PREPARED STATEMENT OF WILLARD K. TOM[*]
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Hearings on Exclusionary Conduct
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Executive Summary

The troublesome issue in dealing with exclusionary conduct is not antitrust doctrine, but the institutional structure of antitrust enforcement — and in particular, the system of remedies and the risk of overdeterrence it implies.

Although the traditional categories, such as exclusive dealing and tying, are not very useful, one *can* make distinctions among different instances of allegedly exclusionary conduct. In particular, the requirements of market power in the monopolized market and economies of scale in the foreclosed market can screen out a large number of inappropriate cases. In addition, comparing the incremental price of the "tied" product to the incremental cost of producing that product can yield a useful benchmark.

Beyond the substantive standard, there are also vexing evidentiary issues, and courts are likely to resolve those issues in a way that gives substantial deference to the factfinder. In the end, the greatest contribution this Commission can make may be on the institutional side rather than the doctrinal one.

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Statement

Thank you for the opportunity to appear before you today. The views I express are, of course, only my own, and should not be attributed to Morgan Lewis or its clients. Some of these ideas were developed or refined while serving in government. I am grateful to the former colleagues, at both federal agencies, with whom I had the privilege of discussing and writing about these issues, but needless to say, these thoughts should not be attributed to them, either.

Let me add yet another disclaimer. I am not going to be proposing a broad, overarching rule or standard to settle the treatment of exclusionary practices by a dominant firm in all settings and for all time. I think we need to approach these issues with a great deal of humility. Knowledge in this area is limited and in flux. Our willingness to make sweeping generalizations should be limited commensurately.

In preparation for this hearing, I took the opportunity to re-read Judge Posner's speech on "Antitrust in the New Economy."[1] It struck me at the time as extremely wise in many respects, and the passage of time has not changed my mind. Indeed, in the current, imperfect state of our knowledge about exclusionary practices, it may say almost everything there is to be said by judges and lawyers about these practices. (This comment does not apply to economists, who have a lot — often conflicting — to say on this topic.) In particular, the speech implicitly or explicitly made three points that I would like to use to frame my remarks today:

- The "troublesome" issue is not antitrust doctrine, but "the institutional structure of antitrust enforcement."

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[1] http://www.ali-aba.org/aliaba/posner_101100.htm.

- The traditional categories, such as exclusive dealing and tying, are not very useful. "Exclusive dealing . . . is analytically the same as tying. And both "can be accomplished in a variety of different ways, including vertical integration, contract, product design . . . , and bundling . . . ."

- Nonetheless, one *can* make distinctions among different instances of allegedly exclusionary conduct. While we should be skeptical about claims of unilateral monopolizing actions, "skepticism . . . is not the same as denial." Factors such as economies of scale in consumption and economies of scale at the distribution level can help identify cases in which anticompetitive effects are possible.

Institutional Structure

Let me start with institutional structure. Here I am not referring to Judge Posner's specific recommendations about state antitrust enforcement, to which I do not fully subscribe, but rather to the broad point that institutional structure may be more problematic than substantive doctrine in this area.

I think many of us would agree that our economic understanding of practices such as loyalty discounts, bundled discounts, etc. is, to say the least, imperfect. What are the policy implications of that imperfection? If one goes back twenty-five years or so, the principal role of economics was to determine what inferences were plausible. In one memorable passage, the Fifth Circuit noted: "If a frog be found in the party punch bowl, the presence of a mischievous guest — but not the occurrence of spontaneous generation — may reasonably be inferred."[2] One would think, therefore, that the current imperfect state of our economic knowledge would imply more deference on the part of appellate courts and less willingness to overrule the factfinder. Indeed, such an understanding of

[2] AT&T v. Delta Communications Corp., 590 F.2d 100, 102 (5th Cir. 1979).

its judicial role appears to be what drove the Third Circuit in its *en banc* decision in *LePage's*.[3]

What gives many people pause about that response, however, is the institutional context in which antitrust violations are determined and punished. First, there is a certain "piling-on" built into the current system. The government suit — or in the context of exclusionary conduct, perhaps the competitor suit — may be followed in turn by the direct purchaser class actions, the indirect purchaser class actions, and the opt-out actions. Each of those actions carries with it the risk that treble-damages will be imposed, perhaps resulting in significant overdeterrence of conduct that may have ambiguous effects. Second, most people are far more willing to entrust to a lay factfinder decisions about whether a tangible event has occurred — did driver A run a red light; did competitor X speak the words, "you raise your price 10¢, and I'll raise mine the next day" — than to ask it to make sophisticated judgments about the competitive significance of certain conduct.

To the extent that it is the vision of massive damages being imposed by unsophisticated factfinders that is driving the search for simple, hard-and-fast rules about what exclusionary conduct is and is not lawful (despite the absence of very much knowledge that would inform those rules), the Commission should be careful not to paint with too broad a brush. It may be, for example, that procedural reforms recommended by the Commission in the area of remedies will ameliorate the need for premature rules defining exclusionary conduct. Similarly, it may be that legal standards under Section 5 of the FTC Act may be left to evolve more naturally in response to new economic

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[3] LePage's Inc. v. 3M, 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004).

learning and the facts of each case. Indeed, the Areeda treatise has long espoused such a position: "The FTC Act was clearly conceived as a supplement to the Sherman Act, a vehicle for evolving, through administrative expertness, prohibitions of conduct not formerly thought unlawful or contrary to good business morals."[4] "The Commission should feel free to 'enjoin' any unjustified behavior that tends to impair competition and is capable of being differentiated adequately from permissible behavior."[5] In the FTC context, the remedy is purely prospective, a finding of violation is not even prima facie evidence in a subsequent private lawsuit, and the adjudicator is an expert body with ample experience in making judgments about the likely competitive effects of a variety of practices in various markets.

I should note at this point that it is not solely the institutional factors that drive the search for limiting rules. There is also a concern that an erroneous enforcement action could deter or forbid procompetitive conduct — always an issue in the rule-of-reason context. This concern has been most salient in the area of predatory pricing. As the Supreme Court stated in *Matsushita*,[6]

> In *Monsanto*, we emphasized that courts should not permit factfinders to infer conspiracies when such inferences are implausible, because the effect of such practices is often to deter procompetitive conduct. . . . [C]utting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect.

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[4] 3 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 651g at 84 (2d ed. 2002); *cf.* 3 AREEDA & HOVENKAMP ¶ 651d at 79 (rev. ed. 1997) (same).

[5] 2 AREEDA & HOVENKAMP ¶ 302h3 at 24 (2d ed. 2000); *cf.* 2 AREEDA & HOVENKAMP ¶ 307c at 25 (rev. ed. 1995) (same).

[6] Matsushita Electric Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986).

Indeed, some commentators have treated bundled discounts as if they were equivalent to predatory pricing.[7] It is less than clear, however, that a bundled discount necessarily results in a price decrease to consumers in every case. In many cases, the "discount" is off of a price for the monopolized product that is above the level that would be monopoly-profit-maximizing had there been no bundle.

The task of balancing the respective costs of false positives and false negatives is made even more complex in the bundled discount situation than in the predatory pricing situation by (a) the greater costliness of predatory pricing as an entry-deterring strategy and (b) the greater possibility in the bundled discount situation that less restrictive alternatives are available. In the predatory pricing context, the monopolist cuts its price in a fairly general way — a costly proposition — and has few options to avoid a charge of predatory pricing other than to raise that price. In the bundled discount situation, the complaint is likely not about the price cut as such, but about its structure and ancillary requirements, such as the percentage of goods in the competitive category that must be sold by the retailer in order to qualify for any discount at all, the display space that must be given, the exclusion of particular competitive threats, and so on. In this way, a monopolist may be able to tailor its program to deter entry or marginalize rivals at relatively low cost.

Accordingly, unlike in the predatory pricing situation, I think the greater concern here is with the institutional factors that make false positives exceptionally costly, rather than with the close resemblance between procompetitive and anticompetitive conduct.

[7] *See, e.g.*, Timothy J. Muris, Comments On Antitrust Law, Economics, And Bundled Discounts, Submitted On Behalf of the United States Telecom Association In Response to the Antitrust Modernization Commission's Request For Public Comments, at 25-26 (July 15, 2005) (stating, in discussing bundled discounts, "[w]e should not deter above-cost price-cutting by alleged monopolists because consumers benefit when a monopolist lowers its prices").

The Equivalence of Exclusive Dealing and Tying, and the Variety of Different Forms They Can Take

Judge Posner's statement that "[e]xclusive dealing . . . is analytically the same as tying" has its analog in the bundled discount context. As I have argued elsewhere, a loyalty discount can be viewed as equivalent to a bundled discount where the discount is structured in such a way as to tie the purchase of units as to which demand is elastic to the purchase of units as to which demand is inelastic.[8] The key issue is not what label one applies to the conduct, but whether the conduct enables the party to gain power over price and thereby harm consumers.[9]

Judge Posner's observation about the variety of forms that exclusive dealing and tying can take is also noteworthy. The equivalence of all of those forms, however, may be only half the story. The other half is the endless number of variations within any of those forms, variations that may be competitively significant in a particular context. For example, there may be a vast competitive difference between a subscription ticket to the symphony and an arrangement in which I give retailers discounts on product A, B, and C (which I monopolize) only if they devote 100% of their shelf space for category D (in which there is a new entrant) to my product in that category.

Making Distinctions Among Different Instances of Allegedly Exclusionary Conduct

Judge Posner's speech identifies two important features of — perhaps even prerequisites for — an anticompetitive exclusive dealing arrangement. First, defendant must have market power in at least one of the products it sells. In the *Standard*

[8] *Anticompetitive Aspects of Market-Share Discounts*, *supra* note *, at 628 n.37 ("It is as if the first six units were a different product than the remaining units. In that sense, the hypothetical is economically equivalent to the cases involving discounts for aggregate purchases of a bundle of products . . . .").

[9] *See generally* Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986).

Fashion[10] case, of which he approves, "defendant manufactured a line of women's clothing that was very popular. Retailers thought it essential to be able to sell the line." Judge Posner's speech focuses on market power deriving from economies of scale in consumption, because the focus of the speech was on network industries in the so-called "new economy." But market power can also derive from economies of scale in production,[11] or from other factors. Second, there must be economies of scale in the foreclosed market (in *Standard Fashion*, the market for distribution services); otherwise, excluded competitors could simply bypass the foreclosed distributors and set up their own distribution. In *Standard Fashion*, these distribution economies derived from the fact that "[c]onsumers didn't want to traipse from store to store [but instead] wanted a full line in each store." In focusing on these two factors, Judge Posner essentially follows the traditional raising rival's costs literature.[12]

These two requirements alone should significantly reduce the number of false positives. The question is whether we can identify safe harbors that would further reduce the false positive risk (or red flags that would reduce the false negative risk).

In this regard, a common strategy has been to adapt the price-cost test used in the predatory pricing area. In the case of bundled discounts, one can ask, "what is the

[10] Standard Fashion Co. v. Magrane-Houston Co., 258 U.S. 346 (1922).

[11] I do take issue with Judge Posner's suggestion that, because "[t]he traditional industries are characterized by multiplant and multifirm production," economies of scale are necessarily limited. I suspect that many traditional consumer products industries are characterized by very large advertising and other brand-building expenditures, so that average total costs continue to fall at very high output levels.

[12] *See, e.g.*, Krattenmaker & Salop, *supra* note 9.

incremental price of the 'tied' product?"[13] In the loyalty discount context, one can analogously ask, "what is the incremental price of the incremental unit?"[14]

Once one has identified the incremental price, the next question is to what it should be compared. An obvious approach is to compare it to defendant's own incremental cost of production, or equivalently, to that of a hypothetical equally efficient competitor.[15] An alternative, advanced by the court in *Ortho*, is to require the plaintiff to show that it "is at least as efficient a producer of the competitive product as the defendant, but that the defendant's pricing makes it unprofitable for the plaintiff to continue to produce."[16] These two tests produce different results in at least two situations:

- If plaintiff is more efficient than defendant and is not driven out of the market, the bundled discount may still harm consumers if plaintiff's costs and prices rise because, for example, lower volume deprives it of economies of scale.
- If plaintiff is less efficient than defendant and would have been driven from the market even by a lawful bundled discount, but some other, more efficient, competitor is deterred from entering, again, consumers may be harmed.

In both instances, the "hypothetical efficient competitor" test produces an accurate result, while the "equally efficient plaintiff" test produces a false negative.[17] I hasten to add that that observation, standing alone, is not a conclusive reason to favor one test over the other. For example, both tests produce a false negative — at least under a consumer

[13] *See* Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455, 467 (S.D.N.Y. 1996); 3 AREEDA & HOVENKAMP, *supra* note 4, at ¶ 749 at 247 (2005 Supp.).

[14] *See* United States v. Microsoft, 59 Fed. Reg. 42,845, 42,854 (Aug. 19, 1994) (Proposed Final Judgment and Competitive Impact Statement); *Anticompetitive Aspects of Market-Share Discounts*, *supra* note *, at 627-29.

[15] *See* 3 AREEDA & HOVENKAMP, *supra* note 4, at ¶ 749 at 247 (2005 Supp.).

[16] *Ortho*, 920 F. Supp. at 469.

[17] Because of the antitrust injury requirement, I presume that neither test would award damages in the second situation; the differences would occur only with respect to injunctive relief (or, if plaintiff cannot even surmount the antitrust injury standard under Section 16, only with respect to governmental action).

welfare standard — in a case in which, even with all discounts attributed to the competitive product, defendant prices above its cost, succeeds in driving out a less efficient competitor, and thereafter is able to maintain a price above that which the competitor was charging. I think few of us would be willing to support a test that would reach this last category of conduct, because of sheer lack of administrability and the increased risk of false positives. Nonetheless, all other things being equal, the "hypothetical efficient competitor" test does seem to have a slight advantage.

Identifying useful standards is only one part of the battle. Equally vexing issues arise when one starts to consider matters such as evidence and burden of proof. Consider a hypothetical. Plaintiff fails to come forward with any detailed, quantitative study establishing that, when the discounts were all attributed to the competitive products, defendant's incremental prices for those products were below its incremental costs. Worse, when defendant's expert produces a study purporting to show that incremental prices were above incremental costs, plaintiff is unsuccessful in rebutting it. However, plaintiff offers into evidence multiple documents produced by high-level company managers and strategists clearly articulating a plan to "cut off [plaintiff's] air supply, no matter what it costs," and thereby "remove the competitive threat for a generation." The documents go on to say that "there is no way those SOBs can match this price, no matter how much better they are at making the product," and "the program will hardly cost us anything, because we'll just raise the list prices for the products where the customers have no choice."

In a bench trial, how should the court decide? In a jury trial, should the judge let the case go to the jury? If so, what should the instructions say? Can the jury permissibly infer that the incremental price for the competitive product was below incremental cost?

I think all of us who have practiced in the antitrust field for any length of time have qualms about overreliance on documents, especially intent documents. For a colorful quote, I once again turn to Judge Posner — not his speech, this time, but his opinion in *Olympia Leasing*:

> The importance of intent in such fields as tort and criminal law makes it natural to suppose that it should play an important role in antitrust law as well, for an antitrust violation is a statutory tort. But there is an insoluble ambiguity about anticompetitive intent that is not encountered in the ordinary tort case . . . . If firm A through lower prices or a better or more dependable product succeeds in driving competitor B out of business, society is better off, unlike the case where A and B are individuals and A kills B for B's money. In both cases the 'aggressor' seeks to transfer his victim's wealth to himself, but in the first case we applaud the result because society as a whole benefits from the competitive process. That Western Union wanted to 'flush these turkeys' tells us nothing about the lawfulness of its conduct.[18]

Yet there is a difference between documents that simply express a desire to "flush these turkeys" and documents that lay out the specifics of a strategy to gain power over price by raising rivals' costs and that disclaim significant consumer benefits. Similarly, there is a difference between documents written by a "crazed middle manager" and those written by persons with real power and influence with a company. Distinguishing among such pieces of evidence and evaluating their respective reliability has been the traditional role of the factfinder, aided by the court's instructions and curbed, where needed, by the limits of plausibility.[19]

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[18] Olympia Equip. Leasing Co. v. Western Union Telegraph Co., 797 F.2d 370, 379 (7th Cir. 1986).

[19] I have suggested elsewhere that one of the effects of the rise of game-theoretic models in the industrial organization literature has been to push outward the limits of plausibility, resulting in the expansion of the

The Supreme Court cases that began to move away from *Poller's*[20] emphasis on "motive and intent" and began to exercise greater judicial control over the jury generally follow this traditional approach. Although they are more demanding than previous cases in terms of what inferences are plausible, they generally do not specify particular types of evidence that are required to meet plaintiff's burden of proof. Rather, they speak in terms of direct *or circumstantial* evidence that "reasonably tends to prove" the ultimate issue in the case or "tends to exclude" the possibility of independent action (or in this context, action that it is procompetitive or competitively neutral).[21] Left to their own devices, I think this is where most courts will go. It is what appellate judges are trained to do. It is what the Supreme Court did in *Kodak*[22] when new economic learning had expanded the realm of the plausible. It is what the Third Circuit did in *LePage's*.

Whether that is a good thing or a bad thing, I leave for this Commission to decide for itself. I am inclined to think that, but for a system of civil remedies that is quite out of control, there is nothing wrong with such a judicial – one might say judicious — approach. The greatest contribution the Commission can make here, therefore, may be to hasten reform of institutional structure rather than make changes to antitrust doctrine or evidentiary practice.

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domain of the factfinder and contraction of that of the law-finder. Willard K. Tom, *Game Theory in the Everyday Life of the Antitrust Practitioner*, 5 GEO. MASON L. REV. 457, 464-68 (1997).

[20] Poller v. CBS, 368 U.S. 464 (1962).

[21] Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 768 (1984); *see also* Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588 (1986) (quoting *Monsanto*).

[22] Eastman Kodak Co. v. Image Technical Services, 504 U.S. 451 (1992).