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A BRIEF ANALYSIS OF POLICY AND LITIGATION

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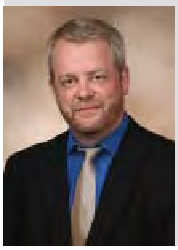
Court Rules that Limited Profit-Pooling Agreements Are Not Subject to the Truncated Rule of Reason

J. Stephen Stockum



J. Stephen Stockum, a Principal at EI, was the economic expert witness for the State of California in the case discussed. He previously worked at the FTC as a Staff Economist, Economic Advisor to the Director of the Bureau of Competition, and Economic Advisor to Commissioner Starek.

The U.S. Court of Appeals, Ninth Circuit, recently ruled (*California ex rel. Harris v. Safeway, Inc.*) that a limited profit-pooling agreement is neither per se illegal nor actionable under the truncated rule of reason (the "quick look" standard). The decision by an en banc panel overturned a prior ruling of a three-judge panel of that Circuit.

The challenged profit-pooling agreement was entered into by the four largest supermarket chains in Southern California prior to an anticipated labor strike. Under the agreement, a supermarket chain that lost sales disproportionately would be compensated for lost profits. More than $140 million was transferred among the competing supermarket chains. Defendants alleged that the agreement was efficient because it would counter "whipsawing," a labor tactic by which unions selectively target a single employer with strikes. The court never reached the efficiencies defense and ruled against the Defendants on a labor exemption claim.

The dissenting judges argued that "[profit-pooling] agreements have traditionally been held to be anticompetitive because they remove the incentive to engage in competitive behavior." But the majority held that the agreement "evades any 'easy label' of 'profit-pooling' . . ." because it was "among some, but not all" of the competitors and because it had a "limited and unknown duration."

It is appropriate to disqualify a case from the per se and quick-look standards when the fact pattern separates the case from those involving behavior that has predictable and pernicious anticompetitive effects. But the Ninth Circuit's decision disqualifies cases whose only fault is that the behavior involved has relatively limited harmful effects on consumers.

Limitations on the duration of anticompetitive agreements can reduce the economic harm they cause but do not eliminate it. Similarly, when a conspiracy falls just short of a complete monopoly, consumer injury likely will occur but will be somewhat less than that created by a conspiracy of all competitors.

The two exceptions created by the Ninth Circuit may act to create safe harbors for limited but otherwise per se violations of the antitrust laws. A primary efficiency of abbreviated standards of evidence is that they lower the costs of prosecution thus making it practical to challenge certain egregious violations. Accordingly, the Ninth Circuit's decision might act to protect anticompetitive behavior that will not attract the considerable prosecutorial resources required by a full rule-of-reason analysis.

Keyword Advertising and Trademark Infringement

Erica E. Greulich and Clarissa A. Yeap

Keyword advertising recently has spawned numerous trademark infringement cases. Internet search engines sometimes sell trademarked words and phrases for use as keywords to the trademark holder's competitors. Trademark holders argue that this practice creates consumer confusion as to the source of products associated with the mark, thereby eroding the mark's information value and raising consumers' search costs. Trademark holders have sued competitors for unauthorized use of marks. They have also sued search engines, alleging both direct infringement in the sale of the mark as a keyword and contributory infringement as the search engine allegedly facilitated the advertiser's direct infringement. Advertisers and search engines have responded that keyword searches benefit consumers and do not create confusion. Recent rulings on these suits have considered how the rise of Internet marketing and advances in search engine technology have changed the way consumers search for and compare products. Economic analysis informs numerous aspects of keyword advertising litigation. For example, economists can assess market facts, such as the information value of the mark and the proximity of goods. Economists can also use Internet traffic data and consumer surveys to evaluate the likelihood of confusion and estimate damages from allegedly infringing sales.

Search engines, such as Google and Microsoft Bing, sell the rights to specific keywords that trigger the display of advertisements. When a user enters the keyword in a query, the results page will show sponsored advertisements for companies that purchased the keyword. The advertisements do not affect search results and appear in a separate section. When a user clicks on a sponsored link, the user is taken to the advertiser's website, and the advertiser pays a fee to the search engine. The potential problem arises when keywords include company names or other trademarks. Some consumers searching for the trademark holder's website instead may click on an advertisement, open a competitor's website and purchase the competitor's products.

This process can be considered normal competition if it does not cause consumer confusion, in the same way that a consumer might search for a particular brand of cereal in a store but then purchase a different brand placed on the same shelf. Keyword advertising could even lower the consumer's search costs by displaying alternative products, including those the consumer may not have been aware of. Nonetheless, the competitor's advertisement could lead the consumer to mistake the competitor's product for the desired item. This confusion degrades the information provided by the mark and makes it harder for the consumer to locate the desired product.

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Trademark law grants protection to marks for their value in designating a particular good or service, enabling consumers to lower their search costs in locating that product. Trademarks do not enjoy protection as entities in and of themselves. Infringement occurs when the use of a mark is likely to confuse consumers as to the source, sponsorship or approval of goods. Importantly for search engines, trademarks are not protected if they are deemed "functional," meaning that without infringement a competitor either could not make its product or could only make it at a cost much higher than the cost with infringement. Recent keyword advertising litigation has centered on likelihood of confusion and search engines' liability.

An eight-factor test dating to *AMF v. Sleekcraft* (1979) was the traditional standard for assessing likelihood of confusion. The courts have ruled in plaintiffs' favor based on the traditional eight factors in keyword advertising cases, such as *Binder v. Disability Group Inc.*, finding likelihood of confusion and willful infringement. In such cases, economic analysis can assess the alleged harm to both trademark holders and consumers, using established techniques to estimate infringing sales, increased costs, diminished goodwill, and costs of corrective advertising.

However, a recent decision advocates flexible application of the traditional eight factors in keyword advertising cases. The Ninth Circuit's landmark 2011 decision in *Network Automation v. Advanced Systems Concepts International* stated that although "same market channel" was one of the traditional eight factors, the mere fact of a common online

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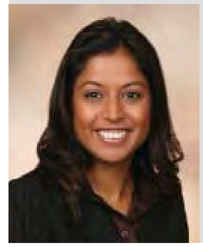
Calibration of Upward Pricing Pressure under the New DOJ/FTC Horizontal Merger Guidelines

Lona Fowdur

The Gross Upward Pricing Pressure Index (GUPPI), a new tool to assess unilateral merger price effects in markets for differentiated products, has become prominent since the release of the new Horizontal Merger Guidelines (2010 Guidelines) by the Department of Justice (DOJ) and the Federal Trade Commission (FTC). This new tool provides a quick, albeit crude, measure of Upward Pricing Pressure, the unilateral incentive for the merged firm to increase prices post-merger. The GUPPI calculation does not rely on market definition or concentration. Instead, it calibrates the value of sales diverted to one merging firm's product due to a post-merger increase in price of the other merging firm's product, relative to revenue lost due to fewer sales of the product with the price increase.

For example, suppose Firm 1 and Firm 2, which produce Product 1 and Product 2, plan to merge. While a GUPPI can be computed for each of the products of the merging parties, this example focuses on the incentive to increase the price of Firm 1's product. The GUPPI's measurement of Upward Pricing Pressure hinges on two factors: a diversion ratio and the net incremental profits from Product 2. The diversion ratio is an estimate of the degree of substitutability between the products of the two merging firms. Net incremental profit from Product 2 is its price less its marginal cost. To see how the GUPPI works, consider the pricing decision for Product 1. Suppose that a price increase causes the sales of Product 1 to fall by five units. Since Product 1 and Product 2 are substitutes, the price increase also causes some sales of Product 1 to shift to Product 2. The diversion ratio is the ratio of sales gained by Product 2 to sales lost by Product 1. Suppose a five unit decline in the sales of Product 1 causes the sales of Product 2 to increase by one unit; then the diversion ratio is 0.2. Before the merger, Firm 1 would not find the price increase to be profitable because the price of Product 1 was already set at Firm 1's profit-maximizing level. Firm 1 would not consider the gain in sales for Firm 2 when considering the profits from the price increase. After the merger, however, the merged firm would realize that for every unit of Product 1 it loses due to the price increase, it gains 0.2 units in additional sales of Product 2. The benefits of the increase in sales of Product 2 depend on the net incremental profits from that product. For each unit of Product 1 that it forgoes due to a price increase, the merged entity collects extra profits equal to the product of the diversion



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ratio and the net incremental per-unit profit from Product 2. Thus, the merged firm has an incentive to increase price that it did not have before the merger.

The GUPPI expresses the incentive trade-off between a gain equivalent to the profits on sales diverted to Product 2 and a loss equivalent to the profits on the foregone sales of Product 1. When the GUPPI is small, the post-merger incentive to increase the price of Product 1, measured by the proportional profits on diverted sales to Product 2, is likely small. The converse is likely to be true with a high GUPPI. Unfortunately, the 2010 Guidelines do not establish any clear thresholds for what constitutes a high as opposed to a low GUPPI or what values are likely to trigger enforcement actions, simply stating, "If the value of diverted sales is proportionately small, significant unilateral price effects are unlikely."

An advantage of the GUPPI is that it can be extended to include potential efficiencies. Efficiencies reduce the incentive to raise price, producing downward pricing pressure, because they increase the margin on each unit of sales lost due to a price rise. In particular, for every unit of Product 1 that it forgoes due to a price increase, the merged entity loses the efficiency saving on the unit, and the merged firm needs to factor this loss into the pricing decision for Product 1. The reduction in the cost of Product 1 due to the efficiencies can be expressed in the same units as the GUPPI. Hence it is straightforward to include efficiencies in the calculation of the GUPPI to determine whether or not the transaction gives an incentive to raise price.

In spite of their theoretical elegance, GUPPIs provide only a crude and incomplete estimate of unilateral incentives because they disregard other factors that affect a firm's pricing decision, such as repositioning by non-merging firms, new entry and changes in demand. Furthermore, GUPPIs cannot be used to quantify the extent of a price change post-merger; they merely indicate the change in the merged firm's incentives to raise prices relative to pre-merger prices.

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Keyword Advertising

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channel did little to help determine likelihood of confusion. Consumers were deemed sufficiently sophisticated for online marketing to fit the cereal analogy described above. Moreover, that decision considered factors not in the traditional test, such as the labeling of advertisements and their surrounding context on the results page. This ruling emphasized the careful consideration of how keyword advertising could affect a consumer's search process and thus the value of a mark. In light of this decision, facts peculiar to each case must inform the choice of factors relevant to assessing likelihood of confusion. Economic analysis informs this choice by helping to define the relevant market, identify consumers' search costs and quantify the value of the mark to its holders and to consumers.

Traditional trademark infringement cases have relied in part on consumer surveys to assess the likelihood of confusion. These surveys provide information about consumers' perception of different products, their preferences for product features and their propensity to substitute among alternatives. In keyword advertising cases, traffic data that provide information about consumers' Internet activity are also important. Through quantitative analysis of detailed consumer surveys and traffic data, economists can determine whether there is evidence of confusion in consumers' perceptions of competing goods, their search patterns and purchasing decisions. With sufficient data on consumer choice, economists can also estimate the extent of alleged infringing sales and, if relevant, damages.

A recent decision regarding search engines' liability for infringement is *Rosetta Stone Ltd. v. Google Inc.* The U.S. District Court for the Eastern District of Virginia found that Google's practice of selling keyword advertising was protected under the functionality doctrine. Google's search engine used keywords in an "essential indexing function" and keyword searches using trademarked terms reduced the cost and increased the quality of its advertising program. The court also found that Rosetta Stone's brand awareness had increased due to its trademark's use as a keyword and its appearance in sponsored advertisements. The ruling is under appeal in the Fourth Circuit, and numerous amicus briefs challenge the District Court's analysis. They dispute the applicability of the functionality doctrine to Google's product and contend that this finding would limit infringement liability for any firm that used another's trademark to improve its business. Functionality can be analyzed economically by examining a defendant's business model and comparing the cost savings provided by the disputed activity to alternative practices. Economists can evaluate the contribution of trademarked keywords to the quality of an advertising program by studying advertisers' and consumers' preferences for this feature.

Economic analysis can inform keyword advertising litigation that involves claims of infringement, unfair competition, trademark dilution, or false advertising. Economists establish market facts, such as the strength of a mark and competition between parties' products. Using data on consumers' preferences and online activity, economists evaluate alleged harm by estimating consumers' but-for choices and quantifying changes in a mark's value due to allegedly infringing behavior. Assessment of these relevant market conditions leads to an appropriate determination and quantification of infringement damages.

Upward Pricing Pressure

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Given the limitations of a GUPPI analysis alone, the 2010 Guidelines specify that the Agencies may also use other tools, such as merger simulation techniques, as well as any other relevant qualitative or quantitative evidence to determine the extent to which unilateral effects would reduce competition. For example, in a paper reviewing the activities of the Economic Analysis Group (EAG) of the DOJ Antitrust Division for 2009 and 2010, Carl Shapiro, then Deputy Assistant Attorney General for Economics at the Antitrust Division of the DOJ, summarized EAG's analysis of the proposed Baker Hughes/BJ services merger and pointed out that EAG determined that the proposed merger would generate significant upward pricing pressure on the products of the two firms on the basis of a GUPPI calculation. That paper highlights that in addition to the GUPPI analysis, EAG also considered other factors including the elasticity of the residual demand curve, the number of additional firms in the market and capacity constraints.

EI News and Notes

Pantech Settles Patent Infringement Suit Brought by Fractus

EI Senior Vice President Richard Shin and EI Senior Economist Gale Mosteller assisted Pantech Company in a patent infringement suit brought by Fractus. They computed a reasonable royalty for the alleged infringement of antenna patents and analyzed the methodology used and royalty proposed by Fractus's damages expert. Shortly after the submission of EI's report, the parties settled the lawsuit. Pantech was represented by H.C. Park & Associates PLC.

FirstEnergy Corp Merges With Allegheny Energy Inc.

The Department of Justice has completed its review of the companies' proposed merger and has closed its investigation. EI Principal John Morris represented both companies in their respective filings. Dr. Morris leads the energy practice at EI and has consulted on several merger filings at the Department of Justice, the Federal Regulatory Commission and other antitrust agencies. Dr. Morris's team at EI included EI Senior Vice President Richard Shin and EI Senior Economists Lona Fowdur, Allison Holt, Su Sun, Gale Mosteller and Carol Miu. FirstEnergy Corp was represented by Akin Gump Strauss Hauer & Feld LLP and Allegheny Energy Inc. was represented by Skadden, Arps, Slate, Meagher & Flom LLP.

Article Published on the Horizontal Merger Guidelines

EI Senior Vice President Michael G. Baumann coauthored an article that reviews the Horizontal Merger Guidelines recently issued by the U.S. Department of Justice and the Federal Trade Commission. The article, entitled, "Margin of Error: The Flawed Paradigm in the New Merger Guidelines," is in the *Antitrust Chronicle—Competition Policy International*. It points out that the analytical core of the new Guidelines relies on an assumption that was long ago shown to be invalid and demonstrates that the paradigm in the new Guidelines is not consistent with basic economic principles.

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