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September 9, 2005

Andrew Heimert, Esquire
Antitrust Modernization Commission
1120 G Street, NW, Suite 810
Washington, DC 20005

Dear Andrew:

Enclosed is a copy of my submission to the Antitrust Modernization Commission with respect to issues to be discussed on September 29. I assume Commission staff will circulate this to members of the Commission and members of my panel.

As to your request that I identify opinions and cases or relevant articles, that's quite a challenge. In my years as a Commissioner and then Chairman of the FTC, there were several major Section 2 enforcement actions. Among others, I recall the challenge to Intel's refusal to deal with companies that brought lawsuits against Intel, and the Mylan exclusive dealing arrangements. On the publication side, I did coauthor an article on the essential facilities doctrine (Pitofsky, Patterson and Hooks, "The Essential Facilities Doctrine under US Antitrust Law," 70 Antitrust LJ 443 (2002)), and recently discussed various Section 2 issues in an article in the *Chicago Law Review* ("Past, Present and Future of Antitrust Enforcement at the Federal Trade Commission," 72 U.Chi L.Rev. 209 (2005)). Can't recall any decision or article on the bundling issue.

Please let me know if there is anything further I need to do. See you on September 29. Best regards.

Sincerely,

BP

Robert Pitofsky

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Enclosure

Comments to the Antitrust Modernization Commission

STANDARDS FOR EXCLUSIONARY BEHAVIOR UNDER SECTION 2 OF THE SHERMAN ACT

Robert Pitofsky*

Executive Summary

In the following pages I address briefly the inadequacies of antitrust law under Section 2 of the Sherman Act in the areas of refusal to deal and of bundling by dominant firms, and then discuss the merits of various proposed reforms.

Basic antitrust law would find dominant firm behavior that is "unreasonably exclusionary" to be anticompetitive. The law with respect to refusals to deal by a dominant firm under that standard should be clarified, but not in a way that as a practical matter eliminates or largely reduces enforcement under Section 2 of the Sherman Act. In recent years, controversy has focused on efforts to find a single factor to determine whether the exclusion is unreasonable – for example, conduct cannot be "exclusionary unless it would make no economic sense for the defendant but for its tendency to eliminate or lessen competition." For reasons discussed in the paper, I believe this and similar proposals are far too permissive toward monopolistic behavior and therefore I would continue to rely on a balancing test under Section 2 (incorporating measurements of anticompetitive effects, asserted justifications, and the possibility of a less restrictive alternative). We impose that kind of rule of reason balancing test in virtually all non *per se* areas of antitrust enforcement.

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I believe bundling of two or more products at a discount, so long as the products can be purchased separately at specified prices, is a form of waging competition and is decidedly a benefit to consumers. If the price of the entire package is below some appropriate level of cost, then it can be regarded as illegal predatory pricing. Also, if all or virtually all buyers take the bundled deal, that is the equivalent of an outright tie and should be judged under tie-in rules – not necessarily illegal but subject to careful review. On the other hand, if a substantial number of dealers reject the deal – one recent case put the rejection level at about 25% - the offer should be deemed legal. It is the direction the law appears to be taking in all but the Third Circuit Court of Appeals and is an appropriate form of antitrust enforcement.

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I have been invited to offer comments to the Antitrust Modernization Commission on the proper design of rules covering exclusionary behavior under Section 2 of the Sherman Act, specifically on the subject of refusals to deal and bundling of products or services by firms with dominant market power.

1. Refusals to Deal. I wrote recently that questions concerning the nature of the behavior by a monopolist that violates Section 2 "is one of the most uncertain areas of antitrust."[1] I add that the uncertainty is costly to sellers and consumers. Sellers may be unduly timid in selecting competitive strategies because they don't know where the line is describing permissible conduct; as a result, consumers may be denied efficiencies or other benefits they would enjoy if the antitrust laws were more certain.

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[1] Pitofsky, Past Present and Future of Antitrust Enforcement at the Federal Trade Commission, 72 Chic. L. Rev. 209, 216 (2005).

I assume at the core antitrust would declare illegal conduct by a monopolist that is unreasonably exclusionary. The problem is deciding when efficient conduct becomes unreasonable or exclusionary. Some issues are easy to decide. For example, cases that involve lowering prices above some standard of cost, improving products, investing in innovation are all in the safe harbor usually entitled "superior skill foresight and industry." On the other hand, behavior by a monopolist that violates some other provision of the antitrust laws, such as procuring a patent by fraud on the Patent Office, or selling at what eventually is recognized as "below cost," are almost always indefensible.

Refusal to deal cases fall in the vast gray area between those clear cases and are therefore very difficult to decide. On the one hand, it is settled law that a seller can pick and choose among its customers[2] (at least where its purpose is not to achieve or maintain a monopoly) and has no obligation to offer affirmative assistance to prospective rivals.[3] On the other hand, an abrupt discontinuance of prior dealings with the purpose and effect of injuring the competitive process has been found (correctly, I believe) to be an antitrust violation unless there are significant business justifications.[4]

In recent years, proposals have been advanced in the literature and by enforcement officials that would adopt a much more lenient view of permissible behavior by a monopolist. For example, the government's amicus brief to the Supreme Court in Verizon Communications, Inc. v. Law Offices of Curtis V. Trenko, 540 U.S. 398 (2004)

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2 United States v. Colgate, 250 U.S. 300 (1919).

3 Olympia Equipment Leasing v. Western Union Telegraph, 797 F.2d 370 (7th Cir. 1986).

4 Aspen Skiing Co. v. Aspen Highlanders Skiing Corp., 472 U.S. 585, 605 (1985).

advocates a rule that conduct is not "exclusionary unless it would make no economic sense for the defendant but for its tendency to eliminate or lessen competition."[5] There are many variations on this formulation. For example, the increasingly discussed "sacrifice of profits test" asks whether the alleged exclusionary conduct would have been unprofitable except for the fact that it enhanced barriers to competition. Other similar formulations have been advanced. Some have suggested that the "no economic sense" or "sacrifice of profits" finding would be the sole evidence that determines whether behavior is unreasonably exclusionary – often by noting that it is an efficient way of eliminating "false positives" (unwise enforcement efforts) in connection with Section 2.

These various approaches represent efforts to adopt a simple and relatively clear rule that covers a broad range of fact patterns. Nevertheless, in my view, adoption of these rules would be unwise. Essentially, they look only at the business justification side of the equation and if any significant justification can be asserted, declare the conduct legal. But suppose the conduct – assume it's a refusal to deal – allows the incumbent monopolist to raise barriers to entry and thereby raise consumer prices by 50 units, but introduces efficiencies which, even if passed on to consumers, would only amount to 10 units. The simple fact that there are some efficiencies, or some other plausible business justification, should not justify any and all otherwise exclusionary conduct by a monopolist.

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[5] Brief of the United States and the Federal Trade Commission as amicus curiae in Verizon Communications v. Law Offices of Curtis V. Trinko LLP, No. 02-682, filed May 23, 2003.

I read Aspen Ski and the unanimous opinion of the D.C. Circuit in United States v. Microsoft Corp.[6] as requiring a balancing approach that compares the adverse impact of the refusal to deal on the competitive process with any efficiency effects that may simultaneously arise, taking into account the possibility of less restrictive alternatives that might produce comparable efficiencies. I understand the infirmities of the balancing approach – uncertainty, unpredictability, vagueness – but at least it takes all relevant factors into account. There are at least two other important reasons for preferring a balancing test over one that focuses upon a single factor. Behavior that justifiably should be found to violate the conduct element of Section 2 can vary across a broad range. I doubt that the very same test should be applied to predatory pricing, vertical restrictions, or refusals to deal, given the different prospects that such behavior would help or hurt consumers. It seems likely to me that the test or tests that eventually are adopted will vary among these different forms of behavior. A balancing test allows enforcement officials or courts to take into account the respective weights of anti-competitive effects as opposed to redeeming efficiencies. A second reason to prefer the balancing test is that the other proposed tests – including the "no economic sense" or "profit sacrifice" standard – focus on the impact upon the party engaging in the allegedly anticompetitive behavior. But antitrust is supposed to focus on the welfare of consumers.

Finally, let me touch upon several of the reasons that have been advanced in favor of a simplified or single factor test. First, it has been suggested that more lenient enforcement under Section 2 makes sense (i.e., fewer false positives) because in the end monopoly prices will invite new entry, and the innovation and other consumer

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[6] 253 F.3d 34, 59 (D.C. Cir. 2001).

advantages introduced by monopolists will contribute to consumer welfare. I regard that as a direct challenge to the fundamental insight of Section 2 which is that unreasonably exclusionary behavior by monopolists undermines the incentives of the victim of the exclusion and often its ability to compete on the merits, and may even undermine incentives of the monopolist to compete in procompetitive ways. The point is fairly clear in the legislative history of Section 2 and all but the most recent scholarship and case law. Another suggestion is that the balancing approach is too complicated to be imposed by judges of limited competence.[7] That is a challenge to a broad range of antitrust enforcement including rule of reason balancing under Section 1 and merger analysis under Section 7. Unless we are to move to a system where there is nothing but *per se* legal and *per se* illegal categorizing, balancing efforts under some form of rule of reason are unavoidable.

2. Bundling. The market tactic I will address involves the offer of two or more products at a discount. The products can be purchased separately – each at a specified price – but the combined price will always be lower than the total of separate purchases. Such cases can be brought as tie-in sales under Section 3 of the Clayton Act but more usually are brought under Section 2 of the Sherman Act as an instance of monopolizing.[8]

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[7] See Easterbrook, The Limits of Antitrust, 63 Tex L. Rev. 1 (1984).

[8] See SmithKline v. Eli Lilly, 575 F.2d 1056 (3rd Cir. 1978); Ortho Diagnostic Sys., Inc. v. Abbott Labs. Inc., 920 F. Supp. 455 (S.D.N.Y. 1966); LePages, Inc. v. 3M Company, 324 F.3d 141 (3rd Cir. 2003) (*en banc*).

In recent years (with the possible exception of several decisions in the Third Circuit)[9], courts have recognized that a presumption of illegality in connection with bundled discounts is not justified. Most recognize that it is often a way of waging competition. The typical situation – for example, a 10% discount on a bedroom set over and above separate prices for a bed, lamp, table and chair – may put pressure on the seller of just lamps, but almost invariably leads to lower prices to purchasers. Also, the seller's goal might be to increase total sales through a promotional discount, and then pass efficiencies on to consumers in the form of lower prices. Finally, a rule that discourages package pricing might discourage aggressive competition by efficient firms and hold a price umbrella over their less efficient rivals.

Two types of challenges to bundled discounts continue to be taken seriously. The first is the charge that one or more of the items in the package, as a result of the discount, are sold at "predatory prices." If the entire package is sold at a price that is below some appropriate level of cost, the offer is plainly illegal if the seller can reasonably be expected to recoup its investment in low prices.[10] But consider a marketing plan that raises much more complicated issues. Suppose a seller offers 10 items in a package. Each item can be purchased separately, but if a customer takes the entire package, it receives a three percent discount on the package. A competitor on item 10 might complain that in order to meet the discount, it would have to offer a 30% price cut and that would have serious exclusionary effects. If the entire impact of the discount can be allocated to each product, the result would be that many package discounts would be

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[9] See note 8, supra.

[10] See Brooke Group v. Brown & Williamson Tobacco, 509 U.S. 209 (1993).

declared illegal. An alternative would be to allocate the discount among the several products, or to simply insist that the price of the entire package remain above the standard for predatory pricing. Since I regard package discounts as a way of waging competition, I would opt for one of those alternatives.

Even in the absence of predatory pricing, some have argued that package discounts often have the same effect at tie-in sales – particularly where the package discount is so attractive that all or nearly all customers would accept it because it is economically irrational to turn the deal down. See T. Harris Young & Associates v. Marquette Electr., Inc.[11] Again, a rule focusing on "economic coercion" would result in the elimination of many pro-consumer package discounts. With that effect in mind, lower courts appear to be moving generally in the direction of a common rule of law – i.e., that no antitrust violation can be found where a significant number of purchasers who are offered the package decline the offer and buy the products separately.[12] That seems a sensible rule to me. LePages took a different approach and that is one of many reasons why it is unfortunate that the Supreme Court declined review on that particular case.

3. What should the Modernization Commission do?

I believe the state of antitrust laws in the two areas discussed today is less than adequate. Antitrust enforcement standards with respect to Section 2 are confusing and uncertain, and hostility to bundled discounts by dominant firms, at least in one important Circuit Court of Appeals, seems to me unduly aggressive.

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[11] 931 F.2d 816, 822 (11th Cir. 1991).

[12] See Nobel Scientific Industry v. Beckman Instruments, 670 F. Supp. 1313, 1324 (D. Md. 1986) (no de facto tie because 50-55% of the time product sales were separate); Ways & Son Means v. Ivac Corp., 506 F. Supp. 697, 701 (N.D. Cal. 1979), affirmed,

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But what is to be done? A proposal for legislative reform seems to me unwise and probably impractical. The range of behavior that would need to be addressed – particularly with respect to refusals to deal by dominant firms – is extremely varied. Legislative reform would involve a complicated statute covering a wide range of fact situations. The problem of variety of fact is not as extreme with respect to bundled discounts. Also, the law with respect to bundling seems to be moving in the right direction except in the Third Circuit. The history of legislative reform in other areas of antitrust is not encouraging – for example, revisions of Section 2 of the Clayton Act as a result of enactment of the Robinson-Patman Act are widely regarded as inconsistent, confusing, and generally unwise.

These two areas – refusals to deal and bundling – are essentially candidates for clarification and reform in the courts, and ultimately in the Supreme Court. A report by the Modernization Commission describing the infirmities that appear, and noting (particularly with respect to bundling) the direction of recent decisions in the courts and in most scholarship, would appear to be the most constructive approach.

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638 F.2d 143 (9th Cir. 1981) (no de facto tie because 25% of the time product sales were separate).