



eSAPIENCE CENTER FOR COMPETITION POLICY

VIEWPOINTS:

**TESTIMONY ON TYING FOR THE DOJ/FTC HEARINGS
ON SINGLE-FIRM CONDUCT**

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By

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The following is testimony given by the author on November 1, 2006 before the U.S. Department of Justice and Federal Trade Commission at the Public Hearing on Single-Firm Conduct and Antitrust Law Modernization.

I would like to make two points today. First, the enforcement agencies should take a leadership role in ending per se liability for tying. They should abandon any form of per se analysis themselves. And they should advocate change in both Congress and the Supreme Court. Second, tying is a routine competitive practice. The courts and competition authorities should presume that tying is efficient, or at least benign, in the absence of significant contrary evidence.

Let me turn to the first point.

Under *Jefferson Parish v. Hyde*, as it is widely understood, a firm that has market power in product A is liable under Section 1 of the Sherman Act for requiring consumers to take product B. Hardly anyone in the antitrust profession supports what we might call a “conditional per se” test. There are lots of articles on tying. But you are more likely to be hit by lightning than to find a paper by an economist that comes close to supporting this test or anything like it. Hardly any legal scholars advocate this test either. There is just no significant economic or judicial learning that supports the view that tying should be

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treated as an especially pernicious business practice for which there should be an especially high level of judicial scrutiny.

Yet, despite this consensus per se tying cases keep on truckin'. More than 30 private antitrust cases with a per se tying claim have been filed in the last 5 years. Recent ones include *Jensen Enters., Inc. v. Oldcastle, Inc.*,¹ *Broadcom Corp. v. Qualcomm Inc.*,² and *Mumford v. GNC Franchising LLC*.³ And you might recall that the biggest settlement in antitrust history came just three years ago after a district court judge found that MasterCard and Visa failed the major elements of the *Jefferson Parish* test, as a matter of law, on summary judgment. He noted the *possibility* that the courts require a showing of competitive harm and left only that for a jury trial.

Now, some commentators have suggested that *Independent Ink* shows that the Supreme Court has backed away from *Jefferson Parish*. I really wish that were true in the sense that matters for lower courts and businesses. But Justice Stevens appears to have been quite careful in saying nothing whatsoever in his decision in *Independent Ink* that repudiates his decision in *Jefferson Parish*. We continue to have conditional per se liability for tying that follows all too easily from having market power in the tying product.

There are good vibes though from *Independent Ink* and I'm optimistic that the Court will eventually conclude that tying is a relic of a by-gone era in antitrust when populist hostility towards business practices prevailed and economics hadn't yet pointed the way. But the U.S. Department of Justice and the Federal Trade Commission shouldn't

¹ 2006 U.S. Dist. LEXIS 68262 (N.D. Cal.).

² 2006 U.S. Dist. LEXIS 62090 (D. NJ.).

³ 437 F. Supp. 2d 344 (W. D. Penn. 2006).

just sit still and wait another five or ten years or whatever for that to happen. So I have four recommendations for you.

- First, the Justice Department should adopt a policy that it will not file claims that companies have committed a per se violation of Section 1 of the Sherman Act as a result of engaging in tying. Now I'm not suggesting that DOJ has been trigger happy. In fact the Department hasn't filed any Section 1 tying cases in the last five years although I don't believe it has filed any significant single-firm conduct cases of any stripe.
- Second, at the next opportunity, the DOJ and the FTC should encourage the Supreme Court to overrule *Jefferson Parish*. Unfortunately, there isn't anything in the pipeline, as far as I know, that would allow them to do that. The two enforcement agencies should also encourage Congress to modify or kill Section 3 of the Clayton Act. By the way, it's unfathomable to me that the Antitrust Modernization Commission hasn't considered tying as part of its agenda for reform. The antitrust laws for the 21st century shouldn't target tying as an especially pernicious practice.
- Third, there is a bill in Congress to repeal certain exemptions that the insurance industry has from the antitrust laws. Now that's a debate I sure don't want to wade into today. But HR 2401 perpetuates the mistake of treating tying as a separate and presumably especially harmful antitrust offense. The enforcement agencies should oppose that provision of the bill.
- Fourth, the Justice Department should embark on a global recall of American tying law. Following our lead the courts and competition authorities in many

jurisdictions have subjected tying to some form of per se or conditional per se liability. We should let them know that there is no sound support for that approach.

Of course saying farewell to per se liability leaves open the question of what approach we should welcome in its place. That brings me to my second proposition: the antitrust laws should set a high bar for finding that tying is anticompetitive and prescribe a structure to guide the analysis. To explain why let me take a brief detour.

Most of us are Bayesians at heart. That is, to make decisions we combine prior experience with the knowledge at hand, we recognize that given the inherent uncertainty we will surely make mistakes, and we consider the likelihood and costs of making the wrong decision. And the courts have adopted this reasoning implicitly. It is really what underlies the whole distinction between per se and the rule of reason. Moreover, the courts have adopted this reasoning more or less explicitly. *Brooke Group* is the leading example in antitrust.

Now when it comes to single-firm conduct it is helpful to think about what prior information tells us, what the likelihood of error is, and the cost of those errors. With that I have three observations.

First, when practices are common in pretty competitive markets we have prior information that these practices are efficient. That doesn't mean that they couldn't be used to harm competition. It does mean there should be a presumption that these practices are pro-competitive. They couldn't survive otherwise. Will Baumol and Dan Swanson

have made just this point in their article on price discrimination.⁴ And the Supreme Court recognized it in *Independent Ink*.

Second, juries have a lot of trouble deciding complex cases. I've testified before a lot of juries and I have a great respect for the system. But face it: these single-firm conduct cases require complex assessments of facts and legal nuances. The DOJ and FTC have had trouble agreeing on how to treat bundled rebates. Asking twelve average citizens to do so invites error. This is a particular problem of course in private litigation and especially in treble-damage, class-action litigation involving single-firm conduct.

Third, modern industrial organization economics emphasizes the need for caution. We tend to find that businesses have the incentive and ability to engage in anticompetitive conduct in fairly limited circumstances. And there is little if any empirical evidence that these circumstances hold often in practice.

Now I am absolutely positively not arguing for the repeal of Section 2 or for gutting Section 2 in practice. It plays an important role in disciplining businesses with significant market power. I also believe that as economic learning progresses we may find that it is easier to separate bad business practices from good business practices. But, for now, we ought to be pretty cautious about letting the courts, and ultimately juries in private litigation, embark on a rule of reason inquiry without some structure—some discipline—attached to it to reduce errors.

⁴ William J. Baumol & Daniel G. Swanson, *The New Economy and Ubiquitous Competitive Price Discrimination: Identifying Defensible Criteria of Market Power*, 70 ANTITRUST L.J. 661-85 (2003).

So let me apply these considerations to tying. Well at the risk of restating what everyone knows and what the courts have acknowledged in *Fortner*, *Jefferson Parish*, and *Independent Ink*: ***tying is ubiquitous; it is utterly common.***

Firms make decisions all the time on how to design their products and what product lines to offer. They take into account consumer demand for different options. That demand depends on transaction and information costs and those have critical implications for what consumers want and what firms should offer then. And firms take into account their own costs for offering different product offerings. A practical matter that results in product offerings that could be characterized as tying all over the place. Mike Salinger and I have series of papers that go into many of these considerations. Perhaps the most important observation is that there are fixed costs of offering product combinations. That necessarily limits the variants offered by firms and can result in price bundling and tying.

Now the case law sometimes talks about tying denying consumers' choice. The fact of the matter is that a lot of times consumers don't want choice. They want producers to make decisions because the producers are in a better position to do that than they are. And consumer choice isn't costless. It can raise prices to all consumers as the market gets fragmented.

So our prior expectation when we see tying is that it is probably efficient and the result of market forces. As the DC Circuit noted in its unanimous decision in *Microsoft*, "bundling by all competitive firms implies strong net efficiencies."⁵

⁵ *United States v. Microsoft Corp*, 253 F.3d 34 (D.C. Cir. 2001), at 88.

That doesn't end the analysis. One might imagine that economists had spent the last twenty years researching the subject of tying and concluded that, as a matter of theory, it was a highly plausible anticompetitive strategy for firms with significant market power. And you might imagine that economists had actually discovered empirical evidence that supported these theories. But you would, indeed, be imagining this. We have tremendous insights from the papers by Mike Whinston and by Dennis Carlton and Mike Waldman. Read one of the articles in this literature though and you will see what hard work they had to put in to find anticompetitive tying and how many assumptions it depends on. And even then they assume away efficiencies we know often exist.

So how should we analyze tying going forward? Where tying is simply a device to engage in price discrimination I would make it per se lawful. There's no strong economic basis to condemn price discrimination and it is common in competitive markets. The law on patent misuse could still address whether we should limit the returns from intellectual property rights by prohibiting tying. But there's no basis a priori for allowing patent holders to engage in price discrimination in a primary market but not through mechanisms that involve a secondary market.

Otherwise, we should leave open the possibility that under the rule of reason tying practices could be found unlawful. However, plaintiffs should have a high hurdle.

- First, plaintiffs should of course as a starting matter have to show that the defendant has significant market power in the tying product that the plaintiff has posited.
- Second, plaintiffs should have to show the tying practice has the likely effect of excluding a significant amount of competition from the market for the tied

product. Such exclusion is the source of competitive harm in all of the economic work in this area.

- Third, plaintiffs should have to raise significant doubts that the tying practice is not just a normal competitive practice explained by efficiencies for consumers or firms. That means showing that there are two separate products and that in the absence of an anticompetitive exclusionary strategy we would expect that consumers would be offered the tied product without the tying product.
- Fourth, plaintiffs should have to show by way of economic theory and empirical evidence that the defendant has embarked on a plausible anti-competitive strategy.

And of course ultimately plaintiffs need to be able to demonstrate persuasively that tying will cause a net reduction in consumer welfare. These are not impossible hurdles by any means. Plaintiffs should be able to find evidence to support each of these tests if in fact a firm has engaged in tying to acquire a monopoly in a secondary market or maintain a monopoly in a primary market.

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