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AN APPROACH TO THE CONTEMPORARY TREATMENT OF VERTICAL INTEGRATION CASES IN ANTITRUST LAW FROM A LAW & ECONOMICS PERSPECTIVE: RECENT EXPERIENCES IN THE U.S. AND E.U.

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(I) Introduction

After more than one-hundred years of experimenting and accumulating experience, antitrust lawyers are only comfortable making a few statements. Luckily, the significance of economic analysis in antitrust law application is blessed in one of those comfort zones. Although the extent to which economic analysis should impact antitrust law application is still a matter of debate, there is no doubt that "all antitrust law cases must make economic sense".[2] Yet, the gap between the legal interpretation of antitrust rules applicable to vertical relationships (vertical mergers and vertical restraints, together) and the correct approach suggested by their economic analysis still seems quite substantial. Perhaps, among all areas in antitrust, this gap reaches its greatest dimensions when dealing with issues concerning the treatment of vertical integration matters. Therefore, vertical integration matters are among the most delicate fields of antitrust law policy. This was precisely the reason why a flood of learned commentary (Allen, 1971; McGee and Bassett, 1976; Bork, 1978; Williamson, 1979; Posner, 1976/2001; Armentano, 1982) that focused on the mishandling of the economics of vertical integration followed the initial controversial decisions[3] regarding vertical merger matters despite vertical merger issues commanding less attention from the U.S. Supreme Court than many other issues arising in merger cases.

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[2] Syufy Enterprises v. United States, 404 U.S. 802 (1971).

[3] Some of such "triggering" vertical merger cases decided by the U.S. Supreme Court under Section 7 of the Clayton Act were United States v. E. I. du Pont de Nemours & Co., 353 U.S. 586 (1957); Brown Shoe Co. v. United States, 370 U.S. 294 (1962); Ford Motor Co. v. United States, 405 U.S. 562 (1972).

The tension between various policy objectives of antitrust law has a great impact on how various vertical integration issues will be dealt with in a given antitrust law regime. Different antitrust law regimes attribute varying weight and importance to these objectives, and they also may have a few items in their "list of objectives" that may not even exist in other regimes' lists. For example, for the E.U. competition law application, "single market integration" is an important goal (Sauter, 1997; 118 and Snyder, 1990), perhaps the most important one. Whereas for the U.S. antitrust law application, or for the Turkish competition law application of today, no single market integration goal may exist, let alone superseding any other policy objective.

Many approaches to "the goal of antitrust law" have been developed in the past. In addition to "the maximization of consumer welfare by way of targeting economic efficiency in antitrust law enforcement", many other goals, which were then summed under the rubric of 'populist goals' by their opponents, have been identified. Among them are "protection of small enterprises", "prevention of the accumulation of economic and political power in one hand", "protection of the consumer", "redistribution of welfare", "promotion of fairness in the trade conduct of enterprises", and even "prevention of the impersonal way of doing business of big companies" (Elzinga, 1977; Schwartz, 1979; Pitofsky, 1979 and Hovenkamp, 1982).[4]

As a result of the close relationship between the handling of vertical integration matters in an antitrust law regime and the objectives of that antitrust law regime, vertical integration issues constitute a favorite battle ground of the different schools of thought in antitrust law. Therefore, for each antitrust law regime, one fundamental question must be answered before engaging in the discussion of how to best treat the vertical integration cases: "What is the objective of the antitrust law enforcement?" In an antitrust regime where the possible answers to this question have not been discussed to a certain level of maturity, coming up with a coherent and meaningful antitrust law approach to vertical integration issues would be a bungling effort, if not impossible. As we proceed, we will try to link some specific discussions to the bigger discussion on the "objective of antitrust law".

[4] For a good summary of the discussion about the non-economic goals of antitrust law, see Sullivan and Grimes, 2000.

With this article, we will also attempt to lay out certain aspects of the law and economics of vertical integration in general and explore the relationship between the objectives of antitrust law and the treatment of vertical integration cases, while also making use of two contemporary cases; AOL/Time Warner and GE/Honeywell. To develop a coherent approach where some of the legal terms and references blend properly, we divided this study into five sections, including the introduction section. In Section II, we briefly summarize the significance of economic analysis in antitrust law, we define “vertical integration”, and diagnose certain gaps between the legal interpretation and economic analysis in the treatment of vertical relationships. In Section III, we provide a brief summary of the economic analyses and areas of debate concerning vertical integration matters. This section will contain our opinion on the ideal burden of proof allocation for contemporary vertical integration cases after a brief outlook on the possible procompetitive and anticompetitive consequences of vertical integration. In Section IV, we will attempt to illustrate some of the contemporary issues that arise in vertical integration cases and the role of economic analysis in the current treatment of vertical arrangements under antitrust law by making use of specific cases like AOL/Time Warner and GE/Honeywell. Section V will contain our brief conclusion regarding the discussions contained in this paper.

(II) Vertical Integration, Law and Economics, Gaps and Contradictions

(A) The Significance of Economic Analysis in Antitrust Law: No More Blindfolds in the Evaluation of Vertical Relationships

Although it was not always conceded that economics would have the prevalent role in antitrust law as it has today (Bork and Bowman, 1965), especially by way of the developments in the field of Industrial Organization, it has had a huge impact on the last few decades of antitrust law enforcement. The theories of Industrial Organization, to the extent they tied facts to sound theoretical explanations, has integrated the tools of economics into antitrust law application. The central role of economics in antitrust law application has started to rid the discussions around certain economic phenomena from ideologically driven claptraps. Together with the emancipation of antitrust law issues from ideas that lack objective benchmarks by which to guide antitrust, the enforcement habits and principles of antitrust law went through a drastic revision, especially in some areas. Vertical integration was perhaps the first and foremost of those re-thought areas.

Today, especially in some countries and jurisdictions where the antitrust law enforcement is a relatively new experience, there is still a tension between lawyers and economic consultants as to whose area antitrust primarily is. Whereas in the jurisdictions where the antitrust law enforcement has matured enough to prove that both legal analysis and economic analysis are essential components of a healthy antitrust enforcement regime, lawyers and economists have started to supplement each other to a greater extent. Economic analysis in antitrust law, primarily as a tool that provides the ability to explain commercial behavior, liberates lawyers to a great extent. After all, what is the huge difference between the facts of *Dr. Miles*[5] or *Schwinn*[6] and *GTE Sylvania*[7] cases? Don't the lawyers of GTE Sylvania have a 'thank you' ready for Mr. Lester Telser? Don't we all?

As of 1967, vertical restraints, both price and non-price, were adjudged illegal per se[8] under U.S. antitrust law.[9] But then, thanks to the impacts of Lester Telser's influential article dated 1960 (Telser, 1960), a legitimate economic explanation of the commercial behavior of manufacturers was utilized and accepted by lawyers in the *GTE Sylvania* case; and the U.S. Supreme Court reversed the per se rule against non-price vertical restraints. Telser argued in his article that, rather than being anticompetitive, many vertical restraints were imposed to eliminate the free-rider[10] problems. The potential of the free rider idea in antitrust, while very commonly utilized

[5] Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911)

[6] United States v. Arnold Schwinn & Co., 388 U.S. 365 (1967).

[7] Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).

[8] "Per se" approach entails a judgment without regard to the competitive impacts of a certain act.

[9] United States v. Arnold Schwinn & Co., 388 U.S. 365 (1967).

[10] A more detailed discussion of free rider issues in the vertical integration context will be provided in Section III below. The free rider explanation of Telser was a first step in responding to the question of why manufacturers might desire vertical restraints. According to this explanation, a possible answer was "in order to provide dealers incentives to provide consumers with more services". Those services would in return increase overall demand for the manufacturer's products. Vertical restraints at the retailer level was necessary for the manufacturers, as it was the only way to prevent the sale of the dealers who did not provide the service to consumers who received the services elsewhere.

now, was unexplored until *GTE Sylvania*. For an antitrust lawyer, until the concept of free rider was acknowledged in 1977 as a market imperfection that antitrust law should permit vertical restraints to cure, pure free rider issues must have led to one of those annoying-silence situations each time. The annoying-silence situation is a moment of despair for the antitrust lawyer. You look at your client's (probably the manager of the company) face to see an explanation of the economic rationale behind her action, while she looks at you with a blank face seeking for some legal help. This still happens in some other areas of antitrust law today. Nevertheless, those areas are much more limited in number and in scope now. They consist of those rare situations when, this time around, there is a trio of confused professionals around the table, including the economic analysis consultant. In other words, those situations are not cases where the economic analysis necessary to interpret the commercial behavior is not employed; rather these are cases where the law and economics of a certain antitrust law field still remains in a state of disequilibrium.

As we will briefly discuss in Section III below, after the "post-Chicago" developments following Lester Telser's contribution, the issue of proper treatment of vertical relationships is still a hotly debated area. Many commentators have noted that Telser's theory does not suffice to explain the wide range of vertical restraints (See, e.g., Scherer, 1983). Although very useful and informative, consumer free riding theories alone have been unable to dismiss concerns of anticompetitive conduct. General antitrust law policy regarding vertical restraints could not be formulated on the basis of Telser's free riding theories, because they did not explain certain cases. While the hot debate is still pending, today, in an antitrust regime that has the prime objective of maximization of consumer welfare, some vertical restraints are virtually immune from antitrust law investigation, whereas some other restraints are judged illegal per se. This, in our opinion, creates a substantial incongruity, since their economic results and their ability to influence commercial behavior are very similar. We will discuss this issue further under Section II/C.

(B) The Term "Vertical Integration"

If a manufacturer merges with the distributor of its products, the self-distribution capability resulting from such vertical merger would enable the post-merger enterprise to reach results that would maximize its overall profits (e.g. reduction of the cost of distribution to the minimum necessary to maximize sales, elimination of intrabrand competition to gain strength in interbrand competition,[11] etc.). Although it is not as common as the former in the antitrust law application, a merger between two manufacturers may be a vertical merger as well. This is the case when two manufacturers, one of which produces an end product and the other a component of the end product merge. Vertical mergers are sometimes termed “complete vertical integration” in antitrust law application.

Similarly, with contractual vertical restraints, the manufacturer would be able to supervise and control its dealers in a way similar to its own employees. The term “vertical restraints” refer to restrictive arrangements between persons operating at different levels in the distribution of a product or service, typically between manufacturer or supplier and dealer. Vertical restraints can be delineated into two groups: Those that relate to prices at which dealers may resell a manufacturer's goods, known as vertical price fixing, or resale price maintenance (RPM), and those that relate to the other aspects of a dealer's autonomy in the sale of those goods, such as limitation on its geographic area of operation, known as vertical non-price restraints. Vertical restraints are sometimes termed “partial vertical integration” in antitrust law application.

Vertical contractual restraints and vertical mergers are two different strategies available to a firm to reach very similar end results. These two strategies are therefore substitutes in most cases. As we will try to discuss below, this simple statement has, or should have, a significance in terms of the antitrust law treatment to be provided to these two strategies.

Turning back to the issue of proper definition, vertical integration, therefore, occurs whenever a manufacturer controls the means of distributing and/or retailing its own product (Posner, 1974).[12]

[11] Interbrand competition is the competition among the manufacturers of the same generic product, and in our opinion, should be the primary concern of antitrust law. Intrabrand competition is the competition between the distributors (wholesale or retail) of the product of a given manufacturer (Areeda and Kaplow,1997).

[12] COLE’s simple definition of “vertical integration” as “that type of organization that comes into existence when two or more successive stages of production and/or distribution are combined under the same control.” (Cole, General Discussion of Vertical Integration, in “Vertical Integration in Marketing” 9, 99, Bureau Econ. & Bus. Research, U. Ill., No. 74, 1952) is convenient as well. As an alternative definition, ADELMAN and BORK utilize the following definition: “A firm is called vertically integrated when it transmits from one of its departments to another a good or service which could, without major adaptation, be sold in the market.” (Adelman, Integration and Antitrust Policy, 63 Harvard law Review 27 (1949), and Bork, Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception, 22 U. Chi. Law Rev. 157 n.1 (1954)).

Vertical integration also can be qualified from a different perspective. Forward vertical integration is a producer's integration into the next level of production, closer to the end use customer. Backward vertical integration occurs when the producer seeks to integrate into its supply market, e.g., the manufacturer seeks to take over production of its own source of supply. When integrating forward, its monopoly power in the upstream market may be used as a leverage by an enterprise. Whereas, monopsony power would be relevant to integrate backward.[13]

(C) Gaps and Contradictions

As we referred to briefly above, a disparity between what the economic analysis of vertical integration suggests as the proper treatment, and the treatment provided by antitrust law application may be diagnosed right here. We included both vertical mergers and vertical restraints in the scope of our study; and in the scope of our definition of vertical integration to put emphasis on a contradiction between economic analysis and antitrust law treatment: Complete and partial vertical integration are very similar to each other, as they generally lead to almost identical economic results. Despite this fact, in the application of antitrust laws, there has always been a big difference as to how vertical mergers and vertical restraints are viewed and treated.

Some say that if vertical integration by merger or internal growth is acceptable from an economic analysis standpoint, a fortiori, vertical agreements between independent firms should be acceptable as well (Elzinga, 2001). Similarly, former professor and Judge Easterbrook says, "No practice a manufacturer uses to distribute its products should be a subject of serious antitrust attention... It should make no difference whether the restrictions are set by contract or by manufacturers' ownership of the retail outlets"(Easterbrook, 1984). However, today, both in the U.S. and in the E.U., most vertical restrictions are dealt with under a highly deferential standard of review, except for retail price maintenance (vertical price fixing) and tying arrangements. Whether there is a sound economic analysis that mandates to lawyers not to bring the treatment

[13] The vast majority of vertical integration cases have dealt with monopolists and forward integration rather than monopsonists and backward integration. Backward integration generally cannot extend a monopolist's market control into the second level or increase barriers to entry.

of tying in line with the other restrictions on distribution (or with complete vertical integration, for that matter) is questionable.

For example, we are of the opinion that, under a purely economic analysis of such cases, the antitrust law standards that authorities apply in judging tying conduct of a monopolistic firm, and the different standards that are applied in judging a vertical merger effected by the same firm could not be reconciled in some instances. These two kinds of commercial conduct are sometimes so likely to yield equivalent economic results that the big discrepancy in the likelihood of greater antitrust liability for tying at a policy preference level cannot be justified. While it is not our position to compare the effects of these two profit maximization strategies from the perspective of economic welfare generally, I can easily report as an antitrust lawyer to interested economists that, in some cases we handle, both forms of commercial conduct result in similar profits for the monopolist; they alter the commercial behavior of the distributor in exactly the same way, and there is no indication that real resources are not utilized equally efficiently.

Similarly, the functional similarities between alternative contractual methods of complete vertical integration are also frequently disregarded, and contradictory policies are developed in the antitrust law field concerning different types of vertical restraints (e.g., exclusive dealing arrangements, acts of tying, franchise agreements, etc.).

For example, there is little doubt that exclusive dealing arrangements are regarded as benign or procompetitive in antitrust law (Marvel, 1982). However, tying practices remain and expose companies to antitrust risk. If the general assessment of the risk potential of exclusive dealing is correct, legal rules governing partial vertical integration by contract should be more receptive to tying arrangements as well.

It has been argued in the past that antitrust policy should treat different forms of vertical relationships consistently to permit an enterprise to choose the mix of strategies that minimizes transaction costs (Katz, 1989). We support this Coasian view.

(III) <u>Overview of Vertical Integration Economics in Antitrust Law: Fundamentals and Contemporary Issues</u>

(A) Possible Procompetitive and Anticompetitive Consequences of Vertical Integration

(1) Procompetitive Consequences

Vertical integration, through merger or contract, brings certain pro-competitive results and sometimes, possible anti-competitive consequences. Ultimately, distribution is a cost just like any other cost for the manufacturer enterprise. Basic economics knowledge tells us that, all things being equal, a manufacturer wishes to minimize its costs to increase its profits. Therefore, it is quite intuitive that every firm, even a monopoly firm, has an incentive to adopt efficient distribution measures. Vertical integration is a good means to achieve efficient production, distribution and use of the new technology by internalizing externalities.[14] Although there may be other possible reasons for vertical integration (we will discuss some of such reasons under heading (b) below), it would not be an over simplification of the matter to say that the main economic reason for integration lies in a cost-benefit evaluation, whatever the origin of the costs: production (Stigler, 1951) or transaction (Williamson, 1975).[15]

To that end, " avoiding free-riders" is a very significant procompetitive consequence of certain types of vertical integration. I will first elaborate on the free-rider issues in a relatively detailed manner, as it provides good examples that indicate how economics and law interact in the antitrust law field. I will then summarize other major procompetitive consequences of vertical integration before engaging in a brief discussion of its anticompetitive potential.

(a) Avoiding Free Riders

Avoiding free riders is a very important aspect of vertical integration that allows the establishment of an efficient distribution network. The famous story of the computer store in Berkeley located next to a discount store that advertised "Go next door. Find out what you want, come back to buy it cheaper" explains perfectly how free riding on services works. There is no

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[14] We do not mean to allege that all externalities from network effects can be internalized by way of vertical integration. For example, a remaining issue might be the possibility of nonoptimal levels of investment. If there are too few users of a new technology, vertical integration might not achieve its purpose (See, Dahlman, 1979).

[15] In some cases, vertical integration might aim at minimizing a third source of cost; risk exposure of the integrating company. For example, an alternative method of providing a customer that has bankruptcy or payment risk with a grant might be directly buying the customer. Similarly, if the incomes of an upstream firm and a downstream firm are negatively correlated, they can minimize their total risks by buying each others' stocks, and a practical method of such diversification might be complete vertical integration, due to capital market restrictions.

doubt that free riding would hinder manufacturers' efforts to promote service for the product. The issue that is more relevant for the purposes of the efficiency explanation would be whether or not a manufacturer's provision of additional services raises demand more than it increases costs. Since a competitive firm will only provide increased services if, at the margin, the revenue generated by the increase in demand is greater than the cost increase, the Chicago argument is that any arrangement to provide additional services by a firm is efficient. Therefore, vertical integration, to the extent it serves to avoid free-riding, enhances efficiency.

Especially with respect to RPM, there is a sophisticated attack on this simple approach. The situation of the "Infra-Marginal Consumer" comes into play. This argument is a good example of a rare situation at the other end of the interaction between law and economics in the antitrust law field. It is an example of how economic theory might end-up unnecessarily complicating the issue for lawyers. The infra-marginal consumer is the consumer who is already purchasing the product before the provision of additional services. Those additional services cherished by the Chicagoan approach provide her with no added value. Insofar as the infra-marginal consumer is concerned, the additional services decrease consumer welfare, as the infra-marginal consumer pays a higher price for no added value.

In legal practice, it is almost impossible to find a case where this issue played a role. The area of applicability of this problem is not even close to jeopardizing the credibility of the free-rider argument on its own. First of all, it is only natural that a seller would do its best to devise methods of supplying service that address only the marginal consumer. Charging the infra-marginal consumer for the unused benefits might work to the detriment of the seller in the long term. Furthermore, employing only the resources that are necessary and sufficient to bring about the increase in demand should be considered as a natural part of the cost management of the seller. Therefore, the possible impacts of the problem of the infra-marginal consumer would be negligible. Secondly, it would be a far stretch to claim that economic analysis tools available to us today are sufficient to distinguish clearly those instances where the overall welfare effects of avoiding free rider are negative due to the problem of the infra-marginal consumer.

Lastly, there seems to be a functional problem with the infra-marginal consumer approach in terms of legal theory. While finding a healthy blend of economics and law in the enforcement of antitrust law, it is always useful to remember that economic analysis can be employed in the legal arena only to the extent that it allows the treatment of antitrust issues in an acceptable manner under fundamental legal principles. Even if avoiding free-rider creates a cost to infra-marginal consumers that exceeds its benefit to marginal consumers, is there really an antitrust law issue here? What's next? Are we going to find an antitrust law violation in their vertical agreement when a distributor, as per the relevant clause of its distribution agreement with its market leader manufacturer, provides the same boring advertisement for 365 consecutive nights on television? After all, the market leader manufacturer, with a vertical agreement, imposes the same kinds of costs on the majority of consumers who are already purchasers of the product.

Clearly, a manufacturer's desire to avoid free riding can be a valid economical explanation for many vertical arrangements, such as exclusive territories, or even retail price maintenance (RPM). Unfortunately, even in the most obviously welfare enhancing cases,[16] the free rider defense is not available for retail price maintenance[17] under global antitrust law practice. Except for the cases where the contract providing for retail price maintenance is a cover for a cartel arrangement,[18] there seems to be no strong economic justification for such sensitivity. Although not yet available as a defense for RPM, the free rider concept has been frequently utilized and is now well established in vertical integration cases by antitrust defense lawyers since GTE Sylvania.

At this stage, we should mention an area where, this time around, lawyers make life difficult for economists: "Free-riding on reputation" is one form of the free-rider defense that is most

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[16] Since the profit margin of the retailers would be under contractual protection, a RPM agreement may induce retailers to compete against each other and against retailers of rival products by offering services, information and quality valued by consumers.

[17] In this study, I refer to minimum retail price maintenance with RPM. Although maximum retail price maintenance is technically a type of RPM as well, it is well established in both economics and global antitrust law that no credible anticompetitive scenario can be developed regarding that type of RPM.

[18] With a strong network of RPM arrangements between manufacturers and retailers in a particular market, the competitive impact at the retail level would be identical to a horizontal price fixing agreement between retailers. Another possible method of backing up a cartel arrangement with a RPM contract would be benefiting from its capacity to solve the biggest organizational problem faced by all cartels: Cheating of cartel members. When manufacturers are already engaging in a cartel, a proper network of correctly drafted and implemented RPM contracts may help identify the cheater, and that threat may increase the effectiveness of the illegal horizontal arrangement.

appealing to antitrust lawyers. The broad range of promotional and reputational efforts of today's seller requires the lawyer to see if the free-rider argument, which was originally applied only to service and sales assistance, might be applied to such efforts as well. No doubt, the "vertical-agreement-induced image" of a product increases the willingness of the consumers to pay. Nevertheless, ultimately, if there are interchangeable products that would precisely meet the same consumer needs, the impacts of such vertical arrangement may well be welfare-diminishing. On the other hand, can you expect a manufacturer to invest millions of dollars in brand-image and then do nothing about it when its distributors start to ruin all such efforts?

We know, as legal representatives of business people, that avoiding free-riding on reputation is sometimes the only and sincere reason for a manufacturer to engage in vertical agreements bearing restrictions of competition. What we are not sure of is whether vertical arrangements to maintain reputation of a brand should be differentiated in terms of legal treatment from vertical arrangements to maintain technological quality or services from an economic analysis point of view.[19]

At this point, we should also mention and stress the importance of giving due consideration to another desire of manufacturers that might be pursued by vertical restraints, although it is not attempting to avoid free-rider in its traditional meaning. I first saw this type of an issue while defending a client in an investigation of the Turkish Competition Authority in 1998. The matter is currently on appeal before the High State Council (Danıştay), and therefore I will prefer to make use of a similar case that was handled under the U.S. antitrust law regime. Adolph Coors Co. v. FTC[20] demonstrates the issue clearly. Coors was a beer that was not pasteurized, unlike most other beers. Therefore, there were strict refrigeration and product rotation conditions imposed on Coors' dealers by the manufacturers together with limited inventories. Coors felt it

[19] Tying is another vertical arrangement area that is problematic despite the establishment of free-rider arguments in antitrust-law. It is true that, with the help of economic analysis, we understood in today's antitrust law enforcement that tying arrangements are not always evil tools of extending monopoly power from one product to the other. Tying can be used to monitor quality efficiently. Sometimes, for example, if the tied product is a complementary part that ensures proper maintenance or use of the tying product, it might be economically rational for a manufacturer and beneficial for the consumer to market the tying product together with the tied product. Tying also can be used to charge different prices to buyers with different demand elasticities. However, whether such price discrimination has positive welfare effects would require a thorough economic analysis.

[20] Adolph Coors Co. v. FTC, 497 F.2d 1178 (10th Cir, 1974).

had to make sure that dealers did not have an incentive to recoil from refrigeration and inventory requirements. It imposed minimum retail prices on its dealers to prevent dealers from financing their price reductions by reducing the costly services. Coors controlled the possibility of its dealers shirking on service requirements further by threatening them with termination in such a case. It was also stipulated in their vertical arrangement that such termination would cost the dealer the future stream of Coors' sales at a premium price.

It is important to note that the market imperfection that Coors fought in this situation is not Telser's free-riding issue. In this case, there is no way that consumers could receive services from full-price dealers and then purchase the product from a discount dealer. The market failure here is an informational one at the consumers' level at the time of purchase. Because consumers could not detect inferior quality before purchase, and because the poor quality would generally be attributed to the manufacturer, dealers have an incentive to stop investing in the required services. Whereas the manufacturer, Coors in this case, takes huge commercial and legal risks if the product is not treated properly by its dealers. Therefore, in this type of a case as well, although the manufacturer is not avoiding a traditional free-rider issue, a thorough economic analysis may one day liberate lawyers. If it can be proven that (i) price competition is prevented only to the extent it was necessary to ensure adherence with the desired marketing requirements, (ii) that there was no other viable option available for the manufacturer, and (iii) that the consumer welfare is worse off in the absence of such RPM arrangement, the arrangement should be allowed. Obviously, this also depends on what the prime objective of the relevant competition regime is. If protection of competition is not aimed as a tool of enhancing welfare but as an end result within itself, it will never be possible or meaningful to engage in this discussion. Today, there is no way of looking into the possible economic explanations and legal defenses that may explain certain RPM arrangements. Because RPM is considered per se illegal anyway, there would be little justification for the legal and economic consultancy fees incurred.

(b) Other Procompetitive Benefits of Vertical Integration

In addition to its possible benefits mentioned above, vertical restrictions may fix certain other glitches that may occur during the manufacturer's efforts to increase demand in the long term. For example, to maintain brand loyalty, the manufacturer may wish distributors to sell at locations that are unprofitable for the distributor. Vertical restraints would allow a manufacturer to reach its goal. Similarly, minimizing search costs for consumers may increase demand, and the manufacturer would feel an urge to set the same price at all outlets to obtain such result. The latter would be closely scrutinized and probably condemned in today's antitrust law enforcement while a vertical arrangement to reach the former goal might pass muster with careful drafting of relevant vertical restraints.[21]

Vertical integration, especially complete integration, may[22] also enable a vertically integrated firm to put feedback mechanisms into play, which would in turn foster innovations and improve quality control by creating a better coordination between input suppliers and output producers with respect to production (Jorde and Teece, 1990).

When mentioning the procompetitive consequence of vertical mergers, perhaps "eliminating the double markups" is one of the most important benefits. Depending on how competitively the upstream and downstream markets were performing before the vertical merger, the magnitude of this potential efficiency benefit may be quite significant. If the upstream and downstream markets are highly competitive before the vertical merger, the fact that marginal input costs are marked-up twice (once by the input supplier and once by the output producer) may not result in a significant efficiency loss. However, if the upstream and downstream markets are not sufficiently competitive before the vertical merger, when the post-merger firm can efficiently supply inputs to itself, this can reduce output prices by eliminating one of the two markups.

Finally, a vertical merger may bring procompetitive consequences as it may prevent inefficient utilization of substitutable inputs. If the input price in a market exceeds the marginal cost level because of imperfect competition at the input market, the output producer may engage in cost-reducing input substitution. This may not lead to the economically efficient solution, because such substitution would be dictated by prices that exceed marginal costs. Whereas a vertically

[21] Notwithstanding the foregoing, a vertical restraint does not always provide leverage to the manufacturer against its distributors. It is frequently advantageous for the distributor as well, sometimes even against the manufacturer. For example, exclusive territories may protect distributors against manufacturers' opportunistic behavior to appropriate a distributor's investments by free riding off the efforts of their formerly devoted dealers.

[22] This procompetitive benefit would not flow from each and every vertical merger, although its potential benefits might be very significant if it does.

integrated firm would transfer input to its downstream at marginal costs, and any cost-reducing input substitution that can still be done under such circumstances would definitely be an efficiency enhancing decision. Because the vertically integrated firm would not get input at a price in excess of marginal costs, it may be able to reduce its costs, which would then provide it with the incentive to increase output and reduce its output price.[23]

(2) Possible Anticompetitive Consequences

Antitrust concerns regarding the possible anticompetitive effects of vertical integration can be classified under three main categories: Exclusionary effects (by increasing rivals' costs[24] of doing business or costs of entering a market), facilitating tacit or express coordinated conduct (by facilitating the exchange of competitively sensitive information in either input or output market), and allowing a firm to evade pricing regulation. Each of these three concerns may arise on a case-by-case basis in a vertical integration case, depending on the outcome of a specific economic analysis.

Nevertheless, I will not try to explain each of these anticompetitive consequence possibilities here on general terms. I do not acknowledge any of these classes as a serious and generally applicable drawback of vertical integration issues. In my view, they might occasionally bring about anticompetitive results but the outcome of an overall balancing of anticompetitive impacts and procompetitive consequences of vertical integration sure does not warrant a general discussion about its anticompetitive impacts. I believe that the issue of anticompetitive consequence of vertical integration can only be discussed by using specific cases from an economic analysis perspective. To borrow and bend a joke by Judge Easterbrook, the main welfare losses from vertical integration might be the trees that died to produce paper for analyzing their anticompetitive potential on general terms. I prefer not to contribute to welfare losses caused by vertical integration. Notwithstanding this, because it is the primary concern in

[23] For further discussions on rational input usage, see, (Warren-Boulton, 1974; Waterson, 1982; Westfield, 1981).

[24] The "raising rivals' costs" theory has been developed in the economic literature of the last decade. It is yet another significant tool that is provided by economists that helps us in understanding the actual impact on competition from foreclosure. According to this theory, a vertical merger has the potential to cause anticompetitive results only when the remaining alternatives (upstream or downstream) are either inferior, inadequate, or more costly. This situation is believed to allow the integrating firm to impose higher costs on its rivals, which would in turn permit it to raise its own prices.

most of the recent vertical integration cases, especially in the E.U.,[25] I will very briefly describe the nature of the exclusionary effect (and foreclosure) issues below. I am hoping to illustrate the anticompetitive impact concerns attached to vertical integration matters better while analyzing some specific recent cases under Section IV below.

Turning back to the nature of the exclusionary effect issues, this concern relates to the possibility that vertical merger might increase the merged firm's incentives to engage in exclusionary conduct in its pricing, marketing, and purchasing decisions at both the upstream and downstream levels. At the input level, this may involve the upstream division raising the input price it charges to rivals of the downstream division or refusing to supply them. At the customer level, this may involve refusing to purchase from rival input suppliers. It is generally feared that the conduct may harm competition by giving the integrated firm the power to raise or maintain input or output prices above the competitive level. Foreclosure may also involve raising rivals' entry barriers. The excluded enterprise there would be a "potential competitor", and the exclusion would be from a market that it would enter but for the raise in its entry costs.

According to these approaches, by increasing the likelihood of exclusion, vertical mergers permit the integrated firm to achieve, enhance, or maintain market power. The economics of the idea of

[25] The European Commission has a clear tendency toward the foreclosure scenarios in vertical integration cases. Although this tendency of the Commission drew global attention only after the GE/Honeywell case, which will be reviewed in Section IV below, there have always been cases where the European Commission acted very receptive of the foreclosure allegations. The most recent example of this is the Sonera / Telia merger that is conditionally approved as of July 10, 2002. The European Commission was concerned by the strong vertical links between, on the one hand, the parties' strong position in certain retail markets such as mobile communications services and corporate communications services in Sweden and Finland and, on the other hand, the parties' monopoly positions for wholesale call termination on their fixed and mobile telephony networks and leading positions for the provision of wholesale international roaming in Sweden and Finland. According to the European Commission, this vertical integration would give the merged entity the incentive and ability to foreclose competitors from the retail services markets in both Sweden and Finland. The Commission was convinced that the case would probably result in the strengthening of already strong positions for mobile communications services and bundled voice and data communications solutions (corporate communications services), in particular for services directed to corporate customers with pan-Nordic needs. In order to overcome these foreclosure concerns, the companies offered to create a legal separation between their fixed and mobile networks as well as services in Finland and in Sweden. They also undertook to grant non-discriminatory access to their networks. Finally, the parties offered to divest Telia's nation-wide cable TV business in Sweden. (Cable TV networks, when they exist and especially when they have a wide coverage, are considered to be the most credible substitute to the infrastructure of incumbent telecoms firms in that they can be used, if sufficiently upgraded, to provide broadband Internet services, data transmisson and voice telephony.) (available at:
http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/02/1032|0|RAPID&lg=EN)

a possibility of exclusion stemming from vertical integration is still not crystal clear. As explained briefly above, one of the fundamental theories that is subject to this hot debate is the "Raising Rivals' Costs" theory which was introduced by Salop and Scheffman in 1983 (Salop and Scheffman, 1983). According to this theory, a firm may operate to raise its rivals' costs by developing an exclusive relationship with the suppliers. This relationship is presumed to cover a wide range of contracts, from "input overbuying" to "naked exclusion",[26] or the vertical integration of the upstream enterprise (Schmalensee, 1973). Nevertheless, there are many criticisms arguing that the Raising Rivals' Costs Theory is counter-intuitive as a firm normally does not find an interest in buying inputs at a higher price than those paid by the competitors. Furthermore, it does not seem to be a logical strategic behavior for the supplier to relinquish part of the demand (Lopatka and Godek, 1992).

Notwithstanding these debate at the economics side of the picture, the antitrust law application of post-Chicago era, particularly after late 1990s, is constantly increasing its reaction to vertical integrations, especially in the cases when the vertical integration sets up entry barriers that foreclose non-integrated firms of the downstream market, or raises irregularly the rivals' costs, or refrains competitive behaviors either for the integrated firms or the rivals (Parker, 1998).

We are not sure if the increased reaction of the antitrust law enforcement to these heating debates in economics is proper or timely. To begin with, even in a case where input foreclosure raises a real potential for harm to competition, this should not mean that the proposed vertical merger necessarily is anticompetitive. Likely efficiency benefits also must be weighed to judge properly the net competitive impact of a transaction. However, again, depending on how the relevant antitrust regime defines the prime objective of antitrust law, the efficiency of such a vertically integrating firm rings further alarm bells for enforcement authorities in some jurisdictions. In an antitrust law regime that focuses on the consumer welfare, the mere possibility of exclusion may not cause the authorities to hit the panic button if there is sufficient expectation of efficiency gains. Whereas, in an antitrust law regime that focuses on limiting market power of enterprises, this might result in protecting competitors rather than competition, and the mere size and

[26] The supplier contractually (or even perhaps tacitly) commits itself not to sell inputs to the firm's rivals. For a detailed discussion of this issue see, (Rasmusen; Ramseyer and Wiley, 1991).

enhanced efficiency of a company might mean further problems for the defense counsel, let alone cancelling out the negative effect of the possibility of exclusion. We will have the opportunity to illustrate this conflict in Section IV below, with the GE/Honeywell case.

(B) The Reflection of The Ambiguity in The Economics of Vertical Integration to The Legal Treatment: What Should Be The Legal Approach in The Transition Period?

In light of all of the trends and approaches briefly discussed above, the legal treatment of vertical integration issues has ended up in a state of inaction for a long time. Now, the idea of antitrust law remedy to vertical integration is being revitalized with new tools, according to new findings. It is true that the post-Chicago learning has greatly changed and improved our understanding of the vertical integration issues. However, the economic analyses and principles emerging in this area are still quite difficult to apply in legal practice. To be honest, most people are aware that there is a transition period in the learning of the economics of vertical integration, and the wiser antitrust law regimes are hesitant to bring clean-cut legal preferences in this area. In my view, this is one of the main reasons why the vertical aspects of the 1982 Guidelines have not been revised in the U.S. Antitrust Law system.[27] The agencies are not yet enthusiastic about reaffirming a body of recent case law on vertical integration. With the further expansion of our economic understanding in the vertical integration area, legal principles that draw bright line rules may emerge again. The only thing we are sure of right now, with the help of the post-Chicago approaches to vertical integration matters, is that the balance between the procompetitive potential and the anticompetitive risks of vertical integrations may not always justify the benign neglect of the vertical integration area in the antitrust law application of 1980s. The outcome of the current hot debate between economists concerning the vertical integration issues will definitely have a determining impact on how relevant agencies and courts will reshape legal principles concerning vertical integration matters.

[27] Although 1984 Guidelines contained a section that relates to non-horizontal mergers, it was a mere reprint of the Section 4 of 1982 Guidelines. Then, as it is obvious from its name, the 1992 “Horizontal Merger Guidelines” totally skipped the non-horizontal issues, leaving the 1984 Merger Guidelines in effect for the evaluation of non-horizontal mergers under U.S. antitrust law.

At this point, an important question for me as an antitrust lawyer is this: So long as economists cannot provide me with a commonly agreed tool to sort the rare occasions where vertical restrictions are deleterious manifestations of anticompetitive intents,[28] should I try to develop a legal rule that attempts to deter businessmen only from certain types of vertical relationships, or is it better not to try than to try and fail? The discussion concerning the applicability of per se legality doctrine to vertical relationships surfaces as a result of this question.

Generally, for most of the Chicagoan laissez-faire approaches to vertical mergers and restraints, the central contention is that the efficiency benefits of such vertical relationships are likely in almost all cases to outweigh any possible anticompetitive harms. For example, in the area of vertical price agreements, a prominent commentator called for replacing per se illegality with per se legality, as early as 1981 (Posner, 1981). This may be a convenient approach for antitrust lawyers as well. Lawyers adore certainty. Nevertheless, as a matter of economic theory, it has never been clear why we should assume that efficiency benefits should necessarily dominate anticompetitive effects. Especially the models of Ordover et. al. (Ordover, Saloner and Salop, 1990) and Hart and Tirole (Hart and Tirole, 1990) indicate that a vertical merger can lead to anticompetitive effects with no efficiency benefits at all.

There is no doubt that efficiency benefits of a vertical relationship may be substantial and can exceed competitive harms in many cases. But the vice versa may be true for a non-negligible number of other cases. We need convincing proof, in order to be able to assume comfortably with a legal rule that dominating efficiency benefits are inherent whenever a vertical merger raises anticompetitive concerns. To date, there is no such widely acclaimed proof.[29] Until that time, we have to employ a rule of reason analysis.

One has to be equally accomodating at both ends of the scale though. Not missing the competitive benefits of a vertical price agreement, which may exceed the competitive harms in a specific case, should be equally as important as finding the rare cases where risks of competitive

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[28] Therefore, for the development of antitrust law application, studies in the economics area that specifically deal with the welfare results of non-horizontal mergers have a huge significance and impact potential.

[29] On the contrary, post-Chicago views are continuously gaining more grounds in favor of a rule of reason approach to vertical relationships in antitrust law.

harms are more likely to be greater than the possible efficiency benefits. Therefore, rather than a per se legality or a per se illegality approach to the application of any area of antitrust law to vertical relationships, a rule of reason analysis that balances the magnitude of competitive harms against competitive benefits should be employed while evaluating any vertical relationship under antitrust law.

The only question left is this: Did the economic analysis methods of today reach a level of maturity where there is a common ground on which the competitive harms are identified and balanced against the realizable efficiency potential in vertical mergers and vertical restraints in all cases? If the answer is affirmative, there still is no need for the per se approach. For the reasons above, we should analyze vertical relationships under a rule of reason approach.

However, the humble opinion of this antitrust lawyer is that the answer seems to be negative. The AOL/Time Warner case (one of the two cases that will be discussed below under Section IV in greater detail) demonstrated that economic analysis in the vertical integration area, even when it is employed within the same economic philosophy approach, leads to very different opinions.[30] In the AOL/Time Warner merger, the level of sophistication of the economic arguments advanced in support of , and in opposition to, the merger were very high. Yet, unlike the GE/Honeywell discussions, it never turned into a dispute among the adherents of "pre-Chicago", "Chicago", and "post-Chicago" theories. At that high level of sophistication, it remained as a dispute between economists who largely shared the same economic philosophy but simply had quite different opinions about how the merger would effect the fast-moving industries. Too little historical background in the relevant industries existed from which to draw guidance, and the exact same data led to totally different conclusions despite sharing certain fundamental assumptions.

If the answer to the question we posed above is negative, as we think it is, we turn back to the original question: Should we try to draw a general legal distinction between certain types of

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[30] *America Online, Inc.*, FTC Docket No. C-3989 (Apr. 18, 2001), *available at* http://www.ftc.gov/os/2001/04/aoltwdo.pdf .

vertical relationships, even in the absence of sufficient justification provided by economic analysis tools? Is there any use for the per se rule at all, toward legality or illegality, when there are many issues in the area of economics of vertical integration that are not discovered (or commonly agreed on) as of yet? What type of legal policy toward vertical restriction would navigate the ship of welfare maximization the best, so that it sails with the least amount of scratches in the murky waters of vertical integration?

In view of the vertical integration experience accumulated in the antitrust law field to date, we propose that the legal rule for the interim period should not place the demonstration of competitive benefit as the condition of legality. Antitrust law would be perverse in itself if it forbad whatever it could not totally understand. From a legal perspective, because we cannot use ignorance as the basis of condemnation, the burden of proof in challenging a vertical relationship under antitrust law has to be on the plaintiff. From an economical perspective as well, following a Coasian rule to do no harm, the burden of proof must rest on the plaintiff.

While balancing the likelihood of competitive harms against competitive benefits, we propose that this should be done on a balance that is slightly tilted in favor of vertical relationships.[31] By properly using the burden of proof mechanism, the antitrust law enforcement would be able to forbid welfare-diminishing vertical relationships without risking condemnation of a practice simply because we have a poor economic understanding of it.

(VI) Sample Vertical Integration Cases from the U.S. and E.U. Antitrust Law Regimes

In the U.S., although we have not seen many judicial or administrative trials about these issues, vertical integration matters are increasingly being scrutinized. The basic Chicago-school insight that vertical mergers are problematic only to the extent that they are likely to have an effect on horizontal-level competition (see, e.g., Morse, 1998) still carries weight today. However, recent theories about strategic behavior are gaining importance. These theories have provided the basis for a number of consent settlements already. Although I believe that such decrees (e.g., the Eli

[31] As discussed above, a manufacturer has a legitimate incentive to be concerned about efficiency-hampering free rider issues anyway. It is therefore relatively safe to assume that manufacturers would have a powerful economic incentive to develop efficient devices to internalize externalities that do not lessen competition. Vertical agreements are bound to be integral parts of such devices.

Lilly decree[32], and the decree in response to the PBM[33] acquisition by Merck[34]) do not have particular precedential significance, it is important to observe and acknowledge that recent theories on strategic behavior are increasingly used as the basis for consent settlements.

Then we experienced the negotiations among the FTC, American Online, Inc. (AOL) and Time Warner, Inc. (Time Warner).[35] Although it did not go to trial, the AOL/Time Warner transaction, which can be summarized as a vertical merger of AOL and Time Warner's distribution capacity and Time Warner's content, presented very interesting vertical issues relating to the potential for strategic behavior. The AOL/Time Warner transaction was a vertical combination at three distinct levels: (i) media entertainment of various kinds, in which one wing of Time Warner had arguably the broadest portfolio in the world; (ii) internet service, in which AOL was the dominant "narrowband" provider with the potential to become the dominant "broadband" company; and (iii) cable services, for which another wing of Time Warner was the dominant provider in approximately 20% of the country. The consent decree in this case was very interesting for everyone working on antitrust matters, as it imposed the most far-reaching conduct remedies, combined with ongoing monitoring obligations, of any merger decree approved by either the FTC or the DOJ in the late vertical merger enforcement era.

This case demonstrated the combination of the dynamics of the new economy and the worries of the traditional antitrust law enforcement. Similar to most vertical merger cases that take place in network industries, but perhaps more than most of them, the proposed transaction presented significant dynamic efficiency potential. Notwithstanding this, antitrust issues in the case ultimately boiled down to the traditional competitive issue presented by most vertical mergers:

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[32] *Eli Lilly and Co*., 120 F.T.C. 243 (1995).

[33] PBM stands for pharmaceutical benefit managers. They are bodies that interface between the manufacturers and the large health plans which provide coverage for their members. Early in the 1990s, there were a number of acquisitions by pharmaceutical companies of so-called pharmaceutical benefit managers.

[34] *Merck & Co*., FTC Docket No. C-3853, (Feb. 24, 1999)(decision and order), *available at* http://www.ftc.gov/os/1999/9902/9510097merck.do.htm

[35] *America Online, Inc*., FTC Docket No. C-3989 (Apr. 18, 2001), *available at* http://www.ftc.gov/os/2001/04/aoltwdo.pdf

foreclosure of access. Not surprisingly, the 5 million dollar question (well, in this case it was a 112 billion dollar question) was whether government antitrust enforcement agencies should apply a more static approach to emerging markets or whether they should act preemptively, even if our knowledge of the relevant market does not justify such enthusiasm to intervene. My view on this issue is in harmony with my view concerning the burden of proof for vertical integration cases suitable in this transition period of vertical integration economics. Network industry markets are not ripe enough to give us a capability of forward-looking antitrust analysis. Therefore, the rule should be non-intervention, insofar as the allegations concerning anticompetitive effects are speculative. I acknowledge that the failure to intervene preemptively could make intervention at a later stage almost impossible. This is especially true in the case of dynamic network markets. Still, my view is that a fear from the difficulty of unscrambling the eggs at a later stage cannot and should not drive an antitrust policy.

Now let's take a look at this challenging case, and then engage in a discussion of the famous GE/Honeywell case:

(A) <u>The AOL / Time Warner Decision</u>

In December 2000, the FTC entered into a settlement agreement conditionally approving the $112 billion merger between AOL and Time Warner. AOL is the largest Internet Service Provider (ISP) in the world. Time Warner is the second largest provider of cable television in the U.S. It also has interests in television programming, film, music and print journalism.[36] This merger remains the largest closed merger in U.S. history. The settlement agreement was approved by the FTC with a 5-0 vote.

The usual suspect of vertical integration cases defined the main fear: foreclosure of access. According to the FTC, this merger, as it was originally proposed, potentially foreclosed access to broadband cable for Internet service providers competing with AOL, and access to media content under the control of Time Warner. This fear created significant discomfort in the review process,

[36] FTC, File No. 001 0105 (proposed consent, Dec. 14, 2000). The valuation is based on the companies' stock prices as of Dec. 12, 2000.

since these are the two vital ingredients of the next generation of interactive media and entertainment. Furthermore, the denial of access to these products -unlike the denial of access to most other products- had potential First Amendment[37] implications. Briefly, the case turned around the possibility of foreclosure of access resulting from vertical integration into one entity that takes care of cable carrier and distribution businesses, together with cable programming.

The agreement resolved concerns as to whether the originally proposed transaction would violate Section 7 of the Clayton Act and Section 5 of the FTC Act by lessening competition in the residential broadband cable Internet access market, undermining AOL's incentive to promote digital subscriber line (DSL) broadband Internet service as an alternative to cable broadband, and by restraining competition in the market for interactive television (ITV).

Subsequent to this overview, let's get acquainted with the parties of the proposed merger: AOL's business description is much more straightforward. Although AOL did a few things, it did them exceptionally well. According to the FTC complaint, AOL was the leading internet service provider in the world, with nearly 28 million subscribers.[38] It also owned the Netscape Navigator browser and several Internet portals (e.g., AOL.com, Netscape.com) and had 135 million registered users on its Internet site.

Time Warner's story is a bit more complicated but nevertheless impressive. Time Warner is the second largest cable television distributor with cable systems reaching approximately 20% of U.S. cable television households.[39] At the time of the merger, Time Warner was also a majority owner of the second largest provider of cable broadband ISP service in the U.S. (the Roadrunner), with more than 1.1 million subscribers. Time Warner is also one of the leading cable television network providers: it owns HBO (around 30 million subscribers), Cinemax,

[37] The First Amendment is probably the most important part of the U.S. Constitution. It guarantees freedom of speech, together with the freedoms of religion, writing and publishing, peaceful assembly and freedom to raise grievances with the Federal Government.

[38] This number includes more than 25 million subscribers with America Online and over 2.6 million with subsidiary CompuServe.

[39] Approximately, 21 million homes in the U.S.

CNN, Turner Classic Movies, the Cartoon Network, and TBS and TNT. Consequently, it reaches more than 75 million homes. In print media, it owns such magazines as Time, People and Sports Illustrated and earns 21% of magazine advertising revenues in the U.S.; there are an estimated 130 million readers of Time Warner magazines. In the recorded music market, it owns such record labels as Warner Bros. Records and Atlantic Records and accounts for 16% of U.S. sales. In the movie industry, Time Warner owns such studios as Warner Bros. and New Line Cinema and accounts for 13% of U.S. box-office sales.

And then, these two companies wanted to merge. Why? Well, why not? The efficiencies and opportunities waiting for them are quite clear, even with a mere reading of their business descriptions. There was a key factor, however, that made both parties really enthusiastic about this transaction: They sought the dissemination of a technology, which has taken longer to realize than initially expected. They wanted to engage in the delivery of high-speed Internet access over broadband, cable television lines. Broadband Internet service over cable lines is many times faster than the dialed up "narrowband" service provided by conventional telephone wires. AOL and Time Warner judged the importance of broadband cable access to the Internet correctly, and decided that they needed each other: From AOL's perspective, AOL needed access to content and broadband cable delivery for its ISP service to millions of subscribers.[40] Time Warner, for its part, simply needed an Internet partner for the wider distribution of its content. Although they would probably be satisfied with just that, they were aware that AOL offered to them the future of entertainment. AOL's contribution was going to make their never-dull-but-always-unilateral content flexible and interactive. The transaction was expected to bring the "death of old media", as competitors were expected to vanish to the extent that they depended on paper, tape or the analog protocols that defined today's radio, television and cable so far.[41]

As we said, the principal fear from the transaction was discriminatory treatment. When one aims at preventing discriminatory treatment (i.e. the discrimination of competing ISPs seeking access to AOL Time Warner's cable systems) in an unknown market like this, the story has to look like

[40] Prior to its hook-up with Time Warner, no major cable company would carry AOL's services.

[41] P. Huber, "The Death of Old Media," The Wall Street Journal, p. A26 (Jan. 13, 2000).

the New York Bar Exam: No matter how much effort you spend, the best you can come up with is nothing more than an educated guess.

In order to assess the importance of broadband cable Internet access, the FTC analyzed four methods of delivering high-speed Internet access: cable television lines, telephone lines, fixed wireless and satellite. Broadband cable offers high-speed Internet access with a special cable modem. Telephone companies can enhance the capacity of traditional (copper) telephone lines for high-speed Internet access through a technology called Digital Subscriber Line (DSL). Fixed wireless high-speed Internet access is becoming increasingly popular and strong, but especially at the time of the proposed transaction, it was still at a developmental stage. The same goes for the satellite high-speed access, which is still not commercially available. Therefore, the FTC predicted that broadband cable would soon emerge as by far the predominant technology for high-speed Internet access.

After this educated guess, the FTC further horrified itself by constantly repeating that "a merger of the leading content provider -the leading ISP by a vast amount- and a company that is number two in the cable business" had to present antitrust problems. Moreover, the fact that AT&T, the number one cable provider in the U.S., had a "significant stock relationship" with Time Warner and together with Time Warner accounted for 50 percent of the cable industry in the country did not help the situation.[42] However, this was not the main sensitivity in the case. The primary sensitivity was whether reasonable suspicion of discrimination should suffice to block a merger with obvious efficiency potentials. Again, the question was: "Is it better not to try than to try and fail?".

When those are the dynamics in an antitrust review, any solid observation may have a huge impact on the whole process. Sometimes that impact may have a magnitude that is disproportionate with the economic significance of the observed situation. The AOL/Time Warner review was no exception. At the beginning of the review process, there was at least a general perception that the merger was not significantly problematic under antitrust law. Most of

[42] Antitrust and Trade Reg. Rprt., Vol. 79, No. 1988 at 564-55 (Dec. 15, 2000)

the relief was provided by the lack of market power of both parties. Although it was the market leader with 20%, AOL apparently did not have market power in the ISP market. Time Warner, although the second largest provider of cable television systems, apparently did not have market power in that market either. In addition to the lack of market power, the "foreclosure of access" worries were somewhat relieved by the CEOs of AOL and Time Warner. They testified in Congress that they were committed to open access. But then, Time Warner proceeded with its decision in May 2000 that, most Commissioners thought, was the best proof of its ability and willingness to exclude rivals: Time Warner, while engaged in a contractual dispute with the Walt Disney Company, decided to block Disney's ABC programming from millions of Time Warner cable viewers. This incident gave the Commissioners the tool to condemn the merger as it was proposed. One Commissioner clearly said, "if there was ever a doubt about market power, that incident dispelled that doubt for all of us."[43] Therefore, reborn after the incident of brief removal of ABC's programming, fears of FTC started to conquer the scene.

In the end, the FTC concluded that the combined AOL Time Warner, under the originally proposed terms of the merger, would be in a position to exert excessive influence over broadband internet access in Time Warner's cable markets. The main fear was that they would discriminate against other ISPs seeking broadband cable access for their customers. As indicated above, the FTC alleged in its complaint that the merger as originally proposed would have anticompetitive effects and violate Section 5 of the FTC Act[44] and Section 7 of the Clayton Act[45] with respect to three specific markets: (A) the market for broadband Internet access; (B) the market for residential broadband Internet transport services; and (C) the market for interactive television (ITV) services. We'll try to explain the logic behind each of these three concerns:

[43] "Some Tangled Issues Kept F.T.C. on Edge During Negotiations," New York Times, Dec. 15, 2000.

[44] Section 5 of the FTC Act outlaws "unfair methods of competition." The Supreme Court has ruled that violations of the Sherman Act also are violations of Section 5, but Section 5 covers some practices that are beyond the scope of the Sherman Act. Only the FTC enforces Section 5.

[45] Section 7 of the Clayton Act prohibits mergers and acquisitions where the effect "may be substantially to lessen competition, or to tend to create a monopoly."

(1) Concerns of The FTC Regarding The Proposed Transaction

(a) Violation of Section 5 of the FTC Act and Section 7 of the Clayton Act With Respect to The Market for Broadband Internet Access

With broadband Internet access, users can exchange data at rates substantially faster, as compared to narrowband access. Narrowband access is the access to Internet by standard telephone lines through an Internet service provider. Most residential users of Internet still choose, or settle for, this method. According to the FTC complaint, AOL was likely to become a major broadband ISP competitor. After all, it is the dominant narrowband Internet service provider.[46] When the relevant geographic market was defined as "Time Warner cable areas", AOL and Road Runner, in which Time Warner owns a controlling interest, were two of the most significant broadband ISP competitors. According to the FTC complaint, the merger was going to increase concentration in the broadband ISP markets. Furthermore, and perhaps more importantly, the merger also would increase the ability of the combined firm to unilaterally exercise market power in Time Warner cable areas and throughout the U.S. New entry was declared unlikely to be timely or sufficient to prevent the new firm from exercising market power. Therefore, it was decided that potential competition was not a good enough threat to protect the competitive dynamics of the market.

We mentioned above that the key to the complaint and the consent decree negotiations was the FTC's concern over the anticompetitive potential for discriminatory access. According to the FTC, AOL Time Warner could utilize the standard tools that are used for alleviating Internet congestion,[47] to cause favored content to reach subscribers more quickly or even to interfere with the transmission of a rival's content.[48]

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[46] AOL had approximately 50% of narrowband subscribers.

[47] Namely, the "caching" (storing) and "quality of service" techniques.

[48] According to this allegation, for example, AOL would be able to cache CNN locally, so that a broadband subscriber receives it at speeds that allow for a very high video quality, while using quality of service controls to

The FTC imposed various conditions to prevent discrimination by AOL Time Warner on the basis of affiliation, and it took measures to ensure that a full range of content and services from non-affiliated ISPs would be available to subscribers.

Therefore, pursuant to the decree, before AOL Time Warner could make AOL's broadband ISP service available in certain identified cable divisions (Identified Cable Divisions) representing over 70 percent of Time Warner's cable customers, AOL Time Warner had to make available cable broadband service offered by Earthlink, Inc., the second largest ISP in the U.S. The parties entered into a contract with Earthlink after the FTC insisted on having a buyer (an ISP) in place before reviewing the consent decree. With its now traditional buyer-up-front attitude, the FTC wanted to be able to evaluate in advance whether the prospective buyer of assets to be divested pursuant to a consent decree would make a viable competitor.

The FTC took additional measures to ensure that Earthlink was available as a competitor at the same time that AOL introduced its cable broadband ISP service. With the decree, it prohibited AOL Time Warner from advertising AOL's broadband ISP service to subscribers in a cable division[49] until Earthlink's competing ISP service was available to subscribers in that cable division or until Earthlink advertised or promoted its service in that cable division, whichever occured first. In addition, AOL Time Warner was urged to enter into agreements to carry at least two other non- affiliated broadband ISPs to provide cable broadband ISP services in the Identified Cable Divisions, within 90 days of making AOL's broadband ISP service available to subscribers. Each such agreement was subject to prior FTC approval. Each agreement had to bear terms comparable to the terms of the agreement with Earthlink, or between AOL and another cable system (e.g. AT&T). In a case where AOL did not enter into such agreements in a timely manner, the Commission had the power to appoint a trustee who would have the authority to enter into such agreements on behalf of the company.

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slow the reception of content from competing news sources. Such discrimination would not be visible to the average subscriber; they would only see that CNN works a lot faster than rival sites. That way, Time Warner’s content would gain a competitive advantage over its competitors, due to the discrimination of AOL.

[49] Generally, distinct geographic areas, such as Manhattan or Queens are each a cable division.

An in-house lawyer's worst nightmare was also foreseen by the FTC. The following provisions were designated as the key provisions that had to apply to all of AOL Time Warner's contract negotiations: (1) A most favored nations clause (which would enable ISPs seeking access to Time Warner's cable to obtain terms as favorable as those obtained by AOL on other cable systems), (2) the requirement that Time Warner should offer the same levels of service to unaffiliated ISPs that it offers to AOL's service over broadband cable, and (3) the provision that, if requested by a non-affiliated ISP, Time Warner will provide the non-affiliated ISP with the same point of connection within its cable divisions that it currently provides or will provide to affiliated ISPs.[50] Perhaps one of the most aggressive conditions that was imposed was that AOL Time Warner was further required to negotiate and enter into arms' length, commercial agreements with any other non-affiliated ISP that sought to provide cable broadband ISP service on Time Warner's cable system.[51]

(b) Violation of Section 5 of the FTC Act and Section 7 of the Clayton Act With Respect to The Market for Residential Broadband Internet Transport Services

The FTC saw cable television lines and digital subscriber lines as the two principal means of providing access[52] to customers for broadband ISPs. However, in terms of market penetration and acceptance, DSL was substantially behind cable modem service. As we explained above, satellite and fixed wireless technologies were not seen (certainly by the FTC but, allegedly, by the consumers as well) as competitive with cable and DSL for providing access to customers for broadband ISPs. Before the merger, AOL's principal means of providing such broadband "last mile access" was through DSL, and the FTC thought that every DSL broadband subscriber it signed represented a lost revenue opportunity for cable broadband providers. Subsequent to the merger, however, AOL might lose its incentive to promote and market broadband access through

[50] This last term was designed to prevent Time Warner from discriminating against non-affiliated ISPs by providing them with a less-advantageous connection point to its network than it provides to AOL.

[51] This is quite a far-stretched condition as it regulates the day-to-day commercial decisions of Time Warner to quite a detailed extent. Notwithstanding this, provided that the basis for such act is not the ISP's affiliation or any eventual impact on an affiliated ISP, Time Warner was allowed to decline to enter into such negotiations or agreements. The same rule was applicable for its decisions to impose rates, terms or conditions.

[52] It is called the "last mile access", in the FTC complaint.

DSL in Time Warner cable areas, because it will be able to offer the superior option of cable broadband service. Thus, the concern arose that AOL, as the owner of a cable system, would "pull the plug" on telephone broadband access and exercise unilateral market power. Quite frankly, I think this is exactly what Schumpeter calls a “constructive destruction process” (Schumpeter, 1942), and stopping it might not be antitrust policy’s prime objective. Turning back to the case, the FTC tried to remedy this allegedly anticompetitive effect, by compelling AOL with the decree to charge for DSL service no more in area A, where AOL cable broadband ISP service or Road Runner was available, than it charged for its DSL service in area B, where neither AOL cable broadband ISP service nor Road Runner was available. The FTC also required AOL to market and promote its DSL services to subscribers in Time Warner cable areas, where AOL cable broadband ISP or Road Runner was available, at the same or comparable level as it marketed and promoted DSL services to subscribers in areas where neither AOL cable broadband ISP service nor Road Runner was available. Notwithstanding all these tight restrictions, AOL was allowed to charge different prices for its DSL service, insofar as such pricing differences reflected any actual cost differences for DSL transmission services.

(c) Violation of Section 5 of the FTC Act and Section 7 of the Clayton Act With Respect to The Market for Interactive Television (ITV) Services

Interactive television (ITV) combines television programming with the Internet. This was perhaps the most interesting market concerning the proposed transaction. Since it largely depends on the ability to receive high-quality picture and/or video, ITV demands broadband transmission capacity. Narrowband is not as suitable for this job as it takes much longer to receive data, and the application may crash altogether from time to time while retrieving video data over the Internet by using narrowband. AOL was likely to become a major provider of ITV services, as evidenced by its then recent ITV product; the AOL-TV. Due to the compatibility reasons we briefly explained above, the FTC thought AOL was likely to do this through broadband cable. Then, another anxiety of the FTC came into play: Local cable companies control the interactive content delivered over their systems, and therefore they play a crucial role in enabling the delivery of ITV service. The FTC therefore feared that, AOL Time Warner, as a leading cable operator, would have the ability and incentives to prevent or deter rival ITV providers from competing with AOL's ITV service. Thus, the merger allegedly could enable AOL to exercise unilateral market power in the market for ITV services in Time Warner cable areas.

The FTC had the strong medicine too, as always. In order to eliminate these anxieties, the FTC decree prohibited Time Warner from interfering in any way with content passed along its bandwidth by non-affiliated ISPs. It specifically prohibited Time Warner from interfering with the ability of a subscriber to use, in conjunction with ITV services provided by a non-affiliated entity, interactive signals or other content that AOL Time Warner agreed to carry.

(2) The Outcome

In December, 2000, the FTC conditionally approved the merger of AOL and Time Warner. Both of these companies are now owned by a parent holding company; TWI. TWI is the second largest cable operator in the United States, servicing about 20% of the U.S. households. We tried to explain the thought behind each of the conditions imposed on the merger by the FTC. At the end, the approval of the merger was conditioned upon the following[53]:

(a) The merged entity agreed to give consumers a choice of Internet providers, including a deal with EarthLink,

(b) Before Time Warner can make AOL's broadband ISP service available in certain Time Warner areas, Time Warner must first make available cable broadband service offered by Earthlink,

[53] Although this 9-item list of conditions in the AOL/Time Warner decree is a full coverage of the imposed conditions, these conditions can be summarized under three main categories: (1) Requiring AOL Time Warner to make available to subscribers at least one non- affiliated cable broadband ISP service on Time Warner's cable system before AOL itself began offering service, followed by two other non-affiliated ISPs within ninety days and a requirement to negotiate in good faith with others; (2) Prohibiting AOL Time Warner from interfering with content to pass along the bandwidth contracted for by non-affiliated ISPs; and (3) Requiring AOL Time Warner to market and offer AOL's DSL services to subscribers in Time-Warner cable areas where affiliated cable broadband service is available in the same manner and at the same retail pricing as it does in those areas where affiliated broadband ISP service is not available.

(c) At least one competitor must be signed on to offer high speed cable Internet service in cities served by Time Warner before AOL can offer service on those lines,

(d) Time Warner and AOL must offer other Internet services in Time Warner cities terms equal to or better than those given to EarthLink,

(e) The combined company must offer at least three Internet providers, in addition to AOL, within three months of offering services in a market,
(f) AOL must offer high-speed digital services offered by telephone companies in cities where Time Warner controls cable lines at the same price it charges in other areas,

(g) AOL must inform the FTC of any complaints from Internet and interactive- TV competitors that they are unable to obtain access to Time Warner's online news and entertainment on reasonable terms,

(h) Market-opening provisions that require the combined companies to give AOL's competitors any favorable contract terms that AOL wins from cable companies, and

(i) Appointment of a Monitor Trustee to monitor compliance with the comprehensive order.

(3) Thoughts on The U.S. Aspects of The AOL / Time Warner Decision

With the above summarized fears and precautions, the decree prepared by the FTC reshaped the entire AOL/Time Warner transaction, and the future commercial conduct of AOL Time Warner. The term of the decree demonstrated a bizarre contradiction. The decree was designed to remain in force for only five years. In view of the content of the decree, I think this was a substantial contradiction. As we summarized above, this decree imposed very strict and detailed limitations on the commercial decision-making ability of AOL Time Warner. Nevertheless, mentioning the dynamic nature of the market as a reason,[54] the duration of the decree was limited only to five

[54] Antitrust & Trade Regulation, Vol. 79, No. 1988 at 563 (Dec. 15, 2000)

years. I am of the opinion that such accurate observation about the market should have resulted in hesitancy on the part of the FTC while imposing such aggressive and manipulative conditions. It is always better to cut a loosely tailored suit for the still-growing teenager, rather than to put a label on the closely-knit suit that forbids use after five years. I do not think we know the growing habits of this teenager; I even have my doubts as to whether we know how many arms and legs it has.

There are innovative and flexible aspects of this decree as well. For example, the FTC definitely deserves kudos in that it did not choose the simple route of requesting Time Warner to divest its interest in Road Runner. Instead of that, in order to prevent AOL from gaining a competitive first mover advantage through its interest in Road Runner, the FTC required that AOL Time Warner hold Road Runner and AOL separate in each Identified Cable Division until AOL Time Warner has made an affiliated ISP available to broadband customers in that division. This was a good way of implementing the remedies necessary to extinguish the fears of the FTC without ruining the synergies available in the transaction. It is one thing to question whether such fears are accurate, and quite another to review the manner with which those fears are dealt. While we have our doubts about the former, the latter issue is handled in good style concerning this particular issue. That said, I think prohibiting AOL and Road Runner from joint activities, joint or cooperative advertising and any steps to benefit from each other's business was just not a simple reflection of the same thought. Making sure that there is a competing enterprise in the market might make sense under certain circumstances. However, prohibiting use of AOL Time Warner’s significant potential does not follow the same line of thought. It simply takes away a valuable aspect of the merger.

Turning back to yet another contradiction: We explained above in great detail that the incident of AOL cutting off ABC programming had a triggering effect on the FTC. Despite this fact, nothing in the decree prevents AOL Time Warner from discriminating against other content providers from its Internet service or any future interactive television service. As we mentioned above, in a vague environment, any concrete and clear experience may have a blown-out-of-proportion impact on the review process. We think, this is what happened during the AOL / Time Warner merger review. The fact that not one of the remedies brought with the decree relates to the acknowledged triggering event supports our view.

Other aspects of the decree might not be as interesting from an economist's point of view, but we should briefly mention a few of them that are certainly very important for U.S. antitrust lawyers. The trustee provisions of the decree are quite far-reaching. As we mentioned above, the FTC is authorized to appoint a trustee to enter into broadband agreements with non-affiliated ISPs if AOL Time Warner (1) fails to enter into agreements with two additional ISPs in the Identified Cable Divisions within 90 days of making an affiliated ISP available to subscribers or (2) if AOL Time Warner fails to enter into agreements in its other (smaller market) cable divisions with at least three non-affiliated ISPs within 90 days of making any affiliated ISP available. What is even more shocking is that the decree authorizes the FTC to appoint a "Monitor Trustee" to monitor compliance with the decree. It gives the Monitor Trustee the power and authority to monitor AOL Time Warner's compliance with the decree, including complete access to personnel, books, records, documents and the like. The legal status of this trustee is very debatable. If he is an agent of the FTC, can he report irrelevant antitrust issues to the FTC based on his review of the books and records of the company? Would AOL Time Warner have to ask for the permission of this trustee for their commercial acts that would be iffy under the decree? Would his consent provide any protection to AOL Time Warner in a subsequent lawsuit?

(4) Brief Review of The E.U. Aspects of The AOL / Time Warner Transaction

The review of the E.U. aspects of the AOL / Time Warner transaction is brief, as the issues discussed under the E.U. application did not contain good examples of how the E.U. competition law currently handles critical vertical integration matters. Since Time Warner owned no cable networks in Europe, and as AOL ranked as at most the second largest ISP in any country in the European Union, this transaction was simply not critical enough in the E.U. to create a good sample case concerning foreclosure (We will save our appetite to the GE/Honeywell case reviewed below). The European Commission cleared the AOL/Time Warner merger in October, only after AOL agreed to sever all ties with Bertelsmann AG, a German media group.[55]

[55] See Case COMP/M.1845, AOL/Time Warner (Oct. 11, 2000), available at http://europa.eu.int/comm/competition/mergers/cases/.

The European Commission's concerns were focused on preventing the combined company from dominating online music distribution. The Commission had concerns that AOL, because of its proposed merger with Time Warner and because of its European joint ventures with Bertelsmann, would have controlled the leading source of music publishing rights in Europe.[56] Time Warner, Bertelsmann and EMI (with which Time Warner planned to merge its music recording and publishing activities) together would have held approximately 50% of European music publishing rights.[57] The EC was concerned that AOL could have become the "gate-keeper" in the emerging market for Internet on-line music delivery.[58] Since Warner Music, a subsidiary of Time Warner, and EMI Group abandoned their proposed $20 billion joint venture in the face of European Commission opposition (based on collective dominance issues), the Commission's concerns with the AOL Time Warner merger were resolved to a large extent. Therefore, at the end, both the undertakings proposed by the merging firms and the fact that the EMI/Time Warner deal did not take place ensured that the merged entity would not have the tools, in terms of music publishing rights, to dominate the market.

(B) The GE / Honeywell Decision

(1) The Significance of This Decision

The GE/Honeywell Decision[59] is very significant for various reasons. Its predominant impact on the discussions concerning the global convergence of antitrust enforcement is at least as important as the hints this case gave about the current idiosyncrasies of the vertical integration review of the European Commission. To quickly take a look at where we started this study, GE/Honeywell is the perfect example of how the difference among the prime objectives of different antitrust regimes also explains the different treatment of the same vertical integration issue under different regimes. The rejection of the GE/Honeywell merger by the European

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[56] See, (Castaneda, Collins, Crampton, Gray, Harty, Masuda, Matthews, Peterson, Solomon, and Stock, 2001).

[57] See id.

[58] See id.

[59] Commission Decision, General Electric/Honeywell, Case No. COMP./M.2220 at 84 (July 3, 2001), available at http://europa.eu.int/comm/competition/mergers/cases/decisions/m2220_en.pdf (hereinafter referred to as "GE/Honeywell Decision")

Commission despite a clearance from the U.S. authorities was chilling for most antitrust lawyers, especially for those practicing in the U.S. When the European Commission unanimously agreed to block General Electric Co.'s $45 billion acquisition of Honeywell International Inc. on July 3rd, 2001, that was the first time the Commission blocked a merger that had been cleared by the U.S. authorities. What added more color to the picture was the fact that the proposed and rejected transaction was an all-US party merger.

In view of the global nature of the parties' businesses and their customers, it would not be too presumptuous to think that the effect in the U.S. of such a vertical integration on competition would be similar to that in the E.U. The outcome of the efforts of legal counsels of General Electric Co. and Honeywell International Inc. to clear the transaction vis-à-vis the U.S. and E.U. authorities were, however, completely different.

The conflict between the treatment of similar vertical issues under these two antitrust regimes were obvious, since none of the reasons cited by the Commission for blocking the merger were local in nature. The Commission's concerns about the possible consequences of the proposed merger were, as will be discussed below in greater detail, already considered by the U.S. authorities. Although the facts were very similar for both reviews, the two leading antitrust regimes of the world came to different conclusions. U.S. Department of Justice (through Assistant Attorney General Charles A. James) issued a statement on the divergent conclusions that "the Antitrust Division reached a firm conclusion that the merger, as modified by the remedies we insisted upon, would have been pro-competitive and beneficial to consumers. Our conclusion was based on findings, confirmed by customers worldwide, that the combined firm could offer better products and services at more attractive prices than either firm could offer individually. That, in our view, is the essence of competition."[60]

Apparently, the "essence" of competition that the antitrust law must protect, or in our wording, the "prime objective" of antitrust law was something different from that in the E.U. According to Assistant Attorney General Charles A. James, "The E.U., however, apparently concluded that a

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[60] Statement dated July 3, 2001 by Charles A. James, Assistant Attorney General for Antitrust, Antitrust Division, U.S. Department of Justice, on the European Commission's decision regarding the GE/Honeywell Acquisition, available at: http://www.usdoj.gov/opa/pr/2001/July/303at.htm

more diversified, and thus more competitive GE could somehow disadvantage other market participants."[61] In another occasion, he further acknowledged that the issue at hand is primarily a part of the bigger discussion about the objectives of antitrust law by stating that the approach the European Commission used was "antithetical to the goals of antitrust law enforcement".[62] On the same subject, European Competition Commissioner Mario Monti stated that "it was unfortunate that, in the end, (both sides) reached different conclusions, but each authority has to perform its own assessment and the risk of dissenting views, although regrettable, can never be totally excluded. This does not mean that one authority is doing a technical analysis and the other pursuing a political goal, as some might pretend, but simply that we might interpret facts differently and forecast the effects of an operation in different ways."[63]

No matter what, some of the differences between the U.S. and E.U. competition regimes elucidated by the review of GE/Honeywell merger clearly indicate that the two regimes have different goals, fears, and methods while dealing with vertical issues. Different priorities concerning the objectives of antitrust law enforcement may result in different outcomes for vertical integration cases. An examination of the GE/Honeywell case, in addition to showing the peculiarities of the E.U. vertical integration review, will be helpful to illustrate this as well.

(2) A General Summary of the Antitrust Law Issues In the GE/Honeywell Case

The business descriptions of the parties to the proposed merger, as it relates to the relevant product markets reviewed by the European Commission,[64] are as follows: GE makes, sells, and services large aircraft engines. Honeywell, itself the result of a 1999 merger between Allied Signal and Honeywell, makes small aircraft engines, various avionics components, and other

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[61] See Id.

[62] Charles A. James, Assistant Attorney General for Antitrust, Antitrust Division, U.S. Department of Justice, International Antitrust Enforcement in the Bush Administration 4 (Sept. 21, 2001).

[63] Press release dated July 3, 2001, available at:
http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/01/939|0|RAPID&lg=EN

[64] A significant portion of the business activity of GE and Honeywell was not under review in this case. The product lines of concern to the European Commission accounted for less than 10% of GE's annual revenues, and about 25% of Honeywell's revenues.

"non-avionics" components, such as environmental control systems, wheels and brakes, and auxiliary power units.

GE and Honeywell wanted to merge as a result of their desire to combine their complementary product lines in the civil aerospace industry. As we discussed above, the basic Chicago-school insight that vertical mergers are problematic only to the extent that they are likely to have an effect on horizontal competition still carries weight today. We also stated, however, that recent theories about strategic behavior are gaining importance. For this proposed merger, especially in view of the magnitude of the merger itself, the horizontal overlaps were surprisingly insubstantial. Apart from those negligible horizontal aspects that could be fixed by divestitures, the merger was, at least in the beginning, a straightforward conglomerate merger that carried some vertical aspects.

The vertical relationship arose primarily because the GE Capital Aviation Services Unit (GECAS), GE's aircraft leasing and financing arm, was the largest purchaser of aircraft in the world, twice as big as its nearest competitor. GECAS was also one of the two leading leasing companies buying aircraft on a speculative basis. In addition to the "mixed bundling" concerns that will be explained below, one major concern of the European Commission with the proposed transaction was the role and competitive implications of GECAS in Honeywell's primary aircraft equipment product markets. The Commission was concerned that GE could use its position as a purchaser of aircraft, through its GECAS subsidiary, to harm competition in those aircraft equipment markets where Honeywell already had a leading share.

Notwithstanding the above, it would be a fair summary to say that the European Commission based its conglomerate case on the theory that the merged entity would engage in "foreclosure through packaged offers." The Commission was convinced that a combined GE/Honeywell would have the ability and incentive to offer customers attractive discounts encompassing GE's engines and Honeywell's avionics and non-avionics products.[65] The prospect of the merged entity engaging in "mixed bundling, whereby complementary products are sold together at a price which, owing to the discounts that apply across the product range, is lower than the price

[65] "The merged entity will be able to offer a package of products that has never been put together on the market prior to the merger and that cannot be challenged by any other competitor on its own." GE/Honeywell Decision ¶ 350.

charged when they are sold separately"[66] particularly concerned the European Commission. By way of enabling significant package discounts, the merger of GE and Honeywell supposedly would strengthen what the Commission viewed as GE's dominant position in aircraft engines for large commercial aircraft and create a dominant position in Honeywell's markets as well.

(3) Mixed Bundling Concerns

At this point, it might be useful to explain briefly the “mixed bundling” approach. As we briefly mentioned above, one of the main issues raised by the proposed GE/Honeywell merger concerned the possibility of "bundling" and its likely impact on competition in the markets for jet aircraft engines and avionics. Although many studies on "simple bundling" exist, in which a firm sells complementary products only in a bundle and does not make them available as separate products, the theory and application of the “mixed bundling” allegation is relatively untouched. The European Commission’s assessment of the likely impact of mixed bundling on competition depended on a theoretical model that benefited from the insights of the existing economic literature but was modified to the facts of the case.

According to the European Commission, the combined GE/Honeywell was expected to engage increasingly in pure bundling for new generations of aircraft. For existing generations of aircraft, however, the European Commission thought it more likely that GE/Honeywell would engage in "mixed bundling," where the company would continue to sell the individual components separately but sell them more cheaply as a bundle (Choi, 2001).[67]

In other words, the main concern of the European Commission was that mixed bundling by GE/Honeywell would be likely to reduce substantially the profitability of its competitors in the engine and avionics markets. According to the European Commission, if GE/Honeywell were to bundle its engine and avionics sales, it would result in a foreclosure.

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[66] Id. ¶ 351.

[67] See, (Choi, 2001). We benefited further from some insights of this article under this heading while explaining the “mixed bundling” concerns of the European Commission.

First of all, simply put, the merged firm could reduce the price of its bundled engine-avionics system and expand its market share. But for the merger, any price cut by GE or Honeywell would tend to benefit the other's sales; however, neither party would be able to realize that benefit. If the parties could proceed with the merger, GE/Honeywell could have "internalized" those "pricing externalities" by reducing the price of the bundle below the prices the two firms would have chosen had they been acting independently. That lower price would have had the effect of expanding GE/Honeywell's sales and market share.

Secondly, the European Commission suspected that the merged firm would raise the prices of its stand-alone components above their pre-merger levels. GE/Honeywell would have less to lose from raising its stand-alone prices than the firms did prior to the merger because some portion of the customers switching away from the stand-alone components would switch to the GE/Honeywell bundle rather than a competing system. The merged entity would therefore have an increased incentive to set high prices for its components, which would drive consumers away from the "mix-and-match" systems (i.e., systems including a GE/Honeywell component alongside a competitor's component).

After reaching this stage, the model of the European Commission assumed that the independent rivals would cut prices in order to retain some market share, as a response to the price cut by GE/Honeywell for the bundled system and the price increase for the "mix-and-match" systems. However, because they cannot internalize the externality arising from the complementing nature of their components, it would not be a commercially viable option for them to cut their prices as much as the merged firm. Thus, even if they attempted to participate in the price competition, their system would remain more expensive than the bundled GE/Honeywell system, and they would fail to recapture their lost market shares. As a result of the loss of market share and the need to cut prices, the profits of GE/Honeywell's competitors would drop significantly. This constituted the backbone of the model of the European Commission while applying the mixed bundling theory to this case.

Of course, even if these potential anticompetitive effects (in the form of market foreclosure) are correctly diagnosed, bundling also has efficiency benefits. Nevertheless, the European

Commission was convinced that the detrimental impact of foreclosure in this case would outweigh any efficiency benefits associated with bundling. They suspected that the proposed merger might result in the short-term exit of the competitors. Alternatively, even if the post-merger profitability of the rivals enabled them to remain in the market over the short term, the dynamics of the market after the merger might have invalidated the justifications for new R&D investment or capital expenditure. The European Commission was concerned that the rival enterprises would not be able to stay in the market as viable competitors in either case.

(4) Thoughts on the GE/Honeywell Decision

Despite all the explanations above, it is hard (if not impossible all together) to see and accept the reasons why the ability of the merged entity to price its packaged deals in a way that would induce customer demand toward GE/Honeywell products should be an antitrust offense. A model developed from a strategic behavior perspective is definitely an important tool; however, a game theory model cannot and should not replace a full-fledged review of a case under the goals and principles of antitrust law. Ultimately, this decision forbids the creation of a merged firm that will supply better and cheaper products to the consumers, although the decision is based on nothing more than the possibility of a reduction in the profitability of other competitors.

The reasons for rejection of the proposed transaction are so counter-intuitive under antitrust law that the extensions of such reasons are directly contradicting with the normally desired end results of the antitrust law application. For example, when the European Commission realizes that airlines generally welcome the financial incentives that come with bundled offers, as they are under great pressure in the short-term to keep their costs under control,[68] this necessarily constitutes a reason for the Commission to reject the proposed merger due to its capability to create an entity that can offer the airlines what they desire. Anomalies like this, and the general inconsistency within the reasoning of the GE/Honeywell Decision that result from the desire of protecting "competitors" is precisely what the U.S. antitrust review avoided while approving the

[68] Id. ¶ 449.

transaction.[69] Some people claim that they can see the reasoning behind the GE/Honeywell decision from an antitrust law application perspective (See, e.g., Briggs and Rosenblatt, 2001; or Reynolds and Ordover, 2002). I am not one of them. I find this decision hard to reconcile with the primary goals of antitrust law.

The once vivid border line between aggressive competition and foreclosure will fade if we start to characterize a firm as having foreclosed its rivals just because it takes a step ahead of its competitors by serving consumers' needs with a cheaper price. If the pre-merger entity will gain an economic ability and incentive to reduce prices that would not otherwise arise, the transaction involves merger-specific efficiencies, and such efficiencies should support the proposed merger regardless of whether they result from a strategic behavior or a cost reduction. There has to be quite an extreme possibility of use of monopoly power by a firm to limit the ability of others to compete effectively against it, so that an antitrust enforcement that rejects a merger that will lead to lower prices can make some sense. This is definitely not the case for the GE/Honeywell Decision.

It is true that this was not a merger involving "efficiencies" in a commonly understood sense of the term: The transaction was not designed to lower the cost for the merged entity as to any particular input or output; nor was it a transaction that was going to increase output as to any relevant product. Nevertheless, lawyers of the parties never tried to defend the transaction on the ground that it would have generated those types of conventional efficiencies anyway. Especially in the absence of any horizontal effect potential, the fact that "the combined firm could offer better products and services at more attractive prices than either firm could offer individually"[70] should have created a positive tendency, not a misgiving, concerning the approval of the proposed transaction.

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[69] Statement dated July 3, 2001 by Charles A. James, Assistant Attorney General for Antitrust, Antitrust Division, U.S. Department of Justice, on the European Commission's decision regarding the GE/Honeywell Acquisition, available at: http://www.usdoj.gov/opa/pr/2001/July/303at.htm

[70] Statement dated July 3, 2001 by Charles A. James, Assistant Attorney General for Antitrust, Antitrust Division, U.S. Department of Justice, on the European Commission's decision regarding the GE/Honeywell Acquisition, available at: http://www.usdoj.gov/opa/pr/2001/July/303at.htm

It is really worth discussing whether there is any economic basis for the European Commission's hostility to price reductions resulting from the combination of complementary products. In my view, it is not easy to support the distinction the European Commission drew between such efficiencies and, for example, cost efficiencies. In the end, there can be no guarantee that cost efficiencies can be achieved after a merger, and even if that were the case, such cost savings may not be passed through to customers. On the other hand, if a strategic behavior that would decrease the prices is only possible and anticipated after a merger, there is no such handicap. This is not to claim that such efficiencies, which depend on a combination, should be held superior to cost efficiencies. Neither am I supporting a view that all strategic incentives resulting from conglomerate mergers need to be regarded as procompetitive. However, when totally new incentives to reduce prices can only be made available to a competitor in the market by way of a merger, such merger-specific efficiencies should not be branded anticompetitive just because they are enjoyed by a firm that is regarded as powerful or dominant.[71]

Unfortunately, the approach of the European Commission was different: As we explained above, the Commission interfered with the situation, as it feared that the price reductions would create a situation where the component suppliers might lose market shares to the benefit of the merged entity and experience an immediate damaging profit shrinkage due to their lack of ability to match the bundle offers of the merged entity. The Commission thought the merger was therefore likely to lead to market foreclosure on the existing aircraft platforms and subsequently to the elimination of competition in these areas.[72]

In similar cases in the future, antitrust lawyers in the E.U. may deem it necessary to de-emphasize the aspects of a merger that provide incentives for the merged entity to set lower prices while seeking merger approval. If the definitions and duties given to the antitrust law field in the Chicago and post-Chicago eras, including my understanding of the definition of antitrust law, are at all helpful in hitting the Pinata of "proper objective", the addition of "efficiencies" to the list of "arguments with an uncertain impact on the outcome of the case" cannot be healthy.

[71] For further discussion on how the mere size of the parties to the proposed merger negatively effected the outcome of the GE/Honeywell Decision, see, (Patterson and Shapiro, 2001).

[72] GE/Honeywell Decision, at ¶ 355.

From my perspective, antitrust law is an "ongoing search for a legal device that can secure consumer welfare by fostering a competitive process that promotes economic efficiency in the production and distribution of goods and services" (Gürkaynak, 2002). I leave the issue of whether there is a conflict between this type of a definition and the handling of the vertical aspects of the GE/Honeywell case in the E.U to the reader.

(V) <u>Conclusions</u>

(1) Economics, especially by way of the developments in the field of Industrial Organization, has a huge impact on antitrust law enforcement. Especially in the field of vertical integrations, it is vital for healthy antitrust law enforcement to make use of the economic analysis and balance the procompetitive consequences and anticompetitive risks properly. For the time being, a rule of reason analysis should be employed in all vertical cases, including the ones that involve tying or even retail price maintenance. This would allow exploration of all of the business practices that result in complete or partial vertical integration with the proper economic analysis tools.

(2) Complete and partial vertical integration are very similar to each other, as they generally lead to almost identical economic results. Nevertheless, in the application of antitrust laws, there has always been a big difference between how vertical mergers and vertical restraints are viewed and treated. Similarly, the functional similarities between alternative contractual methods of complete vertical integration are also frequently disregarded, and contradictory policies are developed in the antitrust law field concerning different types of vertical restraints (e.g., exclusive dealing arrangements, acts of tying, franchise agreements, etc.). Antitrust policy should minimize these discrepancies, and should treat different forms of vertical relationships consistently to permit an enterprise to choose the mix of strategies that minimizes transaction costs.

(3) The increase in the reaction of the antitrust law enforcement to vertical issues relying on the post-Chicago developments in the debate concerning vertical integration economics is not timely. The outcome of the current hot debate between economists concerning the vertical integration issues will definitely have a determining impact on how relevant agencies and courts will reshape legal principles concerning vertical integration matters. Until the economic analysis

methods of today reach a level of maturity where there is a common ground on which the competitive harms are identified and balanced against the realizable efficiency potential in vertical mergers and vertical restraints in all cases, the legal rule for balancing the likelihood of competitive harms against competitive benefits should create a balance that is slightly tilted in favor of vertical relationships. By properly using the burden of proof mechanism, the antitrust law enforcement would be able to forbid welfare-diminishing vertical relationships without risking condemnation of a practice simply because we have a poor economic understanding of it.

(4) Network industry markets are not ripe enough to give us a capability of forward-looking antitrust analysis in reviewing vertical integration cases. In these types of dynamic markets, the legal rule should be non-intervention, insofar as the allegations concerning anticompetitive effects are speculative. Even when the failure to intervene preemptively could make intervention at a later stage almost impossible, a fear from the difficulty of unscrambling the eggs at a later stage cannot and should not drive an aggressive enforcement regarding vertical integrations in these markets.

(5) The discussion on the objectives of antitrust law is closely related to how the vertical integration cases will be treated under antitrust law. In an antitrust regime where "efficiency" is treated as an antitrust offense from time to time, it would be optimistic to expect business people to go forward with efficiency enhancing merger plans in the future with the same enthusiasm. Any uncertainty created under antitrust law enforcement as to whether "efficiency" is good or bad, including ascription of a negative aspect to any specific type of efficiency (e.g., cost efficiency, efficiencies arising out of strategic behavior potential, dynamic efficiencies, etc.) would hurt the main purposes of antitrust law enforcement.

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