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INNOVATIONS IN ANTITRUST ENFORCEMENT

GEORGE A. HAY*

I. INTRODUCTION

Each antitrust administration, both at the Department of Justice and the Federal Trade Commission, has its theme—one or a few areas of antitrust enforcement that it wants to pay particular attention to and in that way be identified with. And, as part of this emphasis, administrations often seek to innovate in some way or another, to do something different, or in a different way than previous administrations.

One factor stimulating innovation in antitrust enforcement is simply that new people with new ideas come into a new job. Sometimes those new people bring with them ideas that they had been developing in the private sector (Richard Gilbert, the former Deputy Assistant Attorney General for Economics, for example, has long been associated with the economics of R&D; and Diane Wood, the former Deputy Assistant Attorney General for International Antitrust, has long been known for her special interest in the international aspects of antitrust).

In other cases the innovation is deliberate, and in part the natural and generally laudable consequence of wanting to appear to be innovative, of wanting to be seen as having fresh ideas or approaches. And this, in turn, is no doubt linked to the great demands on antitrust officials to give speeches. (In a recent issue of *FTC Watch* I noted approximately thirty-five scheduled speeches by FTC or DOJ officials in the period March 14–April 25.) No one likes to give speeches without having something to say, and a speech which simply says "business as usual," or even "we are going to work hard and do an even better job on the usual matters," is not likely to make the evening news, however reassuring such a pronouncement might be to the audience or the business community at large.

In any event, the themes emerge. For example, I think of Thomas Kauper as being associated with the program of regulatory intervention,

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and Donald Baker with tougher sentences for price-fixers. John Shenefield will forever be associated with "shared monopoly," and James Rill emphasized the international aspects of antitrust enforcement. Over at the FTC, I think of Kevin Arquit and "invitations to collude," and Terry Calvani and "nonprice predation." Right now, the main innovation of the current DOJ team is innovation itself, and we want to try to understand what this means for us and our clients in terms of actual antitrust enforcement.

But this brief commentary on the origins of innovation in antitrust has a purpose, and it is to remind us that there is often a significant gap between what an administration *says* is its main focus and what the administration actually does. The plain vanilla truth is that the day-to-day business of the antitrust agencies has not changed dramatically in twenty years. Every hint of horizontal price fixing is investigated vigorously and prosecuted where appropriate, all major horizontal mergers are evaluated,[1] and that's about it. There are, and always have been, few government-filed vertical cases or monopolization cases. And that probably is a sensible allocation of resources given the paucity of reasonable candidates and the ability of private plaintiffs to address them. (The *Microsoft*[2] matter may serve as a good example of the problems of pursuing monopolization cases that no private plaintiff has been willing or able to mount successfully.)

Put somewhat less politely, speeches often reflect more what an administration would like to do, or would like its audience to think that it will do, rather than what it has done, is now doing, or will actually do in the near future. (By way of example, I note that, during the period 1978–1980, the ratio of speeches about shared monopoly to shared monopoly cases filed was very high. The same could be said about nonprice predation and invitations to collude.) I will come back to this towards the end, but I think a fair warning about innovations with respect to innovation is to watch what they do, not what they say.

II. SOME OLD NEWS

Consideration of innovation in an antitrust context is not new. By way of example, consider the following issues in which concern about innovation has played some role.

[1] The reason there are so few merger cases actually filed is that when the agencies signal a likely suit, the transaction is often abandoned.

[2] United States v. Microsoft Corp., Civ. No. 94-1564LO (D.D.C. filed July 15, 1994), *decree entered*, 1995-2 Trade Cas. (CCH) ¶ 71,096 (D.D.C. Aug. 21, 1995).

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A. INNOVATION AS A DEEP BACKGROUND FACTOR IN MERGER ANALYSIS

Traditional merger analysis has generally featured static analysis of price and output because that is where the anticompetitive consequences of the conduct under scrutiny are expected to occur. The fear is that the higher concentration will result, either through undetected collusion or increased oligopolistic interdependence, in higher prices. There have been exceptions, but for the most part, innovation or technical change has not played a central role in the analysis, even though it has long been recognized that the potential pro-consumer benefits of innovation are likely to be far more significant than those of static price competition.

However, even though the static effects of higher concentration have been the primary focus of merger analysis, concern about innovation has always been a part of merger analysis in the sense that it is part of the background against which merger policy has been developed. Scholars and policymakers have, at least in principle, been sensitive to the possibility, for example, that a more permissive attitude towards mergers might allow American firms to achieve the necessary size to compete effectively in a world market and that part of that size equation has to do with the ability and incentive to engage in R&D. The problem has always been that the links between concentration and R&D, or concentration and innovation itself, were murky enough, or equivocal enough, that there didn't seem to be any real argument for changing the merger standards to accommodate these dynamic concerns. And in any event, there was enough rethinking going on about the proper static thresholds that concern about innovation got swamped in the process.

B. INNOVATION AS CONDUCT UNDER SECTION 2

While public concern about monopoly is occasionally framed as there being too little innovation once monopoly has been achieved (recall J.R. Hicks' famous remark: "The best of all monopoly profits is a quiet life"), an occasional concern under Section 2 is that innovation has been used to retard competitors and to help to achieve a monopoly.

The Justice Department's quixotic adventure against IBM, which began with a bang in 1969 and ended with a whimper in 1982,[3] encompassed allegations that IBM had used innovation in some fashion to disadvantage competing mainframe manufacturers by developing "fighting machines" to target a competitor's flagship model, or announc-

[3] U.S. Department of Justice, Antitrust Div'n, Memorandum for the Attorney General Re: U.S. v. International Business Machines Corp. (Jan. 6, 1982).

ing "paper machines," not yet in production but allegedly just around the corner, to discourage the purchase of a competitor's presumably soon-to-be-outdated model. Similarly, it allegedly used innovation to disadvantage competing makers of plug-compatible peripheral equipment by channeling innovation in mainframes in such a way as to make competitors' peripheral equipment no longer compatible.

Berkey's case against Eastman Kodak[4] included, as an element, allegations that Kodak used its innovative capacity in film to gain a competitive advantage in cameras by innovating in such a way that only Kodak's newest model camera would be capable of using Kodak's newest, and presumably much-desired, film.

Even the FTC's unsuccessful foray against the producers of ready-to-eat cereals[5] can be seen as aimed at innovation, broadly defined, since the claim was that the manufacturers developed new product varieties precisely for the purpose of making it difficult for smaller rivals or new entrants to gain a competitive foothold.

C. Innovation as an Aspect of Conduct Under Section 1

While there has been a flurry of activity involving licensing agreements and related matters that impact directly on the fruits of past innovation or the incentives with respect to future innovation,[6] concern about innovation in these contexts is hardly new. Concern about restrictions in patent licenses and the impact they may have on the incentive to innovate can be found in vintage cases (e.g., the "smog case" against the major auto producers[7]); and, only slightly indirectly, the recent cases involving access to electronic funds transfer networks can be seen as mainly concerned with the tension between more open access on the one hand and, on the other hand, how the long-run incentives to innovate can be diminished by allowing latecomers to "free ride" on the risk-taking innovative efforts of the original participants.

III. INNOVATIVE IDEAS ABOUT INNOVATION

I take it that the thrust of the recent emphasis on innovation by speech-writers and speech-givers is that, perhaps because of changes in the

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[4] Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263 (2d Cir. 1979), *cert. denied*, 444 U.S. 1093 (1980).

[5] Kellogg Co., 99 F.T.C. 8 (1982).

[6] *See* Robert J. Hoerner, *Innovation Markets: New Wine in Old Bottles?*, 64 ANTITRUST L.J. 49 (1995) (collecting cases).

[7] United States v. Automobile Mfrs. Ass'n, 1969 Trade Cas. (CCH) ¶ 72,907 (C.D. Cal. 1969).

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structure of the U.S. economy, with its emphasis on services and high-technology products, or changes in the way that the United States interacts with the rest of the world, or some other reason, innovation ought to move closer to the center stage in antitrust analysis. And, some would argue, to handle concerns about innovation appropriately, new tools of antitrust analysis, such as "innovation markets," must be developed or existing tools substantially modified.

It is hard to argue with the assertion that we ought to be more concerned with innovation, and I will not attempt to do so. The more important issue is how this affects, or ought to affect, antitrust analysis and whether, as claimed, new tools are required. With no claim that the treatment is exhaustive of the possibilities, let me suggest several areas of antitrust analysis where increased attention to innovation might be warranted and the possible implications for antitrust analysis of that increased attention. The categories I have selected correspond to the three categories of antitrust analysis mentioned under the heading "Old News," but the order has been changed.

A. INNOVATION AS CONDUCT UNDER SECTION 2

If, as claimed, an increasing part of the economy will be devoted to high-tech products and services, it is appropriate to be alert to the possibility that innovation will be a more important potential weapon for a firm seeking to disadvantage competitors. We need no better reminder than the recent fuss about what the Justice Department did or didn't do about conduct that Microsoft did or didn't engage in. And, while it occurred in a merger context, the Justice Department's concern about the AT&T-McCaw merger[8] was in part a concern that AT&T would use its market power in long-distance services and in cellular equipment to disadvantage McCaw's rivals in the cellular services market, possibly to the point of achieving market power in those markets as well. At least the equipment part of the case involved issues of how innovation might be channeled to favor McCaw or disfavor its competitors.

But while concern about the number of markets in which innovation can be used as a competitive weapon may be warranted, and further, to properly analyze the competitive issues in those markets might require a more high-tech background than possessed by the ordinary antitrust mortal, it is not clear that any special new antitrust tools of analysis are needed. In any event, for those who require a new bottle to store the

[8] United States v. AT&T Corp., Civ. No. 94-01555 (D.D.C. July 15, 1994), Proposed Final Judgment and Competitive Impact Statement, 59 Fed. Reg. 44,158 (Aug. 26, 1994).

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wine, the "raising rivals' cost" model is still new enough to be under the original manufacturer's warranty. I don't see that anything newer is required.

B. INNOVATION AS AN ASPECT OF CONDUCT UNDER SECTION 1

1. *Patent Licensing Issues*

I take it that the effort here is primarily to undo the damage done by the famous "nine no-no's" of the early 1970s.[9] While it is clearly important to get the job done right, and we seem to be making some progress (can we finally agree that merely the existence of a patent does not mean that the patent holder has market power in the antitrust sense of the phrase?), the analysis necessary to get it right today was, for the most part, readily available for those willing to pay attention in the 1970s. I would not be surprised to see game theory increasingly applied to some of the licensing issues, but I don't know that any new antitrust concepts are called for.

2. *Joint Venture Issues*

I refer here to the claim, advanced primarily by Jorde and Teece,[10] that the current treatment of production joint ventures is too restrictive and safe harbors need to be created for certain of such joint ventures. I agree that the antitrust laws ought to be sensitive to the possible benefits of production joint ventures but remain skeptical as to whether legislatively created safe harbors are needed. In any event, I do not see the need for any new conceptual constructs in this area.

C. INNOVATION AS A FACTOR IN MERGER ANALYSIS

1. *Innovation as a Source of Entry Reducing the Anticompetitive Consequences of a Given Merger*

The degree and direction of innovative activity may have consequences for the conclusion we normally draw from traditional measures of rivalry, such as high concentration. Hence, a merger which increases concentration may pose less of a risk of increased price and reduced output if innovation will likely result in substantial new entry in the foreseeable future. The basic analytical point is that historical market shares may

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[9] *See* Bruce Wilson, Deputy Assistant Attorney General, Antitrust Div'n, Law on Licensing Practices: Myth or Reality? Remarks to the American Patent Law Ass'n, Washington, D.C. (Jan. 21, 1975).

[10] Thomas M. Jorde & David J. Teece, *Rule of Reason Analysis of Horizontal Arrangements Designed to Advance Innovation and Commercialize Technology*, 61 ANTITRUST L.J. 579 (1993), and more generally, ANTITRUST INNOVATION AND COMPETITIVENESS (Thomas M. Jorde & David J. Teece eds., 1992).

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not be a good indicator of individual or collective market power in a market characterized by rapid innovation. Existing market shares may shift rapidly among competitors as they develop new and improved versions of existing products or significantly reduce costs and therefore price. Moreover, if the innovation is not confined to existing firms, new entry can render even collective high market shares insignificant in a relatively short period of time.

The theme that historical market shares may not be a good proxy for market power (or the ability of a firm or group of firms profitably to raise price in the *future*) is hardly novel. Especially in the merger context this is the teaching of *General Dynamics*.[11] The challenge is to turn this theoretical generalization into some useful practical advice. Obviously, one such piece of advice would be that in industries characterized by rapid innovation, presumptions based on historical market shares are to be treated with great caution and perhaps the usual market share thresholds for establishing a presumption of market power ought to be raised. This advice depends, however, on an underlying assumption that the degree of successful innovation is not highly correlated with existing market shares. I take it that the claim of the Justice Department in several recent cases is that this assumption is not necessarily correct—rather, that the ability to be an effective innovator is closely associated with a firm's current market shares or perhaps even with a firm's cumulative production over a period of years. If the latter, this makes firms with historically high shares relatively impervious to new entry or expansion by fringe players, even in markets characterized by innovation.

I do not take the Department to be arguing that this correlation between historical share and the ability to innovate is to be generalized across industries and markets, but simply that it is a potential warning light to those who would casually adopt the position that innovative industries are necessarily characterized by low entry barriers. I declare myself warned and thank the Department for its assistance. Of course, the hard part, identifying industries where innovation is especially inbred, remains.

2. *Innovation as a Factor Increasing the Anticompetitive Consequences of a Given Merger*

The more interesting possibility for antitrust analysis is that some firms with historically low, or even nonexistent, market shares, because they are likely to be successful innovators, will be very important players in the future and that a merger of two such firms (or one existing strong

[11] United States v. General Dynamics Corp., 415 U.S. 486 (1974).

firm with one potential innovator) will have an adverse effect on competition in the future.

Where the innovation is evolutionary rather than revolutionary, so that the product being traded in the future is simply a more advanced version of the product being traded today or where the innovation is aimed at improving the process for producing an existing product, I see no reason why the traditional antitrust analysis is inadequate to do the job. This seems to me just the flip side of *General Dynamics*. For existing firms with small market shares, the argument is simply that their historical shares understate their real competitive significance, and if *General Dynamics* is good law in one direction, it ought to be good law in the other direction as well. (Indeed, the Merger Guidelines have always had a provision for an unusually important but small competitor.[12]) For firms not currently selling the product, the proper pigeonhole is the potential competition doctrine. While I take Robert Hoerner's point that the Court has never completely blessed the actual potential competition doctrine,[13] I don't think there is any conceptual flaw in the doctrine and have always understood the problems to be primarily those of proof rather than theory.

Richard Gilbert and Steven Sunshine, in their *Antitrust Law Journal* article,[14] present an example that they claim supports the need to define a separate "innovation market." In their example, aluminum ingot is an intermediate product used to fabricate aluminum products: cable, where the firms are duopolists, and lawn furniture, where the firms are each monopolists in separate geographic markets.

Gilbert and Sunshine claim that if each of the firms was engaged in R&D aimed at reducing the cost of ingot and if, as a result of a merger between the two firms, the innovation will not occur or will occur at a later date, the anticompetitive effects of the merger (the higher cost of ingot resulting from the slowdown in innovation will mean higher profit-maximizing prices in lawn furniture and in cable) will not be fully captured by looking only at the output markets. Gilbert and Sunshine's arithmetic point is correct: the price of both lawn furniture and cable will be higher if the ingot innovation is adversely affected by the merger, but the results depend entirely on the assumption that the merger will reduce the incentives of the firms to achieve the cost reduction in ingot.

[12] Such a firm is referred to as a "maverick" in the 1992 Guidelines. U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines § 2.12 (1992).

[13] Robert J. Hoerner, *supra* note 6, at 55–56.

[14] Richard J. Gilbert & Steven C. Sunshine, *Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets*, 63 ANTITRUST L.J. 569 (1995).

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While it is possible that competition in cable will make the firms keener to reduce ingot costs, that is not obviously the case—even the post-merger monopolist has an incentive to reduce costs since any cost reduction will flow directly through to profits. Indeed, the monopolist's incentives may be greater because it uses more ingot than either of the firms individually used pre-merger. Moreover, the ability of the one remaining firm to coordinate R&D efforts may eliminate wasteful duplication and make the R&D effort more efficient.

With respect to innovation aiming at products which do not currently exist, there are at least two separate problems. Each problem would involve a situation where two firms seeking to merge are known to be doing R&D aimed at a product which does not yet exist.

In the first version of the problem we assume that each of the two firms is likely to be successful in its efforts so that each will be a seller when the market for that product develops. Also assume that there is something special about these two firms such that, in the absence of the merger, we expect each of them to have significant market shares. There are at least two analytical approaches one could take to this problem.

Using traditional tools, this is simply a case where each of the firms is a potential entrant into the market and there are, by assumption, few such likely entrants. The problem, if there is one, is that the market does not yet exist and whether, in such circumstances, the court will allow a market for a future product to be defined for antitrust purposes. I can think of no analytical or policy reason why such future markets cannot be relevant markets for antitrust purposes (although I can think of dozens of reasons why the number of mergers that would raise a competitive concern with respect to such markets would be very few), but I can't rule out the possibility that a court simply will not entertain the suggestion. In such an event the primary alternative is to define a market for innovation and identify the two firms in question as important players in that market.

But, under either analytical approach, the factual basis for concern is the belief that, but for the merger, both firms would have been significant independent sellers of the product in question and after the merger there will be only the one. In my view the fact that the result of the merger will be that one of the firms will, in effect, abandon its R&D effort before the product has been created, instead of combining production and sales decisions after the product already exists, is of no great importance and does not, by itself, require a new analytic approach. Indeed, focusing on the R&D aspect may be misleading because, although the assumption that firms in a more concentrated market will

generally set higher prices is generally accepted for purposes of merger analysis, as Richard Rapp points out,[15] predictions about the effect of higher concentration on R&D effort or on innovative success are far more controversial.

In the second version of the problem, the innovation is a product innovation that is patentable. Hence, regardless of which firm is the first to innovate, there will be only a single producer. In this case, analysis of the product market will not reveal any antitrust problem since the market will be monopolized in any event. Rather, the claim must be that if the two merging firms are two of only a few firms doing R&D aimed at this particular product, and if the consequence of the merger is to reduce the incentives of the merged entity to carry out the R&D program, consumers may not get the benefit of the innovation at all, or may see the innovation later than otherwise. Hence, it may seem to be necessary to define an innovation market and focus on the effect of the merger on the incentives to innovate. But this seems to be to have the same structure and the same flaw as the Gilbert-Sunshine example, that is, the assumption that the merger will reduce the incentive to engage in R&D and that this is necessarily a bad thing.

This general issue is nicely addressed by Richard Rapp in his article. Suffice it to say that there is no solid basis in economic theory or empirical observation to reach the conclusion either that the likely result of the merger will be to reduce the incentive to engage in R&D or that, if duplicate R&D is reduced, that is necessarily a bad thing. But even if these propositions could be debated, one thing is certain—there is absolutely no basis for believing that the structure of the Guidelines, specifically associating given market share thresholds with a high likelihood of reduced competition and higher prices for a given product, can be carried over to an analysis of market shares of R&D inputs in an innovation market or something similar. So while I can appreciate that the DOJ might reasonably be concerned that a given merger will reduce the incentive to engage in R&D, I think that concern must be addressed on more of an ad hoc basis rather than trying to import and translate the Guidelines' apparatus to innovation inputs.

IV. CONCLUSIONS

Innovation is important. Innovation is good. The incentives to innovate should be protected and possibly strengthened. Innovation can affect the way we deal with traditional antitrust problems and can suggest new

[15] Richard T. Rapp, *The Misapplication of the Innovation Analysis Approach to Merger Analysis*, 64 Antitrust L.J. 19 (1995).

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competitive concerns that would not arise in a static world. The DOJ should be alert to those possibilities, and it is reassuring to be informed by their many speeches on the subject that they are fully awake at the switch. However, I suspect that when the dust has cleared, the analytical tools we have mastered and are comfortable with will stand us in good stead. Failure to gear up on "innovation markets" may make certain negotiations with the Department in merger matters a bit more roundabout, but should not put us at a major disadvantage in counseling clients, litigating cases, or reading the opinions in cases others have litigated. For those inclined to nervousness at the emphasis on new approaches contained in the many speeches by enforcement officials, the message for lawyers and clients is, as suggested earlier, "Watch what they do, not what they say."

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