Federal Trade Commission

Monopolies, Innovation, and Predatory Pricing:
Observations on Some Hard Questions in the Section 2 Context

Remarks of J. Thomas Rosch*
Commissioner, Federal Trade Commission

before the

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I've been asked today to provide some perspectives on unilateral conduct enforcement. I've spoken about this topic on many occasions – including, in fact, here in Los Angeles earlier this week where I opined about the extent to which the Commission should use Section 5 to reach anticompetitive unilateral conduct that Section 2, with its current common law baggage, might not reach. Rather than revisit that topic (my remarks will be posted on the Commission's website), I'd like to take a different approach today and discuss the extent to which we at the enforcement agencies, as well as federal judges, have a particularly heavy responsibility when it comes to hard cases

* The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisor, Amanda Reeves, for her invaluable assistance preparing this paper.

(including those in the Section 2 context) to make sure that the rules we are applying in a particular context actually make sense. My remarks will proceed in three parts. First, I'll discuss the deference that we, as public enforcers of the antitrust laws, should pay to the patent laws in the Section 2 context. Second, I'll discuss what degree of deference the existence of a patent should get in the context of our Section 2 enforcement. Third, I'll discuss the application of the antitrust laws, and specifically Section 2, to firms that make huge upfront investments in developing or exploiting their intellectual property.

I.

The extent to which deference should be paid to firms that enjoy monopoly power has been the subject of extensive debate, including comment by the Supreme Court. In the *Trinko* case, for example, Justice Scalia suggested that those who enforce the antitrust laws ought to be deferential to firms with monopoly power, which he characterized as "an important element of a free market system."[1] The reason for that, he said, is that the opportunity to acquire monopoly power and charge monopoly prices is "what attracts 'business acumen' in the first place" and "induces risk taking that produces innovation and economic growth."[2] In contrast, others, stretching back to Learned Hand's decision

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[1] *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).

[2] *Id*. The DOJ Section 2 Report likewise embraced this view by basing much of its analysis on theory that the promise of monopoly profits drives firms to innovate and compete. *See, e.g.*, U.S. DEP'T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (2008) [hereinafter REPORT] at 7-8, 49, 119.

in *Alcoa*,[3] have argued that monopoly power incentivizes conduct that is inefficient and thereby harms consumers and society as a whole.[4]

Perhaps both sides have painted with too broad a brush. I'd like to suggest today that it may be the case that monopolies are neither presumptively good or bad but instead that if we're going to defer to monopoly power (and create rules that protect it), we need to conclude that monopoly power does, in fact, in the industry at hand, drive innovation. If the opportunity to charge monopoly profits isn't driving innovation, then arguably protecting those monopolies makes no sense. At that point, not only are the aims of the antitrust laws not being served, but on balance, the aims of the patent laws are arguably not being served either.

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[3] *United States v. Aluminum Co. of America* ("*Alcoa*"), 148 F.2d 416, 427 (2d Cir. 1945) (identifying three evils associated with monopoly power: (1) that a dominant firm has excessive power over price; (2) that excessive prices reduce efficiencies and create deadweight loss; and (3) that monopolies "deadens initiative," "depress[] energy" and eliminate[] rivalry"); *see also Standard Oil Co. v. FTC*, 340 U.S. 231, 252 (1980) (citing the danger that a monopoly will "fix the price," impose a "limitation on production," or cause a "deterioration in the quality of the monopolized product").

[4] To this end, it is not clear that greater concentration impedes optimal dynamic performance. *See* Fed. Trade Comm'n, *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy* Ch. 2 at 12-15 (2003) [hereinafter FTC Innovation Report] ("Statistical cross-section studies examining multiple industries have not identified any clear relationship between concentration and innovation."); *see also Federal Trade Commission and Department of Justice Hearings on Section 2 of the Sherman Act: Single-Firm Conduct As Related to Competition*, Sept. 26, 2006 Hr'g Tr., Empirical Perspectives at 13 (Scherer), *available at* http://www.ftc.gov/os/sectiontwohearings/docs/transcripts/sept26EmpiricalPerspectivestrans.pdf (observing that reluctance to "cannibalize the rents that they are earning on the products that they already have marketed" may make monopolists "sluggish innovators"); Statement of Chairman Timothy J. Muris, Genzyme Corporation / Novazyme Pharmaceuticals, Inc., FTC File No. 021 0026 (Jan. 13, 2004), *available at* http://www.ftc.gov/os/2004/01/murisgenzymestmt.pdf ("[N]either economic theory nor empirical research supports an inference regarding the merger's likely effect on innovation (and hence patient welfare) based simply on observing how the merger changed the number of independent R&D programs. Rather, one must examine whether the merged firm was likely to have a reduced incentive to invest in R&D, and also whether it was likely to have the ability to conduct R&D more successfully.").

Several studies have found, for example, that patents rarely drive innovation in certain industries; instead, firms generally prefer a variety of other mechanisms for appropriating their innovations such as secrecy and lead time over competitors (the "first mover" advantage). An early and relatively small study of 100 firms concluded that patents were essential for innovation in only two of twelve industries: pharmaceuticals and chemicals, but, significantly, not in high tech industries.[5] A later study of 650 firms found that patents were rated last out of five strategies for protecting new products and that, again, patents were considered more useful for protecting pharmaceuticals and certain chemicals.[6] A third study concluded that "patents are unambiguously the least central of the major appropriability mechanisms."[7] Like the other studies, this one found that the importance of patents varies by industry, with pharmaceuticals and medical equipment standing out at the high end and semiconductors and communications equipment at the low end.[8]

A few years ago, the ABA's Section of Antitrust Law reviewed the empirical studies and likewise concluded that patents are an important inducement to innovation in only a few industries and that expanding the rights provided by an existing patent system

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[5] Edwin Mansfield, *Patents and Innovation: An Empirical Study*, 32 Mgmt. Science 173 (1986).

[6] Richard C. Levin et al., *Appropriating the Returns from Industrial R&D*, Brookings Papers on Economic Activity 783, 794-95 (1987). The five ways of protecting new processes and products in the survey were lead time, learning curve advantages, complementary sales or service advantages, secrecy, and patents.

[7] Wesley M. Cohen, Richard R. Nelson & John P. Walsh, *Protecting Their Intellectual Assets: Appropriability Conditions and Why U.S. Manufacturing Firms Patent (or Not)* 9 (Nat'l Bureau of Econ. Research Working Paper No. 7552, 2000).

[8] *Id*. Table 1.

doesn't increase overall inventive activity.[9] The ABA Report found that patents helped stimulate R&D in the pharmaceutical industry but not in some high-tech industries where "the advantages that come with a head start, including setting up production, sales and service structures and moving down the learning curve, were judged much more effective than patents as an inducement to R&D."[10] Several other surveys of the empirical data have also concluded that there is little or no link between the degree of patent protection and innovation in many industries.[11]

The upshot of these studies may suggest a sectoral approach to antitrust law enforcement when it comes to practices associated with patents, as for example, patent pools, refusals to license, and the like. These studies may suggest that insofar as innovation is considered important to the free enterprise system, more tolerance for these

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[9] ABA Section of Antitrust Law, *The Economics of Innovation: A Survey* § II.E. (2002).

[10] *Id*. For a contrary view, see Yi Qian, *Do National Patent Laws Stimulate Domestic Innovation in a Global Patenting Environment? A Cross Country Analysis of Pharmaceutical Patent Protection, 1978-2002*, 89 Rev. Econ. & Statistics 436 (2007) (concluding that patent protection does not stimulate pharmaceutical innovation).

[11] *See, e.g.*, FTC Innovation Report, *supra* note 7, Ch. 2(II)(A)(2), at 11 (2003) ("Empirical study has shown that in some industries, firms often innovate to exploit first-mover advantages, learning-curve advantages, and other advantages, not to gain patent protection."); *see also id.* ch. 2(I)(A)(1), at 5 ("[A] number of studies have shown that [other] measures typically are more important than patents for protecting appropriability in many industries."); Cohen, *supra* note 19, at 2 (stating that prior studies "suggest that patent protection is important in only a few industries, most notably pharmaceuticals"); Adam B. Jaffe, *The U.S. Patent System in Transition: Policy Innovation and the Innovation Process*, 29 Research Policy 531, 540, 554 (2000) (noting that there is "little empirical evidence" that strengthening patent protection in the 1980s increased innovation and that several studies suggest "that patents are not central to appropriating the returns to R&D in most industries"); Michele Boldrin & David K. Levine, *Does Intellectual Monopoly Help Innovation?* 13 (Working Paper 2009) ("We have identified twenty three economic studies that have examined the issue empirically. The executive summary: they find weak or no evidence that strengthening patent regimes increases innovation; they find strong evidence that strengthening the patent regime increases patenting!").

practices is warranted when the industry involved is an industry like the pharmaceutical industry, where patentability is deemed a driver of innovation, than in high tech industries, where patentability is thought to be less critical to innovation.[12] Such an approach would be consistent with the Supreme Court's view that the degree of antitrust protection to conduct involving patents should be a function of whether the imposition of antitrust liability would undermine the incentives for innovation and disclosure created by the patent regime.[13]

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[12] *See, e.g,*. FTC Innovation Report, *supra* note 7, Ch. 2(II)(A)(2), at 11 (2003) ("Empirical study has shown that in some industries, firms often innovate to exploit first-mover advantages, learning-curve advantages, and other advantages, not to gain patent protection."); *see also id.* ch. 2(I)(A)(1), at 5 ("[A] number of studies have shown that [other] measures typically are more important than patents for protecting appropriability in many industries."); Cohen, *supra* note 19, at 2 (stating that prior studies "suggest that patent protection is important in only a few industries, most notably pharmaceuticals"); Adam B. Jaffe, *The U.S. Patent System in Transition: Policy Innovation and the Innovation Process*, 29 Research Policy 531, 540, 554 (2000) (noting that there is "little empirical evidence" that strengthening patent protection in the 1980s increased innovation and that several studies suggest "that patents are not central to appropriating the returns to R&D in most industries"); Michele Boldrin & David K. Levine, *Does Intellectual Monopoly Help Innovation?* 13 (Working Paper 2009) ("We have identified twenty three economic studies that have examined the issue empirically. The executive summary: they find weak or no evidence that strengthening patent regimes increases innovation; they find strong evidence that strengthening the patent regime increases patenting!").

[13] *See, e.g., Walker Process Equip., Inc. v. Food Mach. & Chem. Corp.*, 382 U.S. 172, 179-80 (1965) (Harlan J., concurring) ("It is well also to recognize the rationale underlying this decision, aimed of course at achieving a suitable accommodation in this area between the differing policies of the patent and antitrust laws.") (noting that exposing patentees to antitrust liability for the assertion of a patent known to have been procured by fraud "cannot well be thought to impinge upon the policy of the patent laws to encourage inventions and their disclosure"); *Zenith Elec. Corp. v. Exzec. Inc.*, 182 F.3d 1340, 1352 (Fed Cir. 1999) ("The patent and antitrust laws are complementary in purpose in that they each promote innovation and competition."). As Herbert Hovenkamp has noted:

> It is commonly said . . . that the patent and antitrust laws necessarily clash . . . At the same time, the two regimes seek the same object: the welfare of the public . . . Antitrust law forbids certain agreements tending to

II.

That leads me to the second topic I'd like to discuss, and that is the degree of deference that those of us charged with public law enforcement can or should grant claims that innovation is ongoing or is likely to occur. This issue most frequently arises when we assess mergers under Section 7 of the Clayton Act. But it may also arise when we assess single firm conduct by firms with monopoly power. In both instances, we're frequently met with the assertion that the market is dynamic, by which I mean that the market structure is likely to change dramatically over time. Or, it may be asserted that a transaction or practice will be efficient over time because of innovation. We certainly cannot ignore those assertions. After all, in *General Dynamics*, the Supreme Court held that when the past (or present) is not prologue, our assumptions based on current empirical data or other evidence must be adjusted to reflect those changes.[14] In my view, there are at least three overlapping issues in this context.

The first issue is how much time should we, as public law enforcers, give for such innovation to occur? Should our analysis be capped at a period of years looking forward? Or should it be more fluid depending on the industry? In the pharma context, for example, the FDA approval process gives us a concrete sense of the products that at least have a possibility of coming to the market, but most other markets do not provide such clarity. On the one hand, we cannot and should not wait indefinitely for the changes in

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> restrict output and elevated prices and profits about the competitive level. Patent law also serves the interests of consumers by protecting invention against prompt imitation in order to encourage more innovation than would otherwise occur.

H. Hovenkamp, Antitrust Law: An Analysis of Antitrust Principles and Their Application, P 1780a (1999) (citations and quotations omitted).

[14] *United States v. General Dynamics Corporation*, 415 U.S. 486 (1974).

market structure to occur or for the efficiencies to materialize. Otherwise, consumers are likely to suffer an inordinate amount of injury while we dither. On the other hand, it's equally clear that in some circumstances—as, for example, when there is concrete evidence that innovation is likely to occur in the future, but not immediately—prudence may dictate that a longer period of time be allowed. The 1992 Horizontal Merger Guidelines imply that, at least in the merger context, two years is generally an appropriate period to wait for new products to enter the market.[15] But I wonder whether that period is sufficient, especially where, as in some industries, there are circumstances that may make the time to entry or innovation harder to pin down.

A second question we face in evaluating the proper deference to innovation claims is determining what evidence should guide our analysis and how concrete that evidence should be. It seems to me that, at the very least, we need to closely examine the empirical evidence regarding what's happened in the past. That evidence may take many forms. It may, for example, consist of evidence of prior entry or innovation. Or, it may consist of the stability (or lack thereof) of market shares over time. Or, it may consist of the extent to which venture capital is flowing to certain firms in the industry. In short, there are numerous clues about whether a market's structure is really dynamic, and about whether efficiencies are indeed likely to flow from a transaction or practice, and we should examine them all (within a reasonable period of time of course).

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[15] U.S. Dep't of Justice and Federal Trade Comm'n, *Horizontal Merger Guidelines* § 3.2, *available at* http://www.ftc.gov/bc/docs/horizmer.htm ("In order to deter or counteract the competitive effects of concern, entrants quickly must achieve a significant impact on price in the relevant market. The Agency generally will consider timely only those committed entry alternatives that can be achieved within two years from initial planning to significant market impact.").

A third issue is whether certain practices involving intellectual property should be characterized as per se legal. This subject is usually debated where a party with a patent refuses to license intellectual property to a competitor. Section 271(d) of the Patent Act declares that refusing to license a patent cannot be patent misuse, even when the refusal is by a firm with monopoly power.[16] Likewise, a number of courts have held that a refusal to license intellectual property, standing alone, cannot be an antitrust violation.[17] Indeed, that was the context in which Justice Scalia made the comments in *Trinko* that I've already described. There he was observing that a rule that imposed a duty to license a

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[16] 35 U.S.C. § 271(d) ("No patent owner otherwise entitled to relief for infringement . . . of a patent shall be denied relief or deemed guilty of misuse or illegal extension of the patent right by reason of his having . . . refused to license or use any rights to the patent . . . .").

[17] *See, e.g.*, *Hartford-Empire Co. v. United States*, 323 U.S. 386, 432 (1945) ("A patent owner is not in the position of a quasi-trustee for the public or under any obligation to see that the public acquires the free right to use the invention. He has no obligation either to use it or to grant its use to others."); *United States v. United Shoe Mach. Co. of N.J.*, 247 U.S. 32, 57 (1918) ("[A patent's] strength is in the restraint, the right to exclude others from the use of the invention . . . . Its exertion within the field . . . is not an offense against the Anti-Trust Act."); *Intergraph Corp. v. Intel Corp.*, 195 F.3d 1346, 1362 (Fed. Cir. 1999) ("[T]he antitrust laws do not negate the patentee's right to exclude others from patent property."); *Cygnus Therapeutic Sys. v. Alza Corp*., 92 F.3d 1153, 1160 (Fed. Cir. 1996) (patentee "under no obligation to license" under antitrust laws); *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1186 (1st Cir. 1994) ("The courts appear to have partly settled an analogous conflict between the patent laws and the antitrust laws, treating the former as creating an implied limited exception to the latter."); *SCM Corp. v. Xerox Corp*., 645 F.2d 1195, 1204 (2d Cir. 1981) ("A patent holder who lawfully acquires a patent cannot be held liable under Section 2 of the Sherman Act for maintaining the monopoly power he lawfully acquired by refusing to license the patent to others."); *United States v. Westinghouse Elec. Corp*., 648 F.2d 642, 647 (9th Cir. 1981) ("The right to license [a] patent, exclusively or otherwise, or to refuse to license at all, is 'the untrammeled right' of the patentee."); *W.L. Gore & Assocs., Inc. v. Carlisle Corp*., 529 F.2d 614, 623 (3d Cir. 1976) ("right to refuse to license is the essence of the patent holder's right").

patent to rivals would reduce the incentives for innovation both by the original inventor, as well as by rivals seeking their own alternatives to the patents or the inventor.[18]

Although the lower courts that have addressed the issue of refusal to deal have generally found that, so long as their patents were lawfully acquired, patent owners have no duty to deal with competitors, the federal appellate courts have divided on what standard should apply to analyze refusals to deal.[19] In the *Kodak* case, for example, the Ninth Circuit held that a unilateral refusal to license intellectual property by a firm with monopoly power could violate Section 2 of the Sherman Act, if the firm's conduct was not supported by a valid business justification.[20] In what may have been the first time a federal court imposed antitrust liability for the refusal to license a patent, the court found that Kodak's reliance on the fact that intellectual property rights were involved as a justification for refusing to license was largely pretextual.

Three years later, however, the Federal Circuit rejected the Ninth Circuit's approach in the Xerox/ISO case, when it held that a patent holder's unilateral refusal to license or sell patented goods was an absolute right, subject to a few narrowly drawn exceptions for illegal tying, fraud, or sham litigation.[21] The court explained that "we will not inquire into [the patent holder's] subjective motivation for asserting his statutory rights, even though his refusal to sell or license his patented invention may have an

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[18] *Trinko, LLP*, 540 U.S. at 407-08.

[19] *See Telecom Technical Servs. v. Rolm Co.*, 388 F.3d 820, 826-27 & n.7 (11th Cir. 2004) (recognizing that the First, Ninth, and Federal Circuits have each "adopted a different approach" to dealing with issue "of how to weigh the significance of a firm's assertion of intellectual property rights as a justification for its refusal to deal" but declining to enter the fray and resolving case on alternative grounds).

[20] *Image Technical Services v. Eastman Kodak Co.* , 125 F.3d 1195 (9th Cir. 1997).

[21] *See In re Independent Service Organizations Antitrust Litigation (ISO)*, 203 F.3d 1322, 1327-28 (Fed. Cir. 2000).

anticompetitive effect, so long as that anticompetitive effect is not illegally extended beyond the statutory patent grant."[22] In a 2006 decision, the Seventh Circuit joined the Federal Circuit's rejection of the Ninth Circuit's analysis.[23]

Nevertheless, a circuit split remains. *Trinko* didn't resolve this split because, as I've already noted elsewhere,[24] the one and only question before the Court in that case was whether that defendant's refusal to license constituted monopolization, given the regulatory "safety net" that existed. To the extent that Justice Scalia, joined by five other members of the Court, chose to address the separate issue of whether a refusal to license more generally could ever be a Section 2 violation, those observations in Justice Scalia's opinion constitute dicta because they were not necessary to resolve the issue at hand. Nor can it be said that the federal enforcement agencies have reached a consensus on the issue. In 2007 the FTC and DOJ issued a report on antitrust enforcement and intellectual property rights that weighed in on this subject. The report concluded that "antitrust liability for mere unilateral refusals to license patents will not play a meaningful part in

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[22] 203 F.3d at 1327-28.

[23] *Schor v. Abbott Labs*., 457 F.3d 608 (7th Cir. 2006). *Cf. Data General Corp. v. Grumman Systems Supoprt Corp.*, 36 F.3d 1147, 1181-82, 1187 n.64 (1st Cir. 1994) (holding, in the context of a claim that a computer manufacturer refused to license copyrighted diagnostic tool that "the desire of an author to be the exclusive user of its original work is a presumptively legitimate business justification for the author's refusal to license competitors and finding that the plaintiffs failed to present proof that was "sufficient" but noting that the opinion should not be read as holding "than an antitrust plaintiff can never rebut this presumption, for there may e rare cases in which imposing antitrust liability is unlikely to frustrate the objectives of the Copyright Act").

[24] Commissioner J. Thomas Rosch, "The Role of Static and Dynamic Analysis in Pharmaceutical Antitrust," Fifth Annual In-House Counsel Forum on Pharmaceutical Antitrust (Feb. 18, 2010), *available at* http://www.ftc.gov/speeches/rosch/100218pharmaantitrust.pdf; Commissioner J. Thomas Rosch, "Wading Into Pandora's Box: Thoughts On Unanswered Questions Concerning the Scope and Application of Section 2 & Some Further Observations on Section 5," LECG Newport Summit on Antitrust Law & Economics (Oct. 3, 2009), *available at* http://www.ftc.gov/speeches/rosch/091003roschlecgspeech.pdf.

the interface between patent rights and antitrust protections."[25] However, as the Commission majority explained in criticizing the DOJ's 2008 Report on Single-Firm Conduct,[26] the word "mere" must be emphasized—if and to the extent that the refusal to license doesn't stand alone, it may be challenged, if employed by firms with monopoly power.[27] This is all to say that there are still many unanswered questions when it comes to how the antitrust laws should treat claims related to innovation and/or patent law.

III.

Third and finally, I'd like to discuss a perceptive analysis written by Federal District Court Judge Claudia Wilken, of the Northern District of California, in *Meijer v. Abbott Laboratories* that highlights the panoply of open issues associated with Section 2.[28] Although initially this may not seem related to the topics that I've discussed thus far, by the time I'm done, I hope you'll see that it does.

Before discussing the specifics of Judge Wilken's decision, however, some context is in order. You'll recall that in its 1993 *Brooke Group* decision, the Supreme Court held that to prevail on a predatory pricing claim, the plaintiff must show, in part, that the defendant priced its products "below an appropriate measure of cost."[29] Because

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[25] U.S. Dep't of Justice & Fed. Trade Comm., *Antitrust Enforcement and Intellectual Property Rights: Protecting Innovation and Competition* 30 (2007).

[26] U.S. Dep't of Justice, Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act (2008).

[27] Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice at 8-9 (Sept. 8, 2008), *available at* http://www.ftc.gov/os/2008/09/080908section2stmt.pdf.

[28] 544 F. Supp. 2d 995, 999-1005 (N.D. Cal. 2008).

[29] *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993) (holding that to prevail under a predatory pricing claim, the plaintiff must show, first, that the defendant priced its products below an appropriate measure of its costs, and, second,

the parties in that case agreed that the relevant measure of cost was the defendant's average variable cost, the Court declined to resolve the question of what standard a trier of fact should use to determine whether or not a defendant's pricing was below cost. Seventeen years later, the Court has repeatedly declined to state what precise measure of "cost" is dispositive for the purpose of the *Brooke Group* analysis. Likewise, the Court hasn't resolved whether *Brooke Group* should apply to other categories of pricing conduct that might violate Section 2, such as bundled rebates – where rebates are tied to the purchase of multiple products bundled and discounted together.[30] In the absence of definitive guidance from the Supreme Court, the lower courts remain split on both of these questions.

For the purposes of my discussion today, I'd like to focus on the law in the Ninth Circuit because when Judge Wilken decided *Meijer*, she was bound by Ninth Circuit precedent and, more specifically, by the Ninth Circuit's decision in *Cascade Health Solutions v. PeaceHealth*.[31] In that decision the Ninth Circuit applied a modified version of the *Brooke Group* standard and held that to prevail on a Section 2 bundled discounting claim, the trier of fact had to find that the defendant priced the product on which the parties competed below cost, after attributing all of the discounts offered in the bundle to

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that there was a dangerous probability that the defendant would recoup its investment in below-cost prices, but not addressing the appropriate measure of cost because the parties agreed that the relevant measure of cost was average variable cost).

[30] Compare *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc) (holding that *Brooke Group* did not set out a general rule that all discounting practices resulting in above-cost pricing were *per se* legal), *with Cascade Health Solutions v. PeaceHealth*, 502 F.3d 895 (9th Cir. 2007) (applying a modified version of *Brooke Group* to analyze the legality of bundled rebates under Section 2).

[31] 502 F.3d 895.

the cost of the competitive product when sold separately. The Ninth Circuit also held that the proper measure of cost was the average variable cost and not the average total cost.[32]

The *Meijer* case before Judge Wilken turned on whether Defendant Abbott Labs had engaged in anticompetitive bundled pricing in violation of Section 2. Abbott Labs manufactured and had the patent on the protease inhibitor Norvir (a drug used to treat HIV). After Norvir's release, however, it became clear that Norvir was more effective when it was paired with a booster drug. Moreover, the booster's effectiveness also meant that smaller dosages of Norvir were needed to be effective. Several boosters began to come on the market, and their success lowered the demand for Norvir. In 2003, Abbott raised the wholesale price for Norvir by 400 percent while keeping the price of its own booster constant. Abbott said the price increase brought the price more in line with the drug's clinical value. Meijer responded by suing Abbott, claiming that Abbott's price increase in the Norvir market was an attempt to increase its power in booster market because the revenues that Abbott received from its sales of Norvir allowed it to charge a lower price for its booster.

The central issue before Judge Wilken was whether she was bound by *Peacehealth*'s holding that average variable cost is the appropriate measure of cost.[33] Abbott argued that she was, meaning that Meijer had to show that the price of Abbott's boosted product was below Abbott's average variable cost of producing it. Judge Wilken, however, rejected that contention and, in so doing made two key observations.

First, she observed that while *Brooke Group* does provide some rules on analyzing anticompetitive pricing, *Brooke Group* also observed that there may be

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[32] *Id.* at 919-21.

[33] *Id.* at 1002.

exceptions to those rules – exceptions that, again, my be sectoral specific. In this regard, she noted that the Ninth Circuit recognized in *Peacehealth* that *Brooke Group* only governs "the normal case."[34] In her view, Abbott's sale of its booster was "a strong candidate for the exception contemplated by the Ninth Circuit . . . because the stated goal of the [*Peacehealth*] rule—making unlawful only pricing that would exclude equally efficient competitors from the market—would not be served by the applying the rule here."[35] Specifically, she observed that *Peacehealth* and the Areeda-Turner article advocate the use of an average variable cost standard based on the assumption that, in a perfectly competitive market, the market price should equal the marginal cost.[36] In the pharmaceutical industry, however, that assumption does not hold up. As Judge Wilken pointed out, a pharmaceutical manufacturer must engage in very large upfront investments in the form of R&D;[37] as a result, the "fixed costs in the form of investment in research and development dwarf variable costs."[38] Why does this matter for Section 2? If the prevailing wisdom is that we should use average variable costs as the

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[34] *Id.* at 1003 ("[T]he Ninth Circuit viewed the Supreme Court's opinions as strongly suggest[ing] that, *in the normal case*, above-cost pricing will not be considered exclusionary conduct for antitrust purposes.") (quoting *Peacehealth*, 515 F.3d at 901).

[35] *Id.*

[36] *Id.* at 1004 n.7.

[37] *Id. See also* Brianna Carignan, *Legalizing Importation of Prescription Drugs: The Economic Implications of the Pharmaceutical Market Access and Drug Safety Act of 2005*, 12 New Eng. J. Int'l & Comp. L. 161, 165 (2005) ("[T]he developer of a drug could never recover its research and development costs by charging prices near its marginal cost of production. The economic purpose of patents is to bar entry of copy products for the term of the patent, to provide the innovator firm with an opportunity to price above marginal cost and thereby recoup R&D expense, in order to preserve incentives for future R&D. Without patents, generic Pharmaceuticals could enter the market immediately and price at marginal cost because they would not have any R&D expenses to recover.").

[38] *Id.* at 1004.

benchmark for determining whether a party is engaged in anticompetitive pricing, but you have an industry (like pharmaceuticals) where the fixed costs are very high but the variable costs are not, then a firm's market price will always exceed its average variable cost. As a result, under such a rule, it will never be the case that a firm will engage in anticompetitive pricing because the firm will always price "above cost."

Second and relatedly, Judge Wilken observed that "[m]ore fundamentally, using average variable cost as a gauge of anticompetitive pricing leads to an exclusive concern with promoting manufacturing efficiency."[39] That concern, however, is beside the point in cases where the concern is not with the defendant excluding an equally efficient manufacturer *of the same drug*, but is instead with excluding manufacturers of *new equally efficient drugs* that would compete with a patented drug. Put differently, in Judge Wilken's words, "an antitrust doctrine that seeks exclusively to promote the efficient production of pills will not serve to promote the introduction of new medicines to compete with a patented drug."[40] Instead, she concluded, the appropriate rule "should have the effect of prohibiting Abbott's pricing practices if a hypothetical equally efficient developer of an equally effective [patented drug] would not be able to profit if it introduced that [patented drug] to the market" at the price of Abbott's patented drug. Thus, because the average variable cost rule did not accomplish that rule, she refused to apply it. Unfortunately, although Judge Wilkin certified her decision to the Ninth Circuit for interlocutory appeal, subsequent events made the case moot.

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[39] *Id.*

[40] *Id.* at 1004.

The flip side of Judge Wilkins' analysis surfaced in the DOJ's challenge to Oracle's attempt to acquire Peoplesoft in 2004.[41] I was on the Oracle trial team at the time. In that case, the arguably central issue was what the market structure would be if the acquisition succeeded. The government argued that the acquisition would leave Oracle and SAP as the only two remaining sellers of the relevant software. Though Judge Walker decided the case on other grounds, I always thought, subliminally, he was saying to himself about the transaction "So what?" More specifically, the record showed that both Oracle and SAP had sunk so much of the total cost of the product into R&D that the average variable cost was de minimus; the overwhelming majority of the cost was fixed. As a result, Oracle and SAP stood to lose big-time if they lost a sale because each lost sale meant that there would be no contribution to overhead. And for that reason, Judge Walker may well have reasoned that even if those two firms were the only firms remaining in the market, they would compete fiercely for each sale.

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In closing, my observations on Oracle notwithstanding, my point today is not to say that anytime there are two firms with high fixed costs, a competitive duopoly will result. My point is actually just the opposite. Antitrust is hard. While there has been emphasis placed on the need for bright line rules – emphasis that I, as a defense lawyer for 40 years appreciate – decision-makers can't and shouldn't blindly apply those rules without thinking long and hard about whether they make sense in a particular context. This may mean that, in the case of monopolization, we want to protect certain incentives (such as the power to engage in monopoly pricing) for certain industries, but protect other

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[41] *United States v. Oracle*, 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

incentives for other industries. In the context of innovation, it may mean that while a guideline says we only look 2 years out for new products, we should look at a shorter or longer period of time if there's concrete evidence that innovation in a particular industry is quicker or slower than we would normally expect. And in the context of predatory pricing, it may mean that as Judge Wilken's correctly discerned, before the courts or the Commission simply assumes that existing precedent should apply, we need to do the hard work to make sure that the application of a particular rule in any given case comports more generally with that rule's objective. Such careful decision making inevitably requires some heavy analytical lifting by the courts and the Commission, but we're not doing our job of protecting competition and consumer choice if we don't test whether a particular rule or guideline's underlying assumptions hold up before we apply it.