Chapter I.A

Antitrust Law and the "New Economy"

1. INTRODUCTION

The term "new economy" can describe a diverse array of markets in which new information, communication, and other technologies have produced significant changes in recent decades. For purposes of this Report, the key question is whether antitrust analysis can properly account for the economic characteristics of these markets. Those economic characteristics include innovation, intellectual property, and technological change. As referenced in this Report, the new economy includes those industries in which innovation, intellectual property, and technological change are central features.

To assess how well antitrust law addresses competitive issues in such industries first requires an understanding of the major changes in antitrust analysis in recent decades. During this period a quiet transformation has strengthened the economic foundations of antitrust and increased its flexibility. These changes have improved the likelihood of an accurate assessment of competitive effects. In particular, the flexibility to account properly for the efficiencies associated with business conduct means that antitrust analysis has become less likely to condemn improperly business conduct that in fact benefits consumer welfare.

The Commission sought comment on and testimony about the application of antitrust analysis in industries in which innovation, intellectual property, and technological change are central features. Among other things, the Commission asked whether antitrust law encouraged a static analysis of dynamic industries or whether particular features of new economy industries posed distinctive problems for antitrust analysis. The Commission also asked whether antitrust law should use different benchmarks for market definition or market power assessments in new economy industries because innovation-driven firms may need to set prices above marginal costs to earn reasonable returns on their investments in innovation.

Commenters and witnesses largely agree that antitrust analysis has sufficient grounding in sound economic analysis, openness to new economic learning, and flexibility to enable the courts and the antitrust agencies properly to assess competitive issues in new economy industries. Most importantly, commenters noted, the economic principles on which antitrust is based do not require revision for application to those industries. As one economist noted, basic economic principles do not become "outdated" simply because industries become highly dynamic.[1]

The Commission agrees and makes the following recommendations.

1. **There is no need to revise the antitrust laws to apply different rules to industries in which innovation, intellectual property, and technological change are central features.**
2. **In industries in which innovation, intellectual property, and technological change are central features, just as in other industries, antitrust enforcers should carefully consider market dynamics in assessing competitive effects and should ensure proper attention to economic and other characteristics of particular industries that may, depending on the facts at issue, have an important bearing on a valid antitrust analysis.**

The economic principles that guide antitrust law remain relevant to and appropriate for the antitrust analysis of industries in which innovation, intellectual property, and technological change are central features. Antitrust analysis, as refined to incorporate new economic learning, is sufficiently flexible to provide a sound competitive assessment in such industries. This has improved the potential for a sound competitive assessment in all industries, including those characterized by innovation, intellectual property, and technological change.

To be sure, not all agree with the results in particular cases. That antitrust has the proper tools for an economically sound analysis of competitive effects does not mean that everyone agrees on how to use those tools in particular cases or interpret the results of their use. Nonetheless, the Commission concluded that current antitrust analysis is up to the task of properly assessing the competitive effects of business conduct in new economy industries.

Just as in other industries, of course, antitrust enforcers evaluating business conduct in new economy industries must ensure proper attention to particular market dynamics and economic characteristics that may play a role in determining likely competitive effects. Certain characteristics may arise more frequently in markets in which innovation, intellectual property, and technological change are key factors than in some other industries. These characteristics can include:

- very high rates of rapid innovation;
- falling average costs (on a product, not a firm-wide, basis) over a broad range of output;
- relatively modest capital requirements;
- quick and frequent entry and exit;
- demand-side economies of scale;

- switching costs; and
- first-mover advantages.

That one or more of these characteristics may be important in the context of a new economy industry, however, does not suggest that such characteristics never appear in other industries or that all of the listed characteristics always appear in new economy industries. Rather, the point is simply that proper antitrust analysis in *all* industries requires careful consideration of economic characteristics of the industry, and the listed characteristics are ones that may play important roles in industries in which innovation, intellectual property, and technological change are central features.

2. BACKGROUND

Antitrust law has gone through many changes. From the 1950s through the early 1970s, antitrust law was expansively interpreted and broadly enforced. Plaintiffs frequently won, and a wide variety of business practices were presumed to be illegal.[2] The bases for such expansive interpretations was sometimes questionable, however. Courts, for example, in some cases seemed more concerned about protecting competitors than consumers. Business practices might be quickly condemned, seemingly on the basis of courts' skepticism that businesses would try to maximize profits by becoming more efficient, rather than by obtaining greater market power.

These expansive interpretations of antitrust law precipitated a sea change, led by critics who questioned the basic premises of antitrust law as it was then enforced. "In the 1960s through the 1980s, [antitrust scholars generally associated with the University of Chicago] explained how many market structures and practices that antitrust treated with hostility could be beneficial."[3] Around the same time, antitrust scholars generally associated with Harvard advanced the concept that, in developing antitrust rules, courts and enforcers should keep in mind institutional limits, so that "antitrust rules [do] not outrun the capabilities of implementing institutions."[4] In the 1980s, developments in economics continued to influence antitrust thinking, with "'post-Chicago' economic literature argu[ing] that certain market structures and types of collaborative activity are more likely to be anticompetitive than Chicago School antitrust writers imagined."[5]

All of these schools of thought "emphasize[] reliance on economic theory in the formulation of antitrust rules."[6] The reassessment of antitrust doctrine based on economic learning has resulted in significant improvements to antitrust law over the past thirty years. This Section briefly reviews a few of the most important developments below. First, antitrust case law integrated the related principles that antitrust protects competition, not competitors, and it does so in order to ensure consumer welfare. Second, as new economic learning suggested possible procompetitive explanations for conduct previously assumed to be anticompetitive, the courts moved away from per se rules of automatic illegality toward a more flexible rule of reason analysis that would allow consideration of procompetitive explanations of challenged business conduct. Finally, antitrust enforcers have recognized the importance of intellectual property as a spur to innovation and have adopted policies that reflect a greater sensitivity to the need to protect incentives to innovate.

A. Antitrust Protects Competition, Not Competitors, and Should Ensure Consumer Welfare

During the 1960s and early 1970s antitrust decisions from the Supreme Court sometimes seemed more directed to protecting small businesses than to protecting competition that would benefit consumers through lower prices, improved quality, or innovation.[7] Indeed, in some instances the Court "condemned conduct precisely *because* it reduced costs or generated more desirable products [for consumers]."[8] For example, in *FTC v. Procter & Gamble* the Court affirmed that a merger was illegal because it created efficiencies its rivals could not match.[9] Decisions such as this were criticized as likely to deprive consumers of lower prices or other benefits from the increased competition that a more efficient merged firm could provide.[10]

Such decisions also were criticized for the absence of a coherent rule of law that could explain them.[11] On what basis should courts decide to disallow cost-saving, pro-consumer transactions so that smaller, less efficient firms could be kept afloat? The Court's premise seemed to be that all markets should be made up of many small firms, staying as close as possible to the economic ideal of "perfect competition."[12] "The Warren Court defined 'competitive' as a market containing many firms, the small ones having a 'right' to compete with the bigger ones."[13] The underlying economic assumption was that a "certain [industry] structure made certain types of conduct inevitable, so antitrust should be directed mainly toward anticompetitive industry structures."[14]

Developments in economic learning seriously undermined these premises and sent antitrust law in a new direction. Economic research found procompetitive reasons to explain highly concentrated markets—that is, that the most efficient firms were winning the competitive struggle and thereby achieving high market shares.[15] Some economists and lawyers further contended that effective competition did not require dozens of little firms, but instead could occur with relatively few firms in a market.[16] If effective competition could occur without many small firms in a market, then courts did not need to interpret antitrust law to protect small businesses at the expense of consumers.

In response to this and other advances in economic understanding, the Supreme Court in 1977 stated without caveat that the "antitrust laws . . . were enacted for 'the protection of *competition*, not *competitors*.'"[17] The adoption of this principle represented a marked change in the direction of antitrust law. There is now a better understanding that trade-offs exist between the goals of consumer welfare and protecting small firms. To protect small firms can mean a less efficient economy in which consumers must pay higher prices.

Conversely, to allow firms to achieve economies of scale may harm small firms. "For example, large scale production and distribution may reduce costs but also eliminate competitive opportunities for small firms."[18]

In 1979 the Supreme Court once again chose to interpret the antitrust law to protect consumers, not small businesses, describing the Sherman Act as a "consumer welfare prescription."[19] Other courts have adopted similar views.[20] For the last few decades courts, agencies, and antitrust practitioners have recognized consumer welfare as the unifying goal of antitrust law.[21] "Few people dispute that antitrust's core mission is protecting consumers' right to the low prices, innovation, and diverse production that competition promises."[22]

B. Procompetitive Explanations May Exist for Much Business Conduct, So Antitrust Law Should Avoid Per Se Rules of Automatic Illegality

Over time, new economic learning has brought to the fore procompetitive explanations for certain business practices previously condemned outright.[23] Some have argued that many practices reflect aggressive competition or innovation and "that nearly all vertical practices [*e.g.*, arrangements between manufacturers and distributors], price discrimination and most strategic pricing, many patent practices, and business torts were rarely or never anticompetitive."[24] New anticompetitive theories have also emerged.[25] Given the potential for either procompetitive or anticompetitive explanations for business conduct, antitrust analysis needed to move away from per se rules of automatic illegality.

In 1977 in *Continental T.V., Inc. v. GTE Sylvania Inc.*, the Supreme Court relied on economic reasoning to hold that territorial restraints on franchisees should be evaluated under the rule of reason, rather than viewed as per se illegal.[26] Territorial restraints forbid franchisee retailers from selling the manufacturer's products outside their agreed-upon locations, which typically do not overlap with those of other franchisees. Although such restrictions could reduce competition among franchisees of the same manufacturer ("intrabrand competition"), the Court explained that they also could increase competition among different manufacturers' franchisees ("interbrand competition").[27]

"Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers," the Court stated.[28] For example, such restrictions may be used to provide franchisees with sufficient incentives to engage in promotional activities or to provide service and repair facilities for the manufacturer's products. Franchisees might be reluctant to make such investments without territorial restraints because they would worry that other franchisees of the same manufacturer would "free ride" on their efforts to promote the manufacturer's brand, the Court pointed out.[29] In light of these potentially "redeeming virtues," the rule of reason, not a per se rule of automatic illegality, should be applied.[30] Moreover, the Court directed, "departure from the rule of reason standard must be based upon demonstrable economic effect rather than . . . upon formalistic line drawing."[31]

The Court's decision in *Sylvania* marked a major turning point in antitrust law. After this decision, "the Court systematically went about the task of dismantling many of the per se rules it had created in the prior fifty years, and increasingly turned to modern economic theory to inform its interpretation and application of the Sherman Act."[32] Indeed, only two years later, in *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, the Court refused to apply a per se rule to circumstances in which alleged price-fixing among competitors provided substantial efficiencies that could not be obtained through other means.[33] Defendants were the American Society of Composers, Authors and Publishers (ASCAP) and Broadcast Music, Inc. (BMI), both of which had thousands of composers as members. The composers granted nonexclusive licenses to their compositions to ASCAP or BMI, which then created blanket licenses authorizing the playing of millions of copyrighted musical compositions at agreed-upon fees. Plaintiff CBS objected that the blanket licenses issued to television networks were per se illegal price-fixing. The Court described the critical question as "whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output, and in what portion of the market, or instead one designed to 'increase economic efficiency and render markets more, rather than less, competitive.'"[34] For several reasons, including a substantial lowering of costs through eliminating thousands of individual transactions, the Court held the blanket licenses should be "subjected to a more discriminating examination under the rule of reason."[35]

Since *Sylvania* and *BMI*, the Supreme Court and lower courts have often looked to economic learning to understand why firms may use particular business practices. Rule of reason analysis allows this examination of potential efficiency rationales for challenged conduct. Although there are exceptions, of course,[36] the use of per se rules of automatic illegality is now substantially reduced, replaced by a more discriminating analysis under the rule of reason.

C. Antitrust Analysis Has Incorporated a More Sophisticated Understanding of How Intellectual Property Can Benefit Competition and Consumer Welfare

During much of the twentieth century, the courts, antitrust enforcers, and antitrust practitioners viewed intellectual property with deep skepticism.[37] Most assumed that a patent or other intellectual property automatically created a monopoly,[38] and Supreme Court cases fostered that presumption.[39] Antitrust enforcers attempted to restrict the use of intellectual property so that competition would be protected.[40] Over-zealous antitrust rules for the use of patents reached a pinnacle when, in 1972, the Antitrust Division of the Department of Justice (DOJ) issued the so-called "Nine No-Nos," a list of nine patent licensing practices the DOJ generally viewed as per se illegal.[41]

The influence of economic learning about the competitive benefits of intellectual property and the potential efficiencies of intellectual property licensing and other conduct reversed this trend. In 1981 the Chief of the Intellectual Property Section of the Antitrust Division explained that because patents increase the reward for research and development, inventions are produced that otherwise would not have come about (or would not have come about as quickly); in those cases, "the availability of a patent [serves] only to benefit competition—to make additional or less expensive choices available to consumers."[42] In 1981 officials from the DOJ renounced the Nine No-Nos.[43] The 1995 Antitrust Guidelines for the Licensing of Intellectual Property (DOJ/FTC IP Guidelines), issued jointly by the DOJ and the Federal Trade Commission (FTC), take the view that "intellectual property licensing . . . is generally procompetitive"[44] and should be examined under the rule of reason.[45]

As part of this trend, Congress in 1988 amended the Patent Code to eliminate a presumption that a patent confers market power in the context of patent misuse.[46] The antitrust agencies expanded that concept to include copyrights and trade secrets, stating in the DOJ/FTC IP Guidelines that the antitrust agencies "will not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner."[47] In 2006 the Supreme Court recognized that "Congress, the antitrust enforcement agencies, and most economists have all reached the conclusion that a patent does not necessarily confer market power upon the patentee."[48] In light of this consensus, the Court reversed its prior holdings and held that, in a tying case, "the mere fact that a tying product is patented does not support . . . a presumption [of market power.]"[49]

Over the course of recent decades, the courts and the antitrust agencies have thus moved away from a presumption that intellectual property automatically creates a monopoly and intellectual property arrangements are likely to harm competition. They now assess whether particular intellectual property in fact confers market power and consider how business arrangements involving intellectual property can benefit consumer welfare. This move has opened antitrust analysis to a more economically sophisticated approach to intellectual property issues, increasing the likelihood that antitrust will properly value the contribution of intellectual property rights to innovation and competition.

3. RECOMMENDATIONS AND FINDINGS

1. There is no need to revise the antitrust laws to apply different rules to industries in which innovation, intellectual property, and technological change are central features.

Current antitrust analysis has a sufficient grounding in economics and is sufficiently flexible to reach appropriate conclusions in matters involving industries in which innovation, intellectual property, and technological change are central features. Judge Richard A. Posner, for example, has concluded that "antitrust doctrine is sufficiently supple, and sufficiently informed by economic theory, to cope effectively with the distinctive-seeming antitrust problems that the new economy presents."[50] Others agree, finding, for example, that "[w]hile the new economy has a number of distinct characteristics, antitrust enforcement is sufficiently flexible to account for the distinguishing features of the new economy and to preserve competition when it benefits consumers."[51]

The fundamental economic principles that guide antitrust law remain relevant to and appropriate for the antitrust analysis of new economy industries. Over the years, antitrust analysis has been refined to incorporate useful aspects of new economic learning. This has improved the potential for a proper competitive assessment in all industries, including those characterized by innovation, intellectual property, and technological change.

Moreover, antitrust analysis, guided by valid economic principles, is sufficiently flexible to provide a sound competitive assessment in such industries. Rule of reason analysis, for example, can accommodate the assessment of a wide variety of factors, including likely procompetitive effects of challenged conduct. As discussed above, advances in economic learning have persuaded courts to replace many per se rules of automatic illegality with a more flexible analysis under the rule of reason.

Increased flexibility and improved economic understanding can be seen in the evaluation of both joint and unilateral conduct under the Sherman Act, where courts have largely turned away from the application of per se rules of automatic illegality and moved toward rule of reason analysis. Likewise, the analysis of mergers has moved away from structural presumptions that increased concentration will necessarily result in anticompetitive conduct, toward a more complex analysis that incorporates predictions of competitive effects using tools of modern economic analysis. Significantly, both rule of reason analysis and current merger analysis require an evaluation of procompetitive efficiencies that may result from firms' agreements, unilateral conduct, or proposed transactions. This is a significant positive change from the typical antitrust analysis of thirty years ago.

In addition, as discussed above, the courts and the antitrust agencies in recent decades have evidenced a greater appreciation of the importance of intellectual property in promoting innovation and, accordingly, the need to incorporate this recognition into a dynamic analysis of competitive effects. Witnesses and commenters remarked there is an improved understanding that antitrust law and patent law are complementary, with both seeking to encourage innovation and competition.[52]

Antitrust analysis can be properly applied in dynamic, innovation-driven industries.[53] Rapid technological progress and innovation are not new issues in antitrust law.[54] One witness pointed out "innovation has been the driver of American economic growth since at least the passage of the Sherman Act in 1890" and maintained "antitrust doctrine does not focus on static analysis."[55] Yet another stated that "[a]ntitrust law is sufficiently flexible to take innovation concerns into account, and today's theories, which may be replaced over time, need not be codified into the statute."[56]

Indeed, the evolution of antitrust law—both through case law and agency guidelines—has shown that new or improved economic learning can be incorporated into antitrust analysis as appropriate. Allowing the ongoing incorporation of economic learning into antitrust case law and agency guidelines is preferable to attempts at legislative change to specify different antitrust analyses for industries characterized by innovation, intellectual property, and technological change. Industries that fall into those categories will keep changing over time; attempts to define them would likely be difficult and impermanent at best. Furthermore, economic learning continues to evolve, and antitrust law needs to be able to incorporate this new learning as appropriate. It is important that antitrust develops through mechanisms, such as case law development in the courts and agency guidelines, that allow ongoing reassessments of existing law and economic principles relevant to antitrust analysis.

2. **In industries in which innovation, intellectual property, and technological change are central features, just as in other industries, antitrust enforcers should carefully consider market dynamics in assessing competitive effects and should ensure proper attention to economic and other characteristics of particular industries that may, depending on the facts at issue, have an important bearing on a valid antitrust analysis.**

Antitrust analysis in *all* industries requires careful assessments of each industry's market dynamics and economic characteristics. To take proper account of market dynamics, antitrust analysis should carefully consider the incentives and obstacles that firms seeking to develop and commercialize new technologies may face.[57] Antitrust enforcers should "explicitly recognize that market conditions, business strategies, and industry structure can be highly dynamic."[58]

Innovation provides a significant share of the consumer benefits associated with competition, particularly in the most dynamic industries.[59] New and improved products and services, as well as new business methods and production processes, are created through innovation.[60] To improve the application of antitrust in new economy industries, antitrust enforcers should give further consideration to efficiencies that lead to more rapid or enhanced innovation.[61] The potential benefits to consumer welfare from such efficiencies are great, thus warranting careful assessments of the potential for certain business conduct to create more rapid or enhanced innovation.

"[A] proper market-power inquiry in new economy industries must include a serious analysis of the vigor of dynamic competition" that looks beyond current sales figures.[62] To account properly for dynamic effects, antitrust enforcers must recognize that current market shares may overstate or understate likely future competitive significance. The Supreme Court identified this issue thirty years ago in *United States v. General Dynamics*, a merger case in which a coal company's share of uncommitted coal reserves was a better indicator of its likely ability to compete for future supply contracts than its historical market share.[63]

Analogous examples can be found in new economy industries, in which there may be "sequences of races to develop a new product or . . . to replace an existing product through drastic innovation."[64] For example, if a firm has failed recently to introduce new and improved products comparable to rivals' new offerings, and has no plans to do so, its likely future competitive significance may be far less than would be indicated by its historical market share.[65] A recent entrant with a promising new product, on the other hand, may have greater likely future competitive significance than its current low market share might suggest.[66]

Intellectual property may be critical to future innovation in an industry, so it is also important "to examine ownership of and investment in relevant intellectual property—which may involve technologies not currently in commercial use."[67] If, for example, the current leader "owns all intellectual property necessary for radical innovation, dynamic competition will not be effective."[68] If a firm with a low market share holds an intellectual property asset essential for future product development, that firm's likely future competitive significance may be far greater than that of a current market leader that has no promising new products or intellectual property assets in the pipeline.[69]

Antitrust analysis also must recognize that a price above marginal cost, by itself, does not necessarily suggest that a firm has market power that should be relevant in an antitrust matter or is operating anticompetitively in a relevant antitrust market.[70] Particularly in innovative industries, such as those in which intellectual property assets are key, firms may have large, up-front fixed costs for research and development, and relatively small marginal costs of production.[71] In pharmaceuticals, for example, a drug that costs millions of dollars to research, develop, and put through clinical testing may cost only a few cents per pill to produce.[72] Over the long run, the pharmaceutical company must set a competitive price that will cover its up-front fixed costs, including a risk-adjusted cost of capital.[73] Firms in innovative industries also must cover the costs of innovation failures, such as drug products that fail before or during clinical testing.[74]

For these reasons, firms with low marginal costs but large fixed costs, for research and development and other innovative activity, for instance, often need to price significantly above marginal costs simply to earn a competitive return in the long run. "This basic economic observation is not new, either in practice or in theory: it holds in any industry with large fixed costs, from railroads to microprocessors, from newspapers to computer software."[75]

A number of industries in which innovation, intellectual property, and technological change are central features also have one or more of the characteristics described briefly below. Depending on the facts at issue, such characteristics may have an important bearing on a proper antitrust analysis.

Very high rates of rapid innovation. One critical feature of new economy industries is innovation competition.[76] Competitive pressure to get new products or services to market ahead of one's competitors can lead to short product life cycles,[77] with new products replacing the old every few months instead of years. In addition, in some industries, "[s]uccessful incumbents . . . are constrained primarily . . . by the threat that another firm will come up with a drastic innovation that causes demand for the incumbent's product to collapse."[78] Threats of drastic innovations may "force new-economy firms to invest heavily in R&D and to bring out new versions of their products—including versions that lead to the demise of their old versions."[79]

Relatively modest capital requirements. Some new economy industries do not require entrants to incur substantial sunk costs. Depending on the circumstances, some software markets, for example, may require only modest capital investments for entry. Ease of entry is relevant to assessment of whether a firm has or could obtain market power.

Quick and frequent entry and exit. In industries with relatively modest capital requirements entry and exit may be quick and frequent. Start-up software enterprises, for instance, particularly during the 1990s, were frequently born only to die while very young.[80] The extent to which quick and frequent entry and exit characterize an industry also will be relevant to whether a firm in such an industry could possess durable market power.

Falling average costs (on a product, not a firm, basis) over a broad range of output. Economies of scale over a wide range of output are typical of industries with "large fixed costs (most of which are sunk R&D expenditures) and low marginal costs."[81] New entrants may not be able to duplicate these economies of scale and therefore may not be able to constrain incumbent firms.[82]

Demand-side economies of scale. "Economies of scale in consumption describe the situation in which the larger the firm's output is, up to some point, the more valuable that output is to its customers."[83] Examples include telephones and other interactive services, such as email and online auctions.[84] Computer programs also "tend to be more valuable the more people use them because training, support by information-technology personnel, and standardization of equipment and procedures are facilitated."[85] The presence of demand-side economies of scale can have a variety of implications for antitrust analysis, including that common standards typically are necessary to benefit from such economies.

Switching costs. In industries with demand-side economies of scale consumers may need to incur costs to switch from one competitor to another. Such switching costs may deter customers from moving from an incumbent to a new entrant and thus cause entrants to be an ineffective competitive constraint.[86]

First-mover advantages. "There is often a substantial advantage to being the first in a high-tech industry to develop and introduce a new product or the first to gain a significant market presence."[87] This advantage can arise, for instance, because the first to market can quickly take advantage of demand-side economies of scale or gain a head-start on moving down the learning curve for making the new product.[88] Whatever the source of a first-mover advantage in a particular industry, its effect is to encourage fierce competition by firms to be the first to market. Antitrust analysis should take into account such competitive incentives.

In sum, antitrust law has sufficient grounding in economic learning and flexibility to provide appropriate analyses of competitive issues in new economy industries. Developments in antitrust law in recent decades have made this possible. To tether antitrust law to the goal of consumer welfare, achieved through free-market competition, with an analysis based on economic learning, has benefited consumers and produced more consistency and predictability in antitrust doctrine.

Notes

1 Prof. Carl Shapiro, Statement at AMC New Economy Hearing, at 2 (Nov. 8, 2005) [hereinafter Shapiro Statement re New Economy].

2 *See generally* HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 1–10 (2005) [hereinafter HOVENKAMP, ANTITRUST ENTERPRISE].

3 GELLHORN ET AL., ANTITRUST LAW AND ECONOMICS 105 (5th ed. 2004) [hereinafter GELLHORN, ANTITRUST LAW AND ECONOMICS].

4 William E. Kovacic, *The Intellectual DNA of Modern U.S. Competition Law for Dominant Firm Conduct: The Chicago/Harvard Double Helix*, 2007 COLUM. BUS. L. REV. 101, 138 [hereinafter Kovacic, *Intellectual DNA of Modern U.S. Competition Law*] ("A hallmark of the antitrust treatise authored by Professors Areeda and Turner is the recurring attention to institutional factors and the precept that antitrust rules should not outrun the capabilities of implementing institutions.").

5 HOVENKAMP, ANTITRUST ENTERPRISE, at 36.

6 Kovacic, *Intellectual DNA of Modern U.S. Competition Law*, at 136.

7 *See* HOVENKAMP, ANTITRUST ENTERPRISE, at 2; GELLHORN, ANTITRUST LAW AND ECONOMICS, at 47 & n.14.

8 HOVENKAMP, ANTITRUST ENTERPRISE, at 1 (citing Albrecht v. Herald Co., 390 U.S. 145 (1968) (per se unlawful for dealer to limit maximum price charged by its dealers); Brown Shoe Co. v. United States, 370 U.S. 294 (1962) (merger unlawful, in part because it would enable resulting firm to undersell its rivals);

FTC v. Procter & Gamble, 386 U.S. 568 (1967) (merger illegal for creating efficiencies its rivals could not match)).

[9] *See Procter & Gamble*, 386 U.S. at 579.

[10] *See, e.g.*, Hovenkamp, Antitrust Enterprise, at 2 ("[I]n the 1960s and 1970s the Supreme Court went overboard in protecting small business from larger firms, often at the expense of consumers.").

[11] *See, e.g.*, *id.* (result "was a mélange of incoherent policies that confused competition with small business protection").

[12] Gellhorn, Antitrust Law and Economics, at 105 ("During the 1960s, when the antitrust laws were applied expansively, real market divergences from the model of perfect competition were viewed suspiciously and often were subject to prosecution.").

[13] Hovenkamp, Antitrust Enterprise, at 2.

[14] *Id.* at 37.

[15] *See* Gellhorn, Antitrust Law and Economics, at 92–93 (quoting Harold Demsetz, *Two Systems of Belief about Monopoly*, *in* Industrial Concentration: The New Learning 164 (Harvey J. Goldschmid et al. eds., 1974)).

[16] Hovenkamp, Antitrust Enterprise, at 32.

[17] Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 488 (1977) (quoting *Brown Shoe*, 370 U.S. at 320). The Court had made this observation fifteen years earlier as well, but in that case had disallowed a merger that would produce a firm with a 5 percent market share, noting "Congress' desire to promote competition through the protection of viable, small, locally owned businesses." *Brown Shoe*, 370 U.S. at 344. By contrast, "[i]n *Brunswick*, the Court studied the Janus-like features of *Brown Shoe* and ignored the face of business egalitarianism." Gellhorn, Antitrust Law and Economics, at 47.

[18] Gellhorn, Antitrust Law and Economics, at 45.

[19] Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979) (quoting Robert H. Bork, The Antitrust Paradox 66 (1978)); *see* Gellhorn, Antitrust Law and Economics, at 47. Debate continues over whether the Supreme Court implicitly adopted the goal of allocative efficiency or the goal of preventing wealth transfers as the standard by which consumer welfare should be measured. *See* Merger Enforcement Transcript at 112–15 (Rule) (Nov. 17, 2005). *See generally* Introduction of this Report, note 22.

[20] *See* Gellhorn, Antitrust Law and Economics, at 47.

[21] *See, e.g.*, *id.*

[22] Hovenkamp, Antitrust Enterprise, at 1.

[23] *See generally id.* at 25–39.

[24] *Id.* at 32.

[25] For example, "[p]ost-Chicago scholars developed a fairly robust theory of 'raising rivals' costs,' under which dominant firms or cartels adopt strategies that impose higher costs on rivals, thus creating a price umbrella for the strategizing firms." *Id.* at 38.

[26] Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 57–59 (1977).

[27] *Id.* at 54–55.

[28] *Id.* (citation omitted).

[29] *Id.* at 55.

[30] *Id.* at 54–59.

[31] *Id.* at 58–59.

[32] Gavil et al., Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy 358 (2002) [hereinafter Gavil, Antitrust Law in Perspective].

[33] Broadcast Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1 (1979).

[34] *Id.* at 19–20 (quoting United States v. United States Gypsum Co., 438 U.S. 422, 441 n.16 (1978)).

[35] *BMI*, 441 U.S. at 24.

[36] *See, e.g.*, Arizona v. Maricopa County Med. Soc'y, 457 U.S. 332 (1982).

[37] *See generally* Gavil, Antitrust Law in Perspective, at 1109.

[38] *See, e.g.*, Robert P. Merges & John F. Duffy, Patent Law and Policy: Cases and Materials 1349 (3d ed. 2002) ("During the middle part of the twentieth century, the courts tended to associate patents with monopolies, and hence to view them as narrow exceptions to the nation's antitrust laws. This view [was] especially prominent in the Supreme Court cases from the 1930s until the 1960s . . . .").

[39] *See, e.g.*, International Salt Co. v. United States, 332 U.S. 392 (1947) (in tying context, court will presume market power from a patent), *overruled by* Illinois Tool Works, Inc. v. Independent Ink, Inc., 126 S. Ct. 1281 (2006).

[40] *See generally* Willard K. Tom & Joshua Newberg, *Antitrust and Intellectual Property: From Two Separate Spheres to Unified Field*, 66 Antitrust L.J. 167 (1997); Herbert Hovenkamp et al., IP and Antitrust: An Analysis of Antitrust Principles Applied to Intellectual Property Law I15–I17 (2002).

[41] *See* Bruce B. Wilson, Deputy Ass't Att'y Gen., Antitrust Div., Dep't of Justice, Remarks Before Michigan State Bar Antitrust Law Section and Patent, Trademark and Copyright Law Section (Sept. 21, 1972), *reprinted in* 5 CCH Trade Reg. Rep. 50,146 (current comment transfer binder 1969–83) (DOJ official's speech articulating what came to be called the "Nine No-Nos").

[42] Roger B. Andewelt, Chief, Intellectual Property Section, Antitrust Div., Dep't of Justice, Basic Principles to Apply at the Patent-Antitrust Interface, Remarks Before Houston Patent Law Association, at 4–5 (Dec. 3, 1981).

[43] *See* Abbott B. Lipsky, Jr., *Current Antitrust Division Views on Patent Licensing Practices*, 50 Antitrust L.J. 515, 517–24 (1981). Mr. Lipsky was then a Deputy Assistant Attorney General in the Antitrust Division of the DOJ.

[44] Dep't of Justice & Federal Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property, § 2.0 (1995) [hereinafter DOJ/FTC IP Guidelines].

[45] The DOJ/FTC IP Guidelines call for per se treatment in certain limited circumstances, but still make clear that the agencies use the rule of reason "[i]n the vast majority of cases." *Id.* § 3.4.

[46] 35 U.S.C. § 271(d)(5); *see also Independent Ink*, 126 S. Ct. at 1290.

[47] DOJ/FTC IP Guidelines, § 2.2.

[48] *Independent Ink*, 126 S. Ct. at 1292.

[49] *Id.* at 1284.

[50] Posner, Antitrust Law, at 256. Judge Posner finds more "troublesome" the institutional structure of antitrust enforcement. *Id.* The Commission addresses antitrust enforcement institutions in Chapter II of this Report.

[51] Prof. Richard J. Gilbert, Statement at AMC New Economy Hearing, at 2 (Nov. 8, 2005) [hereinafter Gilbert Statement].

[52] *See, e.g.*, M. Howard Morse, Statement at AMC New Economy Hearing, at 6 (Nov. 8, 2005) [hereinafter Morse Statement] (patents and antitrust are complementary, "as both are aimed at encouraging innovation, industry, and competition") (citing Atari Games Corp. v. Nintendo of Am., Inc., 897 F.2d 1572, 1576 (Fed. Cir. 1990)).

[53] *See, e.g.*, Gilbert Statement, at 4.

[54] *See, e.g.*, Jonathan M. Jacobson, *Do We Need a "New Economy" Exception for Antitrust Law?*, 16 Antitrust, Fall 2001, at 89, 89–90.

[55] Shapiro Statement re New Economy, at 2–3.

[56] Morse Statement, at 5.

[57] *See* Shapiro Statement re New Economy, at 2; *see also id.* (endorsing this Commission's description of new economy industries because it focuses on the economic characteristics of those industries).

[58] *See id.*

[59] *See, e.g.*, Gilbert Statement, at 4 ("[D]ynamic competition to develop new products and to improve existing products [in innovation-driven industries] can have much greater impacts on consumer welfare than static price competition."); Morse Statement, at 5 ("Everyone should understand that small increases in productivity from innovation dwarf even significant reductions in static efficiency over time.") (citing F.M. Scherer & D. Ross, Industrial Market Structure and Economic Performance 31, 613 (3d ed. 1990)); Shapiro Statement re New Economy, at 2 ("[A]t least over the medium to long term, the lion's share of consumer benefits associated with competition in our most dynamic industries results from innovation.").

[60] *See* Shapiro Statement re New Economy, at 2.

[61] *See* Morse Statement, at 4 (noting that "such efficiencies often drive [merger] transactions in high-tech industries"). Conversely, because of innovation's importance, "anticompetitive effects on innovation can have much greater impact than effects on price." *Id.* at 5.

[62] David S. Evans & Richard Schmalensee, *Some Economic Aspects of Antitrust Analysis in Dynamically Competitive Industries*, at 25 (National Bureau of Economic Research, Working Paper 8268, May 2001) [hereinafter Evans & Schmalensee, *Antitrust Analysis in Dynamically Competitive Industries*].

[63] United States v. General Dynamics Corp., 415 U.S. 486, 498, 502, 510–11 (1974).

[64] *See* Evans & Schmalensee, *Antitrust Analysis in Dynamically Competitive Industries*, at 11.

[65] Shapiro Statement re New Economy, at 3.

[66] *Id.* at 3–4.

[67] Evans & Schmalensee, *Antitrust Analysis in Dynamically Competitive Industries*, at 25.

[68] *Id.*

[69] *See* Shapiro Statement re New Economy, at 3–4.

[70] *See* Gilbert Statement, at 9–10; Shapiro Statement re New Economy, at 6–7.

[71] *See, e.g.*, Gilbert Statement, at 9–10; Morse Statement, at 7; Shapiro Statement re New Economy, at 7.

[72] *See, e.g.*, Gilbert Statement, at 9 (reporting an estimate that researching, developing, and testing a new drug costs $800 million) (citing Joseph DiMasi et al., *The Price of Innovation: New Estimates of Drug Development Costs*, 22 J. Health Econ. 151 (2003)).

[73] *See* Shapiro Statement re New Economy, at 7.

[74] *See id.*

[75] *Id.*

[76] *See* Gilbert Statement, at 7.

[77] Morse Statement, at 6.

[78] Evans & Schmalensee, *Antitrust Analysis in Dynamically Competitive Industries*, at 20.

[79] *Id.* at 21.

[80] William J. Baumol, The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism 172 (2002) (discussing the frequency of entry and exit in new economy industries).

[81] Gilbert Statement, at 4.

[82] *See id.* at 4–5.

[83] Posner, Antitrust Law, at 247.

[84] *Id.*

[85] *Id.* at 248.

[86] *See* Gilbert Statement, at 5.

[87] Morse Statement, at 8.

[88] *Id.*

Chapter I.B
Substantive Merger Law

1. INTRODUCTION

Section 7 of the Clayton Act, enacted in 1914 and amended in 1950, prohibits mergers or acquisitions where "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly" in a relevant market.[1] Both the substance and the procedures of antitrust merger enforcement have changed significantly in recent decades. These changes are to some extent interrelated.

Before 1976, antitrust challenges typically occurred after a merger already had been consummated; such challenges sometimes took years to litigate. In cases where a court ultimately ruled the merger illegal and ordered the merged firm to divest the acquired assets, it was sometimes difficult to recreate a competitively viable firm—that is, to "unscramble the eggs"—and effectively restore lost competition.

Passage of the Hart-Scott-Rodino Antitrust Improvements Act in 1976 (HSR Act) changed this dynamic.[2] The HSR Act requires firms that propose mergers or acquisitions of a certain size to notify the antitrust agencies and to adhere to certain waiting periods before consummating the proposed transaction.[3] The HSR Act enables the agencies to obtain documents and other information to assess whether to challenge the proposed transaction. Either the agencies can sue to block the entire transaction, or they can seek the divestiture of assets in order to resolve competitive concerns while allowing the overall transaction to proceed. In practice, merging companies most often consent to relief sought by the agencies in order to avoid time-consuming litigation that would delay closing the transaction and the realization of related efficiencies.

As a result, there have been fewer litigated merger cases interpreting application of the antitrust laws to mergers and acquisitions and greater reliance on agency enforcement guidelines and other guidance explaining how the agencies assess mergers and exercise their prosecutorial discretion. This development has made merger enforcement more predictable, due to the issuance of agency guidelines and other guidance and the fact that the enforcement agencies systematically review a greater number of transactions than was the case prior to enactment of the HSR Act. Such expanded review has led to the development of substantial expertise within the agencies. Agency guidelines have served as both a source of guidance to business and a mechanism through which advances in economic learning have been integrated into substantive merger analysis. At the same time, the paucity of litigated court cases has made the merger review process much more administrative in nature.

Over time, the antitrust agencies and courts have moved away from the stringent enforcement standards that prevailed during the 1950s and 1960s, when mergers resulting in a merged firm's market share as small as 5 percent had sometimes been found unlawful.[4] The agencies' promulgation of guidelines for merger analysis played an important role in this process. In 1968 Assistant Attorney General Donald Turner "used the first merger guidelines to bring rigor and transparency to the merger review process."[5] In 1982, and again in 1984, Assistant Attorney General William Baxter further advanced merger analysis with new guidelines outlining specific issues that must be addressed to answer the critical question of whether a merger would tend to "create or enhance market power or . . . facilitate its exercise."[6] The antitrust agencies have jointly updated these guidelines two more times: first in 1992, when the agencies revised the guidelines to clarify their analysis of competitive effects, and most recently in 1997, when they added a section specifically addressing efficiencies. The courts have played significant roles in interpreting and applying these guidelines.[7]

The Commission's review and study of current merger enforcement standards revealed a general consensus that the framework for analyzing mergers used by the antitrust agencies and the courts is basically sound. Most agree that current law, including as interpreted and applied under the agencies' merger guidelines, is sufficiently grounded in economic learning and has sufficient flexibility to analyze properly the competitive issues that can arise in industries in which innovation, intellectual property, and technological change are central features.

Nonetheless, room for improvement exists. The Commission has agreed on recommendations that the agencies give substantial weight to certain factors in merger analysis, particularly with respect to efficiencies related to innovation; that the agencies further study the bases for merger enforcement policy; and that the agencies increase the transparency of merger review through a variety of means. The Commission makes the following recommendations.

3. No statutory change is recommended with respect to Section 7 of the Clayton Act.

3a. There is a general consensus that, while there may be disagreement over specific merger decisions, and U.S. merger policy would benefit from continued empirical research and examination, the basic framework for analyzing mergers followed by the U.S. enforcement agencies and courts is sound.*

3b. The Commission was not presented with substantial evidence that current U.S. merger policy is materially hampering the ability of companies to operate efficiently or to compete in global markets.†

* Commissioner Kempf does not join this recommendation.

† Commissioner Kempf does not join this recommendation.
Commissioner Garza joins this recommendation with qualifications.

4. No substantial changes to merger enforcement policy are necessary to account for industries in which innovation, intellectual property, and technological change are central features.*

    4a. Current law, including the Merger Guidelines, as well as merger policy developed by the agencies and courts, is sufficiently flexible to address features in such industries.†

5. The Federal Trade Commission and the Antitrust Division of the Department of Justice should ensure that merger enforcement policy is appropriately sensitive to the needs of companies to innovate and obtain the scope and scale needed to compete effectively in domestic and global markets, while continuing to protect the interests of U.S. consumers.

6. The Federal Trade Commission and the Antitrust Division of the Department of Justice should give substantial weight to evidence demonstrating that a merger will enhance efficiency.

7. The Federal Trade Commission and the Antitrust Division of the Department of Justice should increase the weight they give to certain types of efficiencies. For example, the agencies and courts should give greater credit for certain fixed-cost efficiencies, such as research and development expenses, in dynamic, innovation-driven industries where marginal costs are low relative to typical prices.

8. The Federal Trade Commission and the Antitrust Division of the Department of Justice should give substantial weight to evidence demonstrating that a merger will enhance consumer welfare by enabling the companies to increase innovation.

9. The agencies should be flexible in adjusting the two-year time horizon for entry, where appropriate, to account for innovation that may change competitive conditions.

* Commissioner Delrahim does not join this recommendation.

† Commissioner Kempf does not join this recommendation.
Commissioner Garza joins this recommendation with qualifications.

10. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should seek to heighten understanding of the basis for U.S. merger enforcement policy. U.S. merger enforcement policy would benefit from further study of the economic foundations of merger policy and agency enforcement activity.**

10a. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should conduct or commission further study of the relationship between concentration, as well as other market characteristics, and market performance to provide a better basis for assessing the efficacy of current merger policy.**

10b. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should increase their use of retrospective studies of merger enforcement decisions to assist in determining the efficacy of merger policy.**

11. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should work toward increasing transparency through a variety of means.**

11a. **The agencies should issue "closing statements," when appropriate, to explain the reasons for taking no enforcement action, in order to enhance public understanding of the agencies' merger enforcement policy.**

11b. **The agencies should increase transparency by periodically reporting statistics on merger enforcement efforts, including such information as was reported by the Federal Trade Commission in its 2004 Horizontal Merger Investigation Data, as well as determinative factors in deciding not to challenge close transactions. These reports should emanate from more frequent, periodic internal reviews of data relating to the merger enforcement activity of the Federal Trade Commission and the Antitrust Division of the Department of Justice. To facilitate and ensure the high quality of such reviews and reports, the Federal Trade Commission and the Antitrust Division of the Department of Justice should undertake efforts to coordinate and harmonize their internal collection and maintenance of data.***

* Commissioner Kempf does not join this recommendation.

11c. The agencies should update the Merger Guidelines to explain more extensively how they evaluate the potential impact of a merger on innovation.*

11d. The agencies should update the Merger Guidelines to include an explanation of how the agencies evaluate non-horizontal mergers.†

2. BACKGROUND

Federal antitrust merger enforcement has evolved significantly since enactment of the Clayton Act in 1914. It has shifted in emphasis from a litigation-based system focused on judicial review of consummated deals to an administrative regime in which two federal agencies, the Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission (FTC), review mergers above a certain size prior to consummation.[8] In recent years, the DOJ/FTC Horizontal Merger Guidelines (Merger Guidelines or Guidelines) have described the analytical framework used by the agencies for merger enforcement and guided the agencies' enforcement approach.[9]

The Antitrust Division (under Assistant Attorney General Donald Turner) issued its first set of merger enforcement guidelines in 1968.[10] The DOJ explained that its purpose in publishing the 1968 Merger Guidelines was to inform business, counsel, and others of "the standards currently being applied by the Department of Justice in determining whether to challenge corporate acquisitions and mergers."[11] The 1968 Merger Guidelines used concentration within the relevant market as a guidepost for whether enforcement action should be taken, setting thresholds by which merger challenges became more likely as market concentration and the market shares of the merging firms increased.[12]

In 1982 the DOJ issued a revised set of merger guidelines, under the leadership of Assistant Attorney General William Baxter.[13] To measure market concentration, the 1982 Merger Guidelines introduced use of the Herfindahl-Hirschman Index (HHI) and established revised concentration thresholds, which are still in use today.[14] More important, the 1982 Merger Guidelines expanded merger analysis beyond concentration thresholds to explain how mergers may raise competitive concerns and to include an assessment of additional factors in the markets of relevance to the merger.[15]

The 1982 Merger Guidelines explained that antitrust law seeks to prevent mergers that could increase the likelihood of collusion, either tacit or explicit, in a post-merger market.[16]

* Commissioners Carlton and Kempf do not join this recommendation.

† Commissioner Kempf does not join this recommendation.

Thus, merger enforcement is one of the ways in which antitrust enforcers attempt to prevent tacit coordination in oligopolistic markets.[17] Antitrust law also seeks to prevent mergers that would enhance market power by creating or strengthening a dominant firm, the 1982 Merger Guidelines explained.[18]

To ground the analytical framework of merger analysis more firmly, the 1982 Merger Guidelines set forth a methodology for assessing market definition based on the behavior that would be profitable post-merger for a hypothetical profit-maximizing monopolist.[19] Market definition requires an assessment of substitutes to which customers could turn if the merged firm attempted to raise price. The 1982 Merger Guidelines also introduced the concept that entry by other firms into the relevant market might deter or counteract attempts by a merged firm to raise prices post-merger, thus negating a merger's potential anticompetitive effects.[20]

Several factors, including ongoing economic research that questioned the extent to which market concentration was correlated with reduced competition, prompted these revisions to merger analysis.[21] In 1984 the DOJ made modest revisions to update the 1982 Merger Guidelines with recent thinking and "to correct any misperception that the Merger Guidelines are a set of rigid mathematical formulas that ignore market realities, and rely solely on a static view of the marketplace."[22]

In 1992 the DOJ and the FTC jointly issued merger guidelines, the first time both agencies set forth a unified approach to merger analysis.[23] For market definition, the 1992 Merger Guidelines continued to ask whether a hypothetical monopolist could successfully impose a small but significant non-transitory increase in price.[24] The 1992 Merger Guidelines further deemphasized the HHI thresholds. Although mergers that would increase concentration by a certain amount in a highly concentrated market remained subject to a presumption of anticompetitive effects, the 1992 Merger Guidelines explained that "market share and concentration data provide only the starting point for analyzing the competitive impact of a merger."[25]

Once past this starting point, the 1992 Merger Guidelines emphasized a need to explain how the proposed transaction could harm competition and which factors suggest the likelihood of such harm. The 1992 Merger Guidelines articulated more fully two mechanisms of anticompetitive effects: (1) coordinated effects, that is explicit or tacit collusion, and (2) unilateral effects resulting from the relaxation of competitive constraints on the combined firm due to the acquisition of a close competitor. For each mechanism, the Guidelines outlined how particular factors might be more or less conducive to a particular theory of anticompetitive effects.[26] In addition, the Guidelines refined the analysis of entry to focus on the potential entrants' need to sink costs in a relevant market as a key determinant of whether entry would be "timely, likely, and sufficient" to deter or counteract anticompetitive effects.[27]

In 1997 the FTC and the DOJ revised the 1992 Merger Guidelines to elaborate on the treatment of merger-related efficiencies. The revisions recognized that the main benefit of mergers to the economy is their potential to achieve efficiencies.[28] The Guidelines explained that merging parties must show that the efficiencies resulting from the merger "would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in the market."[29]

Although the Merger Guidelines have not been altered since 1997, the FTC and the DOJ issued a Commentary on the Horizontal Merger Guidelines in 2006.[30] The Commentary provides further explication of the Merger Guidelines, including examples of how the agencies have applied them in particular matters. The Commentary does not change the standards of the Merger Guidelines, however. Rather, the antitrust agencies issued the Commentary "to provide greater transparency and foster deeper understanding regarding antitrust law enforcement."[31]

3. RECOMMENDATIONS AND FINDINGS

A. Merger Policy in General

3. No statutory change is recommended with respect to Section 7 of the Clayton Act.

3a. There is a general consensus that, while there may be disagreement over specific merger decisions, and U.S. merger policy would benefit from continued empirical research and examination, the basic framework for analyzing mergers followed by the U.S. enforcement agencies and courts is sound.*

3b. The Commission was not presented with substantial evidence that current U.S. merger policy is materially hampering the ability of companies to operate efficiently or to compete in global markets.†

* Commissioner Kempf does not join this recommendation.

† Commissioner Kempf does not join this recommendation.

Commissioner Garza joins this recommendation but notes that the Commission was unable to assess evidence sufficient to opine on the actual efficacy or effects of merger enforcement policy.

4. No substantial changes to merger enforcement policy are necessary to account for industries in which innovation, intellectual property, and technological change are central features.*

4a. Current law, including the Merger Guidelines, as well as merger policy developed by the agencies and courts, is sufficiently flexible to address features in such industries.†

5. The Federal Trade Commission and the Antitrust Division of the Department of Justice should ensure that merger enforcement policy is appropriately sensitive to the needs of companies to innovate and obtain the scope and scale needed to compete effectively in domestic and global markets, while continuing to protect the interests of U.S. consumers.

1. U.S. Merger Policy is Fundamentally Sound

The current merger policy of the United States is fundamentally sound. The testimony of numerous antitrust practitioners and economists and comments from a variety of interested parties show general consensus on this point. Commentators agree that merger policy has significantly improved since the 1950s and 1960s and, as a general matter, is on the right course. Accordingly, the Commission does not recommend any statutory change to Section 7 of the Clayton Act or any wholesale changes to merger policy overall.

Merger policy has seen significant improvements over the past twenty-five years. One witness reported that, during that period, "merger enforcement has become increasingly predictable, transparent, and analytically sound."[32] He also explained that merger policy has become stable and bipartisan, affording "a sense of gravity that previously was lacking."[33] Changes since the early 1980s mark a significant improvement from the policies reflected in court cases of the 1950s and 1960s.[34] Several witnesses stated that U.S. merger enforcement policy is readily defensible[35] and that room for improvement exists only on the margins.[36]

Commenters agreed that merger policy in the United States has benefited significantly from the introduction of the Merger Guidelines, along with subsequent revisions and refinements to them.[37] There is general consensus that the Merger Guidelines have acted as the

* Commissioner Delrahim does not join this recommendation.

† Commissioner Kempf does not join this recommendation.

Commissioner Garza joins this recommendation with the proviso that current enforcement can be improved in the ways suggested in the Commission's other recommendations.

"blueprint[] for the architecture" of merger analysis and, overall, provide a guide that "functions well."[38] The Guidelines have had a significant influence on judicial development of merger law, which is reflected in their widespread acceptance by the courts as the relevant framework for analyzing merger cases.[39] Conversely, the courts have occasionally influenced how the agencies have revised the Guidelines.[40] The Guidelines have also provided useful guidance and transparency to the business community and antitrust bar.[41] Finally, the Guidelines have helped to influence the development of merger policy by jurisdictions outside the United States.[42]

To be sure, some disagree with the outcomes of particular merger cases. Different antitrust enforcers may interpret evidence differently and therefore reach different conclusions as to the likelihood of anticompetitive effects. Nonetheless, there does not appear to be a systematic bias toward either overenforcement or underenforcement.[43] The ongoing debate over merger policy is an important one. Overall, however, the Commission found no need to recommend changes to Section 7 of the Clayton Act or wholesale changes to merger policy in the United States.

2. U.S. Merger Policy is Sufficiently Flexible to Address Industries in Which Innovation, Intellectual Property, and Technological Change are Central Features

As discussed in Chapter I.A, the common-law development of antitrust doctrine has permitted the courts and the agencies to adapt the contours of the antitrust laws to new economic learning, changes in markets, shifting consumer and business behavior, and numerous other factors. Innovation has driven the U.S. economy since before the passage of the Sherman Act.[44] In some respects, the challenges for antitrust analysis presented by dynamic, innovation-driven industries today are analogous to those presented in past years.[45] Current merger policy has met this challenge. It is well grounded in economics and is sufficiently flexible to provide a sound competitive assessment in matters involving industries in which innovation, intellectual property, and technological change are central features.[46]

As described above, merger analysis has moved away from structural presumptions, which presume increased concentration will likely lead to anticompetitive outcomes, toward a more complex analysis that predicts competitive effects using modern economic tools.[47] Furthermore, as explained below, current merger analysis requires an evaluation of procompetitive efficiencies that may result from transactions and an assessment of whether these efficiencies offset the potential anticompetitive effects of a merger. These changes have positioned U.S. merger policy so that it does not currently need substantial change to account for innovation, intellectual property, and technological change.

Merger law and policy—as it has developed through both agency guidelines and case law—has incorporated new or improved economic learning. Industries characterized by innovation, intellectual property, and technological change will continue to evolve, and economic learning will progress.[48] Guidelines and case law provide flexible vehicles through which antitrust analysis can continue to develop. In contrast, efforts to adjust antitrust analysis though statutory change would likely prove difficult, and would require continual amendment or pose the risk of codifying economic learning at only one point in time.[49] For these reasons as well, the Commission does not recommend any changes to Section 7 of the Clayton Act.

3. U.S. Merger Policy Must Continue to Protect U.S. Consumers While Allowing Companies to Innovate and Compete Effectively

U.S. merger policy has served U.S. consumers well in recent years. By and large, it has done so without preventing companies from competing effectively and continuing to innovate.[50] The agencies should remain mindful of the importance of both objectives going forward to ensure that U.S. merger policy remains the leading paradigm for competition policy throughout the world.

B. Efficiencies and Innovation

6. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should give substantial weight to evidence demonstrating that a merger will enhance efficiency.**

7. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should increase the weight they give to certain types of efficiencies. For example, the agencies and courts should give greater credit for certain fixed-cost efficiencies, such as research and development expenses, in dynamic, innovation-driven industries where marginal costs are low relative to typical prices.**

8. **The Federal Trade Commission and the Antitrust Division of the Department of Justice should give substantial weight to evidence demonstrating that a merger will enhance consumer welfare by enabling the companies to increase innovation.**

9. **The agencies should be flexible in adjusting the two-year time horizon for entry, where appropriate, to account for innovation that may change competitive conditions.**

1. The Importance of Efficiencies

Since the 1980s, the courts and the antitrust agencies have recognized that efficiencies resulting from a merger can improve consumer welfare and should be considered in the overall assessment of the merger's likely effects on competition.[51] A merger can allow firms to realize efficiencies from the combination of two complementary companies. Such efficiencies can benefit firms by lowering their costs and can benefit consumers through lower prices, higher quality prodcts, or entirely new products.

The DOJ and the FTC formally recognized the relevance of efficiencies to their evaluation of mergers in 1997, when they revised the Merger Guidelines to add a section describing the circumstances in which the agencies would consider the efficiencies that would result from a merger.[52] The Guidelines now explicitly recognize that "the primary benefit of mergers to the economy is their potential to generate . . . efficiencies."[53] As the agencies explain, "mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction."[54] When a firm is able to lower its costs (or increase quality) consumers benefit from the merger.

The Guidelines generally require that the savings from efficiencies be "passed on" to consumers; that is, they must be "sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market."[55] This is because "[e]ven when efficiencies generated through merger enhance a firm's ability to compete . . . a merger may have other effects that may lessen competition and ultimately may make the merger anticompetitive."[56] Accordingly, the agencies take into account both the benefits that efficiencies would bring to consumers along with the anticompetitive effects a merger is predicted to have. Thus the FTC or the DOJ "will not challenge a merger . . . . if cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market."[57]

Overall, the Commission was presented with little evidence the agencies were routinely failing to take efficiencies into account. A number of witnesses and commenters argued that the agencies' current approach to assessing efficiency claims works well and is appropriate.[58] The FTC and the DOJ readily acknowledge that they do and must, as part of any complete evaluation of a merger, take into account efficiencies that will result from the merger and the effect those efficiencies will have on a firm's incentives to reduce output or increase prices.[59]

In particular, there was little support for the argument that, as a general matter, the agencies impose too high a burden on the parties to demonstrate efficiencies offsetting competitive concerns raised by a merger. Witnesses and commenters generally agreed that the evidentiary burden imposed by the agencies on parties to demonstrate the likelihood and magnitude of asserted efficiencies is appropriate where other evidence indicates that the merger would likely have anticompetitive effects.[60] Requiring merging companies to demonstrate efficiencies is also appropriate because the companies have the best access to information regarding the value and likelihood of achieving the efficiencies they assert.[61]

The explicit acknowledgment in the Merger Guidelines of the importance of efficiencies underscores the important role efficiencies play in both driving mergers and bringing lower cost, higher quality products to consumers.[62] Of course, for a substantial majority of proposed mergers, efficiencies will not play a role in the agency's assessment, because market conditions will ensure that the merger will not have an anticompetitive effect. In such cases, any efficiencies can be fully realized by the companies. However, in cases where a merger may raise competitive concerns, a detailed assessment of the potential efficiencies the parties will realize may be necessary. The agencies should ensure that they give substantial weight to efficiencies in formulating merger enforcement policy and in evaluating specific transactions.

2. The Agencies Should Ensure that they Give Sufficient Credit to Certain Fixed-Cost Efficiencies

The agencies should account for the value of fixed-cost efficiencies in assessing the likely competitive effects of a merger.[63] As one commenter explained, "[s]ince all costs vary in the long run, reductions in capital expenses or other costs fixed in the short run should also be considered."[64] Failure to take account of and give proper weight to such fixed costs in evaluating a merger could deprive consumers and the U.S. economy of significant benefits from a procompetitive merger.

The agencies currently place the greatest weight on efficiencies that will reduce prices to consumers in the short run.[65] Efficiencies that do not lower prices in the short run are given less weight.[66] Thus, for example, a merger that allows a company to reduce the cost of producing each widget by 10 percent (for example, through improved production line technology or streamlining of distribution) can quickly benefit consumers in the form of lower prices. Such efficiencies are typically fully credited by the agency (if substantiated). By comparison, reductions in total costs (including fixed costs)—such as through the elimination of redundant facilities or by improvement upon the rate and quality of innovation—have less (if any) effect on pricing in the short run. In the longer run, however, some (if not all) such efficiencies are also likely to benefit consumers in the form of lower prices or improved quality.[67]

The Commission identified one type of fixed-cost efficiency in particular—those increasing innovation through research and development—to which the agencies may be giving insufficient credit. As one witness explained, "an increasing part of the economy is comprised of research-intensive products . . . such as computer chips, software, pharmaceuticals and media content [that] have very high fixed costs."[68] Mergers generally benefit consumers by making innovation more likely or less costly in such industries, rather than by reducing (the generally very low) marginal costs.[69] Indeed, such innovation efficiencies "often drive transactions in high-tech mergers."[70] More generally, there is "broad agreement . . . that research and development is a major source of economic growth."[71] It is important to make sure that merger policy does not unduly inhibit that basis for growth.

Innovation efficiencies can result in a variety of ways. For example, a merger may make it easier to "combine complementary assets and know-how."[72] Alternatively, a merged company may be better able to share risks associated with research and development.[73] In some industries, such as pharmaceuticals, a merger can "increase the odds of successful commercialization of the product."[74] In each of these instances, the efficiencies do not necessarily lower prices to consumers immediately, but have the potential to bring significant benefits to consumers through new, improved, or lower priced products in the longer run. If the agencies discount those benefits too greatly, they run the risk of preventing mergers that may have short-term anticompetitive effects but long-run procompetitive benefits to consumer welfare.[75]

The enforcement policy of the FTC and the DOJ may give insufficient recognition to innovation efficiencies in some mergers in which they believe anticompetitive effects may result in the short term. For example, although the Merger Guidelines recognize that R&D efficiencies should be considered, they appear to view them with particular skepticism: "Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions."[76] One witness testified that the FTC failed to give proper credit to innovation efficiencies in its evaluation of the merger his company was proposing.[77] More generally, the American Bar Association, Section of Antitrust Law observed that the agencies emphasize potential anticompetitive short-term price effects from a merger and pay insufficient attention to how a merger could increase the merged firm's ability to produce better products and to innovate.[78]

As the nation's economy moves toward an increasing role for goods and services involving intellectual property—such as computer software, electronics, and biotechnology—it becomes even more important for U.S. consumers that the value of efficiencies and innovation that can result from mergers in such industries be realized where possible.[79] A failure by the agencies to take into account fully the benefit of such efficiencies in evaluating whether a merger will harm or benefit consumers could deprive consumers of significant benefits and value.[80] In addition, it "may end up limiting some firms' ability to compete more effectively."[81] Although some witnesses stated that the agencies were not, in fact, hostile to innovation benefits cited by merging parties,[82] on balance, the agencies may in some cases give insufficient credit or weight to such efficiencies. The agencies should ensure that they give substantial weight in evaluating a merger to evidence presented by the merging parties that demonstrates a merger will enhance consumer welfare through innovation and similar efficiencies.

To be sure, such efficiencies are often not easy to measure.[83] Moreover, the agencies may need to balance the value of future benefits that potentially will result from innovation against any current costs to consumers.[84] While analytical methods to assess a merger's likely anticompetitive effects are relatively well developed, methods for analyzing whether a merger will encourage innovation are far less advanced.[85] Nonetheless, the agencies should endeavor to weigh more heavily the potential for welfare-enhancing innovation that a merger will create.

3. The Antitrust Agencies Should be Flexible in Considering the Time Horizon for Entry

Innovation can give rise to dynamic change in markets. Such change may occur over a short or long period of time. For example, although computer software programs may be outdated within six months, approval of a new drug may take years. Under the Merger Guidelines, the possibility of dynamic change over a longer period of time is not clearly taken into account by their treatment of entry. The Guidelines provide that a merger is unlikely to harm competition where entry is sufficiently easy that market participants cannot, collectively or unilaterally, raise prices from pre-merger levels.[86] To meet this requirement, entry must be "timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern."[87] As a general matter, the FTC and the DOJ will consider timely "only those committed entry alternatives that can be achieved within two years from initial planning to significant market impact."[88]

The two-year time horizon may be inappropriately short in some cases. In particular, innovation may result in entry beyond the two-year horizon. The agencies should consider the potential for such entry in assessing the likely competitive effects of the merger.[89] Although it appears that the Guidelines provision represents an approximation, not a hard-and-fast rule,[90] the Commission recommends that the agencies increase their flexibility in this regard to ensure that innovation that will change competitive conditions more than two years in the future receives proper credit. This will help ensure that the agencies' analysis of competitive effects appropriately takes account of competitive dynamics in the markets at issue and that they will not seek to block mergers that, as a result of innovation, may not present a longer-term threat to competition and consumer welfare.

C. Further Study of Merger Policy

10. The Federal Trade Commission and the Antitrust Division of the Department of Justice should seek to heighten understanding of the basis for U.S. merger enforcement policy. U.S. merger enforcement policy would benefit from further study of the economic foundations of merger policy and agency enforcement activity.

10a. The Federal Trade Commission and the Antitrust Division of the Department of Justice should conduct or commission further study of the relationship between concentration, as well as other market characteristics, and market performance to provide a better basis for assessing the efficacy of current merger policy.

10b. The Federal Trade Commission and the Antitrust Division of the Department of Justice should increase their use of retrospective studies of merger enforcement decisions to assist in determining the efficacy of merger policy.

While there is general consensus that the basic framework for current U.S. merger enforcement policy has improved markedly over the past forty years and appears to be fundamentally sound, there is limited empirical support for these conclusions. This shortfall in support allows for reasonable criticism both that merger policy is too lenient or too strict. Indeed, one recent, prominent study questioned whether merger policy has benefited consumers at all,[91] while one commenter suggested that policy should be more aggressive.[92]

The agencies should undertake further study of merger policy and its effects. The potential benefits of such study are substantial; empirical studies and the development of the economics of antitrust law have played a central role in the transformation of merger policy over the past forty years. Further research in this area would improve the empirical basis for merger policy and could improve understanding of the overall costs and benefits of that policy.[93]

To be most useful, further study should focus on questions of particular importance to the evaluation and implementation of merger policy. While there are numerous potentially valuable avenues for research, the Commission identifies two areas in which further research would be especially desirable: (1) studies of the effects on competition of market concentration and other market characteristics; and (2) retrospective studies of the results of merger enforcement decisions.

1. Studies of the Effects of Concentration and Other Market Characteristics on Competition

Current U.S. merger enforcement policy is premised on assumptions about how concentration and other market characteristics (such as ease of entry) affect competition and market power. Empirical evidence gives only limited support for these assumptions, however.[94] In particular, one of the central assumptions of current merger policy is that increased concentration in a relevant market potentially (but not necessarily) leads to a reduction in competition. This basic assumption is reflected in the Merger Guidelines, which use concentration and market-share thresholds as screens that indicate the need for further analysis of the proposed transaction.[95] Nonetheless, several observers have pointed out that there is limited economic knowledge about the levels of concentration at which market power emerges, increases substantially, or becomes problematic for competition.[96] Indeed, although a variety of studies suggest a relationship between concentration and market power, none of these studies, either alone or together, provide a good sense as to the level of concentration at which "antitrust should bite."[97] Furthermore, understanding regarding the impact on competition of other market characteristics, such as the ease of entry, is also limited. Focused study to increase understanding of how these important characteristics of the competitive landscape affect a merger's impact could improve the enforcement agencies' understanding and ability to enforce the antitrust laws in a manner that maximizes benefits for U.S. consumers.

Increasing learning about the validity of the economic theories and assumptions that inform current merger policy, such as empirical study of the relationship between concentration and the probability of the exercise of market power, would be beneficial. To be sure, it can be difficult to obtain the necessary data, to differentiate the effects of concentration from other factors affecting operation of a market, or to draw conclusions about the effects of concentration that apply across diverse industries. For that reason, several witnesses advised that such studies would be unlikely to shed much light on merger policy.[98] However, greater understanding of these relationships is essential to the design and evaluation of merger policy, and similar advances in understanding have promoted substantial improvement in merger policy in the recent past.

2. Retrospective Studies of Merger Enforcement Decisions

The FTC and the DOJ should increase their use of retrospective studies of merger enforcement decisions to assist in determining the efficacy of merger policy. Such retrospective studies would review enforcement decisions in a particular merger or for several mergers in a given industry. Such studies—both in markets in which mergers were allowed to proceed and in those in which mergers were blocked—will help the agencies to evaluate whether their previous decisions have incorrectly blocked mergers that would not have been anticompetitive or permitted mergers that were ultimately anticompetitive.[99] Such studies may also be informative about such things as what levels of concentration or market shares give rise to competitive issues and the effectiveness of entry.[100] More important, such studies may shed light on why a particular decision was later shown to be erroneous, thereby allowing the agencies to modify the models and approaches they use in conducting merger analysis.

3. The Agencies Should Consider "Outsourcing" Studies of Both Types

The agencies should consider whether much of the work for the studies can be more effectively done by outsourcing it to economists and researchers outside the agency. Such studies can require extensive work, and conducting them internally may distract the agencies from their principal mission of detecting and preventing anticompetitive conduct. In addition, outsourcing will help avoid the perception (and possible reality) that the results of such studies are biased toward justifying agency practice. Placing responsibility for conducting the study with economists and other consultants who are not closely connected with the agency largely avoids this problem.

D. Increased Transparency

11. The Federal Trade Commission and the Antitrust Division of the Department of Justice should work toward increasing transparency through a variety of means.

"Transparency" can mean several things with respect to merger policy. The Commission uses it here to mean providing the public with information about both the decisions the agency makes and the methods or approaches that drive those decisions. Transparency promotes basic fairness to parties contemplating mergers by enabling them to predict the legal consequences of contemplated transactions. For example, a firm can determine whether a potential transaction will be likely to be cleared or blocked by the agencies. Moreover, when parties are able to predict in advance what types of transactions are likely to result in enforcement actions, they can eschew them in the first instance, thereby reducing the need for costly investigations and enforcement actions.[101] Transparency thereby economizes on the agencies' scarce merger enforcement resources, which can cover only a small number of transactions. Ultimately, the public's confidence in the ability of the antitrust laws to promote competition relies upon transparent decision-making that can be predicted with some confidence in advance.

Both agencies have taken numerous steps in recent years to provide antitrust practitioners and the general public with information about their enforcement activities. To provide the public with a clear statement of the basic principles of enforcement policy, the agencies have issued, and periodically revised, the Merger Guidelines. In 2006 the agencies issued an extensive "commentary" on those Guidelines that includes various examples illustrating the principles in the Guidelines by describing their application to particular merger matters. The agencies also use various other vehicles—such as speeches, testimony, and reports—to explain their merger policy priorities. In addition, the agencies have issued several other guidelines for conduct, including regarding the licensing of intellectual property and regarding joint conduct. Finally, the agencies provide information regarding their enforcement activity. The agencies routinely provide explanations of the enforcement actions they take, and, in a few instances, have provided some explanation of decisions not to take enforcement actions. Moreover, they also have recently begun to provide data on merger enforcement activities.

On the whole, agency policy statements, commentary, and data on enforcement activity supplement the current Merger Guidelines, and thereby provide informative guidance to merging parties and the public regarding current enforcement policy.* Nonetheless, the Commission believes that the agencies could further improve upon their efforts, including in four specific respects, described below: (1) increase the use of closing statements explaining decisions not to challenge transactions; (2) continue regular reporting of statistics regarding merger enforcement activity; (3) update the Merger Guidelines to explain how the agencies evaluate the potential impact of a merger on innovation; and (4) update the Merger Guidelines to include an explanation of how the agencies evaluate non-horizontal mergers. While the agencies have already taken some steps toward these recommendations, the Commission concludes that further efforts in these specific areas are of particular importance.

11a. The agencies should issue "closing statements," when appropriate, to explain the reasons for taking no enforcement action, in order to enhance public understanding of the agencies' merger enforcement policy.

Both the DOJ and the FTC generally provide a statement of reasons as to why they are taking an enforcement action against a merger. If either agency seeks a preliminary injunction to block an allegedly anticompetitive merger, the complaint and subsequent pleadings will spell out the agency's concerns with the proposed transaction. Similarly, when either the FTC or the DOJ enters into a consent decree with respect to a merger, it will provide a statement explaining the reasons why the agency sought relief and how the relief resolves its concerns that the merger would otherwise be anticompetitive.[102]

The agencies often decide, after a thorough review of a proposed merger, not to seek any relief and to allow the merger to be completed. In the vast majority of cases, when either agency decides to close a merger investigation, it provides no explanation as to why it did not seek relief. In many of those investigations, the decision not to seek relief is non-controversial; over 95 percent of mergers that are notified to the FTC or the DOJ are determined not to pose competitive problems sufficient to warrant an extended investigation.[103] Nonetheless, in the instances when the FTC or the DOJ closes the investigation of a merg-

* Commissioner Kempf does not agree with this assessment.

er after an extended investigation, the public and antitrust bar may be left to speculate why the agency declined to seek relief.

Although the agencies are not required to explain why they decided not to challenge a merger, they have in recent years issued such explanations with respect to a limited number of transactions. For example, the FTC and the DOJ have issued explanations as to why they closed investigations without seeking relief in the cruise line, airline, media, and telecommunications industries.[104] This increased use of closing statements has benefited the merging parties, interested observers, and the agencies themselves, by reducing uncertainty, increasing predictability, and promoting voluntary business compliance.

Increased issuance of such statements would further benefit the public and businesses.[105] In particular, the agencies have tended to issue closing statements in higher-profile, "close" cases for which there is keen interest from the public in the outcome. The Commission recommends that the FTC and the DOJ expand issuance of closing statements to other matters in which they undertake significant reviews of a transaction (that is, issuance of a second request along with an extended, as opposed to "quick look," investigation). Such statements need not be lengthy, and will necessarily omit details containing confidential business information.

The Commission does not recommend imposition of a requirement that the FTC and the DOJ explain why they decided not to seek relief, as advocated by some.[106] The agencies have already issued explanatory statements in many matters, and can be expected to continue to do so. Requiring a statement in all cases, however, could place burdens on the agencies and might present problems with respect to the confidentiality that the HSR Act provides to the merging parties and third parties who provide information to the agencies.[107] Leaving the publication of such statements to the discretion of the agencies leaves them free not to issue statements where the burden of doing so might be substantial. Accordingly, the Commission believes that continued encouragement of expanded efforts to issue closing statements is sufficient to improve agency transparency in this regard.

11b. The agencies should increase transparency by periodically reporting statistics on merger enforcement efforts, including such information as was reported by the Federal Trade Commission in its 2004 Horizontal Merger Investigation Data, as well as determinative factors in deciding not to challenge close transactions. These reports should emanate from more frequent, periodic internal reviews of data relating to the merger enforcement activity of the Federal Trade Commission and the Antitrust Division of the Department of Justice. To facilitate and ensure the high quality of such reviews and reports, the Federal Trade Commission and the Antitrust Division of the Department of Justice should undertake efforts to coordinate and harmonize their internal collection and maintenance of data.*[*]

The DOJ and the FTC have recently undertaken several efforts to complement their statements on merger enforcement policy with statistical information concerning their actual enforcement activity. In 2003 the FTC and the DOJ published a report summarizing data on market structure for the horizontal mergers in which they had sought relief during Fiscal Years (FY) 1999–2003.[108] During 2004 the Federal Trade Commission published a report containing similar (and some additional) data on nearly all of the mergers it had investigated through the issuance of a second request, covering FY1996–2003.[109] In January 2007 the FTC updated this report with data through the end of FY2005.[110]

The FTC and the DOJ should continue to conduct, and make available to the public, periodic reviews of data and other statistics regarding enforcement activity. While general statements of policy provide useful guidance to business, data on actual enforcement actions provide particularly valuable insights into how the agencies actually apply the relevant policies. In combination with statements about individual cases, systematically collected data about enforcement practices—released on a regular (for example, a biennial or triennial) basis—can provide additional valuable transparency regarding agency enforcement practices.[111] Such data collection and publication would be most useful if it focuses on the key considerations that govern whether the agency takes an enforcement action.[112] Among other things, it will help supplement the Guidelines' information on the concentration levels used as screens and information on the levels of concentration that actually draw challenges.

The Commission's recommendation contemplates that the agencies will regularly engage in careful internal reviews of data regarding enforcement activity. However, not all such reviews need be released publicly. Rather, more frequent internal reviews could form the basis

[*] Commissioner Kempf does not join this recommendation.

for less frequent, but regular public reports. Keeping the reviews internal in most cases will permit the agencies to focus resources on broadening their data analysis to determine whether there are new trends in their enforcement practices, rather than devoting energy to preparing frequent reports for public review. In addition, it will permit the agencies to focus their public releases on the data and analysis that are most likely to improve public understanding of the key variables driving agency enforcement practice.

Finally, the Commission is concerned that current efforts to develop such data may be hindered by differences in the data collection and retention policies followed by each agency. The ability of the agencies to discern trends and provide meaningful information to the public, particularly in a form that permits useful comparisons between the approach each agency takes, requires consistency in the data and other information retained. As part of undertaking studies of this type, the agencies will inevitably identify ways in which they retain data and other information differently. The Commission encourages the agencies to undertake efforts to adopt a common approach to and standards for retention of data and other information about their enforcement activities.[113]

11c. The agencies should update the Merger Guidelines to explain more extensively how they evaluate the potential impact of a merger on innovation.*

The ability to increase innovation is a significant reason for some mergers, as explained above. However, the current Merger Guidelines offer little explanation as to how the agencies will analyze the claims of parties that a merger will enhance their ability to innovate and how the agencies will balance a predicted increase in innovation with potential anticompetitive effects from the merger. Indeed, the only mention of innovation is in a passing reference in a footnote.[114] The agencies have provided limited guidance on these issues through actions in individual matters, albeit in large part because the issue is not presented squarely in many investigations.

The agencies should update the Merger Guidelines to provide more extensive discussion regarding how they evaluate the competitive effects of a merger on innovation. As explained above, innovation is extremely important to economic welfare, and it is important for the agencies to articulate clearly how they analyze the effects of a merger on innovation.[115] The Commission recognizes that there remains a need for additional learning regarding innovation.[116] However, it believes that the agencies have sufficiently considered the issues involved to produce useful guidelines in this area.

* Commissioners Carlton and Kempf do not join this recommendation.

11d. The agencies should update the Merger Guidelines to include an explanation of how the agencies evaluate non-horizontal mergers.*

Horizontal mergers involve a merger between two companies that generally compete with each other to sell products in the same markets. Vertical (or non-horizontal) mergers, in comparison, occur between two companies in a distribution chain, where one company sells an input to the second company's business in a "vertical" relationship. The analysis of each type of merger differs substantially (mergers may present both horizontal and vertical "issues"). ("Conglomerate" mergers, which are neither horizontal nor vertical, generally do not raise antitrust issues.)

The 1982 Merger Guidelines contained a section addressing non-horizontal mergers, including vertical mergers and mergers raising potential competition concerns.[117] These provisions were also included in the 1984 Merger Guidelines. However, subsequent Guidelines revisions in 1992 and 1997 did not include the non-horizontal mergers section, although the agencies did not formally abandon that part of the 1984 Guidelines.[118] Significant thinking regarding vertical mergers has taken place since then, but the Guidelines have not been updated or separate guidelines issued to address non-horizontal mergers.

The existing Merger Guidelines have brought significant transparency to the business community and antitrust bar as to how the agencies evaluate horizontal mergers. Businesses and antitrust practitioners would benefit greatly from a similar statement of how the agencies assess the competitive effects of vertical mergers.[119] While the issues are challenging, providing an explanation of how the agencies undertake analysis in non-horizontal mergers would supply beneficial transparency.

* Commissioner Kempf does not join this recommendation.

Notes

[1] 15 U.S.C. § 18. The Act contains several additional paragraphs of extending and limiting coverage. *See id.*

[2] Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. No. 94-435, 90 Stat. 1383 (codified as amended at 15 U.S.C. § 18a).

[3] *See generally* Chapter II.B of this Report regarding the Hart-Scott-Rodino Act pre-merger review process.

[4] *See* American Bar Association, Section of Antitrust Law, Monograph No. 12, Horizontal Mergers: Law and Policy 37–38 (1986) [hereinafter ABA, Horizontal Mergers] (citing United States v. Pabst Brewing Co., 384 U.S. 546 (1966) (combined shares of 4.49 percent); United States v. Von's Grocery Co., 384 U.S. 270 (1966) (combined shares of 7.5 percent)). One Supreme Court Justice concluded from this string of cases that the "sole consistency . . . is that . . . the Government always wins." *Von's*, 384 U.S. at 301 (Stewart, J., dissenting).

[5] Ernest Gellhorn et al., Antitrust Law and Economics 421 (5th ed. 2004) [hereinafter Gellhorn, Antitrust Law and Economics] (citing Oliver E. Williamson, *The Merger Guidelines of the U.S. Department of Justice—In Perspective* (June 10, 2002), *available at* http://www.usdoj.gov/atr/hmerger/11257.htm).

[6] Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines, § 0.1 (1992, revised 1997) [hereinafter DOJ/FTC Horizontal Merger Guidelines] ("The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise."). Unless otherwise specified or clear from the context, all citations to the DOJ/FTC Horizontal Merger Guidelines are to the Horizontal Merger Guidelines, as revised in 1997 and currently in effect.

[7] *See generally* Gellhorn, Antitrust Law and Economics, at 453–64.

[8] A description of the procedural aspects of this pre-merger review, including the size-of-transaction threshold, appears in Chapter II.B of this Report regarding the HSR Act.

The FTC does not have jurisdiction to review mergers of certain common carriers, certain banks and financial institutions, and certain entities in the meatpacking business. *See* 15 U.S.C. § 45(a)(2). In addition, several regulatory agencies have principal or exclusive authority to review mergers in the industries they regulate. *See, e.g.*, 12 U.S.C. § 1828(c) (banks subject to Comptroller of the Currency, Federal Reserve Board of Governors, FDIC, or the Office of Thrift Savings Director); 47 U.S.C. §§ 214, 310(b) (FCC authority to review license transfers incident to mergers); 49 U.S.C. § 11321(a) (Surface Transportation Board's exclusive jurisdiction over rail mergers).

[9] *See generally* DOJ/FTC Horizontal Merger Guidelines.

[10] Dep't of Justice, Merger Guidelines (1968), *reprinted in* ABA, Horizontal Mergers, at 264–76 [hereinafter 1968 DOJ Merger Guidelines]. The FTC neither participated nor joined in the issuance of these Guidelines. *Id.* at Introduction, ¶ 1 (explaining that "these Guidelines are announced solely as a statement of current Department [of Justice] policy"). *See generally* Hillary Greene, *Agency Character and the Character of Agency Guidelines: An Historical and Institutional Perspective*, 72 Antitrust L.J. 1039 (2005) (contrasting the 1968 Guidelines (as well as subsequent guidelines and FTC statements) with prior and contemporaneous industry-specific guidelines promulgated by the FTC).

[11] 1968 DOJ Merger Guidelines, at Purpose, ¶ 1.

[12] *See id.* § 1, ¶¶ 4–6. The 1968 DOJ Merger Guidelines used the four-firm concentration ratio, which is the sum of the market shares (as a percentage) of the four largest firms in the relevant market, in determining whether to challenge a merger. *Id.* § 1, ¶¶ 5–6.

[13] Dep't of Justice, Merger Guidelines (1982), *reprinted in* ABA, Horizontal Mergers, at 277–98 [hereinafter 1982 DOJ Merger Guidelines].

[14] 1982 DOJ Merger Guidelines, pt. III.A.

[15] *Id.* pt. III.

[16] *Id.* pt. III.C.

[17] *See, e.g.*, Gellhorn, Antitrust Law and Economics, at 410.

[18] 1982 DOJ Merger Guidelines, pt. III.

[19] *Id.* pt. II.A.

[20] *Id.* pt. III.B.

[21] ABA, Horizontal Mergers, at 45 ("[O]ngoing economics research continued to cast doubt on the strength of inferences that could be drawn from concentration data.").

[22] Dep't of Justice, Statement to Accompany Release of 1984 Merger Guidelines (June 14, 1984), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,103. The 1984 revisions continued to cover non-horizontal mergers of various types, including vertical mergers and those raising potential competition issues. American Bar Association, Section of Antitrust Law, Mergers and Acquisitions: Understanding the Antitrust Issues 20 (2d ed. 2004) [hereinafter ABA, Mergers and Acquisitions]. Although not much used, the non-horizontal portions have not been superseded. *Id.*

[23] Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines (1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104 [hereinafter 1992 DOJ/FTC Horizontal Merger Guidelines].

[24] *Id.* § 1.11.

[25] *Id.* § 2.0. *But see* Gellhorn, Antitrust Law and Economics, at 406 ("On the other hand, concentration can matter: 'In cross-section comparisons involving markets in the same industry, seller concentration is positively related to the level of price.'") (quoting Richard Schmalensee, *Inter-Industry Studies of Structure and Performance*, *in* 2 Handbook of Industrial Organization 951, 988 (Richard Schmalensee & Robert D. Willig eds., 1989) (stylized fact 5.1)); *id.* (citing Paul A. Pautler, Evidence on Mergers and Acquisitions, 48 Antitrust Bull. 119, 207 (2003) ("[S]everal studies of differing industries using price to measure performance suggest that increasing concentration may indeed lead to higher prices.")).

[26] *See* 1992 DOJ/FTC Horizontal Merger Guidelines, § 2.

[27] *Id.* § 3.

[28] DOJ/FTC Horizontal Merger Guidelines, § 4.

[29] *Id.*

[30] Dep't of Justice & Federal Trade Comm'n, Commentary on the Horizontal Merger Guidelines (2006).

[31] *Id.* at v. (Foreword).

[32] Merger Enforcement Transcript at 26 (Baer) (Nov. 17, 2005); William J. Baer, Statement at AMC Merger Enforcement Hearing, at 14 (Nov. 17, 2005) [hereinafter Baer Statement] ("Merger enforcement is more predictable, transparent and analytically sound than ever before."); Merger Enforcement Trans. at 16 (Rill) (opining that "the current merger enforcement regime [is] on the right track").

[33] Baer Statement, at 5–6 (citing similarities in policies pursued by Pitofsky and Muris); *see also* Merger Enforcement Trans. at 46–47 (Scheffman) (policy is bipartisan); Thomas B. Leary, *The Essential Stability of Merger Policy in the United States*, 70 Antitrust L.J. 105, 107 (2002).

[34] David T. Scheffman, Statement at AMC Merger Enforcement Hearing, at 2 (Nov. 17, 2005) [hereinafter Scheffman Statement] ("There are few if any knowledgeable people that would defend the pre-1982 merger enforcement policy in the U.S."); Economists' Roundtable on Merger Enforcement Transcript at 29 (Bresnahan) (Jan. 19, 2006) (there is "nothing as remotely troubling about merger review today as there was in the early 1980s.").

[35] Economists' Roundtable Trans. at 107–08 (White, Rubinfeld, Reiss, Kaplan, Bresnahan); *see also* Statement of Prof. Robert D. Willig, at AMC Merger Enforcement Hearing, at 1 (Nov. 17, 2005) [hereinafter Willig statement]; American Bar Association, Section of Antitrust Law, Public Comments Submitted to AMC Regarding Horizontal Merger Guidelines, at 1 (Nov. 10, 2005) [hereinafter ABA Comments re Guidelines] (opining that, "generally speaking, federal merger policy has been effective without unduly limiting the ability of firms to achieve efficiencies and expand internationally" while noting "room for improvement"); Economists' Roundtable Trans. at 10–11 (Rubinfeld) ("My sense is that the merger laws, the Clayton and FTC Acts, really work well and that the level of enforcement has generally been good.").

[36] Merger Enforcement Trans. at 26 (Baer) (stating that "the need for changes, really are at the margins"); Baer Statement, at 14 (cautioning about the effect of uncertainty resulting from change); James F. Rill, Statement at AMC Merger Enforcement Hearing, at 3 (Nov. 17, 2005) [hereinafter Rill Statement] (while there have been some critical observations with "some kernel of validity" in recent years, "they are marginal criticisms that misjudge the flexibility of the *Merger Guidelines* to adapt").

[37] Rill Statement, at 2 ("[T]he 1982 *Merger Guidelines* were a fundamental turning point in merger enforcement."); Baer Statement, at 2 ("Today's approach to merger enforcement largely dates to the adoption of the 1982 Merger Guidelines."); Scheffman Statement, at 2 (merger enforcement policy has continued to improve since 1982 from the perspective of both economic efficiency and consumer welfare).

[38] Willig Statement, at 2; *see also* Merger Enforcement Trans. at 22 (Baer) (commending agencies for achieving "better internal discipline about how [they] look at a merger"); *id.* at 23 (Baer) (the system "basically works well"; quarrels focus on particular decisions).

[39] Rill Statement, at 3–5 (citing cases); Baer Statement, at 6–8; Merger Enforcement Trans. at 77–78 (Baer) (although twenty years ago there was a "tremendous divergence" between courts relying on 1960s precedents and agency enforcement practice, courts have since then largely adopted the Guidelines' approach); *id.* at 17–18 (Rill) (noting improvement in U.S. courts and internationally); *see also id.* at 80 (Scheffman) (Guidelines provide judges with a "roadmap"); *id.* at 81–82 (Willig) (it is a slow process, but judges appear to be making "some pretty good decisions" on market definition) (citing FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004); United States v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004)).

[40] For example, after losing a series of merger challenges because courts found that easy entry would deter any anticompetitive effects, the agencies adopted a more extensive entry provision in their next revisions to the Guidelines. This section set forth what the agencies believe is required for entry to be "timely, likely, and sufficient to deter or counteract anticompetitive effects." DOJ/FTC Horizontal Merger Guidelines, § 0.2. *See generally id.* § 3. So far, courts appear to have accepted this change. *See generally* GELLHORN, ANTITRUST LAW AND ECONOMICS, at 456–57.

[41] *See, e.g.*, ABA Comments re Guidelines, at 1 (the Guidelines "have stood the test of time and provide valuable guidance to the bar and business community"); Merger Enforcement Trans. at 22–23 (Baer).

[42] Rill Statement, at 4–5 (citing the development of the Canadian and E.U. guidelines); Baer Statement, at 8 (focusing on the acceptance by the European Union and other jurisdictions of a substantial lessening of competition standard for merger enforcement).

[43] *See* Merger Enforcement Trans. at 39 (Willig) ("I don't see systematic errors" in merger enforcement); *id.* at 38 (Rill) ("I think the error rate is low."). *But see* American Antitrust Institute, Public Comments Submitted to AMC Regarding Merger Enforcement, at 2 (July 15, 2005) [hereinafter AAI Comments re Merger Enforcement] ("It appears that enforcement policy has evolved to the point where 2 to 1 or 3 to 2 mergers are the only ones that the agencies will regularly consider dangerous to competition.").

The fact that the agencies sometimes lose in court does not necessarily mean that they are overenforcing. *See* Economists' Roundtable Trans. at 11 (Rubinfeld) ("If the agencies are not out there aggressively pursuing mergers that they think are anticompetitive because they're afraid of losing a case, we're going to be having under-enforcement.").

[44] Prof. Carl Shapiro, Statement at AMC New Economy Hearing, at 2 (Nov. 8, 2005) [hereinafter Shapiro Statement re New Economy]; M. Howard Morse, Statement at AMC New Economy Hearing, at 5 (Nov. 8, 2005) [hereinafter Morse Statement].

[45] *See, e.g.*, Jonathan M. Jacobson, *Do We Need a "New Economy" Exception for Antitrust?*, 16 ANTITRUST, Fall 2001, at 89, 89–90.

[46] *See* Willig Statement, at 2 ("[T]he standards for merger enforcement have appropriately adapted to major changes in the economy and in our capabilities and methodologies for analyzing competition."); *see also* New Economy Transcript at 6–7 (O'Connell) (Nov. 8, 2005) (stating that antitrust laws "are flexible enough . . . to work in all industries, including those that are constantly evolving through the introduction of new technologies. . . . This is a flexible fact-based analysis that's supported by sound economic principles that don't change from industry to industry, and it enables us to deal with industries that experience fast-paced changes while serving the primary goal of protecting competition in rapidly evolving markets."); *see also* Prof. Richard J. Gilbert, Statement at AMC New Economy Hearing, at 2 (Nov. 8, 2005) [hereinafter Gilbert Statement] ("[A]dvocates of an antitrust exemption for the new economy represent another special interest group . . . ."); New Economy Trans. at 20 (Morse) ("[T]he broad language of Sherman and Clayton Acts are sufficiently flexible to take innovation concerns into account."); Shapiro Statement, at 1–2.

[47] *See* Part 2 of this Section; *see, e.g.*, Deborah Platt Majoras, Reforms to the Merger Review Process, at 6 (Feb. 16, 2006), *available at* www.ftc.gov/os/2006/02/mergerreviewprocess.pdf ("[S]tandards for reviewing transactions have changed substantially since the passage of the HSR Act, such that today the agencies rely less on readily apparent structural indicators, such as market shares, and more on detailed and direct market analyses."); Susan A. Creighton, Statement at AMC Merger Enforcement Hearing, at 2–3 (Nov. 17, 2005) (emphasizing the impact of "increasing sophistication of substantive merger analysis," "rigorous [judicial] standards," and "increasing use of data-dependant economic analysis"); International Bar Association, Public Comments Submitted to AMC Regarding Merger Enforcement, at 25 (Oct. 26, 2005) [hereinafter IBA Comments re Merger Enforcement] ("US merger review has come a long way and now involves detailed and sophisticated microeconomic analysis of a merger's likely impact on prices and markets."); Mark D. Whitener, Statement at AMC Merger Enforcement Hearing, at 6 (Nov. 17, 2005) (agencies and courts "rely more heavily on econometric analysis of business data," and companies in turn are able to collect more data); Shapiro Statement re New Economy, at 4 ("Gone are the days when the government could rely heavily on a static measure of market shares to challenge a merger in a dynamic industry. Modern merger analysis is far from static."); Baer Statement, at 4 ("Market concentration and the market shares of the merging parties correlate with the likelihood of investigation but do not alone dictate enforcement decisions."); Morse Statement, at 3.

[48] *See* Willig Statement, at 2 ("[E]conomic understanding has continued to deepen and be guided in new directions by both the changes in the economy and by continuing progress of productive thinkers in academe, government, and antitrust practice.").

[49] *See* Shapiro Statement re New Economy, at 2 ("Technology changes. Economic laws do not. . . . [T]he Commission should be wary of proposals to modify the antitrust laws, or their enforcement, based on claims that we are living in a 'New Economy.'") (internal quotations omitted); Morse Statement, at 5 ("Antitrust law is sufficiently flexible to take innovation concerns into account, and today's theories, which may be replaced over time, need not be codified into the statute."); *see also* Merger Enforcement Trans. at 21 (Rill) ("please, no" to the idea of "legislation in the merger area"; things are working well).

[50] *See* Part 3.B.2 of this Section (discussing the Commission's recommendations on ensuring appropriate weight is given to increased innovation that may result from a merger).

[51] *See, e.g.*, FTC v. Tenet Health Care Corp., 186 F.3d 1045, 1054–55 (8th Cir. 1999); FTC v. H.J. Heinz Co., 246 F.3d 708, 720–22 (D.C. Cir. 2001); United States v. Carilion Health Sys., 707 F. Supp. 840, 849 (W.D. Va.) (denying preliminary injunction, in part based on finding that the merger would help the parties achieve economies), *aff'd mem.*, 892 F.2d 1042 (4th Cir. 1989); FTC v. Owens-Illinois, Inc., 681 F. Supp. 27, 53 (D.D.C.) (granting preliminary injunction in part based on finding that "defendants' con-

tention as to realization of economies is, at this preliminary stage of review, the more persuasive"), *vacated as moot*, 850 F.2d 694 (D.C. Cir. 1988); *see also* William J. Kolasky & Andrew R. Dick, *The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers*, 71 ANTITRUST L.J. 207, 214 (2003) [hereinafter Kolasky & Dick, *The Merger Guidelines and the Integration of Efficiencies*] ("parties began increasingly in the late 1970s and early 1980s to include efficiencies arguments in presentations to the agencies in merger investigations" with some success). *See generally* AMERICAN BAR ASSOCIATION, SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 360–63 (6th ed. 2007) [hereinafter ANTITRUST LAW DEVELOPMENTS].

52 DOJ/FTC Horizontal Merger Guidelines, § 4.

53 *Id.*

54 *Id.*

55 *Id.* The Guidelines provide that the agencies may also take into consideration efficiencies that do not have a "short-term, direct effect on prices in the relevant market." *Id.* § 4 n.37. The Guidelines call for giving such savings less weight because they are "less proximate and more difficult to predict." *Id.*

56 *Id.* § 4 n.37.

57 *Id.* § 4 (footnote omitted)

58 *See, e.g.*, Prof. Jonathan Baker, Statement at AMC Merger Enforcement Hearing, at 1 (Nov. 17, 2005); Merger Enforcement Trans. at 120 (Baker) ("[T]here's no serious problem involving efficiencies in merger analysis that would call for intervention by your Commission, and . . . in particular, there's no need to recommend any legislation to address anything concerning efficiencies."); George S. Cary, Statement at AMC Merger Enforcement Hearing, at 2 (Nov. 17, 2006) [hereinafter Cary Statement] ("The Agencies, by and large, have taken appropriate account of efficiencies in deciding whether to challenge mergers, and the courts have done quite well in evaluating efficiency arguments in litigation."); Merger Enforcement Trans. at 116 (Cary) ("[A]fter eight years of seeing the Guidelines in action . . . it's my view that the basic trade-offs made in the Guidelines were right. . . . the process of actually doing the efficiency analysis that is set forth in the Guidelines is more manageable and more administrable than one might have thought going into the process of creating the Guidelines' analysis in the first place."); Baer Statement, at 12 ("The 1997 amendments to the Merger Guidelines in my view handle efficiencies appropriately.") (footnote omitted); Rill Statement, at 14–16 (the Merger Guidelines provide a proper approach to analyzing efficiencies); *see also* Kolasky & Dick, *The Merger Guidelines and the Integration of Efficiencies*, at 207–10.

Others believe the agencies should give more credit to efficiencies. *See* Charles F. (Rick) Rule, Statement at AMC Merger Enforcement Hearing, at 13 (Nov. 17, 2005) [hereinafter Rule Statement re Merger Enforcement] ("To the extent that merger enforcement continues to focus exclusively on price effects (and reductions in consumer surplus) and ignores the way in which increases in productive efficiency benefit consumers as whole even when such increases generate producer surplus, the thresholds for identifying anticompetitive mergers are likely to be too low and the explicit *and* implicit treatment of productive efficiencies is likely to be too limited."); American Bar Association, Section of Antitrust Law, Public Comments Submitted to AMC Regarding Efficiencies, at 1 (Nov. 10, 2005) [hereinafter ABA Comments re Efficiencies] (stating that the 1997 revisions to the Merger Guidelines "clarified and improved the [agencies'] treatment of efficiencies in merger review," while suggesting improvements in the treatment of efficiencies that result in "substantial reductions in fixed costs" or "development of new products").

59 Kenneth Heyer, Statement at AMC Merger Enforcement Hearing, at 2–3 (Nov. 17, 2005) [hereinafter Heyer Statement] ("[T]he Merger Guidelines underscore the central role of efficiencies in the evaluation of the likely competitive effects of proposed mergers. . . . There is simply no way to evaluate whether a merger will give the merged firm the ability and incentive to raise prices, either unilaterally or in coordination with other firms, without examining the efficiencies a merger may produce."); *see* Michael A. Salinger, Statement at AMC Merger Enforcement Hearing, at 2 (Nov. 17, 2005) [hereinafter Salinger Statement] ("As the merger guidelines have developed through their various iterations, efficiencies have moved, in

part, from a possible 'defense' to part of an integrated analysis of competitive effects."); Scheffman Statement, at 10 (suggesting that standard of proof required by agencies in efficiency analysis is "sometimes unrealistic").

[60] *See, e.g.*, Rill Statement, at 14 ("The Merger Guidelines do not preclude recognition of longer-term cost savings that are demonstrable and merger specific."); *see also* Merger Enforcement Trans. at 107 (Heyer) ("We actually need some evidence to support the fact that there may be efficiencies from what might otherwise be a troublesome merger . . . ."); Salinger Statement, at 4 ("[W]e cannot conclude that a merger will generate efficiencies simply because the parties say it is so. Mere assertion is not proof or even, by itself, supporting evidence."). *But see* Merger Enforcement Trans. at 84–85 (Scheffman) (efficiencies claims are "speculative," but so are predictions of anticompetitive effects).

[61] Cary Statement, at 8–9 ("Requiring the party with greater access to information to come forward with evidence of a proposition that is helpful to its position is not at all unusual in antitrust cases generally or merger cases particularly."); *see* Heyer Statement, at 4 ("[T]he information needed to make an informed and reasoned judgment about such claims is almost always uniquely in the hands of the merging parties. We cannot verify efficiency claims without their cooperation.").

[62] Some assert that enforcement could be more aggressive without limiting merger-related efficiency gains. *See* AAI Comments re Merger Enforcement, at 3, 6–7 (citing economic literature suggesting many mergers do not increase market value or ultimately provide efficiency gains); *id.* at app. 19–20 (Statement of AAI on Horizontal Mergers and the Role of Concentration in the Merger Guidelines); F.M. Scherer, Public Comments Submitted to AMC, at 1–3 (Mar. 1, 2006); *see also* Economists' Roundtable Trans. at 72 (Rubinfeld) (opining that many mergers reviewed by the DOJ during his tenure as the Economics Deputy were bad for the company but pursued due to "the stupidity or the egos of the CEOs of the two companies"); Charles D. Weller, Public Comments Submitted to AMC Regarding Merger Enforcement, at 2–3 (July 16, 2005) (arguing that most mergers are not successful).

Others argue that enforcement could be less aggressive by pointing to economic literature suggesting few mergers are undertaken to enhance market power, and rather are generally driven by efficiencies. *See* Economists' Roundtable Trans. at 22–28 (Kaplan); Prof. Steven N. Kaplan, Statement at AMC Economists' Roundtable on Merger Enforcement, at 13–15 (Jan. 19, 2006) (economics literature, based on a number of stock-market "event" studies on mergers, suggests that mergers seldom increase market power and, on average, increase the total economic value of the parties).

[63] Rill Statement, at 14 ("'[A]n arbitrary exclusion of fixed costs from cognizable efficiencies is unwarranted because savings in fixed costs may affect competition and have an ultimate downward effect on price.'") (quoting Federal Trade Comm'n Staff Report, Anticipating the 21st Century: Competition Policy in the New High-Tech Global Marketplace, ch. 2, at 34; Rule Statement re Merger Enforcement, at 13 ("Consumer welfare benefits from fixed cost savings just as much as variable savings."); Merger Enforcement Trans. at 86 (Scheffman) (courts should consider fixed-cost efficiencies and "things that fall into this pass-through trap"); IBA Comments re Merger Enforcement, at 47–48 ("For example, industries with significant R&D investments may have pricing unrelated to marginal cost, but rather geared towards recouping large investments in fixed costs. Large fixed cost efficiencies in such industries can directly affect price and should be given greater consideration where appropriate."); ABA Comments re Efficiencies, at 6 ("[W]here fixed cost savings in a merger have the potential to lead to lower prices or will lead to reduced allocations of direct, shared or common fixed costs that are incorporated in the economic justifications underlying such investment decisions, fixed cost savings should be accorded specific credit in evaluating the benefits of the proposed merger or acquisition.").

[64] AAI Comments re Merger Enforcement, at 8–9 (footnotes omitted). *But see* Merger Enforcement Trans. at 110 (Salinger) (claims of overhead savings are often properly rejected, not because they are fixed costs (which they are not), but because overhead costs tend to bear the same ratio to total expenses for both large and small companies, meaning a merger will not likely create savings in such costs); *see also id.* at 128 (Salinger) ("[O]n the pass-through, we make a distinction between fixed-cost savings and marginal-cost savings, because we operate under a consumer welfare standard.").

65 DOJ/FTC Horizontal Merger Guidelines, § 4 & n.37.

66 *Id.* § 4 n.37. The Guidelines do not rule out taking account of longer-run efficiencies; ordinarily, however, "the result of [the Agency's] analysis over the short term will determine the Agency's enforcement decision in most cases. The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market." *Id.*

67 Over the longer run, costs that are at one time fixed (or sunk) become variable. Thus, savings in such costs could lower prices. *See, e.g.*, William J. Kolasky, The Role of Economics in Merger Enforcement: Efficiencies and Market Definition under Conditions of Price Discrimination, Presented at Charles River Associates Conference: Current Topics in Merger & Antitrust Enforcement, at 10 (Dec. 11, 2002) ("[F]ixed cost savings matter. . . . First, which costs are variable depends in part on how long our time horizon is. With a longer horizon, costs that might otherwise appear fixed may indeed impact marginal pricing decisions."); Michael L. Katz & Howard A. Shelanski, *Mergers and Innovation*, 74 ANTITRUST L.J. 1, 55 (2007) [hereinafter Katz & Shelanski, *Mergers and Innovation*] ("[I]t is important to remember that, over a long enough time horizon, everything is variable.").

68 Cary Statement, at 12; *see* Prof. Daniel L. Rubinfeld, Statement at AMC Economists' Roundtable on Merger Enforcement, at 4 (Jan. 19, 2006) [hereinafter Rubinfeld Statement] ("[M]any firms have relatively high price-cost margins, yet little or no market power in the antitrust sense. This is particularly true in high-fixed cost, low variable cost industries, including high technology, where incremental costs are low and profit margins are high (to cover the fixed costs).").

69 Cary Statement, at 12 ("Competition takes the form of expenditures in R&D designed to differentiate the product from those of rivals and to increase the value of the product in terms of enhanced productivity for customers. In such a market, efficiencies that reduce already trivial marginal costs are irrelevant. . . . For example, even a small increase in the productivity of an oil refinery through better computer modeling can be worth hundreds of millions of dollars a year.").

70 Morse Statement, at 4; *see also* New Economy Trans. at 22 (Morse) ("[I]t is just such efficiencies from the combination of complementary expertise, while not easily measured, that drive many transactions and have great potential consumer benefit.").

71 *See* Richard Gilbert, *Looking for Mr. Schumpeter: Where Are We in the Competition-Innovation Debate?*, *in* 6 INNOVATION POLICY AND THE ECONOMY 159 (Adam B. Jaffe et al. eds., 2006) [hereinafter Gilbert, *Looking for Mr. Schumpeter*]; *see also* Katz & Shelanski, *Mergers and Innovation*, at 1 ("Policymakers and economists strongly agree that innovation is a critical component of a sustained healthy economy.").

72 Gilbert Statement, at 14.

73 Gilbert Statement, at 14; *cf.* Morse Statement, at 7 (emphasizing "notoriously expensive and risky" investments required in the pharmaceutical industry, including the high percentage of "dry wells"); John E. Osborn, Statement at AMC New Economy Hearing, at 4–5 (Nov. 8, 2005) [hereinafter Osborn Statement].

74 New Economy Trans. at 18 (Osborn). Mr. Osborn explained that mergers enable "research-stage" firms with an innovative product to combine with commercial-stage firms that have critical expertise (for example, regulatory, clinical, marketing, sales, or medical) necessary to develop a product, gain FDA approval, and commercialize a product. New Economy Trans. at 16–17 (Osborn); *see also* Osborn Statement, at 4–6 (Nov. 8, 2005) (companies must deal with high development costs and high probabilities that products will ultimately not be developed or commercially successful). *But see* New Economy Trans. at 92 (Shapiro) (must consider alternative ways that the smaller firm might have commercialized the technology).

75 *See* ABA Comments re Guidelines, at 4 ("[T]he costs of short-term anticompetitive pricing can quickly be overwhelmed by the benefits provided by even small efficiencies, as these benefits can be expected to be long-lived and potentially widely distributed.").

76 DOJ/FTC Horizontal Merger Guidelines, § 4. Moreover, "delayed benefits from efficiencies (due to delay in the achievement of, or the realization of consumer benefits from, the efficiencies) will be given less

weight because they are less proximate and more difficult to predict." *Id.* § 4 n.37.

77 New Economy Trans. at 18, 44 (Osborn) (investigating staff tended "to resolve uncertainties against the proposed merger" without "putting a lot of value on the consumer benefits" from innovation); Osborn Statement, at 3–4.

78 ABA Comments re Guidelines, at 2.

79 *See* ABA Comments re Guidelines, at 4 ("[G]iven the importance of innovation to the economy's overall productivity . . . there might well be benefit in expanding the efficiencies that are recognized to include those that allow the combined firm to conduct R&D more efficiently . . . ."); *see also* Morse Statement, at 4–5; Osborn Statement, at 3.

80 *See* Daniel Cooperman Statement at AMC New Economy Hearing, at 1 (Nov. 8, 2005) (due to the rapid nature of innovation in the software industry, "a procompetitive transaction that is delayed [by merger review] may be derailed altogether").

81 ABA Comments re Guidelines, at 2.

82 New Economy Trans. at 9 (O'Connell) ("[The DOJ] does care about the effects of a merger on innovation . . . ."); *id.* at 49–50 (O'Connell, Morse) (observing no general anti-merger bias at the agencies); *id.* at 50–51 (Shapiro) (suggesting that appearance of such biases may reflect skepticism of staff as part of building its case).

83 *See* Morse Statement, at 4; *see also* New Economy Trans. at 22 (Morse) ("[I]t is just such efficiencies from the combination of complementary expertise, while not easily measured, that drive many transactions and have great potential consumer benefit.").

84 *See* Katz & Shelanski, *Mergers & Innovation*, at 2–3 ("Consumers benefit from competition because, when producers face rivalry, they seek to attract customers through lower prices and higher quality. Consumers also benefit from technological innovation because, when firms invest in research and development (R&D), they can create valuable new products and reduce the costs of producing existing products. Product-market competition and innovation are both, therefore, natural objectives of public policies designed to further consumer welfare. But policies designed to pursue one of these objectives cannot always be implemented without costs for the other."); *id.* at 56–57; *see also* Introduction of this Report, note 22 (discussing different definitions of "consumer welfare" and the tradeoffs each definition would make).

85 *See* Gilbert Statement, at 8 ("Economic theory is ambiguous on the relationship between competition and innovation."); Shapiro Statement re New Economy, at 11–12 ("[T]here is no consensus among industrial organization economists about the general relationship between concentration and innovation competition."); Gilbert, *Looking for Mr. Schumpeter*, at 206 ("We remain far from a general theory of innovation competition . . . ."); *see also* Katz & Shelanski, *Mergers & Innovation*, at 14 ("[I]n markets in which innovation is significant, the traditional concentration-competition relationship is on a weaker or more nuanced empirical and theoretical footing than otherwise."); *id.* at 18–19 (describing ways in which competition can either drive or hamper innovation).

86 DOJ/FTC Horizontal Merger Guidelines, § 3.0.

87 *Id.*

88 *Id.* § 3.2 (footnote omitted).

89 Morse Statement, at 9 ("[W]here later entry will deter anticompetitive effects, it should be considered timely."); *see also* Gilbert Statement, at 11 (recommending flexible application based on capacity to deter anticompetitive effects). Of course, impacts further in the future may be more uncertain, and the agencies should take such uncertainty into account in their assessments. *See* DOJ/FTC Horizontal Merger Guidelines, § 4 n.37.

90 James J. O'Connell Jr., Statement at AMC New Economy Hearing, at 5 (Nov. 8, 2005) (the DOJ "certainly has considered expected effects—both positive and negative—more than two years into the future in

its merger analysis, particularly in matters involving the development of innovative, next-generation products"); *id.* at 5 n.9 (pursuant to the Guidelines, in the case of durable goods, entry that is expected to occur outside the two-year window will be considered timely "so long as it would deter or counteract the competitive effects of concern within the two-year period and subsequently") (quoting DOJ/FTC Horizontal Merger Guidelines, § 3.2); Shapiro Statement re New Economy, at 9 ("[T]here is nothing magical about the two-year time horizon in this calculus."). *But see* Katz & Shelanski, *Mergers & Innovation*, at 56 ("Under current practice . . . the agencies often take an approach of considering a two-year horizon in assessing the effects of entry, with little or no discounting within the horizon and complete discounting of anything beyond.").

91 *See* Robert W. Crandall & Clifford Winston, *Does Antitrust Policy Improve Consumer Welfare? Assessing the Evidence*, 17 J. ECON. PERSP. 3, 3–4 (2003). For criticisms of this study, see Jonathan Baker, *The Case for Antitrust Enforcement*, 17 J. ECON. PERSP. 27 (2003); Gregory J. Werden, *The Effect of Antitrust Policy on Consumer Welfare: What Crandall and Winston Overlook* (Dep't of Justice, Antitrust Div., Discussion Paper No. EAG 03-2, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=384100.

92 *See* AAI Comments re Merger Enforcement, at 2–3 (arguing that U.S. merger policy should be more strict).

93 *See, e.g.*, Public Comments Submitted to AMC Proposing Issues for Study, at 1 (Jan. 5, 2005) (proposing that this Commission undertake comprehensive empirical study of the antitrust laws).

94 *See* ABA Comments re Guidelines, at 2 ("[T]here has been insufficient empirical research to create confidence that particular merger enforcement decisions (and the *Merger Guidelines*) are based upon accurate assumptions about the relationship between concentration and performance of the market."); Economists' Roundtable Trans. at 6–8 (White) (none of the empirical studies provide a good sense as to the level of concentration at which "antitrust should bite"); Economists' Roundtable Trans. at 33 (Bresnahan) (knowledge of the "functional relationship" of concentration and market power is limited, but "we do know the extreme end of it around the range that modern merger policy would intervene").

95 DOJ/FTC Horizontal Merger Guidelines, § 1.5. *See generally* ANTITRUST LAW DEVELOPMENTS, at 344–50.

96 *See, e.g.*, ABA Comments re Guidelines, at 2; Economists' Roundtable Trans. at 32 (Bresnahan); *cf. id.* at 40 (White) ("[W]e now have 20 or so years of price-oriented data and studies that show that concentration matters and that show up as price effects."). *But see* AAI Comments re Merger Enforcement, at 14 (stating that the "consensus conclusion from more recent studies using more sophisticated research tools is that increased concentration, at high levels, is associated with higher prices, and is therefore a suitable proxy, at least in the first instance, for an expectation of market power"); *id.* at 3 ("[C]urrent economic thinking . . . and evidence still support the presumption that concentration implies anticompetitive potential . . . .").

97 Economists' Roundtable Trans. at 6–8 (White); *id.* at 78–80 (White) (citing the need for pricing studies).

98 *See, e.g.*, *id.* at 30–31 (Bresnahan) (because there's substantial "heterogeneity in industries," it is not possible to draw generalizations about the effect of concentration that will apply broadly across industries); *see also id.* at 63–64 (Reiss) (heterogeneity of industries and firms have led economists away from cross-industry studies of the effect of entry and to "within-industry studies"); *id.* at 31 (Bresnahan) (similar past efforts—structure-conduct-performance studies and Chicago Economics—"were empirical disasters").

99 *See, e.g.*, ABA Comments re Guidelines, at 5–6 (recommending "case studies" examining "the market effects from particular mergers that were cleared by the antitrust agencies to see if they led to neutral or procompetitive outcomes in the relevant industries . . . or to higher prices/less innovation/etc."); Merger Enforcement Trans. at 66–67 (Scheffman) (noting similar FTC studies); *id.* at 68 (Baer) ("[S]uch studies are a good idea, and more ought to be done."); *id.* at 71–72 (Rill) (supporting the use of "retrospective reviews"); *id.* at 73 (Scheffman) ("retrospectives are very important").

100 Economists' Roundtable Trans. at 8, 69, 79–80 (White); Prof. Lawrence White, Statement at AMC

Economists' Roundtable on Merger Enforcement, at 7–8 (Jan. 19, 2006).

[101] Barnett/Majoras Transcript at 20 (Majoras) (Mar. 21, 2006) (explaining that "transparency . . . [is] a high priority" because "[v]oluntary compliance with the law is the best outcome for consumers, and compliance depends on knowing when the line is being crossed").

[102] The DOJ provides a statement pursuant to the Tunney Act. *See* 15 U.S.C. § 16(b). The FTC provides an analysis to aid public comment pursuant to regulation. *See* 16 C.F.R. § 2.34(c) (2006). For examples of such statements, see Competitive Impact Statement, United States v. Verizon, No. 1:05CV02103 (D.D.C. Nov. 16, 2005), and Analysis of Agreement Containing Consent Orders to Aid Public Comment, *In re* Procter & Gamble Co. and Gillette Co., FTC File No. 051-0115 (Sept. 30, 2005).

[103] *See* Chapter II.B of this Report summarizing data regarding enforcement under the HSR Act.

[104] *See, e.g.*, Statement of Chairman Majoras, Commissioner Kovacic, and Commissioner Rosch Concerning the Closing of the Investigation, *In re* Comcast, Time Warner Cable, and Adelphia Commc'ns, FTC File No. 051-0151 (Jan. 31, 2006) (approving decision by Bureau of Competition to close investigation, and setting forth reasons); Dep't of Justice, Antitrust Div., Statement on the Closing of its Investigation of Whirlpool's Acquisition of Maytag (Mar. 29, 2006) (setting forth background on transaction and reasons for allowing the merger to proceed); *see also* Dep't of Justice, Antitrust Div., Issuance of Public Statements Upon Closing of Investigations (Dec. 12, 2003); Thomas Barnett, Statement at AMC Barnett/Majoras Hearing, at attachment 6 (Mar. 21, 2006) (reporting that the DOJ had issued 12 statements upon closing investigations); Federal Trade Comm'n, Commission Closing Letters, *available at* http://www.ftc.gov/os/closings/commclosing.htm (collecting a number of closing letters issued by the FTC).

[105] *See generally* Merger Enforcement Trans. at 71 (Baer) (advocating public statements "as to major matters"); IBA Comments re Merger Enforcement, at 15; Scheffman Statement, at 7 ("[M]ore detailed explanations for agency decisions, as is routinely done in the EU . . . would clearly be beneficial.").

[106] IBA Comments re Merger Enforcement, at 4 ("FTC and DOJ should publish reasoned decisions (or summaries of their findings) in all cases where a Second Request has been issued."); *id.* at 15–16; U.S. Chamber of Commerce, Public Comments Submitted to AMC, at 14 (Nov. 8, 2005); *see also* U.S. Chamber of Commerce, Public Comments Proposing Issues for Study, at 2 (Sept. 30, 2004); International Chamber of Commerce, Public Comments Submitted to AMC, at 6–7 (Sept. 5, 2005) (proposing that speeches, press releases and other communications be used to publish information about agency decisions in high-profile cases).

[107] American Bar Association, Section of Antitrust Law, Public Comments Submitted to AMC Regarding the Hart-Scott-Rodino Second Request Process, at 15 (Dec. 7, 2005).

[108] Dep't of Justice, Antitrust Div. & Federal Trade Comm'n, Merger Challenges Data, Fiscal Years 1999–2003 (Dec. 18, 2003), *available at* http://www.ftc.gov/os/2003/12/mdp.pdf. Mergers were deemed to have been challenged by the FTC if it voted to challenge the transaction (either in court or administratively). Mergers were deemed to have been challenged by the DOJ if a complaint was filed in court or a press release was issued by the DOJ announcing that the transaction had been abandoned or restructured in response to the DOJ's concerns. In addition, mergers involving financial institutions subject to the Bank Merger Acts of 1960 and 1966 or the Bank Merger Holding Company Act were deemed to have been challenged by the DOJ if the transactions were restructured to satisfy the DOJ's concerns, even absent a press release. *Id.* at 2.

[109] Federal Trade Comm'n, Horizontal Merger Investigation Data, Fiscal Years 1996–2003 (Feb. 2, 2004, revised Aug. 31, 2004), *available at* http://www.ftc.gov/os/2004/08/040831horizmergersdata96-03.pdf.

[110] Federal Trade Comm'n, Horizontal Merger Investigation Data, Fiscal Years 1996–2005 (Jan. 25, 2007),

available at http://www.ftc.gov/os/2007/01/P035603horizmergerinvestigationdata1996-2005.pdf.

[111] *See* Merger Enforcement Trans. at 91–92 (Willig) (suggesting that the agencies keep records of basic information (for example, on relevant market and concentration levels) for transactions for which a second request is issued); *see also id.* at 94–95 (Baer) (advocating systematic collection of information on enforcement).

[112] *See id.* at 94 (Rill).

[113] *See also* Chapter II.B of this Report regarding a recommendation for the agencies to collect data on the burdens imposed by the HSR Act.

[114] *See* DOJ/FTC Horizontal Merger Guidelines, § 0.1 n.6.

[115] New Economy Trans. at 22, 46 (Morse); *id.* at 83–84 (Shapiro); Morse Statement, at 2. *But see* New Economy Trans. at 65–66 (O'Connell) (the Guidelines are "not meant to address every possible theory or even every way of looking at a merger. . . . The Division doesn't believe that the Guidelines need to be amended to reflect or address additional theories, because we believe that those theories are already incorporated where appropriate in the analysis that we conduct.").

[116] Merger Enforcement Trans. at 59–60 (Rill).

[117] 1982 DOJ Merger Guidelines, pt. IV.

[118] ABA, MERGERS AND ACQUISITIONS, at 20.

[119] *See, e.g.*, AAI Comments re Merger Enforcement, at 5 ("Formally updating the agencies' policy on vertical mergers would provide much needed guidance.").

Chapter I.C
Exclusionary Conduct

1. INTRODUCTION

Section 2 of the Sherman Act outlaws conduct, joint or by a single firm, to "monopolize, or attempt to monopolize . . . any part of the trade or commerce among the several States."[1] The law directs itself to improper conduct, not the possession of a monopoly. Section 2 does not prohibit firms from having monopoly power in a relevant market or from charging monopoly prices.[2] Rather, it prohibits conduct that improperly maintains or facilitates acquiring, or attempting to acquire, a monopoly.

How to evaluate single-firm conduct under Section 2 poses among the most difficult questions in antitrust law. Appropriate antitrust enforcement must distinguish aggressive competition that benefits consumers, such as most price discounting, from conduct that tends to destroy competition itself, and thus maintains, or facilitates acquiring, monopoly power. The Supreme Court has defined improper "exclusionary" conduct under Section 2 to "comprehend[] at the most behavior that not only (1) tends to impair the opportunities of rivals, but also (2) either does not further competition on the merits or does so in an unnecessarily restrictive way."[3] Thus, a crucial distinction in Section 2 enforcement entails whether a firm's conduct represents competition on the merits or improper "exclusionary" conduct.

To ask whether a firm's conduct is "exclusionary" is not sufficient to make this determination. After all, companies routinely attempt to "exclude" competitors from the market simply by producing the best quality product at the lowest price. Accordingly, an observation that a particular firm's conduct "excludes" its competitor does not answer whether the conduct is harmful to competition or just to the firm's competitor. Antitrust law is concerned with harm to competition, not particular competitors.

In addition, a firm may achieve monopoly power through competition on the merits. Judge Learned Hand long ago pointed out that a "single producer may be the survivor out of a group of active competitors, merely by virtue of his superior skill, foresight and industry. . . . The successful competitor, having been urged to compete, must not be turned upon when he wins."[4]

The Commission examined whether the substantive standards for evaluating alleged anticompetitive conduct under Section 2 should be revisited, and, if so, whether improvements could best be achieved through legislation or case law development. In recent decades the courts have adopted and applied sound general principles for Section 2 enforcement. These general principles emphasize that appropriate legal rules should identify unreasonably exclusionary conduct, without discouraging aggressive competition that benefits consumers or creating excessive litigation and compliance costs for businesses and problems of administrability for courts. The use of these principles has assisted courts in developing appropriate tests to identify when certain types of conduct, such as predatory pricing, are unreasonably exclusionary.

Section 2 standards are not fully developed with respect to all types of conduct, however. In particular, the Commission focused on two types of conduct that have been the subject of recent court decisions and ongoing debate. One type of conduct involves the sale of products bundled together at a discount from their prices when purchased separately. Widespread agreement exists that discounts offered for bundled products (for example, "meal deals" combining a hamburger and a soda) often benefit consumers. Economic theories suggest, however, that in certain circumstances a firm may be able to use discounts on bundled products to obtain or maintain a monopoly by excluding rivals, or otherwise harm consumers, on some basis other than competition on the merits. A recent decision by the United States Court of Appeals for the Third Circuit that upheld a finding of Section 2 liability for discounts on bundled products, *LePage's v. 3M*, has provoked criticism and argument about the circumstances in which bundled discounts could violate Section 2.[5]

The second type of conduct involves a firm's refusal to deal with its rival in the same market. In 1919 the Supreme Court confirmed the right of a firm to make its own decisions about the business entities with which it will deal, absent "any purpose to create or maintain a monopoly."[6] Whether—and, if so, when—a firm's refusal to deal with its rival may violate Section 2 has long troubled antitrust courts and commentators. The Commission studied this issue in light of the Supreme Court's recent decision in *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko LLP.*[7]

The Commission also examined the question of whether courts should apply a presumption of market power for patents in tying cases, a question that the Supreme Court has recently resolved, as well as whether such a market-power presumption should be applied to copyrights or trademarks in tying cases.

The Commission's study and analysis lead it to make the following recommendations.

12. In general, standards for applying Section 2 of the Sherman Act's broad proscription against anticompetitive conduct should be clear and predictable in application, administrable, and designed to minimize overdeterrence and underdeterrence, both of which impair consumer welfare.

13. Congress should not amend Section 2 of the Sherman Act. Standards currently employed by U.S. courts for determining whether single-firm conduct is unlawfully exclusionary are generally appropriate. Although it is possible to disagree with the decisions in particular cases, in general the courts have appropriately recognized that vigorous competition, the aggressive pursuit of business objectives, and the realization of efficiencies not available to competitors are generally not improper, even for a "dominant" firm and even where competitors might be disadvantaged.

14. Additional clarity and improvement are best achieved through the continued evolution of the law in the courts. Public discourse and continued research will also aid in the development of consensus in the courts regarding the proper legal standards to evaluate the likely competitive effects of bundling and unilateral refusals to deal with a rival in the same market.

15. Additional clarity and improvement in Sherman Act Section 2 legal standards are desirable, particularly with respect to areas where there is currently a lack of clear and consistent standards, such as bundling and whether and in what circumstances (if any) a monopolist has a duty to deal with rivals.

16. The lack of clear standards regarding bundling, as reflected in *LePage's v. 3M*, may discourage conduct that is procompetitive or competitively neutral and thus may actually harm consumer welfare.

17. Courts should adopt a three-part test to determine whether bundled discounts or rebates violate Section 2 of the Sherman Act. To prove a violation of Section 2, a plaintiff should be required to show each one of the following elements (as well as other elements of a Section 2 claim): (1) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product; (2) the defendant is likely to recoup these short-term losses; and (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.[*]

18. In general, firms have no duty to deal with a rival in the same market.[†]

19. Market power should not be presumed from a patent, copyright, or trademark in antitrust tying cases.

[*] Commissioners Carlton and Garza join this recommendation with qualifications.

[†] Commissioners Jacobson and Shenefield join this recommendation with qualifications.

2. BACKGROUND

A. General Standards

Section 2 of the Sherman Act forbids "monopolization" and "attempted monopolization" (as well as combinations and conspiracies to monopolize) of any part of the trade or commerce of the United States.[8] The classic statement of unlawful monopolization is found in *United States v. Grinnell Corp.*:

> The offense of monopoly under § 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market; and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.[9]

The Supreme Court has defined "monopoly" power as the power to "control prices or exclude competition."[10] In general, "monopoly" power is treated as "substantial market power."[11] Modern economics generally defines "market power" as "the ability to raise prices above a competitive level *without suffering an immediate and unprofitably substantial loss of sales*,"[12] thus emphasizing that the power to control price or exclude competition must have some degree of durability to constitute market power of concern to antitrust law. A plaintiff may prove a defendant's possession of monopoly power through direct evidence of the defendant's actual control over price or exclusion of competition within a relevant market, or through indirect evidence, most typically a defendant's high market share and barriers to entry that make challenge to the defendant's market position unlikely.[13]

After establishing the defendant's monopoly power, a plaintiff must prove the monopolist has obtained or maintained its dominant position through unlawful exclusionary or predatory conduct.[14] As the Supreme Court stated in *Spectrum Sports, Inc. v. McQuillan*, the Sherman Act "directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."[15] Courts and commentators have often found it easier to identify conduct that is not or should not be unlawful under Section 2 than to identify conduct that Section 2 does prohibit. For example, two of the most commonly cited articulations explain that Section 2 is *not* violated by either "growth or development as a consequence of a superior product, business acumen, or historic accident"[16] or conduct attributable to "superior skill, foresight and industry."[17] Attempts to develop more definitive standards have evolved over time.

B. Definitions of "Exclusionary" Conduct

A variety of factors, including changing perspectives on the significance of monopoly power, have influenced courts' views on the scope of conduct that should be considered potentially exclusionary. In the mid-twentieth century, courts evidenced deep concern about the dangers of monopoly power. The opinion of Judge Learned Hand in *United States v. Aluminum Co. of America* provides the best-known expression of this attitude:

> Many people believe that possession of unchallenged economic power deadens initiative, discourages thrift and depresses energy; that immunity from competition is a narcotic, and rivalry is a stimulant, to industrial progress; that the spur of constant stress is necessary to counteract an inevitable disposition to let well enough alone.[18]

In *Alcoa* the Second Circuit held that a firm with 90 percent of the market for virgin ingot aluminum had violated Section 2 by repeatedly building new capacity to serve new demand in that market, thus discouraging its rivals from expanding their existing capacity or entering with new capacity.[19] In the court's view, "[i]t was *not inevitable* that [Alcoa] should always anticipate increases in the demand for ingot and be prepared to supply them."[20]

The Supreme Court quickly endorsed this expansive view of exclusionary conduct.[21] The question of whether the challenged conduct was "inevitable" appeared in other cases as well.[22] With such a broad scope of conduct that might be viewed as exclusionary, the government pursued and won several monopolization cases over the next few decades.[23] This aggressive view of the law reached its zenith in the 1970s, with proposals from well-regarded antitrust practitioners and scholars that proof of monopoly itself should be sufficient to establish a violation of Section 2.[24]

Questions about this approach arose with increasing frequency during the 1960s and 1970s, however, as developments in economic analysis spurred antitrust scholars to examine more closely what types of incentives encouraged vigorous competition and how certain business practices might benefit, rather than harm, consumers.[25] Commentators questioned the bases of many prior court decisions, including *Alcoa*, asking, for example, whether antitrust law should require a firm with a dominant position not to compete to serve new demand.[26] Courts and commentators began to reexamine whether the standards for exclusionary conduct were likely actually to discourage aggressive competition that could benefit consumers.[27]

One of the first court decisions to evidence this shifting attitude was *Berkey Photo, Inc. v. Eastman Kodak Co.*[28] The defendant, Eastman Kodak, sold cameras and held a monopoly in the film market; the plaintiff, Berkey Photo, sold cameras and also competed with Kodak in other photo-related services. When Kodak introduced a new kind of film compatible with only one of Kodak's cameras, Berkey alleged that Kodak had violated Section 2 by failing to give Berkey advance notice of the new product design so that Berkey could develop its own cameras to handle the new Kodak film. The Second Circuit reversed the jury verdict in Berkey's favor, holding that "a firm may normally keep its innovations secret from its rivals as long as it wishes, forcing them to catch up on the strength of their own efforts after the new product is introduced."[29] The court emphasized that firms' incentives to innovate rested on the prospect of market success:

> It is the possibility of success in the marketplace, attributable to superior performance, that provides the incentives on which the proper functioning of our competitive economy rests. If a firm that has engaged in the risks and expenses of research and development were required in all circumstances to share with its rivals the benefits of those endeavors, this incentive would very likely be vitiated.[30]

Unlike the Second Circuit's decision in *Alcoa*, which associated *existing* monopoly power with deadened initiative and competition, the Second Circuit's decision in *Berkey Photo* used a wider lens to see how *the prospect of market success* spurred competition and innovation. This perspective has been preeminent in recent decades.[31]

Most recently, the Supreme Court expressed the view in *Trinko* that the "prospect of market success" includes the prospect of obtaining monopoly power:

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth.[32]

This view—that the prospect of gaining monopoly is an appropriate incentive for competition and innovation—implies that the application of overly stringent antitrust rules for monopolists' conduct could discourage competition and innovation. Some disagree, pointing to economic studies that either suggest monopoly affirmatively discourages innovation[33] or are ambiguous as to whether monopoly power encourages innovation.[34]

Courts have also increasingly scrutinized the potential for consumers to benefit from precisely the type of conduct once commonly condemned as exclusionary. The theory of predatory pricing, for example, involves a company selling its product at very low prices to force its competitors out of business, and then raising its prices to a supracompetitive level that enables it to recoup its losses and earn monopoly profits. Thus, the first step in a predatory pricing scheme is to sell at low prices—something that generally benefits consumers. As the Supreme Court has observed, if a court erroneously concludes that a firm has engaged in illegal predatory pricing, "the costs of [such] an erroneous finding of liability are high"[35] because firms may be reluctant to cut prices aggressively if they fear predatory pricing allegations. Overdeterrence could harm consumers.

In addition, courts have carefully examined the likelihood that an alleged exclusionary scheme could succeed. In *Matsushita Electric Industrial Co. v. Zenith Radio Corp.* the Supreme Court joined commentators who had concluded that "predatory pricing schemes are rarely tried, and even more rarely successful."[36] The reasons for this skepticism include the speculative nature of the scheme: it requires a firm to forgo definite profits in the short run, in hopes that competitors will leave the market and allow the firm, in the long run, to reap monopoly profits sufficient to make up for its prior losses and provide significant gains for the future.

The improbability of predatory pricing schemes, combined with the certainty that lower prices benefit consumers, persuaded the Supreme Court to select a test that may fail to capture all instances of predatory pricing, but will not incorrectly condemn price discounting.[37] This test excludes the possibility that above-cost pricing could constitute price predation. The Court cited the difficulty that courts would have determining just *how much* above cost a defendant's prices must be to avoid liability for predatory pricing, as well as the Court's concern that the possibility of such liability would chill aggressive price cutting.[38]

The adoption of a "safe harbor" in the area of predatory pricing also illustrates courts' desire to adopt bright-line legal rules that businesses can understand and follow with relatively little difficulty. This issue has become increasingly important as economic understandings of business conduct have become more sophisticated, and courts have struggled to take into account a wide variety of factors that may be relevant to judging the likely competitive effects of a particular business practice. Then-Judge (current Justice) Breyer explained the need for simplifying rules more than two decades ago:

> [W]hile technical economic discussion helps to inform the antitrust laws, those laws cannot precisely replicate the economists' (sometimes conflicting) views. For, unlike economics, law is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counter-productive, undercutting the very economic ends they seek to serve.[39]

Particularly in the context of Section 2 predatory pricing enforcement—where overdeterrence may deprive consumers of the benefits of aggressive competition—courts have been increasingly willing to adopt potentially underinclusive, but simple and objective cost-based legal rules.

This is not to say, however, that developments in the understanding of monopolizing conduct have all tended to restrict potential liability for such conduct. There have been a number of recent Section 2 cases in which liability was found. *Microsoft*, for example, is the most prominent Section 2 case in the last decade. In that case the United States Court of Appeals for the District of Columbia Circuit upheld portions of the lower court's ruling that Microsoft had engaged in various forms of unreasonably exclusionary conduct in maintaining its operating system monopoly.[40] The court held that the evidence established that Microsoft had engaged in various forms of anticompetitive conduct to prevent its rival, Netscape, from attaining a market position from which Netscape could challenge Microsoft's monopoly of Intel-compatible PC operating systems.[41] The case ultimately was settled by consent decree.[42]

The Federal Trade Commission (FTC) recently investigated and filed complaints against two companies that allegedly achieved monopoly power through unreasonably exclusionary conduct. In *Unocal* the FTC alleged that Unocal falsely represented to a government panel that Unocal's technologies were nonproprietary, when it knew it held patents on these technologies,[43] and that Unocal thereby was able to obtain monopoly power over certain gasoline formulas dictated by government regulation.[44] The matter was ultimately settled by consent decree in connection with another firm's acquisition of Unocal.[45]

In *Rambus* the FTC recently held that Rambus illegally monopolized certain technologies required for computer memory. The FTC concluded that Rambus exploited its participation in a standard-setting organization to obtain patents that would cover technologies incorporated into the standards adopted by the organization, without revealing its patent position to other members of the standard-setting organization. As a result, the FTC stated, Rambus was able to "distort the standard-setting process" and unlawfully gain monopoly power in the computer memory industry.[46]

Some degree of controversy has surrounded each of these cases, illustrating the ongoing debate in the antitrust community about the proper role of, and legal standards for, Section 2 enforcement. The Commission discusses some of the issues in this debate below.

3. RECOMMENDATIONS AND FINDINGS

As discussed below, the Commission concludes that, compared to legal standards in the mid-twentieth century, the Supreme Court has now adopted and is applying legal standards and rules for Section 2 that are more sensitive to the possible efficiencies of business conduct and more attuned to the potential for consumer harm from overly stringent application of Section 2 standards in some cases. This represents progress.

This Part discusses the general principles underlying Section 2 enforcement below, as well as tests that have been proposed for general use in identifying exclusionary conduct. It then turns to specific observations about the need to develop improved legal standards to evaluate discounts for bundled products and refusals to deal with a rival in the same market.

A. General Principles for Section 2 Standards

12. In general, standards for applying Section 2 of the Sherman Act's broad proscription against anticompetitive conduct should be clear and predictable in application, administrable, and designed to minimize overdeterrence and underdeterrence, both of which impair consumer welfare.

13. Congress should not amend Section 2 of the Sherman Act. Standards currently employed by U.S. courts for determining whether single-firm conduct is unlawfully exclusionary are generally appropriate. Although it is possible to disagree with the decisions in particular cases, in general the courts have appropriately recognized that vigorous competition, the aggressive pursuit of business objectives, and the realization of efficiencies not available to competitors are generally not improper, even for a "dominant" firm and even where competitors might be disadvantaged.

In recent decades, more often than not, courts have used appropriate caution in assessing single-firm conduct. Courts have relied on general principles, including those that follow, to guide the development and application of rules for Section 2 enforcement. The use of these principles has benefited and encouraged appropriate antitrust enforcement.

Section 2 standards should be clear and predictable in application and administrable. The area of predatory pricing law provides the best example of success in achieving these goals. In *Brooke Group* the Supreme Court established an objective, cost-based test that first requires a predatory pricing plaintiff to prove that the alleged predatory prices are below an appropriate measure of the defendant's costs.[47] This rule is relatively clear, predictable, and administrable. The Court's test further requires predatory pricing plaintiffs to demonstrate that the defendant "had a reasonable prospect, or, under Section 2 of the Sherman Act, a dangerous probability, of recouping its investment in below-cost prices."[48] This part of the test not only ensures that a Section 2 violation is found only if consumer welfare can be harmed, but also enhances administrability for the courts by allowing summary disposition of claims where market circumstances—such as easy entry—preclude the possibility of recoupment.[49]

The Supreme Court has taken other steps as well to enhance the administrability of predatory pricing litigation. In *Matsushita* the Court affirmed summary judgment for the defendant, refusing to allow the case to go to trial based on ambiguous evidence, which included rebates and other price-cutting activities that the plaintiff alleged tended to prove a conspiracy to suppress prices.[50] The Court explained that "cutting prices in order to increase business often is the very essence of competition."[51] To avoid summary judgment, the Court required the plaintiffs to produce evidence that "tends to exclude the possibility" that the challenged conduct was permissible competition that did not involve a conspiracy.[52] This comparatively clear and administrable rule has enabled courts to avoid costly and extensive litigation based solely on evidence from which inferences of permissible competition and anticompetitive joint conduct were equally plausible.

Section 2 standards should be designed to minimize overdeterrence and underdeterrence, both of which impair long-run consumer welfare. At least two observations underlie this general principle. One is that business practices typically offer more efficiencies and, thus, benefits to consumer welfare, than recognized in the early-to-mid-twentieth century. A second observation is that aggressive competition on the merits may resemble unreasonably exclusionary conduct. As discussed earlier, for example, price discounting may appear the same as predatory pricing.

These observations have given courts a better understanding that, like underdeterrence, overdeterrence also can harm consumer welfare. Thus, it is important to consider whether proposed legal rules are likely to chill procompetitive conduct or create unintended consequences. For example, the Supreme Court has observed that "[i]t would be ironic indeed if the standards for predatory pricing liability were so low that antitrust suits themselves became a tool for keeping prices high."[53]

The recognition of potential consumer harm from overdeterrence has led courts to try to avoid "false positives"—that is, finding Section 2 liability for a firm that has not engaged in unreasonably exclusionary conduct, but instead was simply competing aggressively on the merits.[54] Nonetheless, it remains important to avoid underdeterrence that results in "false negatives"—that is, failing to condemn anticompetitive conduct—when the challenged conduct typically provides few or no benefits to consumer welfare and does not resemble competition on the merits.[55] In an ideal world, of course, legal rules would avoid both underdeterrence and overdeterrence. In practical reality, however, such precision is often difficult to achieve. Thus, courts may need to make a trade-off between accuracy and the risks of either chilling procompetitive, or encouraging anticompetitive, conduct.

B. Further Development of Section 2 Standards

1. Continued Case Law Development in the Courts

14. Additional clarity and improvement are best achieved through the continued evolution of the law in the courts. Public discourse and continued research will also aid in the development of consensus in the courts regarding the proper legal standards to evaluate the likely competitive effects of bundling and unilateral refusals to deal with a rival in the same market.

As noted earlier, the Supreme Court defined improper "exclusionary" conduct under Section 2 to "comprehend[] at the most behavior that not only (1) tends to impair the opportunities of rivals, but also (2) either does not further competition on the merits or does so in an unnecessarily restrictive way."[56] This articulation improves on earlier analysis asking whether the conduct at issue was "inevitable," but it begs the question of what specific types of conduct in what circumstances should be considered "competition on the merits." This issue has precipitated much debate and discussion.

The appropriate legal standards should continue to evolve in the courts, with continuing sensitivity to the need to avoid chilling procompetitive conduct and undue enforcement costs. The federal enforcement agencies should use appropriate opportunities to aid development of the law.[57] The FTC and the Antitrust Division of the Department of Justice (DOJ) are currently soliciting comments and holding hearings on Section 2 standards,[58] and the FTC is co-chairing the International Competition Network Unilateral Conduct Working Group, which plans to conduct an in-depth study of the issue over the next several years. The Commission is hopeful that those research efforts will prove useful.

2. Tests for Particular Types of Conduct or a Single Test for All Conduct

15. Additional clarity and improvement in Sherman Act Section 2 legal standards are desirable, particularly with respect to areas where there is currently a lack of clear and consistent standards, such as bundling and whether and in what circumstances (if any) a monopolist has a duty to deal with rivals.

Many commentators are skeptical that any one legal standard should be used to evaluate the wide variety of different types of conduct that may be challenged under Section 2.[59] Others, however, have urged the use of a single test. Two proposals—the "no economic sense" and "profit sacrifice" tests—have their genesis in the predatory pricing test, which implicitly defines "competition on the merits" as pricing that is above an appropriate measure of the defendant's costs. Those and other proposals are discussed below.

"No Economic Sense" Test. The DOJ has advocated the use of a "no economic sense" test,[60] which asks "whether, on the basis of information available to a firm at the time of the challenged conduct, the challenged conduct would have made economic sense even if it did not reduce or eliminate competition."[61] The test condemns conduct only when its anticompetitive objective is unambiguous because the conduct would not have been undertaken "but for" the prospect of obtaining or maintaining monopoly power.[62] Although the DOJ has advanced this test in several cases, including *Microsoft*,[63] *Dentsply*,[64] and *Trinko*,[65] no court has ever adopted it.

Proponents contend the test is consistent with existing case law and "can be administered effectively by courts and businesses alike"[66] because the test essentially focuses on the economic rationality or profitability of the defendant's conduct from the defendant's perspective at the time the defendant decides whether to undertake a particular course of conduct.[67] Although this test may not capture all anticompetitive single-firm conduct, proponents believe underinclusiveness is preferable to requirements for complex evidentiary judgments.[68]

Others counter that the test can fail to capture substantially anticompetitive conduct by focusing exclusively on the profitability of the conduct for the defendant. Thus, the test fails to examine the challenged conduct's effects on consumer welfare, critics assert.[69] The test exculpates conduct that offers some minimal efficiencies—that is, that makes *some* economic sense—even where the conduct may cause disproportionately great anticompetitive effects.[70] In addition, in exclusive dealing cases the application of the "no economic sense" test is arguably unintelligible because exclusive dealing "makes economic sense" for the defendant "precisely through the mechanism of exclusion."[71] "In most cases, there is no way to separate the economic benefit to the defendant from the exclusionary impact on rivals."[72] This criticism suggests the test may be overinclusive as well as underinclusive.

"Profit Sacrifice" Test. The "profit sacrifice" test is closely related to the "no economic sense" test. One variant asks whether the defendant has sacrificed immediate profits as part of a strategy whose profitability depends on the recoupment of those profits through the exclusion of rivals.[73] Although it has not specifically adopted this test, the Supreme Court has asked this question in refusal-to-deal cases, noting, for example, that the defendant in *Aspen* "was willing to sacrifice short-run benefits and goodwill in exchange for a perceived long-run impact on its smaller rival."[74] Another variant asks "whether the allegedly anticompetitive conduct would be profitable for the defendant and would make good business sense even if it did not exclude rivals and thereby create or preserve market power for the defendant."[75]

As with the "no economic sense" test, proponents maintain the "profit sacrifice" test is easy to administer and provides clear guidance to businesses, thereby increasing the likelihood that businesses will engage in procompetitive conduct that other legal tests might misconstrue as anticompetitive.[76] The test does not condemn all conduct that might reduce welfare overall, but proponents judge the test to be preferable to "market-wide balancing tests."[77]

Opponents apply basically the same criticisms to the "profit sacrifice" test as to the "no economic sense" test. In particular, one commentator argues the test is "both too broad and too narrow."[78] The test is too broad, this critic contends, because it could condemn a firm "invest[ing] heavily in designing a better mousetrap that, once marketed, will ruin rivals or significantly limit their sales."[79] The test is too narrow, he asserts, "because some exclusionary practices don't involve sacrifice at all."[80] He agrees the test is dispositive in predatory pricing cases, however, and also finds the test "quite helpful in cases involving unilateral refusals to deal."[81]

Less Efficient Competitor Test. Judge Richard A. Posner has proposed that an unreasonably exclusionary practice is one that is "likely in the circumstances to exclude from the defendant's market an equally or more efficient competitor."[82] Proponents see value in this test,[83] but caution that it, too, may be too narrow "where the dominant firm is able to keep the output of rivals inefficiently low by engaging in practices that confer no significant social benefits."[84] Others point out that exclusion of an inefficient rival may harm consumer welfare if the rival is excluded before it reaches minimum efficient scale, or if the less efficient rival has been keeping prices in the relevant market below the monopoly level.[85] Critics also raise concern that the test may be very difficult administratively.[86] Nonetheless, commentators and courts have found this test useful in evaluating bundled discounts or rebates.[87]

Balancing Test. In its *Microsoft* decision, the D.C. Circuit employed a balancing test, which examines both competitive effects and efficiencies, to assess claims under Section 2.[88] That test requires a plaintiff first to establish that the monopolist's conduct had an "'anticompetitive effect.' That is, it must harm the competitive *process* and thereby harm consumers."[89] Once the plaintiff establishes a prima facie case, to avoid liability the defendant must provide a procompetitive justification for its conduct, that is, "a nonpretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal."[90] If the defendant makes this showing, then the plaintiff either must rebut the claim of procompetitive benefits or show that the anticompetitive harm nevertheless "outweighs" those benefits.[91] Proponents point out this is the basic rule of reason test that courts have applied for many years, and continue to apply, in Section 1 and Section 2 cases.[92] They contend that use of this test is necessary to answer the basic question of whether the challenged conduct, on balance, harmed consumer welfare.[93]

Opponents criticize this test as too complex and difficult to administer. They argue that, because businesses will be uncertain of how their course of conduct might be judged, they will be reluctant to undertake procompetitive conduct.[94] Proponents respond that other tests, including the "no economic sense" and "profit sacrifice" tests, are equally complex and less accurate.[95]

As this brief review of possible tests for evaluating conduct under Section 2 suggests, they each seek to identify conduct that harms consumer welfare.[96] Some tests place greater value on the avoidance of chilling procompetitive conduct and undue enforcement costs than on ensuring that the test captures all or most instances of anticompetitive conduct. Others emphasize the importance of focusing on consumer welfare effects and contend that accuracy can be achieved without perverse influences on firms' incentives or undue enforcement costs.

Thus far, no consensus exists that any one test can suffice to assess all types of conduct that may be challenged under Section 2. The current test for predatory pricing, for example, works well in that context, but problems have been identified with the application of its progeny—the "no economic sense" and "profit sacrifice" tests—in some other contexts. The more extensive inquiry mandated by the *Microsoft* balancing test may be appropriate in some circumstances, but, as exemplified by the case of predatory pricing, is not necessarily warranted or desirable for all types of conduct challenged under Section 2. Some contend that the best approach is to develop different tests for different types of conduct.[97]

As courts, antitrust agencies, and commentators continue to refine the antitrust standards for conduct challenged under Section 2, a focal point for their assessment should be whether a particular test is the one most likely to protect consumer welfare in the context of the type of conduct at issue. To answer this question will require, among other things, an evaluation of whether a particular test is likely to overdeter procompetitive, or underdeter anticompetitive, conduct. Particular attention should be given to long-run, as well as short-run, consumer interests. For example, any Section 2 test for refusals to deal with a rival should reflect proper consideration of consumers' long-run interests in maintaining firms' incentives to invest in valuable competitive assets—incentives that could be significantly diminished by forced sharing of assets with a rival in particular circumstances.

C. Specific Areas of Concern—Bundled Discounts and Refusals to Deal with a Rival in the Same Market

1. Discounts on Bundled Products

16. The lack of clear standards regarding bundling, as reflected in *LePage's v. 3M*, may discourage conduct that is procompetitive or competitively neutral and thus may actually harm consumer welfare.

"Bundling" entails the sale of two or more products as a package. Bundled products may be sold only in a package or as part of a package and separately as well.[98] When bundled products are also sold separately, manufacturers may provide a discount or rebate to buyers that purchase the entire bundle, instead of purchasing only certain products in the bundle. These are known as "bundled discounts" or "bundled rebates." Large and small firms, incumbents, and new entrants use bundled discounts and rebates in a wide variety of industries and market circumstances. Because they involve lower prices, bundled discounts and bundled rebates typically benefit consumers.

Despite the ubiquity of bundling, there is a paucity of case law addressing the practice.[99] One prominent and recent appellate decision is *LePage's v. 3M*, in which the Third Circuit, sitting en banc, condemned bundled rebates as a violation of Section 2.[100] Because the court failed to evaluate whether 3M's program of bundled rebates represented competition on the merits, its decision offers no clear standards by which firms can assess whether their bundled rebates are likely to pass antitrust muster. Therefore, the Third Circuit's decision is likely to discourage firms from offering procompetitive bundled discounts and rebates to consumers.

The proconsumer benefits and possible anticompetitive harms of bundled discounts, the *LePage's* decision, and various proposals for legal standards that will deter unfounded claims that bundled discounts violate Section 2 are discussed below. A test that compares incremental revenues with incremental costs, as described below, offers the most promising source of an economically sensible and administrable safe harbor for bundled rebates or discounts.

a. Consumer Benefits, and Theories of Harm, from Bundled Discounts

Product bundling and bundled discounts are widespread throughout the U.S. economy.[101] Fitness clubs may offer their sessions separately or as a package at a discount; a furniture retailer may offer a bed and two dressers separately or together as a bedroom set at a discount; retailers may bundle free parking with a purchase in their stores.[102] Other examples abound.[103]

Businesses may offer bundled products for a variety of reasons. Firms can use bundling to save costs in distribution and packaging, to reduce transaction costs for themselves and their customers, and to increase reliability for customers.[104] Selling products as a package may reduce a manufacturer's costs, and the manufacturer may pass these cost reductions on to purchasers as bundled discounts.[105] Instead of advertising, firms can use bundled discounts to increase demand.[106] When a retailer reduces the number of its suppliers to save costs, multiproduct manufacturers may offer multiproduct discounts to keep the retailer's business.[107] A firm selling a product in one market may employ a bundling strategy as a means of encouraging consumers in another market to try a new product.[108] In some cases, bundling can help a firm enter a new market and compete with established firms. As one witness explained:

> Cable companies attempt to compete with telecommunications companies by offering bundles of digital telephone service, high speed internet service, and digital cable. Telecommunications companies have responded by offering discounts if consumers bundle their phone service with DSL and with satellite television . . . . The resulting bundle versus bundle competition will likely continue to drive down prices, increasing consumer welfare.[109]

These types of bundling can result in bundled discounts or rebates that significantly lower prices to consumers. One witness noted that "virtually everyone who submitted a paper tends to agree that bundling is pro-consumer. It is a way of discounting; it's a way of waging competition."[110] Moreover, the fact that firms without market power often offer bundled discounts suggests that efficiencies, not schemes to acquire or maintain monopoly power, typically explain their use.[111]

Nonetheless, recent economic literature has suggested three theories by which, in certain circumstances, bundled discounts could be unreasonably exclusionary:[112] (1) as a form of predatory pricing; (2) as *de facto* tying; and (3) as exclusionary conduct that deters entry.[113] If bundled discounts were used as a form of predatory pricing, a dominant firm might eliminate competition by forcing its competitors to sell at unprofitably low prices.[114] Under standard predatory pricing law, for this strategy to be plausible, the predator must be able to recoup its investment in below-cost pricing by using its increased market power to capture monopoly profits in the long run.[115]

In the case of *de facto* tying, while consumers are free to buy components separately, the components are priced to make it more attractive to buy the bundled components together.[116] Under this theory, the prices of the components are actually increased, including the stand-alone price of the monopolized good.[117] Thus, instead of receiving a discount, consumers are actually paying more for the bundled products.[118]

Finally, a dominant firm selling multiple products might use bundled discounts to deter entry or otherwise foreclose competition by firms that do not sell multiple products. By providing bundled discounts that reduce the price (net of discounts) of the competing good, a competitor that sells only that good may not be able to compete effectively if it does not also sell the monopoly good.[119] Suppose, for example, each of two manufacturers produces product A at a cost of $10 per unit. The manufacturer that earns monopoly profits in related product B, which it produces at a cost of $10 per unit but sells for $20, can bundle A and B and sell the bundle for $28. The manufacturer that produces only A, however, cannot sell product A for $8 without losing money.

There was disagreement among witnesses before the Commission as to the plausibility of these strategies, the conditions necessary to make them plausible, and the optimal legal standards to assess such anticompetitive risks. All appeared to agree, however, that further empirical study would benefit enforcement and policymakers. In addition, whatever legal standards are adopted should be sufficiently clear to enable companies to conform their conduct to the law, be administrable by the courts, and avoid chilling procompetitive discounting.

b. The Third Circuit's LePage's *Decision*

In *LePage's* the Third Circuit, sitting en banc, upheld a jury verdict that 3M had violated Section 2 through its program of bundled rebates. Plaintiff LePage's and defendant 3M competed in sales of transparent tape. LePage's alleged that 3M used its monopoly in its Scotch-brand tape to gain a competitive advantage in private-label transparent tape by offering higher rebates—that is, lower prices—when purchasers, such as office superstores, bought certain amounts of products across a number of 3M's product lines (including Scotch tape)[120] or increased the amount of Scotch tape purchased in proportion to 3M's private-label tape.[121] If an eligible buyer met certain targets across all of the product lines, a rebate of up to 2 percent was applied to all of its purchases from 3M. Conversely, if the buyer failed to meet any one of the targets in each product line, the 2 percent rebate for all purchases would be rescinded.[122] LePage's alleged that such rebates gave buyers the incentive to purchase either 3M's Scotch tape or 3M's private-label tape, instead of LePage's private-label tape.

3M responded that its pricing was above cost, no matter how cost was calculated, and that, following the Supreme Court's decision in *Brooke Group*, above-cost pricing could not give rise to antitrust liability.[123] The court specifically rejected 3M's argument, stating that "a monopolist will be found to violate Section 2 of the Sherman Act if it engages in exclusionary or predatory conduct without a valid business justification."[124] The court upheld the jury's finding that 3M had no legitimate business justification, in part because no evidence showed that the amount of 3M's savings from bundling its products equaled the amount that 3M had given its customers through bundled rebates.[125] In explaining why such bundled rebates harmed consumers, the court stated that the "principal anticompetitive effect of bundled rebates as offered by 3M is that when offered by a monopolist they may foreclose portions of the market to a potential competitor who does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer."[126]

c. *Criticisms of* LePage's

The fundamental criticism of the Third Circuit's decision is that it did not assess whether 3M's bundled rebates constituted competition on the merits. The court focused on the claimed harm to LePage's, including its loss of market share in the market for transparent tape and its loss of efficiencies in manufacturing.[127] But, as one critic points out, that a monopolist's conduct weakens a rival is not sufficient to trigger liability under Section 2.[128] "Price cutting may result . . . in some competitors being driven out of business, a result that is tolerated as a natural product of legitimate competition when an exit is the product of an inability to compete efficiently on the merits."[129] Lower prices may harm a rival but benefit consumers.

The Third Circuit did not require LePage's to prove it could make tape as efficiently as 3M and therefore that 3M's conduct had excluded an equally efficient rival.[130] In fact, 3M and LePage's both agreed that 3M was a more efficient, lower-cost producer of transparent tape than LePage's.[131] Nor did the court require LePage's to prove that, regardless of LePage's ability to operate efficiently, 3M's conduct would have excluded a hypothetical competitor that was as efficient as 3M.[132] The court did not even consider 3M's assertion that its bundled pricing was above cost, no matter how cost was calculated—an assertion that LePage's did not dispute.[133] Thus, it is unclear what would have been sufficient to convince the court that 3M was competing on the merits, rather than on some basis other than efficiency, with its bundled rebates. The decision is too vague[134] and is therefore likely to chill welfare-enhancing bundled discounts or rebates.[135]

d. Possible "Safe Harbors" for Bundled Discounts

Given the likelihood that most bundled discounts or rebates benefit consumers, many have proposed a safe harbor for bundled discounts that clearly constitute competition on the merits. One proposal, relevant to the use of bundled discounts as *de facto* tying arrangements, would ask what proportion of buyers accepted the bundled discount. If all or almost all buyers accepted the bundled discount, then it should be evaluated under tying law; if a substantial proportion of buyers rejected the bundled discount, it should be deemed legal.[136]

Other proposals relate to the possible use of bundled discounts or rebates in a manner analogous to predatory pricing. One type of safe harbor would also operate as a screen, requiring plaintiffs pursuing a Section 2 challenge first to establish that the bundled prices at issue fell below an appropriate measure of the defendant's cost.[137] If a defendant's costs are properly defined, "below-cost pricing, unlike pricing at or above that level, carries with it the threat that the party so engaged will drive equally efficient competitors out of business, thus setting the stage for recoupment at the expense of consumers."[138] Prices below an appropriate measure of cost would be a necessary, but not sufficient, condition for liability.[139] In addition, plaintiffs would be required to establish that the defendant could recoup the profits it sacrificed through bundled discounts,[140] as well as establish actual or probable harm to competition.

Proposals differ on the appropriate measure of the defendant's costs, although most involve some type of comparison between the defendant's costs and revenues.[141] One approach, comparable to the approach adopted by a decision in the Southern District of New York,[142] would allocate all discounts attributable to the entire bundle of products to the competitive product, and then ask if, after reallocation of those discounts, the competitive product is sold at or above incremental cost.[143] If the competitive product is being sold at or above incremental cost after allocation to it of all bundled discounts, then the bundle would fall within the safe harbor. If not, then the plaintiff would need to demonstrate a likelihood that the defendant could recoup the short-term losses. Put another way, this test would find potential liability under Section 2 if the defendant's incremental price of the competitively supplied good is less than the defendant's incremental cost of producing it.[144]

By comparison, one witness proposed that bundled discounts be evaluated under a modified *Brooke Group* standard that would reject bundling claims whenever the defendant's total revenues derived from the entire bundle exceeded the total of the average variable costs to produce all of the products in the bundle—essentially, a total revenue versus total cost approach.[145] The witness argued this test was appropriate because it would allow a dominant firm to offer a bundled discount "that effectively lowers the price of a supracompetitively priced good."[146] Others see significant problems with the test. They contend the test ignores the effects of bundling insofar as it permits bundled discounts where a monopolist lowered its price in a competitive market below the monopolist's average variable cost for the competitively priced product.[147] Another witness suggested that courts should prorate the total discount and allocate an equal share to each of the products in the bundle, then ask whether any product was sold below incremental cost.[148] In deciding which test to apply, some would ask whether a firm has near monopoly power in a well-defined market, and whether any competing firm can match the defendant's discounts across all product lines.[149]

These and other proposed tests raise various issues, as the federal antitrust agencies recognized in recommending that the Supreme Court decline to grant certiorari in *LePage's* to allow further development in the case law and economic analysis.[150] One witness noted that competitors less efficient than a dominant firm might still constrain the dominant firm to price below a monopoly level.[151] Thus, a test asking whether a bundled discount could exclude a hypothetical equally efficient competitor would not capture instances in which a bundled discount enabled a dominant firm to exclude a less efficient rival that had in fact benefited consumers by constraining prices.[152] Others concede that, just as above-cost predatory pricing could occur, above-cost predatory bundled discounts could occur.[153] Nonetheless, they believe that a safe harbor for above-cost bundled discounts "provides valuable clarity to the business community and reduces the number of false positives, which would otherwise discourage procompetitive discounting."[154] Moreover, some courts have concluded that "only price cutting that threatens equally or more efficient firms is condemned under Section 2."[155] They explain that "[t]he antitrust laws were not intended, and may not be used, to require businesses to price their products at unreasonably high prices (which penalize the consumer) so that less efficient competitors can stay in business."[156]

e. Conclusion

17. Courts should adopt a three-part test to determine whether bundled discounts or rebates violate Section 2 of the Sherman Act. To prove a violation of Section 2, a plaintiff should be required to show each one of the following elements (as well as other elements of a Section 2 claim): (1) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product; (2) the defendant is likely to recoup these short-term losses; and (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.[*]

[*] Commissioners Carlton and Garza join this recommendation, but are concerned that the first screen in the three-part test would still require many pricing schemes where exclusion is not at issue to receive further scrutiny under the second and third parts of the test. Bundled discounts that do not pass the first screen in the Commission's proposed test can be used to price discriminate with no exclusionary effect on competition. Failure to recognize that price discrimination is a motive for mixed bundling implies that the incremental revenue is not correctly calculated by the Commission's proposal. Commissioner Carlton elaborates on these points in his separate statement.

The first screen in the recommended three-part test would establish that bundled discounts should be subject to scrutiny under Section 2 only if they could exclude a hypothetical equally efficient competitor. This standard would permit bundled discounts that could exclude a less efficient competitor, even if the less efficient competitor had provided some constraint on pricing of the competitive product. The difficulties of assessing such circumstances, the lack of predictability and administrability in any standard that would capture such instances, and the undesirability of a test that would protect less efficient competitors, however, counsel against the adoption of a screen that protects less efficient competitors.

Importantly, the first screen would provide sufficient clarity to enable businesses to determine whether a particular bundled discount would be "screened out" from further scrutiny under the second and third parts of the tests. In this sense, the first screen could operate as a "safe harbor" and thus ameliorate the chilling of procompetitive bundled discounts that now exists. The first screen is also sufficiently administrable for courts to apply, although the Commission acknowledges it could be difficult to apply in circumstances where the alleged competitive product is separate from the other products in the bundle. This issue arises with other proposed tests as well, however.

The first screen is not perfect; it could reserve for further scrutiny bundled discounts with no anticompetitive exclusionary effects. Thus, it is crucial to apply the second and third parts of the test. Under the second part of the test, a plaintiff would need to prove that the defendant was likely to recoup its losses from its use of the challenged bundled discount or rebate. This would typically require a plaintiff to show that entry into the relevant market is not easy and therefore is unlikely to undermine the defendant's ability to recoup its losses. Like the first screen, this portion of the test also might be considered a "safe harbor" for defendants in relevant markets where entry is easy. Under the third part of the test, a plaintiff would have to establish actual or probable harm to competition.[157] Use of the Commission's proposed three-part test would bring the case law on bundled discounts into line with the reasoning of *Brooke Group*.

The Commission also encourages additional empirical economic research in this area. The courts, the antitrust agencies, and antitrust practitioners generally would benefit from a more thorough and empirically based understanding of the likely competitive effects of bundled discounts in a variety of settings.

2. Refusals to Deal with a Rival in the Same Market.

18. In general, firms have no duty to deal with a rival in the same market.*

The Supreme Court has long held that, "[i]n the absence of any purpose to create or maintain a monopoly, the [Sherman Act] does not restrict the long recognized right of [a] trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal."[158] Recently, in *Trinko* the Supreme Court confirmed there is no general duty to aid rivals under Section 2 of the Sherman Act.[159] Rather, the Court characterized its earlier decisions, including *Aspen Skiing* and *Otter Tail*, as "limited exception[s]" in which the defendant was found liable under Section 2 for a failure to deal with a rival.[160]

Although the Court's decision in *Trinko* provided some guidance on the factors that might suggest liability for a refusal to deal with a rival, the decision is far from definitive. Businesses need better guidance from the courts on how to avoid antitrust scrutiny for a refusal to deal with a rival. The following briefly reviews the reasoning and guidance that can be gleaned from the *Trinko* decision, as well as proposals to the Commission on how courts should evaluate refusals to deal with a rival.

a. Refusals to Deal with Rivals Should Rarely, if Ever, Be Unlawful

Refusals to deal with horizontal rivals in the same market should rarely, if ever, be unlawful under antitrust law, even for a monopolist.[161] In *Trinko* the Supreme Court explained:

> Firms may acquire monopoly power by establishing an infrastructure that renders them uniquely suited to serve their customers. Compelling such firms to share the source of their advantage is in some tension with the underlying purpose of antitrust law, since it may lessen the incentive for the monopolist, the rival, or both to invest in those economically beneficial facilities.[162]

Thus, absent a right to refuse to deal with a rival, a firm that lawfully obtained a monopoly through superior acumen, skill, foresight, or industry would find itself forced to share the fruits of its investment with rivals, thereby undermining the value of its lawfully acquired

* Commissioners Jacobson and Shenefield join this recommendation with qualifications. They believe that, if the refusal to deal with a rival in the same market is likely to raise price or reduce output in that relevant market, and is insufficiently supported by legitimate procompetitive justifications, the conduct is appropriately prohibited. A refusal to deal with a customer in an adjacent market (or different level of distribution), unless the customer agrees not to do business with a rival, is analytically the same as exclusive dealing and should be treated under the same principles. A refusal to deal with a rival in an adjacent market may be harmful to consumers if the defendant is using its monopoly power in one market to attempt to monopolize a second market.

monopoly and discouraging others from making similar investments.[163] Because investments in new facilities and assets often enhance consumer welfare, antitrust rules that discourage such activity should be avoided.[164] Forced sharing stultifies the incentives of smaller firms to develop alternatives to the monopolist's product.[165] Moreover, forced sharing requires courts to determine the price at which such sharing must take place, thereby transforming antitrust courts into price regulators, a role to which they are ill suited.[166] Setting a price too low, for example, could dampen the incentives of monopolists and others to develop substitutes for the monopolist's product[167] and ultimately disserve the interests of consumers.[168]

In *Trinko*, the Court noted it has been cautious in finding exceptions to the general rule of no duty to aid a rival, precisely "because of the uncertain virtue of forced sharing and the difficulty of identifying and remedying anticompetitive conduct by a single firm."[169] The Court appeared to link its prior exceptions to two factors: (1) the defendant's unilateral termination of a voluntary, and thus presumably profitable, prior course of dealing with the plaintiff (*Aspen Skiing*), and (2) the defendant's refusal to provide to a customer rival the same service that it provided to other customers (retail sales of ski-lift tickets in *Aspen*, power transmission over its network in *Otter Tail*). Questions have been raised concerning the Court's use of these two factual circumstances as key indicators of a potentially anticompetitive refusal to deal with a rival in the same market.[170] The Court seemed to suggest that either type of conduct might be worthy of scrutiny to assess whether it reflected a willingness to forsake short-term profits to achieve an anticompetitive end.[171] The Court did not clarify that point, however, and it also did not explain what additional factors would be required to establish Section 2 liability in such circumstances.

b. Further Proposals for Evaluating Refusals to Deal

The principal approaches advanced at the Commission's hearings were: (1) a rule of reason test centered on a pricing benchmark; (2) a "no economic sense" or "profit sacrifice" test; and (3) an examination of whether the conduct or pricing at issue is coercive or provides incentives.

Rule of Reason/"Consumer Welfare Effect" Test. The purpose of this test is to determine whether the refusal to deal would enable the monopolist to charge supracompetitive prices in any market.[172] If the defendant possessed monopoly power in a relevant market for inputs used by the firm's rivals, the court would determine whether the defendant's refusal to sell such inputs—or its insistence on terms so unattractive as to constitute an effective refusal to deal (a "non-negotiable" refusal to deal)—would lead to supracompetitive prices in a market.[173] Because requiring a monopolist to share inputs or facilities with its rivals at any price could destroy a firm's incentive to develop the capacity to produce such inputs in the first place,[174] this test would require the plaintiff to demonstrate that the rival was willing to pay a *sufficient* price for the monopolized product. The fact finder would ask whether the rival was willing to pay a price high enough to support an inference that the refusal to sell at that price was exclusionary.[175] The monopolist could rebut a prima facie claim by showing that the refusal was necessary to create efficiencies, and that these efficiencies counteracted any harmful impact of the refusal.[176] The court would then balance the harmful effects of the refusal against the benefits proved by the defendant in a way analogous to the rule of reason analysis that courts employ in the merger and Section 1 contexts.[177]

Objections to this proposal centered on its complexity, the difficulty of determining the proper "non-exclusionary benchmark price," and questions whether the conduct the standard would condemn as unreasonably exclusionary actually would harm consumer welfare.[178] Some questioned whether there was sufficient evidence of durable monopoly power to support the use of such a complex test instead of a simpler test that could better avoid "false positives." Witnesses also argued that courts are not rate-making bodies and are ill equipped to determine the "non-exclusion benchmark price" as required by this test.[179] Finally, a determination of harm to consumer welfare would require a determination whether rivals would be able to obtain alternative, cost-effective sources of supply, and other factors that could increase the potential for error in application of the test.[180]

The "Profit Sacrifice" and "No Economic Sense" Tests. As discussed earlier, to establish liability for a refusal to deal with a rival, the "no economic sense" and "profit sacrifice" tests would require proof that the refusal makes "no economic sense" or is unprofitable but for the refusal's tendency to fortify preexisting market power or help the monopolist acquire new market power.[181] If the refusal does make economic sense absent such a contribution to market power (or the expectation of acquiring market power), the conduct survives Section 2 scrutiny, without additional analysis.

Although proof that a monopolist's refusal to deal makes no economic sense is a *necessary* condition for liability under this test, it is not sufficient, and thus the test acts only as a screen.[182] The second step of the inquiry requires a determination that the conduct harmed competition.[183] Thus, under the "no economic sense test," a plaintiff may prevail by proving four elements: (1) the defendant's possession of a monopoly over an input; (2) the refusal to sell the input or the sale of the input at a price that significantly disadvantages rivals; (3) the absence of any economic rationale for the refusal, apart from its tendency to maintain or acquire monopoly power; and (4) the maintenance or acquisition of market power as a result of such refusal.[184]

Some have found this test useful in the context of refusals to deal with rivals.[185] Nonetheless, some antitrust practitioners question whether the test can be applied sensibly in all circumstances, given the fine distinction between seeking to exclude competitors by increasing a firm's sales as opposed to seeking to obtain or maintain monopoly power.[186]

"Coercing" versus "Incentivizing" Conduct. A third proposal focuses on whether the challenged conduct is "coercing" or "incentivizing."[187] This question is the third, and most important part, of a three-part inquiry under this approach. The first part calls for courts to

determine whether conduct is "excluding" or "exploiting."[188] Exploiting conduct is that which may be undertaken by a monopolist as a fruit of its monopoly, and should not give rise to an antitrust claim.[189] Excluding conduct is conduct that is designed to eliminate rivals, and potentially is actionable.[190] Second, this approach asks whether the challenged conduct is horizontal or vertical. If the conduct relates only to horizontal dealings among competitors, this approach concludes that antitrust law should rarely (if ever) be concerned with the conduct.[191] Vertical conduct, however, may be actionable.

If the conduct is excluding and vertical, then the analysis asks whether the challenged conduct is coercing or incentivizing. Coercing conduct occurs when a firm refuses to deal with a (potential) customer because that customer also deals with the firm's rivals.[192] By comparison, a firm engages in incentivizing conduct when it continues to deal with a customer, despite that customer's dealing with the rival, but not necessarily on the same favorable price terms.[193]

The proponent of this test argues that this proposed distinction is important for three reasons. First, a monopolist is uniquely capable of coercing because of its monopoly status; any firm is capable of engaging in incentivizing conduct (at least to the limits of its "checkbook").[194] Second, coercing conduct hurts the customer by issuing a "take it or leave it" choice; incentivizing conduct provides a choice to the customer.[195] Third, a monopolist's competitors can respond to incentivizing conduct by providing their own incentive offers.[196]

Under this test, coercing conduct would be presumptively unlawful, with the presumption overcome only if the defendant could show procompetitive justifications for the conduct.[197] By comparison, incentivizing conduct would be presumptively lawful.[198] The only exception would be for price incentives so great that they would constitute predatory pricing under the *Brooke Group* standard.[199] The test's author contended it has several advantages because, among other things, it provides companies with clarity as to what conduct is permissible,[200] and it would harmonize refusal-to-deal analysis with tying law by making unlawful only that conduct that creates the type of coercion that an unlawful tie-in creates.[201]

c. Conclusion

The Commission endorses the longstanding principle that, in general, firms have no duty to deal with a rival in the same market. To the extent that circumstances exist in which firms may be liable for a refusal to deal with a rival in the same market, the courts should further clarify those circumstances.

3. Intellectual Property in Tying Cases

19. Market power should not be presumed from a patent, copyright, or trademark in antitrust tying cases.

In *Illinois Tool Works, Inc. v. Independent Ink, Inc.* the Supreme Court reversed a decision by the Court of Appeals for the Federal Circuit adhering to previous Supreme Court precedents that provided for a presumption of market power.[202] The Court unanimously held that "a patent does not necessarily confer market power upon the patentee" and that, "in all cases involving a tying arrangement, the plaintiff must prove that the defendant has market power in the tying product."[203]

In reaching this decision, the Court reviewed the history of tying law generally and its application in cases involving intellectual property in particular. It explained that the presumption originated in patent misuse cases involving tying of patented and unpatented goods, and that subsequent cases—particularly *International Salt Co. v. United States*[204]—"imported" this doctrine into tying law, in part on the ground that the policy considerations were the same.[205] As a result, the Court had characterized such patent ties as "illegal per se."[206]

The Court explained that its reconsideration of the "presumption of per se illegality of a tying arrangement involving a patented product" was appropriate in light of developments since those earlier rulings.[207] Most important, in 1988 Congress "amended the Patent Code to eliminate [the market power] presumption in the patent misuse context."[208] After considering "the congressional judgment reflected" in this amendment, the Court concluded that ties involving patented products should be treated like other ties, and not be condemned without a showing of market power.[209] The Court also observed that imposing this requirement was supported by "the vast majority of academic literature" addressing the question and by "a virtual consensus among economists" on this matter.[210] Furthermore, it noted, the antitrust enforcement agencies' Intellectual Property Guidelines provide that the agencies "will not presume that a patent, copyright or trade secret necessarily confers market power upon its owner."[211]

Consistent with the "virtual consensus" the Court identified in *Independent Ink*, witnesses at the Commission's hearing (which took place before *Independent Ink* was decided) were united in their opposition to the market-power presumption.[212] Similarly, a number of commenters argued that there should be no presumption of market power from patents or copyrights.[213] Thus this Commission's witnesses and commenters generally advocated what is now the state of the law.

The Supreme Court decision in *Independent Ink* is clearly correct. For similar reasons, courts should not presume market power from a copyright or trademark in tying cases.

Notes

[1] 15 U.S.C. § 2.

[2] *See, e.g.*, Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407–08 (2004). Section 2 also does not make mere size an offense. United States v. International Harvester Co., 274 U.S. 693, 708 (1927); United States v. United Shoe Mach. Co., 247 U.S. 32 (1918); American Tobacco Co. v. United States, 221 U.S. 106 (1911).

[3] Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 605 n.32 (quoting III Phillip E. Areeda & Donald F. Turner, Antitirust Law 78 (1978)); *see also* Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 127 S. Ct. 1069, 1074 (2007); Illinois Tool Works, Inc. v. Independent Ink, Inc., 126 S. Ct. 1281, 1288 (2006); Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993).

[4] United States v. Aluminum Co. of Am., 148 F.2d 416, 430 (2d Cir. 1945) (Hand, J.).

[5] LePage's, Inc. v. 3M Co., 324 F.3d 141 (3d Cir. 2003) (en banc).

[6] United States v. Colgate & Co., 250 U.S. 300, 307 (1919).

[7] *Trinko*, 540 U.S. at 398.

[8] *See* 15 U.S.C. § 2 ("Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States . . . shall be deemed guilty of a felony . . . .").

[9] United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1966).

[10] *See, e.g.*, United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377, 391 (1956).

[11] Andrew I. Gavil et al., Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy 564–65 (2002) [hereinafter Gavil, Antitrust Law in Perspective].

[12] *Id.* at 564 (emphasis added).

[13] *See id.* at 564–71; *see also* United States v. Microsoft Corp., 253 F.3d 34, 57–58 (D.C. Cir. 2001) (monopolization claim supported by direct evidence that a firm can raise prices substantially above a competitive level in a relevant market); United States v. Syufy, 903 F.2d 659 (9th Cir. 1989) (ease of entry dooms monopolization claim); *Alcoa*, 148 F.2d at 424–26 (market share screen).

[14] *See Aspen Skiing*, 472 U.S. at 605; *Grinnell*, 384 U.S. at 570–71; Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 482–83 (1992).

[15] Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447, 458 (1993).

[16] *Grinnell*, 384 U.S. at 570–71.

[17] *Alcoa*, 148 F.2d at 430.

[18] *Id.* at 427.

[19] *Id.* at 430–31.

[20] *Id.* at 431 (emphasis added). Judge Hand's decision in *Alcoa*, although expansive, rejected the view that monopolization was illegal per se. *Id.* at 429–30.

[21] *See* American Tobacco Co. v. United States, 328 U.S. 781, 813–15 (1946) (quoting approvingly large sections of *Alcoa* decision, specifically including *Alcoa*'s statement that "we can think of no more effective exclusion than progressively to embrace each new opportunity as it opened," *Alcoa*, 148 F.2d at 431).

[22] For example, in *United States v. United Shoe Machinery Corp.*, where the government challenged the terms on which the largest maker of shoe-making machines leased those machines, the court explained that the defendant "is denied the right to exercise effective control of the market by business policies that are not *the inevitable consequences of its capacities or its natural advantages*." United States v. United Shoe Mach. Corp., 110 F. Supp., 295, 345 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954) (emphasis added).

[23] *See generally* GAVIL, ANTITRUST LAW IN PERSPECTIVE, at 593–99.

[24] *See* NATIONAL COMMISSION FOR THE REVIEW OF ANTITRUST LAWS AND PROCEDURES, REPORT TO THE PRESIDENT AND THE ATTORNEY GENERAL 150–63 (1979); *cf.* Eleanor M. Fox, *Monopoly and Competition; Tilting the Law Towards a More Competitive Economy*, 37 WASH. & LEE L. REV. 49, 55–62 (1980) (advocating an approach to monopolization doctrine whereby proof of monopoly would itself establish liability under Section 2 and "[w]illfulness or bad conduct would not be a requisite part of the case"). This approach no longer has support. *See, e.g.*, Exclusionary Conduct Transcript at 121 (Pitofsky) (Sept. 29, 2005) (Section 2 should not ban obtaining monopoly power through superior skill, foresight, and industry).

[25] *See* Chapter I.A of this Report.

[26] *See, e.g.*, ROBERT H. BORK, THE ANTITRUST PARADOX 165–70 (1978) [hereinafter BORK, ANTITRUST PARADOX]; Oliver E. Williamson, *Dominant Firms and the Monopoly Problem: Market Failure Considerations*, 85 HARV. L. REV. 1512, 1512–13 (1972); Richard A. Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562, 1596–97 (1969); Aaron Director & Edward Levi, *Law and the Future: Trade Regulation*, 51 NW. U. L. REV. 281, 286 (1956).

[27] *See, e.g.*, ROBERT H. BORK, THE ANTITRUST PARADOX 431–34 (2d ed. 1993) (discussing in epilogue general improvements in Section 2 enforcement).

[28] Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263 (2d Cir. 1979).

[29] *Id.* at 281.

[30] *Id.* The Federal Circuit has held, and other cases have suggested, however, that, absent any product improvement or reduced costs, a deliberate effort to create incompatibility with a rival's product violates Section 2. *See* C.R. Bard, Inc. v. M3 Sys., Inc., 157 F.3d 1340, 1382 (Fed. Cir. 1998). *See generally* GAVIL, ANTITRUST LAW IN PERSPECTIVE, at 627.

[31] *See, e.g.*, Thomas A. Piraino, Jr., *Identifying Monopolists' Illegal Conduct Under the Sherman Act*, 75 N.Y.U. L. REV. 809, 824–25 (2000) ("To punish a firm simply because it has achieved a monopoly is to discourage superior business performance."); Alan J. Meese, *Monopolization, Exclusion, and the Theory of the Firm*, 89 MINN. L. REV. 743, 834–35 (2005).

[32] *Trinko*, 540 U.S. at 407.

[33] *See, e.g.*, Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, *in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 609–25 (Richard R. Nelson ed., 1962); *see also* Jonathan B. Baker, *Beyond Schumpeter vs. Arrow: How Antitrust Fosters Innovation* (Feb. 8, 2007), *available at* http://ssrn.com/abstract=962261; M. Howard Morse, Statement at AMC New Economy Hearing, at 10 (Nov. 8, 2005) (citing economic studies that suggest smaller firms or new entrants without a vested interest in the status quo are more likely to introduce paradigm-shifting innovations); *cf.* New Economy Transcript at 68–69 (Shapiro) (Nov. 8, 2005) (business documents show competition is "a very powerful force to innovate").

[34] See Jonathan B. Baker, *Promoting Innovation Competition Through the* Aspen/Kodak *Rule*, 7 GEO. MASON L. REV. 495, 512 (1999) ("As a matter of economic theory, it is impossible to say for certain whether enforcement of the antitrust prohibition against monopolization, which might restrict the conduct of a dominant firm, will on balance enhance or reduce aggregate industry innovation in general."); *see also* RICHARD A. POSNER, ANTITRUST LAW 20 (2d ed. 2001) [hereinafter POSNER, ANTITRUST LAW] (explaining that empirical studies indicate it is unclear "whether monopoly retards or advances innovation"); American Bar Association, Section of Antitrust Law, Public Comments Submitted to AMC Regarding Exclusionary Conduct, at 8 (Mar. 17, 2006) [hereinafter ABA Comments re Exclusionary Conduct] ("Some disagreement exists among experts as to whether the ability to charge monopoly profits indeed induces risk taking, innovation and economic growth."); *cf.* Andrew I. Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3, 43 (2004) ("[U]nless firms are hopelessly disconnected from the real world, the pipe dream of 'monopoly' can hardly be the major incentive that drives most firms to innovate . . . . Profits, not monopoly profits, are the principal spur to innovation that attracts 'business acumen.'") (citations omitted).

[35] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 226 (1993) (citing Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986)).

[36] *Matsushita*, 475 U.S. at 589.

[37] *See Brooke Group*, 509 U.S. at 226–27.

[38] *Id.* at 223 (Section 2 does not forbid above-cost pricing that preserves a dominant position); Phillip E. Areeda and Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697, 733 (1975) (proposing that prices above average variable cost be presumptively lawful, and that prices below average variable cost be presumptively predatory); *see also* Carl Shapiro, Statement at AMC Exclusionary Conduct Hearing, at 4 (Sept. 29, 2005) [hereinafter Shapiro Statement re Exclusionary Conduct]; Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The "No Economic Sense" Test*, 73 Antitrust L.J. 413, 418–20 (2006) [hereinafter Werden, *No Economic Sense Test*] (explaining how *Brooke Group* created a "prudential safe harbor" for above-cost pricing).

[39] *See* Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 234 (1st Cir. 1983). One witness expressly endorsed the reasoning of Justice Breyer in *Barry Wright*. *See* Exclusionary Conduct Trans. at 10 (Popofsky) (stating that *Barry Wright* is "perhaps the most important Section 2 case that was ever decided"). Two other witnesses embraced similar reasoning without mentioning the decision. *See id.* at 55–56 (Rule) ("I think the issue is that: how do you—can you really develop a cost-effective rule for evaluating [the impact of unilateral conduct] in these circumstances?"); Shapiro Statement re Exclusionary Conduct, at 3–4.

[40] *Microsoft*, 253 F.3d at 61–64 (holding restrictions on licenses with computer manufacturers were unlawfully exclusionary); *id.* at 64–67 (holding that "Microsoft's exclusion of IE from the Add/Remove Programs utility and its commingling of browser and operating system code constitute exclusionary conduct"); *id.* at 66–71 (holding agreements with Internet access providers were unlawful, exclusionary devices); *id.* at 72–74 (holding exclusive-dealing arrangements with independent software vendors and Apple were unlawfully exclusionary); *id.* at 74–78 (holding certain actions involving Java were unlawfully exclusionary).

[41] *See id.* at 50, 53–54.

[42] *See* Final Judgment, United States v. Microsoft Corp., Civil Action No. 98-1232 (CKK) (Nov. 12, 2002).

[43] Complaint, *In re* Union Oil Co. of Cal., FTC Docket No. 9305 (Mar. 4, 2003).

[44] *Id.*; *see also* Susan A. Creighton et al., *Cheap Exclusion*, 72 Antitrust L.J. 975, 985–87 (2005) [hereinafter Creighton, *Cheap Exclusion*].

[45] Agreement Containing Consent Order, *In re* Union Oil Co. of Cal., FTC Docket No. 9305 (June 6, 2005).

[46] Opinion of the Commission, *In re* Rambus Inc., FTC Docket No. 9302, at 3 (Aug. 2, 2006).

[47] *Brooke Group*, 509 U.S. at 222.

[48] *Id.* at 224.

[49] *See id.* at 226.

[50] *Matsushita*, 475 U.S. at 594–95.

[51] *Id.* at 594.

[52] *Id.* at 588.

[53] *Brooke Group*, 509 U.S. at 226–27.

[54] *See, e.g.*, Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1, 21 (1984); Frank H. Easterbrook, *When is it Worthwhile to Use Courts to Search for Exclusionary Conduct?*, 2003 Colum. Bus. L. Rev. 345, 357–58. *See generally* Bork, Antitrust Paradox.

[55] *See* Creighton, *Cheap Exclusion*, at 981–82.

[56] *Aspen Skiing*, 472 U.S. at 605 n.32 (quoting III Phillip E. Areeda & Donald F. Turner, Antitrust Law 78 (1978)).

[57] *See, e.g.*, Kenneth L. Glazer, Statement at AMC Exclusionary Conduct Hearing, at 11 (Sept. 29, 2005) [hereinafter Glazer Statement]; R. Hewitt Pate, Statement at AMC Exclusionary Conduct Hearing, at 1 (Sept. 29, 2005) [hereinafter Pate Statement]; Robert Pitofsky, Statement at AMC Exclusionary Conduct Hearing, at 9 (Sept. 29, 2005) [hereinafter Pitofsky Statement]. Mr. Rule, the sole witness who recommended repeal of Section 2, recognized that repeal was unlikely. Charles F. (Rick) Rule, Statement at AMC Exclusionary Conduct Hearing, at 15 (Sept. 29, 2005) [hereinafter Rule Statement re Exclusionary Conduct]. He accordingly made ten suggestions for courts to consider in deciding Section 2 claims that would not be effectuated through legislative change. *Id.* at 16–17.

[58] *See* Thomas O. Barnett, The Gales of Creative Destruction: The Need for Clear and Objective Standards for Enforcing Section 2 of the Sherman Act, Opening Remarks for FTC and DOJ Hearings Regarding Section 2, at 2–3 (June 20, 2006) (hearings to increase understanding and advance development of law).

[59] *See* Mark S. Popofsky, *Defining Exclusionary Conduct: Section 2, the Rule of Reason, and the Unifying Principle Underlying Antitrust Rules*, 73 ANTITRUST L.J. 435, 437 (2006) [hereinafter M.S. Popofsky, *Defining Exclusionary Conduct*]; *see also* Exclusionary Conduct Trans. at 158–59 (Pitofsky); Shapiro Statement re Exclusionary Conduct, at 3.

[60] Pate Statement, at 2.

[61] *Id.*; *see also* Werden, *No Economic Sense Test*.

[62] Werden, *No Economic Sense Test*, at 413.

[63] The DOJ alleged that Microsoft's conduct to protect its operating system monopoly was exclusionary because it "would not make economic sense unless it eliminated or softened competition." *See* ABA Comments re Exclusionary Conduct, at 10; Brief for Appellees, United States v. Microsoft Corp., Nos. 00-5212, 00-5213 (D.C. Cir. Feb. 9, 2001).

[64] The DOJ argued that the defendant's policies of not using dealers who distributed the products of rivals "made no economic sense but for their tendency to harm rivals" because the policies were costly to defendant but produced no benefit except reducing competition. ABA Comments re Exclusionary Conduct, at 10; Brief for the United States, United States v. Dentsply Int'l, Inc., No. 03-4097 (3d Cir. May 14, 2004). The DOJ won the case on appeal, but the Third Circuit applied a business-justification test similar to the balancing test applied in *Microsoft*. United States v. Dentsply Int'l, Inc., 399 F.3d 181, 196–97 (3d Cir. 2005) (citing United States v. Brown Univ., 5 F.3d 658, 669 (3d Cir. 1993)).

[65] In their amicus brief on the merits, the FTC and the DOJ argued that Trinko's complaint failed to allege exclusionary conduct because it did not explain how Verizon's failure to assist rivals "would not make business sense apart from the effect on competition, the pertinent standard here." Brief for the United States and the Federal Trade Commission as Amici Curiae Supporting Petitioner, Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP, No. 02-682, at 7–8 (May 2003) [hereinafter DOJ & FTC, *Trinko* Amicus Brief].

[66] Pate Statement, at 3; *see also* Werden, *No Economic Sense Test*, at 472–73.

[67] Werden, *No Economic Sense Test*, at 416–17.

[68] Pate Statement, at 8 (stating "while the [no economic sense] test will lead to some false negatives, this criticism has more purchase in the seminar room than in the real world").

[69] *See, e.g.*, Jonathan M. Jacobson & Scott A. Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*, 73 ANTITRUST L.J. 779, 780–81 (2006) [hereinafter Jacobson & Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*]; Steven C. Salop, Statement at AMC Exclusionary Conduct Hearing, at 16–17 (Sept. 29, 2005) [hereinafter Salop Statement]; Pitofsky Statement, at 5–6.

[70] Pitofsky Statement, at 4.

[71] See Jacobson & Sher, "*No Economic Sense" Makes No Sense for Exclusive Dealing*, at 781.

[72] *Id.*

[73] See HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE & EXECUTION 152 (2006) [hereinafter HOVENKAMP, ANTITRUST ENTERPRISE].

74 *Aspen Skiing*, 472 U.S. at 610–11.

75 A. Douglas Melamed, *Exclusionary Conduct Under the Antitrust Laws: Balancing, Sacrifice, and Refusals to Deal*, 20 Berkeley Tech. L.J. 1247, 1255 (2005) [hereinafter Melamed, *Exclusionary Conduct Under the Antitrust Laws*].

76 *See* A. Douglas Melamed, *Exclusive Dealing Agreements and Other Exclusionary Conduct—Are There Unifying Principles?*, 73 Antitrust L.J. 375, 389–403 (2006) [hereinafter Melamed, *Exclusive Dealing Agreements*].

77 Melamed, *Exclusionary Conduct Under the Antitrust Laws*, at 1258.

78 Hovenkamp, Antitrust Enterprise, at 152.

79 *Id.*; *see also* ABA Comments re Exclusionary Conduct, at 10 (short-run profit sacrifice cannot be sufficient to find conduct exclusionary, because that would capture procompetitive conduct, such as R&D or purchasing capital equipment, and would thus overdeter procompetitive conduct).

80 Hovenkamp, Antitrust Enterprise, at 152.

81 *Id.*

82 Posner, Antitrust Law, at 194–95.

83 Hovenkamp, Antitrust Enterprise, at 153 ("[D]efinition works well much of the time and occasionally provides the best analytic tool for determining whether a practice is anticompetitive.").

84 *Id.*

85 ABA Comments re Exclusionary Conduct, at 11–12.

86 *Id.* at 11.

87 *See* Part 3.C.1 of this Section (discussing bundled discounts).

88 *See Microsoft*, 253 F.3d at 58–59. The use of a balancing test in evaluating Section 2 claims is not new. For example, the FTC had already used a similar test in 1980. *In re* E. I. DuPont de Nemours & Co., 96 F.T.C. 653 (1980) (stating that "a balancing approach, which takes due account of rational, efficiency related conduct, is best suited to the task at hand").

89 *Microsoft*, 253 F.3d at 58.

90 *Id.* at 59; *see also Eastman Kodak*, 504 U.S. at 483 (once plaintiff makes out a prima facie case, "liability turns, then, on whether 'valid business reasons' can explain [the defendant's] actions") (citing *Aspen Skiing*, 472 U.S. at 605).

91 *Microsoft*, 253 F.3d at 59.

92 Jacobson & Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*, at 800; Pitofsky Statement, at 5–6. The FTC endorsed this test in evaluating the type of conduct at issue in *Rambus*, while specifically rejecting the "profit sacrifice" (or "no economic sense") test to evaluate such conduct. Opinion of the Commission, *In re* Rambus Inc., FTC Docket No. 9302, at 30–31 (Aug. 2, 2006) (noting that the "no economic sense" test may be appropriate in some Section 2 cases "where the risk of interfering with vigorous competitive activity is heightened," but that it is inappropriate when evaluating the type of conduct engaged in by Rambus).

93 Jacobson & Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*, at 800–01; Pitofsky Statement, at 5–6.

94 Melamed, *Exclusionary Conduct Under the Antitrust Laws*, at 1257.

95 Salop Statement, at 16–17; Jacobson & Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*, at 790–93.

96 *See* Shapiro Statement re Exclusionary Conduct, at 2–3 (defining "legitimate competition" as that which "benefits consumers"); Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal—Why* Aspen *and* Kodak *Are Misguided*, 68 Antitrust L.J. 659, 671 (2001) [hereinafter Carlton, *Why*

Aspen *and* Kodak *Are Misguided*] ("The key issue is whether one can distinguish when these theories imply a harm to competition as distinct from a harm to a rival.").

[97] *See* M.S. Popofsky, *Defining Exclusionary Conduct*, at 437; *see also* Exclusionary Conduct Trans. at 158–59 (Pitofsky); Shapiro Statement re Exclusionary Conduct, at 3.

[98] Bundled products sold only as a package are known as "pure" bundles; bundled products also sold separately are termed "mixed" bundles. *See, e.g.*, David S. Evans & Michael Salinger, *Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law*, 22 Yale J. on Reg. 37, 54 (2005) [hereinafter Evans & Salinger, *Why Do Firms Bundle and Tie?*]. One commentator has adopted the terms "forced" bundling and "optional" bundling. *See* Barry J. Nalebuff, *Bundling as a Way to Leverage Monopoly*, at 4 (Yale School of Management Working Paper ES-36, Sept. 1, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586648.

[99] LePage's Inc. v. 3M Co., 324 F.3d 141 (3d Cir. 2003) (en banc); SmithKline Corp. v. Eli Lilly & Co., 427 F. Supp. 1089 (E.D. Pa. 1976), *aff'd*, 575 F.2d 1056 (3d Cir. 1977); Virgin Atl. Airways Ltd. v. British Airways, PLC, 69 F. Supp. 2d 571 (S.D.N.Y. 1999); Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455 (S.D.N.Y. 1996).

[100] *LePage's*, 324 F.3d at 169.

[101] Evans & Salinger, *Why Do Firms Bundle and Tie?*, at 89; Prof. Timothy J. Muris, Statement at AMC Exclusionary Conduct Hearing, at 2 (Sept. 29, 2005) (Public Comment Regarding Bundling Submitted to AMC on Behalf of USTelecom, July 15, 2005) [hereinafter Muris Statement re Exclusionary Conduct] ("The use of bundles to sell goods or services . . . is ubiquitous throughout the American economy.").

[102] Pitofsky Statement, at 7; Muris Statement re Exclusionary Conduct, at 2 (citing Thomas T. Nagle & Reed K. Holden, The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making 244–45 (3d ed. 2002)).

[103] *See generally* Evans & Salinger, *Why Do Firms Bundle and Tie?*, at 40–41.

[104] *See* David S. Evans & A. Jorge Padilla, *Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach*, 72 U. Chi. L. Rev. 73, 90 (2005); *see also* Daniel A. Crane, *Multiproduct Discounting: A Myth of Nonprice Predation*, 72 U. Chi. L. Rev. 27, 39–43 (2005).

[105] *See* Business Roundtable, Public Comments Submitted to AMC, at 25 (Nov. 4, 2005) [hereinafter Business Roundtable Comments]. *But see* Willard K. Tom, Statement at AMC Exclusionary Conduct Hearing, at 6 (Sept. 29, 2005) [hereinafter Tom Statement].

[106] Muris Statement re Exclusionary Conduct, at 4.

[107] *Id.*

[108] *See id.* at 3–4.

[109] *Id.* at 2.

[110] Exclusionary Conduct Trans. at 110 (Pitofsky).

[111] *See* Evans & Salinger, *Why Do Firms Bundle and Tie?*, at 41–42; Muris Statement re Exclusionary Conduct, at 2; Exclusionary Conduct Trans. at 102 (Muris).

[112] *See* Shapiro Statement re Exclusionary Conduct, at 17–18 ("One can construct economic models in which a dominant firm selling multiple products can profitably employ multi-product discounts to drive its smaller rivals from the market and then recoup those discounts in the form of higher prices."). *But see* Muris Statement re Exclusionary Conduct, at 16–17 (discussing shortcomings of models that purport to show that bundling can produce harms); *id.* at 22 ("Empirical support for the anticompetitive hypothesis is virtually nonexistent.").

[113] *See* Muris Statement re Exclusionary Conduct, at 12–18; Daniel Rubinfeld, *3M's Bundled Rebates: An Economic Perspective*, 72 U. Chi. L. Rev. 243, 254–61 (2005) [hereinafter Rubinfeld, *Bundled Rebates*].

[114] Muris Statement re Exclusionary Conduct, at 12; Rubinfeld, *Bundled Rebates*, at 254–56.

[115] Muris Statement re Exclusionary Conduct, at 12.

[116] *Id.*

[117] *Id.* at 14.

[118] *Id.* This theory relies on the "one monopoly rent" theory not applying to the behavior. *See* Patrick Greenlee et al., *An Antitrust Analysis of Bundled Loyalty Discounts*, at 12 (Economic Analysis Group Discussion Paper EAG 04-13, Oct. 2004), *available at* http://papers.ssrn.com/soL3/papers.cfm?abstract_id=600799; *see also* Salop Statement, at 3 (listing circumstances in which one monopoly rent, or "single monopoly profit" (SMP) does not apply).

[119] *See* Rubinfeld, *Bundled Rebates*, at 256–58; Muris Statement re Exclusionary Conduct, at 16.

[120] *LePage's*, 324 F.3d at 144–45. The six product lines were: Health Care Products, Home Care Products, Home Improvement Products, Stationery Products (including transparent tape), Retail Auto Products, and Leisure Time. *Id.* at 154.

[121] *See id.* at 171 (Greenberg, J., dissenting); *see also* Joanna Warren, LePage's v. 3M*: An Antitrust Analysis of Loyalty Rebates*, 79 N.Y.U. L. Rev. 1605, 1614 (2004).

[122] *See LePage's*, 324 F.3d at 170–71 (Greenberg, J., dissenting).

[123] *See id.* at 147 & n.5.

[124] *Id.* at 152.

[125] *Id.* at 164.

[126] *Id.* at 155.

[127] *Id.* at 161–62.

[128] Rubinfeld, *Bundled Rebates*, at 262.

[129] *Ortho*, 920 F. Supp. at 465.

[130] *See, e.g.*, Muris Statement re Exclusionary Conduct, at 10 ("The Third Circuit did not require LePage's to prove that it could make tape as efficiently as 3M . . . ."); Pate Statement, at 14; *see also* Business Roundtable Comments, at 25.

[131] Rubinfeld, *Bundled Rebates*, at 248.

[132] *See, e.g.*, Muris Statement re Exclusionary Conduct, at 10 ("The Third Circuit did not require LePage's to prove . . . that 3M's conduct would have excluded a hypothetical equally efficient competitor."); Pate Statement, at 14.

[133] Rubinfeld, *Bundled Rebates*, at 249.

[134] *See* Muris Statement re Exclusionary Conduct, at 11–12; Pate Statement, at 15–16; Business Roundtable Comments, at 24. *But see* American Antitrust Institute, Public Comments Submitted to AMC Regarding Exclusionary Conduct, at 25 (July 15, 2005) [hereinafter AAI Comments re Exclusionary Conduct] (concluding that the outcome in *LePage's* was "reasonable and predictable").

[135] Business Roundtable Comments, at 24. *See, e.g.*, Crane, *Multiproduct Discounting*, at 38–48; Richard A. Epstein, *Monopoly Dominance or Level Playing Field? The New Antitrust Paradox*, 72 U. Chi. L. Rev. 49, 68–71 (2005); Rubinfeld, *Bundled Rebates*, at 254–62.

[136] *See* Pitofsky Statement, at 2; *id.* at 8 & n.12 (citing SmithKline v. Eli Lilly, 575 F.2d 1056 (3d Cir. 1978); *Ortho*, 920 F. Supp. 455 (S.D.N.Y. 1996); *LePage's*, 324 F.3d 141 (3d Cir. 2003)).

[137] *See* Exclusionary Conduct Trans. at 39 (Tom); Muris Statement re Exclusionary Conduct, at 23–27; Exclusionary Conduct Trans. at 52 (Popofsky); *id.* at 110–11 (Pitofsky); Shapiro Statement re Exclusionary Conduct, at 18; Business Roundtable Comments, at 24–25; International Bar Association, Antitrust and Trade Law Section, Public Comments Submitted to AMC, at 19 (Sept. 26, 2005) [hereinafter IBA Comments]. Professor Salop expressed concern that monopolists could circumvent a cost-based test by manipulating the benchmark against which such a test was applied. *See* Exclusionary Conduct Trans.

at 72. Nonetheless, he seemed to endorse such a test as a matter of theory. *See id.*; *see also id.* at 81–82 (Salop).

[138] *Ortho*, 920 F. Supp. at 466.

[139] *See* Pate Statement, at 17 (price-cost test should operate as a necessary but not sufficient condition for liability); Shapiro Statement re Exclusionary Conduct, at 18.

[140] Shapiro Statement re Exclusionary Conduct, at 18; Muris Statement re Exclusionary Conduct, at 20–21; Tom Statement, at 8–9 (endorsing the requirement that the market from which a rival is purportedly excluded be characterized by economies of scale that prevent reentry). Some also have suggested that courts require an additional showing that the purportedly excluded rival could not rationally match the challenged discounts, or that courts allow defendants to adduce proof that the bundle produces benefits not reflected in the defendant's production costs. *See, e.g.*, IBA Comments, at 20–21 (courts should also ask whether the injured rival can rationally match the challenged discounts); *see also* Muris Statement re Exclusionary Conduct, at 17 (explaining that bundling that seems to exclude an equally efficient rival may in fact be a means of reducing transaction costs).

[141] *See* Shapiro Statement re Exclusionary Conduct, at 18; IBA Comments, at 18–19; *see also* M. Laurence Popofsky, Statement at AMC Exclusionary Conduct Hearing, at 11–13 (Sept. 29, 2005).

[142] *See Virgin Atlantic*, 69 F. Supp. 2d at 580 n.8 (describing *Ortho* as holding "that there would be an antitrust violation if the competitive product in the bundle were sold for a price below average variable cost after the discounts on the monopoly items in the bundle were subtracted from the price of that competitive product") (citing *Ortho*, 920 F. Supp. at 467–69).

[143] *See* Shapiro Statement re Exclusionary Conduct, at 18; Tom Statement, at 9.

[144] *See* Muris Statement re Exclusionary Conduct, at 23 (citing PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 749 (2005 Supp.)).

[145] *See* Muris Statement re Exclusionary Conduct, at 13, 20–27. Under this approach, courts would "allow bundled discounts as long as the price of the bundle exceeds the sum of the separate costs of the constituent elements. Put another way, if the total price of the bundle exceeds the total cost of its constituents (taking into account the efficiencies directly attributable to bundling), the firm has not engaged in predatory bundling." *Id.* at 13.

[146] *See id.* at 24.

[147] Exclusionary Conduct Trans. at 60–61 (Salop).

[148] *See id.* at 110–11 (Pitofsky).

[149] Muris Statement re Exclusionary Conduct, at 24 (citing PHILLIP E. AREEDA & HERBERT HOVENKAMP, III ANTITRUST LAW, ¶ 749, at 184).

[150] Upon the Court's invitation to express the views of the United States, the Solicitor General recommended that the Court deny certiorari in *LePage's*. Brief for the United States as Amicus Curiae on Petition for Writ of Certiorari, 3M Co. v. LePage's Inc., No. 02-1865, at 19 (May 2004) (stating that "at this juncture, it would be preferable to allow the case law and economic analysis to develop further and to await a case with a record better adapted to development of an appropriate standard").

[151] Salop Statement, at 5 ("Entry by higher cost (even clearly less efficient) competitors can provide competition to a monopolist and cause prices to fall and output to rise, which increases consumer welfare and allocative efficiency.").

[152] *See id.*

[153] *See, e.g.*, Shapiro Statement re Exclusionary Conduct, at 18.

[154] *Id.*

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

[156] *Id.* at 470 (quoting Buffalo Courier-Express, Inc. v. Buffalo Evening News, Inc., 601 F.2d 48, 58 (2d Cir. 1979)).

[157] The recommended three-part test is proposed here for challenges to bundled *pricing* practices, and its purpose, as the text explains, is to avoid deterring procompetitive price reductions. The Commission is not recommending application of this test outside the bundled pricing context, for example in tying or exclusive dealing cases. The Commission did not undertake to study tying and exclusive dealing issues more generally.

[158] United States v. Colgate & Co., 250 U.S. 300, 307 (1919).

[159] *Trinko*, 540 U.S. at 407–09.

[160] *Id.* at 409.

[161] *See* Exclusionary Conduct Trans. at 161 (Pitofsky); Glazer Statement, at 4; Rule Statement re Exclusionary Conduct, at 16–17 (refusals to deal should be lawful per se); Shapiro Statement re Exclusionary Conduct, at 13–16 (advocating per se legality except where there has been a prior course of dealing); *see also* Exclusionary Conduct Trans. at 157–58 (Pate) (appearing to endorse rule of per se legality for refusals to deal even when there has been a prior course of dealing).

[162] *Trinko*, 540 U.S. at 407–08.

[163] *See id.* at 407 ("The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place."); *see also* Shapiro Statement re Exclusionary Conduct, at 12.

[164] *See* Rule Statement re Exclusionary Conduct, at 17 (investment in "development and deployment of technological innovation should be viewed as an efficiency justification, and never a threat to consumer welfare"); Shapiro Statement re Exclusionary Conduct, at 4 (advocating the use of a safe harbor for investment in "new and superior production capacity" and "unadorned product improvement").

[165] Shapiro Statement re Exclusionary Conduct, at 11; Herbert Hovenkamp, Federal Antitrust Policy, § 7.5b (3d ed. 2005) (forced sharing "undermines the competitive market process of forcing firms to develop their own sources of supply"); *Trinko*, 540 U.S. at 408; DOJ & FTC, *Trinko* Amicus Brief, at 17 ("A firm that has the right to utilize an input from an incumbent—or that can claim that right through litigation—may have a reduced financial incentive to develop the input itself.").

[166] Shapiro Statement re Exclusionary Conduct, at 12; Rule Statement re Exclusionary Conduct, at 14; *see Trinko*, 540 U.S. at 408 ("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."); *see also* AT&T v. Iowa Utils. Bd., 525 U.S. 366, 428 (1999) (Breyer, J., concurring in part and dissenting in part) ("Even the simplest kind of compelled sharing, say, requiring a railroad to share bridges, tunnels, or track, means that someone must oversee the terms and conditions of that sharing.").

[167] Shapiro Statement re Exclusionary Conduct, at 11–12; Rule Statement re Exclusionary Conduct, at 14.

[168] Shapiro Statement re Exclusionary Conduct, at 11.

[169] *Trinko*, 540 U.S. at 408.

[170] *See* Carlton, *Why* Aspen *and* Kodak *Are Misguided*, at 676–78.

[171] *Trinko*, 540 U.S. at 409–10.

[172] *See* Salop Statement, at 5.

[173] *See id.* at 2, 5–6.

[174] *See id.* at 7 ("[T]he integrated firm generally should be entitled to earn a return on input sales commensurate with whatever market power it has achieved legitimately. A return on this investment in the input technology also may be needed to maintain adequate investment incentives."); *see also* Shapiro Statement re Exclusionary Conduct, at 12; Glazer Statement, at 5.

[175] Salop Statement, at 7.

[176] *See id.* at 6–7.

[177] *See, e.g.*, Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines, § 4 (1992, revised 1997); Capital Imaging Assocs., P.C. v. Mohawk Valley Med. Assocs., Inc., 996 F.2d 537, 543 (2d Cir. 1993) ("Ultimately it remains for the factfinder to weigh the harms and benefits of the challenged behavior.").

[178] *See* Pate Statement, at 10-12; Melamed, *Exclusive Dealing Agreements*, at 387 (A "static market-wide balancing test . . . would still pose a daunting challenge to any decision maker and would place a costly and often impossible burden on the defendant when deciding in real time how to conduct its business.").

[179] *See* Pate Statement, at 3, 8–12 (arguing that courts can readily administer the "no economic sense" test, and it is easier to administer than the "consumer welfare effects" test); Shapiro Statement re Exclusionary Conduct, at 12 (experience with regulation "makes me doubt that the courts are well placed to control unconditional refusals to deal by imposing price caps and regulating the terms on which dominant firms deal.").

[180] *See generally* Pate Statement, at 10.

[181] *See id.* at 2–12 (defending the "no economic sense" test and criticizing the "consumer welfare effects" test); Melamed, *Exclusive Dealing Agreements*, at 376, 411–12 (advocating the "profit sacrifice" test for all Section 2 claims); Werden, *No Economic Sense Test*, at 415–22. Moreover, the DOJ and the FTC recently advocated such a test in an amicus brief filed in the *Trinko* case. *See* DOJ & FTC, Trinko Amicus Brief, at 7, 15–20.

[182] *See* Exclusionary Conduct Trans. at 163–64 (Pate).

[183] Melamed, *Exclusive Dealing Agreements*, at 391 (the "sacrifice" or "no economic sense" test includes an inquiry into whether the conduct does or will in fact protect or enhance a firm's monopoly power); *see* DOJ & FTC, *Trinko* Amicus Brief, at 14 ("A *sine qua non* for any claim of monopolization or attempted monopolization is conduct that 'reasonably appear[s] capable of making a significant contribution to creating or maintaining monopoly power.'" (quoting III PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW, ¶ 651F, at 83–84)); *see also* United States Telecom Association, Public Comments Submitted to AMC Regarding Refusals to Deal, at 11 (July 15, 2005) [hereinafter USTA Comments re Refusals to Deal] (endorsing requirement of proof of harm as part of a "no economic sense" test); John E. Lopatka & William H. Page, *Monopolization, Innovation, and Consumer Welfare*, 69 GEO. WASH. L. REV. 367, 387–92 (2001) (arguing that proof of actual consumer harm should be a necessary condition for establishing a violation of Section 2); Timothy J. Muris, *The FTC and the Law of Monopolization*, 67 ANTITRUST L.J. 693 (2000) (contending that proof of actual anticompetitive effect should be a *sine qua non* of any Section 2 case); *cf. Brooke Group*, 509 U.S. at 224–26 (holding that some prospect of recoupment is a necessary element of predatory pricing claim, without regard to apparent rationality (or not) of the defendant's pricing).

[184] *See* Melamed, *Exclusive Dealing Agreements*, at 389–90; USTA Comments re Refusals to Deal, at 10–12; IBA Comments, at 10–11; *see also* DOJ & FTC, *Trinko* Amicus Brief, at 15–20; *cf.* AAI Comments re Exclusionary Conduct, at 15–16 (absence of legitimate business justification as a necessary condition for refusal-to-deal liability).

[185] *See, e.g.*, Pate Statement, at 2; *see also* DOJ & FTC, *Trinko* Amicus Brief, at 7, 15–20.

[186] *See, e.g.*, Exclusionary Conduct Trans. at 27–30 (Rule); M.S. Popofsky, *Defining Exclusionary Conduct*, at 464; *see also* Steven C. Salop, 73 ANTITRUST L.J. 311, 373 (2006).

[187] *See* Glazer Statement, at 1.

[188] *Id.* at 1–2.

[189] *See id.* at 2.

[190] *See id.*

191 *See id.* at 4.

192 *See id.* at 6–7 (citing Lorain Journal Co. v. United States, 342 U.S. 143 (1951); United States v. Dentsply Int'l, Inc., 399 F.3d 181 (3d Cir. 2005)).

193 Glazer Statement, at 7.

194 *Id.* at 8.

195 *Id.*

196 *Id.*

197 *Id.* at 9.

198 *Id.*

199 *Id.*

200 *Id.* at 9–10.

201 *See id.*

202 Illinois Tool Works, Inc. v. Independent Ink, Inc., 126 S. Ct. 1281 (2006), *rev'g* 396 F.3d 1342 (Fed. Cir. 2005).

203 *Id.* at 1293.

204 International Salt Co. v. United States, 332 U.S. 392 (1947).

205 *Illinois Tool Works*, 126 S. Ct. at 1288–89.

206 *Id.* at 1289 (quoting United States v. Columbia Steel Co., 334 U.S. 495, 522–23 (1948)).

207 *Illinois Tool Works*, 126 S. Ct. at 1290.

208 *Id.*

209 *Id.* at 1291.

210 *Id.* at 1291 n.4, 1292.

211 *Id.* (quoting Dep't of Justice & Federal Trade Comm'n, Guidelines for the Licensing of Intellectual Property, § 2.2 (1995)).

212 New Economy Trans. at 38 (witnesses appeared "unanimous in saying that the mere fact that you have a patent shouldn't give the presumption of market power"); *see also* James J. O'Connell, Statement at AMC New Economy Hearing, at 3 (Nov. 8, 2005) ("[T]here should not be a presumption of market power in tying cases when there is a patent.") (citing Brief for the United States as Amicus Curiae Supporting Petitioners, Illinois Tool Works Inc. v. Independent Ink, Inc., No. 04-1329, *cert. granted*, 73 U.S.L.W. 3729 (June 21, 2005)); Carl Shapiro, Statement at AMC New Economy Hearing, at 7–8 (Nov. 8, 2005) ("[m]any patents are "of limited commercial significance" and "many copyrights merely allow their owners to differentiate their products" from others); Richard J. Gilbert, Statement at AMC New Economy Hearing, at 10 (Nov. 8, 2005) ("There should be no presumption that a patent or copyright is a source of market power in tying cases or in other antitrust contexts.").

213 *See* Motion Picture Association of America, Inc., Public Comments Submitted to AMC, at 3–4 (July 15, 2005) (stating that "[t]he great weight of analysis and opinion" opposes the presumption, citing numerous authorities); American Intellectual Property Law Association, Public Comments Submitted to AMC, at 1–3 (July 25, 2005) (urging that this Commission recommend congressional action to eliminate the presumption if the Supreme Court does not do so); Computer & Communications Industry Association, Public Comments Submitted to AMC Regarding New Economy, at 12 (July 20, 2005) (a presumption is "unnecessary").

Chapter I.D
Antitrust and Patents

1. INTRODUCTION

Patents have played an important role in the innovation that has enabled the United States to become "the world's preeminent technological and economic superpower."[1] Patents "are granted on the assumption that, although firms and individuals have many incentives to invent and create, some innovations are less likely to be forthcoming in the absence of a grant of exclusive rights providing an opportunity to recoup initial investments while excluding imitators."[2]

A number of issues relating to how antitrust law evaluates conduct and transactions involving patents were proposed to the Commission for study. Several issues were not ripe for resolution by this Commission due to recent congressional action or ongoing litigation about the issue.[3] Accordingly, the Commission did not undertake a comprehensive survey of the interaction between antitrust and patent law and policy.

The Commission studied some of these issues, however, which are discussed in other sections of this Report. For example, Chapter I.B proposes that, in merger analysis, the agencies take a flexible approach to the two-year time horizon generally used in assessing the likely competitive impact of new entry, and give greater weight to research-and-development-related efficiencies. These recommendations address how the effect of innovation should be assessed in a dynamic competitive analysis. Chapter I.C discusses the Commission's recommendation that market power should not be presumed from a patent, copyright, or trademark.

This Section of the Report discusses two additional issues involving competition and patents. The first addresses a situation in which members of a standard-setting organization (SSO) may need to pay higher royalties to license a patent *after* SSO members have chosen a standard covered by that patent than they would have *before* the standard was chosen. SSO members may take a range of approaches to mitigate this possibility, including possible joint negotiation of licensing terms before patented technology is adopted as a standard. Some SSOs apparently have avoided joint negotiations with patent holders out of concern that the conduct would be considered a per se unlawful violation of the Sherman Act.[4]

Joint negotiations between SSO members and patent holders, without more, may be reasonably necessary in the circumstances to ensure that SSO members obtain reasonable patent licensing terms. At the same time, joint negotiations carry a risk of anticompetitive conduct, so they should be subject to antitrust scrutiny. Accordingly, without intending to endorse any particular approach by SSOs, the Commission makes the following recommendation.

20. Joint negotiations with intellectual property owners by members of a standard-setting organization with respect to royalties prior to the establishment of the standard, without more, should be evaluated under the rule of reason.*

The second issue involves the relationship between the patent system and competition. Patents and patent law play an important role in the property rights regime essential to a well-functioning competitive economy. Properly applied, patent and antitrust laws are complementary, as both are aimed at encouraging innovation, industry, and competition. As discussed in Chapter I.A, the courts and antitrust agencies in recent decades have developed a more sophisticated understanding of how certain business arrangements involving patents can benefit innovation and competition and have taken such potential procompetitive effects into account.

Just as the proper application of antitrust law is important to holders of patents, how well the patent system operates matters for competition. Patents on obvious subject matter, for example, may impede competition without the offsetting benefits of rewarding innovation. Recent reports from the Federal Trade Commission (FTC)[5] and the National Academy of Sciences (NAS),[6] as well as recent cases in which the Supreme Court has granted certiorari,[7] have raised questions about whether the patent system is functioning as well as it should. Given the importance of proper operation of the patent system to free-market competition, the Commission makes the following recommendations.

* Commissioner Delrahim does not join this recommendation.
Commission Garza joins this recommendation with qualifications.

21. **Congress should seriously consider recommendations in the Federal Trade Commission and National Academy of Sciences reports with the goal of encouraging innovation and at the same time avoiding abuse of the patent system that, on balance, will likely deter innovation and unreasonably restrain competition.* In particular:**

21a. **Congress should seriously consider the Federal Trade Commission and National Academy of Sciences recommendations targeted at ensuring the quality of patents.†**

21b. **Congress should ensure that the Patent and Trademark Office is adequately equipped to handle the burden of reviewing patent applications with due care and attention within a reasonable time period.**

22. **The courts and the Patent and Trademark Office should avoid an overly lax application of the obviousness standard that allows patents on obvious subject matter and thus harms competition and innovation.**

2. NEGOTIATIONS OF PATENT ROYALTIES BY MEMBERS OF STANDARD-SETTING ORGANIZATIONS

A. Background

Collaborative standard setting can produce many procompetitive benefits. Particularly in high-technology industries, collaborative standard setting is ubiquitous as a means to achieve interoperability among a variety of products. Interoperability typically requires agreement on a technical standard that all manufacturers will use in producing their products. Agreement on a standard that achieves interoperability can increase competition, innovation, and output, as well as significantly reduce costs to manufacturers and consumers.

In many circumstances, particularly in technology-intensive industries, the implementation of a technical standard will require firms to obtain licenses to patents that cover the technology chosen as the standard. Before the standard is chosen, patent holders may compete to have a technology that their patents cover chosen as the standard. As part of that

* Commissioners Delrahim and Kempf do not join this recommendation.
Commissioner Garza joins this recommendation with qualifications.

† Commissioners Delrahim and Kempf do not join this recommendation.

competition, they may offer reasonable patent royalties and other licensing terms. Once the standard has been chosen, however, patent holders may believe they can obtain much higher royalty rates and more restrictive licensing terms. At that point, members of the SSO may already have begun designing, testing, and producing goods that conform to the standard. Competition may not operate as a significant constraint on patent holders' demands in such circumstances because the members of the SSO may find it much too expensive and time-consuming to develop a new standard around a different technology. The higher royalties paid by members of an SSO in such circumstances might be passed on to consumers of the ultimate product.[8]

Some SSOs have adopted various practices to reduce the risk of unexpectedly high licensing demands from a patent holder once a standard has been chosen. For example, some SSOs require members to disclose patents that would cover a technology under consideration as a standard and to promise to license any such patents on "reasonable and nondiscriminatory" terms.[9] Other organizations have pursued alternative approaches. For example, VITA, a non-profit standards development organization, recently sought review by the Antitrust Division of the Department of Justice (DOJ) of a proposed policy requiring participants in VITA's standard-setting process to "disclose patents that are essential to implement a new standard and declare the most restrictive licensing terms that will be required to license any such patents."[10] Under this proposed plan, the patent holder and each prospective licensee will negotiate separately, "subject only to the restrictions imposed by the patent holder's unilateral declaration of its most restrictive terms."[11] The DOJ concluded that "[i]mplementation of the proposed policy should preserve, not restrict, competition among patent holders."[12] Among other things, the DOJ noted that, "[u]nless the standard-setting process is used as a sham to cloak naked price-fixing or bid-rigging, the Department analyzes action during the standard-setting process under the rule of reason."[13]

B. Recommendation and Findings

20. Joint negotiations with intellectual property owners by members of a standard-setting organization with respect to royalties prior to the establishment of the standard, without more, should be evaluated under the rule of reason.*

Members of some SSOs may wish *jointly* to negotiate with patent holders about patent licensing terms before the members select a standard. Such joint negotiations would carry antitrust risk, of course. One antitrust concern would be that members of the SSO might cross the line from discussing royalty rates for licensing patents they need to discussing prices for products they will sell, a per se violation of Section 1 of the Sherman Act.[14] Another concern would arise if the members of an SSO jointly possess monopsony power[15] and can force patent holders to offer royalty rates below a reasonable level, leading innovators to respond by reducing new investments in research and development.[16]

Depending on the circumstances, joint negotiations can also offer sufficient potential procompetitive benefits to merit examination under the rule of reason, however. Joint negotiations can allow members of an SSO to obtain reasonable licensing terms from patent holders, which can lead to lower marginal costs for the standardized product and lower consumer prices.[17] By eliminating a potential threat of demands for unreasonably high royalty rates from patent holders, joint royalty negotiations might also facilitate a more timely and efficient development of standards and reduce the need for litigation to resolve issues of patent royalties and other licensing terms.[18]

For these reasons, both the Chairman of the FTC and the Assistant Attorney General for Antitrust at the DOJ have stated the FTC and the DOJ likely would evaluate such joint negotiations under the rule of reason.[19] The Commission agrees.

* Commissioner Delrahim does not join this recommendation for the reasons set forth in his separate statement.

Commissioner Garza joins this recommendation insofar as it simply recommends general rule of reason treatment for the legitimate activities of standard-setting organizations, including the joint negotiation of licensing terms before a particular standard is selected. It is critical to note, however, that the Commission is not recommending that such joint negotiation is a preferred approach under the antitrust laws or a necessary one to avoid "hold up" issues. Issues relating to the adoption of an industry standard are complex. This recommendation should be taken as a starting point for analysis.

3. THE RELATIONSHIP BETWEEN COMPETITION AND PATENT LAW

The patent laws encourage invention by granting to those who develop new, useful, and nonobvious inventions the exclusive right to practice their inventions for a period of years. Patents and patent law play an important role in the property rights regime essential to a well-functioning competitive economy.

Just as the proper application of antitrust law is important to patent holders, so the proper application of patent law is important to maintaining effective free-market competition. The U.S. patent laws express "a careful balance between the need to promote innovation and the recognition that imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy."[20] Patents on obvious subject matter, for example, may impede competition without the offsetting benefits of rewarding innovation. As the Supreme Court has explained, "[t]aken together, the novelty and nonobviousness requirements [to obtain a patent] express a congressional determination that the purposes behind the Patent Clause [of the U.S. Constitution] are best served by free competition and exploitation of either that which is already available to the public or that which may be readily discerned from publicly available material."[21]

Recent reports from the FTC and the NAS have raised questions about whether the patent system is functioning as well as it should.[22] In recent years, bills have been introduced in Congress to address some of the concerns that have been raised.[23] In addition, the Supreme Court has granted certiorari and heard oral arguments in *KSR International Co. v. Teleflex, Inc.*, a case that presents the issue whether the Federal Circuit's test for nonobviousness is sufficiently rigorous to screen out obvious patents.[24] In an amicus brief urging the Supreme Court to grant certiorari in that case, the Solicitor General stated that the Federal Circuit's approach to the non-obviousness inquiry "unnecessarily sustains patents that would otherwise be subject to invalidation as obvious."[25] The brief explained the "extension of patent rights to obvious combinations of familiar elements retards, rather than advances, new discoveries."[26]

The Director of the U.S. Patent and Trademark Office (PTO) and Under Secretary of Commerce for Intellectual Property, Jon Dudas, has reported that a record 440,000 patent applications were filed in 2006 and "the volume of patent applications continues to outpace our capacity to examine them."[27] Moreover, he noted that the PTO currently has "a pending application backlog of historic proportions."[28] To meet this challenge, the PTO has introduced new ways to improve the speed of its patent examinations, as well as the quality of its review of patent applications[29] and Congress has appropriated funds for the hiring of more examiners.[30] Nonetheless, the steadily increasing numbers of patent applications each year—in 2006 about 100,000 more patent applications were filed than in 2001—continue to raise concerns that the PTO receive the resources it needs to do its job properly.

Because the proper operation of the patent system is important to maintaining effective free-market competition, the Commission makes the following recommendations.

21. Congress should seriously consider recommendations in the Federal Trade Commission and National Academy of Sciences reports with the goal of encouraging innovation and at the same time avoiding abuse of the patent system that, on balance, will likely deter innovation and unreasonably restrain competition.* In particular:

21a. Congress should seriously consider the Federal Trade Commission and National Academy of Sciences recommendations targeted at ensuring the quality of patents.†

21b. Congress should ensure that the Patent and Trademark Office is adequately equipped to handle the burden of reviewing patent applications with due care and attention within a reasonable time period.

21c. The courts and the Patent and Trademark Office should avoid an overly lax application of the obviousness standard that allows patents on obvious subject matter and thus harms competition and innovation.

* Commissioners Delrahim and Kempf do not join this recommendation. While they join their fellow Commissioners in urging Congress to consider taking actions that would help ensure the quality of patents, they believe that some of the specific recommendations made by the FTC are not necessarily designed to accomplish that, do not do so, and may well not be helpful in advancing innovation incentives.

Commissioner Garza joins the recommendation to give serious consideration to the recommendations in the FTC and NAS Reports but does not necessarily endorse all of the recommendations.

† Commissioners Delrahim and Kempf do not join this recommendation for the reasons stated in the previous note.

Commissioner Garza joins this recommendation with the reservation expressed in the previous note.

Notes

[1] New Economy Transcript at 102–03 (Pinkos) (Nov. 8, 2005).

[2] National Research Council of the National Academies of Sciences (NAS), Board on Science, Technology, and Economic Policies (STEP), Committee on Intellectual Property Rights in the Knowledge-based Economy, A Patent System for the 21st Century 18–19 (Stephen A. Merrill et al. eds., 2004) [hereinafter NAS-STEP Report].

[3] Congress recently took action in the area of standard setting. *See, e.g.*, Standards Development Organization Advancement Act of 2004, Pub. L. No. 108-237, 118 Stat. 661 (2004). Also, certain issues—such as patent settlements between brand and generic drug manufacturers and alleged abuses of standard-setting processes—are exceedingly fact-specific and are being addressed in the context of ongoing litigation, and perhaps legislation. *See* Opinion of the Commission, *In re* Rambus, Inc., FTC Docket No. 9302 (Aug. 2, 2006) (finding anticompetitive abuse of the standard-setting process); Schering-Plough Corp. v. FTC, 402 F.3d 1056 (11th Cir. 2005) (agreement between brand and generic drug manufacturers), *cert. denied*, 126 S. Ct. 2929 (2006); *In re* Tamoxifen Citrate Antitrust Litig., 466 F.3d 187 (2d Cir. 2006), *petition for cert. filed*, 75 U.S.L.W. 3333 (Dec. 13, 2006) (No. 06-830) (agreement between brand and generic drug manufacturers); *see also* Preserve Access to Affordable Generics Act, S. 316, 110th Cong. (2007) (proposed legislation sponsored by Senators Kohl, Leahy, and others aimed at preventing brand drug companies from compensating generic drug companies for delaying their entry into the market), *available at* http://www.govtrack.us/congress/bill.xpd?bill=s110-316.

[4] Hewlett-Packard Co., Public Comments Submitted to AMC Proposing Issues for Study, at 6–7 (Jan. 5, 2005); Cisco Systems, Inc., Public Comments Submitted to AMC Proposing Issues for Study, at 1–2 (Jan. 7, 2005); Sun Microsystems, Inc., Public Comments Submitted to AMC Proposing Issues for Study, Regarding Ex Ante Disclosure of IPRs, at app. (Sept. 30, 2004). *See generally* Qualcomm Inc., Public Comments Submitted to AMC (Mar. 1, 2007); Sun Microsystems, Inc., Public Comments Submitted to AMC Proposing Issues for Study, Regarding Standard-Setting Processes (Jan. 4, 2005).

[5] Federal Trade Comm'n, To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy (2003) [hereinafter FTC Report].

[6] NAS-STEP Report, at 18–19.

[7] Teleflex, Inc. v. KSR Int'l Co., 2005 WL 23377 (Fed. Cir. Jan. 6, 2005), *cert. granted*, 126 S. Ct. 2965, 2966 (2006) (nonobviousness standard); eBay Inc. v. MercExchange, L.L.C., 126 S. Ct. 1837, 1841 (2006) (standard for injunctive relief); *cf.* Laboratory Corp. of Am. Holdings v. Metabolite Labs., Inc., 126 S. Ct. 2921 (2006) (writ of certiorari denied as improvidently granted); *see id.* at 2921, 2929 (Justice Breyer, joined by Justices Stevens and Souter, dissenting from dismissal of writ of certiorari and arguing that a decision by the Court would "contribute to the important ongoing debate . . . as to whether the patent system, as currently administered and enforced, adequately reflects the 'careful balance' that 'the federal patent laws . . . embody'") (quoting Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141 (1989)).

[8] *Cf.* Deborah Platt Majoras, FTC Chairman, Recognizing the Procompetitive Potential of Royalty Discussions in Standard Setting, Prepared for Standardization and the Law: Developing the Golden Mean for Global Trade, at 8 & n.13 (Sept. 23, 2005) [hereinafter Majoras, Royalty Discussions] (stating that if such royalty rate increases are prevented, "we can generally expect lower royalty rates to lead to lower marginal costs for the standardized product and lower consumer prices").

[9] *See* Mark. A. Lemley, *Intellectual Property Rights and Standard-Setting Organizations*, 90 Cal. L. Rev. 1889, 1906, 1923–27 (2002).

[10] Letter from Thomas O. Barnett, Ass't Att'y Gen., Antitrust Div., Dep't of Justice, to Robert A. Skitol, at 1 (Oct. 30, 2006), *available at* http://www.usdoj.gov/atr/public/busreview/219380.pdf [hereinafter VITA DOJ Business Review Letter].

[11] *Id.* at 9.

[12] *Id.* at 10.

[13] *Id.* at 8.

[14] Majoras, Royalty Discussions, at 10–11; VITA DOJ Business Review Letter, at 9–10 ("Any efforts to reduce competition by using the declaration process as a cover to fix downstream prices of VME products would be a per se violation of section 1 of the Sherman Act, and the Department would not hesitate to condemn such activity.").

[15] *See, e.g.*, Mandeville Is. Farms v. American Crystal Sugar Co., 334 U.S. 219, 242–43 (1948) (finding per se unlawful an agreement among local sugar refiners to set the price at which the refiners would purchase sugar beets). The Supreme Court recently has remarked that "[t]he kinship between monopoly and monopsony suggests that similar legal standards should apply to claims of monopolization and to claims of monopsonization." Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 127 S. Ct. 1069, 1076 (2007).

[16] Majoras, Royalty Discussions, at 7–8; *cf.* VITA DOJ Business Review Letter, at 9 ("The proposed policy should not permit licensees to depress the price of licenses for patented technologies through joint action because it prohibits any joint negotiation or discussion of licensing terms among the working group members or with third parties at all VSO and working group meetings."). *But see* Majoras, Royalty Discussions, at 9–10 (discussing ameliorating factors, such as manufacturers in SSOs recognizing that exercising monopsony power might deter patent holders from joining the SSO, thus preventing manufacturers from obtaining pre-standard-setting disclosures; and that monopsony power might be difficult to exercise when the patent holders themselves are also the manufacturers).

[17] Majoras, Royalty Discussions, at 8 & n.13.

[18] *Id.* at 8 (stating that ex ante discussions could "reduce the extent to which litigation is needed to resolve issues relating to patent and standards").

[19] Majoras, Royalty Discussions, at 7; VITA DOJ Business Review Letter, at 9 n.27.

[20] *Bonito Boats*, 489 U.S. at 146.

[21] *Id.* at 150. The Constitution authorizes Congress "[t]o promote the Progress of Science and useful Arts, by securing for limited Times to . . . Inventors the exclusive Right to their respective . . . Discoveries." U.S. Const. art. I, § 8, cl. 8.

[22] *See generally* FTC Report; NAS-STEP Report.

[23] *See, e.g.*, S. 3818, 109th Cong. (2006); H.R. 2795, 109th Cong. (2005).

[24] *Teleflex*, 2005 WL 23377, *cert. granted*, 126 S. Ct. at 2966; *see also* Brief for the United States as Amicus Curiae, KSR Int'l Co. v. Teleflex, Inc., 2006 WL 1455388 (May 25, 2006) [hereinafter U.S. Amicus Brief]. The Supreme Court granted certiorari on June 26, 2006, and heard oral argument on Nov. 28, 2006. *Teleflex*, 126 S. Ct. at 2966, *argued*, 75 U.S.L.W. 3311 (Nov. 28, 2006); *see also eBay*, 126 S. Ct. at 1841 (addressing issue of which test courts should employ in awarding permanent injunctive relief under the Patent Act).

[25] U.S. Amicus Brief, at *12.

[26] *Id.* at *9. Similarly, the Solicitor General's amicus brief on the merits argued that the Federal Circuit test for nonobviousness "exacts a heavy cost in the form of unwarranted extension of patent protection to obvious subject matter." Brief for the United States as Amicus Curiae Supporting Petitioner, KSR Int'l Co. v. Teleflex, Inc., 2006 WL 2453601, at *10 (Aug. 22, 2006). Some members of the Supreme Court have also recently shown interest in reevaluating what constitutes eligible subject matter. *See* Laboratory Corp. of Am. Holdings v. Metabolite Labs., Inc., 126 S. Ct. 2921, 2925 (2006) (Justice Breyer, joined by Justices Stevens and Souter, argued in a dissent to a dismissal of certiorari as improvidently granted that the Court should address the issue of whether certain patents should be deemed "invalid in light of the 'law of nature' principle.").

[27] Performance and Accountability Report Fiscal Year 2006, U.S. Patent and Trademark Office, Message from the Director, at 2, *available at* http://www.uspto.gov/web/offices/com/annual/2006/200_message_director.html.

[28] *Id.*

[29] For example, the PTO has proposed rule changes "to produce a more focused, higher-quality, and efficient [patent] examination," and "to provide the most relevant information to examiners as early as possible." *Id.* at 3.

[30] Id. at 2.

Chapter II
Enforcement Institutions and Processes

In the United States, in addition to the Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission (FTC), fifty states and the District of Columbia are authorized to enforce federal antitrust laws as *parens patriae*, including in instances where the federal enforcers might have chosen not to challenge a transaction or conduct. Each state also has its own antitrust laws, which generally parallel federal law. In addition, numerous international competition authorities have begun to pursue enforcement much more aggressively, sometimes at odds with U.S. enforcement policies.

Principles of federalism and sovereignty support the authority of these many enforcers. Their existence is not without costs, however. Multiple enforcers may investigate the same conduct or transaction, increasing the burdens on companies and, ultimately, costs to consumers. In addition, different authorities may have divergent views as to how antitrust law should apply to certain types of conduct or mergers. These differences potentially subject companies to a range of different legal obligations, thus either imposing substantial compliance costs or compelling companies to follow the rules of the most restrictive jurisdiction. Multiple enforcers also may seek different remedies with respect to the same conduct or transaction, whether because they view the merits of the conduct or merger differently, or because the applicable law compels a different outcome. All of these differences across antitrust authorities have the potential to impose costs and inefficiencies on companies that may be passed on to consumers.

Of course, antitrust compliance and enforcement will always impose some costs on companies, regardless of the number of enforcers. It is important, however, to ensure that those costs do not overwhelm the benefits of antitrust enforcement or undermine consensus about the value of a strong antitrust enforcement regime. Enforcers should strive to avoid the imposition of unreasonable costs—for example, costs not reasonably justified by legitimate needs to gather further evidence or that could be avoided by coordination with, or deference to, other antitrust enforcers.

The Commission was urged to examine the need for multiple enforcers and the costs that multiple enforcers impose. In particular, it was suggested that the Commission consider whether it is necessary to maintain two federal enforcement agencies—the DOJ and the FTC—to enforce the antitrust laws and whether it is necessary, or even appropriate, for states to enforce federal antitrust law as *parens patriae*. In addition, many commenters expressed concern about international enforcement, including the potential that other jurisdictions might apply their competition laws to discriminate against U.S.-based companies, that international trade might be adversely affected by the policies of other jurisdictions that may be more restrictive than those of the United States, or that other regimes might be more hostile to intellectual property rights.

These important and interrelated questions focus attention directly on the procedural mechanisms used to enforce the antitrust laws. Accordingly, the Commission undertook to study a range of issues relevant to enforcement institutions and processes. The recommendations set forth in this Chapter address: (A) the consequences and costs of having two principal federal antitrust enforcers; (B) the costs of the merger review process used by the FTC and the DOJ pursuant to the Hart-Scott-Rodino Act; (C) the authority of the states independently to enforce federal antitrust laws; and (D) the implementation of mechanisms to enhance international cooperation in antitrust matters and appropriate convergence toward similar procedural and substantive approaches under each nation's antitrust laws.