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A BRIEF ANALYSIS OF POLICY AND LITIGATION

The Economics of *Pacific Bell v. linkLine Communications*

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EI special consultant Scott J. Wallsten has worked on many telecommunications matters, including cable television, broadband, and spectrum issues. He also has experience in antitrust matters in other industries.

The Supreme Court recently granted certiorari in *Pacific Bell Telephone Co. v. linkLine Communications*. The grant was controversial, with the Department of Justice urging the Court to hear the case and the Federal Trade Commission disagreeing. The case raises important questions concerning the antitrust economics of price squeezes and the incentives to invest in certain telecommunications networks.

linkLine accuses Pacific Bell (now AT&T) of setting its wholesale and retail rates for DSL service so close together that a competitor could not profitably buy wholesale DSL access and then resell the service to retail customers. Thus, linkLine accuses Pacific Bell of engaging in a classic price squeeze. The Supreme Court will decide whether a firm can be held liable for a price squeeze even though the firm is under no antitrust duty to deal.

At first blush, the economic implications of this case appear to be limited, at least in telecommunications, since the FCC does not require firms to grant wholesale access to new infrastructure. However, a ruling in favor of linkLine could have far-reaching implications for investment in any network subject to so-called "open access" requirements, such as those the FCC imposed in its most recent spectrum auction.

The open access rules stipulate that a network built using a particular part of the spectrum be open to any compatible device and service. The extent to which the network will actually be open will depend on the wholesale price for access, and no regulatory decisions have yet been made concerning that price.

Should the Supreme Court find for linkLine, then a company operating an open network could be subject to the argument that its wholesale and retail prices are too close together. By default, the first aspect of price regulation would therefore be a defined gap between the provider's retail and wholesale prices. The result would be either a floor on the incumbent's retail price or a ceiling on its wholesale price. Those limits make it difficult for the provider to compete at retail. Limiting the provider's ability to compete will also limit potential returns from network investments. As a result, providers may reduce their investment, or perhaps choose not to build the network at all.

Also In This Issue

Resale Price Maintenance and the Rule of Reason

Laura A. Malowane uses a recent case in Kansas State Court to discuss how courts may deal with resale price maintenance under the rule of reason. In such cases, a court must address two issues. First, was the RPM policy anticompetitive? Second, if the RPM policy was anticompetitive, did it result in injury or damage to the plaintiffs, in this case the members of a class? In addressing these issues, it is important to remember that manufacturers often have procompetitive reasons for RPM. Such policies may enable manufacturers to give retailers incentives to carry and invest in its brands, thus making the manufacturer a stronger competitor for other brands. As a result, rather than suffer antitrust injury, consumers may benefit from RPM. The Kansas court granted defendant summary judgment, because plaintiffs could not present compelling evidence of injury.

The McCarran-Ferguson Act's Antitrust Exemption: Lessons from Europe

The insurance industry has certain exemptions from the competition laws in both the United States and the European Union (EU). David D. Smith describes how the EU's review of its insurance industry's antitrust exemption could have important lessons for the United States. In the United States, the McCarran-Ferguson Act exempts from the federal antitrust laws collaborative behavior by the insurance industry under certain circumstances. In the insurance industry, some cooperation among competitors can substantially increase efficiency. Nonetheless, this special treatment of one industry has been under attack for complicating antitrust enforcement and creating economic distortions across industries. The EU's consideration of this issue will provide Americans with an opportunity to follow a debate on the need for antitrust exemptions specific to the insurance industry.

Resale Price Maintenance and the Rule of Reason

Laura A. Malowane

A recent case in Kansas State Court provides an early example of how courts may deal with resale price maintenance (or RPM) agreements under the rule of reason. RPM was viewed as a per se violation for almost 100 years until in 2007 the Supreme Court, in *Leegin Creative Products, Inc. v. PSKA, Inc.*, reversed that prohibition. The Supreme Court case involved an action against fashion accessories manufacturer Leegin. A similar case was brought against the same defendant in Kansas State Court by a class of Kansas consumers. The Kansas plaintiffs claimed that Leegin's pricing policy violated Kansas antitrust law and that, as a result of this violation, the class had suffered antitrust injury.

In the Kansas case, the court addressed two issues. First, was the RPM policy anticompetitive when judged under the rule of reason? Second, if the RPM policy was anticompetitive, did it result in injury or damage to the plaintiffs, in this case the members of the class?

In answering either question, it is important to realize that RPM policies, like other restrictions affecting the vertical relationships between a manufacturer and its dealers, are typically procompetitive. Manufacturers generally desire competitive wholesale and retail sectors because efficiency in those sectors will expand their product sales through lower costs and prices. Nonetheless, a manufacturer sometimes benefits from imposing vertical restrictions on its dealers' activities. Some restrictions on intrabrand competition (competition among sellers of the same brand) may increase the intensity of interbrand competition (competition among sellers of different brands). The net effect of the restriction is to make the manufacturer a stronger competitor, which benefits consumers. The procompetitive objectives of antitrust law generally align with a manufacturer's use of vertical restrictions.

Manufacturers may use vertical restrictions to create the incentive and ability for their dealers to invest in marketing the manufacturer's brand in a setting and manner that supports the brand image and reputation in the long run. One such vertical arrangement is where a manufacturer deals only with retailers that adhere to a suggested resale pricing and promotion policy. A manufacturer wants its retailers to sell as much of its product as possible. Competitive low pricing helps increase sales, but so do non-price factors, such as better service and marketing. Providing quality retail service and marketing is costly, and a retailer will carry and invest in

Laura A. Malowane together with Allison M. Holt assisted William C. Myslinski, who submitted both class and merits testimony to the court on behalf of Leegin in the Kansas case.

brands only if it can do so profitably. Free-riding retailers can eliminate the incentive and ability of high-service, high-quality retailers to make the necessary long-term commitments to marketing a particular brand.

By dealing only with retailers that adhere to a suggested retail pricing and promotion policy, a manufacturer prevents other dealers from free-riding on their dealers' investments and undercutting their dealers' incentives to support the manufacturer's brand. A manufacturer would not profit from imposing vertical restrictions that reduced sales by making the product more expensive for consumers without a commensurate increase in value. As a general matter, a manufacturer will want to restrict intrabrand competition only if that restriction promotes more vigorous and effective interbrand competition. As a result of a manufacturer's retail pricing policy, a consumer may find less retail price dispersion among retailers of the manufacturer's product but may also find those products at more retailers and in greater selection. As a result, the manufacturer's brand becomes a stronger interbrand competitor to the benefit of consumers.

Leegin's pricing policy provides an example. Leegin primarily sells its Brighton fashion accessories products to specialty high-end "boutique" retailers. These retailers have built a reputation and image for high-end goods and service by investing in a high-quality physical environment and a well-trained sales staff and by carefully selecting brands, styles and products to carry. Without Leegin's pricing policy, low-end discount retailers (who make none of the costly investments made by boutique retailers) would be able to sell Brighton products at a substantially lower price. Two things would likely follow. Brighton sales would shift away from the specialty boutiques to the lower-priced free-riding retailers and, because of the low-quality service and environment at these retailers, Brighton's brand image would be weakened. As business shifted to the free-riding retailers, the specialty boutiques may lose the incentive or the financial ability to continue to

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The McCarran-Ferguson Act's Antitrust Exemption: Lessons from Europe

David D. Smith

The insurance industry has been granted certain exemptions from the competition laws in both the United States and the European Union (EU). The EU has begun a review of its exemption and will issue a report by March 2009. There are indications that the EU is likely to drop its current exemption. For example, EU Competition Commissioner Neelie Kroes has stated, "Sector specific competition regulations are exceptional legal instruments. If there are to be special rules for a particular sector, I need to be convinced that they are justified in terms of bringing real benefits to competition and to consumers." Similarly, the EU recently completed a Sector Inquiry into European business insurance and concluded that, "in respect of the Block Exemption Regulation, the Sector Inquiry has not produced compelling reasons, as regards business insurance, to prolong it beyond 2010."

The EU's executive branch, the European Commission ("EC"), has a regulation that provides a "block exemption regulation" (BER) from competition laws for insurers. That regulation is scheduled to expire in 2010. Thus, the default future policy in Europe will be to have no exemption. On April 17, 2008, the EC Competition Commission began a Consultation, or investigation, to determine if the block exemption should be renewed. If the Commission does drop the block exemption, it would also need to decide if and how it would protect pro-competitive collaborative activities involving insurers. Absent new legislation, the enforcement officials would likely analyze the pro-competitive and anti-competitive effects of collaboration among insurance companies by using the competition analysis outlined in the *Guidelines on the Applicability of Article 81 of the EC Treaty to Horizontal Cooperation Agreements.*

In the United States, the McCarran-Ferguson Act, which exempts some insurance company activity from the antitrust laws, has been federal law since 1945. In contrast to the situation in the EU, this exemption will continue unless Congress changes the law; there is no expiration date.

The United States may be able to learn valuable lessons from the EC's Consultation. The EC's investigation will provide Americans with an opportunity to follow a debate on the need for antitrust exemptions specific to the insurance industry. Policy makers in the United States can take advantage of this opportunity by monitoring these arguments to determine whether they provide any guidance on what to do about the American insurance industry's exemption. Also, if Europe drops its BER, it will provide a before-and-after occasion that might be suited to an event study.

David D. Smith has extensive experience analyzing competition in the insurance industry. He has dealt with this industry both at EI and in his previous position at the Antitrust Division of the U.S. Department of Justice.

In the United States, the McCarran-Ferguson Act exempts from the federal antitrust laws collaborative behavior by the insurance industry under certain circumstances. In particular, conduct is exempt if it constitutes "the business of insurance," is "regulated by State Law," and is not an "agreement to boycott, coerce, or intimidate, or [an] act of boycott, coercion, or intimidation." In the insurance industry, some cooperation among competitors for activities such as sharing loss information, developing standardized policy forms, forming voluntary joint-underwriting agreements, and participating in residual market mechanisms can substantially increase efficiency. Nonetheless, this special treatment of one industry has been under attack for complicating antitrust enforcement and creating economic distortions across industries. Most recently, the Senate held hearings in March 2007 to consider repealing the Act, but they have not led to any changes in the law.

The EC originally granted two individual competition law exemptions to the insurance industry in 1990. Subsequently, in 1992, the EC Competition Commission adopted a BER. When this exemption expired at the end of March 2003, it was replaced with the current BER. This regulation, which runs for seven years and expires on March 31, 2010, grants exemptions from competition law to certain types of agreements in the insurance industry. These exemptions allow agreements between competitors on calculations of average cost for a specified risk, studies on the probable impact of various undertakings, non-binding standard policies, non-

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EI News and Notes

Vallourec Acquisition of Grant Prideco Assets

EI economists Philip B. Nelson, Henry B. McFarland, and Robert D. Stoner worked with lawyers at Akin Gump on behalf of French seamless steel tube producer Vallourec to obtain DOJ's approval of Vallourec's acquisition of three businesses from Grant Prideco Inc. The three businesses are Atlas Bradford, a firm that threads oil country tubular goods; TCA, which specializes in heat treatment operations; and Tube-Alloy, which produces and repairs tubular accessories for the oil and gas industry.

Interlocking Directorate Claims

In *Charming Shoppes Inc. v. Crescendo Partners II, L.P., et al.*, Principal William P. Hall, assisted by Stephanie M. Mirrow, submitted an expert report on behalf of the defendants with respect to market definition and Clayton Section 8 claims regarding interlocking directorates. The U.S. District Court for the Eastern District of Pennsylvania denied the plaintiff's request for a preliminary injunction in this proxy battle litigation.

DOJ Settlement with Anthrax Mailings "Person of Interest"

EI economist Laura A. Malowane assisted lawyers at the Department of Justice in a suit filed against them by Steven Hatfill, a biomedical researcher and former Army scientist. Mr. Hatfill, who was named as a "person of interest" in the investigation of the 2001 deadly anthrax mailings in the United States, claimed that his privacy rights were violated during the DOJ investigation. He also claimed that, as a result of the government's actions, he lost his current job as well as future employment opportunities. Dr. Malowane, who has extensive experience in analyzing damages in commercial and personal litigation, submitted an expert report and testified at deposition on behalf of the Department of Justice. In June 2008, an agreement was reached between the two parties.

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support the Brighton brand or even to continue to carry the Brighton products. If high-quality retailers stopped supporting and carrying Brighton products, overall sales of the brand likely would decline. The resulting weakening of the Brighton brand image and reputation would reduce interbrand competition. Leegin's pricing policy enables Brighton to provide strong competition to other fashion accessories brands.

Even if a rule of reason analysis finds that an RPM policy was anticompetitive, the court still must determine whether the plaintiffs were in fact "injured or damaged" by the agreement. Determining injury requires constructing a model of what prices consumers would have paid and what level of retail services they would have received in the absence of the alleged unlawful agreement. The difference between these "but-for" prices and "but-for" services and the actual prices paid by class members and the actual retail services they received is the measure of actual impact or "fact of injury," if any. Among other arguments, Leegin contended that one highly plausible but-for pricing scenario would be for Leegin to adopt a lawful "Colgate safe-harbor" pricing policy (i.e., announce that it would not sell to retailers that did not adhere to its suggested retail prices and discounts). Had Leegin adopted such a policy, consumers would have faced the same prices as had existed under the RPM policy.

In July 2008, the Kansas court ruled in favor of defendant and granted its motion for summary judgment. The court ruled that there was not enough evidence to evaluate Leegin's pricing policy under the rule of reason at that time. Nonetheless, the court granted Leegin's request for summary judgment based on the failure of plaintiffs' economic experts to provide sufficient evidence of class-wide proof of antitrust injury. The court noted that, at a minimum, plaintiffs must show that the defendant's alleged RPM policy resulted in higher prices to the consumer for these products. A mere showing that an RPM policy exists and that, in theory, RPM policies result in higher prices is not sufficient: "In order for Plaintiff to establish she paid supra-competitive prices as a result of Defendant's RPM policy, she must establish what the competitive price level would have been in the absence of the RPM policy."

The McCarran-Ferguson Act

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binding models of the profitability of various insurance policies, reinsurance, and the technical specifications of security devices.

Under the Implementation Regulation, the Commission is required to submit a report to the European Parliament and Council on the BER by March 9, 2009. The report will evaluate the effects of the exemption, and also propose any amendments it deems appropriate. As part of the Consultation that it has undertaken to develop background for its report, the Commission sent questionnaires to certain affected parties, public authorities and consumer organizations. Interested parties were also invited to submit comments to the Commission on the Consultation. The EU National Competition Authorities were involved in the draft Consultation, and will continue to be involved in the review.

Although McCarran-Ferguson and the BER are structured somewhat differently, the issues analyzed in the Commission's report and associated Consultation will be similar to those considered in evaluating McCarran-Ferguson in the United States. As a result, it should be possible to apply many of the findings from the BER effort to McCarran-Ferguson. For example, the ABA has recommended that McCarran-Ferguson be repealed and replaced with certain "safe harbors," such as cooperating in the collection and dissemination of past-loss experience data, and cooperating to develop standardized policy forms. Some safe harbors are currently included in the BER.

While U.S. policy makers may learn much from the ongoing EC review, one must recognize that this report will have its limitations. First, the review may not cover all of the topics that are relevant to a U.S. decision to repeal McCarran-Ferguson. For example, the EC report may not discuss boycotts and coercion, since these are not explicitly addressed in the European law. Second, because there are institutional differences between the U.S. and EU, the lessons of the EC report must be interpreted with care when applying them to the United States. For instance, in the United States the McCarran-Ferguson exemption from the federal antitrust laws still leaves the industry regulated by the states, while no similar regulatory oversight would be present in the EU. In addition, private litigation in front of juries is more common in the United States, which can affect the appropriate policy. For example, the arguments for safe harbors might be stronger in the United States than in Europe because private litigation is more common in the States.

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