No. 07-512

In The
Supreme Court of the United States

PACIFIC BELL TELEPHONE COMPANY,
D/B/A AT&T CALIFORNIA, ET AL.
Petitioners,

v.

LINKLINE COMMUNICATIONS, INC., ET AL.,
Respondents.

On Writ of Certiorari to the
United States Court of Appeals
For the Ninth Circuit

BRIEF OF THE WASHINGTON LEGAL FOUNDATION AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

DANIEL J. POPEO
RICHARD A. SAMP
WASHINGTON LEGAL FOUNDATION
2009 Massachusetts Avenue, N.W.
Washington, DC 20036
(202) 588-0302

MARK J. BOTTI
(Counsel of Record)
ANTHONY W. SWISHER
PAUL B. HEWITT
AKIN GUMP STRAUSS HAUER & FELD, LLP
1333 New Hampshire Avenue, N.W.
Washington, DC 20036
(202) 887-4000

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QUESTION PRESENTED

Whether a vertically integrated alleged monopolist, with no antitrust duty to deal with its rivals, engaged in an unlawful "price squeeze" under federal antitrust law by leaving an insufficient margin between the wholesale price it charges its rivals and the retail price it charges consumers.

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INTEREST OF *AMICUS CURIAE*

The Washington Legal Foundation (WLF) is a public interest law and policy center based in Washington, DC, with supporters nationwide.[1] WLF engages in litigation and administrative proceedings in a variety of areas, and devotes a substantial portion of its resources to defending free enterprise, individual rights, and a limited and accountable government. To that end, WLF has frequently appeared as *amicus* in this and other federal courts to address the proper scope of the antitrust laws. *See, e.g.*, *Weyerhaeuser Company v. Ross-Simmons Hardwood Lumber Co.*, 127 S. Ct. 1069 (2007); *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004) ("*Trinko*"); *United States Tobacco Co. v. Conwood Co.*, *cert. denied*, 537 U.S. 1148 (2003); *In re Stock Exchs. Options Trading Antitrust Litig.*, 317 F.3d 134 (2d Cir. 2003).

WLF is concerned that the decision below expands antitrust liability beyond this Court's precedents, chills lawful, procompetitive conduct, and creates uncertainty in the law.

SUMMARY OF ARGUMENT

The Ninth Circuit's decision stands in stark contrast with this Court's recent antitrust decisions that have announced sensible and objective standards for the evaluation of unilateral pricing conduct under the antitrust laws. This Court's prior decisions allow

[1] This brief is filed with the written consent of all parties, whose letters of consent are already on file with the Court. Pursuant to Rule 37.6, no counsel for either party authored this brief in whole or in part, nor did any party make a monetary contribution to the preparation or submission of this brief.

businesses to readily conform their conduct to the requirements of the antitrust laws and avoid unexpected antitrust exposure while competing aggressively and efficiently in the nation's markets. The Ninth Circuit's decision disrupts this settled landscape by applying different rules to firms that have vertically integrated, and thus undermines this Court's decisions in both *Trinko* and *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

The "price squeeze" claim recognized by the court below not only confounds established precedent, but also frustrates the animating purpose of the antitrust laws – to enhance competition. In short, the Ninth Circuit's holding will significantly chill legitimate, procompetitive conduct by imposing liability based upon facts that are unknown and unknowable to a business when it decides to set prices at the wholesale and retail levels. Such expansive and ill-defined liability rules burden commerce and chill robust economic activity. The resulting uncertainty will create a broad chilling effect on legitimate conduct, distorting the market, artificially skewing pricing decisions based on liability fears rather than sound economics, and thus harming consumers.

Expansive and ill-defined liability rules burden commerce and chill robust economic activity. *See, e.g.*, Steve Hantler, Washington Legal Foundation, *Judges Must Play Key Role In Stemming Tide of Asbestos Litigation* (May 7, 2003), *available at* http://www.wlf.org/upload/050903LBHantler.pdf; Victor E. Schwartz and Leah Lorber, Washington Legal Foundation, *Vaccine Liability Law Clarification Protects Lives and Resources* (January 6, 2003), *available at* http://www.wlf.org/upload/ 010603LBSchwartz.pdf.

The Ninth Circuit's decision imposes just such an imprudent burden on legitimate, procompetitive conduct, and should be reversed.

ARGUMENT

The Ninth Circuit's "Price Squeeze" Claim Defies Precedent, Antitrust Policy, And Market Reality

This case concerns the pricing decisions of vertically integrated businesses. A vertically integrated business may sell products or services to third parties at the wholesale level, while continuing to compete with those third parties at the downstream retail level. Petitioners here are vertically integrated with respect to Internet-access service – selling components of the service at the wholesale level to Respondents, and also competing at the downstream level for retail consumers purchasing Internet service.[2] Pet. App. 3a. Respondents have alleged that Petitioners have engaged in a "price squeeze" by leaving an insufficient margin between the price at which they sell inputs to Respondents at the wholesale level and the price at which they sell to consumers at the retail level to permit Respondents to compete.

The Ninth Circuit held that such allegations state a claim under the federal antitrust laws. Pet. App. 18a-19a. But recognition of a "price squeeze" claim is contrary to Supreme Court precedent, logic, and marketplace realities and, accordingly, should be reversed.

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[2] For purposes of this brief, WLF assumes the facts as set out by the Ninth Circuit to be correct.

A. The Ninth Circuit's Decision Renders Unlawful Conduct That This Court Has Held Is Lawful

In the decision below, the Ninth Circuit held that "[b]ecause a price squeeze theory formed part of the fabric of traditional antitrust law prior to *Trinko*, those claims should remain viable notwithstanding either the telecommunications statutes or *Trinko*." Pet. App. 14a. The Ninth Circuit's recognition of a "price squeeze" claim is inconsistent with this Court's precedents and the Court should reject it.

A "price squeeze" claim involves a vertically integrated firm that sells products or services to rivals at the upstream wholesale level while also competing with those rivals at the downstream retail level. *See, e.g.*, Julian O. von Kalinowski, 2 *Antitrust Laws and Trade Regulation* § 27.04[1], at 27-40 (2d ed. Matthew Bender 2007) (quoted in decision below, Pet. App. 8a). In this case, at the upstream level, where Petitioners are alleged to enjoy a monopoly position, Petitioners are alleged to have charged an excessively high price to Respondents. Pet. App. 5a-6a. At the downstream level, where Petitioners face competition from Respondents, they are alleged to have charged an excessively low price. The resulting "squeeze" allegedly deprives Respondents of the opportunity to earn a sufficient margin to compete. *Id.*

This Court's decisions establish the lawfulness of petitioners' pricing conduct under the antitrust laws. First, at the upstream level, petitioners are under no antitrust duty to deal with respondents under *any* terms, and so their unilateral setting of the price terms on which they are willing to deal is protected from antitrust scrutiny by the Court's decision in

Trinko, 540 U.S. at 410 ("We conclude that Verizon's alleged insufficient assistance in the provision of service to rivals is not a recognized antitrust claim under this Court's existing refusal-to-deal precedents."). Indeed, "'it makes no sense to prohibit a predatory price squeeze in circumstances where the integrated monopolist is free to refuse to deal.'" *Covad Commc'ns Co. v. Bell Atlantic Corp.*, 398 F.3d 666, 673 (D.C. Cir. 2005) (*quoting* 3A Phillip E. Areeda & Herbert Hovenkamp ("Areeda & Hovenkamp"), *Antitrust Law* ¶ 767c3 (2d ed. 2002)).

Second, at the downstream level, Petitioners' decision to charge lower prices fully comports with the antitrust law, in the absence of any allegation of predatory pricing. Thus, to render Petitioners' pricing decisions unlawful, Respondents must allege that the prices fall "below an appropriate measure" of their costs, *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222 (1993), and that they had "a dangerous probability of recouping [their] investment in below-cost prices," *id.* at 224. The Ninth Circuit's decision, however, would impose liability even in the absence of such predatory pricing allegations. Pet. App. 23a.

The Ninth Circuit's decision would thus circumvent established proof obligations under the antitrust laws. But this Court adopted its bright-line rules in *Trinko* and *Brooke Group* to promote certainty and administrability for businesses on both upstream and downstream pricing. At the upstream level, *Trinko* makes clear to businesses that, except in very narrow circumstances, it does not have an antitrust duty to provide assistance to its rivals. At the downstream level, *Brooke Group* assures businesses that, without more, above-cost pricing will not support a predatory pricing claim. Under the Ninth Circuit's decision, both of these stable and certain rules would evaporate for a vertically integrated firm, which would now face liability under a theory that two rights make a wrong.

Furthermore, the Ninth Circuit's rule would punish businesses for becoming vertically integrated – conduct which, at least until now, has often been considered to be beneficial to consumers, *see, e.g.,* 3A Areeda & Hovenkamp, *Antitrust Law* ¶ 757 (explaining how vertical integration can produce "significant cost reductions" by enabling production and transactional efficiencies). The decision below thus substantially unravels this Court's holdings in both *Trinko* and *Brooke Group*, and the stability in the law that they sought to establish, while expanding antitrust liability well beyond this Court's precedents.

B. The Ninth Circuit's "Price Squeeze" Frustrates Antitrust Policy

1. The Threat of "Price Squeeze" Liability Will Reduce Procompetitive Conduct

In straying from this Court's precedents, the Ninth Circuit's decision promotes unsound antitrust policy that will chill legitimate, procompetitive conduct and harm consumers.

This Court has long recognized the danger that expansive and ill-defined antitrust liability will chill benign and procompetitive conduct. *See, e.g.*, *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955, 1964 (2007) (refusing to permit a Sherman Act § 1 complaint to proceed which alleged conduct "consistent with conspiracy, but just as much in line with a wide swath of rational and competitive business strategy unilaterally prompted by common perceptions of the market"); *Weyerhaeuser*, 127 S. Ct. at 1078 ("Given the multitude of procompetitive ends served by higher bidding for inputs, the risk of chilling procompetitive behavior with too lax a liability standard is as serious here as it was in *Brooke Group*."); *Trinko*, 540 U.S. at 414 ("Mistaken inferences and the resulting false condemnations 'are especially costly, because they chill the very conduct the antitrust laws are designed to protect.' The cost of false positives counsels against an undue expansion of § 2 liability." (internal citation omitted)); *Brooke Group*, 509 U.S. at 223, 224 (decrying the "intolerable risks of chilling legitimate price-cutting" and stating that "discouraging a price cut and forcing firms to maintain supracompetitive prices, thus depriving consumers of the benefits of lower prices in the interim, does not constitute sound antitrust policy").

The result of the Ninth Circuit's approach will be a broad chilling effect that will distort the free operation of the market at two levels. At the upstream level, even for firms that have an entirely lawful monopoly, antitrust liability would prevent mere unilateral price-setting, which the Court has recognized as "an important element of the free-market system" that "induces risk taking that produces innovation and economic growth." *Trinko*, 540 U.S. at 407.

At the downstream level, the risks from imposing antitrust liability on prices that are allegedly too low, but are above an appropriate measure of the seller's costs, are manifest, and have been acknowledged repeatedly by the Court. *See, e.g.*, *Weyerhaeuser*, 127 S. Ct. at 1074 ("We were particularly wary of allowing recovery for above-cost price cutting because allowing such claims could, perversely, 'chil[l] legitimate price cutting,' which directly benefits consumers." (quoting *Brooke Group*, 509 U.S. at 223-24)); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990) ("Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition."). Perversely, the more efficient a vertically integrated firm becomes, and the more it is able to lower prices to consumers, the more it exposes itself to potential antitrust liability under the Ninth Circuit's decision. That stands antitrust policy on its head.

2. The Ninth Circuit's Rule Is Inadministrable

The chilling effect of an unsound antitrust rule stems not only from the risk of a "false positive" finding of liability where none is warranted (although that risk is considerable), but also from the risk of expending considerable time, money, and distraction on the litigation process itself, as unclear and inadministrable liability rules encourage those who lose in the economic marketplace to shift their battle to the courtroom. As this Court acknowledged in *Twombly*, the risks and costs involved just in defending against private antitrust claims that ultimately prove to be baseless can be considerable.

> [I]t is one thing to be cautious before dismissing an antitrust complaint in advance of discovery, but quite another to forget that proceeding to antitrust discovery can be expensive. . . . It is no answer to say that a claim just shy of a plausible entitlement to relief can, if groundless, be weeded out early in the discov-

> ery process through 'careful case management,' given the common lament that the success of judicial supervision in checking discovery abuse has been on the modest side."

Twombly, 127 S. Ct. at 1967 (internal citations omitted).

What is more, the chilling effect of the Ninth Circuit's liability rule is more acute than in *Twombly* because there are few, if any, objective standards that would allow a vertically-integrated firm to determine prospectively whether it might commit a "price squeeze." The rule against horizontal price fixing at issue in *Twombly* is well-established and firms have experience in identifying and avoiding conduct that could result in a price-fixing claim.

Navigating the Ninth Circuit's judicially crafted pricing constraints, however, will be far more hazardous, if not impossible. According to the Ninth Circuit the firm must make sure that its upstream prices are not "so high," Pet. App. 8a, that its competitor/customers cannot compete downstream. This rule would require the firm not only to consider its own profit-maximizing price (as might any firm), but also to account for the multiple variables that determine whether its rivals will operate at a profitable level. In essence, the rule recognized by the Ninth Circuit would require a vertically integrated firm to take into account such factors as the cost structure and margin requirements of its downstream rivals when setting its own prices. One leading economic scholar has captured the difficulty of this approach as follows:

> Figuring out which way the results go is hard, because necessary data are almost always un-

> available or uncertain. *Moreover, the inquiry as to whether a price squeeze leads to competitive harm necessarily must be conducted ex post, which therefore makes it impossible for a firm to know in advance whether its pricing practices will be anticompetitive.*

Dennis W. Carlton, *Should "Price Squeeze" Be a Recognized Form of Anticompetitive Conduct?*, 4(2) J. of Competition L. & Econ. 271, 276 (2008) (emphasis added); *cf. Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 905 (9th Cir. 2008) ("A potential defendant who is considering offering a bundled discount will likely not have access to information about its competitors' costs, thus making it hard for that potential discounter . . . to determine whether the discount it wishes to offer complies with the antitrust laws."). In short, under the Ninth Circuit's decision below, it will be virtually impossible for a firm to correctly ascertain in advance whether it is setting its upstream prices at a level that its rival will find acceptable, or whether its prices to consumers are too low to allow less efficient firms to compete.

The inadequacy of Rule 12(b)(6) as a screen against untenable price squeeze claims additionally gives such claims a greater chilling effect than the horizontal claims at issue in *Twombly*. *Twombly's* plausibility inquiry focused on whether the facts pled in the complaint sufficed to give rise to an inference of conspiracy, and Rule 12(b)(6) serves well to screen out claims where the underlying facts as pled are inadequate to support the conspiracy.

The allegations of a price squeeze pose a greater challenge to the courts. Allegations of prices "so high" for the input product that the rivals cannot compete downstream do not readily lend themselves to dismissal because no inferences are necessary; instead these allegations would seem to require extensive factual development into the competitiveness of rivals. As the Court recognized in *Trinko*, however, the task of determining the "reasonableness" of a firm's prices is inappropriate for an antitrust court. "Enforced sharing also requires antitrust courts to act as central planners, identifying the proper price, quantity, and other terms of dealing – a role for which they are ill suited." *Trinko*, 540 U.S. at 408. The Court made a similar point in *Brooke Group*, stating:

> As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, *or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting*.

Brooke Group, 509 U.S. at 223 (emphasis added).

The First Circuit has applied the same observation to a price-squeeze case, recognizing that a court cannot determine a "fair price" without "acting like a rate-setting regulatory agency." *Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990) (Breyer, C.J.). The court acknowledged the difficulty in determining a reasonable price, identifying inefficient firms, and dealing with changes in a dynamic market. *Id.* It concluded that "we have said enough to show why antitrust courts normally avoid direct price administration, relying on rules and remedies (such as structural remedies, *e.g.*, prohibiting certain vertical mergers) that are easier to administer." *Id.*

Accordingly, unlike *Twombly*, where the federal courts may at least mitigate the risk from untenable claims, the federal courts are less able to screen out untenable price squeeze claims.

A further aggravating factor is that the price squeeze claim, while as matter of technical antitrust doctrine applies only to a monopolist, is not so easily confined in terms of its practical effect. It can be very difficult for a court to determine whether a particular firm has monopoly power, to say nothing of a lay person running a business. A firm would have to identify accurately the correct relevant market within which to measure its market share, correctly determine whether its market share was high enough for it to be considered a monopolist, and evaluate a host of other market factors, any one of which could change the outcome. *See, e.g., United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 187 (3d Cir. 2005) ("Other germane factors [in identifying a monopolist] include the size and strength of competing firms, freedom of entry, pricing trends and practices in the industry, ability of consumers to substitute comparable goods, and consumer demand."). Such determinations would be beyond the abilities of most businesses without incurring the expense of retaining counsel and an economist versed in antitrust economics. Given the practical difficulty of making the threshold determination of monopoly power, the risk of a broad chilling effect is even greater, potentially causing firms that may not meet the legal definition of a monopolist to nonetheless shy away from legitimate activity for fear of liability.

3. A Rule That Expands Antitrust Liability Should Not Uniquely Penalize Those Who Engage In Inherently Efficient Conduct

A price squeeze claim may well lead to some truly ironic situations where liability is imposed in circumstances simply contrary to sound antitrust policy. Consider a business with significant market share but below that which might plausibly give rise to a charge that it is a monopolist. Vertical integration into downstream markets could generate substantial efficiencies, lowering its costs and allowing it to achieve a competitive advantage over its rivals. If the firm has excess capacity at the upstream level, however, it might rationally continue to supply rivals. Through its "superior skill, foresight and industry," *i.e.*, the increased efficiency from vertical integration, it should capture more of the market and grow its share. *United States v. Aluminum Co. of America*, 148 F.2d 416, 430 (2d Cir. 1945).

All of that would seem to be good and healthy competition under the antitrust laws. The catch comes, however, if the firm is so successful that it captures sufficient share to render it a monopolist. At that point, the rational firm might choose not to exploit the efficiency from its vertical integration for fear of the antitrust laws. The price squeeze claim thus runs headlong into the long-recognized principle of antitrust doctrine that "[t]he successful competitor, having been urged to compete, must not be turned upon when he wins." *Id.*

This hypothetical illustrates a general and likely sweeping effect of recognizing price squeeze liability: it will cause well-counseled firms to steer clear of conduct that could potentially impose legal liability, regardless of the economic efficiency and enhanced competition that the conduct would produce. Rather than face a lawsuit, a vertically-integrated firm may set prices at a level at which even its most inefficient rival would not be offended – a decidedly undesirable result for consumers. The consequences, as discussed by one scholar, are contrary to the goals of sound antitrust policy:

> Indeed, if the price of supplying a rival is a cessation of vigorous price competition with a rival, . . . so as to preserve profit margins of those participants who depend on rivals as a source of supply, then there may be an outbreak of peaceful price stability in the industry resulting from a chilling effect on price reduction. That result would harm consumers.

J. Gregory Sidak, *Abolishing the Price Squeeze as a Theory of Antitrust Liability*, 4(2) J. of Competition L. & Econ. 279, 294 (2008). Furthermore, some businesses may choose to avoid the risk of illegality by refusing to deal with rivals at all, or forsaking beneficial vertical integration that leads to increased efficiency and lower prices for consumers. However manifested, firms would be pricing their products and deciding to whom they sell them based on the fear of potential antitrust liability, not on the economically rational, and presumably efficient, prices that the market would dictate.

The uncertainty created by the decision below, and the resulting chilling effect on beneficial conduct, undermines the rule of law, and is directly at odds with this Court's repeated admonitions that antitrust liability should be no broader than necessary, so as not to harm inadvertently the consumers the antitrust laws were designed to protect.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

DANIEL J. POPEO
RICHARD A. SAMP
WASHINGTON LEGAL FOUNDATION
2009 Massachusetts Avenue, N.W.
Washington, DC 20036
(202) 588-0302

MARK J. BOTTI
(Counsel of Record)
ANTHONY W. SWISHER
PAUL B. HEWITT
AKIN GUMP STRAUSS HAUER & FELD, LLP
1333 New Hampshire Avenue, N.W.
Washington, DC 20036
(202) 887-4000

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