The Issue: Antitrust Law and Policy in the Innovation Age

This edition of Washington Legal Foundation’s Conversations With assesses how competition policy and the enforcement of antitrust laws are evolving in the context of an economy increasingly organized around technology and information. Former Attorney General of the United States and Pennsylvania Governor Dick Thornburgh leads an informative conversation with John Thorne, Senior Vice President and Deputy General Counsel of Verizon Communications Inc. Mr. Thorne, who has personally litigated many of Verizon’s major antitrust and intellectual property cases and is responsible for corporate compliance in those areas, shares his perspective and knowledge on the intersection between antitrust and intellectual property; the federal courts’ gradual shift toward a more free market economics-based antitrust jurisprudence; and the recent update of the federal Horizontal Merger Guidelines.

Governor Dick Thornburgh: The impact of intellectual property (IP) rights on innovation is increasingly being considered by regulators, academics, and some judges. Antitrust policy and enforcement is often injected into the discussion by those who feel that IP rights reward or foster anticompetitive behavior. Are IP rights and antitrust law conflicting in their goals and application, or can they be complementary?

John Thorne: Antitrust and IP law are aligned in their aspirations, since both hope to promote innovation, but they operate differently. Antitrust protects a competitive process in which firms are motivated by profits to produce innovations that are desirable to consumers. (As Justice Scalia explained in the Trinko case, “[t]he opportunity” to profit “is what attracts ‘business acumen’ in the first place; it induces risk taking that produces innovation and economic growth.”) Patents likewise use the profit motive to induce firms to innovate, but instead of the rough and tumble of the competitive process, patents do this by awarding a government-created exclusive property right to the first inventor of an important innovation. The patent-holder can invoke the full power of the government’s enforcement mechanisms to exclude others who want to practice the invention.

Stimulating innovation is especially critical while we are pulling the economy out of recession. One of the great questions of the day is whether granting lots of little patent monopolies is a help or a hindrance, but that is a separate conversation.

Governor Thornburgh: IP holders recover the cost of their investments and profit from their innovations through licensing. Some policymakers and even private businesses have sought greater antitrust scrutiny of
licensing decisions. Do such calls for antitrust oversight of licensing trouble you?

Mr. Thorne: This depends on your view of patents. If you work at a pharmaceutical company, you think patents properly protect the enormous investment made in developing the next miracle drug. If you work at a high-tech company, you think the U.S. Patent and Trademark Office is inundating the market with tens of thousands of small property rights that fragment the ownership of a unitary product like a Droid or an iPhone. If you dislike patents enough, you are willing to contort antitrust as an antidote.

My own view is that using antitrust to force licensing on involuntary terms risks deterring investment, the same way that forced sharing of other property risks such deterrence. An innovator won’t invest as much if it must share the successful inventions on non-voluntary terms, and rival innovators will be less eager to risk independent efforts if they think they can piggyback through forced licensing on someone else’s efforts. And courts aren’t very good at setting the price and other terms of forced dealing arrangements. So the circumstances where antitrust is appropriate are quite limited. For example, if a monopolist is voluntarily licensing to some but refusing to deal with others who happen to be rivals, it may be appropriate to ask the monopolist to explain why it is discriminating against rivals. Although the longest living antitrust consent decree happens to require licensing of ASCAP and BMI, even there the Supreme Court declined to apply a \textit{per se} rule of automatic illegality and instead said licenses should be "subjected to a more discriminating analysis under the rule of reason."1

Governor Thornburgh: What are some other areas in antitrust theory and law where academic scholarship and judicial decision-making have evolved from viewing certain business activity as \textit{per se} illegal to potentially acceptable or even \textit{per se} legal?

Mr. Thorne: Cases in the late 1970s and 1980s established the principle — until then sharply contested — that the Sherman Act was intended to protect consumers, not competitors. Implementing that principle, the courts cut back sharply on rules of \textit{per se} illegality, particularly as applied to vertical agreements (for example, those between manufacturers and distributors).

Over the last decade the Supreme Court has shown an interest in creating rules of \textit{per se} legality, particularly to protect freedom of unilateral action that benefits consumers. In \textit{Brooke Group Ltd. v. Brown \& Williamson Tobacco Corp.},2 the Court adopted a rule that strongly protects firms’ ability to cut prices, even if such price cuts make it more difficult for competitors to survive. In \textit{NYNEX Corp. v. Discon, Inc.},3 the Court protected monopolists’ ability to switch suppliers, even if the monopolist violated a regulation designed to curb monopoly power. In \textit{Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP.},4 the Court held that monopolists can generally make investments without facing later obligations to share those investments with rivals. In \textit{Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.},5 the Court held that decisions to buy more resources needed to increase output would not be challenged. In \textit{Bell Atlantic Corp. v. Twombly},6 the Court held that decisions whether and how to enter markets would not be second-guessed on

---

the grounds that other firms had adopted parallel strategies. In Pacific Bell Tel. Co. v. linkLine Comm., Inc., the Court held that a monopolist can reduce retail prices to consumers without reducing wholesale prices to rivals. These decisions, several of them at the motion to dismiss stage and therefore creating categories of *per se* legality, reflect the importance of having doctrines based on common-sense assessments of systemic effects. Clever economists can always construct models showing potential market harms, but, if the circumstances of actual harm are rare and difficult to distinguish from normally beneficial conduct, it is important to have strong rules of legality to prevent litigation that deters pro-consumer behaviors such as price cuts, switching suppliers, new investment, increased output, and market entry.

**Governor Thornburgh:** One business practice that is increasingly common and popular with many consumers is the packaging or bundling of products or services. How have regulators and courts dealt with this, and have they done so in a proper way?

**Mr. Thorne:** Virtually all multi-product firms throughout the economy offer package or bundle discounts. The universe of bundled discounts includes such simple fare as "value meals" at fast-food restaurants, season ticket offerings of sports teams, and furniture sold both in suites and by individual item. It includes expensive packages offered by travel providers and complex packages involving computer hardware and software, hospital supplies, financial services, and licenses to play copyrighted music. It includes products so commonly offered as a package that the bundling aspect is almost taken for granted — mutual fund shares, round-trip air-

plane tickets, newspapers that include news, sports, and style sections.

Regulators and the courts have not given clear answers on when a bundle may be bad. The Third Circuit in a much-criticized decision, *LePage’s Inc. v. 3M*, held that even above-cost bundled discounts may be illegal if a jury determines after the fact that the discounts made it hard for a single-product rival to compete. The then-head economist at the Department of Justice, David Sibley, declared that bundled discounts should be scrutinized to see if they exclude equally efficient competitors. Worrying about the welfare of competitors discourages the sort of aggressive competition that is so good for consumers. Nonetheless, a wave of new lawsuits has begun challenging bundled discounts in diverse industries.

Nobel Prize-winning economist Vernon Smith has run experiments to test the effects of bundled discounts. The experimental design used conditions that were expected (according to theory) to produce exclusionary results. But the results contradicted the predictions of harm to consumers. Time after time, bundled discounts increased consumer welfare.

**Governor Thornburgh:** You have argued for clear rules of antitrust legality in some areas we've been discussing here, such as price reductions and bundling. Why is it important for commerce and consumers to have such clarity in the antitrust laws?

**Mr. Thorne:** Lack of clarity or uncertainty about conduct where an error means class actions, treble damages, attorneys' fees, and joint and several liability will tend to deter that conduct. You don't want to deter price reductions, for example: you

---

Want to encourage them.

That's especially true when you're talking about dominant firm conduct. Judge Posner has a good rule. He says: "If the practice is one employed widely in industries that resemble the monopolist's but are competitive, there should be a presumption that the monopolist is entitled to use it as well. For its widespread use implies that it has significant economizing properties, which implies in turn that to forbid the monopolist to use it will drive up his costs and so his optimum monopoly price."¹¹ I have a slightly stronger view: If a dominant firm offers the market a price cut (or an innovation, an efficiency, or an investment), antitrust should get out of the way! Dominant firms often have little pressure on them to cut prices (or to innovate, be efficient, or invest), so if they do any of those things, customers will benefit.

**Governor Thornburgh:** You were directly involved in the *Bell Atlantic v. Twombly* litigation. How important has the Court's ruling been for defendants opposing private antitrust lawsuits?

**Mr. Thorne:** Thanks to *Twombly*, courts can continue to dismiss frivolous cases without wasting judicial resources or racking up big expenses in discovery for the parties involved. However, the percentage of cases that are dismissed at the outset has gone up only a little, and there is no evidence that any meritorious cases are being dismissed. The Federal Judicial Center is conducting a study that will include more comprehensive data on how *Twombly* is affecting dismissals.

**Governor Thornburgh:** Some lawmakers are currently pursuing the congressional reversal of *Twombly*. What would be the result if their efforts succeed?

**Mr. Thorne:** Courts will be clogged with a larger number of frivolous cases, which will impair access to the courts for meritorious claims.

**Governor Thornburgh:** Turning back to federal enforcement for a moment, do you see an intensified focus at the Justice Department on anticompetitive activity in the government procurement context? From what sectors of industry do such concerns and cases most often arise?

**Mr. Thorne:** A year ago, the Justice Department launched a major program seeking to detect suspicious conduct that indicates possible antitrust misconduct — hard-core antitrust violations like price fixing and bid rigging. The Justice Department knew that the hundreds of billions of stimulus funds would attract bad conduct. Over the past year, Justice has trained tens of thousands of government procurement officials in how to look for warning signs or "red flags" that may indicate improper collusion.

**Governor Thornburgh:** What type of compliance activities can businesses undertake to minimize the risks of anticompetitive activity within their own companies and in their purchasing chains?

**Mr. Thorne:** Verizon set up a training program for our own procurement organization modeled on what the Justice Department is doing. We call it "CLEWS," which stands for Competition Law Enforcement Warning System. Like the Justice program, we train our procurement people to recognize warning signs and red flags of hard-core antitrust violations.

We focus on where the problems are most likely: international sourcing is an emphasis but not the sole focus. International cartels, facilitated by weak antitrust enforcement in key jurisdictions abroad, make a foreign focus important. About one-third of the United States’ $2 trillion annual imports comes from suppliers operating in countries without effective antitrust enforcement. The OECD estimates that harms from international cartels amount to billions of dollars each year.

We try to design a procurement process that deters collusion in the first place. But if we catch someone committing an antitrust offense, we will take action. We’ve brought several offensive antitrust cases before, including against suppliers.

**Governor Thornburgh:** Have other businesses embraced this approach? What are the main benefits of doing so?

**Mr. Thorne:** Over a dozen large U.S. companies in a wide range of industries have trained their procurement officials in detecting antitrust misconduct, and more companies have said they are going to do the training. The benefits are pretty obvious: The cost of antitrust misconduct to the victim is high. The cost of training is low. If you catch an antitrust violation, you can recover triple damages and attorneys’ fees. If you deter an antitrust violation, you pay lower prices.

**Governor Thornburgh:** The Federal Trade Commission and the Justice Department recently revised their Horizontal Merger Guidelines. Why is that such an important venture?

**Mr. Thorne:** It had been 13 years since the last revision of the Guidelines. Practitioners welcome the update, which more accurately reflects current agency practices. But more important, historically the courts and other antitrust enforcement agencies have paid special attention to methods specifically mentioned in the Guidelines. For that reason, it is important that the Guidelines not refer to particular methods whose reliability has not been tested and that may be unsound.

**Governor Thornburgh:** Is there any particular area or factor in merger analysis where the new Guidelines fall short?

**Mr. Thorne:** I want to resist taking pot-shots at the new Guidelines. It is healthy and transparent for the new leadership of the Antitrust Division and the Federal Trade Commission to try to better conform the Guidelines to actual agency practice. But since you asked, I’d like to mention two aspects of the Guidelines that raise concerns.

First, the Guidelines describe a novel merger review tool known as the upward pricing pressure, or UPP, test. This is a mathematical formula derived from theory that displaces traditional market definitions, depends on difficult-to-obtain data, and may easily be misapplied to condemn pro-competitive or competitively neutral deals. It has not yet been tested and may produce incorrect answers even in some theoretical situations that seem likely to occur frequently in practice. Experimental tools that have not yet been shown to be reliable may get an undeserved endorsement by being included in the Guidelines.

Second, the Guidelines added a section recognizing that buyers can "often" protect themselves from merger harms. But
In rapidly expanding markets, minor competitive distortions at the outset can create durable market power that is difficult to dislodge later. As the twig is bent, so is the tree inclined.

John Thorne

Governor Thornburgh: Is the U.S. view on buyer self-protection in line with what other nations’ antitrust authorities consider when examining mergers?

Mr. Thorne: Other nations give greater weight to buyer responses. For example, the European Commission considers “to what extent customers will be in a position to counter the increase in market power that a merger would otherwise be likely to create.” For example, buyers can “threaten to resort, within a reasonable timeframe, to alternative sources of supply should the supplier decide to increase prices [or erode quality], … threaten to vertically integrate into the upstream market or to sponsor upstream expansion or entry, for instance by persuading a potential entrant to enter by committing to placing large orders with this company … [or] by refusing to buy other products produced by the supplier or, particularly in the case of durable goods, delaying purchases.” Similarly, the International Competition Network’s Recommended Practices for Merger Analysis includes consideration of buyer response.

Governor Thornburgh: In the context of innovation, do the current Guidelines adequately consider the ability of a merged entity to reduce its fixed costs, such as through research and development?

Mr. Thorne: I was part of a group of commenters that urged the agencies to give more credit to fixed cost efficiencies — particularly in R&D — in mergers in dynamic, high-tech industries. The Guidelines now clarify that the agencies "may consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market," and that fixed-cost efficiencies "can benefit customers in the longer run, e.g., if they make new product introduction less expensive." The statement is an important step in the right direction, and I applaud the agencies for taking it.

The Antitrust Modernization Commission took an even stronger stand, saying the agencies "should account for the value of fixed-cost efficiencies in assessing the likely competitive effects of a merger," and that "[f]ailure to take account of and give proper weight to such fixed costs in evaluating a merger could deprive consumers and the U.S. economy of significant benefits from a procompetitive merger." Reductions in costs — including fixed costs — can generate real consumer savings because, "[o]ver the longer run, costs that are at one time fixed (or sunk) become variable."

Many industries that are the focus of current antitrust attention — including computers, telecommunications, pharmaceuticals, and others — are characterized by high levels of R&D and intense competition to innovate. In such industries, reductions in fixed costs are likely to increase incentives to invest in R&D by lowering...
the "hurdle" that firms must overcome to realize a profitable opportunity. Failure to account adequately for the effect of mergers on such incentives can cause agencies to stop mergers that would benefit consumers by fostering such innovation. Fixed cost reductions result in real resource savings which benefit society. To cite one example, Kevin Murphy and Robert Topel of the National Bureau of Economic Research find that advances in medical technology and health care have resulted in very large benefits to consumers. They conclude that "[c]umulative gains in life expectancy after 1900 were worth over $1.2 million to the representative American in 2000, whereas post-1970 gains added about $3.2 trillion per year to national wealth, equal to about half of GDP."\textsuperscript{12}

Governor Thornburgh: More generally, do antitrust principles need to be adjusted for the rapid innovations of the Internet Age?\textsuperscript{2}

Mr. Thorne: Most antitrust lawyers would say no adjustment is needed, that sound economic principles work just as well in new markets as in the old ones we understand better. On the other hand, many antitrust lawyers would say that antitrust should be especially cautious in the Internet Age because the enforcement mechanisms are too slow to keep up. In the new economy, by the time a case can be brought and litigated, the facts on which it is based will have been superseded by rapid innovation, quick entry and exit, shifts in consumer preferences, and other market changes. To take a current example, an investigation that the Federal Trade Commission might have wanted to pursue in May into the Google-AdMob merger was closed only a month later in June because of a new product development by Google's rival Apple.

But — recognizing the additional challenges of using slow antitrust to address fast moving markets — sound antitrust enforcement may be even more critical in the new economy. In rapidly expanding markets, minor competitive distortions at the outset can create durable market power that is difficult to dislodge later. As the twig is bent, so is the tree inclined. For example, I think the Justice Department was wise to intervene in the Google Book Search Settlement Agreement, although I have no view on the merits of that agreement, because if there is a competitive problem, it would be quite difficult to rectify after the entire market has been locked up.

Washington Legal Foundation’s (WLF) seventh publication format, CONVERSATIONS WITH, provides an occasional forum for leading experts from business, government, academia, and the legal profession to discuss current legal policy. Our participants provide their thoughts on a wide range of important contemporary subjects.

Washington Legal Foundation is a national, non-profit, public interest law and policy center. WLF utilizes a unique approach to forward its mission — publishing timely legal studies, engaging in innovative litigation, and communicating directly to the public. To receive information about WLF publications, contact Glenn Lammi, Chief Counsel, Legal Studies Division at (202) 588-0302 or visit www.wlf.org.

The Honorable Dick Thornburgh is a former Attorney General of the United States, Governor of Pennsylvania, and Under-Secretary-General of the United Nations. He is currently Of Counsel to the international law firm K & L Gates LLP, and Chairman of Washington Legal Foundation's Legal Policy Advisory Board. Governor Thornburgh began his public service career as a United States Attorney in Pittsburgh and an Assistant Attorney General in charge of the Criminal Division. As a private attorney, he was appointed in 2002 as Examiner in the WorldCom bankruptcy proceedings, the largest ever filed, to report on wrongdoing and malfeasance that led to the company's downfall. Governor Thornburgh was also chosen in 2004 by CBS to conduct an investigation into the 60 Minutes Wednesday segment on President George W. Bush's service in the Texas Air National Guard.

John Thorne is Senior Vice President and Deputy General Counsel of Verizon Communications Inc., where he works on antitrust, intellectual property, and strategic initiatives. He is also a member of the adjunct faculty at Columbia Law School and Georgetown University Law Center. Mr. Thorne represented Verizon before the U.S. Supreme Court in Verizon v. Law Offices of Curtis V. Trinko, LLP, Bell Atlantic v. Twombly; and NYNEX v. Discon He is a coauthor (with Peter Huber and Michael Kellogg) of the principal academic treatises on telecommunications regulation, cited repeatedly by the U.S. Supreme Court, Federal Telecommunications Law (Aspen Law & Business 2d ed. 1999 & Supps. 2004-2010) and Federal Broadband Law (Little Brown & Co. 1995). Mr. Thorne's keynote address to the Madrid meeting of the International Bar Association, "Five Freedoms," was reprinted in Vital Speeches of the Day, June 1, 2005. Global Counsel Awards named Mr. Thorne the world's best corporate competition lawyer in 2009, and named his Intellectual Property group one of the world's five best in 2008 and 2010. Mr. Thorne is chair of the board of the Bishop John T. Walker School for Boys, a tuition-free private school for boys from low-income families in Southeast Washington, DC.