

Antitrust Modernization Commission Hearings
Summary of Exclusionary Conduct: Refusals to Deal and Bundling and
Loyalty Discounts

September 29, 2005

The Antitrust Modernization Commission (“AMC”) held hearings on September 29, 2005 in order to analyze the issue of exclusionary conduct under § 2 of the Sherman Act. Section 2 of the Sherman Act aims to detect and remedy unilateral conduct that threatens consumers and economic efficiency. The AMC has chosen to study the issue because some believe the statute provides little guidance and results in incorrect application and unpredictability in the courts. In light of these concerns, the AMC heard from two panels of experts including practitioners, scholars, and economists to understand whether certain standards and rules can be adopted to clarify the identification and remediation of harmful unilateral conduct. The hearings primarily focused on assessing standards for refusals to deal and bundling, the status of the Essential Facilities Doctrine, and obtaining recommendations for rules and modifications to be made in order to facilitate proper application of § 2.

Each panelist made recommendations and contributed varied insights, which the Commission appeared to find helpful in its analysis of potential § 2 modernizations. Despite much disagreement over the proper standard for unilateral refusals to deal, and little discussion on the state of the Essential Facilities Doctrine, the session seemed to result in consensus on a few fronts. Most notably, the AMC responded favorably to the following recommendations: adopt FTC safe harbors for bundling; allow the case law to continue to develop in the courts rather than trying to legislate change; clarify the *LePage’s*¹ decision with some kind of objective standard; and further consider the imposition of a single damage remedy under § 2.

I. Summary of Written Testimony From Panel I:

A. Kenneth L. Glazer. In-house lawyer at Coca-Cola Company in Atlanta, Georgia, who works closely with the business people in the company.

Proper analysis under § 2, Ken Glazer argues, turns on recognition and understanding of three key distinctions in exclusionary conduct: excluding versus exploiting, horizontal versus vertical, and coercing versus incentivizing. Of these

¹ *LePage’s Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S.Ct. 2932 (2004). LePage’s brought suit under § 2 based on 3M’s entry into the private label transparent tape business, in which LePage’s was dominant. In seeking to expand into labels, 3M engaged in various marketing practices such as exclusive dealing arrangements secured by cash incentives, bundled rebate programs where customers obtained lower prices by increasing product purchases across a number of 3M’s product lines. LePage’s conceded 3M didn’t sell below cost, but the Court ultimately held 3M’s conduct to be illegal exclusionary behavior.

three, the most rarely recognized and yet most important distinction is the one between coercing and incentivizing conduct. Glazer explains that there are two ways a firm can get a customer or supplier to confer an advantage on it: one is by refusing to deal with any firm that does not confer that advantage; the second is by offering incentives to firms that confer that advantage. He believes that there should be recognition of this coercion/incentivizing distinction and that the problem with the vertical area of § 2 is that this distinction has not been recognized and applied. If courts recognize this difference in conduct, then they might be able to apply a rule which would help clarify some of the gray areas under § 2. For example, coercive conduct could be presumed unlawful and incentivizing conduct could be presumed lawful using the *Brooke Group* predatory pricing standard.² Glazer believes that properly understanding the difference between these two types of conduct leads us to a correct and simplified analysis under § 2. Because incentivizing conduct does not involve the use of monopoly power, but rather gives customers and rivals a choice unlike coercion, it seems intuitive that these two types of behavior should be distinguished under the law.

B. M. Laurence (“Larry”) Popofsky. An attorney with Heller Ehrman LLP in San Francisco, California, whose firm litigated the appeals of important § 2 “price” cases such as *LePage’s Inc. v. 3M*.

Larry Popofsky discussed on the analytical flaws in the Third Circuit’s reasoning in deciding *LePage’s*. Popofsky argues that even though the *Barry Wright* bright-line cost based standard for predatory pricing is the proper analysis, lower courts have not gotten the message.³ Recent litigation brought by small competitors challenging pricing practices of allegedly dominant firms show a marked failure by the lower courts to apply Supreme Court precedent, which requires a meaningful analysis of price/cost relationships (under *Barry Wright*) before pricing can be condemned as exclusionary. This situation has been exacerbated by the failure of the Solicitor General to urge that *certiorari* be granted in *LePage’s*.

Despite the result in costs and injury to the nation’s competition policy, Popofsky finds that legislative remediation is not the solution. Rather, he calls for strong amicus intervention by the enforcement agencies in private litigation with

² *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). The Court emphasized the importance of “recoupment” in predatory pricing cases. If the defendant cannot recoup its losses from below cost pricing, antitrust concerns are not implicated because low prices benefit consumer welfare. The Court said that plaintiffs must satisfy two requirements: first, the plaintiff must “prove that the prices complained of are below an appropriate measure of its rival’s cost,” and second, the plaintiff must demonstrate “that the defendant had a reasonable prospect, or under § 2 a dangerous probability, of recouping its investment in below-cost prices.”

³ *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983). The court endorsed a bright-line cost based standard for pricing while recognizing that predation still could occur through imposing “limit” pricing.

the mission of redirecting courts from an open-ended rule of reason analysis toward a proper application of cost-based rules. In litigation, he is concerned that juries will jump to the conclusion that the “big [firm] is bad,” and therefore he recommends that the judiciary shape rules rather than shipping cases to juries.

C. Charles F. (“Rick”) Rule. Chair of the Antitrust Department at Fried, Frank, Harris, Shriver & Jacobson LLP in Washington, D.C., Rule was also former Assistant Attorney General at the DOJ Antitrust Division.

Rick Rule finds § 2 to be a “mess” and thinks that it should be repealed because of the large error, administrative, and uncertainty costs it imposes on the economy. He also finds § 2 unnecessary because most conduct which threatens consumer welfare is covered by §1. The scope of § 2 is limited to cases alleging: force or fraud, price discounting, and refusals to deal. Therefore, the costs associated with §2’s enforcement do not justify the value the law brings in regulating a very narrow type of conduct.

Nevertheless, Rule acknowledges that his preference to do away entirely with § 2 is simply unrealistic, and so he proposes modifications to the law in order to increase efficiency and lower costs. First, he suggests a bright-line rule that would impose a burden on the plaintiff to show that exclusionary conduct threatens immediate harm to competition and outweighs the pro-competitive benefit. Second, he agrees with the general consensus on the panel in preferring that the benefits of the alleged conduct should be measured in terms of “consumer welfare,” over “profit sacrifice” and “raising rivals’ costs” tests.⁴ The consumer welfare approach balances conduct that reduces total surplus by diminishing allocative efficiency with any improvements such conduct makes in productive efficiency. If the AMC proposes any rules, he believes they should be designed to comport with such an analysis, with a focus on detecting and deterring practices that substantially threaten to reduce consumer welfare. In addition, Rule sets out in his written submission ten rules that he believes should be implemented in order to decrease costs and make the law more efficient.⁵

⁴ *The Section 2 “Mess”: Do We Really Need It or Can We At Least Make It Better?*, Charles F. Rule, at 7-10 (September 27, 2005 “Draft Paper,” and written submission to AMC). “Raising rivals’ cost” occurs when a dominant firm uses certain practices to raise the marginal costs of rivals, thereby excluding competitors from the market. The “profit sacrifice” test condemns dominant firm sacrifice of short-term profits in order to impair the ability of rivals to compete, eventually allowing the dominant firm to reap monopoly profits in the long-run.

⁵ Other members of the panel view a repeal of § 2 to be unlikely, and view Rule’s suggestion to adopt the above rules to be quite unrealistic. Rule suggests the following: 1) Section 2 should be reserved for conduct that can only be reached by that statute, 2) Section 2 should be reserved for real, durable monopolies, 3) Plaintiff should be required to prove substantial credible harm to consumer welfare, 4) Plaintiff should be required to prove that “but for” the unilateral conduct, consumer welfare would not be harmed, 5) Objective evidence of anticompetitive effect should be relied upon, 6) Defendant should be allowed to rebut plaintiff’s proof with evidence of efficiencies, 7) Investments in the development of technological innovation should be viewed as efficiency, 8)

D. Professor Steven C. Salop. Professor of economics and law at Georgetown University Law Center in Washington, D.C.

Steve Salop proposes § 2 cases use a consumer welfare rule of reason-type approach, which he argues provides the proper framework to analyze refusals to deal because it focuses on the direct competitive effects. He rejects any “short-cut” standards which fail to tie in the anticompetitive effect of certain conduct and which run counter to the basic premises of antitrust law. He openly acknowledges the arguments of his critics that his rule of reason-type standard is too complex, and responds by reciting his genuine belief that “antitrust is up to the task” of applying such an analysis for unilateral refusals to deal and disagrees with concerns that this test would compromise innovation.

Under Salop’s conservative consumer-welfare effects standard, a defendant would be held liable only if the conduct is proven to have the effect of permitting the integrated firm to raise or maintain prices and reduce output relative to an appropriate (court determined) non-exclusion benchmark. A court would employ traditional balancing: weighing pro-competitive efficiencies of the conduct against evidence that the effect of the refusal to deal is to raise prices. He hopes that the AMC agrees with his version of this standard and endorses the use of the “profit sacrifice” and “no economic sense” tests as a component of the rule of reason analysis under the consumer welfare standard.⁶

Despite his articulation of a specific standard, Salop does not recommend legislation to mandate this or any other standard. Rather, he believes that an appropriate standard should evolve through the development of the case law.

E. Willard K. Tom. An attorney in the Antitrust Practice Group at Morgan, Lewis & Bockius LLP in Washington, D.C., who has also authored an article on the issue of discounts.

Willard Tom summarizes his point of view on § 2 effectiveness in five main points. First, he testifies that any rules the AMC urges on courts should only be rules of thumb. Second, he hopes that any rules urged on courts will be offered on a structure which reconsiders a treble damages remedy. Third, Tom holds that in the loyalty and bundling discount area, a hypothetical efficient competitor test, while

Monopolist’s should have choice as to whom it will and won’t deal, 9) Monopolist’s prices or discounts should not be condemned unless below marginal cost, and 10) Remedies that narrowly prohibit the conduct should be the only ones relied upon.

⁶ *Avoiding Error in the Antitrust Analysis of Unilateral Refusals to Deal*, Steven C. Salop, at 4 (Revised September 21, 2005, written submission to AMC). The “no economic sense” test is a variant of the “profit sacrifice” standard, which holds the integrated firm liable if the refusal to deal would not be as profitable as dealing at the non-exclusionary benchmark price, absent any tendency to lessen competition caused by the conduct.

not perfect, is the preferable standard.⁷ Fourth, he believes that such a test should be in the nature of a safe harbor. Last, he argues that antitrust cases in the “real world” are decided on overreliance on documentary “intent” evidence. He cautions that courts should exercise more control in distinguishing between documents that are merely empty words versus correspondence which evidences a strategy to gain power over rivals by pricing them out of the market. In addition, he suggests that the AMC should consider model jury instructions on what evidence is sufficient to go to the jury.

Tom ultimately concludes that the greatest contribution the AMC can make is not doctrinal and standards based, but rather is institutional, focusing more on the system of remedies and the risk of overdeterrence. He maintains that skepticism regarding the merits of unilateral conduct claims under § 2 is proper, but he holds that full denial about the existence of such claims is wholly inappropriate. Last, he emphasizes caution before jumping to any broad standards or conclusions, mentioning that even when it comes to bundled discounts, consumers do not necessarily benefit from every price decrease.

II. Highlights from Panel I Questions and Answers:

A. What standards should be used under § 2? Is it appropriate to think of a standards based test? I am worried that something like the “profit sacrifice” test could lead to an investigation where a company decides to invest in an activity like advertising. Is it possible that liability could be found where a company is deemed to be improving a product too much?

Popofsky: I do not think profit sacrifice test is helpful.

Rule: Profit sacrifice is a bad rule because it trivializes the harm to competition that should be at the center of the issue. Second, it places the burden on the defendant to explain the conduct. Ultimately, it is reasonable to have exclusive dealing sometimes, but there must be some efficiency for it. Usually the result of the “profit sacrifice” and “no economic sense” tests is that the defendant loses because courts and juries are bad at recognizing efficiencies.

B. I don’t think it’s accurate to describe “ad hoc” whether conduct facilitates or aggravates competition. It seems possible to have balancing or a consumer welfare test and I agree that a price/cost test could work as long as it is

⁷ *Prepared Statement Before the Antitrust Modernization Commission*, Willard K. Tom, at 9-10 (September 29, 2005). The “hypothetical efficient competitor” test says that a plaintiff must show that it is at least as efficient a producer of the product as defendant, but that defendant’s pricing strategy makes it unprofitable for plaintiff to continue to produce the product.

administrable and understandable to jury. The jury instructions in Aspen were appalling, providing no meaningful guidance, yet they were embraced by the Supreme Court. Should we have a price/cost analysis of some kind made by the court, which would give the court the ability to analyze and potentially take the case away from the jury?

Rule: I agree that there should be a price/cost test, and that we need a rule indicating a certain pricing measure (maybe pricing below marginal cost). It seems that the consumer welfare test is a good test. The issue is: can you really develop a cost effective rule for evaluating certain § 2 circumstances where in unilateral conduct cases, the immediate effect on the economy is good for consumers, but the long term harm is worrisome.

C. What can we do as a Commission in terms of making recommendations to Congress?

Popofsky: The cases suggest that you need some kind of price/cost rule (which may not be perfect), but which benefits consumer welfare. My sense is that the only way to solve the problem is to adopt some kind of price/cost rule which judges and juries can understand.

Salop: But, you can't use the total revenue cost test because then the firm can keep bundling rebates with products that the firm has power in. The result would be that the argument is weakened because then a firm can show average price is higher than average cost.

D. Does anyone favor repeal of § 2? A: No. Does anyone think that § 2 cases should only be brought by the government? A: No. Does anyone think that it is better that § 2 cases should only be brought for injunctive relief?

A: Maybe.

Popofsky: Damages, at least single damages, would be appropriate in a situation like that in *Lorain Journal Co v. United States*, 342 U.S. 143 (1951).

Tom: Single damages would be a substantial improvement, and if we could avoid trying these kinds of cases to a jury that would be an improvement too. The Commission should do follow up work on this issue.

Rule: Single damages would make things better, but at the end of the day there are fundamental problems that this solution would not address

Salop: We should study single damages issue and determine the impact it would have on deterring litigation.

E. Suppose that the Consumer Welfare Effects test is the best way to assess harm under § 2, what would be an administrable rule for bundling?

Tom: Incremental price/cost test makes sense. The hard question is what do you need to prove that incremental price is below cost? How would jury decide?

(Question to Glazer): What is the test for incentivizing conduct?

Glazer: Was it coercive? Is it express/implicit? Did they play around with pricing? If no, then it would be an incentivizing case.

Rule: *Brooke Group* is the appropriate standard, “recoupment” is the important link between behavior and harm to competition that is sustained over time. Part of the problem in *LePage’s* reasoning was that the Court didn’t look at recoupment.

Salop: Incremental price/incremental cost, but you need to worry about a benchmark.

Popofsky: Recoupment (set of circumstances that never happened) issue is harder to win on in court. Rather, price/cost is more conducive to presentation in court.

III. Summary of Written Testimony From Panel II:

A. Timothy J. Muris. Co-chair of the Antitrust & Competition Practice at O’Melveny & Myers LLP in Washington, D.C. Muris, a former Chairman of the FTC, is also a Professor of Law at George Mason University.

Timothy Muris argues that consumers are essentially better off with a bundle than without, and generally there is no anticompetitive harm in the practice.⁸ He states that bundled discounts are ubiquitous, and only recently have economic theories developed which suggest certain conditions where bundled discounts could be anticompetitive. The narrow “equally efficient competitor” test (adopted by *Areeda/Hovencamp*) holds that if a bundle excludes an equally efficient competitor then the bundles poses a problem to competition. Muris disagrees with this theory. He believes that the focus of this theory is misguided because the inquiry centers

⁸ Compare with Willard Tom’s Statement of Position Before the AMC, *infra* at 5.

around harm to competitors rather than harm to competition and bundled discounts can usually lower prices and increase consumer welfare.

- B. R. Hewitt Pate. Head of the Global Competition Practice Group at the law firm Hunton & Williams LLP in Washington, D.C., Pate also served as Assistant Attorney General of the DOJ Antitrust Division.

In his position statement, Pate summarized his conclusions on exclusionary conduct under § 2: when looking at refusals to deal, the “no economic sense” test is better than consumer welfare balancing because the latter does not look at whether or not from a business perspective the conduct makes sense. He also concludes that the essential facilities doctrine cannot be plausibly maintained after *Trinko*. Pate highlights the need for some objective standard for bundling to clarify the confusion *LePage’s* brought to the law. He points out that the *Brooke Group* test may be the only one that can be administered. For refusals to deal, essential facilities, and bundling discounts, he believes that the common law process for developing rules works, even though the process has yet to generate clear rules for evaluating certain types of conduct. Pate firmly believes that the Commission should not recommend legislative change. Rather, standards for exclusionary conduct should be developed through judicial elaboration based on sound economic theory.

Pate’s written submission further sheds light on his position with regard to a § 2 standard for refusals to deal and his preference for the “no economic sense” test over the consumer welfare test. He argues that “no economic sense” is more grounded in sound economic theory and is superior because it can be administered effectively by courts and businesses alike. In the “real world,” where businesses must risk capital and make decisions, no such consumer welfare test exists as part of normal business conduct. Instead, businesses predict whether the proposed conduct makes economic sense, identifying the bases for that prediction.

- C. Professor Robert Pitofsky. A Professor of Law at Georgetown University in Washington, D.C., Pitofsky is also Of Counsel at Arnold & Porter LLP, and was a Former Chairman of the FTC.

Professor Pitofsky briefly addressed bundling and essential facilities. He stated that everyone tends to agree that bundling is pro-consumer and that courts should exercise caution when blocking bundles. He believes that the *Brooke Group* recoupment test makes most sense. On the issue of essential facilities, Pitofsky mentions that lower courts still follow this doctrine and he does not believe that this doctrine has been entirely abandoned. He argues for cautious application, limits, and clarity in the standards. That being said, he believes there is an independent claim under the essential facilities despite the doctrine’s narrow application.

On the issue of § 2 refusals to deal, Pitofsky vehemently disagrees with the DOJ Amicus Brief filed in the *Trinko* case, and rejects worries about false positives, jury confusion, and the case that monopolies are good. He reasons that while balancing in antitrust is problematic for its vagueness, uncertainty, and unpredictability, “we [still] do it in antitrust.” Furthermore, the “no economic sense” test, focuses on the seller when the focus should be on the consumer.

D. Professor Carl Shapiro. Professor of Business Strategy and Economics at the Haas School of Business, University of California at Berkeley, Shapiro is also the Director of the Institute of Business and Economic Research and is a Senior Consultant at CRA International.

Refusals to deal are hard to define and since there are many different types, the distinction between conditional versus unconditional refusals to deal is an important one. Conditional refusals to deal require fact based inquiries about what the conditions state. Unconditional refusals to deal, are much harder for antitrust law to reach or control. When assessing the standard for refusals to deal, Shapiro emphasizes the practical considerations: that courts are poorly suited to regulate conditions of dealing, that it is easy for a plaintiff to claim “if you sell me your monopolist input I will be more competitive and then consumers will be better off,” and that the defense to this does not present well to a jury. Shapiro distinguishes the situation where there is exploitation of consumers. In situations where there are misrepresentations, there needs to be more careful scrutiny and more complex inquiry.

On the issue of bundling, Shapiro supports an “incremental revenues” safe harbor versus the *Brooke Group* test. Because multi-product discounts are generally pro-competitive and because recent decisions like *LePage’s* are likely to stifle some pro-competitive discounting, a safe harbor would improve the law in this area. Shapiro includes an example safe harbor in his written submission to the Commission. He states:

“A multi-product pricing structure fits into the safe harbor if the incremental revenues exceed the incremental cost for all relevant subsets of products. Of course, even multi-product pricing structures that fall outside the safe harbor may well be procompetitive or competitively neutral. Plaintiff would have to show that the structure employed was likely to harm consumers....[a]s part of this inquiry, one must consider the scope of discounting in question.”⁹

IV. Highlights from Panel II Questions and Answers:

⁹ *Exclusionary Conduct: Testimony Before the Antitrust Modernization Commission*, Carl Shapiro, at 18 (September 29, 2005).

A: Do each of you agree that as a general principle antitrust law is aimed at preventing markets from monopolist power or market power (provided that conduct is not on merits)? Why should antitrust policy not be hostile to conduct that facilitates exercises of market power [in second market]?

Pitofsky: Because it is too tough of a rule. There are things a monopolist ought to be able to do which may entrench monopoly but may have efficiencies, if those things are not so severely anticompetitive. Bad conduct must be substantially anticompetitive and there must be no efficiency justification which outweighs the anticompetitive effect. The sole defense should not be superior skill and foresight.

Muris: I agree with that.

Pate: I agree as well but I am concerned about whether consumers will be better/worse off in long run in terms of innovation. As antitrust lawyers, we may not understand markets well enough and should not intrude too much.

Q: Is there a consensus that we not view the extension of monopoly from market A to market B if there are efficiencies that offset net gain to consumers associated with that market? Is that accurate?

Muris: Yes.

Pate: I am on board with that in theory, but an open-ended test may not work so well. I think screens and safe harbors are the superior approach; that way business is not chilled.

B: Vertical refusals to deal or exclusive dealing arrangements could in theory be capable of extending or enhancing monopoly power. Should we apply a “no economic sense” test?

Pate: We would need to look at the entirety of conduct, but I think that the “no economic sense” test makes sense.

Shapiro: I don't think “no economic sense” test makes sense with respect to *Microsoft*. In terms of imposing costs on competitors, Microsoft indicated that “no economic sense” test makes no sense.

Muris: I don't support a “no economic sense” test across the board. In the context of *Trinko*, I think it was appropriate because of the distinction between conditional and unconditional.

Pitofsky: I do not think the “no economic sense” test is irrelevant when looking at exclusionary conduct. I am simply stating that it is not dispositive, but it could be a relevant factor.

C: Can we agree on some kind of concept of safe harbors? For example, Shapiro’s safe harbors? Does anyone think any other safe harbors should be added or do Shapiro’s make sense?

Pitofsky: Bundling, in general, is a good thing, and I am in favor of an easy and simple to understand rule.

Pate: I like Shapiro’s safe harbors, but I think we need to clarify that they are not the only legal way and we shouldn’t look only at the incremental revenues and costs.

Muris: I have not studied Shapiro’s safe harbor, but I think cost safe harbors are on the right track. Pitofsky is right about bundling.

D. Ought we have a per se rule that bundling is always fine?

Muris: No. It’s clear that bundling can exclude. We would need more empirical evidence.

E. The “no economic sense” test has been criticized, and perhaps it is best used to help inform a broader balancing approach. Is there value to adopt screens for different types of behavior that can be deterred? Is there value of having two different types of screens: 1) bundling and 2) unconditional refusals to deal?

Pate: The “no economic sense” test is not an all purpose resolution to all of § 2. I believe in screens so businesses will know when to fear action.

Pitofsky: This question raises a constructive approach to this panel. There is no single rule to cover all behavior under § 2. We should concentrate on a series of rules that address different behaviors.

Shapiro: I like the phrasing in the question; that the “no economic sense” test can help inform broader balancing. It is instructive to ask: why did company engage in that conduct?

F: Is legislative clarification a fix or is that not realistic or likely? How do we give better clarity to this issue?

Pate: *LePage's* is a bad holding and courts should apply an objective standard. I would urge the Commission to report this. [Everyone agrees.]

Pitofsky: I think the AMC report should emphasize areas where law is going in the right direction, especially with respect to bundling.

Shapiro: In the refusal to deal area, the Commission should take “baby steps” and talk about unconditional refusals to deal and, perhaps, better jury instructions. A Commission report which makes authoritative statements on these areas and doesn't try to do too much would be a success.