

The Clayton Act, Innovation Markets, and Potential Competition Doctrine

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During the 1990s, when the Antitrust Division and Federal Trade Commission introduced the “Antitrust Guidelines for the Licensing of Intellectual Property” (“IP Guidelines”), there was much debate over the role of the “new economy” and innovation markets in merger analysis. Since then, as a matter of regular course, the agencies have challenged mergers on the basis of predicted anticompetitive effects in future markets.¹ That challenges premised on harm to future markets may promote competition is clear, but the number of challenges based purely on research and development competition have been few and far between. So while a proposed merger of two pharmaceutical companies with the only two forthcoming drug treatments for a particular illness would attract an investigation notwithstanding the uncertainty of FDA approval, a merger of firms having undeveloped R&D in the same area would likely go through untouched.

We discuss here some of the important questions as to (1) whether and how such challenges fit within the rubric of the Clayton Act; and (2) what standard the agencies should employ when evaluating these mergers. In general, we conclude that the agencies should seek relief in future markets only when the emergence of the new market is reasonably foreseeable—that is, a reasonable probability that the merging firms will generate sales and revenues from these products that do not yet exist. This counsels in favor of possible challenges to mergers involving products in active development, but against challenges further along the R side of R&D.

Without some real sense of a reasonable probability that actual product competition will be diminished, the agencies (and the courts) should not be left to speculate on the development of future markets. That is the teaching of the actual potential cases, and the standard applied there seems similarly appropriate here. Application of this type of standard requires no modification of the text of section 7 of the Clayton Act, should capture acquisitions that truly threaten consumers, and is based on a body of developed case law. At the same time, application of this kind of standard should avoid intervention in mergers solely on the basis of speculation.

Why Intervene in New Economy/Innovation Markets?

Section 7 prohibits mergers or acquisitions that may “substantially . . . lessen competition, or tend to create a monopoly.”² The language is forward-looking on its face. And it is an

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¹ See, e.g., *Ciba-Geigy, Ltd.*, 123 F.T.C. 842 (1997); Complaint, *In the Matter of Nielsen Holdings, N.V. and Arbitron Inc.*, FTC File No. 131-0058 (Sept. 20, 2013), available at <http://www.ftc.gov/sites/default/files/documents/cases/2013/09/130920nielsenarbitroncmpt.pdf>.

² 15 U.S.C. § 18.

understatement to say that innovation is one of the most important aspects of competition. But the statute also talks of a “lessening” of competition in a “line of commerce,” and it is fair to ask how competition that does not yet exist can be “lessened” by an acquisition. So even if it is true (as it surely is) that “future competition can be harmed by mergers that result in a reduction in research and development,”³ it is fair to ask how protecting future competition can be squared with the text of the statute. One answer is that this kind of finicky literalism has never held much sway in antitrust law.⁴ Instead, the Clayton Act should be construed consistently with the broader body of antitrust law, suggesting an overall goal of protecting competition – in this case both present and future.⁵

While measuring a reduction in innovation is certainly trickier than calculating harm associated with higher prices in more traditional analyses (itself a challenging exercise), reduced innovation is obviously harmful to consumers.⁶ It has long been the position of the agencies that “[c]ompetition often spurs firms to innovate.”⁷ But the relationship between innovation and competition has never been clear.⁸ Some economists, most prominently Joseph Schumpeter, have argued that highly concentrated markets experience a faster pace of innovation.⁹ Others suggest that monopolists are generally less motivated to innovate, and that competitive markets are more conducive to innovation.¹⁰ While there are merits to both sides of the argument, it is logical that the antitrust enforcement agencies would favor a policy of competition, even when

³ Thomas N. Dahdouh, *The Shape of Things to Come: Innovation Market Analysis in Merger Cases*, 64 ANTITRUST L.J. 405, 405 (1996).

⁴ *National Soc. of Professional Engineers v. United States*, 435 U.S. 679, 687-88 (1978) (“One problem presented by the language of § 1 of the Sherman Act is that it cannot mean what it says. The statute says that ‘every’ contract that restrains trade is unlawful. But, as Mr. Justice Brandeis perceptively noted, restraint is the very essence of every contract; read literally, § 1 would outlaw the entire body of private contract law.”).

⁵ See Richard J. Gilbert & Steven C. Sunshine, *Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets*, 63 ANTITRUST L.J. 569, 573 (1995).

⁶ See *id.*

⁷ Merger Guidelines § 6.4.

⁸ See Douglas H. Ginsburg & Joshua D. Wright, *Dynamic Analysis and the Limits of Antitrust Institutions*, 78 ANTITRUST L.J. 1, 4 (2012) (“the complex relationship between static product market competition and the incentive to innovate is not well understood”).

⁹ See JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 106 (1950); cf. Gilbert & Sunshine, *supra* note 5, at 574-75 (“At the heart of Schumpeter’s argument is a monopoly’s supposed superior ability to absorb the costs and risks of innovative activity.”).

¹⁰ See *id.*; Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources to Invention*, in THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 609 (NBER 1962).

markets have yet to materialize.¹¹ But how can antitrust policy best promote innovation without creating more problems than are solved?

It is common ground that “[a] finding of illegality under Section 7 must rest on a probable effect on commerce.”¹² Where there is no present commerce, the most logical conclusion is that there must be some reasonable probability that a new market will emerge, and that competing firms will earn revenues in that market, to satisfy the commerce requirement. When future innovations are not imminent or predictable, the effect on commerce is too speculative; any intervention by the agencies or the courts in these situations could do more harm than good. We should thus be wary of claimed effects in vague innovation markets that do not identify specific goods or services. Requiring the future market’s reasonable foreseeability would minimize speculation by the agencies, provide clarity to businesses and the courts, and comport with current policy goals.

Why Is a Reasonable Foreseeability Standard Appropriate?

For at least the past two decades, the agencies have sought to protect innovation competition. Recognizing that licensing agreements could affect future research and development competition, the agencies’ IP Guidelines formally established a separate competitive effects analysis within “innovation markets” as an alternative to traditional goods (or services) markets analysis. Such an inquiry comes into play when current R&D competition may lead to development of new products or improvements in goods or processes.¹³ Though less explicit in their recognition of “innovation markets,” the 2010 Horizontal Merger Guidelines (“Merger Guidelines”) similarly appreciate the potential effect for a merger to lessen innovation competition.¹⁴ Here, the fundamental concern is that one or both merging parties may engage in innovation designed to “capture substantial revenues from the other merging firm.”¹⁵ Yet neither set of Guidelines articulates a standard for assessing the probable effect of such a transaction on the competitive process—how likely is it that one or both of the merging firms will bring a new or improved product to market such that their merger will lessen competition?

A reasonable foreseeability requirement would minimize agency and judicial speculation, and correspond more closely to what the agencies do in actual practice. Cases premised on harm to innovation markets are inherently more speculative than traditional merger cases.¹⁶ It is quite

¹¹ See Jonathan M. Jacobson, Merger Policy & Innovation, Presentation to the New York State Bar Association, Antitrust Section, Annual Meeting (Jan. 25, 1996).

¹² See Gilbert & Sunshine, *supra* note 5, at 600; see also Robert J. Hoerner, *Innovation Markets: New Wine in Old Bottles?*, 64 ANTITRUST L.J. 49, 50 (1995) (“The absolute minimum requirement, then, for a ‘line of commerce’ to exist is buy/sell transactions.”).

¹³ IP Guidelines § 3.2.3.

¹⁴ See Merger Guidelines § 6.4.

¹⁵ *Id.*

¹⁶ Ginsburg & Wright, *supra* note 7, at 19.

difficult to predict whether specific firms may develop technology to enter or alter a market, and many such determinations would at least require industry expertise.¹⁷ The agencies, however, “are neither organized nor staffed in such a way as to incorporate learning from fields far removed from industrial organization economics.”¹⁸ Application of innovation market analysis thus increases the risk of harmful false positives—preventing efficient mergers with no anticompetitive effects.¹⁹ To bring a case, the agencies must be able to define a specific future product or service and show that significant development is already underway. And they should not seek relief when there is a good possibility that a new innovation may never even come to exist.

Reduced speculation at the agency level would diminish judicial speculation as well. In the past, courts have been reluctant to make predictions on the development of future products.²⁰ One of the most well-known instances, the Second Circuit held in *SCM v. Xerox* in 1981 that there could be no antitrust liability resulting from patent acquisitions where the relevant market for the patented inventions had yet to emerge.²¹ In opposing certiorari as an amicus, the Justice Department went further, saying that an “acquisition by a company having no power in the relevant market at the time of the acquisition does not violate Section 1 or 2 of the Sherman Act or Section 7 of the Clayton Act,” whether a patent is involved or not.²²

Since *SCM*, however, “it has become routine for both DOJ and the FTC to challenge mergers in which the market has not yet emerged but where its emergence is foreseeable.”²³ But market foreseeability is key, and unspecified innovation markets have been rejected on that basis. In *Golden Gate Pharmacy Services*, the Northern District of California found that plaintiffs’ alleged innovation markets for “the research and development of new prescription pharmaceutical products” and “the research and development of new brand name prescription pharmaceutical products” were not cognizable product markets.²⁴ Without specific alleged

¹⁷ See *id.* at 15; see also Timothy J. Muris & Bilal Sayyed, *Three Key Principles for Revising the Horizontal Merger Guidelines*, Antitrust Source 1, 13 (Apr. 2010) (“innovation inquiries must be even more factually intensive than product market investigations”).

¹⁸ Ginsburg & Wright, *supra* note 7, at 17.

¹⁹ See Ronald W. Davis, *Innovation Markets and Merger Enforcement: Current Practice in Perspective*, 71 ANTITRUST L.J. 677, 697 (2003) (innovation market enforcement could do “more good than harm”).

²⁰ See Ginsburg & Wright, *supra* note 7, at 12 (“Courts and agencies generally have also been reluctant to predict the specific path of technological evolution.”).

²¹ *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195, 1207-09 (2d Cir. 1981).

²² Brief for the United States as Amicus Curiae at 9, *SCM Corp. v. Xerox Corp.*, No. 80-2092 (U.S., filed Feb. 1982).

²³ Jonathan M. Jacobson, *Do We Need a ‘New Economy’ Exception for Antitrust?*, Antitrust Magazine 89, 91 (Fall 2001).

²⁴ *Golden Gate Pharmacy Servs., Inc. v. Pfizer, Inc.*, No. C-09-3854, 2009 WL 4723739, at *4 (N.D. Cal. Dec. 2, 2009).

products, the plaintiffs were unable to make the requisite showing of product interchangeability.²⁵

A reasonable foreseeability standard is similar to that applied in actual potential competition cases. In that context, a merger may be enjoined if the plaintiff can show that either the acquiring or the acquired firm was likely to enter the relevant market in the absence of the transaction,²⁶ where the firm's entry would be unique, and where the probable effect of the entry would be to enhance competition significantly. While there is not a unified standard of proof for evaluating the likelihood of entry, the Second, Fifth, and Eighth Circuits have adopted a "reasonable probability" standard.²⁷ Granted, this is an imperfect comparison. Actual potential competition implicates markets already in existence, and the Supreme Court has not expressly ruled on the validity of the doctrine itself.²⁸ But it offers useful guidance for innovation market analysis because it asks the same question of whether a firm (or its product) is likely to enter a particular market.

The Federal Trade Commission recently drew this parallel in its review of the Nielsen/Arbitron merger. When the acquisition was proposed, both firms were developing "cross-platform measurement services, which measure viewership across TV, the Internet, and other platforms."²⁹ Although neither firm's product was market-ready at the time of the investigation, the Commission found that "[b]oth companies [met] the standard to be considered actual potential entrants."³⁰ Nielsen and Arbitron had invested significantly in R&D, were in the process of beta-testing with customers, and were believed by industry participants to be the "best-positioned" to provide this future service.³¹ Arbitron was thus required to divest certain

²⁵ *See id.*

²⁶ *See* AMERICAN BAR ASS'N, SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 377, 380-81 (7th ed. 2012).

²⁷ *See United States v. Siemens Corp.*, 621 F.2d 499, 506-07 (2d Cir. 1980) ("at least a 'reasonable probability' that the acquiring firm would enter the market . . . and preferably clear proof that entry would occur"); *Mercantile Tex. Corp. v. Bd. of Governors*, 638 F.2d 1255, 1268-69 (5th Cir. 1981) (explaining notion of "reasonable probability"); *Yamaha Motor Co. v. FTC*, 657 F.2d 971, 977-79 (8th Cir. 1981) (questioning whether firm would have "probably" entered market absent joint venture).

²⁸ *See generally United States v. Marine Bancorporation*, 418 U.S. 602 (1974).

²⁹ Deborah L. Feinstein, *The Forward-Looking Nature of Merger Analysis*, at 20 (2014), available at http://www.ftc.gov/system/files/documents/public_statements/forward-looking-nature-merger-analysis/140206mergeranalysis-dlf.pdf.

³⁰ Statement of the Federal Trade Commission, *In the Matter of Nielsen Holdings, N.V. and Arbitron Inc.*, FTC File No. 131-0058 (Sept. 20, 2013), available at <http://www.ftc.gov/sites/default/files/documents/cases/2013/09/130920nielsenarbitroncommmt.pdf>. The statement does not articulate a specific standard, but it notes that it is "less stringent" than the "clear proof" standard set in *B.A.T. Indus.*, 104 F.T.C. 852 (1984).

³¹ *Id.*

assets related to its cross-platform measurement services business.³² In contrast, in *In the Matter of Polypore*, the Commission found that the acquired firm, Microporous was *not* a market participant in the provision of uninterruptible power source products, despite its R&D efforts. No remedy was sought in this product space, where there was “mixed evidence” on the likelihood of Microporous’s efforts to yield a viable product.³³

Challenges by the Justice Department have been consistent with this approach. In 2001, the DOJ filed suit to block General Dynamics’ acquisition of Newport News Shipbuilding.³⁴ The complaint alleged harm to a relevant product market of “electric drive technology for submarines and surface combatants.”³⁵ Although electric drives had not yet been developed for such use, the DOJ concluded that the merging parties were the “leading firms” on this development initiative.³⁶ Similarly, in 1998, the DOJ approved the merger between Monsanto and DeKalb Genetics only after Monsanto spun off claims to IP relating to an “emerging” technology used to introduce genetic traits into corn seed. The explicit purpose was to protect “future competition in corn transformation technology.”³⁷

Limiting intervention to situations of reasonable foreseeability is also consistent with the Merger Guidelines themselves. When determining whether a firm is a market participant, the agencies include firms that “have committed to entering the market in the near future,” even if they do not yet earn revenues in that market.³⁸ We see this most frequently in the pharmaceutical industry, where there are “regulatory features that make identifying market participants, and determining likelihood of competitive effects, relatively tractable.”³⁹ Specifically, the FDA’s lengthy and detailed approval process provides the agencies with sufficient information to

³² *Id.*

³³ See Feinstein, *supra* note 29, at 9.

³⁴ See Department of Justice Press Release, “Justice Department Files Suit to Block General Dynamics’ Purchase of Newport News Shipbuilding,” *available at* http://www.justice.gov/atr/public/press_releases/2001/9366.htm.

³⁵ Complaint, *United States v. General Dynamics Corp. & Newport News Shipbuilding Inc.*, No. 1:01CV02200 (Oct. 23, 2001), *available at* <http://www.justice.gov/atr/cases/f9300/9373.htm>.

³⁶ *See id.*

³⁷ Department of Justice Press Release, “Justice Department Approves Monsanto’s Acquisition of DeKalb Genetics Corporation,” *available at* http://www.justice.gov/atr/public/press_releases/1998/2103.htm (emphasis added).

³⁸ Merger Guidelines §5.1.

³⁹ Muris & Sayyed, *supra* note 17, at 12; *see also* Davis, *supra* note 19, at 696 (“It is difficult for enforcers to obtain reliable information to detect deals that fit within the scenarios under discussion, especially outside the pharmaceutical arena (where the FTC is aided by the nature of FDA regulation and by access to the FDA’s knowledge base)”).

determine whether and when particular drugs will come to market.⁴⁰ This reduces greatly the guesswork involved with predicting future market participants and specific products. For example, the Watson/Actavis acquisition in 2012 put six future pharmaceutical markets into issue. Because the Commission found that “generic development was underway and generic entry was imminent” in these markets, it required divestitures.⁴¹

Most recent FTC cases involving future markets, such as Watson/Actavis, have involved future development of generic drugs.⁴² This makes sense—there is much less uncertainty surrounding R&D for a generic drug when the branded drug already exists on the market. But there are situations, such as the Pfizer/Warner-Lambert merger in 2000, when the FTC has required relief in a new future market. Even though the FDA had yet to approve any EGFR-tk inhibitors for the treatment of cancer, the FTC concluded that the proposed merger would reduce the number of companies competing to develop the product from four to three.⁴³

But there are limits to regulation of defined innovation markets, even within the pharmaceutical industry. The investigation of the consummated Genzyme/Novazyme merger is instructive. There, although the merging firms had been competing to develop a treatment for Pompe disease, a genetic disorder, the Commission closed its investigation in part because of the uncertainty surrounding the success of both firms’ research programs.⁴⁴ Chairman Muris’s statement also rejected the dissent’s suggestion of a “rebuttable presumption of anticompetitive effects from a merger between the only two companies that are attempting to innovate in a product market.”⁴⁵ This reinforces one of the key benefits to the reasonable foreseeability standard—it requires a case-by-case, fact-specific analysis of whether new market entry is likely

⁴⁰ See Dahdouh, *supra* note 4, at 422 (“enforcement actions concerning innovation markets are likely to be limited to situations where there is solid evidence delineating the innovation markets or where the governmental approval process creates an observable ‘pipeline’ for the introduction of new products”); see also Feinstein, *supra* note 28, at 12.

⁴¹ Feinstein, *supra* note 28, at 14; see also Complaint, *In the Matter of Watson Pharmaceuticals Inc. and Actavis Inc.*, Dkt. C-4373 (Oct. 15, 2012), available at <http://www.ftc.gov/sites/default/files/documents/cases/2012/10/121015watsonactaviscmpt.pdf>.

⁴² See, e.g., Complaint, *In the Matter of Barr Pharms., Inc.*, Dkt. No. C-4171 (Oct. 19, 2006), available at <http://www.ftc.gov/sites/default/files/documents/cases/2006/10/0610217barrcomplaint.pdf>.

⁴³ Complaint, *In the Matter of Pfizer Inc. & Warner-Lambert Co.*, Dkt. No. C-3957 (June 19, 2000), available at <http://www.ftc.gov/sites/default/files/documents/cases/2000/06/pfizercmp.htm>.

⁴⁴ Statement of Chairman Timothy J. Muris, *In the Matter of Genzyme Corporation/Novazyme Pharmaceuticals, Inc.*, File No. 021 0026, available at <http://www.ftc.gov/system/files/attachments/press-releases/ftc-closes-its-investigation-genzyme-corporations-2001-acquisition-novazyme-pharmaceuticals-inc./murisgenzymestmt.pdf>.

⁴⁵ *Id.*

to occur.⁴⁶ As the Merger Guidelines support such analysis, adding a requirement of foreseeability would fit well within the parameters of the agencies' current approach.

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⁴⁶ See Feinstein, *supra* note 28, at 10-11 (“*Polypore* makes clear that employing a forward-looking approach involves a fact-specific inquiry.”).