ECONOMICS COMMITTEE NEWSLETTER

Contents

Welcome

It is with great pleasure that we welcome you to the Fall 2007 volume of our newsletter. The goal of this endeavor is to provide a forum where Antitrust Section and Economics Committee members can share their views on the many faceted relationship between antitrust law and economics.

This newsletter is intended to provoke discussion. As a result, the opinions expressed in this newsletter are only those of the authors. The opinions found herein do not necessarily reflect those of the economics editor, legal editor, their respective employers, or members of the Economics Committee.

Enjoy!

Sincerely,

Seth Sacher, Economics Editor
Neil Imus, Legal Editor

Call for Articles

We are always looking for articles for future issues of the newsletter. If you have an article or an idea for an article regarding the current or improved use of economics in analyzing issues of antitrust law, by all means, please share it with us. Contact Seth Sacher at sethsacher@gmail.com or Neil Imus at nimus@velaw.com for more information.

Calendar of Events

Meet Michael Baye
New Director of the Bureau of Economics at the FTC
October 17, 2007, 12:00PM-1:30PM
Michael will be speaking on "Getting the Most from Your Economic Expert"
Kirkland & Ellis
655 15th Street, NW
RSVP to Connie Carrol, LECG, ccarrol@lecg.com, 202-973-0533. (Your name is needed for security clearance.)

More information is available online at:
http://www.abanet.org/dch/committee.cfm?com=AT308000.

Economics Fundamentals of Health Care Antitrust
November 8, 2007, 9:00AM-12:30PM
This economics fundamentals for lawyers program will focus on hospitals, health care professionals and health care insurers.

Moderator
Tracey Weir, Hogan & Hartson

Faculty:
David Argue, Economists Incorporated
Lawrence Wu, NERA Economic Consulting

Hogan & Hartson
555 13th Street
Washington, DC
RSVP to Connie Carrol, LECG, ccarrol@lecg.com, 202-973-0533.

Market Definition in Cases Involving Branded and Generic Pharmaceuticals

Robert Larner and Caterina Nelson*
CRA International

As the term relevant market suggests, market definition does not occur in a vacuum. The analysis underlying market definition must do more than merely investigate whether two or more products compete at all or under some set of circumstances. A properly defined market is one that is relevant to the analysis of the competitive issues arising in a specific scenario and takes account of the nature of the alleged or potential anticompetitive effects being examined.

We develop this argument below, in the context of an antitrust case involving a prescription pharmaceutical: *Geneva Pharms. Tech. Corp. v. Barr Labs., Inc.* In this matter, the court was faced with the question of whether a branded drug should be included in the same relevant product market as generic formulations of the drug. CRA was retained by counsel for plaintiffs to determine the relevant market and analyze the competitive impact of defendants' actions.[1] From our analysis, we concluded that the nature of competition between two generic formulations of a branded drug (and the difference between this competition and that between a branded drug and its generic equivalents) was such that the relevant market comprised only the generic products. Plaintiffs lost on summary judgment on the antitrust issues, based in large part on the District Court's opinion that the brand and its generic alternatives were in the same market,[2] but the Second Circuit reversed the dismissal of the antitrust claims, finding that the relevant market for purposes of the case was limited to the generic products.[3] The parties subsequently settled the litigation.

The Case and Analytical Issues

Although its patent expired in 1962, DuPont remained the sole U.S. supplier of warfarin sodium, an oral anti-coagulant sold under the brand name Coumadin, until 1997, when Barr Laboratories introduced a generic version of the product. Shortly thereafter, a joint venture of two pharmaceutical companies sought to launch a second generic version, but the launch was delayed by approximately a year following FDA approval. The second generic entrant ("Geneva") filed suit, alleging that the delay in its entry was caused by the anticompetitive conduct of Barr and other defendants.

Market definition was a primary and contentious issue in the litigation and was also central to the issue of whether Barr possessed monopoly power. The parties and their economic experts agreed that there was competition between Coumadin and generic warfarin sodium but disagreed vigorously about the relevance of this competition to the issues at hand.[4] Defendants argued that the relevant market was the molecule, encompassing both Coumadin and its generic equivalents, and that Barr lacked monopoly or market power in that market. The District Court, having determined that the relevant market included both Coumadin and generic warfarin sodium, found that during the period of defendants' alleged anticompetitive behavior, "Barr's share of the relevant market … grew from 11% to 14%, [that] as of December 2000, Barr's share was about 24%, [and that] [t]hese percentages cannot support a claim for monopolization or attempted monopolization."[5]

In our view, the nature of the competition between the branded and generic versions of warfarin sodium did not warrant the conclusion that, for purposes of evaluating the competitive issues in this case, the relevant market was the molecule. Competition between Coumadin and generic warfarin sodium differed in fundamental respects from competition between two or more suppliers of the generic product. While Coumadin's price set a ceiling on the price Barr could charge, it was competition between Barr and Geneva that would determine how close the generic price came to this ceiling. The relationship between Barr's and Coumadin's prices was irrelevant to the issues in the case, moreover, because the alleged anticompetitive effect was that Barr's conduct enabled it to extend the time it was able to maintain its price at this ceiling.

More generally, the proper antitrust market in a case is the market relevant to an analysis of the competitive effects of the alleged behavior. For example, if the allegation is that a manufacturer of a therapeutically unique brand-name prescription drug has engaged in exclusionary behavior to prevent or delay entry by the first generic supplier of the drug, the proper market for evaluating the competitive effects of such conduct is likely the molecule, because the alleged anticompetitive effect is suppression of competition between the brand and the generic.[6] On the other hand, if the allegation under investigation is that the sole generic supplier of a pharmaceutical has engaged in unlawful behavior to prevent or delay entry by a second generic supplier, the relevant market for analyzing the competitive effects of such conduct encompasses only the generic product, as evidenced by the differential impacts of additional generic entry on the prices of the generic and branded products.

In the warfarin sodium case, the delay in additional generic entry had no impact on the price of Coumadin, but it did enable Barr to realize a premium price as the sole supplier of generic warfarin sodium for approximately an additional year. This conclusion and the underlying analysis are strongly supported by evidence cited by the Second Circuit in its opinion in the case.[7] Barr introduced its generic product at about 70 percent of the price of Coumadin and maintained this relationship until Geneva entered the market. Geneva's entry had no discernible effect on the price of Coumadin, which continued to rise. In sharp contrast, Geneva's entry had a substantial and immediate impact on Barr's pricing, resulting in a significant decline in the generic price. Evidence supporting this impact on Barr's price can be found in IMS price data, the testimony of Barr executives, Barr's own price forecasts, and its differential pricing of two dosage strengths not offered by Geneva.

The Second Circuit noted the differential impact of additional generic entry: "When other generic competitors entered the market, Barr's prices dropped substantially, but Coumadin's remained unchanged and even rose slightly."[8] Barr's invoice prices dropped by a small, but statistically significant amount, and, more importantly, competition with Geneva forced it to offer substantial off-invoice discounts and rebates as well. The court cited testimony of Barr's senior vice president of sales and marketing confirming the impact of Geneva's entry on Barr's pricing: "Regarding wholesalers, he testified Barr offered 15-20 percent rebates after Geneva entered, and with chain pharmacies, he confirmed that Geneva's entry cost Barr 'many millions of dollars.' As one example, he noted that Geneva's entry forced Barr to give rebates to the CVS and Walgreens chain pharmacies each in excess of a million dollars a year."[9] Additional evidence of Barr's market power came from the differential impact of Geneva's entry on Barr's pricing of different dosage strengths of the product. Barr cut the prices of the dosage strengths that Geneva offered, but not of the two dosage strengths for which Barr remained the sole generic supplier.[10]

Barr's planning documents also recognized the distinct nature of its competition with other generic suppliers. Barr forecasted a price for its warfarin sodium equal to 70 percent of Coumadin's price in the first year after its entry, when it was the only generic supplier; 50 percent in the second year, when it assumed a second generic supplier would enter; and 40 percent in the third year, when it assumed a third generic supplier would enter.[11] Furthermore, the Court noted: "This effect is consistent with the literature on generic drug competition describing how generic pricing is a function of the number of generic competitors."[12]

In discussing industry recognition of the distinct nature of competition among generics, the Second Circuit cited the testimony in another matter of Dr. Bernard Sherman, then a director of and major stockholder in Barr: "…As a result, from the standpoint of the patentee drug company, it matters not whether there is one, two, ten or twenty generic drug companies since each successive generic entrant only gains market share from the previous generic competitors and not from the patentee."[13]

General Issues

Failure to account for the differences in the nature of competition between a branded pharmaceutical and its generic equivalents and competition among generic products in defining antitrust markets and evaluating the competitive effects of firm behavior is an example of "The Price-Up Trap," which Professor Steven C. Salop defines as "Mistaking a firm's inability to profitably raise price above the current level for an inability to exercise market power by preventing competitors' conduct that would otherwise reduce price below the current level, thereby labeling a maintenance of market power as a lack of market power."[14]

In defining a relevant market in an antitrust case involving two products, it is, of course, necessary to inquire whether the two products compete with each other. An affirmative conclusion does not end the analysis, however, as not all substitutes are the same in the way and to the degree that they constrain the pricing discretion of a particular supplier or group of suppliers. Only after examining the nature and extent of competition involving the two products in the context of the facts in the case and the alleged or potential anticompetitive effects of the behavior under investigation can one complete the process of market definition. [15]

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* The analysis and conclusions are those of the authors and do not necessarily represent the views of CRA International. We wish to thank Tasneem Chipty and Bob Levinson of CRA, Colin Underwood and Harry Frischer of Proskauer Rose LLP, Michael Gallagher of White & Case LLP, and Fred Dettmer of the Law Office of Frederick R. Dettmer for contributing to our analysis of the case and to this paper.

[1] Larner was the testifying economic expert for plaintiffs and was supported by a team of CRA economists led by Nelson. In compliance with the protective order in the case, we cite only evidence in the public record and not other confidential information and data that we took into account in our analysis.

[2] 201 F.Supp.2d 236 (S.D.N.Y. 2002). According to the Court, "In order to establish the existence of a submarket consisting solely of the generic sodium warfarin, plaintiffs primarily rely on a supposed price increase on the part of Coumadin(R) and price decrease on the part of Barr's generic product after the plaintiff's entry into the market." (See 201 F.Supp.2d 236 (S.D.N.Y. 2002) at 269, citations omitted.)

[3] Geneva Pharmaceuticals Technology Corp., et al. v. Barr Laboratories, Inc. et al., 386 F.3d 485.

[4] This agreement was noted in the District Court's opinion. (See 201 F.Supp.2d 236 (S.D.N.Y. 2002) at 269.)

[5] See 201 F.Supp.2d 236 (S.D.N.Y. 2002) at 271.

[6] This is the market definition asserted by Barr in its antitrust suit against DuPont Merck, the manufacturer of Coumadin, *Barr Laboratories, Inc. v. DuPont Merck Pharmaceutical Company.*

[7] As we mention above, the Second Circuit reversed the District Court's dismissal of the antitrust claims, stating that "…the relevant market for our purposes is the market for generic warfarin sodium tablets." (See 386 F.3d 485 at 500.)

[8] *Id* at 497.

[9] *Id* at 497.

[10] Barr later cut the prices of these two dosage strengths when another generic competitor began to offer them. While this might be viewed as support for separate markets by dosage strength, our argument was that it was confirmatory evidence of the existence of a generic-only market, as DuPont sold all dosage strengths of Coumadin, yet the only prices that were changed were for the dosage strengths sold by both generic manufacturers.

[11] *Id* at 499.

[12] *Id*. Indeed, a 2002 FTC Working Paper looked at the impact of the number of generic firms on the ratio of the generic price to the pre-patent expiration brand price and found that the ratio fell from 82 percent when there was one generic firm to 76 percent when there were two (falling to 71 percent with five firms). (See Reiffen, David, and Michael R. Ward, "Generic Drug Industry Dynamics," FTC Working Paper 248, February 2002, p. 23 and Table 4.) Reiffen & Ward's results are consistent with the findings by Caves, Whinston, and Hurwitz that the ratio of the generic price to the branded price was 7.35 percent higher when there was only one generic product than when there were two generic products. (See Caves, Richard E., Michael D. Whinston, and Mark A. Hurwitz, "Patent Expiration, Entry, and Competition in the U. S. Pharmaceutical Industry," *Brookings Papers: Microeconomics 1991*, pp 1-66, at p. 34.)

[13] 386 F.3d 485 at 498. The Court also noted that Dr. Sherman was defendant ACIC/Brantford's principal owner.

[14] Salop, Steven C., "The First Principles Approach to Antitrust, *Kodak*, and Antitrust at the Millennium," 68 Antitrust Law Journal pp. 187-202, at p.194.

[15] This analysis of whether there were significant differences in the nature or extent of competitive constraints imposed by different products or suppliers in determining the relevant market was done by the courts in the *Staples* and *Whole Foods* cases. In *Federal Trade Commission v. Staples, Inc. et al.*, 970 F. Supp. 1066, at 1080, the court found that the relevant product market was limited to sale of consumable office supplies through office supplies superstores, because "…non-superstore sellers of office supplies are not able to effectively constrain the superstores' prices…. ," whereas the court in *Federal Trade Commission v. Whole Foods, Inc., et al.*, 502 F. Supp. 2d.1 at 32 (D.D.C. Aug. 16, 2007) found that the relevant product market was not limited to "premium natural and organic supermarkets," as claimed by the FTC, due to evidence that "many customers could and would readily shift more of their purchases to any of [the] increasingly available substitute sources of natural and organic foods….," which would defeat a small but significant and non-transitory increase in price.

As Congress Responds to Higher Gasoline Prices: Is Tougher Merger Enforcement Really the Answer?

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In May of 2004 the GAO issued a report entitled the *Effects of Mergers and Market Concentration in the U. S. Petroleum Industry*.[1] The report found that oil industry mergers during the 1990s had increased market concentration in the downstream segment of the petroleum market, leading to higher U.S. wholesale gasoline prices. On August 4, 2003, the FTC received an advance copy of the GAO's report. After reviewing it, Chairman Tim Muris wrote a letter to Jim Wells, the Director of the Natural Resources and Environment division of the GAO, outlining several concerns that FTC economists had with the report's methodology and conclusions.[2] In January of 2005, economists from both agencies participated in a conference exploring the techniques used by each side in analyzing the oil industry.[3] One important conclusion many participants drew from the conference was the need for additional research to test the validity of models estimating the price effects of oil industry mergers. [4]

Despite the uncertainty concerning the results of the GAO study, several members of Congress have used it to advocate for greater restrictions on mergers in the oil industry. During the 109th Congress, Sen. Kohl, Sen. Cantwell, and Rep. DeFazio each introduced legislation that would have changed the way section 7 of the Clayton Act applied to oil companies.[5] This year both Sen. Kohl and Rep. DeFazio have reintroduced their bills.

Senator Kohl's bill, S. 878, would amend section 7 so that in any civil case where a plaintiff alleges that an oil industry merger has substantially lessened competition, the burden of proof would be on the oil company to establish by a preponderance of the evidence that the merger would not substantially lessen competition or tend to create a monopoly.[6] In addition, Senator Kohl's bill would call for the FTC and the DOJ, to review and to revise the *Horizontal Merger Guidelines* and the *Non-Horizontal Merger Guidelines* so that they:

(1) specifically address mergers and acquisitions in oil companies and among companies involved in the [oil industry];

(2) ensure that the application of these guidelines will prevent any merger and acquisition in the oil industry, when the effect of such a merger or acquisition may be to substantially lessen competition, or to tend to create a monopoly, and reflect the special conditions prevailing in the oil industry ….[7]

Both the FTC and the DOJ would then submit a report to the Judiciary Committee of both the House and Senate about the findings of their review and the substantive changes the agencies made to the guidelines.[8]

Representative DeFazio's bill, H.R. 1500, also advocates shifting the burden of proof for oil companies under section 7. The bill would amend section 7 by preventing any oil industry merger that is unlikely "to result in a net benefit to consumers by maintaining or increasing competition.''[9] In addition, the bill would place a mandatory one year moratorium on mergers between oil companies with annual net sales or assets over $10,000,000. Under Rep. DeFazio's scheme, the Attorney General would be given the authority to waive the moratorium for insolvent firms or firms in financial distress. The bill would also call for the creation of a Petroleum Industry Concentration and Market Power Review Commission. The commission would study the nature, extent, and trends of concentration in the oil industry, as well as the effect of concentration on production, prices, and consumers. Additionally, it would study how current law and administrative practices support and encourage concentration.[10]

Considering that it is still unclear how oil industry mergers are impacting gasoline prices, I believe the legislative initiatives introduced by Sen. Kohl and Rep. Defazio are currently unjustifiable. In addition, even if it could be shown conclusively that oil industry mergers were adversely affecting gasoline prices, I believe that neither bill should be supported, because each bill would have unintended negative consequences for the industry and consumers. First, regardless of the modeling technique employed by the GAO and the FTC, both agencies agree that oil industry mergers have not posed a significant threat to competition in the upstream market for oil.[11] Since both pieces of legislation would change the burden of proof faced by the entire oil industry, they are drafted too broadly. As drafted, both bills would likely harm consumers, because they increase the risk that procompetitive mergers in the upstream market would be blocked or abandoned.

Additionally, Sen. Kohl's bill should not be supported, because it would automatically shift the initial burden of proof from plaintiffs to defendant-oil companies. Under current law, a court presumes that the plaintiff has met his burden of proof under section 7, if he can show that the merger would produce a firm that controls an undue percentage of the relevant market.[12] This presumption is known as the *Philadelphia National Bank* presumption. Basically, Sen. Kohl's bill would apply the *Philadelphia National Bank* presumption to all oil companies, regardless of market share. The problem with this change is that it would do little to affect the way that mergers of companies with large market shares are reviewed, while increasing the burden faced by companies with small market shares, because mergers of companies with large market shares already fall under this presumption, while mergers of companies with small market shares do not. Therefore, if Sen. Kohl's bill were to become law, the burden faced by oil companies with a large share of the market would remain relatively unchanged, while the burden faced by oil companies with a small market share would increase. This increased burden for oil companies with small market share would make them less competitive relative to oil companies with large market share, because they would now have more difficulty adapting to changes in the market through merger. As a result, overall competition in the market might actually decrease as a result of the bill.

Another problem with Sen. Kohl's bill is that it mandates modifying the *Horizontal Merger Guidelines* and the *Non-Horizontal Merger Guidelines* to reflect the special conditions in the oil industry. The FTC already has some previous experience with industry specific guidelines. During the 1960s the FTC issued industry specific guidelines for the cement, food distribution, grocery products, textile, and dairy industries.[13] However, the passage of the Hart-Scott-Rodino Act and the issuance of more general merger guidelines preempted the need for many of these specific guidelines, so they were repealed.[14] During the 1990s, industry specific guidelines reappeared with the issuance of the 1993 Statement of Enforcement Policy in Health

Care. The FTC's past experience with industry specific guidelines has revealed two general problems with industry specific guidelines. First, industry specific guidelines increase the incentives for further government regulation. Second, industry specific guidelines cannot adequately keep pace with changes in the industry and have quickly become outdated.[15] These problems can seriously harm consumers by interfering with the efficiency of markets. In the oil merger context there is no justification for taking this risk, because there is simply not enough evidence that the *Horizontal Merger Guidelines* and *Non-Horizontal Merger Guidelines* are providing inadequate protection of competition.

Rep. DeFazio's bill poses its own unique set of problems. When a plaintiff challenges a merger under section 7, his bill would require oil companies to demonstrate that their mergers would create benefits for consumers. Though this standard would protect consumer welfare, it creates an unworkable and ineffective standard, because the only way for oil companies to show that their merger benefits consumers would be to argue that the merger creates efficiencies that could be passed down to consumers. However, courts have shied away from acknowledging efficiency defenses in merger cases, because efficiency claims are usually highly speculative.[16] Furthermore, plaintiffs tend to have trouble challenging efficiency claims because, they lack either the industry knowledge or the inside information necessary to refute the defendants' efficiency claims.[17] Finally, courts generally lack the expertise necessary to weigh the efficiency claims made by either party.[18] Therefore, the standard established by the DeFazio bill would move courts outside of their judicial competencies and encourage decisions based on highly speculative efficiencies analyses.

Another problem with Rep. DeFazio's bill is that it advocates a mortatorium on mergers. This response is clearly overzealous. Even assuming that some mergers create anticompetitive problems, that fact does not justify a ban on all mergers, even if that ban would only last one year. Most mergers are procompetitive. Therefore, it is likely that more consumers would be harmed by banning mergers, than by allowing them. Moratorium is an extreme and unwarranted response to a problem that might not even exist.

After analyzing both bills, it is clear that neither bill provides an appropriate response to rising gasoline prices and that neither bill should be supported. The evidence that mergers in the oil industry have led to price increases is still inconclusive. In addition, both bills are too broadly drafted, because they would affect both unconcentrated and concentrated markets. Furthermore, both bills would create problematic section 7 standards either by harming participants with small market share or creating an immeasurable evidentiary burden. Finally, both bills would lock regulators into an overly rigid regulatory scheme, through either a set of inflexible industry specific guidelines or an unavoidable merger moratorium.

If either bill were to pass, it would likely have a negative impact on consumers, because it would make it more difficult for oil companies to adjust rapidly to changing market conditions. Instead of introducing legislation that is of dubious necessity and effectiveness, Congress should encourage increased research into the operation of oil markets, so that agencies, such as the GAO and the FTC can develop the econometric tools necessary to analyze these complex markets. Until more is known about how mergers affect oil markets, it is impossible to design legislation that will promote consumer welfare. By making aggressive legislation before it is clear that there is a need for it, legislators run the risk of harming the very consumers they are trying to protect.

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* I would like to thank Larry Fullerton, who provided guidance in the writing of this article. This paper reflects solely the views of the author.

[1] Government Accountability Office, Effects of Mergers and Market Concentration in the U. S. Petroleum Industry (2004) [hereinafter GAO Report].

[2] Letter from Timothy J. Muris, Chairman, Federal Trade Commission, to James Wells, Director of Natural Resources & Environment, General Accounting Office 1-2 (Aug. 25, 2003).

[3] Federal Trade Commission, Estimating the Price Effects of Merger and Concentration in the Petroleum Industry: An Evaluation of Recent Learning (Jan. 14, 2005).

[4] Luke M. Froeb et al., Economics at the FTC: Cases and Research, with Focus on Petroleum, 27 Rev. of Indus. Org. 227 (2005).

[5] S. 2854, 109th Cong. §3 (2006); S. 2829, 109th Cong. §212 (2006); H.R. 3544, 109th Cong. §9 (2006).

[6] S. 878, 110th Cong. §3 (2007).

[7] S. 878, 110th Cong. §4(a) (2007).

[8] S. 878, 110th Cong. §4(d) (2007).

[9] H.R. 1500, 110th Cong. §7 (2007).

[10] H.R. 1500, 110th Cong. §8 (2007).

[11] GAO Report, *supra* note 1, at 44; FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

[12] United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 363 (1963).

[13] Hillary Greene, Agency Character and the Character of Agency Guidelines: An Historical and Institutional Perspective, 72 Antitrust L.J. 1039, 1043 (2005).

[14] *Id.* at 1045, n. 27

[15] *Id.* at 1054.

[16] *See* FTC v. University Health, 938 F.2d 1206, 1222-4; *See also* Timothy Muris, *The Government and Merger Efficiencies: Still Hostile After All These Years*,7 Geo. Mason L. Rev. 729, 730 (1999).

[17] *Id.*

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[18] Id.

“Unprofessional” Economic Testimony: Why It Is a Problem and How Technical Advisors Can Help

Jonathan Tomlin
LECG Corporation
and David Cooper
20/20 Business Vision

Economic experts should strive to present testimony that is independent, well supported, and free of bias. However, as most of the economists recently surveyed by the Economic Evidence Task Force of the ABA’s Antitrust Section recognized, economic testimony that is “baseless or intentionally misleading” sometimes occurs in antitrust litigation.[1] Such testimony will typically be biased in favor of the litigant retaining the expert providing it. Legal practitioners and scholars have recognized the existence of biased (or, following language used by the Task Force, “unprofessional”) testimony for decades, if not centuries.[2]

The occurrence of unprofessional economic testimony begs two fundamental questions. First, does unprofessional testimony lead to biased judicial outcomes? Second, if it does lead to biased judicial outcomes, how can it be minimized? As we explain below, unprofessional economic testimony can lead to biased judicial outcomes and a tendency toward excessive damages awards. As we also explain, if judges make greater use of technical advisors, improved economic testimony can be obtained with little cost.

The Effects of “Unprofessional” Economic Testimony on Judicial Outcomes

Although unprofessional expert testimony can certainly arise in many types of litigation, for purposes of this article, we focus on expert testimony in antitrust litigation. Unprofessional testimony in antitrust litigation can be particularly troublesome due to the often complex economic arguments and calculations involved and the often large damages at stake (including the possibility of treble damages). Unprofessional economic expert testimony in antitrust litigation can impact judicial decisions regarding liability, damages, or both.

With regard to antitrust liability, it is quite clear that unprofessional testimony can lead to inaccurate judicial decisions. This follows from two important facts. First, judges and juries do not always have sufficient information to distinguish perfectly between unbiased and biased testimony. Second, economic expert testimony impacts judicial decisions.[3] With regard to damages, however, the issue is more complex. One may appropriately wonder whether biased expert testimony on damages by plaintiff and defendant experts may simply “cancel out,” with an appropriate damages award being reached on average (either in an individual case or averaged across cases).[4] In fact, such an outcome is highly unlikely.

Two fundamental asymmetries in the extent to which plaintiff and defendant experts may submit unprofessional testimony prevent a reasonable expectation that appropriate damage awards will be reached by some sort of judicial averaging of biased opinions. First, the amount by which antitrust damages proffered by the plaintiff’s expert may exceed actual damages is theoretically unlimited, while the potential bias in a defendant expert's proffered damages is truncated at zero (i.e., the defendant cannot ask for negative damages). This asymmetry tends to lead to excessive damages (i.e., biased toward the damages proffered by the plaintiff's expert) when experts act unprofessionally. Second, the Federal Rules of Civil Procedure often lead to a defendant's expert providing her report after the report of the plaintiff's expert has been provided.[5] This can provide a defendant's expert who is acting unprofessionally with what game theorists call a "second mover advantage." Other things being equal, this asymmetry, resulting from the chronological order in which experts submit their reports, puts a downward bias on expected damages when experts act unprofessionally.[6]

As can be shown in a formal framework, these two asymmetries, when combined, can produce either excessive or insufficient damages awards (and therefore settlements) depending on which effect dominates.[7] The tendency for inaccurate damages awards and settlements (and the impact on liability decisions) resulting from unprofessional testimony makes the existence of such testimony a legitimate and important concern.

How Court-Appointed Technical Advisors Can Help

In the federal court system, court-appointed experts fall into three primary categories - "special masters" appointed under Rule 53 of the Federal Rules of Civil Procedure, testifying experts appointed under Rule 706 of the Federal Rules of Evidence, and technical advisors appointed under the court's inherent powers. Special masters are often appointed by the court to expedite cases and assist in the discovery process.[8] Rule 706 court-appointed experts may testify in court or present written findings and are subject to cross examination.[9] Court-appointed technical advisors provide advice and guidance to a judge and, although they may present testimony, there is no inherent requirement for testimony or cross examination.[10]

In the law review literature, greater use of court-appointed experts in various forms has often been prescribed as a remedy to the malady of unprofessional expert testimony.[11] This was also the "favorite remedial solution of the economists surveyed" by the Task Force.[12] Yet, the Task Force (like the law review literature preceding it) was unable to reach consensus on whether or not greater use should be made of court-appointed experts and the appropriate circumstances for their use. This is unfortunate.

More frequent court appointment of experts acting in the specific role of technical advisors providing guidance to the court in its decision on whether or not to exclude expert testimony as "unreliable" under Rule 702 of the Federal Rules of Evidence (often called "*Daubert*" based on the Supreme Court decision[13]) can significantly improve economic testimony in antitrust cases (and, indeed, can improve expert testimony more generally). It can accomplish this by increasing the likelihood that biased testimony will be excluded, which will, in turn, lower the expected "return" to litigants of retaining experts who act unprofessionally. This reduced return to unprofessional testimony would reduce its occurrence as litigants would often find it contrary to their own best interests to retain experts inclined to proffer such testimony. For example, exclusion of the testimony of the plaintiff's damages expert has often led to an outcome in which the plaintiff has not obtained any damages.[14] Because of this, a plaintiff involved in a case in which there is a substantial likelihood that a judge will exclude unprofessional testimony will be deterred from retaining an expert who will provide such testimony.[15] Greater use of technical advisors can increase the likelihood that unprofessional testimony will be excluded by improving a judge's understanding of complex economic arguments.

Economic expert testimony can often involve complex techniques like multiple regression analysis and a judge not trained in these techniques may have difficulty comprehending them. This is especially true in antitrust cases. Because of this, it is unreasonable to expect that judges will consistently exclude unprofessional economic testimony in the absence of sound guidance on the reliability of the economic techniques being utilized. A technical advisor, however, can provide an explanation to a judge on the reliability of economic techniques utilized, including how those techniques and their application comport with the existing economic literature. Moreover, a technical advisor can provide a resource for the judge to ask whatever questions she deems necessary to understand the economic testimony being presented and be confident in her decision regarding potential exclusion of any testimony. Technical advisors have been used in healthcare litigation to help a judge evaluate the reliability of expert testimony on the health effects of silicon breast implants.[16] Judges could use technical advisors in evaluating antitrust economic testimony in much the same way.

The benefits of a court-appointed technical advisor used in this way comes with little or none of the costs that have often been associated with court-appointed experts and which have caused judicial reluctance to make such appointments.[17] One concern is that a court-appointed expert may exert too much influence on the judge or jury in a legal system that relies on the adversarial process, in which lawyers choose their expert and present their arguments to enable a jury to make an informed decision on its own.[18] However, because the threat of appointment alone can lead to better testimony and better judicial outcomes, there should be little concern with interference with the adversarial process. Moreover, technical advisors do not have to testify before a jury, and there should therefore be little concern that they exert excessive influence on jury decisions.

Another concern associated with court-appointed experts is their cost.[19] However, many of the benefits of appointing technical advisors will come from the deterrent effect. In other words, judges who establish a reputation for appointing technical advisors in the appropriate circumstances will find that they often will not have to make such an appointment (and therefore the litigants will not have to incur the cost of a technical advisor). Moreover, an appropriately trained and experienced economist can usually uncover unsound economics in the litigation context simply by reviewing the expert reports that have been submitted (and perhaps deposition testimony and supporting documents).

Another concern that has been raised is that court-appointed experts, like experts retained by the litigants, often have previously formed opinions on issues that may be in dispute and therefore cannot be truly neutral. In the antitrust context, Judge Posner has referred to economic experts often falling into the camps of antitrust "doves" or "hawks."[20] However, technical advisors used in the context of informing judges in *Daubert* decisions would be focused on assessing whether or not economic testimony is based on fundamentally sound economic reasoning and analysis. A well trained economist should recognize fundamentally unsound economics regardless of any proclivity toward being an antitrust "dove" or "hawk." Although a judge appointing a technical advisor should certainly attempt to avoid appointing an expert who may appear to lack neutrality on an important issue in contention, the focus on sound economics should attenuate the concern over previously formed opinions unduly influencing the opinions of court-appointed experts.

Conclusion

The recently convened Economic Evidence Task Force of the ABA's Antitrust Section expressed a well-founded concern that economic expert testimony can sometimes be unprofessional. Such testimony tends to lead to inaccurate judicial decisions. While it would not eliminate all unprofessional testimony, greater use of technical advisors in combination with the threat of exclusion would lead to better economic testimony and improved judicial outcomes in antitrust cases (and, indeed, in cases involving economic and other testimony more broadly). Moreover, the benefits of technical advisors would be associated with little cost. Hopefully, judges will begin to make greater use of technical advisors in assisting them in the *Daubert* process, and lawyers, when concerned with unprofessional testimony by an opposing party's expert, will begin to propose their use.

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[1] Final Report of the Economic Evidence Task Force dated August 1, 2006. The Economic Evidence Task Force was comprised of lawyers, antitrust economists, and a federal judge assembled in 2005 by the ABA's Antitrust Section for the purpose of "examining the role and effectiveness of economic evidence in antitrust proceedings."

[2] *See, e.g.*, John H. Langbein, *The German Advantage in Civil Procedure*, University of Chicago Law Review, 52 U. Chi. L. Rev. 823, (1985).

[3] *See, e.g.*, Allan Raitz, Edith Greene, Jane Goodman, & Elizabeth F. Loftus, *Determining Damages: The Influence of Expert Testimony on Jurors' Decision Making*, Law and Human Behavior, 14, 385-395, 1990; Edith Greene, Cheryl Downey, Jane Goodman-Delahunty, *Juror Decisions About Damages in Employment Discrimination Cases*, Behav. Sci. Law 17: 107-121 (1999).

[4] For an example of an economic model showing a "split the difference" outcome like this *see* Luke Froeb & Bruce H. Kobayashi, *Evidence Production in Adversarial vs. Inquisitorial Regimes*, Economics Letters, 70 (2), (2001), 267-272.

[5] Fed. R. Civ. P. 26.

[6] Upon seeing the plaintiff's expert provide unbiased and accurate damages testimony, an ethically challenged defendant's expert may choose to exploit the situation by providing unprofessional testimony that damages are well below actual damages. *See*, Jonathan Tomlin & David Cooper, *Expert Witnesses, Technical Advisors, and the Determination of Damages*, working paper, July 2007, available on the Social Science Research Network at http://papers.ssrn.com/soL3/papers.cfm?abstract_id=902434.

[7] Tomlin & Cooper *id.* In this context, we mean that damages awards are excessive or insufficient relative to the true level of damages, not to any measure of damages that may promote optimal deterrence of antitrust violations.

[8] See, e.g., Sofia Adrogue & Alan Ratliff, The Independent Expert Evolution: From the "Path of Least Resistance to the "Road Less Traveled?," 34 Tex. Tech L. Rev. 843, 885 (2003).

[9] Fed. R. Evid. 706. See, also, Joe S. Cecil and Thomas E. Willging, Accepting Daubert's Invitation: Defining a Role for Court-Appointed Experts in Assessing Scientific Validity, 43 Emory L.J. 995 Summer (1994).

[10] Cecil & Willging, *id*., at 1002.

[11] *See, e.g*., Adrogue & Ratliff, *supra* note 8; G. Michael Fenner, *The Daubert Handbook: The Case, Its Essential Dilemma, and its Progeny*, 29 Creighton L Rev. 939 (1996); Timothy Hillman, *Using Court-Appointed Experts*, New England Law Review, Vol. 36:3, 587, 2002; Lewis A. Kaplan, *2005 Milton Handler Antitrust Review: Experts in the Courthouse: Problems and Opportunities*, Colum.

Bus. L. Rev. 247 (2006); Joseph Sanders, *From Science to Evidence: The Testimony on Causation in the Bendectin Cases*, 46 Stan. L. Rev. 1 (1993); Brian Huseman, Note, *Taylor v. State, Rule 709, and the DNA Database: Future Directions in DNA Evidence*, 22 Okla. City U.L. Rev. 397 (1997); Jay Lazo, Comment, *True or False: Expert Testimony or Refused Memory*, 28 Loy. L.A. L. Rev. 1345 (1995); Michael C. Polentz, Comment, *Post-Daubert Confusion with Expert Testimony*, 36 Santa Clara L. Rev. 1187 (1996); Developments in the Law, *Confronting the New Challenges of Scientific Evidence*, Harv. L. Rev. 1481 (1995); Note, *Improving Judicial Gatekeeping: Technical Advisors and Scientific Evidence*, 110 Harv. L. Rev. 941 (1997).

[12] Final Report of Economic Evidence Task Force dated August 1, 2006, p. 8.

[13] Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993).

[14] *See, e.g.*, Zenith Elecs. Corp. v. WH-TV Broad. Corp., 395 F.3d 416 (7th Cir.), *cert. denied*, 125 S. Ct. 2978 (2005); Storage Tech. Corp. v. Cisco Sys., Inc., 395 F.3d 921 (8th Cir. 2005); Group Health Plan, Inc. v. Philip Morris USA, Inc., 344 F.3d (8th Cir. 2003); Lifewise Master Funding v. Telebank, 374 F.3d 917 (10th Cir. 2004); Lantec, Inc. v. Novell, Inc., 306 F.3d 1003 (10th Cir. 2004).

[15] Greater risk of exclusion may also impact the availability of witnesses willing to offer biased testimony due to the risk of harm to reputation from exclusion. However, what, if any effect, this deterrent effect on witnesses by itself would have on litigation outcomes is unclear if litigants and their attorneys, through the witness selection process, may select witnesses who they believe will maximize their own expected litigation outcomes.

[16] Hall v. Baxter Healthcare Corp., 947 F. Supp. 1387 (D. Or. 1996).

[17] For example, only 20% of federal district court judges surveyed in 1988 responded that they had used a court appointed expert on one or more occasions. *See*, Cecil & Willging *supra* note 9.

[18] *See, e.g.*, Cecil & Willging *supra* note 9 at 1018; Ratliff & Androgue *supra* note 8 at 886.

[19] *See, e.g.*, Final Report of Economic Evidence Task Force, *supra* note 1 at 9.

[20] Richard A. Posner, *The Law and Economics of the Economic Expert Witness*, Journal of Economic Perspectives, Spring 1999, Volume 13, Number 2.

The RPM Controversy: Dr. Miles, Leegin, and Beyond

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Introduction

George Bernard Shaw enjoyed telling the story of Count Leo Tolstoy to illustrate his argument that the public does not appreciate what it does not pay for. According to the story, Tolstoy put into the public domain the copyrights to his works as a gesture to mankind, unintentionally causing an immediate decline in the sales of his books.[1] This story captures a common market phenomenon: the demand for certain goods increases with price up to a certain point.[2] Examples of goods for which demand curves do not slope downward are abundant.[3] High-end fashion manufacturers often adjust prices upward to maintain the luxury status of their brands. For consumers of fashion houses like Louis Vuitton, Burberry, or Miu Miu, high price is part of the product's allure. It confers exclusivity and prestige.[4] In 2002, Tiffany began aggressively raising prices of its profitable silver jewelry lines in order to preserve its image as a high-end, luxury jewelry maker. Tiffany's executives were concerned that the popularity of its inexpensive lines of silver jewelry among middle-class shoppers would alienate its lucrative clientele of wealthy luxury consumers.[5] Wine is another example of a product which demand climbs with its price, up to a certain point. Similarly, some colleges have discovered that they were losing applicants when the tuition was low and attracting more qualified applicants when tuition is high.[6]

Many manufacturers use high prices to acquire and maintain a luxury image, utilizing various business schemes to preserve the high level of their prices and prevent the appearance that their products can be purchased at bargain prices. One of the simplest schemes to accomplish this goal is resale price maintenance ("RPM"). In June 2007, the Supreme Court, divided 5-4, handed down its decision in *Leegin*,[7] reversing the almost century old *per se* prohibition against RPM established by *Dr. Miles* (1911).[8]

The economic logic of the *per se* illegality of RPM has always been controversial, although the number of *Dr. Miles* supporters has dramatically declined over time. In *Leegin*, the Supreme Court did not declare RPM to be *per se* legal;[9] rather, it held that courts should examine RPM practices under the rule of reason. In this article, we review the RPM controversy, presenting the traditional arguments for and against *per se* illegality of RPM and emphasizing one of the most straightforward motivations for RPM – high prices as a product feature. The latter reason has played a background role in many RPM cases, including *Leegin*, although courts rarely address it directly. The myriad of competitive and anticompetitive effects of RPM suggest that *per se* illegality is indeed an undesirable standard.

The Underlying Questions

The RPM controversy involves one substantive question and two administrative questions. The substantive question is whether RPM is always or almost always anticompetitive and, therefore, should be illegal *per se*.[10] The administrative questions concern the impact of reversing a *per se* rule on business certainty and courts' ability to evaluate the competitive effects of RPM. Dissenting in *Leegin*, Justice Breyer attributed weighty significance to the administrative questions. The practical importance of these questions, however, is rather low for three reasons. First, under *Colgate* (1919), manufacturers can effectively dictate minimum prices through unilateral policies.[11] Second, judicial difficulties in evaluating a particular activity hardly justify outlawing that activity. Last but not least, the assessment of competitive effects of RPM does not pose intellectual challenges that are substantially different from those posed by other practices presently examined under the rule of reason. For these reasons, we examine only the substantive question of whether RPM practices are always or almost always anticompetitive so as to justify a *per se* prohibition.

Four major lines of theories offer justifications for and against *per se* illegality of RPM: conspiracy, free-riding, contract-enforcement mechanism, and the product-image theories. We review each line of theories separately, although they may intertwine in reality. Specifically, we argue that the *Leegin* Court missed another opportunity to address the role of RPM as a means to preserve high-prices to maintain brand image.

Conspiracy Theories

Conspiracy theories view RPM as means to facilitate a retailers' or manufacturers' cartel. Proponents of these theories, therefore, argue that RPM should be *per se* illegal.

In its most straightforward form, the conspiracy theory views RPM as a price-fixing tool among retailers, functioning like any horizontal price-fixing arrangement. Under this theory, RPM is the result of retailers' organized pressure on the manufacturer to enforce a retailer cartel. In such cases, RPM serves the interest of retailers, not those of the manufacturer or consumers.[12] In *Dr. Miles*, the Supreme Court endorsed this theory.[13] That case involved "over four hundred jobbers and wholesalers and twenty-five thousand retail dealers"[14] nationwide, figures that rarely support collusion hypotheses. Nevertheless, the record before the Court and additional judicial decisions indicate that the retail druggists indeed colluded to use manufacturers, such as Dr. Miles, as cartel enforcers through RPM.[15]

A second line of "conspiracy" theories warns that dominant retailers may demand RPM to forestall innovation in distribution channels. For example, a brick-and-mortar retailer may demand RPM to prevent efficient online retailers from price competition.[16]

A third line of conspiracy theories views RPM as serving the manufacturer's interests. One explanation is that RPM facilitates collusion among manufacturers, similar to horizontal price-fixing.[17] In such markets, RPM allegedly eliminates manufacturers' incentives to cut prices to retailers, since such price cutting will result in higher profitability for retailers but no changes in sales volume and lower profits for the price-cutting manufacturer.[18]

Another explanation suggests that manufacturers sometimes engage in RPM to offer dealers high markups as a "payment" for the dealers' willingness not to deal with competing manufacturers.[19]

Proponents of the conspiracy theories point out that, in addition to the standard social costs associated with price fixing, RPM could stimulate wasteful non-price competition in which redundant ancillary services and benefits substitute for low prices.[20]

Free-Riding Theories

The non-price competition that "conspiracy theorists" perceive as socially wasteful is for "free-riding theorists" the very justification for RPM. Popularized by Lester Telser,[21] free-riding theories argue that a manufacturer may engage in RPM only in circumstances where non-price competition among retailers serves its interests better than price competition. The starting point of these theories is that, frequently, ancillary services to consumers, such as in-store services, delivery, credit, repair, advertising, and other promotional activities enhance demand. Such ancillary services, however, are costly and retailers have no guarantee they would result in a sale. A retailer that advertises a product, displays it at its showroom, and employs knowledgeable staff to educate shoppers about it cannot prevent shoppers who use these services to learn about the product from purchasing it at a cheaper price from a retailer that does not provide similar services. This inability to contain ancillary services could motivate some retailers to cut costs by free riding on other retailers' ancillary services and use the cost savings to cut prices. Put simply, the concern is that "[a]bsent vertical price restraints, the retail services that enhance interbrand competition might be underprovided."[22] In other words, retailers that provide desirable ancillary services lose business to discounters and may have to stop furnishing such costly services. Free-riding theories, therefore, argue that manufacturers engage in RPM to assure the provision of ancillary services that enhance the demand for their products.

A variant of the traditional free-riding theory is the theory that new manufacturers and manufacturers entering new markets use RPM to induce retailers to invest in promoting the product to consumers who are unfamiliar with the brand or the product.[23]

Another free-riding explanation suggests that sometimes consumers learn about high-quality products from the reputation of retailers that carry such products. Discounters may free ride on the reputation of such retailers, attracting to their stores consumers by selling high-quality products as loss leaders or just at bargain prices.[24] RPM prevents such free riding.

Courts often reduce free-riding theories to a misleading short sentence: "resale price maintenance can stimulate interbrand competition … by reducing intrabrand competition."[25] As explained above, this statement is somewhat simplistic because, as opposed to certain non-price vertical constraints, RPM substitutes intrabrand price competition for intrabrand non-price competition, at least to some extent.[26]

Theories of Contract-Enforcement Mechanisms

Benjamin Klein, Keith Leffler, and Kevin Murphy popularized a third line of theories, under which vertical restraints, including RPM, may function as contract enforcement mechanisms.[27] While the conspiracy and free-riding theories attribute normative implications to vertical arrangements, the theories of contract-enforcement are relatively neutral. They suggest that parties may engage in RPM to enforce vertical contractual arrangements. Such arrangements may be competitive or anticompetitive.

For example, the high markup that RPM offers retailers is used to support both conspiracy and free-riding theories. This markup may function as a payment for willingness not to deal with competitors and it may also function as a payment to furnish desirable ancillary services. Theories of contract-enforcement mechanisms can support either interpretation.

Critics of the free-riding theories frequently raise the question of why manufacturers engage in RPM rather than contracting directly for the provision of desirable ancillary services.[28] Theories of contract-enforcement mechanisms answer this question: RPM saves transaction costs associated with the formation and enforcement of such contracts.

Product-Image Theories

In *Dr. Miles*, one of the manufacturer's arguments was essentially that the discounting retailer used its medicines as loss leaders.[29] Manufacturers' objection to the use of their products as loss leaders is presumably puzzling. Loss-leader pricing theoretically should benefit manufacturers, as the retailer's pricing below cost is likely to increase sales volume, while the manufacturer is still paid the full price. Many manufacturers, however, resent the use of their goods as loss-leaders because they believe such use would damage their good's image and, over time, result in decline in demand. RPM is a simple anti-loss-leader mechanism.[30] The importance of protecting high prices is particularly important for manufacturers of luxury goods.[31]

As the examples at the outset of this article illustrate, luxury goods manufacturers believe that high prices enhance the demand for their products, because in the eyes of their clientele the exclusivity that high prices confer is a desirable product feature. This explanation for RPM is rather straightforward, although generally neglected by courts and the literature.[32] Indeed, in *Leegin*, high price was a feature of the defendant's luxury brand (Brighton). One goal of Leegin's RPM policy was to maintain its brand's image and reputation by preventing discounting.[33] The *Leegin* Court largely ignored this explanation, concentrating on Leegin's "free-riding" justification that RPM gave its retailers sufficient margin to provide customers with the services central to its distribution strategy.[34] The Supreme Court refrained from explicitly stating that maintenance of high prices may be a legitimate business strategy.

Furthermore, the facts of *Leegin* demonstrate that luxury manufacturers care not only about the price of their products but also about the exclusive atmosphere that retailers furnish, which supplements the image created by high price. In *Leegin*, the majority and the minority opinions equated "exclusive atmosphere" with the desirable ancillary services that underlie free-riding theories. Despite the similarities, retailers can contain much of the benefits associated with their stores' atmosphere and, therefore, "atmosphere" is more similar to high prices than to desirable ancillary services.

The *Leegin* Court has followed many other courts and much of the RPM literature by generally neglecting the straightforward observation that RPM is one way to preserve a product feature that is important to certain consumers: high prices.

Conclusion

The RPM controversy is almost one-hundred-year old, although its practical implications are limited. Under *Colgate* (1919), manufacturers can refuse to deal with retailers that sell products below suggested prices, thereby effectively forcing retailers not to undercut such minimum prices.

Many RPM theorists insist that their explanations for the practice are conclusive and exclusive and dismiss other explanations. While systematic empirical evidence is not available, anecdotal evidence suggests that some explanations apply to certain cases and others to other cases.[35] Very often, only a combination of RPM theories explains the reasons and effects of RPM employed by a particular manufacturer. Put simply, neither the conspiracy theories nor the free-riding theories always or almost always apply to RPM cases and, therefore, *per se* illegality or *per se* legality are not the appropriate standards. The rule of reason indeed should govern RPM cases.

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[1] William Jovanovich, Writing and Reading for Love and Money, 22 Bulletin of Copyright Society 235-241, 239 (1975).

[2] *See generally* Robert H. Frank, Choosing the Right Pond: Human Behavior and the Quest for Status (1985); Robert R Frank, Luxury Fever: Why Money Fails to Satisfy In an Era of Excess (1999); Yew-Kwang Ng, Diamonds Are a Government's Best Friend: Burden-Free Taxes on Goods Valued for their Values, 77 American Economic Review 186-191 (1987); Tibor Scitovsky, Some Consequences of the Habit of Judging Quality by Price, 12 Review of Economic Studies 100-105 (1945); Thorstein Veblen, The Theory of the Leisure Class (1899). For antitrust implications, *see* Barak Y. Orbach, Vertical Myths: High Prices as a Product Feature, Arizona Law Review (forthcoming, 2008).

[3] The classic example is of course Giffen goods, first described by Alfred Marshall in 1895. Marshall, Alfred, Principles of Economics 208 (1895). Economists have remained skeptical of the existence of Giffen goods. *See, e.g.*, Gerald P. Dwyer and Cotton M. Lindsay, Robert Giffen and the Irish Potato, 74 American Economic Review 188-192 (1984); George J. Stigler, Notes on the History of the Giffen Paradox, 55 Journal of Political Economy 152-156 (1947); Sherwin Rosen, Potato Paradoxes, 107 Journal of Political Economy S294-S313 (1999). *Cf.* William R. Dougan, Giffen Goods and the Law of Demand, 90 Journal of Political Economy 809-815 (1982). In this article, we focus on luxury goods the common existence of which is not disputed.

[4] *See, e.g.*, Ruth La Ferla, When High Price is the Allure, N.Y. Times, Aug. 9, 2007.

[5] Ellen Byron, To Refurbish Its Image, Tiffany Risks Profits, Wall Street Journal, Jan. 10, 2007, at A1.

[6] Jonathan D. Glater & Alan Finder, In Tuition Games, Popularity Rises With Price, N.Y. Times, Dec. 12, 2006.

[7] Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S.Ct. 2705 (2007).

[8] Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

[9] Twenty some years ago, Richard Posner proposed such a standard. Richard A. Posner, The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality, 48 University of Chicago Law Review 6-26 (1981).

[10] Business Music, Inc. v. Columbia Broadcasting Music, 441 U.S. 1, 19-20 (1979) ("in characterizing … conduct under the per se rule … our inquiry must focus on whether the effect and … the purpose of the practice … would always or almost always tend to restrict competition"); National Collegiate Athletic Assn. v. Board of Regents of University of Oklahoma, 468 U.S. 85, 103-104 (1984) ("Per se rules are invoked when surrounding circumstances make the likelihood of anticompetitive conduct so great as to render unjustified further examination of the challenged conduct").

[11] U.S. v. Colgate & Co., 250 U.S. 300 (1919).

[12] *See, e.g.*, Robert Pitofsky, In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing, 71 Georgetown Law Journal 1487-1495, 1490 (1983) ("Indeed, experience shows that the manufacturer is often induced to act as an organizer of the dealer's cartel by dealer threats or enticements"). A classic example is Interstate Circuit v. United States, 306 U.S. 208 (1939), where the Supreme Court inferred a price-fixing arrangement among eight motion picture distributors enforced through an identical minimum admission fee clause in each distributor's contract with an exhibitor.

[13] *Dr. Miles*, 220 U.S., at 407 ("the advantage of established retail prices primarily concerns the dealers. The enlarged profits … would go to them, and not to the [manufacturer]").[13]

[14] *Id.*, at 381.

[15] Herbert Hovenkamp, Enterprise and American Law: 1836-1937 340-347 (1991); Herbert Hovenkamp, The Antitrust Enterprise: Principle and Execution 186-187 (2005).

[16] *See, e.g.*, Toys "R" Us, Inc. v. FTC, 221 F.3d 928 (7th Cir. 2000).

[17] *Leegin*, 127 S.Ct., at 2727 (Justice Breyer, dissenting).

[18] Pitofsky, In Defense of Discounters, *supra* note 12, at 1490-1491. *See also* Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717, 725-726 (1988); *Leegin*, 127 S.Ct., at 2716.
[19] Howard P. Marvel & Stephen McCafferty, The Welfare Effects of Resale Price Maintenance, 28 Journal of Law & Economics 363-379, 366-368(1985). *See also* Alfred S. Eichner, The Emergence of Oligopoly 190-195 (1969); Basil Selig Yamey, The Economics of Resale Price Maintenance 34-35 (1954); Richard Zerbe, The American Sugar Refinery Company, 1887-1914: The Story of a Monopoly, 12 Journal of Law & Economics 339-375, 368 (1969).
[20] *See, e.g.*, William S. Comanor, Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy, 98 Harvard Law Review 983-1002 (1985).
[21] Lester Telser, Why Should Manufacturers Want Fair Trade?, 3 Journal of Law and Economics 86-105 (1960); Lester Telser, Why Should Manufacturers Want Fair Trade II? 33 Journal of Law and Economics 409-417 (1990).
[22] *Leegin*, 127 S.Ct. at 2715. *See also* Continental T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 51 (1977).
[23] *GTE Sylvania*, at 55. Howard P. Marvel & Stephen McCafferty, Resale Price Maintenance and Quality Certification, 15 Rand Journal of Economics 346-359 (1984).
[24] Marvel & McCafferty, *Id*.
[25] Leegin, id. See also GTE Sylvania, 433 U.S. at 55.
[26] *See also* Richard A. Posner, Antitrust Law (2d ed., 2001) ("the manufacturer may want to increase the amount of non-price competition among the dealers in order to stimulate the provision of point-of-sale services").
[27] Benjamin Klein and Keith Leffler, The Role of Market Forces in Assuring Contractual Performance 89 Journal of Political Economy 615-642 (1981); Benjamin Klein and Kevin M. Murphy, Vertical Restraints as Contract Enforcement Mechanisms, 31 Journal of Law and Economics 265-297 (1988).
[28] Pitofsky, In Defense of Discounters, *supra* note 12, at 1493.
[29] *Dr. Miles*, 220 U.S., at 381-382.
[30] *See, e.g.*, Marvel & Stephen McCafferty, The Welfare Effects of Resale Price Maintenance, *supra* note 19, at 374-378.
[31] *See supra* note 2.
[32] *See*, Orbach, Vertical Myths, *supra* note 2.
[33] *Leegin*, 127 S.Ct. at 2711 ("[Leegin] also expressed concern that discounting harmed Brighton's brand image and reputation").
[34] *Id.*
[35] One of the most cited surveys in the field is Thomas Overstreet's dissertation that the Leegin's Court cited extensively. This work, despite its age, is still useful. Thomas R. Overstreet, Jr., An Economic Analysis of Resale Price Maintenance (Unpublished Dissertation, 1986).

Antitrust Damages in Exclusionary Practice Cases

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Introduction

Exclusionary practices are identified as supporting a Sherman § 2 monopolization or attempt offense. Exclusive contracts and other vertical exclusionary practices such as tied sales, concerted refusals to deal, as well as vertical mergers and non-price restraints fall under the purview of acts thought to facilitate monopoly pricing. Most of these practices have had a rich and contentious history in U.S. antitrust law and analysis. For example, during much of the first half of the twentieth century, U.S. courts typically viewed exclusive contracts as anticompetitive. In the 1950s, proponents of the Chicago School carried out a two-pronged attack on existing economic arguments that viewed exclusive contracts as anticompetitive. First, they argued that rational firms would not engage in practices such as exclusive dealing for anticompetitive reasons. Second, they posited efficiency-enhancing reasons why rational firms would agree to exclusionary practices.[1]

The Chicago view turned out to be enormously influential and has permeated courts' views on vertical practices up through the present. However, more recent game-theoretic models of oligopoly market structures have showed that the courts' pre-Chicago concerns may not be unfounded. These models demonstrate that in certain circumstances rational firms could use exclusionary practices to exclude rivals and reduce competition. However, this very active area of research remains controversial and unsettled.[2] Further, there is little convincing empirical work that has established guidelines for distinguishing between competitively harmless and harmful exclusionary practices.

Economic Analysis

Once antitrust liability is established, antitrust damages are usually calculated "by a comparison of profits, prices and values as affected by the conspiracy, with what they would have been in its absence under freely competitive conditions."[3] In a practical sense, this is tantamount to calculating "lost profits." The status of the plaintiff's business is, of course, a key variable in determining the exact nature of lost profits – the plaintiff could still be in business but has lost sales or has seen an increase in costs owing to the defendant's conduct; it could have gone out of business altogether owing to the defendant's actions; or, it could have been precluded from ever entering the market.

Damages when the Plaintiff is Still in Business

In cases where the plaintiff is a going concern, courts generally accept one of three conventional methods for assessing damages: the before-and-after method, the yardstick method, and the market share method. The following discussion focuses on these three methods.

The before-and-after method is conceptually straightforward but often difficult to execute in practice. Conceptually, the before-and-after method examines relevant metrics (this includes, but is not limited to, sales and profits) of the plaintiff's business before the violation, during the violation period, and after the violation and then estimates the amount of profits lost as a result of the violation. In practice, the damages expert is faced with an array of complications, not least because of the fact that "before-and-after" usually tends to devolve into before-*or*-after because a justifiable "before" and "after" period cannot be identified. Further complications may result from the demand curve for the product market shifting during the violation period to not being able to account for the entry of other competitors. Despite these complications, the before-and-after method is sometimes used by plaintiff's experts, and careful applications of the method employ statistical and/or econometric techniques to isolate the effects of the violation. For example, in *Key Enterprises v. Venice Hospital*, the plaintiff's expert used linear regression along with some conservative judgments about the length of the damages period, the monthly losses of the plaintiff, and the discount rate for calculating the present value of lost sales.[4] However, in the absence of careful application of the before-and-after method, courts may reject the damages study for failing to separate out losses caused by lawful conduct.

The yardstick method is intuitive: the yardstick is usually another firm that is comparable to the plaintiff (or the plaintiff itself) operating in a comparable market selling a comparable product. The plaintiff's expert attempts to use a firm or a market that is very similar to the plaintiff's in all respects but for the effects of the exclusive conduct. In practice, the yardstick method has to examine the degree of similarity between the affected firm/market and the yardstick by examining several factors. These factors include, but are not limited to, whether the markets of the plaintiff firm and the yardstick firm are coterminous, if the two firms offer the same – or very similar – set of products, if the firms have similar product mixes, if they have comparable sales forces, and if their business models are almost identical. Clearly, each factor brings with it a possibility of dissimilarity. Taken together, the potential dissimilarities may therefore fail to produce a reliable inference of a justifiable yardstick. For example, in *Home Placement Serv. v. Providence Journal Co.*, the First Circuit court rejected the yardstick approach because there was not enough evidence that the plaintiff firm and the yardstick firm had similar business models.[5] Similarly, in *Rose Confections, Inc. v. Ambrosia Chocolate Co.*, the Eighth Circuit court opined that dissimilarity of the geographic markets made a yardstick comparison infeasible.[6] To be sure, a critique of the yardstick approach should be tempered by recognizing that the dissimilarities may actually underestimate, rather than overestimate, plaintiff's damages, and that the approach may be used with success for carefully considered markets where products are fairly homogenous and competition is local.

The third approach – the market share method – is premised on the plaintiff's expert establishing a loss in market share as a result of the defendant's exclusionary conduct. This approach can end up being a variation of the first two approaches because the "but for" market share is usually arrived at by either looking at a yardstick or doing a before-and-after comparison. For example, a supplier of the affected product X to a fixed set of hospitals may claim that it enjoyed a 27 percent market share for unaffected product Y in the same set of hospitals. However, it only has a 2 percent market share of X (presumably owing to the rival defendant's exclusionary conduct). Therefore, its lost market share is 25 percent. The market share method can also be predicated on coming up with a yardstick downstream market. For example, in *Multiflex, Inc. v. Samuel Moore & Co.*, plaintiff Multiflex, Inc. sold hydraulic hose bundles to both equipment manufacturers that employed the hoses and end users. (The defendant allegedly used exclusionary means in the former market but not the latter.) The plaintiff's expert used the difference in market shares in the "yardstick" market (end users) with the "tainted" market (equipment manufacturers) along with a formula correlating plaintiff's profits with market shares to calculate Multiflex's lost profit in the equipment market. The Fifth Circuit court accepted this methodology but ended up rejecting the plaintiff expert's model because it failed to isolate Sherman § 1 damages (in which no liability was found) from Sherman § 2 damages (where it was).[7]

Departures from Conventional Methods

An alternative to the lost market share approach is to examine particular sales that have been lost as a result of the violation and apply a profit margin per sale to arrive at damages. This method may be particularly successful if the plaintiff sells the foreclosed product(s) in several markets but antitrust violation occurs in only one market.

Sometimes methodologies that depart quite radically from the three commonly-accepted approaches outlined above find their day in court as the *Conwood* case attests.[8] In *Conwood*, the plaintiff's expert did not carry out a conventional "before-and-after" or "yardstick" test using the available sales data. Instead, he employed an alternative methodology that apparently demonstrated that the growth in the sales of moist snuff (the product in question) was serially correlated in the damages period but uncorrelated in his "before" (the seven year period immediately prior to the damages period that lasted seven years) and "yardstick" (dry snuff, sold by the plaintiff but not the defendant) markets. The correlation in the damages period, he argued, was due to the defendant's conduct: in states where the plaintiff was "forced" into having small market share, the smallness of the market share persisted through the entire damages period. Damages were then calculated by assuming that the plaintiff's "but for" market shares in the low market share states would mimic their shares in the high market share states. Legal and economic scholars have expressed serious reservations about the *Conwood* methodology, not least because the plaintiff's expert did not *prove* that the correlation between initial market shares and subsequent growth was driven solely by the defendant's conduct. That this correlation might be a feature of oligopoly markets (like the moist snuff market) is not something that the plaintiff's expert tested.[9] Nevertheless, it is not a little ironic that the plaintiff expert's alternative methodology led to a more than a billion-dollar damages award when a conventional "before-and-after" or "yardstick" test using the available sales data "would have produced zero or negligible damages."[10]

Damages when the Plaintiff is not in Business

Another set of considerations pertains to cases where exclusionary conduct causes the plaintiff to go out of business altogether or when the plaintiff is precluded from entering the market. In the former case, damages could be calculated as the net present value of future profits or by examining what a rational and willing buyer would have been prepared to pay for the plaintiff's business. In the latter case, where the plaintiff is precluded from entering the market, plaintiffs most often claim future lost profits. This may be a highly speculative exercise, not least because a fairly high proportion of businesses fail to take off for reasons that have nothing to do with the antitrust injury at issue.[11] Examining sunk costs of the precluded entrant and making the plaintiff whole for any already-contracted future sales that were not made as a result of preclusion are some methods that are alternatives to claiming future lost profits.[12]

Conclusion

In most cases that involve damages arising out of exclusionary practices, the plaintiff generally claims damages for what may loosely be called "lost profits." The three commonly-accepted methods for calculating lost profits – before-and-after, yardstick, and lost market share – have enjoyed varying degrees of acceptance by courts, but remain fraught with loopholes, non-sequiturs, and the perils of implausible causal arguments. It is worth quoting in full the Seventh Circuit court's caution in Isaksen v. Vermont Castings, Inc., that

> All [the plaintiff] did to prove damages was to compare his average profits for several years before and several years during the period of unlawful activity. *Post hoc ergo propter hoc* is not a valid methodology for damages calculation, especially when it is apparent that other causal factors are at work.[13]

This caution, while most directly applicable to the before-and-after method, holds true for any methodology that purports to calculate damages arising from exclusionary practices: any calculation of damages should necessarily try to disentangle all the causal factors at work and identify as germane only those causes that arise from the defendant's exclusionary conduct. It is only the latter that should form the predicate for any damages calculation.

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* The views expressed in this article do not necessarily represent the views of Cornerstone Research.

[1] See, for example, A. Director and E. Levi, "Law and the Future: Trade Regulation," Northwestern U. L. Rev. 51: 281-296 (1956); R.A. Posner, *Antitrust Law: An Economic Perspective*, U. of Chicago Press (1976).

[2] For a theoretical overview of models that deal with vertical contracts, see M. Whinston, *Lectures in Antitrust Economics*, Ch.4, MIT Press (2006).

[3] Los Angeles Memorial Coliseum Commission v. National Football League, 791 F.2d 1356, 1367 (9th Cir.1986).

[4] Space does not permit a detailed examination of the specific assumptions made and the method employed in *Key Enterprises*; however, an extensive discussion is provided in William H. Page (ed.), *Proving Antitrust Damages: Legal and Economic Issues*, Section of Antitrust Law American Bar Association, (1996).

[5] Home Placement Serv. v. Providence Journal Co., 819 F.2d 1199, 1205 & n.7 (1st Cir.1987)

[6] Rose Confections, Inc. v. Ambrosia Chocolate Co., 816 F.2d 381, 393-394 (8th Cir.1988).

[7] *Multiflex, Inc. v. Samuel Moore & Co.*, 709 F.2d 980, 996-997 (5th Cir.), rehearing denied, 709 F.2d 901 (5th Cir.1983), cert. denied, 465 U.S. 1100, 104 S.Ct.1594 (1984).

[8] Conwood Co., L.P. v. United States Tobacco Co., 290 F.3d 768 (6th Cir.2002).

[9] See, for example, the discussion in Herbert Hovenkamp, *The Antitrust Enterprise: Principle and Execution*, Harvard U. Press (2005), pp. 174-8 and his *Federal Antitrust Policy: The Law of Competition and its Practice*, 3rd Ed., Thomson West (2005), p.647-8.

[10] Herbert Hovenkamp, Federal Antitrust Policy: The Law of Competition and its Practice, 3rd Ed., Thomson West (2005), p.647.

[11] See, for example, R.D. Blair and W.H. Page, '"Speculative' Antitrust Damages," Wash. L. Rev. 423, 452 (1995).

[12] W.B. Tye, *et al.*, "How to Value a Lost Opportunity: Defining, Proving, and Measuring Damages from Market Foreclosure," 17 Res. L. and Econ. 83 (1995).

[13] *Isaksen v. Vermont Castings, Inc.*, 825 F.2d 1158, 1165 (7th Cir.1987), cert. Denied, 486 U.S. 1005, 108

S.Ct. 1728 (1988); cited in Herbert H. Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice*, 3rd Ed., Thomson West (2005), p.681, n.17. [Emphasis added.]

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