result, that its profits will not fall. CLA is independent of any particular theoretical model of pricing. The analyses advanced in these two papers, on the other hand, depend on the applicability of their (too simplistic, in our view) economic models to the facts of a particular merger and industry.

A Short History of Critical Loss Analysis

Almost every merger investigation that has been conducted by the Federal Trade Commission and the Department of Justice over the last several decades has involved a determination of whether various products are sufficiently close substitutes to justify including them in the same relevant antitrust market. For many years, this often determinative question of how to bound the market was answered without any degree of rigor. Courts generally stated that the question turned on the extent of the cross-elasticity of demand or the reasonable interchangeability of the products in question. Unfortunately, nowhere was there a suggestion as to how high the cross-elasticity must be or how much interchangeability was reasonable.

This unfortunate state of affairs began to change with the issuance of the Department of Justice 1982 Merger Guidelines and their articulation of a hypothetical monopolist paradigm. This paradigm answers the question of how to bound the market. That is, an antitrust market should be no broader than the group of products and geographic areas such that a single seller of those products in those areas would find it profitable to impose a small, but significant and non-transitory price increase.

¹ 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. 161-84 (2003). See also James Langenfeld & Wenqing Li, *Critical Loss Analysis in Evaluating Mergers*, 46 ANTITRUST BULL. 299 (2001).

The test was first criticized as non-operational and too theoretical. But within a relatively short time, it became obvious that the implementation of the hypothetical monopolist test could be facilitated with a very basic type of “break-even” analysis.² In other words, the Guidelines’ market definition paradigm required only some basic arithmetic, first described in an article by Harris and Simons, who termed it “Critical Loss Analysis.”³ Subsequently, Critical Loss Analysis has been widely used by both the Federal Trade Commission and the Department of Justice, and in many litigated cases.

It is now well recognized that CLA is also very useful for assessment of competitive effects. For example, coordinated interaction theories may focus on whether a group of specific competitors (rather than all competitors) would find it possible to raise their prices even though competitors outside the group would not participate in “coordination.” CLA is the analysis relevant to answering this question. Similarly, if different competitors have substantially different costs and/or face substantially different Actual Losses arising from a coordinated price increase, CLA might demonstrate that some competitors would not find it in their interest to participate in a coordinated price increase. Finally, CLA analysis is also useful in assessing unilateral effects theories.⁴ The primary focus of the two papers that we discuss here is unilateral effects analysis rather than market definition. As we discuss below, we have significant disagreements with the papers with respect to both market definition and unilateral effects analysis.

One of the greatest strengths of CLA is that it is “just arithmetic,” and completely neutral as to the appropriate theoretic model that best explains any real life market.

It’s Just “Arithmetic”

The two papers raise concerns on our part that readers might misinterpret the implication of those articles as to the utility of CLA—possibly by losing sight of what is merely “arithmetic” (and indisputable) and what is theory (which requires factual support in order to be applied). One of the greatest strengths of CLA is that it is “just arithmetic,” and completely neutral as to the appropriate theoretic model that best explains any real life market.⁵ In our experience, perhaps because of equations and diagrams in various papers discussing CLA, some merger analysts mistakenly believe that CLA is based on economic theory, beyond the simple assumption of profit-maximization.

In short, CLA involves the following three steps:

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 Gregory J. Werden, *The 1982 Merger Guidelines and the Ascent of the Hypothetical Monopolist Paradigm*, 71 ANTITRUST L.J. 253, 266 (2003) (An early criticism of the 1982 Merger Guidelines approach to market delineation was that it could not be rigorously applied through the analysis of data. It was quickly realized, however, that the criticism was dead wrong. The hypothetical monopolist paradigm can be implemented in an entirely straightforward manner through a “critical elasticity of demand” or “critical loss” analysis” (footnotes omitted).)

³ Barry C. Harris & Joseph J. Simons, *Focusing Market Definition: How Much Substitution Is Enough?* 12 RESEARCH IN L. & ECON. 207 (1989).

⁴ See David Scheffman, “Critical Loss” Analyses, Presentation to EU Merger Task Force (2003), <http://www.ftc.gov/speeches/other/criticalloss.pdf> [hereinafter Scheffman, “Critical Loss” Analyses.]

⁵ We are concerned that footnote 5 of O’Brien and Wickelgren, *supra* note 1, may cause some confusion (“Our criticism is directed at the application of the formula without regard to whether the assumptions and conclusions in the application are consistent with standard economic theory”). There is *no* issue whether CL Analysis is right (again, it is just arithmetic). In particular, it is quite consistent with economic theory for Actual Loss to be significantly greater than Critical Loss, even when incremental margins are large. However, the two papers use simple models of pricing to argue that such a result should be presumed unlikely.

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”);⁶ and
3. Compare estimates of Actual Loss with Critical Loss. If the former is larger than the latter, then the market must be expanded.

We illustrate basic CLA in the following example. We provide this example to make clear that CL Analysis does not involve economics equations or diagrams—it is just arithmetic. Suppose that you are a middleman who resells widgets. You purchase widgets for \$5 a piece and you have no other costs of reselling widgets. Suppose you are able to resell widgets at retail at \$10, i.e., you make a margin of \$5 per widget, and you are currently selling 100 units. Suppose, finally, that you have not changed the retail price for quite awhile, and you are thinking about raising the retail price by \$1 to \$11. Would that raise your profits? Obviously, if your sales would remain at 100 units, the \$1 price increase would increase your profits by \$100. However, it is likely that at least some retail widget customers will reduce their purchases in the short and/or long run as a result of the 10 percent price increase. Given your prices and margins, the extent of sales lost due to the \$1 price increase determines the impact of the price increase on profits. Suppose, for example, you lose sales of 10 widgets when you increase the price by \$1. Profits before the price increase were \$500 (\$5 per unit for 100 units). After the price increase, profits will be \$540 (\$6 per unit for 90 units). In this case the price increase of \$1 would increase profits by \$40. However, notice that if sales fell to 83 units or lower, the price increase would lower profits to \$498 or less.

Note that we need no equations or graphs, and there are no elements of economic theory in the calculation. It is simply arithmetic.⁷ In the example, CL is 17 units (a post price increase level of sales of 83). That is, for a price increase from \$10 to \$11, if sales in fact fall by 17 or more (17 percent or more) units (i.e., if the AL is at least 17 units or 17 percent), the price increase will lower profits to \$498 or less. It is important to be clear that the CL arithmetic tells you nothing about what the magnitude of the Actual Loss would be. That determination must come from evidence bearing on what customers would actually do in response to a price increase. However, the two papers would impose simple pricing theory to make presumptions about Actual Loss—i.e., move from just arithmetic to (simplistic) theory. In our view this is a mistake.

Because CLA is just arithmetic and the arithmetic identifies factual issues highly relevant to the determination of market definition and potential competitive effects—facts that a fact finder or decision maker can resolve (incremental margin and AL)—CLA is highly practical.⁸ This simplicity and ease of practical application is the reason why Critical Loss Analysis has been readily “adopted” by courts and used frequently by the federal antitrust agencies. As discussed above, the key factual issues are: (1) what is the (incremental) margin on sales at the current level and “new” level

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⁶ This cannot be determined from incremental margin. It must be determined from evidence bearing on the responsiveness of sales to prices, i.e., from the “demand side.”

⁷ We have found that for many attorneys (and MBA students) going through the CLA with a simple Excel spreadsheet is more illuminating than using equations or formulas. For a discussion of CLA with simple spreadsheets, see Scheffman, “Critical Loss” Analyses, *supra* note 4. A spreadsheet version is available from the author.

⁸ In addition, analyses equivalent to Critical Loss Analysis (generally called, “break-even,” or “stay even” analyses) have long been taught in marketing courses and are widely used by businesses in considering the financial implications of changing prices. *See, e.g.*, SAM R. GOODMAN, *TECHNIQUES OF PROFITABILITY ANALYSIS* 43 (1970); THOMAS T. NAGLE, *THE STRATEGY & TACTICS OF PRICING* 28–57 (1987). The actual use of analyses equivalent to CL Analysis by many businesses to analyze price changes, itself, provides significant support for the use of CL Analysis.

of sales; and (2) what will be the AL relative to the CL for a given hypothetical price increase.⁹ Resolving these key factual issues typically requires substantial input from economists, in estimating incremental margins, and in estimating AL, for example, through demand-elasticity analyses, customer-switching analyses, etc. These key factual issues may not be easily resolved, but they are the sort of issues that fact finders regularly address in other contexts, for example, in determining damages.

Critiques of CL

The Katz/Shapiro and O'Brien/Wickelgren papers raise two concerns. First, both suggest that CL is often used to argue that industries with large margins (implying a low Critical Loss) have so much to lose from a reduction in sales volume that the hypothesized price increase associated with a merger (either for the candidate market as a whole or for the merging parties themselves) will be unprofitable. In other words, these authors believe that parties arguing for broader markets frequently do only the first step of the Critical Loss Analysis, or implicitly assume without any proof that Actual Loss is greater than Critical Loss for high margin industries. Second, the two papers argue, based on simple models of pricing theory, that Actual Loss (i.e., the response of customers to a hypothetical price increase) can be inferred simply from incremental margins, and that large margins necessarily mean that Actual Loss is low. We have concerns regarding both of these points.

As to the first point, 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. Rather, parties generally utilized the basic analysis correctly, by putting forward evidence they argued established that Actual Loss was greater than the Critical Loss.¹⁰ Sometimes their arguments prevailed and sometimes they did not. The determinative factor, as it should be, is the totality of the evidence bearing on estimates of Actual Loss relative to Critical Loss (and estimates of incremental margins).¹¹

As to the second point, it is important to be clear that because Critical Loss Analysis is just arithmetic, there is no dispute that Critical Loss is low if the (correctly estimated) incremental margins are high. The main thrust of the critiques of CLA for high incremental margin industries are theoretical arguments (not arithmetic) indicating that in high incremental margin industries the Actual Loss will also be low. Of course antitrust law, and Section 7 specifically, are based on economic

⁹ There is also an issue of what hypothetical price increase to use, since whether or not Actual Loss exceeds Critical Loss in some cases depends on the hypothetical price increase.

¹⁰ Typical evidence put forward included customer-switching analyses, analyses of marketing and market research documents, third-party pronouncements or analyses of demand elasticities, and estimates of demand elasticities or analyses relevant to demand elasticities put forward by the parties' economists. For example, in the Cruise Ship investigations, outside and Bureau of Economics staff analyses led to a conclusion that demand was too elastic to pass an across-the-board price increase test based on CLA. Nonetheless, the FTC concluded that Cruise Ships were a market, based on yield management pricing theories. See Mary T. Coleman, David W. Meyer & David T. Scheffman, *Empirical Analyses of Potential Competitive Effects of a Horizontal Merger: The FTC's Cruise Ships Mergers Investigation*, available at <http://www.ftc.gov/be/riocruise0703.pdf>.

¹¹ In hospital merger cases brought by the federal antitrust agencies over the past several years, the government has lost, generally on market definition, based in significant part on CLA-based arguments. To the extent there were problems in the resolution of those cases, it was with the facts used to implement Critical Loss Analysis, rather than CLA itself. For example, in most instances, patient migration patterns probably shed little, if any, light on the Actual Loss that would result from the transactions overwhelmingly at issue, i.e., those between hospitals and third-party payers.

theory—among other things that a monopolist protected from entry will raise prices above “perfectly” competitive levels (if the price increase passes the CLA test). Thus, we agree, absent compelling evidence to the contrary (e.g., prices set directly or indirectly by regulation), that it is reasonable to presume that the existing price/output combination (and level and nature of promotion, characteristics of product, etc., that may be determined in conjunction with pricing) for individual competitors is the outcome of rational decisions on their part. We also agree that it is reasonable to presume that a competitor does not believe that a price *significantly* above or below the pre-merger level for that competitor would significantly increase its profitability overall.¹²

The implications of this profit maximization logic for Critical Loss Analysis are key and cannot be understated. That is, for any particular competitor it is reasonable to assume that Actual Loss is *at least as large* as Critical Loss (assuming there are no regulatory or other significant constraints on pricing). However, Actual Loss may be substantially larger than Critical Loss.

Furthermore, it is reasonable to assume that the Actual Loss for the hypothetical monopolist (or for a merged entity with a significant cross elasticity between the products of the two parties) will be lower than for an individual competitor. However, again, Actual Loss may also be substantially greater than Critical Loss. Thus, we part company with the two papers attempting to infer, with greater specificity, a value of AL from incremental margins and (too simple an) economic theory.

Stripped down to their basic theoretical elements, the critiques take the simplest economic model of pricing, which produces the result that price is set where the percentage gross margin M ¹³ is equal to 1.0 divided by the price elasticity of demand ($M = 1/E$).¹⁴ This is the so-called “Lerner Equation.” In such a model, for small changes in price, Critical Loss equals Actual Loss.¹⁵ Thus, if the “Lerner Equation” ($M = 1/E$) is correct, it is necessarily the case that high margins mean low *Actual* Loss and AL will be close to CL, since E measures actual demand responsiveness to price changes. Katz and Shapiro misstate economic theory when they say “an economically rational firm acting unilaterally sets its price so that its gross margin is inversely related to its elasticity of demand: $M = 1/E$. . .”¹⁶ That is, 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.

To clarify this point, let us return to our example. In the two papers, the Lerner Equation would be used to infer that the incremental margin of 50 percent implies that the demand elasticity facing our widget manufacturer for a hypothetical price increase is approximately 2.0 (1/.5). What might be wrong with such an inference? Suppose that our widget manufacturer would actually lose 30 percent of its sales for the proposed 10 percent price increase, i.e., that the price elasticity for this price increase would be 3. This would be consistent with our assumption that a price higher than \$10 would not be profitable. However, using a simple model of pricing, the logic of the two papers would lead one to the conclusion that this cannot be consistent with profit maximization, by reasoning as follows: If the price elasticity for a price increase is 3, then is not the price

¹² It would generally be naïve to presume that firms are able to “determine” with precision the “demand elasticity” they face.

¹³ M equals price minus incremental cost divided by price. See Katz & Shapiro, *supra* note 1, at 50.

¹⁴ See *id.* at 51; O’Brien & Wickelgren, *supra* note 1, equation (9) and discussion, at 170.

¹⁵ The Lerner Equation condition is actually the condition $CL = AL$, for small price changes. For those remembering their economics, profit maximization occurs where price is at the level where the volume lost on a small change in price is at the level that the change in profits is approximately zero, which is the $CL = AL$ condition for small changes in price.

¹⁶ Katz & Shapiro, *supra* note 1.

elasticity for a price decrease also approximately 3, i.e., a 10 percent reduction in price would lead to a 30 percent increase in units demanded? And if the price elasticity for a price decrease is about 3, our widget manufacturer should have a lower price than \$10, since it could increase his profits with a lower price,¹⁷ i.e., the assumption that the initial price was profit maximizing is violated.

But the price elasticity might be significantly different for price increases than for price decreases. There are various reasons, put forward by economists over many years, why price elasticities for increases might be different from those for price decreases (e.g., demand curves may have “kinks”).¹⁸ Both papers discuss at length arguments about kinks.¹⁹ (In our example, if demand and/or costs are kinked, the Lerner Equation will not hold. We could have constructed our example with, say a price elasticity of 3.0 for price increases and a price elasticity of 1.5 for price decreases—this would be consistent with \$10 being a profit-maximizing price). Thus, kinked demand or costs 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 the two papers that *theoretical* arguments based on kinks are ad hoc, actual behavior by customers and/or competitors might have the effect crudely equivalent to a “kink.”²⁰ Evidence consistent with the existence of a “kink”²¹ is that significant changes in incremental costs do not get translated into changes in prices.²² Thus, although the simple pricing models of the two papers are theoretically rigorous, they are also ad hoc, in the sense that there 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 “real world” profit maximization.

This is the basis of our broader concern—i.e., does the simple economic model of pricing employed in both papers accurately reflect *actual* pricing in the industry being investigated? Again, remember that economic theory does tell us that AL is at least as large as CL. Only by 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.

As just one example, in the typical industrial or commercial product or service industry subject to a merger investigation, competitors have a relatively small number of major customers that account for the lion’s share of their business. In those industries, prices are *negotiated*,²³ and it is

¹⁷ If the price elasticity for a price decrease is 3, a cut in price by 10% would increase total sales to approximately 130 units, for which profits would be approximately \$520 (i.e., the new margin of \$4 times 130 units), which is greater than \$500 at the price of \$10.

¹⁸ Visualize a demand curve that is a straight, relatively flat line down to a price of \$10 and then becomes a significantly more steep line for prices below \$10. For a price increase demand is more elastic than for a price decrease, starting with a price at the kink, i.e., Actual Loss (gain in the case of a price decrease) is significantly greater (in absolute value) for price increases than for price decreases.

¹⁹ Katz & Shapiro, *supra* note 1, at 52; O’Brien & Wickelgren, *supra* note 1, at 178–79.

²⁰ For example, sophisticated customers shift a lot of business away from a competitor attempting to take an unwarranted price increase. A hypothetical monopolist might not face that source of customer pressure, but may face other sources of buyer power. See, e.g., David Scheffman & Pablo Spiller, *Buyers’ Strategies, Entry, and Competition*, 30 *ECON. INQUIRY*, July 1992, at 418–36. But buyer power is not the only reason why individual or market-level demand may have significantly higher price elasticity for price increases than for price decreases, as discussed below in the text.

²¹ The “kink” might be a simplified term or concept for a situation in which price elasticities are substantially larger for price increases than for price decreases.

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.

²³ Even in consumer products industries, manufacturers of consumer products sell to large chain retailers (and/or large wholesalers) and negotiate about shelf space, promotions, etc.

probably not reasonable to “shoehorn” an explanation of pricing based upon the simple economic model of pricing. In particular, the “price” negotiated with a major customer (typically, there are a number of things negotiated besides price) cannot be presumed to result from setting a margin approximating 1.0 divided by the price elasticity of demand of that customer. Rather, prices and margins are determined by opportunity costs, bargaining leverage, relationships, competition, longer-run considerations, etc.

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actualities of pricing.

Finally, it has long been accepted by economists that pricing in high-margin industries, particularly concentrated industries, is probably not explainable by simple economic models of pricing (or oligopoly). Put simply, we agree completely with FTC Chairman Muris that models of pricing and competition (and of the potential competitive effects of mergers) must be soundly based in the institutions and actualities of pricing.²⁴ It would certainly be helpful to have an economic model of pricing that actually fits a given situation. But the great strength of CLA is that if CL and AL are determined correctly based on the evidence, you will get the right answer even without a sophisticated economic model. And AL must necessarily be determined by the totality of evidence on how sales will respond to hypothetical price increase, not by theoretical presumptions.

Authors of both papers agree that the facts and industry setting might rebut the predictions of the simple pricing model. But they apparently would reverse the burden of proof—i.e., require the defendants to disprove the plaintiff’s alleged market definition. We agree completely with Judge Hogan’s opinion in *FTC v. Swedish Match North America, Inc.*²⁵ that, as a matter of both economics and law, you should not infer Actual Loss (or shift the burden of proof) based upon margins.

Furthermore, the models in the Katz/Shapiro and O’Brien/Wickelgren papers predict that if there is a positive cross elasticity between the parties to the merger, then prices will go up as a result of the merger based simply on their margins, evidence of cross elasticity, and economic theory alone!²⁶ This result obtains because if the Lerner Equation holds, $CL = AL$ (for small price changes), and a positive cross elasticity reduces the loss in total margin resulting from the price increase because margin is earned on sales diverted to the merger partner.²⁷ Put differently, a significant cross elasticity undoubtedly makes a hypothetical price increase more profitable, but it cannot be inferred that the price increase would increase profits relative to the status quo. The change in profitability can only be determined by an analysis of AL (relative to CL), which must come from evidence bearing on how much sales will be lost, and to which competitors, as a result of a price increase.

Consider, for example, the Katz/Shapiro proposed new test for market definition and potential competitive effects based on what they define as the “Aggregate Diversion Ratio” (ADR). We do not want to get into the technical details here (which are the subject of another paper), but we argue strongly against supplanting CL Analysis with ADR analysis. Unlike CLA, the ADR analysis is not arithmetic. It imposes and extends the Lerner Equation analysis, which has the same

²⁴ See Timothy J. Muris, FTC Chairman, Improving the Economic Foundations of Competition Policy, Speech Before Geo. Mason L. Rev. Winter Antitrust Symposium (Jan. 15, 2003), available at <http://www.ftc.gov/speeches/muris/improveconfoundatio.htm>.

²⁵ 131 F. Supp. 2d 151, 160–62 (D.D.C. 2000).

²⁶ “[H]igher margins typically make it *more* likely that a price increase by merging firms will be profitable.” O’Brien & Wickelgren, *supra* note 1, at 164. The models of the two papers are the basic (simple) models underlying unilateral effects analysis for differentiated products.

²⁷ Or mixing units of widgets and gadgets, loss of widget units is partially “made up” by gain in gadget units.

[W]e argue that evidence on actual competition between the parties to a proposed merger and its effects is much more probative than evidence bearing on cross elasticities of demand.

defects for unilateral effects analysis as for market definition.²⁸ This analysis is particularly “dangerous” when applied to unilateral effects theories. According to their analyses, 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.²⁹ Although this is a matter for another paper, we argue that evidence on actual competition between the parties to a proposed merger and its effects is much more probative than evidence bearing on cross elasticities of demand.

Litigation should be and generally is determined by facts and fact-based analysis. Economic theory has a role, but the more specific the economic theory employed, the greater the requirement that the economic theory be valid in the specific setting.³⁰ That should continue to be the case, particularly for something as important in an antitrust investigation or case as market definition. As discussed above, we believe that economists have the burden of establishing that a simple pricing model actually is applicable to a specific situation before it can be used to make very strong and important inferences. Of course, if economists could show in a specific instance that actual pricing is suitably “explained” by the simple pricing models, then it would be reasonable to apply those models and results to that specific matter.

Finally, the Katz/Shapiro and O’Brien/Wickelgren critiques focus on high (incremental) margin industries, but their theoretical arguments are independent of the level of margins in an industry because their models predict price increases for all mergers among firms with positive cross-elasticities, whether margins are low or high. (The only difference is that the predicted post-merger price from their models would be smaller, other things equal, in the low margin industries.)

We hasten to add that we are not anti-economic theory. Sound application of sound economic theory is fundamental to sound antitrust policy and sound resolution of antitrust investigations and cases. The authors of the two papers are prominent antitrust economists, and their technical economic analysis is correct. However, imposition of theory that may not comport with the institutions and reality of a real market, and real competitors will not lead to better policy or case resolutions. We agree with both papers that we need to be (and the agencies are) cognizant of the arguments as to why high margins may indicate narrow markets. But we cannot agree that the simple economic theory of pricing should reverse the burden of proof on market definition.

Conclusion

The papers by Katz and Shapiro, and O’Brien and Wickelgren, make useful contributions in identifying potential misuses of Critical Loss Analysis. They correctly point out that high margins do not in themselves suggest broader markets, and, indeed, high margins are, in themselves, quite

²⁸ Consider our example above, where incremental margins on widgets are 50%, and a 10% price increase would reduce *actual* widget unit sales by 30%. The CL percentage is 17%. By assumption (discussed above), the AL percentage is 30%. The Katz/Shapiro ADR condition says that if the acquired gadget manufacturer picks up more than 17% of the actual loss in sales then the price increase is profitable. However, simple CL arithmetic shows that for the 10% price increase to be profitable, an acquired gadget producer would have to pick up approximately $(13/30) = 43\%$ of the lost sales of widgets for a 10% price increase in widgets to have no change in profits. (This assumes that incremental margins on gadgets are the same as incremental margins on widgets.) Again, the Katz/Shapiro ADR condition *only* holds if the Lerner Equation approximately holds.

²⁹ With a significant cross price elasticity with the merger partner, the profitability of a hypothetical price increase is greater than if the cross elasticity is zero. As a matter of theory or fact, however, this does not necessarily mean that the hypothetical price increase is profitable.

³⁰ Again, as a general matter, all economic theory can tell us is that (absent price regulation or other impediments to profit maximization with respect to price) Actual Loss for a specific competitor is at least as large as Critical Loss for that competitor.

consistent with narrow markets. The papers also show that economic theory might be able to push farther than CLA in placing bounds on the Actual Loss. It is up to economists, however, to demonstrate that these price theories adequately explain pricing in a given industry setting.

In this regard, much more work, both theoretical and especially empirical, on pricing in high-margin, concentrated industries (and for basis of comparison, unconcentrated industries) is needed. This subject was a major focus of economic research in the 1930s and 1940s. The economists of that era were conversant with the model of monopoly pricing and of the Cournot and Bertrand oligopoly models and they also understood at least some of the deficiencies in those models for explaining the reality they observed.

What those economists observed appears equally relevant today, i.e., that it is common to find that apparent shifts in demand or costs sometimes, if not often, do not produce changes in prices. These are facts difficult to reconcile with simple price theory. (For example, simple theory predicts that significant increases in incremental costs should be reflected in higher prices). Furthermore, for decades, research on actual business pricing has generally not found business conduct to be consistent with simple price theory. (For example, the most common pricing “strategies” involve pricing based on average *total* costs and/or “market,” rather than price sensitivity/elasticity.³¹ This does not mean the managers are irrational or do not have as an objective long-run profit maximization. Rather pricing in real world markets adds complexities that are often not adequately captured by simple price theory. This may be particularly true in concentrated, high margin industries.

We need models and analyses that can be shown to adequately explain actual pricing in such industries that can be reliably applied in specific situations. Economists involved in merger investigations can advance the ball by developing to the extent possible the determination of prices in the industries under investigation. Doing this specifically in connection with Critical Loss Analysis would be very helpful. ●

³¹ See, e.g., V. Govindarajan & R.N. Anthony, *How Firms Use Cost Data in Price Decisions*, MGMT. ACCOUNTING, July 1983, at 30–36; E. Shim & E.F. Sudit, *How Manufacturers Price Products*, MGMT. ACCOUNTING, Feb. 1995, at 37–39. Other research questions whether the simple pricing economic models that are the basis of the two papers criticizing CL Analysis capture reality. See, e.g., J. Dalen & R. Thurik, *A Model of Pricing Behavior: An Econometric Case Study*, 36 J. ECON. BEHAV. & ORG. 14, 177–95 and bibliography (1998).

The Do-Not-Call Quagmire: Federal Court Rulings Block Implementation But FTC and FCC Are Set to Enforce

Christie L. Grymes

The Federal Trade Commission and Federal Communications Commission began enforcing the national do-not-call registry on October 17, but not before a flurry of court rulings, hurried legislation passed by Congress and signed by the President, and action by a Supreme Court Justice. The uncertainty began in late September, when rulings from federal district courts in Oklahoma and Colorado effectively blocked the FTC's ability to enforce the national do-not-call list. The FTC has appealed both rulings and, pending the appeals, has authority to proceed with implementation and enforcement.

As the ultimate fate of the national registry remains in limbo, the 54 million consumers who have registered for the do-not-call list have likely noticed a decrease in telemarketing calls. Many telemarketers began voluntary compliance on October 1. The FTC and FCC have begun investigating complaints from consumers who receive unwanted telemarketing calls. The FTC announced on November 7 that it had received approximately 63,000 consumer reports of do-not-call list violations. It is reviewing those reports for recurring complaints about certain telemarketers, which will likely trigger an investigation into the telemarketers' compliance with the do-not-call and other requirements of the Telemarketing Sales Rule.¹ The FTC expects to bring an enforcement action by December.

Background

In January of this year the FTC announced, with some fanfare, the creation of a national do-not-call registry as part of amendments to the Telemarketing Sales Rule (TSR).² The FTC issued the original TSR in 1995, giving effect to the Telemarketing and Consumer Fraud and Abuse Prevention Act,³ and based the amendments on that same authority. The TSR applies to any plan, program, or campaign that is conducted through interstate phone calls to sell goods or services or solicit a charitable contribution. The TSR applies to telemarketers that solicit consumers, even on behalf of a third party, and to sellers that provide or arrange to provide goods or services.

In addition to those requirements, consumers may sign up for the do-not-call registry, and for-profit telemarketers and sellers must scrub from their call lists those who have registered for the

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¹ 16 C.F.R. Part 310.

² Although publicity surrounding the amended TSR has focused on the do-not-call registry, other changes also significantly affect all aspects of telemarketing, including requirements to make certain disclosures, obtain express verifiable authorization for payments not made by credit cards, display number on caller ID, tape record certain types of transactions, and eliminate abandoned calls when using predictive dialers.

³ 15 U.S.C. §§ 6101–6108.

do-not-call list. The FTC exempted calls to consumers with whom the caller has an “established business relationship,”⁴ “upsells,”⁵ and callers soliciting charitable and political contributions.

The FCC joined forces with the FTC over the summer to implement and enforce the do-not-call list, announcing its own do-not-call rules and broadening the scope of industries required to comply with the list.⁶ The FTC is responsible for establishing and maintaining the list. The FTC and FCC planned to begin enforcing the do-not-call list requirements on October 1, but ran into significant roadblocks.

First Hurdle: Statutory Authority

On September 23, Judge West of the U.S. District Court for the Western District of Oklahoma ruled that the FTC lacked statutory authority to establish a national do-not-call registry.⁷ The ruling came in a lawsuit filed by the Direct Marketing Association and several of its members challenging certain provisions of the FTC’s amended Telemarketing Sales Rule, including the do-not-call registry. The court found that the regulation of telemarketing in this way must derive from a grant of authority from Congress, which, it said, the FTC lacked. The court declared the registry invalid. It found, however, that, while Congress had not given the FTC authority to establish and enforce a national do-not-call registry, Congress had given such authority to the FCC.

The FTC and Congress responded immediately to the court’s ruling. The next day the FTC filed an appeal and moved for a stay of the court’s order. Congress passed legislation to explicitly grant the FTC authority to create, maintain, and enforce the do-not-call registry. President Bush signed the bill into law on September 30. Although that new statutory authority may have addressed the basis for Judge West’s ruling, thornier problems lay ahead. On the same day that Congress passed the new legislation, a district court in Colorado issued a ruling that presents additional concerns.

Second Hurdle: First Amendment Violation

On September 25, Judge Nottingham of the U.S. District Court for the District of Colorado ruled that the national do-not-call registry violates the First Amendment.⁸ The American Teleservices Association (ATA) had filed a lawsuit in Colorado challenging the do-not-call registry and other provisions of the FTC’s amended Telemarketing Sales Rule. Specifically, the court ruled that the FTC, by exempting charitable and political solicitors from the registry’s requirements, imposed a content-based restriction on speech. The court ruled that nothing in the FTC’s rulemaking record

⁴ The company has an “established business relationship” with the consumer if (a) the consumer has purchased, leased, or rented goods or services from the company within eighteen months preceding the call or (b) the consumer has submitted an application or made an inquiry to the company within three months preceding the call.

⁵ An “upsell” is any solicitation for goods or services that follows an initial transaction of any sort in a single telephone call.

⁶ FCC Report and Order, CG Docket No. 02-278 (release date July 3, 2003). The FCC Rule, issued pursuant to the FCC’s authority under the Telephone Consumer Protection Act (TCPA), establishes compliance responsibilities for any person or entity using the telephone system for solicitation, including industries that are exempt from FTC jurisdiction, such as banks, credit unions, savings and loans, airlines, telephone companies, and insurance companies. Although the FTC’s Telemarketing Sales Rule applies only to interstate calls, the FCC Rule applies to both interstate and intrastate calls.

⁷ U.S. Security v. FTC, available at <http://www.okwd.uscourts.gov/files/03-cv-122order.pdf>.

⁸ Mainstream Mktg. Servs., Inc. v. FTC, No. 03-N-0184 (D. Colo. Sept. 25, 2003), available at http://www.co.uscourts.gov/opinions/ewn_030184.pdf.

or the record before the court justified this differential treatment. Accordingly, the court held the do-not-call registry imposes a regulatory burden on commercial speech that violates the First Amendment, and enjoined the FTC from implementing the registry.⁹

Again, the FTC reacted quickly, asking the court the following day to stay its order and appealing the decision to the U.S. Court of Appeals for the Tenth Circuit. On September 29, Judge Nottingham refused to stay the order, finding that it would not cause the FTC irreparable harm.¹⁰ Later that day, the FTC filed a motion with the Tenth Circuit for an emergency stay pending appeal of the district court's order.

Meanwhile, FTC Chairman Timothy Muris was on Capitol Hill testifying before the Senate Committee on Commerce, Science, and Transportation criticizing the district court's ruling, stating that it eliminated any distinction between commercial and non-commercial speech and erroneously applied two Supreme Court cases, *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York City*,¹¹ and *Cincinnati v. Discovery Network, Inc.*¹² First, the Chairman noted that the district court assumed that calls from charities and commercial entities are equally invasive, despite Congress' conclusions when enacting the TCPA and evidence that commercial entities frequently ignored company-specific do-not-call requests under the TSR. Second, in contrast to the practice ruled unconstitutional in *Discovery Network* that discriminated against only a small percentage of newsrack advertising, the TSR's do-not-call registry covers almost 80 percent of telephone solicitations. Third, the Chairman argued that the registry does not ban any speech; rather, it provides a choice to consumers about the calls they are willing to receive.

On October 7, the Tenth Circuit stayed the Colorado district court's order, giving a green light to the FTC to begin operating the registry pending each agency's appeal.¹³ A hearing on the appeal is scheduled for November 10.¹⁴

In addition to challenging enforcement of the list by the FTC, ATA is challenging enforcement by the FCC. It had asked the Tenth Circuit Court of Appeals to stay the FCC's power to enforce the do-not-call registry. The Tenth Circuit rejected ATA's petition on September 26. On September 29, the FCC announced that it would enforce its do-not-call rules against telemarketers that had obtained the FTC's do-not-call list. The same day ATA escalated its request for a stay to Supreme Court Justice Stephen Breyer, who oversees courts in the Tenth Circuit. Justice Breyer denied the appeal. Hours later, as part of the order refusing to stay the ruling against the FTC that the do-not-call registry was unconstitutional, Judge Nottingham in Colorado prohibited the FTC from using the FCC to implement the registry indirectly.¹⁵ The October 7 ruling from the Tenth Circuit staying the district court's order, however, essentially permits the FCC to go forward with the FTC.

⁹ "[T]he court finds that the FTC's do-not-call registry does not materially advance its interest in protecting privacy or curbing abusive telemarketing practices. The registry creates a burden on one type of speech based solely on its content, without a logical, coherent privacy-based or prevention-of-abuse-based reason supporting the disparate treatment of different categories of speech." *Id.* at 26.

¹⁰ *Mainstream Mktg. Servs., Inc. v. FTC*, No. 03-N-0184 (D. Colo. Sept. 29, 2003), available at http://www.co.uscourts.gov/opinions/ewn_03N184MJW.pdf.

¹¹ 447 U.S. 557 (1980).

¹² 507 U.S. 410 (1993).

¹³ *FTC v. Mainstream Marketing Servs., Inc.*, No. 03-1429 (10th Cir. Oct. 7, 2003), available at <http://www.ck10.uscourts.gov/circuit/031429.pdf>.

¹⁴ A copy of FTC's and FCC's brief is available at <http://www.ftc.gov/os/2003/10/mainstreambrief.pdf>. A hearing on the appeal was held on Nov. 10.

¹⁵ *Mainstream Mktg. Servs., Inc. v. FTC*, No. 03-N-0184 (D. Colo. Sept. 29, 2003), available at http://www.co.uscourts.gov/opinions/ewn_03N184MJW.pdf.

Current Status: Call At Your Own Risk

While the FTC and FCC pursue their appeals, they have moved forward with enforcement initiatives. Consumers can continue to sign up for the registry by visiting www.donotcall.gov or calling 888.382.1212. On October 2, the FCC announced the establishment of a special do-not-call enforcement team. The FTC began collecting consumer complaints on October 11, and has already received over 63,000 reports and, assuming that it wins the courtroom battle, could file its first enforcement action in December. In light of the FTC's reluctance to remain idle and the continuing consumer outcry, telemarketers and sellers could undertake significant risks by continuing to call consumers included on the national do-not-call list. The FTC, states, and private citizens who suffer \$50,000 or more, may bring civil actions in federal district court to enforce the TSR. Entities that violate the TSR are subject to civil penalties of up to \$11,000 per violation, consumer redress, and injunctive relief.

Moreover, over thirty state do-not-call lists remain in effect with aggressive attorneys general ready to enforce them.¹⁶ In some cases, state lists cover a broader range of calls with fewer exceptions. Many state statutes also impose various requirements regarding disclosures, calling times, authorization, and rebuttals. The Colorado court's ruling however, could also jeopardize the validity of state do-not-call lists. The FCC's rules under the Telephone Consumer Protection Act prohibit any state with a state do-not-call list from enforcing the list unless the state list includes the phone numbers of consumers on the national registry. If states cannot access the national registry, they may be prohibited from enforcing their state lists. Moreover, the Denver court's reliance on the First Amendment to block the national do-not-call registry could become the basis for similar challenges to state lists. ●

¹⁶ Shortly over a week ago, the California Attorney General filed a lawsuit against American Home Craft, Inc., a home improvement company and licensed contractor, alleging that the company violated the TCPA and state unfair competition law by calling consumers registered on the national do-not-call list. Although the TCPA is typically enforced by the FCC, states also have enforcement authority. The Attorney General seeks at least \$100,000 in penalties and a permanent injunction. A copy of the Attorney General's complaint is available at <http://caag.state.ca.us/newsalerts/2003/03-137.pdf>. California has also passed legislation to create a state do-not-call list that takes effect on January 1, 2004.

Book Review: Post-Paradox Antitrust

Keith N. Hylton

Antitrust Law: Economic Theory and Common Law Evolution

Cambridge University Press • 2003

Reviewed by David McGowan

Professor Keith Hylton's *Antitrust Law: Economic Theory and Common Law Evolution* is a concise study that integrates antitrust history, policy, economics, and doctrine into a cogent whole. It is a valuable book and a good read to boot.

I will provide reasons for this assessment in a moment. First, however, it is fair to ask why we need another antitrust book. There are already several excellent texts and treatises, almost all of which integrate law and economics. Professor Hylton aims to fill what he sees as a gap between textbooks, which he views as an inefficient way to study doctrine, and hornbooks, which he sees as describing doctrine without providing an adequate theoretical basis for understanding it.

Professor Hylton is right about textbooks, which are meant in part to teach students how to distill doctrine from cases, a skill practitioners already have. And while not all hornbooks are excessively doctrinal, no one has time actually to read a comprehensive multi-volume treatise straight through. There are some excellent single-volume hornbooks, but these tend to be written more to consult on specific issues, or for a student to follow for an entire semester, than to provide an integrated narrative one might actually sit down and read as a regular book. There are some books surveying antitrust law, but they have tended to mix polemics with analysis—an approach that can limit their usefulness.

Professor Hylton fills this niche admirably. His analysis is concise—the ratio of ideas to pages is superb—and though it is a survey of antitrust the book is compact enough to allow the reader to observe how the same economic and institutional pressures affect different doctrines in similar ways.

The book begins with a succinct and accessible discussion of antitrust economics, including the model of perfect competition, transaction cost economics, and the economics of information. The economics are followed by an equally succinct summary of the history and purposes of the antitrust laws. Professor Hylton reviews both the “public interest” and “public choice” explanations for the Sherman Act (the latter more persuasive, in my view), and thus introduces the political pressures that have generated many of the doctrinal conflicts the book examines. The remainder of the book contrasts the Sherman Act with the common law concerning restraints of trade, distinguishes per se analysis from the rule of reason, and then examines various forms of concerted action, monopolization and attempted monopolization, merger policy, and antitrust immunity.

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How Institutional Constraints Affect Doctrine

Professor Hylton integrates economic analysis with doctrine and, importantly, the institutional constraints of courts and agencies. Institutional considerations are properly part of the law and economics of antitrust enforcement, but they sometimes take a back seat to the economic modeling of substantive problems or to arguments over how wealth should be distributed in society. Professor Hylton rightly perceives that one cannot understand the law without understanding the process that generates it.

That process is one of common law decision making within generous but not limitless statutory boundaries. Common law concerns, such as the need for predictability and flexibility, the relative merits of rules and standards, and the ability of courts to understand business practices, are therefore central to understanding antitrust. Professor Hylton identifies the “tension between the economic conception of the reasonableness inquiry and the administrative concerns of courts and agencies” as the “most general and frequently recurring problem in antitrust law.” He believes enforcement officials and statutory modifications pressure courts toward per se rules until the courts, in at least some cases, reach a “validity crisis.” Such a crisis occurs when the relevant doctrine can no longer be defended on economic grounds. At that point, the law turns once again toward a standard of economic reasonableness, and the per se rule is gutted or abandoned.

Professor Hylton is right about this. Opinions that change doctrine often emphasize the Court’s common law-like power to interpret the Sherman Act. And “validity” is a good term to describe an important concern relevant to the job of judging as well as to substantive antitrust doctrine.

Judges need to feel that in deciding cases they are doing something that deserves to be called “law.” In writing an antitrust opinion, a court (at least one with any discretion in what it says) will try to produce understandable doctrine that advances in a consistent manner the goals of the antitrust laws. Judges are practical people, too, and they do not like to think their rulings create economic losses. Advocates who understand these institutional points are in a better position to craft persuasive arguments than those who don’t. Because Professor Hylton understands them, and sheds light on how they affect different doctrines, his analysis is practically useful as well as academically rigorous.

With regard to the purpose of the antitrust laws, Professor Hylton’s economic critique suggests antitrust policy should try to advance economic efficiency net of the costs of administering the policy itself. Courts and agencies should not go after economically reasonable behavior. They should look into the reasonableness of behavior (or at least entertain arguments that do) unless and until the costs of inquiry exceed the gains.

Skepticism Without Dogmatism

One of the strong points of this book is Professor Hylton’s consistent consideration of the costs of mistaken decisions. There is always a risk that a court will condemn as unlawful conduct that enhances social welfare, or fail to condemn conduct that reduces it. A court that cares about welfare will therefore care about the relative likelihood and cost (the expected cost) of each type of error. It will look for ways to assess and to minimize these costs. In part for the institutional reasons mentioned earlier, advocates who are sensitive to the importance of error costs may find ways to present courts with appealing resolutions to complex problems; this book is full of good examples of such arguments.

This approach is not novel, but that is not a deficiency in such a work. Novelty is an ambiguous virtue. Antitrust law is eye-high in economic models proving that things are possible even if

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they never seem to occur—what Judge Frank Easterbrook refers to as “existence theorems.” The intellectual value of Professor Hylton’s book, and the genuine pleasure of reading it, stems from its rigorous and evenhanded analysis as he works through the cases and the main issues that comprise antitrust law.

Professor Hylton’s analysis is skeptical of the proposition that antitrust intervention can make markets work better than they would if they were left alone, but he is not dogmatic. He emphasizes the need for a practical approach to markets, one which recognizes that the economic model of perfect competition is a model, not a description of how most markets work. Rather than presuming that a departure from the model implies the need for antitrust enforcement, Professor Hylton persuasively argues that judges and enforcement officials should ask how “a workably competitive market might respond to the failures of one of the assumptions of the model.”

From a practical point of view, Professor Hylton’s measured skepticism expresses itself throughout the book in his insistence on asking why. Why do firms do what they do? Why do other firms respond as they do? How likely is it that an anticompetitive scheme would work? And, if logic implies that success is a long shot, why would a firm with its own money on the line place such a bet?

It is hard to overstate the importance of asking such questions, and this book exemplifies the gains to be had when they are asked. Such questions are particularly useful when combined with the proposition that real markets are imperfect and real firms may settle for relatively crude strategies that work because more tailored strategies may be too costly and thus less profitable. Professor Hylton reminds us that when asking whether desirable ends could be achieved by less restrictive policies, it is important to analyze the question net of information and other enforcement costs.

For example, Professor Hylton asks why a manufacturer might prefer a policy of resale price maintenance to other ways of combating retailer free-riding, such as charging different prices to retailers that provide different level of service. The problem is that goods flow from manufacturers to retailers before the retailer either does or does not provide services to customers. Retailers might break their promises, so under such a policy manufacturers would have to monitor their performance. Monitoring is costly and imperfect, so manufacturers might prefer pricing policies as an efficient way of aligning the retailers’ interests with its own.

The Role of Intention in Antitrust Analysis

Professor Hylton also emphasizes the problematic role a defendant’s intention plays in antitrust analysis. Collusion is one area where the problem arises. Some analysts, notably Judge Richard Posner, favor aggressive use of the law to attack parallel behavior among competitors in an oligopoly market. Judge Posner has suggested the conspiracy requirement in such cases might be satisfied by analogy to the formation of a unilateral reward contract. On this view, a seller in an oligopoly market who raises its prices is the offeror. The other oligopolists accept the offer by raising their prices. Professor Hylton argues that this view essentially disposes of the agreement requirement. Unless the law requires that oligopolists ignore each other’s prices (and why should it do that?), circumstantial evidence of tacit collusion might also be consistent with other, lawful explanations.

Intent is also a problem with regard to exclusionary conduct in monopolization cases. Professor Hylton argues that modern cases lean toward requiring that a plaintiff alleging monopolization prove that the defendant specifically intended to monopolize a market. He recognizes this view is in tension with language in *Alcoa*, but he believes *Aspen Skiing* implies a revival of the requirement

(which he sees as implicit in early monopolization cases) even though *Aspen* itself quoted from *Alcoa*. His reason is that the defendant in *Aspen* would have won if it had established a credible efficiency justification for terminating its cooperation with the plaintiff. After *Aspen*, Professor Hylton believes the trend is toward a rule that “the plaintiff must show that the sole motivation behind the defendant’s conduct was the elimination of competition, which relieves courts of the balancing of competing explanations involved in *Alcoa*.”

Professor Hylton is right to focus on specific intent as an important issue in monopolization cases, but the judicial trend seems less clear to me than it seems to seem to him. Only credible efficiency justifications count, and credibility determinations imply a weighing process. The D.C. Circuit’s opinion in the *Microsoft* case, which considered and rejected Microsoft’s explanations for certain conduct, exemplifies this point. One may question how far removed such weighing is from the balancing Professor Hylton would, quite understandably, like to escape.

And courts continue to analyze evidence of the subjective beliefs of a firm’s employees in deciding whether conduct is likely to harm competition. Though it is risky to place much weight on bellicose rhetoric within firms, courts seem to feel it is fair to infer that an act was likely to have the effects market participants expected it to have. One can disagree with this aspect of these opinions, and one can understand and sympathize with the drift of Professor Hylton’s analysis, but it is a fair question whether courts will arrive at the conclusion to which he believes the logic of the cases leads.

Nevertheless, Professor Hylton’s analysis on this point is transparent and therefore useful. (For example, he qualifies his argument by saying we do not yet know if a trend toward a specific intent requirement for monopolization “will become a permanent feature of Section 2 case law.”) Here and elsewhere, he analyzes cases to understand them, and to see how they can be made to make sense.

*In addition to asking
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Marginal Benefit Analysis

This last point provides an interesting contrast between Professor Hylton’s book and the work he seems to have used as a model, Robert Bork’s *The Antitrust Paradox*. Though intensely analytical and beautifully written, *The Antitrust Paradox* was a polemic. The rhetorical structure of the book depicted a fall from grace (the supposed “consumer welfare” origins of the Sherman Act) and a call for redemption in the form of efficiency-based antitrust policy. That is a good story, but it rests on questionable history. Professor Hylton does not have to shoulder the burden of radical reform, and his history is less influenced by such narrative demands, which makes his book more useful for placing the current law in context.

More generally, Judge Bork wrote most of his work in an era when courts seemed overtly hostile to the sort of efficiency-based antitrust policy he advocated. His criticism of the cases is correspondingly severe. As he put it in the 1993 introduction to his book, the idea was that if one could not change the law, one could at least inflict some pain on the way out. It is easy and, let’s face it, fun, to make fun of some cases. We all have our favorites. But making fun of them can lead one to miss why judges could rule as they did and how the cases fit with what preceded and followed them. Judges are not fools, even if making their decisions seem foolish is a good way to get them to change their ways.

Freed from the burden of inciting reform, Professor Hylton tries to understand the values and policy goals the opinions express and to use them to illustrate more general trends in antitrust history. In addition to asking the economic “whys,” he asks the institutional whys: Why does the doctrine change as it does? What were judges responding to in the 1960s? What do they

respond to now?

This approach enhances understanding of antitrust history and policy. Professor Hylton criticizes cases very well, but he also takes from them what is useful and explains why it would be better to discard the rest. That is the common law tradition. By adhering to it himself, Professor Hylton has written a welcome addition to the antitrust literature. ●

Paper Trail: Working Papers and Recent Scholarship

Editors' Note: In this issue, we note two articles on the methodology of antitrust analysis, one advocating the use of "TCE" (transaction cost economics), the other of "ICE" (internalizing complementary externalities). In the first article, Alan Meese critiques the federal courts' approach to the rule of reason. The "balancing" structure of rule of reason analysis, he argues, reflects the influence of an outmoded version of "price theory" that does not recognize the insights of TCE. In the second article, Joseph Farrell and Philip J. Weiser contrast the benign view of vertical integration taken by modern antitrust with the malign view of the practice taken by telecommunications regulation. They argue for a consistent approach to vertical integration in network markets, one that recognizes that integration allows ICE, but also that it may be monopolistic in specified circumstances.

Send suggestions for papers to review, or comments, to: page@law.ufl.edu or jwoodbury@crai.com.

—WILLIAM H. PAGE

Papers and Summaries

Alan J. Meese, Price Theory, Competition, and the Rule of Reason, 2003 *Illinois L. Rev.* 77

Alan Meese argues that the present structure of rule of reason analysis is based on a version of price theory that does not allow adequate consideration of the economic benefits of "nonstandard" contracts, that is, contracts that limit the discretion of rivals, suppliers, or purchasers. The article, somewhat confusingly, suggests that adherence to "price theory" implies a belief that the assumptions of the model of perfect competition define the goals of antitrust policy, without consideration of transaction costs. The author's use of this term is thus radically different from Chicagoans', as the author acknowledges at 138 n.328. Cf. William H. Page, *The Chicago School and the Evolution of Antitrust: Characterization, Antitrust Injury, and Evidentiary Sufficiency*, 75 VA. L. REV. 1221, 1230–31 (1989). The article argues that in the populist era of antitrust—the heyday of the "inhospitality tradition"—nonstandard contracts might have been found illegal per se for limiting the freedom of traders. In the modern era, however, they are likely to escape per se treatment because the contracting firms can offer plausible efficiency justifications. Cases like *Sylvania* and *BMI*, based in part on transaction cost economics, have properly recognized that certain nonstandard contracts should not be per se illegal because they may be necessary to correct market failures that occur in markets in which all transactions are spot sales.

But, Meese notes, the same contracts then remain subject to the rule of reason, which, under present law, still reflects the narrow view of "price theory." Some courts allow the plaintiff to make a prima facie case by proving that the contract has an "actual detrimental effect" on competition—for example by increasing the price. Courts that take this view (e.g., the Sixth Circuit in *ReMax*) allow plaintiffs to make this showing, at least with respect to some practices, without proving market power. The defendant must then show that the procompetitive benefits of the contract outweigh the harmful effects; and the plaintiff may still win if there is a less restrictive alternative to the contract. This burden-shifting analysis is inconsistent with insights of transaction cost economics.

The fact that a contract increases prices or changes the terms of dealing is only evidence of harm to competition if we assume a market unconstrained by nonstandard contracts is optimal. That may

be true under the strict assumptions of “price theory,” but transaction cost economics suggests otherwise—various market failures (such as the lack of adequate investment in point-of-sale services in retail markets) may occur under atomistic competition. Nonstandard contracts may be necessary to correct those failures. True, defendants may “rebut” the prima facie case, but courts commonly conceive of this issue as a matter of balancing anticompetitive and procompetitive effects. As Easterbrook and Posner have noted in the context of vertical restraints, the balancing metaphor misconceives the court’s role. If the nonstandard contract corrects market failures, the fact that it increases prices does not indicate that it reduces competition. The further requirement that the defendant adopt a less restrictive alternative also presumes a model of competition that does not recognize the need for nonstandard contracts to correct market failures.

The article concludes: “While courts have often embraced TCE when policing the boundaries of the per se rule, they have clung to an outmoded price-theoretic definition of competition when conducting analysis under the rule of reason. Courts should restructure Rule of Reason analysis to account for the modernization of economic theory.”

—WHP

Joseph Farrell & Philip J. Weiser, Modularity, Vertical Integration, and Open Access Policies: Towards a Convergence of Antitrust and Regulation in the Internet Age, *Harvard J.L. & Tech.* (forthcoming 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=452220

In a wide-ranging article, Farrell & Weiser evaluate the characteristic regulatory and antitrust approaches to issues of open access in network industries, and propose an integrated approach that draws on the strengths of both. The *regulatory* approach to vertical integration in telecommunications, after the breakup of AT&T and the emergence of the Internet, has tended to favor “open access” to prevent leverage of monopoly power from one level of a network to another. Commentators like Lawrence Lessig have argued for a general policy favoring “modularity”—standardized interfaces and mandatory open access. They point to the success of the “end-to-end” architecture of the Internet: an unbiased, open, “dumb” physical network fosters innovation and diversity at its ends. Modular structure, arising in various ways, has also has arguably fostered innovation in telephony and computers.

The *antitrust* approach to vertical integration, however, at least since the ascendancy of the Chicago School, presumes that integration does not harm consumers, because (as Coase showed in *The Nature of the Firm*) profit-maximizing businesses will typically only integrate when it is efficient (and therefore beneficial to consumers) to do so. The authors call this approach “internalizing complementary externalities,” or ICE. It recognizes that integration into complementary markets is often efficient because, for example, it can avoid the problem of compounding monopolies (“double marginalization”) or it can increase incentives for innovation. By the same token, integration will not typically allow a monopolist to garner a second monopoly profit in an adjoining market.

The authors argue that regulators should adopt an ICE approach, but with a thorough awareness of its eight primary exceptions—circumstances in which vertical integration might reduce efficiency. Most of these are familiar, but well outlined here:

1. Integration might allow the monopolist facing price regulation at one level to exercise its monopoly power at another level. The authors call this “Baxter’s law” because of its prominence as a rationale for the *AT&T* case.

2. Integration might allow the monopolist to discriminate in price among buyers without fear of arbitrage.
3. Integration might thwart potential competition (a) by requiring more costly entry at two levels or (b) by weakening a complement that might evolve into a competing platform (think *Microsoft*).
4. Integration might increase the risk that a “gatekeeping” monopolist and an innovative producer of complementary products might fail to agree on terms, even if the bargainers leave money on the table.
5. Allowing integration might tempt an incompetent monopolist to seek a second monopoly even when it would not be rational to do so (as Apple arguably did by bundling its OS and its hardware).
6. A monopolist might remain inefficiently integrated if it fears that allowing access will open it up to antitrust suits later from disgruntled rivals in the market for complementary goods (think *Kodak*).
7. A monopolist might remain inefficiently integrated if it fears that allowing access to one competitively innocuous product will open it up to a later regulatory requirement that it allow open access to other products that threaten its core business.
8. If the products are not entirely complementary—e.g., if some consumers of a complementary product also buy the monopolist’s product and some do not—the monopolist may have an incentive to integrate into the complementary good’s market if doing so prevents a rival from entering that market at the minimum efficient scale. See Michael Whinston, *Tying, Foreclosure, and Exclusion*, 80 AM. ECON. REV. 837 (1990).

The authors suggest that a regulator should consider “first, whether an exception to ICE exists, and, if this seems likely, then how well the regulator can address the competitive harms that might result.” They note that “Baxter’s Law” (avoidance of price regulation) underlay open access regulation of telephony under the MFJ and later under the 1996 Telecom Act. But today, in many network markets, there is no price regulation at any level. Consequently, the authors argue for reconsideration, in each context, of the rationale and mechanisms of open access regulation in light of ICE and its exceptions. Equally important, they emphasize the procedural problems with various regulatory approaches, like structural separation or mandatory unbundling. They usefully canvass how these considerations have cropped up, for example, in *Microsoft*, the FCC’s *Computer Inquiries*, and the regulation of broadband. ●

—WHP