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Antitrust and Innovation: Framing Baselines in the Google Book Search Settlement

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I. INTRODUCTION

As I write—October 19, 2009—we are betwixt and between in the Google Book Search (“GBS”) case. The original settlement agreement was set for an October 7, 2009 fairness hearing before Judge Denny Chin. The run up to that hearing generated more than 400 filings including, most importantly, a statement of interest filed by the Department of Justice late in the evening on September 18, 2009. The fairness hearing was suspended and the district court gave the parties a deadline of November 9, 2009 to file a revised settlement agreement.

Press reports suggest that there are ongoing discussions among the Department of Justice and the parties to try to resolve DOJ’s concerns with the agreement. Of course, objections to the settlement are much broader than just those raised by DOJ. Google’s service promises a strong expansion of access to information and knowledge countered by concerns about privacy and a move to an Orwellian tracking infrastructure. It isn’t clear to what extent the parties will try to make adjustments regarding privacy, the scope of the works encompassed by the settlement (photos excluded so far and, according to France and Germany, too many foreign works included) and much, much more. But the tight timeframe for revisions suggests that the scope of the likely changes will frustrate many of the objectors.

In this brief note, I address three points. First, I do a quick status update on competition issues in the case. Second, I turn to a key issue that has emerged in the commentary on the competition issues; namely, what is the right way to frame the competition policy baseline for assessing whether a new arrangement such as GBS is pro-competitive? That question is of general interest to the intersection of antitrust and innovation policy and given the importance of both to the health of the economy, it is critical that we get the baseline question right.

We will be misled if we simply track expansions in output. Clever cartelists will want to cartelize new industries in their infancy, as they know that a new product innovation will inevitably raise output, even if it does so by much less than we would see in the face of full competition. And innovators will want to bundle anticompetitive features with competitive ones if they know that they are simply being judged against the pre-innovation baseline.

¹Copyright © 2009, Randal C. Picker. All Rights Reserved. Paul and Theo Leffmann Professor of Commercial Law, The University of Chicago Law School and Senior Fellow, The Computation Institute of the University of Chicago and Argonne National Laboratory. I thank the John M. Olin Foundation and the Paul H. Leffmann Fund for their generous research support.

Third, as applied to the Google Book Search settlement itself, antitrust enforcers need to disentangle the genuine benefits of the project from anticompetitive features. Obviously, that is a conventional problem in antitrust but it means here that product innovation can't be used as a general shield against standard antitrust analysis. A single infrastructure such as the digitized book scans can be used to offer many products simultaneously and competitive benefits from one product cannot insulate anticompetitive steps in a second product using that same infrastructure.

II. COMPETITION ISSUES IN THE GOOGLE BOOK SEARCH SETTLEMENT

In a prior article on the settlement, I identified three competition issues.² First, I noted that there was a risk that the settlement itself could preclude subsequent antitrust challenges under the *Noerr-Pennington* doctrine. The world shouldn't work that way, but the case law isn't fully clear on this. The good news is that that issue has gone away as the settlement parties have reported to DOJ that they will not assert defenses under *Noerr-Pennington*.³

Second, the original settlement agreement contemplated two core business models. The first relates to sales of institutional subscriptions to the entire corpus of digitized works—a blanket license to everything. The second business model—Consumer Purchases in the lingo of the original settlement—would enable purchases of single books by online access. Prices for those single copies would be set in a complicated manner, but ultimately Google was to build a pricing algorithm “to find the optimal price for each Book and, accordingly, to maximize revenue for each Rightsholder.” That wasn't particularly clear to me, but it didn't sound like a pricing process that would replicate what would happen in full competition between rightsholders. While the Department of Justice is very careful to note that its statement of interest is only a preliminary analysis, it also regards the pricing algorithm as needing “particularly close scrutiny” and further notes that courts have repeatedly found joint-price-setting mechanisms *per se* illegal. But there may be good news on this as well—my understanding is that the parties have acknowledged the concerns about the original consumer pricing plan and expect to make changes in the revised settlement.

My third point related to the orphan works. These are in-copyright works where we cannot identify or get in touch with the copyright holder. That means that it is impossible to get an affirmative assent from the copyright holder for the use of the work. Those works are suspended in a state of non-use, absent government action. That is the key here: Only the government can give Google (or anyone else) a right to use the orphan works. No private party can do that. We have now entered a problem akin to government franchising: Under what circumstances should the government issue a single license permitting the use of orphan works? The original settlement contemplated exactly that outcome, but Google doesn't defend

² Randal C. Picker, *The Google Book Search Settlement: A New Orphan-Works Monopoly?* 5 J. COMPETITION L.ECON. 383 (2009).

³ Department of Justice, Statement of Interest of the United States of America, Case No. 05 Civ 8136 (DC), *The Authors Guild, Inc. v. Google Inc.*, September 18, 2009, p.16 n.6 (available at <http://www.usdoj.gov/atr/cases/f250100/250180.pdf>).

that outcome in public and, to its credit, believes in broad use of the orphan works. That could be accomplished through legislation but the vehicle in front of us is the revised settlement. Let's see what we see on November 9.

Unsurprisingly, the Department of Justice's statement of interest goes beyond just the three issues that I had identified in my original paper. DOJ addresses the boundaries of class action law and whether an FRCP 23 opt-out class action is an appropriate place to launch a new business. I didn't address those issues in my original paper and don't here either. DOJ did raise an additional antitrust issue, namely whether the settlement agreement amounts to an illegal agreement on wholesale prices; that is, the prices paid by Google to copyright holders for the rights to use their works. At this point, I don't have a good sense of how the settlement parties will revise the settlement to address that point.

III. BASELINES FOR ANTITRUST AND INNOVATION

With the, as it were, weekend update out of the way, let us turn to the issue of how new products and innovations should be framed in antitrust. We will focus on the role of expansions in output and the way that innovators can shape their products through bundling.

A. Cartelization at Birth: Are Increases in Output Necessarily Pro-competitive?

Start with a hypothetical to frame the analysis. It is 1974 and we are approaching the dawn of the VCR. At a point before any VCRs have been sold, the potential manufacturers come together and put in place a price-fixing regime for the new VCRs. Cartelization at birth. When faced with an antitrust challenge to the price fixing, the manufacturers defend their action on the ground that output has risen relative to the pre-VCR baseline. Given the output expansion, their behavior is clearly pro-competitive and therefore insulated from antitrust liability and remedies. How should we assess that claim?

We should have in mind social welfare in four states of the world: (1) the pre-VCR world; (2) a world with VCRs and price-fixing; (3) a fully-competitive VCR world; and (4) finally, a world with an antitrust remedy that blocks VCR price fixing. Welfare clearly increases as we move from world 1 (no VCRs) to world 2 (price-fixed VCRs) to world 3 (competitively-priced VCRs). The question for an antitrust enforcer is whether blocking price-fixing pushes us to competitively-priced VCRs or relegates us to a world without VCRs. If price-fixing was actually marginal for the sustainability of VCRs, we would clearly be better off to permit the price-fixing.

Note how misleading it is to just focus on output. On the first day of a new antitrust class, you tell your students the central message of antitrust: Monopolies reduce output and thereby harm consumers. When you look at an antitrust problem, look for the output reduction. Now flip the proposition: If we see an increase in output, should we think that there are no antitrust concerns? That proposition almost certainly turns out to be wrong and not a meaningful guide to how we do or should implement antitrust policy. Prior to the creation of the cartel, VCRs were not offered at all. In some fundamental sense, the cartel will clearly

expand output of VCRs as there were none before. Is that output expansion a good defense to the price-fixing case? I think the black-letter response to that is no, as price-fixing is *per se* illegal.

Why might that make sense? Because of what we think will happen when we block the price-fixing. We don't compare the before and after worlds; that is, the world before the VCR cartel with the world with the cartel. Instead we focus on what we believe will happen if the cartel is blocked. Antitrust assumes that the price-fixing isn't essential to the creation of the new good. Blocking the proposed deal doesn't mean that VCRs will go away but rather, instead, we will direct the innovative instinct in a different direction, namely, competitively-priced VCRs. That is the world that we think will emerge when we use antitrust to intervene to block the VCR cartel. The relevant comparison isn't the before- and after- worlds as to the cartel but rather the worlds with and without the antitrust remedy.

Note that this treatment of price-fixing very much reflects what we want *per se* rules to do. I don't think that we can, in the abstract, conclude that price-fixing could never be critical for the existence of an industry. Of course, that was the very argument made by the railroads in the great *Trans-Missouri* case. They conceded the price-fixing but wanted the chance to prove its reasonableness. The ultimate unwillingness of the court system to consider the necessity or reasonableness of price-fixing almost certainly reflects our fears that judges would err too frequently in allowing price-fixing to go forward. We instead rely on the political process to jump in and address price-fixing directly, often through an antitrust immunity linked to an industry regulatory framework.

Note what that says about antitrust's *per se* approach to price-fixing. That analysis typically presupposes that a market exists. If we are creating a new market, we should be less confident about *per se* analysis. If price-fixing in the new market was the only way to bring it into being, antitrust authorities should accept the price-fixing as the necessary price of creating the innovation in the first place. But this requires actual judgments: Fully-competitive VCRs would be a better outcome if we can get there and sidestep killing off the innovation. But the *per se* rule against price-fixing reflects the judgment that courts will err too often if we permit courts to bless price-fixing.

A wooden application of some notion of output expansion would be a poor guide to what I think antitrust policy can accomplish. We focus not on the output creation that would emerge were the cartel to go through on its original terms but, rather, on the output creation that will result if we block the price-fixing cartel and facilitate full competition in VCRs. The mistake here is to confuse local maxima with global maxima. Our hypothetical VCR cartel would increase output but that shouldn't suffice to immunize it from antitrust inquiries.

B. Baselines and Bundled Projects

Try a second hypothetical. Suppose two firms got together to form a pro-competitive joint venture in market X but at the same time planned to fix prices in an unrelated market, market Y. The firms don't try to hide this collusion, indeed quite the opposite. They argue that their new arrangements are net pro-competitive, that is that the benefits to consumer in market

X far exceed any losses that consumers will suffer in market Y. Should the government ignore the price-fixing in market Y?

No. We do not let firms assemble bundles of projects and justify anticompetitive projects based on the notion that, on balance, the sum of the benefits of the new projects remain pro-competitive. The opposite rule would mean that firms would routinely seek to bundle anticompetitive projects with pro-competitive projects.

Government regulators should and do separate projects when firms present a bundle to the government. If the joint venture in market X actually makes sense, we should expect the firms to move forward independent of whether their anticompetitive effort in market Y is blocked. We will not let pro-competitive benefits in one market operate as a protective shield for anticompetitive behavior in other markets or in that market. We maximize competitive benefits by not allowing private firms to spend their pro-competitive benefits on anticompetitive behavior.

IV. BASELINES FOR THE GBS SETTLEMENT

How should we apply this analysis to the Google Book Search settlement? Try this claim: “Any unclaimed anticompetitive effects must be measured from the but-for baseline of what would have existed without the settlement.”⁴ I am not quite sure what the pre-settlement world references, but I will take that to mean no Google Book search. (The natural alternative is Google Book Search with litigation on the merits of Google’s copyright fair use claim.) As suggested above, the problem with that standard is that it gives the parties too much freedom to exhaust the competitive benefits of the deal. They can bundle anticompetitive features together with pro-competitive features and avoid inquiry into the anticompetitive features as long as they are just a bit better than the status quo.

Try this in the Google Book Search settlement. We have a single infrastructure—the digitized books and the online apparatus that goes with it—that will support many products. The deal contemplates an all-you-can-eat style blanket license sold to the institutional market and separate by-the-book sales to individual consumers. Assume that the institutional licenses are priced at a competitive level. That is almost certainly contrary to fact: Google is likely to be the only firm offering a broad comprehensive offering in the near future even if the orphan-works license contemplated by the settlement is extended to other entrants. There is every reason to expect that Google will have market power in the institutional subscription market for some time.

But assume a competitive price and the strong pro-competitive benefits that would flow from that price. Then match that offering with a fully cartelized offering in single-access sales ala the consumer purchases program contemplated in the original settlement. Google and the Authors Guild would clearly dispute that characterization on the facts, but this is about making a key analytical point for antitrust enforcement. We shouldn’t treat the pro-competitive benefits

⁴ Einer Elhauge, *Why the Google Books Settlement Is Procompetitive* (August 21, 2009) (unpublished manuscript, available at <http://ssrn.com/abstract=1459028>), p.15.

of the institutional licensing product as somehow immunizing the anticompetitive features of the single-access sales. If, to return to the price-fixing VCRs example, we thought that the cartelized single-access sale program was marginal for the existence of Google Book Search itself—if we could have the competitive institutional blanket licenses only if they were coupled with an anticompetitive single-access program—only then should we engage in net tradeoffs across products. That would then require us to assess whether the pro-competitive benefits of the hypothetically competitive institutional subscriptions exceeded the anticompetitive losses associated with the cartelized single-access sales.

Absent that, antitrust enforcers should block the cartelization of the single-access market and do so notwithstanding the fact that the hypothetical GBS settlement is, on net, pro-competitive. The operating assumption is that the parties would still have the incentive to move forward on the institutional subscriptions and would reformulate the single-access program along more competitive lines.

To tack to the original settlement and its likely revision, the question isn't whether large consumer benefits can be identified from the settlement. I think that GBS is a great product and assume that it will produce many benefits for consumers. The point instead is whether there are separable anticompetitive features of the settlement that antitrust enforcers should challenge. That list starts with the consumer pricing program that Google is expected to revise in the new settlement agreement due on November 9.

As to the orphan-works license, I would place that on a slightly different footing, and in doing so recognize the distinctive role being played by the federal government in the creation of that license. If the Authors Guild and Google dropped their lawsuit and implemented their deal privately, Google would get no rights to the orphan works. Approval of the settlement agreement will define the number of firms that can use the orphan works. Google doesn't believe that it should be entitled to the sole license to use those works and nothing in that analysis seems to turn on whether we proceed through legislation or through a settlement. The government defines the grant process for orphan-works licenses and should do so in a way that pushes competition forward.

V. CONCLUSION

The original Google Book Search settlement agreement was a beta, a rough draft released to the world for comment and feedback. The open-source software adage—with enough eyeballs, all bugs are shallow—applies equally aptly here, with one important limit: we all may not agree on what counts as a mistake. The run up to the planned October, 2009 fairness hearing has made clear that the world believes that it has found no shortage of places to improve the settlement. It seems clear that the settlement parties will make substantial changes to address many of the competition policy concerns raised about the original settlement.

In looking at a revised settlement, we need to make sure that we have the right competition baseline in mind. The question isn't whether the agreement improves matters relative to a world without the settlement. That would allow settling parties to shelter too much



anticompetitive conduct under the cloak of pro-competitive activities that they would undertake anyway. Instead, we need to separate out the anticompetitive features to push the settlement towards achieving the full benefits that it promises.