<u>TYING: ANTITRUST LAW AND POLICY</u>

The Conference Board ✧ March 2007

Challenges to Dominant Firm Exclusionary Conduct

Jonathan M. Jacobson
Wilson Sonsini Goodrich & Rosati
1301 Avenue of the Americas
New York, NY 10019
212.497.7758
jjacobson@wsgr.com

After *Illinois Tool*,[1] it is clear that tying soon will be no longer a per se offense – if, indeed, it can be viewed as a per se violation today.[2] Instead, tying is or will be viewed as illegal only where a firm with market power in a tying product forces buyers to take an unwanted tied product in a manner that harms consumers in either the tied product market or the tying product market – by raising prices, restricting output, or creating, enhancing, or protecting the defendant's market power

This is an appropriate place for the law to be. Going further, and making tying per se lawful, or imposing new burdens on the tying case plaintiff, is unnecessary and could cause significant consumer harm.

Benign Ties

Some ties are clearly benign and, in some cases, efficiency-enhancing. The easiest cases are ones where there really is one product, not two. Some good examples are selling pairs of shoes, or cars with

1 Illinois Tool Works v. Independent Ink, 126 S. Ct. 1281 (2006).

2 *Id.* at 1286 ("Over the years, however, this Court's strong disapproval of tying arrangements has substantially diminished. . . . The assumption that '[t]ying arrangements serve hardly any purpose beyond the suppression of competition,' rejected in *Fortner II,* has not been endorsed in any opinion since.").

engines, or providing houses with financing, as in *Fortner*.[3] The "tie" in those cases lowers transaction costs for buyers and makes the seller's offering more attractive. So-called full line forcing, where the dealer or retailer is required to accept the seller's full line of product offering, is generally procompetitive as well for these same reasons.[4]

Even when the product offerings are clearly separate, the analysis may be easy. Selling cars or electronics products with extended warranties is one example. Some buyers may well prefer to purchase the products without warranties, at a lower cost, and take their chances or farm out the repairs to someone else. If the buyer is well-informed ex ante, however, there is almost never a serious competition problem when there is competition in the product market for the underlying good.

Problematic Ties

Having said all that, it seems plainly wrong to assert that all ties are benign. History provides many instances of tying arrangements that caused substantial consumer harm. Here are a few examples:

---

3 United States Steel Corp. v. Fortner Enterprises, 394 U.S. 495 (1969) and 429 U.S. 610 (1977).

4 Smith Mach. Co. v. Hesston Corp., 878 F.2d 1290, 1295-98 (10th Cir. 1989).

First, the railroads and coal from the 1880s through the early 1900s. Major railroads, especially in the East, forced customers to take the railroad's coal as a condition for obtaining rail transportation. Competing coal producers were forced out of business and prices for delivered coal soared. The practice was stopped only when Congress passed the Commodities Clause of the Hepburn Act in 1906, which prohibited the railroads altogether from carrying coal they had mined.[5] The Supreme Court later gutted the statute but, by then, the Clayton Act had been passed and there was a credible antitrust remedy for anticompetitive tying.[6]

Second, the Motion Picture Trust. Thomas Edison conveyed to the Motion Picture Patents Company the basic patent on the movie projector. The company was able to use this and related patents to monopolize the market for film used in motion pictures, and then extended the monopoly further, into the markets for the exhibition, distribution, and even the production of motion pictures. This was one of the main abuses, together with United Shoe, cited in the reports and debates leading to the passage

---

5 *See* United States v. Lehigh Val R. Co., 220 U.S. 257 (1911).

6 United States v. Delaware, L. & W. R. Co., 238 U.S. 516 (1915).

of section 3 of The Clayton Act.[7] A fair argument can be made that the motion picture industry still has not recovered — some 90 years later — from the cartelization resulting from this tying arrangement.

Third, the tying arrangements of American Can and Continental Can in the late 1940s and early 1950s. Both companies tied can supplies to the sale of can-filling machinery. After the ties were eliminated as a result of Justice Department intervention, there was substantial new entry and lower prices both for cans and machines.[8]

A fourth example is AT&T's tie of its local lines to long distance telephone service. Telephone customers were effectively required to use the Bell system for long distance service, notwithstanding the availability of viable alternatives such as MCI.[9] The tie allowed AT&T to recover some of the profits capped by local line rate regulation through supracompetitive prices on long distance calls. The separation of local and long distance

---

7 *See* Jefferson Parish Hospital v. Hyde, 466 U.S. 2, 10 & n.15 (1984); Motion Picture Patents Co. v. Universal Film Co., 243 U.S. 502 (1917); Gordon Spivack, The Chicago School Approach to Single Firm Exercises of Monopoly Power: A Response, 52 Antitrust L. J. 651, 664-65 (1983); H. R. Rep. No. 627, 63d Cong., 2d Sess., 12-13 (1914).

8 United States v. American Can, 87 F. Supp. 18 (N.D. Cal. 1949).

9 E.g., MCI v. AT&T, 708 F.2d 1081 (7th Cir. 1983).

through the Bill Baxter settlement in 1982 remains today one of the great accomplishments of antitrust.

Arguments for Change

So if some tying arrangements are benign but others are harmful, do we need to change current law in a way that makes it more difficult, or impossible, to outlaw particular tying arrangements? Let's look at some of the arguments.

The first is the basic Chicago School point that, in any given supply chain, there is but a single monopoly profit. Tying arrangements may be welfare-enhancing, the argument goes, by eliminating double marginalization, yielding greater output and lower prices than would be available from successive monopolists.[10] Let me make four points in response.

1. The most obvious is that eliminating double marginalization improves welfare only where the second market is monopolized or noncompetitive. If the second market is competitive, allowing the defendant to obtain a monopoly provides no improvement. The argument

[10] E.g., Schor v. Abbott Labs., 457 F.3d 608, 613 (7th Cir. 2006).

is also inapplicable where pricing in the tying product market is constrained by factors such as rate regulation – as in the AT&T and railroad cases.

2. In addition, the assumptions underlying the double marginalization argument require that the tying and tied products be sold in fixed proportions. If these assumptions are removed, the argument fails. So while the double marginalization argument may work for the sale of shoes as a pair, it does not work at all when there are consumers of the second product who do not need the first. As the Areeda-Hovenkamp treatise points out,[11] those consumers are not directly affected by the tie but are very much affected when the tie reduces the available volume to competing suppliers in the second market so that they can no longer produce at efficient scale.

3. The double marginalization argument also assumes that the only thing that matters is price and that choice does not matter at all. Consumers value having options and, on some occasions, the utility of having at least one other supplier may be greater than the nominal price reduction achieved by eliminating competition in the second market.

[11] 9 Philip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 1706b2 (2d ed. 2004).

4. Finally, as in *Microsoft*,[12] a tie can harm consumers by raising barriers to entry into the tying product market.

The second argument advanced for relaxing antitrust restrictions against tying is that tying arrangements can be efficiency-enhancing.[13]

That statement is surely true, but the argument provides no basis for ousting the rule of reason. Proper application of rule of reason analysis takes all relevant efficiencies into account. Unless the net effect of the tie, accounting for the cost savings, is to harm consumers, the arrangement should be upheld.[14]

The other problem with the efficiencies argument is the one offered during they heyday of the per se rule. Tying arrangement efficiencies can usually be achieved with equal effectiveness through much less restrictive means.

Remember that when we are talking about antitrust challenges to tying, we are talking about contexts in which the buyer is *coerced* into

---

12 United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001).

13 David E. Evans & Michael Salinger, Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law, 22 Yale J. Reg. 37 (2005).

14 E.g., Jonathan Jacobson & Scott Sher, "No Economic Sense" Makes No Sense for Exclusive Dealing, 73 Antitrust L.J. 779 (2006).

accepting a second product she does not want. We are not talking about telling the defendant he can't sell two products at the same time, just forcing the tie upon unwilling consumers. The vast majority of efficiencies are associated with the simple availability of the package, not with its forced acceptance. In the typical case where there are real efficiencies associated with combining the products, the use of product and quality specifications will normally do the trick — just as the old cases suggest.[15]

Going Forward

The hardest cases over the past several years, and for the foreseeable future, are the technological ties, where a supplier releases a new version of her product with previously unbundled products incorporated.

Speaking very broadly, there are two types of approaches to this kind of issue. One is total or near-total laissez-faire, as suggested by the 1998 D.C. Circuit *Microsoft* panel opinion.[16] The other is a careful rule of reason analysis — suggested by the 2001 *Microsoft* en banc opinion — that gives

[15] Standard Oil Co. v. United States, 337 U.S. 293, 306 (1949); IBM v. United States, 298 U.S. 131, 138-40 (1936).

[16] United States v. Microsoft Corp., 147 F.3d 935 (D.C. Cir. 1998).

full consideration of efficiencies but also accounts for the actual or potential harm to competition.[17] I suggest that the latter course is the better one.

Antitrust constraints on tying since 1914 have prevented, in most cases, the most serious tying abuses exemplified by the railroad and motion picture cases. If we remove those constraints, we could easily see the most pernicious practices revived, with what I respectfully suggest would be far more consumer harm than in even the most egregious international cartels.

Consider again the case of Microsoft. If we remove or modify radically the law on tying, what would stop them from releasing a new and more costly version of Windows that bundled Microsoft Money and prevented Quicken or other competing financial software from running on Windows at all? We suddenly would be forced with no choice but Money. Would that be good for consumers? What would prevent Microsoft from monopolizing every other type of software it wanted to in the same fashion?

Tying law is important and necessary. The per se rule is about to become a relic of the past. Let's give the rule of reason a try.

#3038689v.1

[17] United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001).