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ROUNDTABLE ON COMPETITION ON THE MERITS

-- Note by the United States --

This note is submitted by the Delegation of the United States to the Competition Committee FOR DISCUSSION at its forthcoming meeting (1-2 June 2005).

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1. This brief memorandum responds to an invitation for submissions to a roundtable discussion on "competition on the merits" to be held by the OECD's Competition Committee. The invitation notes that "competition on the merits" is a phrase "commonly used by courts and practitioners in their analyses of unilateral conduct by dominant firms." Care must be taken in using the phrase "competition on the merits" because it is often used as though it brings specific content to dominance analysis; in fact, defining abuse by reference to "competition on the merits" tends to be circular because there is no clear agreement on what if anything it actually means.

2. Although the phrase is used in different ways by courts in the United States, "competition on the merits" always refers to conduct regarded as lawful when undertaken by firms that are "dominant," which in U.S. parlance would mean firms that possess monopoly power. Thus, a firm – no matter how "dominant" – cannot be found to have committed an illegal act if all the firm did was to engage in "competition on the merits." Conversely, as the invitational letter states, "when a dominant enterprise is confronted with rivals or the prospect of their entry, it cannot lawfully counter the competitive challenge with conduct that falls outside an area circumscribed by the term 'competition on the merits.'" Under U.S. law, such conduct is referred to as "predatory" or "exclusionary" conduct.[1]

3. Analysts disagree both about why certain conduct is typically thought to fall outside the area of "competition on merits" and, at other times, whether certain other conduct should fall outside or within its perimeter. Our note provides some perspective, from the vantage point of the U.S. antitrust enforcement agencies, on some of the issues identified in the invitation for submissions.[2]

1. Some Principles for Evaluating Single-Firm Conduct

4. We suggest that some of the confusion surrounding "both the perimeter of ['competition on the merits'] and the underlying principles that ought to define it" stem from three interrelated considerations. First, not all monopolies are unlawful. A monopoly that is obtained by "superior skill, foresight, and industry" does not violate competition law.[3] It is important to recall, in setting precedent for the kinds of behaviour that competition agencies are trying to deter, that striving for monopoly is "an important element of the free market system," because "it induces risk taking that produces innovation and economic growth."[4] Accordingly, "the successful competitor, having been urged to compete, must not be turned upon when he wins,"[5] even where that success might have a short-term adverse effect on the welfare of consumers.[6] The consumer-oriented goal of competition policy dictates an overarching need to protect the freedom of even dominant firms to compete.

5. Competition policy, therefore, requires distinguishing permissible from impermissible means to obtain, or maintain, a monopoly. The need to draw this distinction highlights a second consideration: conduct that will defeat competitors is what monopolists engage in to obtain and maintain monopoly power, but it is also what we expect competitors to do in open, freely competitive markets. As one judge put it: "Competition is a ruthless process. A firm that reduces cost and expands sales injures rivals – sometimes fatally. . . . These injuries to rivals are by-products of vigorous competition, and the antitrust laws are not balm for rivals' wounds. The antitrust laws are for the benefit of competition, not competitors."[7] In other words, competitive conduct frequently looks like exclusionary conduct, because aggressive competition may harm less-efficient firms – even though it is "precisely the sort of competition that promotes the consumer interests that the Sherman Act aims to foster."[8]

6. The importance and the difficulty of the need to distinguish between exclusionary and competitive conduct exacerbate yet a third consideration, common to all legal regulation of marketplace behaviour. In measuring behaviour that has taken place, one wants to get correct results, but at the same time to give clear and specific guidance to those who have not yet acted. So, to say one will just weigh all the factors carefully after the fact may generate very defensible results after the fact, but will justifiably be

criticised for failing to give sufficient guidance to businesspeople who must make choices before all the consequences of those choices can be known.[9]

2. Application of These Criteria to Potential Monopolisation Claims

7. For many reasons, especially those sketched above, U.S. law has evolved a textured approach to the question of what constitutes illegal monopolising conduct or illegal monopoly maintaining conduct. This textured approach recognises that when applied to the wide range of business behaviour that might create or protect monopoly power, legal claims vary with respect to their potential chilling effect on competition; the ease with which exclusionary conduct can be distinguished from aggressive competition; and the feasibility and importance of creating “safe harbours” for firms in the marketplace. For example, under U.S. law, pricing practices, especially aggressive price cutting, entail the greatest danger that restricting single-firm conduct ultimately will harm consumers by chilling the competitive process. In contrast, the improper manipulation of government processes to create or maintain monopoly power lacks any cognisable justification. The following expands upon this point with respect to how the principles enumerated above apply to three different types of conduct: pricing and similar practices; distribution practices; and abuse of government processes.

8. *Pricing and Similar Practices* – U.S. courts have recognised that claims that low pricing have led to a monopoly (or are alleged to maintain a monopoly) must be treated with particular caution, for several important reasons. First, with aggressive price cutting, the mechanism through which competition may be excluded “is the same mechanism by which a firm stimulates competition.”[10] The exclusionary and competitive acts thus look precisely alike. Second, “mistaken inferences” of predatory pricing are “especially costly, because they chill the very conduct the antitrust laws are designed to protect.”[11] Third, given the heavy costs of predation to the would-be predator, and the usual lack of entry barriers to potential rivals, the strategy is unlikely to succeed.

9. Given these concerns about predatory pricing claims, U.S. courts have deliberately chosen a rule that seeks to minimise the risk of falsely proscribing competitive acts. In particular, they have held that before low pricing can be condemned, the conduct must be shown to involve the short-run sacrifice of profits in order to attain the probability of long-run market power.[12] At the same time, aggressive, but above-cost, pricing is considered “competition on the merits” and is placed within a safe harbour.[13] Moreover, the Supreme Court has recently relied on many of the same concerns in rejecting the imposition of antitrust liability for other unilateral conduct, in particular, a refusal to deal.[14]

10. *Distribution practices* – When firms compete, one of the ways in which they compete is through their methods of distribution. Restraints such as exclusive dealing arrangements are very common in highly competitive markets, reflecting that such distribution methods can reduce costs and improve firm efficiency, providing “competition on the merits” to the benefit of consumers. It is the case that, in some circumstances, denying rivals access to key distribution channels may be an effective strategy for acquiring or maintaining market power. Nonetheless, because distribution restraints are a frequent and effective form of competition, claims of exclusion based on such practices have the potential to chill conduct that benefits consumers. It is therefore important to provide clear guidance to firms to minimise the undue chilling effect on efficient conduct.

11. The U.S. Department of Justice (“Department”) recently addressed this issue in the *Dentsply* case, in which it prevailed in establishing that the defendant unlawfully maintained monopoly power.[15] The Department argued that the defendant’s policies of not using dealers that distributed products of rivals could be determined to be exclusionary because the policies made “no economic sense” apart from their exclusionary effect, explaining that “[c]onduct is exclusionary when its profitability is attributable to elimination of competition, rather than to successful competition on the merits.”[16] Put another way,

"[c]onduct is exclusionary, even if its cost poses minimal 'burden,' if incurring that cost makes sense only because the conduct serves to eliminate competition."[17]

12. *Abuse of government processes* – One of the most effective ways for a firm to acquire or maintain market power is to use the rules of government against competitors. While such conduct often is perfectly legitimate, it can be unlawful if it is achieved by abusing governmental processes. Indeed, "[m]isuse of courts and governmental agencies is a particularly effective means of delaying or stifling competition."[18] Obtaining a patent by perpetrating fraud on the patent office, for example, is a well-known example of such abuse that may be part of a scheme of unlawful monopolisation.[19] The United States Federal Trade Commission ("Commission") has brought several cases in recent years that involve the alleged abuse of governmental processes to obtain market power shielded by law.[20]

13. Abuse of government processes presents a very different trade-off of risks and benefits than aggressive price cutting for several reasons. First, unlike predatory pricing, it frequently is likely to succeed, because the exclusionary effect often operates by force of law. Second, by comparison with predatory pricing, it may cost little to attempt. Finally, and most fundamentally, the conduct does not in any way resemble "competition on the merits." False statements to government agencies are not susceptible to any justification. They cannot be explained in terms of the defendant's effort to increase output or improve product quality, innovation, or service. They therefore do not raise the same concerns with respect to chilling procompetitive behaviour.[21] Identifying what is properly construed as an abuse of government process, however, can sometimes raise some difficult issues, including the scope of rights guaranteed by the Constitution or intellectual property law.

3. Implications for an Enforcement Agenda

14. We believe that the variety of business conduct that might be subject to claims of "exclusion," viewed in light of the various policy issues discussed above, have three implications for enforcement agencies as they consider their enforcement priorities in this area.

15. First, competition law's impact is felt not only when an enforcement action is initiated or a judicial decision is rendered, but also when businesses take steps (or avoid taking steps) in the context of prevailing legal standards. Accordingly, in deciding what standard to use to determine whether particular conduct constitutes exclusion or "competition on the merits," we believe that enforcement agencies should take into consideration not only the relative risks of "false positives" compared to "false negatives" in the particular case, but also the effect of the articulated standard generally on business conduct in the marketplace. In deciding whether to adopt any particular standard, therefore, we believe that agencies should give careful thought to the relative balance between identifying conduct that may be exclusionary, and the risk of deterring a wide range of conduct that might be highly beneficial to consumers.

16. Second, and following largely from the first, we believe that the issues raised by this roundtable may be advanced by further empirical research. Underlying the various legal formulations and analyses of different forms of business behaviour are a set of assumptions that might be tested by empirical work. For example, with respect to concerns regarding false negatives and false positives, how likely are various practices, frequently attacked as creating or maintaining monopoly power, in fact to be useful methods for reducing costs or lowering output? Where behaviour seems reasonably likely to be efficient, in that it will reduce costs, under what if any circumstances might that behaviour also threaten to generate market power, of sufficient magnitude and probability, that net social welfare will be greatly reduced?

17. Finally, in the allocation of always-scarce enforcement resources, a sound and sensible enforcement program might focus first and foremost on forms of exclusionary conduct that do not even arguably raise cognisable efficiency justifications. Given the ease with which regulatory structures can be

"gamed," and the relatively low cost of trying, such conduct not only is lacking in any benefit to consumers, but is likely to be common relative to other forms of exclusionary conduct. The abuse of government processes and other forms of "opportunism" should have an important place on an enforcement agenda that challenges exclusionary conduct.

NOTES

1. See, e.g., Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 605 n.32 (1985).

2. U.S. national law proscribes both monopolization and attempted monopolization. This short note will discuss only the offence of monopolization. Most of the states also prohibit monopolization or monopolizing conduct, but their experiences are not reviewed here.

3. The phrase comes from Judge Learned Hand's opinion in United States v. Aluminum Co. of Am., 148 F.2d 416,430 (2d Cir. 1945).

4. Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407 (2004).

5. Judge Hand also coined this phrase in the *Alcoa* case. 148 F.2d at 430.

6. Harm to consumers from an efficient monopolist may come about in some cases where the monopolist would restrict market output further (and consequently raise market price higher) than would have been the case in a market with, for example, three rivalrous but slightly less efficient firms. The monopolist is not condemned, nevertheless, because it merely engaged in "competition on the merits." An example of how similar harm to consumers may occur from a merger that generates both market power and merger-specific efficiencies is neatly explained in Ken Heyer, A World of Uncertainty: Economics and the Globalization of Antitrust, 72 Antitrust L.J. 375, 404-06 (2005).

7. Ball Memorial Hospital, Inc. v. Mutual Hospital Insurance, Inc., 784 F.2d 1325, 1338 (7th Cir. 1986) (Easterbrook, J.).

8. Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 767 (1984).

9. Still, a "case-by-case approach, one that bases decisions more explicitly on their likely impact on welfare," may be better than "'bright line proxies' and rules of thumb" at reducing business uncertainty and enhancing welfare. Heyer, A World of Uncertainty, supra note 6, at 417 et seq.

10. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 226 (1993).

11. Id.

12. See id.

13. Brooke Group, 509 U.S. at 223 ("As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting").

14. Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 414 (2004).

15. United States v. Dentsply International, Inc., 399 F.3d 181 (3d Cir. 2005).

16. Reply Brief for the United States, United States v. Dentsply Int'l, Inc. (3d Cir. 2004) at 3.

17. Id. at 4. The Department also has applied the "no economic sense" test in its other recent cases under Section 2 of the Sherman Act. In *Microsoft*, the Department argued that a course of conduct that served to protect the defendant's operating system monopoly was exclusionary because it "would not make economic sense unless it eliminated or softened competition." Brief of the Appellees United States and the States Plaintiffs at 48, United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001), *available at* http://www.usdoj.gov/atr/cases/f7200/7230.htm. In *American Airlines*, the Department contended that the defendant drove out rivals by adding "money-losing capacity" and that "distinguishing legitimate competition from unlawful predation requires a common-sense business inquiry: whether the conduct would be profitable, apart from any exclusionary effects." Brief for Appellant United States of America at 2, United States v. AMR Corp., 335 F.3d 1109 (10th Cir. 2003), *available at* http://www.usdoj.gov/atr/cases/f9800/9814.htm. See generally Gregory J. Werden, The "No Economic Sense" Test for Exclusionary Conduct, Journal of Corporation Law (forthcoming 2005).

The "no economic sense" test may be most useful when it can play what is essentially the role of a sufficient condition: if challenged conduct with a demonstrated tendency to eliminate competition would make "no economic sense" but for that tendency, it must follow that the conduct is exclusionary. The test is not intended as the last word on the subject of exclusionary conduct. There may be cases in which it is infeasible to apply the test, and it may be possible to formulate a better test in the context of a particular case.

18. Robert Bork, The Antitrust Paradox 159 (1978, rev. 1993).

19. See Walker Process Equip., Inc. v. Food Mach. & Chem. Corp., 382 U.S. 172 (1965); see also American Cyanamid Co., 72 F.T.C. 623, 684 (1967), aff'd, Charles Pfizer & Co. v. FTC, 401 F.2d 574 (6th Cir. 1968).

20. See, e.g., Bristol-Myers Squibb Co., FTC Docket No. C-4076 (Apr. 14, 2003) (consent order), *available at* http://www.ftc.gov/os/2003/03/bristolmyersconsent.pdf (alleged false listings and false statements to the Patent and Trademark Office and the Food & Drug Administration for the purpose of maintaining a monopoly in connection with two anti-cancer drugs and an anti-anxiety drug); Union Oil Co. of Cal., FTC Docket No. 9305 (Mar. 4, 2003) (Complaint), *available at* http://www.ftc.gov/os/2003/03/unocalcmp.htm (alleged false representations to Air Resources Board for the purpose of ensuring that firm's technology was incorporated into mandatory government regulations).

21. Some staff members at the FTC have described abuse of government processes as an example of "cheap exclusion" – exclusionary conduct that is "cheap" both in the sense that it is inexpensive to attempt, and that it has little positive value to consumers because it lacks any cognizable efficiencies. See Creighton, Hoffman, Krattenmaker & Nagata, Cheap Exclusion, 72 Antitrust L.J. __ (2005) (forthcoming) (describing false government filings, abuse of standard-setting processes, certain intentional tortious conduct, and abusive litigation as examples of "cheap exclusion").