Promoting Innovation: Just How "Dynamic" Should Antitrust Law Be?

Remarks of J. Thomas Rosch
Commissioner, Federal Trade Commission

before the

USC Gould School of Law 2010 Intellectual Property Institute
Los Angeles, CA

March 23, 2010

My task for today is to give you some insight into the ways that conduct involving patents can raise antitrust concerns. I could talk for hours on this topic if for no other reason than the state of law governing single-firm conduct – i.e. conduct by firms with monopoly power – is in a state of flux. So rather than provide you with a recitation of

has failed to serve those objects, under what circumstances should Section 5 of the Federal Trade Commission Act pick up the slack?

I.

If you were to get together a group of antitr

static analysis than dynamic analysis. Second, there is little incentive for parties to take the time to develop arguments premised on dynamic analysis, given the courts' and antitrust agencies' focus on static analysis. Third, there's the perception – right or wrong – that dynamic analysis is less well developed and less measurable than static analysis.[5] Indeed, as one scholar has noted:

> [The] problem [is that] . . . static price analysis appears to be so precise. It gives this illusion of a precise quantifiable answer that you can see on a graph. But there's just no way that you can easily put quality, innovation, and consumer choice on that graph. Even when you try to have a balance between these two things, our natural bias is to give more weight to the thing that looks measurable.[6]

Complicating matters further is the fact that, while antitrust lawyers can agree that a dynamic (or long-run) analysis is necessary to protect innovation, there remains the important substantive debate as to what incentives firms need in the first place to innovate. Are firms better off with monopoly power? Or with competition? Or is it the case that firms need both – the opportunity to acquire monopoly power coupled with vigorous competition along the way – to work towards innovation?

---

[5] For example, 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 concen [illegible]

In this regard, it is noteworthy that, in the patent context, the constitutional framers appear to have punted on this question. As the Supreme Court explained in *Bonito Boats*, the Constitution's "Patent Clause reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition . . . .[7]" By all accounts, that assessment is correct. On the one hand, the patent system provides a number of incentives for research and innovation – and thus dynamic welfare gains – by helping inventors capitalize on the value of their inventions.[8] Patents provide aspiring patent holders benefits to strive for. In addition to years of exclusivity rights, patent holders are accorded certain advantages in litigation – such as the presumption of validity[9] – and the broad right to license or transfer their patent rights to others. On the other hand, however, providing patent rights can also be inefficient. The grant of a legal monopoly to an inventor harms consumer welfare insofar as the inventor is be able to charge a higher price or reduce output, both of which are detrimental to consumers and result in what economists call a deadweight loss. In addition, a patent holder may spend significant resources obtaining and protecting his intellectual property, and the threat of infringement litigation – whether legitimate or baseless – can act as a barrier to entry by potential competitors.[10] These are also detrimental to consumer welfare.

---

[7] *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989).

[8] U.S. Const. art. I, § 8, cl. 8; (granting Congress the authority to establish a system of patents and copyrights to "promote the Progress of Science and useful Arts"); *Graham v. John Deere Co.*, 383 U.S. 1, 8-9 (1966) (describing a patent as "a reward, an inducement, to bring forth new knowledge").

[9] 35 U.S.C. § 282 ("A patent shall be presumed valid.").

[10] FTC Innovation Report, *supra* note 7, at Ch. 2 p. 8 ("Patent suits against entrants for infringement can 'tax' entry. The threat of being sued for infringement by an incumbent

These static costs may be justified when the promise of a patent helps motivate the investment in (or disclosure of) an invention. But bestowing patents on inventions that would have occurred (or would have been disclosed) without the promise of patent protection results in a windfall to the inventor and higher prices to consumers. Put another way, patenting an invention that would have occurred and been disclosed, absent the inducement of a patent, is unambiguously detrimental because there is a static

protecting new processes, and fourth for protecting new products.[14] The same study found considerable variation by industry, with patents more useful for protecting pharmaceuticals and certain chemicals.[15] A third study found that firms protect profits from invention primarily through secrecy and le

than patents as an inducement to R&D.[20] 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.[21]

The challenge, then, for decision-makers in antitrust cases from an antitrust perspective is to develop rules within the current common law framework that both reflect a dynamic, long-term view, but which incentivize innovation.

II.

Most of what you have been told about antitrust law invariably relates to Section 2 of the Sherman Act, which, generally speaking, prohibits exclusionary conduct by a firm with monopoly power.[22] As I have remarked elsewhere, the growth in Chicago

---

[20] *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).

[21] *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!").

[22] *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966) (distinguishing unlawful conduct from "growth or development as a consequence of a superior product, business acumen, or historic accident").

School and post-Chicago School economic thinking over the last thirty years and the application of the Chicago School's teachings to antitrust law has caused a decided shift in how courts decide cases.[23] Nowhere is this shift more pronounced than in the Section 2 common law. Perhaps foremost among those changes has been the emphasis on whether a rule or holding will foster or inhibit efficiencies as reflected in pricing. Indeed, although there remains a debate about whether there should be a single Section 2 doctrinal test to govern all instances of alleged anticompetitive single-firm conduct, many of the major tests proposed thus far – the "profit sacrifice" test and the "no economic sense" test[24] – focus exclusively on static efficiencies.

The shift in Section 2 law towards focusing on predicted efficiencies and prices – to the exclusion of less easily quantifiable non-price harms and the long-term harm occasioned by a dominant firm's entrenchment – has meant that the Section 2 common law has had very little to say doctrinally about how to value, weigh, or otherwise assess dynamic efficiencies, such as innovation and improvements to quality and choice. In the Section 2 context, the Supreme Court in *Aspen Skiing* and the D.C. Circuit in

arguably came the closest to adopting a paradigm that could account for such dynamic efficiencies. In both cases, the courts examined not only the effect of the defendant's actions, but whether the defendant had an intent to cripple a rival who could constrain the defendant's exercise of its monopoly power.[25] An examination of the defendant's intent at the very least permits the consideration of evidence that could (as it did in *Microsoft*) show harm to something other than price.

And then of course there is Justice Scalia's decision in the *Trinko* case, which arguably is the most direct attempt to account for dynamic concerns.[26] There, Justice Scalia suggested that those who enforce the antitrust laws ought to be deferential to firms with monopoly power, which he characterizes as "an important element of a free market system."[27] 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."[28] So, in

---

[25] *See, e.g.*, *United States v. Microsoft Corp.*, 253 F.3d 34, 59, 76 (D.C. Cir. 2001) (en banc) (observing "[e]vidence of the intent behind the conduct of a monopolist is relevant . . . to the extent it helps us understand the likely effect of the monopolist's conduct" and finding that documents authored by senior executives, which showed that "Microsoft's ultimate objective" was to thwart Java's threat to Microsoft's monopoly power in the market for operating systems were probative of Microsoft's liability); *Aspen Skiing Co. v. Aspen Highlights Skiing Corp.*, 472 U.S. 585, 610 (1985) (observing that that the defendant "elected to make an important change in a pattern of distribution that had originated in a competitive market and had persisted for several years" and that such conduct "support[ed] an inference that [the defendant] was not motivated by efficiency concerns and that it was willing to sacrifice short-run benefits and consumer goodwill in exchange for a perceived long-run impact on its smaller rival).

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

[27] *Id.* at 407.

[28] *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

fairness to Justice Scalia, the Court has more recently acknowledged the benefits of innovation.

The problem with Justice Scalia's assessment, however – apart from the fact that it was completely unnecessary to resolve the issue at hand[29] – is that it goes way too far. While it is true that anticipated financial rewards certainly drive innovation and competition, the observation that monopolies incentivize a monopolist to engage in innovation is meaningless in the Section 2 context so long as it is divorced from the effects that monopolies have on rivals.[30] If the *net* effect of a monopoly is less innovation in the relevant market, whether or not the *monopolist* engages in innovation is beside the point.[31] Indeed, this thinking was the thrust behind many of the government's most prominent recent Section 2 cases, including both *Microsoft* and *Rambus*, where the DOJ and the FTC, respectively, argued that the exclusionary conduct by a monopolist impeded a rival's access to key inputs to the post-innovation market and thereby reduced the possibility that an industry *in the aggregate* would successfully engage in innovation.

In sum, insofar as *Trinko* suggests that antitrust enforcement against monopolists is somehow anti-innovation, I do not agree with that suggestion. To the contrary, to the

---

CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (2008) [hereinafter REPORT] at 7-8, 49, 119.

[29] In *Trinko*, the one and only question was whether that defendant's *conduct* constituted monopolization, given the regulatory "safety net" that existed.

[30] *See* Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice ("FTC Section 2 Statement") 1 (Sept. 8, 2008), *available at* http://www.ftc.gov/os/2008/09/080908section2stmt.pdf.

[31] *See id.* (noting that the financial rewards resulting from monopoly power do "not guarantee that profits resulting from monopoly power will have the same beneficial market effects as profits resulting from competition").

extent that such enforcement has the net effect of increasing the incentives and ability for competitors to engage in innovation, consumers benefit from such enforcement. The debate about how antitrust should incentivize innovation in the Section 2 context will inevitably continue.

III.

Fortunately (or not depending on your view), Section 2 is not the only weapon in the Federal Trade Commission's arsenal. The Commission can also attack anticompetitive conduct under Section 5 of the Federal Trade Commission Act which, among other things, prohibits "unfair methods of competition." I would not be surprised to learn that most of you have never heard of Section 5. The vast majority of cases challenging anticompetitive conduct are brought under Sections 1 and 2 of the Sherman Act, which prohibit anticompetitive agreements and unilateral conduct, respectively. The Federal Trade Commission, the Department of Justice, and the private plaintiffs bar all have authority to bring claims under Sections 1 and 2 of the Sherman Act in federal district court. When Congress created the FTC in 1914, however, it authorized the FTC to prosecute violations of Section 1 and Section 2, as well as all "unfair methods of competition" under Section 5 through an administrative process, subject to review by the federal appellate courts.

What does it mean to engage in an "unfair method of competition"? This has been a subject of intense debate within the antitrust bar. The most recent guidance we have from the Supreme Court is a 1972 decision in *Sperry & Hutchinson*, where the Court held that Section 5 is not simply coextensive with other federal antitrust statutes,

but instead reaches further.[32] Just how far Section 5 should reach beyond the Sherman Act, however, remains an unanswered question and one that the Commission continues to grapple with on a case-by-case basis. To that end, those of us at the Commission have spent a considerable amount of time trying to identify what the appropriate outer limits of our Section 5 enforcement should be. I should emphasize that my thoughts on this topsfbhou351 ble a

therefore provides a means that is still tethered to a demonstrable standard to analyze anticompetitive conduct in dynamic industries where intense competition typically occurs on things other than just price.

Additionally, a consumer choice standard is faithful to Section 5's text. Section 5 prohibits both conduct that constitutes "unfair methods of competition" (which are thought of as antitrust violations) and conduct that constitutes "unfair or deceptive acts or practices" (which are thought of as consumer protection violations).[34] Far too often antitrust and consumer protection violations are thought of in a vacuum and as divorced from one another. This is likely because we normally think about antitrust violations as sounding only in the Sherman Act or the Clayton Act. But there are cases where a firm's conduct implicates both of Section 5's prongs. The classic case of such conduct is when a firm uses deception to help it establish monopoly power and eliminate competition. In such cases, Section 5 (and arguably not the antitrust laws, which focus more on conduct related to price and output) is the better vehicle for protecting competition and consumers.

<u>Second</u>, the Commission should evaluate whether the Commission will make the law more or less predictable by proceeding under Section 5 (as opposed to the Sherman Act). Another way to think about this is to consider those instances where there are gaps in the Sherman Act that do not provide a vehicle for prosecuting anticompetitive conduct. These gaps arise when the Commission believes that conduct is clearly having anticompetitive effects, but where the Commission determines shoehorning it into a Sherman Act claim would be, at best, a stretch. This could occur where the Commission

[34] 15 U.S.C. § 45.

believes it cannot prove a statutory element of the Sherman Act (as, for example, in the case of the invitation to collude – or attempted conspiracy – cases where there is an absence of an agreement, which is a necessary element under Section 1). It could also occur, however, where the Commission concludes that, notwithstanding the absence of a common law element, the defendant's conduct is nevertheless causing anticompetitive harm. Section 5 may be appropriate in each of these instances.

To be clear, I do not mean to say that the Commission should simply throw its hands up anytime it faces a hard question of law under Section 2 and retreat to Section 5. We do no one a service if that is our practice.[35] What I do mean to say, however, is that there may be instances where ordinarily courts might find that a rule of Sherman Act law would not impose liability, but where the particular facts of a case nevertheless suggest that liability should attach because a firm's conduct is having anticompetitive effects that are not outweighed by a pro-competitive business justification. In these cases, if we force the case into a Sherman Act framework we run the risk of either making bad law (to bring an unusual case within the ambit of existing precedent) or, alternatively, losing the case even though the firm's conduct is causing anticompetitive effects because of binding

[35] In this regard, I would point out that even though the Commission could have gone the route of analyzing post-*Leegin* resale price maintenance under Section 5, had the Commission done so, it would have lost out on an opportunity to weigh in on the important debate over what standard should apply to analyze resale price maintenance claims under Section 1. The Commission therefore analyzed such conduct under Section 1 in *Nine West*, when we opined that, after *Leegin*, resale price maintenance agreements should be analyzed under a truncated rule of reason and found that Nine West lacked market power and therefore modified our consent decree. *See In the Matter of Nine West Group Inc.*, Docket No. C-3937, Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000, *available at* http://www.ftc.gov/os/caselist/9810386/080506order.pdf.

precedent that is ill suited to judge the conduct at hand.[36] In my view, the Commission does a greater service by declaring the practice to be an "unfair method of competition," provided that we clearly articulate – be it in a consent decree or a decision – what that unfair method of competition is and why the conduct constitutes an unfair method of competition so that future parties are on notice. Moreover, the more of these Section 5 cases we actually litigate, the more clarity and finality we can get once and for all on the scope of our Section 5 authority. That certainty ultimately has to be better than the endless debating that the antitrust bar is now engaged in.

Third, the Commission should consider whether the Commission's special expertise adds any value to the case at hand. When Congress enacted Section 5 it gave the FTC – and only the FTC – authority to enforce Section 5. To my mind, this delegation of authority means if the FTC is going to sue a firm under Section 5, it must go after conduct that Congress did not intend for private plaintiffs to be able to pursue under the other federal antitrust laws. Or, put differently, there must be something about the conduct that the FTC, as an expert and independent administrative agency, is optimally positioned (in comparison to the average private plaintiff) to claim is anticompetitive.

When would the FTC add special value? I can envision a few types of cases. One category of cases might be those instances where the conduct is in its incipient stages. The Sherman Act has never been thought of as an incipiency statute and there are

---

[36] The case law under Section 2 of the Sherman Act may be "binding" (1) when there is a Supreme Court decision squarely on point or (2) when those regional federal appellate courts that have weighed in on an issue agree that Section 2 should be interpreted and applied in a certain way. It should be noted that both instances are the exception rather than the rule.

undoubtedly good reasons for that – determining what conduct in its nascent stage is likely to lead to conduct that is more anticompetitive than procompetitive is a challenging task – one that private plaintiffs, generalist judges, and lay juries are arguably ill-suited to attempt. Moreover, the cost of them getting it wrong – creating liability for procompetitive conduct – is far too high. The FTC with its ability to engage in pre-complaint discovery and its in-house experience and expertise in competition and economics is arguably uniquely suited to make those difficult decisions.

As I have already alluded to, another category of cases where the FTC might add special value in comparison to a private plaintiff and/or a generalist district court might be those antitrust claims that hinge on claims of deception. I am thinking here about our standard setting cases (*Rambus* and *N-Data*).[37] In both instances, we alleged that the defendant engaged in fraud on a standard setting organization. As our loss in *Rambus* underscores, antitrust courts are not likely to be receptive to marrying claims of deception with Sherman Act violations.[38] I suspect this is because proving that a party was deceived is not the type of evidence that is normally sufficient to show harm to the competitive process. In some cases, however, such as when there is a gatekeeper (like a standard setting organization), deceiving that entity can cause a breakdown in the

---

[37] *Rambus, Inc. v. Federal Trade Comm'n*, 522 F.3d 456 (D.C. Cir. 2008); Analysis of Proposed Consent Order to Aid Public Comment, *In the Matter of Negotiated Data Solutions LLC*, File No. 051 0094 (Jan. 23, 2008), available at http://www.ftc.gov/os/caselist/0510094/080122analysis.pdf

[38] In *Rambus*, the D.C. Circuit held that, even if Rambus had disclosed its intellectual property to the standard setting organization, the Commission failed to find that the standard setting organization would not have standardized Rambus' technologies anyway. Further, the court reasoned that, even if Rambus had engaged in deception, there was no harm to competition because "an otherwise lawful monopolist's use of deception simply to obtain higher prices normally has no particular tendency to exclude rivals and thus to diminish competition." 522 F.3d at 468.

the Commission does not trust the private plaintiffs' bar, generalist judges, and lay juries to responsibly evaluate.

Recent Supreme Court precedent, which has shown a disdain for the private class action bar and generalist district court judges in antitrust cases, underscores this view. This frustration has manifested itself in cases that relate to the procedural components of antitrust law – the pleading of an antitrust claim in *Twombly* and the standard for preemption of an antitrust claim in *Credit Suisse*. In both of these cases, the thrust of the Court's concern was the same: the threat of treble damages available for Sherman Act violations combined with the difficulty generalist district court judges and/or lay juries have in drawing lines between procompetitive and anticompetitive behavior created real

history ever could be. Nevertheless, I believe that the Commission can identify substantive limits on its Section 5 authority that should give the defense bar comfort that Section 5 is subject to much more than an "I know it when I see it" test.

To that end, I would impose the following substantive limitations on Section 5 to obviate the false positives concerns. First, apart from those cases which can be viewed as filling the interstices of Section 1 (because, for example, they involve attempted joint conduct), we should limit our use of Section 5 to cases involving ostensibly exclusionary practices by firms with monopoly power where those practices have an anticompetitive effect, which may include preventing a rival from constraining the exercise of monopoly power. Second, Section 5 should generally be used only where a firm has engaged in not just one act, but multiple acts or practices that have an anticompetitive effect. Third, Section 5 should generally only be used where there is direct or circumstantial evidence of intent or purpose by a firm to achieve an anticompetitive effect. Requiring proof of all of these elements – a firm with monopoly power that engages in multiple exclusionary acts or practices with the intent and ultimate effect of causing anticompetitive harm by constraining consumer choice – best maximizes the Commission's chances of getting our application of Section 5 right and, in turn, minimizes the likelihood that we deter procompetitive conduct.

* * * * *

In conclusion, if you take nothing else away today from my remarks, know that we at the Commission are ready and willing to use Section 5 if and when the right case presents itself. Our recent actions should leave little doubt in that regard.

More broadly, however, I want to suggest that Section 5 may supply an optimal vehicle for challenging conduct that weakens innovation. The common law that has grown up around Section 2 over the last several decades is deeply ingrained in price theory; that static framework, however good it may be for evaluating short-run harm and quantifiable conduct such as price and output restraints, does not easily lend itself to looking at whether a party's conduct has or will dampen innovation or prevent product improvement. Compounding matters is the fact that the difficult line drawing and weighing involved in comparing the likelihood of innovation against the likelihood of quantifiable anticompetitive harm is not something that generalist judges and lay juries are well suited for. Indeed, even the metric for measuring innovation itself remains elusive.

Section 5 in the coming years, provided we can provide clear guidance to parties about when their conduct will trigger Section 5 review.