Federal Trade Commission v. Staples, Inc.

970 F.Supp. 1066 (D.D.C. 1997)

THOMAS F. HOGAN, District Judge. Plaintiff, the Federal Trade Commission ("FTC" or "Commission"), seeks a preliminary injunction pursuant to Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), to enjoin the consummation of any acquisition by defendant Staples, Inc., of defendant Office Depot, Inc., pending final disposition before the Commission of administrative proceedings to determine whether such acquisition may substantially lessen competition in violation of Section 7 of the Clayton Act, 15 U.S.C. § 18, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. The proposed acquisition has been postponed pending the Court's decision on the motion for a preliminary injunction, which is now before the Court for decision after a five-day evidentiary hearing and the filing of proposed Findings of Fact and conclusions of law. For the reasons set forth below, the Court will grant the plaintiff's motion. This Memorandum Opinion constitutes the Court's *Findings of Fact* and conclusions of law.

BACKGROUND

*** Defendants are both corporations which sell office products—including office supplies, business machines, computers and furniture—through retail stores, commonly described as office supply superstores, as well as through direct mail delivery and contract stationer operations. Staples is the second largest office superstore chain in the United States with approximately 550 retail stores located in 28 states and the District of Columbia, primarily in the Northeast and California. In 1996 Staples' revenues from those stores were approximately $4 billion through all operations. Office Depot, the largest office superstore chain, operates over 500 retail office supply superstores that are located in 38 states and the District of Columbia, primarily in the South and Midwest. Office Depot's 1996 sales were approximately $6.1 billion. OfficeMax, Inc., is the only other office supply superstore firm in the United States.

On September 4, 1996, defendants Staples and Office Depot, and Marlin Acquisition Corp. ("Marlin"), a wholly-owned subsidiary of Staples, entered into an "Agreement and Plan of Merger" whereby Marlin would merge with and into Office Depot, and Office Depot would become a wholly-owned subsidiary of Staples. *** Pursuant to the Hart-Scott-Rodino Improvements Act of 1976, 15 U.S.C. § 18a, Staples and Office Depot filed a Premerger Notification and Report Form with the FTC and Department of Justice on October 2, 1996. ***

On March 10, 1997, the Commission voted 4-1 to challenge the merger and authorized commencement of an action under Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), to seek a temporary restraining order and a preliminary injunction barring the merger. Following this vote, the defendants and the FTC staff negotiated a consent decree that would have authorized the merger to proceed on the condition that Staples and Office Depot sell 63 stores to OfficeMax. However, the Commission voted 3-2 to reject the proposed consent decree on April 4, 1997. The FTC then filed this suit on April 9, 1997, seeking a temporary retraining order and preliminary injunction against the merger pursuant to Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), pending the completion of an administrative proceeding pursuant to Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, and Sections 7 and 11 of the Clayton Act, 15 U.S.C. §§ 12, 21. ***

DISCUSSION

I. Section 13(B) Standard for Preliminary Injunctive Relief

Section 7 of the Clayton Act, 15 U.S.C. § 18, makes it illegal for two companies to merge "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." Whenever the Commission has reason to believe that a corporation is violating, or is about to violate, Section 7 of the Clayton Act, the FTC may seek a preliminary injunction to prevent a merger pending the Commission's administrative adjudication of the merger's legality. See Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b). However, in a suit for preliminary relief, the FTC is not required to prove, nor is the Court required to find, that the proposed merger would in fact violate Section 7 of the Clayton Act. The determination of whether the acquisition actually violates the antitrust laws is reserved for the Commission and is, therefore, not before this Court. The only question before this Court is whether the FTC has made a showing which justifies preliminary injunctive relief.

Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), provides that "[u]pon a proper showing that, weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest, and after notice to the defendant, a temporary restraining order or a preliminary injunction may be granted without bond." Courts have interpreted this to mean that a court must engage in a two-part analysis in determining whether to grant an injunction under section 13(b). (1) First, the Court must determine the Commission's likelihood of success on the merits in its case under Section 7 of the Clayton Act, and (2) Second, the Court must balance the equities.

A. Likelihood of Success on the Merits

Likelihood of success on the merits in cases such as this means the likelihood that the Commission will succeed in proving, after a full administrative trial on the merits, that the effect of a merger between Staples and Office Depot "may be substantially to lessen competition, or to tend to create a monopoly" in violation of Section 7 of the Clayton Act. The Commission satisfies its burden to show likelihood of success if it "raises questions going to the merits so serious, substantial, difficult, and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the Commission in the first instance and ultimately by the Court of Appeals." *FTC v. University Health, Inc.*, 938 F.2d 1206, 1218 (11th Cir. 1991). ***

In order to determine whether the Commission has met its burden with respect to showing its likelihood of success on the merits, that is, whether the FTC has raised questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals and that there is a "reasonable probability" that the challenged transaction will substantially impair competition, the Court must consider the likely competitive effects of the merger, if any. Analysis of the likely competitive effects of a merger requires determinations of (1) the "line of commerce" or product market in which to assess the transaction, (2) the "section of the country" or geographic market in which to assess the transaction, and (3) the transaction's probable effect on competition in the product and geographic markets. See *United States v. Marine Bancorporation*, 418 U.S. 602, 618-23 (1974).

II. The Geographic Market

One of the few issues about which the parties to this case do not disagree is that metropolitan areas are the appropriate geographic markets for analyzing the competitive effects of the proposed merger. A geographic market is that geographic area "to which consumers can practically turn for alternative sources of the product and in which the antitrust defendant faces competition." *Morgenstern v. Wilson*, 29 F.3d 1291, 1296 (8th Cir. 1994). In its first amended complaint, the FTC identified forty-two such metropolitan areas as well as future areas which could suffer anti-competitive effects from the proposed merger. Defendants have not challenged the FTC's geographic market definition in this proceeding. Therefore, the Court will accept the relevant geographic markets identified by the Commission.

III. The Relevant Product Market

In contrast to the parties' agreement with respect to the relevant geographic market, the Commission and the defendants sharply disagree with respect to the appropriate definition of the relevant product market or line of commerce. As with many antitrust cases, the definition of the relevant product market in this case is crucial. In fact, to a great extent, this case hinges on the proper definition of the relevant product market.

The Commission defines the relevant product market as "the sale of consumable office supplies through office superstores,"[7] with "consumable" meaning products that consumers buy recurrently, i.e., items which "get used up" or discarded. For example, under the Commission's definition, "consumable office supplies" would not include capital goods such as computers, fax machines, and other business machines or office furniture, but does include such products as paper, pens, file folders, post-it notes, computer disks, and toner cartridges. The defendants characterize the FTC's product market definition as "contrived" with no basis in law or fact, and counter that the appropriate product market within which to assess the likely competitive consequences of a Staples-Office Depot combination is simply the overall sale of office products, of which a combined Staples-Office Depot accounted for 5.5% of total sales in North America in 1996. In addition, the defendants argue that the challenged combination is not likely "substantially to lessen competition" however the product market is defined. After considering the arguments on both sides and all of the evidence in this case and making evaluations of each witness's credibility as well as the weight that the Court should give certain evidence and testimony, the Court finds that the appropriate relevant product market definition in this case is, as the Commission has argued, the sale of consumable office supplies through office supply superstores.

The general rule when determining a relevant product market is that "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use [by consumers] or the cross-elasticity of demand between the product itself and substitutes for it." *Brown Shoe v. United States*, 370 U.S. 294, 325 (1962); see also *United States v. E.I. du Pont de Nemours and Co.*, 351 U.S. 377, 395 (1956). Interchangeability of use and cross-elasticity of demand look to the availability of substitute commodities, *i.e.* whether there are other products offered to consumers which are similar in character or use to the product or products in question, as well as how far buyers will go to substitute one commodity for another. ***

[7] The Commission also offered an alternative product market, that of the sale of consumable office supplies through retail stores to small businesses and individuals with home offices.

Whether there are other products available to consumers which are similar in character or use to the products in question may be termed "functional interchangeability." See, *e.g., E.I. du Pont de Nemours*, 351 U.S. at 399. This case, of course, is an example of perfect "functional interchangeability." The consumable office products at issue here are identical whether they are sold by Staples or Office Depot or another seller of office supplies. A legal pad sold by Staples or Office Depot is "functionally interchangeable" with a legal pad sold by Wal-Mart. A post-it note sold by Staples or Office Depot is "functionally interchangeable" with a post-it note sold by Viking or Quill. A computer disk sold by Staples-Office Depot is "functionally interchangeable" with a computer disk sold by CompUSA. No one disputes the functional interchangeability of consumable office supplies. However, as the government has argued, functional interchangeability should not end the Court's analysis.

*** [T]he Commission has argued that a slight but significant increase in Staples-Office Depot's prices will not cause a considerable number of Staples-Office Depot's customers to purchase consumable office supplies from other non-superstore alternatives such as Wal-Mart, Best Buy, Quill, or Viking. On the other hand, the Commission has argued that an increase in price by Staples would result in consumers turning to another office superstore, especially Office Depot, if the consumers had that option. Therefore, the Commission concludes that the sale of consumable office supplies by office supply superstores is the appropriate relevant product market in this case, and products sold by competitors such as Wal-Mart, Best Buy, Viking, Quill, and others should be excluded.

The Court recognizes that it is difficult to overcome the first blush or initial gut reaction of many people to the definition of the relevant product market as the sale of consumable office supplies through office supply superstores. The products in question are undeniably the same no matter who sells them, and no one denies that many different types of retailers sell these products. After all, a combined Staples-Office Depot would only have a 5.5% share of the overall market in consumable office supplies. Therefore, it is logical to conclude that, of course, all these retailers compete, and that if a combined Staples-Office Depot raised prices after the merger, or at least did not lower them as much as they would have as separate companies, that consumers, with such a plethora of options, would shop elsewhere.

The Court acknowledges that there is, in fact, a broad market encompassing the sale of consumable office supplies by all sellers of such supplies, and that those sellers must, at some level, compete with one another. However, the mere fact that a firm may be termed a competitor in the overall marketplace does not necessarily require that it be included in the relevant product market for antitrust purposes. The Supreme Court has recognized that within a broad market, "well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes." *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962). With respect to such submarkets, the Court explained "[b]ecause Section 7 of the Clayton Act prohibits any merger which may substantially lessen competition 'in any line of commerce,' it is necessary to examine the effects of a merger in each such economically significant submarket to determine if there is a reasonable probability that the merger will substantially lessen competition. If such a probability is found to exist, the merger is proscribed." *Id.* There is a possibility, therefore, that the sale of consumable office supplies by office superstores may qualify as a submarket within a larger market of retailers of office supplies in general.

The Court in *Brown Shoe* provided a series of factors or "practical indicia" for determining whether a submarket exists including "industry or public recognition of the submarket as a

separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." *Id.* Since the Court described these factors as "practical indicia" rather than requirements, subsequent cases have found that submarkets can exist even if only some of these factors are present.

The Commission discussed several of the *Brown Shoe* "practical indicia" in its case, such as industry recognition, and the special characteristics of superstores which make them different from other sellers of office supplies, including distinct formats, customers, and prices. Primarily, however, the FTC focused on what it termed the "pricing evidence," which the Court finds corresponds with *Brown Shoe's* "sensitivity to price changes" factor. First, the FTC presented evidence comparing Staples' prices in geographic markets where Staples is the only office superstore, to markets where Staples competes with Office Depot or OfficeMax, or both. Based on the FTC's calculations, in markets where Staples faces no office superstore competition at all, something which was termed a one firm market during the hearing, prices are 13% higher than in three firm markets where it competes with both Office Depot and OfficeMax. The data which underly this conclusion make it compelling evidence. Prices were compared as of January 1997, which, admittedly, only provides data for one specific point in time. However, rather than comparing prices from only a small sampling or "basket" of goods, the FTC used an office supply sample accounting for 90% of Staples' sales and comprised of both price sensitive and non price sensitive items. The FTC presented similar evidence based on Office Depot's prices of a sample of 500 items, also as of January 1997. Similarly, the evidence showed that Office Depot's prices are significantly higher—well over 5% higher, in Depot-only markets than they are in three firm markets. ***

The FTC also pointed to internal Staples documents which present price comparisons between Staples' prices and Office Depot's prices and Staples' prices and OfficeMax's prices within different price zones.[9] The comparisons between Staples and Office Depot were made in August 1994, January 1995, August 1995, and May 1996. Staples' prices were compared with OfficeMax's prices in August 1994, July 1995, and January 1996. For each comparison, Staples calculations were based on a fairly large "basket" or sample of goods, approximately 2000 SKUs containing both price sensitive and non-price sensitive items. Using Staples' data, but organizing it differently to show which of those zones were one, two, or three firm markets, the FTC showed once again that Staples charges significantly higher prices, more than 5% higher, where it has no office superstore competition than where it competes with the two other superstores. ***

This evidence all suggests that office superstore prices are affected primarily by other office superstores and not by non-superstore competitors such as mass merchandisers like Wal-Mart, Kmart, or Target, wholesale clubs such as BJ's, Sam's, and Price Costco, computer or electronic stores such as Computer City and Best Buy, independent retail office supply stores, mail orders firms like Quill and Viking, and contract stationers. Though the FTC did not present the Court with evidence regarding the precise amount of non-superstore competition in each of Staples'

[9] It was established at the hearing that Staples and Office Depot do not maintain nationally uniform prices in their stores. Instead, both companies currently organize their stores into price zones which are simply groups of one or more stores that have common prices.

and Office Depot's one, two, and three firm markets, it is clear to the Court that these competitors, albeit in different combinations and concentrations, are present in every one of these markets. ***

The evidence with respect to the wholesale club stores is consistent. *** For example, Staples' maintains a "warehouse club only" price zone, which indicates a zone where Staples exists with a warehouse club but without another office superstore. The data presented by the Commission on Staples' pricing shows only a slight variation in prices (1%-2%) between "warehouse club only" zones and one superstore markets without a warehouse club. Additionally, in May 1996, two price comparison studies done by Staples, first using 2,084 SKUs including both price sensitive and non-price sensitive items and then using only 244 SKUs of price sensitive items, showed that prices in the "club only" zones, on average, were over 10% higher than in zones where Staples competes with Office Depot and/or OfficeMax.

There is also consistent evidence with respect to computer and/or consumer electronics stores such as Best Buy. For example, Office Depot maintains a separate price zone, which it calls "zone 30," for areas with Best Buy locations but no other office supply superstores. However, the FTC introduced evidence, based on a January 1997 market basket of "top 500 items by velocity," that prices in Office Depot's "zone 30" price zone are almost as high as in its "non-competitive" price zone, the zone where it does not compete with another office superstore.

There is similar evidence with respect to the defendants' behavior when faced with entry of another competitor. The evidence shows that the defendants change their price zones when faced with entry of another superstore, but do not do so for other retailers. For example, Staples changed its price zone for Cincinnati to a lower priced zone when Office Depot and OfficeMax entered that area. *** There is no evidence that zones change and prices fall when another non-superstore retailer enters a geographic market.

Though individually the FTC's evidence can be criticized for looking at only brief snapshots in time or for considering only a limited number of SKUs, taken together, however, the Court finds this evidence a compelling showing that a small but significant increase in Staples' prices will not cause a significant number of consumers to turn to non-superstore alternatives for purchasing their consumable office supplies. Despite the high degree of functional interchangeability between consumable office supplies sold by the office superstores and other retailers of office supplies, the evidence presented by the Commission shows that even where Staples and Office Depot charge higher prices, certain consumers do not go elsewhere for their supplies. This further demonstrates that the sale of office supplies by non-superstore retailers are not responsive to the higher prices charged by Staples and Office Depot in the one firm markets. This indicates a low cross-elasticity of demand between the consumable office supplies sold by the superstores and those sold by other sellers. ***

Another of the "practical indicia" for determining the presence of a submarket suggested by *Brown Shoe* is "industry or public recognition of the submarket as a separate economic entity." The Commission offered abundant evidence on this factor from Staples' and Office Depot's documents which shows that both Staples and Office Depot focus primarily on competition from other superstores. The documents reviewed by the Court show that the merging parties evaluate their "competition" as the other office superstore firms, without reference to other retailers, mail order firms, or independent stationers. In document after document, the parties refer to, discuss, and make business decisions based upon the assumption that "competition" refers to other office superstores only. For example, Staples uses the phrase "office superstore

industry" in strategic planning documents. Staples' 1996 Strategy Update refers to the "Big Three" and "improved relative competitive position" since 1993 and states that Staples is "increasingly recognized as [the] industry leader." A document analyzing a possible acquisition of OfficeMax referenced the "[b]enefits from pricing in [newly] noncompetitive markets," and also the fact that there was "a potential margin lift overall as the industry moves to 2 players." ***

For the reasons set forth in the above analysis, the Court finds that the sale of consumable office supplies through office supply superstores is the appropriate relevant product market for purposes of considering the possible anti-competitive effects of the proposed merger between Staples and Office Depot. The pricing evidence indicates a low cross-elasticity of demand between consumable office products sold by Staples or Office Depot and those same products sold by other sellers of office supplies. This same evidence indicates that non-superstore sellers of office supplies are not able to effectively constrain the superstores prices, because a significant number of superstore customers do not turn to a non-superstore alternative when faced with higher prices in the one firm markets. In addition, the factors or "practical indicia" of *Brown Shoe* support a finding of a "submarket" under the facts of this case, and "submarkets," as *Brown Shoe* established, may themselves be appropriate product markets for antitrust purposes. 370 U.S. at 325. ***

IV. Probable Effect on Competition

After accepting the Commission's definition of the relevant product market, the Court next must consider the probable effect of a merger between Staples and Office Depot in the geographic markets previously identified. One way to do this is to examine the concentration statistics and HHIs within the geographic markets. If the relevant product market is defined as the sale of consumable office supplies through office supply superstores, the HHIs in many of the geographic markets are at problematic levels even before the merger. Currently, the least concentrated market is that of Grand Rapids-Muskegon-Holland, Michigan, with an HHI of 3,597, while the most concentrated is Washington, D.C. with an HHI of 6,944. In contrast, after a merger of Staples and Office Depot, the least concentrated area would be Kalamazoo-Battle Creek Michigan, with an HHI of 5,003, and many areas would have HHIs of 10,000. The average increase in HHI caused by the merger would be 2,715 points. The concentration statistics show that a merged Staples-Office Depot would have a dominant market share in 42 geographic markets across the country. The combined shares of Staples and Office Depot in the office superstore market would be 100% in 15 metropolitan areas. It is in these markets the post-merger HHI would be 10,000. In 27 other metropolitan areas, where the number of office superstore competitors would drop from three to two, the post-merger market shares would range from 45% to 94%, with post-merger HHIs ranging from 5,003 to 9,049. Even the lowest of these HHIs indicates a "highly concentrated" market.

*** [T]hough the Supreme Court has established that there is no fixed threshold at which an increase in market concentration triggers the antitrust laws, *see, e.g.*, *United States v. Philadelphia National Bank*, 374 U.S. 321, 363-65 (1963), this is clearly not a borderline case. The pre-merger markets are already in the "highly concentrated" range, and the post-merger HHIs show an average increase of 2,715 points. Therefore, the Court finds that the plaintiff's have shown a likelihood of success on the merits. With HHIs of this level, the Commission certainly has shown a "reasonable probability" that the proposed merger would have an anti-competitive effect.

The HHI calculations and market concentration evidence, however, are not the only indications that a merger between Staples and Office Depot may substantially lessen competition. Much of the evidence already discussed with respect to defining the relevant product market also indicates that the merger would likely have an anti-competitive effect. The evidence of the defendants' own current pricing practices, for example, shows that an office superstore chain facing no competition from other superstores has the ability to profitably raise prices for consumable office supplies above competitive levels. The fact that Staples and Office Depot both charge higher prices where they face no superstore competition demonstrates that an office superstore can raise prices above competitive levels. The evidence also shows that defendants also change their price zones when faced with entry of another office superstore, but do not do so for other retailers. Since prices are significantly lower in markets where Staples and Office Depot compete, eliminating this competition with one another would free the parties to charge higher prices in those markets, especially those in which the combined entity would be the sole office superstore. In addition, allowing the defendants to merge would eliminate significant future competition. Absent the merger, the firms are likely, and in fact have planned, to enter more of each other's markets, leading to a deconcentration of the market and, therefore, increased competition between the superstores. ***

By showing that the proposed transaction between Staples and Office Depot will lead to undue concentration in the market for consumable office supplies sold by office superstores in the geographic markets agreed upon by the parties, the Commission establishes a presumption that the transaction will substantially lessen competition. ***

V. Entry Into the Market

*** If the defendants' evidence regarding entry showed that the Commission's market-share statistics give an incorrect prediction of the proposed acquisition's probable effect on competition because entry into the market would likely avert any anti-competitive effect by acting as a constraint on Staples-Office Depot's prices, the Court would deny the FTC's motion. The Court, however, cannot make such a finding in this case.

The defendants argued during the hearing and in their briefs that the rapid growth in overall office supply sales has encouraged and will continue to encourage expansion and entry. *** There are problems with the defendants' evidence, however, that prevent the Court from finding in this case that entry into the market by new competitors or expansion into the market by existing firms would likely avert the anti-competitive effects from Staples' acquisition of Office Depot. For example, while it is true that all office superstore entrants have entered within the last 11 years, the recent trend for office superstores has actually been toward exiting the market rather than entering. Over the past few years, the number of office superstore chains has dramatically dropped from twenty-three to three. All but Staples, Office Depot, and OfficeMax have either closed or been acquired. The failed office superstore entrants include very large, well-known retail establishments such as Kmart, Montgomery Ward, Ames, and Zayres. A new office superstore would need to open a large number of stores nationally in order to achieve the purchasing and distribution economies of scale enjoyed by the three existing firms. Sunk costs would be extremely high. Economies of scale at the local level, such as in the costs of advertizing and distribution, would also be difficult for a new superstore entrant to achieve since the three existing firms have saturated many important local markets. For example, according to the defendants' own saturation analyses, Staples estimates that there is room for less

than two additional superstores in the Washington, D.C. area and Office Depot estimates that there is room for only two more superstores in Tampa, Florida.

The Commission offered Office 1 as a specific example of the difficulty of entering the office superstore arena. Office 1 opened its first two stores in 1991. By the end of 1994, Office 1 had 17 stores, and grew to 35 stores operating in 11 Midwestern states as of October 11, 1996. As of that date, Office 1 was the fourth largest office supply superstore chain in the United States. Unfortunately, also as of that date, Office 1 filed for Chapter 11 bankruptcy protection. Brad Zenner, President of Office 1, testified through declaration, that Office 1 failed because it was severely undercapitalized in comparison with the industry leaders, Staples, Office Depot, and OfficeMax. In addition, Mr. Zenner testified that when the three leaders ultimately expanded into the smaller markets where Office 1 stores were located, they seriously undercut Office 1's retail prices and profit margins. Because Office 1 lacked the capitalization of the three leaders and lacked the economies of scale enjoyed by those competitors, Office 1 could not remain profitable.

For the reasons discussed above, the Court finds it extremely unlikely that a new office superstore will enter the market and thereby avert the anti-competitive effects from Staples' acquisition of Office Depot. ***

The defendants' final argument with respect to entry was that existing retailers such as Sam's Club, Kmart, and Best Buy have the capability to reallocate their shelf space to include additional SKUs of office supplies. While stores such as these certainly do have the power to reallocate shelf space, there is no evidence that they will in fact do this if a combined Staples-Office Depot were to raise prices by 5% following a merger. In fact, the evidence indicates that it is more likely that they would not. For example, even in the superstores' anti-competitive zones where either Staples or Office Depot does not compete with other superstores, no retailer has successfully expanded its consumable office supplies to the extent that it constrains superstore pricing. Best Buy attempted such an expansion by creating an office supplies department in 1994, offering 2000 SKUs of office supplies, but found the expansion less profitable than hoped for and gave up after two years. For these reasons, the Court also cannot find that the ability of many sellers of office supplies to reconfigure shelf space and add SKUs of office supplies is likely to avert anti-competitive effects from Staples' acquisition of Office Depot. The Court will next consider the defendants' efficiencies defense.

VI. Efficiencies

Whether an efficiencies defense showing that the intended merger would create significant efficiencies in the relevant market, thereby offsetting any anti-competitive effects, may be used by a defendant to rebut the government's prima facie case is not entirely clear. *** The Supreme Court, however, in *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 579 (1967), stated that "[p]ossible economies cannot be used as a defense to illegality in section 7 merger cases." There has been great disagreement regarding the meaning of this precedent and whether an efficiencies defense is permitted. Assuming that it is a viable defense, however, the Court cannot find in this case that the defendants' efficiencies evidence rebuts the presumption that the merger may substantially lessen competition or shows that the Commission's evidence gives an inaccurate prediction of the proposed acquisition's probable effect. ***

Defendants' submitted an "Efficiencies Analysis" which predicated that the combined company would achieve savings of between $4.9 and $6.5 billion over the next five years. In addition, the defendants argued that the merger would also generate dynamic efficiencies. For example,

defendants argued that as suppliers become more efficient due to their increased sales volume to the combined Staples-Office Depot, they would be able to lower prices to their other retailers. Moreover, defendants argued that two-thirds of the savings realized by the combined company would be passed along to consumers.

Evaluating credibility, as the Court must do, the Court credits the testimony and Report of the Commission's expert, David Painter, over the testimony and Efficiencies Study of the defendants' efficiencies witness, Shira Goodman, Senior Vice President of Integration at Staples. *** First, the Court notes that the cost savings estimate of $4.947 billion over five years which was submitted to the Court exceeds by almost 500% the figures presented to the two Boards of Directors in September 1996, when the Boards approved the transaction. ***

The Court also finds that the defendants' projected "Base Case" savings of $5 billion are in large part unverified, or at least the defendants failed to produce the necessary documentation for verification. *** For example, defendants' largest cost savings, over $2 billion or 40% of the total estimate, are projected as a result of their expectation of obtaining better prices from vendors. However, this figure was determined in relation to the cost savings enjoyed by Staples at the end of 1996 without considering the additional cost savings that Staples would have received in the future as a stand-alone company. Since Staples has continuously sought and achieved cost savings on its own, clearly the comparison that should have been made was between the projected future cost savings of Staples as a stand-alone company, not its past rate of savings, and the projected future cost savings of the combined company. Thus, the calculation in the Efficiencies Analysis included product cost savings that Staples and Office Depot would likely have realized without the merger. In fact, Mr. Painter testified that, by his calculation, 43% of the estimated savings are savings that Staples and Office Depot would likely have achieved as stand-alone entities.

There are additional examples of projected savings, such as the projected savings on employee health insurance, which are not merger specific, but the Court need not discuss every example here. However, in addition to the non-merger specific projected savings, Mr. Painter also revealed problems with the defendants' methodology in making some of the projections. For example, in calculating the projected cost savings from vendors, Staples estimated cost savings for a selected group of vendors, and then extrapolated these estimated savings to all other vendors. Mr. Painter testified that, although Hewlett Packard is Staples' single largest vendor, it was not one of the vendors used for the savings estimate. In addition, the evidence shows that Staples was not confident that it could improve its buying from Hewlett Packard. Yet, Staples' purchases and sales of Hewlett Packard products were included in the "all other" vendor group, and defendants, thereby, attributed cost savings in the amount of $207 million to Hewlett Packard even though Staples' personnel did not believe that they could, in fact, achieve cost savings from Hewlett Packard.

In addition to the problems that the Court has with the efficiencies estimates themselves, the Court also finds that the defendants' projected pass through rate—the amount of the projected savings that the combined company expects to pass on to customers in the form of lower prices—is unrealistic. *** [I]n this case the defendants have projected a pass through rate of two-thirds of the savings while the evidence shows that, historically, Staples has passed through only 15-17%. Based on the above evidence, the Court cannot find that the defendants have rebutted the presumption that the merger will substantially lessen competition by showing that, because of the efficiencies which will result from the merger, the Commission's evidence gives

an inaccurate prediction of the proposed acquisition's probable effect. Therefore, the only remaining issue for the Court is the balancing of the equities.

VII. The Equities

Where, as in this case, the Court finds that the Commission has established a likelihood of success on the merits, a presumption in favor of a preliminary injunction arises. Despite this presumption, however, once the Court has determined the FTC's likelihood of success on the merits, it must still turn to and consider the equities. *** There are two types of equities which the Court must consider in all Section 13(b) cases, private equities and public equities. In this case, the private equities include the interests of the shareholders and employees of Staples and Office Depot. The public equities are the interests of the public, either in having the merger go through or in preventing the merger. An analysis of the equities properly includes the potential benefits, both public and private, that may be lost by a merger blocking preliminary injunction. ***

The strong public interest in effective enforcement of the antitrust laws weighs heavily in favor of an injunction in this case, as does the need to preserve meaningful relief following a full administrative trial on the merits. "Unscrambling the eggs" after the fact is not a realistic option in this case. Both the plaintiff as well as the defendants introduced evidence regarding the combined company's post-merger plans, including the consolidation of warehouse and supply facilities in order to integrate the two distribution systems, the closing of 40 to 70 Office Depot and Staples stores, changing the name of the Office Depot stores, negotiating new contracts with manufacturers and suppliers, and, lastly, the consolidation of management which is likely to lead to the loss of employment for many of Office Depot's key personnel. As a result, the Court finds that it is extremely unlikely, if the Court denied the plaintiff's motion and the merger were to go through, that the merger could be effectively undone and the companies divided if the agency later found that the merger violated the antitrust laws. *** The public equities raised by the defendants simply do not outweigh those offered by the FTC. ***

Turning finally to the private equities, the defendants have argued that the principal private equity at stake in this case is the loss to Office Depot shareholders who will likely lose a substantial portion of their investments if the merger is enjoined. The Court certainly agrees that Office Depot shareholders may be harmed, at least in the short term, if the Court granted the plaintiff's motion and enjoined the merger. This private equity alone, however, does not suffice to justify denial of a preliminary injunction.

The defendants have also argued that Office Depot itself has suffered a decline since the incipiency of this action. It is clear that Office Depot has lost key personnel, especially in its real estate department. This has hurt this year's projected store openings. The defendants argue, therefore, that Office Depot, as a separate company, will have difficulty competing if the merger is enjoined. While the Court recognizes that Office Depot has indeed been hurt or weakened as an independent stand-alone company, the damage is not irreparable. ***

CONCLUSION

*** In light of the undeniable benefits that Staples and Office Depot have brought to consumers, it is with regret that the Court reaches the decision that it must in this case. This decision will most likely kill the merger. The Court feels, to some extent, that the defendants are being punished for their own successes and for the benefits that they have brought to consumers. In effect, they have been hoisted with their own petards. In addition, the Court is concerned with

the broader ramifications of this case. The superstore or "category killer" like office supply superstores are a fairly recent phenomenon and certainly not restricted to office supplies. There are a host of superstores or "category killers" in the United States today, covering such areas as pet supplies, home and garden products, bed, bath, and kitchen products, toys, music, books, and electronics. Indeed, such "category killer" stores may be the way of retailing for the future. It remains to be seen if this case is sui generis or is the beginning of a new wave of FTC activism. For these reasons, the Court must emphasize that the ruling in this case is based strictly on the facts of this particular case, and should not be construed as this Court's recognition of general superstore relevant product markets. *** The FTC's motion for a preliminary injunction shall be granted.

Federal Trade Commission v. Staples, Inc. and Office Depot, Inc.

190 F. Supp.3d 100 (D.D.C. 2016)

SULLIVAN, J.

I. Introduction

Drawing an analogy to the fate of penguins whose destinies appear doomed in the face of uncertain environmental changes, Defendant. Staples Inc. ("Staples") and Defendant Office Depot, Inc. ("Office Depot") (collectively "Defendants") argue they are like "penguins on a melting iceberg," struggling to survive in an increasingly digitized world and an office-supply industry soon to be revolutionized by new entrants like Amazon Business. Prelim. Inj. Hrg Tr. ("Hrg Tr.") 60:15 (Opening Statement of Diane Sullivan, Esq.). Charged with enforcing antitrust laws for the benefit of American consumers, the Federal Trade Commission ("FTC") commenced this action in an effort to block Defendants' proposed merger and alleged that the merger would "eliminat[e] direct competition between Staples and Office Depot" resulting in "significant harm" to large businesses that purchase office supplies for their own use. Compl., Docket No. 3 at ¶ 4. The survival of Staples' proposed acquisition of Office Depot hinges on two critical issues: (1) the reliability of Plaintiffs' market definition and market share analysis; and (2) the likelihood that the competition resulting from new market entrants like Amazon Business will be timely and sufficient to restore competition lost as a result of the merger.

Subsequent to Defendants' announcement in February 2015 of their intent to merge, the FTC began an approximate year-long investigation into the $6.3 billion merger and its likely effects on competition. Defs.' Proposed Findings of Fact and Conclusions of Law ("Defs.' FOF") ¶ 58. On December 7, 2015, by a unanimous vote, the FTC Commissioners found reason to believe that the proposed merger would substantially reduce competition in violation of § 7 of the Clayton Act and Section 5 of the FTC Act. Compl. ¶ 34. That same day, Plaintiffs commenced this action seeking a preliminary injunction pursuant to Section 13(b) of the FTC Act, 15 U.S.C. § 53 (b) to enjoin the proposed merger until the FTC's administrative proceedings are complete.

II. Background

A. Overview

Every day millions of employees throughout the United States utilize office supplies in the course of their daily work. To sustain employees' use of pens, Post-it notes and paperclips, large

companies purchase more than two billion dollars of office supplies from Defendants annually. Companies that purchase office supplies for their own use operate in what the industry refers to as the B-to-B space. B-to-B customers prefer to work with one vendor that can meet all of the companies' office supply needs.

To establish a primary vendor relationship, companies in the B-to-B space request proposals from national suppliers like Staples and Office Depot. The request for proposal ("RFP") process typically results in a multi-year contract with a primary vendor that guarantees prices for specific items, includes an upfront lump-sum rebate, and a host of other services. Because the office supplies consumed by large companies are voluminous, such companies typically pay only half the price for basic supplies as compared to the average retail consumer.

B. Defendants Staples and Office Depot

Established as big-box retail stores in the 1980s, Defendants are the primary B-to-B office supply vendors in the United States today. Plaintiffs allege that Defendants sell and distribute upwards of seventy-nine percent of office supplies in the B-to-B space. Since the 2013 merger of Office Depot and Office Max, Defendants consistently engage in head-to-head competition with each other for B-to-B contracts.

Staples' "commercial" and Office Depot's "business solutions" segments focus on the B-to-B contracts at issue in this case. While both companies serve businesses of all sizes, this case focuses on large B-to-B customers, defined by Plaintiffs as those that spend $500,000 or more per year on office supplies. Approximately 1200 corporations in the United States are included in this alleged relevant market.

C. FTC Investigation

On February 4, 2015, Defendants entered into a merger agreement in which Staples would acquire Office Depot for a combination of cash and Staples' stock. Shortly after the merger was announced, the FTC launched an investigation into the competitive effects of the proposed merger. Ultimately, the FTC commissioners filed an administrative complaint before an FTC Administrative Law Judge ("ALJ") and also authorized the Plaintiffs to seek a preliminary injunction to prevent the Defendants from consummating the merger to maintain the status quo pending a full hearing on the merits. Plaintiffs filed this suit the same day.

D. Regional and local vendors

Regional and local office supply vendors exist throughout the country. However, they typically do not bid for large B-to-B contracts. When regional office supply vendors compete for large RFPs, they are rarely awarded the contract.

WB Mason is a regional supplier that targets its business to thirteen northeastern states plus the District of Columbia (known in the industry as "Masonville"). WB Mason "ranks a distant third" behind Staples and Office Depot. In fiscal year 2015, WB Mason generated approximately $1.4 billion in total revenue. WB Mason has no customers in the Fortune 100 and only nine in the Fortune 1000. According to WB Mason's CEO, Leo Meehan, "Staples and Office Depot are the only consumable office supplies vendors that meet the needs of most large B2B customer[s] across the entire country, or even most of it."

WB Mason recently abandoned a plan to expand nationwide. When asked during the hearing if WB Mason would accept a divestiture of cash assets from the Defendants to cover the expenses of nationwide expansion, Mr. Meehan would not commit to accepting such a proposal.

III. Legal Standards

A. The Clayton Act

Section 7 of the Clayton Act prohibits mergers or acquisitions "the effect of [which] may be substantially to lessen competition, or to tend to create a monopoly," in any "line of commerce or in any activity affecting commerce in any section of the country." 15 U.S.C. § 18. When the FTC has "reason to believe that a corporation is violating, or is about to violate, § 7 of the Clayton Act," it may seek a preliminary injunction under Section 13(b) of the FTC Act to "prevent a merger pending the Commission's administrative adjudication of the merger's legality." *F.T.C. v. Staples, Inc.*, 970 F.Supp. 1066, 1070 (D.D.C. 1997) (citing 15 U.S.C. § 53(b)); see also *Brown Shoe v. U.S.*, 370 U.S. 294, 317 (1962) ("Congress saw the process of concentration in American business as a dynamic force; it sought to ensure the Federal Trade Commission and the courts the power to brake this force . . . before it gathered momentum.") "Section 13(b) provides for the grant of a preliminary injunction where such action would be in the public interest—as determined by a weighing of the equities and a consideration of the Commission's likelihood of success on the merits." *F.T.C. v. Heinz Co.*, 246 F.3d 708, 714 (D.C. Cir. 2001) (citing 15 U.S.C. § 53(b)).

B. Section 13(b) Standard for Preliminary Injunction

The standard for a preliminary injunction under Section 13(b) requires plaintiffs to show: (1) a likelihood of success on the merits; and (2) that the equities tip in favor of injunctive relief. *FTC v. Cardinal Health*, 12 F.Supp.2d 34, 44 (D.D.C. 1998).[7] To establish a likelihood of success on the merits, the government must show that "there is a reasonable probability that the challenged transaction will substantially impair competition." *Staples*, 970 F.Supp. at 1072 (citation omitted) (internal quotation marks omitted). "Proof of actual anticompetitive effects is not required; instead, the FTC must show an appreciable danger of future coordinated interaction based on predictive judgment." *F.T.C. v. Arch Coal, Inc.*, 329 F.Supp.2d 109, 116 (D.D.C. 2004) (internal quotations omitted).

The Court's task, therefore, is to "measure the probability that, after an administrative hearing on the merits, the Commission will succeed in proving that the effect of the [proposed] merger 'may be substantially to lessen competition, or tend to create a monopoly' in violation of § 7 of the Clayton Act.'" *Heinz*, 246 F.3d at 714 (quoting 15 U.S.C. § 18). This standard is satisfied if the FTC raises questions going to the merits "so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals." *Id.* at 714–15 (citations omitted) (internal quotation marks omitted). As reflected by this standard, Congress' concern regarding potentially anticompetitive mergers was with "probabilities, not certainties." *Brown Shoe Co.*, 370 U.S. at 323 (other citations omitted).

In sum, the Court "must balance the likelihood of the FTC's success against the equities, under a sliding scale." *F.T.C. v. Whole Foods Market, Inc.*, 548 F.3d 1028, 1035 (D.C. Cir. 2008). The equities or "public interest" in the antitrust context include: "(1) the public interest in effectively enforcing antitrust laws, and (2) the public interest in ensuring that the FTC has the ability to order effective relief if it succeeds at the merits trial." *Sysco,* 113 F.Supp.3d at 86.

[7] In contrast, the typical preliminary injunction standard requires a plaintiff to show: (1) irreparable harm; (2) probability of success on the merits; and (3) a balance of equities favoring the plaintiff. *F.T.C. v. Sysco Corporation*, 113 F.Supp.3d 1, 22 (2015) (citing *Heinz*, 246 F.3d at 714)).

Nevertheless, "[t]he issuance of a preliminary injunction prior to a full trial on the merits is an extraordinary and drastic remedy." *F.T.C. v. Exxon Corp.*, 636 F.2d 1336, 1343 (D.C. Cir. 1980) (citations omitted) (internal quotation marks omitted). The government must come forward with rigorous proof to block a proposed merger because "the issuance of a preliminary injunction blocking an acquisition or merger may prevent the transaction from ever being consummated." *Id.*

C. *Baker Hughes* Burden-Shifting Framework

In *United States v. Baker Hughes, Inc.*, 908 F.2d 981, 982–83 (D.C. Cir. 1990), the U.S. Court of Appeals for the D.C. Circuit established a burden-shifting framework for evaluating the FTC's likelihood of success on the merits. See *Heinz*, 246 F.3d at 715. The government bears the initial burden of showing the merger would result in "undue concentration in the market for a particular product in a particular geographic area." *Baker Hughes*, 908 F.2d at 982. Showing that the merger would result in a single entity controlling such a large percentage of the relevant market so as to significantly increase the concentration of firms in that market entitles the government to a presumption that the merger will substantially lessen competition. *Id.*

The burden then shifts to the defendants to rebut the presumption by offering proof that "the market-share statistics [give] an inaccurate account of the [merger's] probable effects on competition in the relevant market." *Heinz*, 246 F.3d at 715 (quoting *United States v. Citizens & S. Nat'l Bank*, 422 U.S. 86 (1975) (alterations in original)). "The more compelling the *prima facie* case, the more evidence the defendant must present to rebut it successfully." *Baker Hughes*, 908 F.2d at 991. "A defendant can make the required showing by affirmatively showing why a given transaction is unlikely to substantially lessen competition, or by discrediting the data underlying the initial presumption in the government's favor." *Id.*

"If the defendant successfully rebuts the presumption, the burden of producing additional evidence of anticompetitive effect shifts to the government, and merges with the ultimate burden of persuasion, which remains with the government at all times." *Id.* at 983. "[A] failure of proof in any respect will mean the transaction should not be enjoined." *Arch Coal*, 329 F.Supp.2d at 116. The court must also weigh the equities, but if the FTC is unable to demonstrate a likelihood of success on the merits, the equities alone cannot justify an injunction. *Id.*

IV. Discussion

The Court's analysis proceeds as follows: (A) legal principles considered when defining a relevant market; (B) application of legal principles to Plaintiffs' market definition; (C) Defendants' arguments in opposition to Plaintiffs' alleged market; (D) conclusions regarding the relevant market; (E) analysis of the Plaintiffs' arguments relating to the probable effects on competition based on market share calculations; (F) Defendants' arguments in opposition to Plaintiffs' market share calculations; (G) conclusions regarding Plaintiffs' market share; (H) Plaintiffs' evidence of additional harm; (I) Defendants' response to Plaintiffs' *prima facie* case; and (J) weighing the equities.

A. Legal principles considered when defining a relevant market

As discussed *supra*, the burden is on the Plaintiffs to show that the merger would result in a single entity controlling such a large percentage of the relevant market that concentration is significantly increased and competition is lessened. See *e.g., Baker Hughes*, 908 F.2d at 982. To consider whether the proposed merger may have anticompetitive effects, the Court must first

define the relevant market based on evidence proffered at the evidentiary hearing. See *United States v. Marine Bancorp.*, 418 U.S. 602, 618 (1974) (Market definition is a " 'necessary predicate' to deciding whether a merger contravenes the Clayton Act."). Examination of the particular market, including its structure, history and probable future, is necessary to "provide the appropriate setting for judging the probable anticompetitive effects of the merger." *F.T.C. v. Arch Coal, Inc.*, 329 F.Supp.2d at 116 (quoting *Brown Shoe* at 322 n. 28); see also *United States v. General Dynamics*, 415 U.S. 486, 498 (1974). "Defining the relevant market is critical in an antitrust case because the legality of the proposed merger [ ] in question almost always depends on the market power of the parties involved." *Cardinal Health, Inc.*, 12 F.Supp.2d at 45.

Two components are considered when defining a relevant market: (1) the geographic area where Defendants compete; and (2) the products and services with which the defendants' products compete. *Arch Coal, Inc.*, 329 F.Supp.2d at 119. The parties agree that the United States is the relevant geographic market. The parties vigorously disagree, however, about how the relevant product market should be defined.

The Supreme Court in *Brown Shoe* established the basic rule for defining a product market: "The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it." *Brown Shoe*, 370 U.S. at 325. In other words, a product market includes all goods that are reasonable substitutes, even where the products are not entirely the same. Two factors contribute to an analysis of whether goods are "reasonable substitutes": (1) functional interchangeability; and (2) cross-elasticity of demand. See *e.g., Sysco*, 113 F.Supp.3d at 25–26.

As the following discussion demonstrates, the concepts of cluster and targeted markets are critical to defining the market in this case.

a. Consumable office supplies as cluster market

Cluster markets allow items that are not substitutes for each other to be clustered together in one antitrust market for analytical convenience. The Supreme Court has made clear that "[w]e see no barrier to combining in a single market a number of different products or services where that combination reflects commercial realities." *United States v. Grinnell Corp.*, 384 U.S. 563, 572 (1966).

Here, Plaintiffs allege that items such as pens, file folders, Post-it notes, binder clips, and paper for copiers and printers are included in this cluster market. Although a pen is not a functional substitute for a paperclip, it is possible to cluster consumable office supplies into one market for analytical convenience. *ProMedica Health Sys., Inc. v. F.T.C.*, 749 F.3d 559, 565–68 (6th Cir. 2014). Defining the market as a cluster market is justified in this case because "market shares and competitive conditions are likely to be similar for the distribution of pens to large customers and the distribution of binder clips to large customers." Shapiro Report at 007.

b. Large B-to-B customers as target market

Another legal principle relevant to market definition in this case is the concept of a "targeted" or "price discrimination" market. According to the Merger Guidelines:

> When examining possible adverse competitive effects from a merger, the Agencies consider whether those effects vary significantly for different customers purchasing the same or similar products. Such differential impacts are possible when sellers can discriminate, *e.g.*, by profitably raising price to certain targeted customers but not to others. [. . .]

> When price discrimination is feasible, adverse competitive effects on targeted customers can arise, even if such effects will not arise for other customers. A price increase for targeted customers may be profitable even if a price increase for all customers would not be profitable because too many other customers would substitute away.

U.S. Dep't of Justice & FTC Horizontal Merger Guidelines § 3 (2010) (hereinafter Merger Guidelines).[9]

Defining a market around a targeted consumer, therefore, requires finding that sellers could "profitably target a subset of customers for price increases . . ." See *Sysco*, 113 F.Supp.3d at 38 (citing Merger Guidelines Section 4.1.4.). This means that there must be differentiated pricing and limited arbitrage. Dr. Shapiro concluded that arbitrage is limited here because "it is not practical or attractive for a large customer to purchase indirectly from or through smaller customers."

B. Application of relevant legal principles to Plaintiffs' market definition

The concepts of cluster and targeted markets inform the Court's critical consideration when defining the market in this case: the products and services with which the Defendants' products compete. *Arch Coal, Inc.*, 329 F.Supp.2d at 119. The parties vigorously disagree on how the market should be defined. As noted *supra*, Plaintiffs argue that the relevant market is a cluster market of "consumable office supplies" which consists of "an assortment of office supplies, such as pens, paper clips, notepads and copy paper, that are used and replenished frequently." Compl. ¶¶ 36–37. Plaintiffs' alleged relevant market is also a targeted market, limited to B-to-B customers, specifically large B-to-B customers who spend $500,000 or more on office supplies annually.[10]

Defendants, on the other hand, argue that Plaintiffs' alleged market definition is wrong because it is a "gerrymandered and artificially narrow product market limited to *some*, but not all, consumable office supplies sold to only the most powerful companies in the world." In particular, Defendants insist that ink and toner must be included in a proper definition of the relevant product market. Defendants also argue that no evidence supports finding sales to large B-to-B customers as a distinct market.

1. *Brown Shoe* "Practical Indicia"

The *Brown Shoe* practical indicia support Plaintiffs' definition of the relevant product market. The *Brown Shoe* "practical indicia" include: (1) industry or public recognition of the market as a separate economic entity; (2) the product's peculiar characteristics and uses; (3) unique production facilities; (4) distinct customers; (5) distinct prices; (6) sensitivity to price changes; and (7) specialized vendors. *Brown Shoe*, 370 U.S. at 325. Courts routinely rely on the *Brown Shoe* factors to define the relevant product market. See, *e.g., Staples*, 970 F.Supp. at 1075–80; *Cardinal Health*, 12 F.Supp.2d at 46–48; *F.T.C. v. Swedish Match*, 131 F.Supp.2d 151, 159–64 (D.D.C. 2000);

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[9] Although the Merger Guidelines are not binding on this Court, the D.C. Circuit has relied on them for guidance in other merger cases. *Sysco*, 113 F.Supp.3d at 38 (citing *Heinz*, 246 F.3d at 716 n.9).

[10] In Plaintiffs' complaint, they alleged that the relevant market was limited to large B-to-B customers, including, but not limited to "those that buy $1 million annually of consumable office supplies for their own use." *Id.* ¶¶ 41, 45. For analytical purposes, Dr. Shapiro drew the line at large B-to-B's that spend $500,000 or more on office supplies. Hrg Tr. 2154:16–2155:14(Dr. Shapiro noting that 90 percent of Enterprise customers spend at least $500,000 on office supplies and that there is no "magic place that's the right place" to draw the line, but necessary for practical analytical purposes).

F.T.C. v. CCC Holdings, 605 F.Supp.2d 26, 39–44 (D.D.C. 2009); *United States v. H & R Block*, 833 F.Supp.2d 36, 51–60 (D.D.C. 2011).[11]

The most relevant *Brown Shoe* indicia in this case are: (a) industry or public recognition of the market as a separate economic entity; (b) distinct prices and sensitivity to price changes; and (c) distinct customers that require specialized vendors that offer value-added services, including: (i) sophisticated information technology (IT) services; (ii) high quality customer service; and (iii) expedited delivery.

* * *

In sum, the evidence shows that the *Brown Shoe* factors support Plaintiffs' alleged market definition because there is: (a) industry or public recognition of the market as a separate economic entity; (b) B-to-B customers demand distinct prices and demonstrate a high sensitivity to price changes; and (c) B-to-B customers require specialized vendors that offer value-added services, including: (i) sophisticated information technology (IT) services; (ii) high quality customer service; and (iii) expedited delivery. These factors support viewing large B-to-B customers as a target market.

2. Expert testimony of Dr. Carl Shapiro and the Hypothetical Monopolist Test

In addition to the *Brown Shoe* factors, the Court must consider the expert testimony offered by Plaintiffs in this case. The parties agree that the main test used by economists to determine a product market is the hypothetical monopolist test. ("HMT"). This test queries whether a hypothetical monopolist who has control over the products in an alleged market could profitably raise prices on those products. If so, the products may comprise a relevant product market. See *H & R Block*, 833 F.Supp.2d at 51–52. The HMT is explained in the Merger Guidelines.

> [T]he test requires that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future seller of those products . . . likely would impose at least a small but significant and non-transitory increase in price ("SSNIP") on at least one product in the market, including at least one product sold by one of the merging firms.

Merger Guidelines § 4.1.1 The SSNIP is generally assumed to be "five percent of the price paid by customers for the products or services to which the merging firms contribute value." Merger Guidelines § 4.1.2.

Dr. Shapiro's HMT analysis emphasizes that the proposed or "candidate" market consisting of the sale and distribution of consumable office supplies includes *all* methods of procuring office supplies by large companies, *i.e.* procurement through a primary vendor relationship, off contract purchases, online and retail buys. "Since the hypothetical monopolist, by definition, controls all sources of supply to large customers, it would not have to worry that raising prices would cause large customers to switch to other suppliers of consumable office supplies: by definition, there are none." Shapiro Report at 014.

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[11] The Court is aware of the academic observation that "the rationale for market definition in *Brown Shoe* was very different from and at odds with the rationale for market definition in horizontal merger cases today." Phillip E. Areeda and Herbert Hovenkamp, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION at 237 (CCH, Inc. 2015).

> Today the concern is that the post-merger firm might be able to raise prices without causing too much output to be lost to its rivals. In contrast, the *Brown Shoe* concern was that by reducing its price (or improving quality at the same price), the post-merger firm could deprive rivals of output, thus forcing them out altogether or relegating them to niche markets.

Id. at 240. Nevertheless, the Court finds the *Brown Shoe* factors a useful analytical tool, and as Judge Amit P. Mehta recognized in *Sysco*, "*Brown Shoe* remains the law, and this court cannot ignore its dictates." *Sysco*, 113 F.Supp.3d at n. 2.

Dr. Shapiro also points out that Staples and Office Depot's head-to-head competition "tells us that a *monopoly* provider of consumable office supplies would charge significantly more to large customers than Staples and Office Depot today charge these same customers." *Id.* Dr. Shapiro also highlights the record evidence that demonstrates Defendants compete "fiercely" for business in the large B-to-B space. *Id.* Dr. Shapiro concludes that such competition implies that "the elimination of competition would lead to a significant price increase to large customers, which in turn implies that the HMT is satisfied." *Id.*

Dr. Shapiro's conclusions are supported by the testimony presented during the hearing. . . . In sum, Dr. Shapiro's expert report and testimony, as well as the testimony of the corporate representatives, supports Plaintiffs' definition of the relevant market as the sale and distribution of consumable office supplies to large B-to-B customers.

C. Defendants' arguments in opposition to Plaintiffs' alleged market

Defendants make two primary arguments in response to Plaintiffs' alleged market. First, although Defendants do not explicitly discuss the *Brown Shoe* practical indicia, they argue that exclusion of ink and toner, as well as "beyond office supplies" or "BOSS" products from the alleged market, is error. Second, Defendants argue that no evidence supports Plaintiffs' contention that large B-to-B customers should be treated as a separate market.

1. Exclusion of ink, toner and BOSS from alleged market is proper

Defendants' principal challenge to Plaintiffs' alleged market centers on the exclusion of ink, toner and BOSS from the alleged relevant market. Defendants advance three arguments, none of which are persuasive. First, Defendants argue that exclusion of these products from the alleged market is a "made for litigation market," that is inconsistent with commercial realties. Second, Defendants argue that Plaintiffs' market definition is inconsistent with the one used by the FTC in 1997 and 2013. *Id.* Finally, Defendants seize on Dr. Shapiro's admission that the FTC made the decision to exclude ink and toner from the proposed market prior to his independent determination that doing so was proper. . . . In other words, because there are more companies that sell ink and toner, Defendants' market share in an ink and toner market would be lower than they are in the alleged market.

All of the above arguments are advanced by Defendants to bolster their assertion that the Plaintiffs have "gerrymandered the market" to inflate Defendants' market share. Defs.' FOF ¶ 4. As discussed *supra*, voluminous record evidence supports excluding ink, toner and BOSS products from the relevant cluster market. To the extent Defendants sought to show that exclusion of ink and toner radically altered Defendants' market share, Defendants could have presented expert testimony to support that proposition.

2. Antitrust laws exist to protect competition, not a particular set of consumers

Defendants' second primary argument in opposition to Plaintiffs' proposed relevant market is that "there is no evidence to support Plaintiffs' claim that large B-to-Bs should be treated as a separate market." Defendants maintain that Plaintiffs' attempt to protect "mega companies" is misplaced because the merger "indisputably will benefit all retail customers, and more, than 99 percent of business customers."

Antitrust laws exist to protect competition, even for a targeted group that represents a relatively small part of an overall market. See Merger Guidelines § 3 ("When price discrimination is feasible, adverse competitive effects on targeted customers can arise, even if such effects will

not arise for other customers."). Indeed, the Supreme Court has recognized that within a broad market, "well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes." *Brown Shoe Co.*, 370 U.S. at 325; *Cardinal Health, Inc.*, 12 F.Supp.2d at 47 (concluding that "the services provided by wholesalers in fact comprise a distinct submarket within the larger market of drug delivery.");

As discussed in Section IV.A.2.a-c *supra*, the nature of how large B-to-B customers operate, including the services they demand, supports a finding that they are a targeted customer market for procurement of consumable office supplies. There is overwhelming evidence in this case that large B-to-B customers constitute a market that Defendants could target for price increases if they are allowed to merge. Significantly, Defendants themselves used the proposed merger to pressure B-to-B customers to lock in prices based on the expectation that they would lose negotiating leverage if the merger were approved.

D. Conclusions regarding the definition of the relevant market

The "practical indicia" set forth by the Supreme Court in *Brown Shoe* and Dr. Shapiro's expert testimony support the conclusion that Plaintiffs' alleged market of consumable office supplies (a cluster market) sold and distributed by Defendants to large B-to-B customers (a targeted market) is a relevant market for antitrust purposes. The *Brown Shoe* factors support Plaintiffs' argument that the sale and distribution of consumable office supplies to large B-to-B customers is a proper antitrust market because the evidence supports the conclusion that: (1) there is industry or public recognition of the market as a separate economic entity; (2) B-to-B customers demand distinct prices and demonstrate a high sensitivity to price changes; and (3) B-to-B customers require specialized vendors that offer value-added services. Dr. Shapiro's unrebutted testimony also supports Plaintiffs' alleged market definition because, in his opinion, "the elimination of competition would lead to a significant price increase to large customers," which implies the HMT is satisfied. Finally, for the reasons discussed in detail in Section IV.C *supra*, Defendants arguments against Plaintiffs' market definition fail.

E. Analysis of the Plaintiffs' arguments relating to probable effects on competition based on market share calculations

Having concluded that Plaintiffs have carried their burden of establishing that the sale and distribution of consumable office supplies to large B-to-B customers in the United States is the relevant market, the Court now turns to an analysis of the likely effects of the proposed merger on competition within the relevant market. "If the FTC can make a *prima facie* showing that the acquisition in this case will result in a significant market share and an undue increase in concentration" in the relevant market, then "a presumption is established that [the merger] will substantially lessen competition." *Swedish Match*, 131 F.Supp.2d at 166. The burden is on the government to show that the merger would "produce a firm controlling an undue percentage share of the relevant market" that would result in a "significant increase in the concentration of firms in that market." *Heinz*, 246 F.3d at 715.

The Plaintiffs can establish their *prima facie* case by showing that the merger will result in an increase in market concentration above certain levels. *Id.* "Market concentration is a function of the number of firms in a market and their respective market shares." *Arch Coal*, 329 F.Supp.2d at 123. The Herfindahl-Hirschmann Index ("HHI") is a tool used by economists to measure changes in market concentration. Merger Guidelines § 5.3. HHI is calculated by "summing the squares of the individual firms' market shares," a calculation that "gives proportionately greater

weight to the larger market shares." *Id.* An HHI above 2,500 is considered "highly concentrated"; a market with an HHI between 1,500 and 2,500 is considered "moderately concentrated"; and a market with an HHI below 1,500 is considered "unconcentrated". *Id.* A merger that results in a highly concentrated market that involves an increase of 200 points will be presumed to be likely to enhance market power." *Id.*; see also *Heinz*, 246 F.3d at 716–17.

1. Concentration in the sale and distribution of consumable office supplies to large B-to-B customers

Dr. Shapiro estimated Defendants' market shares by using data collected from Fortune 100 companies ("Fortune 100 sample" or "Fortune 100"). Shapiro Report at 017. During the data collecting process, 81 of the Fortune 100 companies responded with enough detail to be used in Dr. Shapiro's sample. *Id.;* see also Hrg Tr. 2294:3–19. The critical data provided by the companies was fiscal year 2014 information on: (1) their overall spend on consumable office supplies; (2) the amount spent on consumable office supplies from Staples; and (3) the amount spent on consumable office supplies from Office Depot. Shapiro Report, Exhibit 5A. Some Fortune 100 companies have an established primary vendor relationship with Staples or Office Depot. *Id.* For example, Staples has 100 percent of the market share relating to [redacted text]'s spend on consumable office supplies and Office Depot has 100 percent of the market share relating to [redacted text]'s spend on consumable office supplies. *Id.* Other Fortune 100 customers purchase office supplies from a mix of vendors. For example, Staples accounted for twenty-seven percent of [redacted text]'s spend on consumable office supplies in 2014 and Office Depot accounted for twenty-one percent. *Id.*

Defendants' market share of the Fortune 100 sample as a whole is striking: Staples captures 47.3 percent and Office Depot captures 31.6 percent, for a total of 79 percent market share. The pre-merger HHI is already highly concentrated in this market, resting at 3,270. Put another way, Staples and Office Depot currently operate in the relevant market as a "duopoly with a competitive fringe." If allowed to merge, the HHI would increase nearly 3,000 points, from 3,270 to 6,265. This market structure would constitute one dominant firm with a competitive fringe. Staples' proposed acquisition of Office Depot is therefore presumptively illegal because the HHI increases more than 200 points and the post-merger HHI is greater than 2,500. Shapiro Report at 021; see also *Heinz*, 246 F.3d at 716 (noting that the pre-merger HHI for baby food was 4775, "indicative of a highly concentrated industry" and the 500 point post-merger HHI increase "creates, by a wide margin, a presumption that the merger will lessen competition in the domestic jarred baby food market.")

F. Defendants' arguments in opposition to Plaintiffs' Market Share Calculations

Defendants make several arguments in opposition to Dr. Shapiro's market share methodology and calculation. Defendants argue that: (1) the Fortune 100 sample overstates Defendants' actual market share; (2) treatment of Tier 1 diversity suppliers and paper manufacturers was error; and (3) Dr. Shapiro underestimates leakage, inflating Defendants' market shares. However, despite significant time spent cross-examining Dr. Shapiro with regard to his methodology, Defendants produced no expert evidence during the hearing to rebut that methodology. Moreover, it is significant that Defendants' final 100-page brief devotes only seven paragraphs to challenging Dr. Shapiro's market share calculations.

1. The Fortune 100 is a trustworthy sample to calculate Defendants' market shares

Defendants' first argument in opposition to Dr. Shapiro's focus on the Fortune 100 is that his failure to take a sample of the other approximate 1100 companies in the relevant market is error because it results in "dramatically inflated market shares." Dr. Shapiro conceded that the data he analyzed is imperfect because it does not include all large B-to-B customers. However, Dr. Shapiro was confident that "there is no reason to believe [the market shares] are biased when it comes to estimating the market shares of Staples and Office Depot." To test whether his analysis of the Fortune 100 might have overstated Defendants' market shares because the Fortune 100 companies are especially large, Dr. Shapiro measured the market share of the top half of his sample separate from the bottom half. The range of spending on consumable office supplies among the companies analyzed in Dr. Shapiro's analysis is vast: from less than $200,000 per year on the low end, to more than $33 million per year on the high end. The combined market share for Defendants is seventy-nine percent among the top half of the Fortune 100 and eighty-nine percent among the bottom half. Thus, Dr. Shapiro states that he is "confiden[t] that the market shares for Staple[s] and Office Depot reported in Exhibit 5B are not overstated."

G. Conclusion regarding Plaintiffs' market share analysis

Plaintiffs have met their burden of showing that the merger would result in "undue concentration" in the relevant market of the sale and distribution of consumable office supplies to large B-to-B customers in the United States. The relevant HHI would increase nearly 3,000 points, from 3270 to 6265. These HHI numbers far exceed the 200 point increase and post-merger concentration level of 2500 necessary to entitle Plaintiffs to a presumption that the merger is illegal. The Court rejects Defendants' arguments in opposition to Dr. Shapiro's market analysis for the reasons discussed in detail in Section IV.F *supra*. Nevertheless, to strengthen their *prima facie* case, Plaintiffs presented additional evidence of harm, which the Court analyzes next.

H. Plaintiffs' evidence of additional harm

Sole reliance on HHI calculations cannot guarantee litigation victories. *Baker Hughes*, 908 F.2d at 992. Plaintiffs therefore highlight additional evidence, including bidding data ("bid data"), ordinary course documents, and fact-witness testimony. This additional evidence substantiates Plaintiffs' claim that this merger, if consummated, would result in a lessening of competition.

Mergers that eliminate head-to-head competition between close competitors often result in a lessening of competition. See Merger Guidelines § 6 ("The elimination of competition between two firms that results from their merger may alone constitute a substantial lessening of competition."); see also *Heinz*, 246 F.3d at 717–19; *Swedish Match*, 131 F.Supp.2d at 169; *Staples*, 970 F.Supp. at 1083. Plaintiffs' evidence supports the conclusion that Defendants compete head-to-head for large B-to-B customers. ***

I. Defendants' response to Plaintiffs' *prima. facie* case

Defendants' sole argument in response to Plaintiffs' *prima facie* case is that the merger will not have anti-competitive effects because Amazon Business, as well as the existing patchwork of local and regional office supply companies, will expand and provide large B-to-B customers with competitive alternatives to the merged entity. Plaintiffs argue that there is no evidence that Amazon or existing regional players will expand in a timely and sufficient manner so as to eliminate the anticompetitive harm that will result from the merger. For the reasons discussed below,

Defendants' argument that Amazon Business and other local and regional office supply companies will restore the competition lost from Office Depot is inadequate as a matter of law.

"The prospect of entry into the relevant market will alleviate concerns about adverse competitive effects only if such entry will deter or counteract any competitive effects of concern so the merger will not substantially harm customers." Merger Guidelines § 9. Even in highly concentrated markets, Plaintiffs' *prima facie* case may be rebutted if there is ease of entry or expansion such that other firms would be able to counter any discriminatory pricing practices. *Cardinal Health,* 12 F.Supp.2d at 54-55. Defendants carry the burden of showing that the entry or expansion of competitors will be "timely, likely and sufficient in its magnitude, character, and scope to deter or counteract the competitive effects of concern." *H & R Block,* 833 F.Supp.2d at 73. The relevant time frame for consideration in this forward looking exercise is two to three years. Hrg Tr. 2660-2662 (Dr. Shapiro confirming that two to three years is the relevant temporal scope for the Court to consider the effects of new entrants or expansion of existing competitors).

1. Amazon Business

Defendants seize on Amazon's lofty vision for Amazon Business to be the "preferred marketplace for all professional, business and institutional customers worldwide" to support their contention that Amazon not only wants to take over the office supply industry, but desires to "take over the world." Hrg Tr. 3010 (Ms. Sullivan's Closing Argument). Amazon Business may eventually transform the B-to-B office supply space. The Court's unenviable task is to assess the likelihood that Amazon Business will, within the next three years, replace the competition lost from Office Depot in the B-to-B space as a result of the proposed merger.

Amazon Business has a number of impressive strengths. For example, Amazon Business already enjoys great brand recognition and its consumer marketplace has a reputation as user-friendly, innovative and reliable. Amazon Business' strategy documents also reveal a number of priorities that, if successful, may revolutionize office supply procurement for large companies. For example, [redacted text] DX05033 at 4. [redacted text] Hrg Tr. 710:22-23. Amazon is also working, [redacted text] among other innovative technologies. Hrg Tr. 567:23-568:2; 724:11-25; 744:1-23.

However, several significant institutional and structural challenges face Amazon Business. Plaintiffs point to a long list of what they view as Amazon Business' deficiencies, including, but not limited to: (1) lack of RFP experience; (2) no commitment to guaranteed pricing [redacted text]; (3) lack of ability to control third-party price and delivery; (4) inability to provide customer-specific pricing; (5) a lack of dedicated customer service agents dedicated to the B-to-B space; (6) no desktop delivery; (7) no proven ability to provide detailed utilization and invoice reports; and (8) lack of product variety and breadth. Pls.' FOF ¶ 191. Although Amazon Business may successfully address some of these alleged weaknesses in the short term, the evidence produced during the evidentiary hearing does not support the conclusion that Amazon Business will be in a position to restore competition lost by the proposed merger within three years.

First, despite entering the office supply business fourteen years ago, large B-to-B customers still do not view Amazon Business as a viable alternative to Staples and Office Depot. PX07518 (Amazon) at 001 ("Our customers tell us that [redacted text]."). Moreover, Amazon Business' participation in RFPs has been "limited." Hrg Tr. 546:18-547:4; *see also* 1943:14-1947:9 (HPG) (noting that HPG's membership and advisory board would require proof of Amazon Business' demonstrated success in serving large B-to-B customers before considering Amazon Business

as a primary vendor). Significantly, Amazon Business also has yet to successfully bid to be a large B-to-B customer's primary vendor. When Amazon Business has participated in RFPs, [redacted text]. *Id.* 551:11-552:5; 851:21-852:8; McDevitt Dep. 186:6-16 (Amazon's prices to [redacted text] were [redacted text]% higher than lowest bid).

The Court has considered whether Amazon Business' newly energized focus on the B-to-B space could transform the office supply industry for B-to-B customers in such a dramatic way that the RFP process may be "what dinosaurs do" in the future. Hrg Tr. 2693:19-2694:9 (Ms. Sullivan's cross of Dr. Shapiro: "You know Dr. Shapiro, [Amazon Business] intends to make the RFP process obsolete.). However, during Mr. Wilson's deposition, he testified that Amazon Business does not seek to change the RFP process. PX02125 (Wilson Dep. 193:10-194:1). During cross-examination, Defendants addressed this point with Mr. Wilson directly:

> **Ms. Sullivan:** And anybody that's been watching what's been going on in the world understands that the way the old companies are doing things, running around, trying to get RFPs and a contract is kind of the old world. The new world is going to be procurement officers sitting at their desks using platforms like the one you're developing?
>
> **Mr. Wilson:** I don't know—I mean, that's maybe one vision of what may happen. We'll see how the technology sort of evolves and where things land.
>
> **Ms. Sullivan:** But that's your plan, that that's going to be the new world?
>
> **Mr. Wilson:** Well, our plan is to bring Amazon Business shopping experience to customers. And we would like for them to be able to—to leverage it, and we would like to create a solution that they like.

Hrg Tr. 692:11-25. Mr. Wilson's testimony does not support the conclusion that Amazon Business seeks to make the RFP process obsolete. Defendants did not offer testimony from other industry experts or offer any other credible evidence that the RFP process will become obsolete within the next three years. The evidence before the Court simply does not support a finding that Amazon Business will, within the next three years, either compete for large RFPs in the same way that Office Depot does now, or so transform the industry as to make the RFP process obsolete.

Second, Amazon Business' marketplace model is at odds with the large B-to-B industry. Similar to Amazon's consumer marketplace, half of all sales on Amazon Business are serviced by Amazon directly, while the other half are serviced by third-party sellers. Hrg Tr. 552. Amazon does not control the price or delivery offered by third-party sellers. *Id.* 842:14. Mr. Wilson confirmed that this will not change. *Id.*: 7-9 ("Q: You have no plans to force the third parties to offer particular prices? A: No, we'll never do that. No."). Amazon Business' lack of control over the price offered by third-party sellers contributes to Amazon Business' inability to offer guaranteed pricing. Mr. Wilson also testified that Amazon Business will not [redacted text]. Hrg Tr. 849:9-12 [redacted text]). The evidence thus shows that Amazon Business' [redacted text], guaranteed pricing is not feasible at this time, and [redacted text]. Absent these features, which are fundamental to the current office supply industry for large B-to-B customers, the record is devoid of evidence to support the proposition that large business would shift their entire office supply spend to Amazon Business in the next three years.

Finally, although Amazon Business' 2020 revenue projection is an impressive $[redacted text], only [redacted text] percent of that is forecast to come from the sale of office supplies. Hrg Tr. 856:5-16; PX 06300 (Shapiro Reply) at 028. This level of revenue for office supplies would give Amazon Business only a very small share in the relevant market. Shapiro Hrg Tr. 2432:11-19;

2436:15-19 (Dr. Shapiro: "So, in the end, no, I don't think over the next two years or so that they will-are likely to step in and provide sufficient additional competition to protect large customers....."). Further, Amazon Business' 2020 forecast [redacted text], in part because [redacted text] Hrg Tr. 579:15-581:4; 719:25-720:3; 720:22-721:24, 856:5-13. Even the launch of [redacted text] is uncertain due to [redacted text]. Park Dep. [redacted text] Hrg 731:17-732:1 (testifying that [redacted text]).

At the conclusion of Mr. Wilson's testimony, the Court asked whether, [redacted text] Hrg Tr. 859:10-16. Mr. Wilson answered "[redacted text]" *Id.* at 859:22-23. Similarly, during Mr. Wilson's testimony about Amazon Business' ability to compete for RFPs, the Court engaged in this exchange:

> **THE COURT:** So, if one were to predict—if a vice president were to predict five years from now, you'd be in a much better position to respond, just predicting?
>
> **THE WITNESS:** That's our point, yes.
>
> **THE COURT:** Right. And that—the strength of that prediction is based upon what?
>
> **THE WITNESS:** Investment in resources.
>
> **THE COURT:** Right. And that's something that, I guess from a business point of view, you plan to do?
>
> **THE WITNESS:** I plan to request the resources.
>
> **THE COURT:** Right. Because you want to be as successful as you possibly can and compete, right?
>
> **THE WITNESS:** Absolutely.

Hrg Tr. 553:1-17.

Critically, however, when the Court asked whether Mr. Wilson [redacted text] *Id.* at 860 1-3. This answer, considered in light of Amazon Business' lack of demonstrated ability to compete for RFPs and the structural and institutional challenges of its marketplace model, leads the Court to conclude that Amazon Business will not be in a position to compete in the B-to-B space on par with the proposed merged entity within three years. Just as it would be "pure speculation" for an Amazon Business employee to give a date certain for [redacted text], it would be sheer speculation, based on the evidence, for the Court to conclude otherwise. If Amazon Business was more developed and Mr. Wilson [redacted text], the outcome of this case very well may have been different.

2. WB Mason and other competitors

Brief discussion is necessary with regard to the ability of existing competitors to fill the competition gap that would be left in the wake of this merger. WB Mason is the third largest office supply company in the U.S., but is a distant third behind Defendants, retaining less than one percent market share in the relevant market. PX03021 (WB Mason Decl.) ¶ 6. WB Mason has nine customers in the Fortune 1000. Hrg Tr. 1611:21-1611:24. WB Mason and other regional and local office supply vendors are at a competitive disadvantage because they do not have the resources to serve large customers nationwide. *Id.* at 1601: 3-8, 1687:13-22, 1697:2-8. Although WB Mason is confident in its ability to compete with Staples in Masonville, it does not bid on large RFPs outside of Masonville. Hrg Tr. (Meehan "We'll respond to RFPs that are inside of Masonville, that are headquartered in Masonville, that the majority of the business is inside of Masonville.").

It is significant that WB Mason does not have the desire or the ability to compete with the merged entity outside of Masonville. Pls.' FOF ¶ 44. As WB Mason's CEO Mr. Meehan testified, "we don't have any plans to expand [outside of Masonville] ... We're going to focus on Masonville." Hrg Tr. Meehan, 1671. After establishing that it would take [redacted text] for WB Mason to expand nationwide, the Court asked Mr. Meehan "If [Defendants] gave you $[redacted text], would you accept it to be competitive with them?" He answered "I don't know if I would. That's a big challenge. I mean, that's if I even want to do this, right? Become this. I—no, I would definitely think about it, Your Honor." *Id.* 1790.

Like WB Mason, other regional and local office supply companies also face the structural disadvantage of purchasing from wholesalers instead of manufacturers. *Id.* Hrg Tr. 1584:23-1585:2. This means their costs are higher than those of Defendants. Further, because their overall volumes are lower, they cannot offer the deep discounts that Defendants are able to offer. Pls.' FOF ¶ 168. There was simply no other evidence presented during the hearing that supports Defendants' assertion that utilizing a collection of regional or local office supply companies would meet the needs of large B-to-B customers.

V. Conclusion

As Judge Mehta observed in *Sysco*, "There can be little doubt that the acquisition of the second largest firm in the market by the largest firm in the market will tend to harm competition in that market." 113 F.Supp.3d at 88 (quoting J. TATEL in *Whole Foods*, 548 F.3d at 1043). The Court concludes that Plaintiffs have met their burden of showing by a "reasonable probability" that Staples' acquisition of Office Depot would lessen competition in the sale and distribution of consumable office supplies in the large B-to-B market in the United States. The evidence offered by Defendants to rebut Plaintiffs' showing of likely harm was inadequate as a matter of law. Plaintiffs have therefore carried their ultimate burden of showing that they are likely to succeed in proving, after a full administrative hearing on the merits, that the proposed merger "may be substantially to lessen competition, or to tend to create a monopoly" in violation of § 7 of the Clayton Act.

For the reasons discussed herein, Plaintiffs' Motion for Preliminary. Injunction is GRANTED. A separate order accompanies this Memorandum Opinion.

Federal Trade Commission v. Meta Platforms, Inc.

654 F.Supp.3d 892 (N.D. Calif. 2023)

EDWARD J. DAVILA, United States District Judge: This action was brought by Plaintiff Federal Trade Commission ("FTC") to block the merger between a virtual reality ("VR") device provider and a VR software developer. Defendant Meta Platforms Inc. ("Meta") has agreed to acquire all shares of Within Unlimited, Inc. ("Within," collectively with Meta, "Defendants"). The FTC has come before the Court to seek preliminary injunctive relief pursuant to Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), to enjoin Defendants from consummating their proposed merger (the "Acquisition") pending the outcome of ongoing administrative proceedings before the FTC. ECF Nos. 101, 164.

In addition to the FTC's motion for preliminary injunction, Defendants have filed a motion to dismiss the Amended Complaint ("FAC") ***. Over the course of a seven-day evidentiary hearing, the Court heard the parties' arguments and evidence. The Court has also received briefing on all pending motions, as well as pre-hearing and post-hearing submissions of the parties' proposed findings of fact. Having considered the parties' submissions and evidence, the Court DENIES Defendants' motion to dismiss *** and DENIES the FTC's motion for preliminary injunction.

I. FACTUAL FINDINGS

A. Defendant Meta Platforms, Inc.

1. Defendant Meta Platforms, Inc. is a publicly traded corporation organized under Delaware law and headquartered in Menlo Park, California. Meta operates a collection of social networking platforms referred to as its "Family of Apps," which includes Facebook, Instagram, Messenger, and WhatsApp. Meta also manufactures VR devices, such as the Quest 2 and the Quest Pro headsets, through its Reality Labs division.

2. VR technology enables users to experience and interact with a digitally generated three-dimensional environment by wearing a headset with stereoscopic displays in front of each eye. Users can download a wide variety of VR software applications ("apps") from digital marketplaces, or app stores, for use on their personal VR devices. Quest headsets are designed so that a user's geolocation determines what content is available and at what price.

3. In 2020, 2021, and 2022, Meta spent several billion dollars each year on its VR Reality Labs division.

4. Meta operates an app store called the Quest Store, previously known as the Oculus Store. Third-party app developers can request to have their app distributed in the Quest Store, and Meta also actively seeks out and invites developers to bring apps to the Quest Store Apps must meet several content, technical, and asset requirements before they may be considered for listing on the Quest Store; however, Meta may still reject an app that meets all the requirements pursuant to the Quest Store's curation policy. Apart from the Quest Store, Meta also operates App Lab, an app distribution service for VR applications that meet basic technical and content requirements but is otherwise free from any editorial curating by Meta. Quest users can also download VR apps from other app stores on VR platforms that Meta does not own, such as SideQuest and Steam VR Store.

5. The content and apps that are available for a particular VR system plays an important role in the widespread adoption of that system, and many users may purchase a VR system for specific content they want to experience. As a result, high quality and popular VR apps—

dubbed as "system sellers"—can drive adoption and sales of the specific headsets for which they are available. Broad adoption of a specific VR system, in turn, will attract third-party app developers to create more VR content for that system, a phenomenon referred to as a "flywheel" effect.

6. When a VR app is developed wholly by a developer unaffiliated with Meta, Meta refers to that as third-party ("3P") development. When Meta funds all or most of a VR app's development, Meta refers to that as second-party ("2P") development. When a VR app is developed in-house at Meta, either by acquired VR studios or Meta employees themselves, Meta refers to that as first-party ("1P") development.

7. Meta encourages third-party VR app developers to build apps for the Quest platform by providing funding and technical VR engineering assistance to those developers. Specifically, Meta provides grants that are designed to improve existing VR software or incentivize the development of software on Quest that may only exist on another platform. Meta also maintains a developer relations engineering team consisting of veteran engineers who work directly with developers to improve software quality, fix bugs, or polish the experience they are building. Meta's VR content organization spends approximately [redacted].

8. In addition to providing funding or engineering support to third-party VR app developers, Meta has also sought to increase the VR app content available on its platform by acquiring third-party app developers and developing its own apps internally.

9. Although decisions may be made on a case-by-case basis, Meta typically will seek to acquire or build its own VR app if: [redacted].

10. Similarly, Meta is more inclined to build its own VR app instead of acquiring an existing third-party developer [redacted].

11. In the past three years, Meta has acquired at least nine VR app studios: Beat Games, Sanzaru Games, Ready at Dawn Studios, Downpour Interactive, BigBox VR, Unit 2 Games, Twisted Pixel, Armature Studio, and Camouflaj.

12. The VR apps that Meta has independently developed and released include Horizon Worlds (world building), Horizon Workrooms (productivity), Horizon Venues (live events), and Horizon Home (social networking). Meta's background and emphasis has been on communication and social VR apps. That said, Meta has also developed and released Dead and Buried, a multiplayer shooter game.

B. Defendant Within Unlimited, Inc.

13. Defendant Within Unlimited, Inc. is a privately held corporation organized under the laws of Delaware with headquarters in Los Angeles, California. Within is a software development company founded by Chris Milk and Aaron Koblin, who were experienced visual artists.

14. Within's flagship product is Supernatural, a subscription VR fitness service launched in April 2020 on the Quest Store. Supernatural releases new workouts daily and continues to add new modalities (e.g., aerobic boxing, meditation) to its lineup of workouts. Users access Supernatural's workouts by paying a monthly subscription fee of $18.99 or an annual subscription fee of $179.99. Within has never changed Supernatural's prices.

C. The Alleged "VR Dedicated Fitness App" Market

15. The FTC alleges that the relevant market consists of VR dedicated fitness apps in the United States. The government defines "VR dedicated fitness apps" as VR apps that are "designed so users can exercise through a structured physical workout in a virtual setting anywhere they choose to use their highly portable VR headset."

16. Both Meta and Within have repeatedly referred to VR apps intended to provide immersive at-home structured physical exercise as "deliberate" or "dedicated" fitness apps. Meta now describes these apps as "trainer workout apps." VR dedicated fitness apps are sometimes called "VR deliberate fitness apps" or "trainer workout apps." The Court will use the phrase "VR dedicated fitness apps" throughout.

17. VR dedicated fitness apps are marketed to customers for the purpose of exercise. Some other VR apps, often called "incidental" or "accidental" fitness apps, may include mechanics that may allow users to exercise as a byproduct but have a primary focus other than fitness (such as gaming). Unlike VR incidental fitness apps, VR dedicated fitness apps often have features like trackable progress goals, heart rate tracking, and motion calibration. Additionally, VR dedicated fitness apps generally require the producing company to have expertise and assets that allow them to create exercise content, e.g., workout coaches, green screen studios, stereoscopic capture, post processing pipelines. And because VR dedicated fitness apps create content on an ongoing basis to avoid user boredom, they are better suited than most other VR apps to be priced using a subscription model (although not all VR dedicated fitness apps follow this model).

18. The user base for VR dedicated fitness apps differs from that of VR overall. VR users generally skew younger and male, but VR dedicated fitness app users tend to have an older and more female set of users. In addition to the diverse appeal of VR dedicated fitness apps, they have strong user retention and rapid growth. Within touted these features in a presentation to Meta in April 2021, estimating the "addressable market" for a Quest headset paired with a monthly Supernatural subscription to be 101 million people in North America, and suggesting that fitness could "expand [the] Quest market" to 28 million additional women over the age of 40. A year later, as of [redacted]. Some data suggests that users who [redacted].

19. Multiple companies that make VR dedicated fitness apps consider their products to compete with the extensive range of methods by which an individual can seek to exercise. According to Within, Supernatural "compete[s] with every product or service or offering that offers fitness or wellness," ranging from connected fitness devices like Peloton equipment to gyms to YouTube videos intended to be mimicked by a viewer. Within does not, however, consider a VR incidental fitness app to constitute a fitness offering. The founder of VirZoom, another VR company with a dedicated fitness app (VZfit), made similar claims, and added that VZfit even "compete[s] with somebody who wants to just jump on their bike and go for a bike ride." However, Odders Lab, another VR company that makes not only a dedicated fitness app but also a rhythm game app and a chess app, stated that its fitness app competed most directly with other fitness dedicated apps, such as Supernatural and FitXR, and that the launch of its fitness app had not diminished sales of its rhythm game app.

20. [redacted] Apple provides Fitness+, a paid subscription app, and [redacted], but it does not currently offer its own headset.

21. The customers for more established fitness offerings are perceived to be more likely to have long-term or well-developed fitness routines, while VR dedicated fitness app users are targeted more toward "fitness strugglers" who have less fitness experience. No record evidence

suggests that these firms possess VR engineering expertise. As such, these fitness offerings do not create the 360-degree embodiment in a virtual environment provided by VR dedicated fitness apps. Although some fitness offerings may display videos of various locations around the world, those videos are displayed on a flat screen.

22. Connected fitness devices are generally stationary and larger than the portable and relatively small VR headset equipment required to use a VR dedicated fitness app. The upfront device cost can be over $1,000, and users pay a monthly subscription fee to access fitness content; for example, Peloton and Tonal are connected fitness device companies, and cost, respectively $1,445 plus $44 per month and $3,495 plus $49 per month. There are also more affordable alternatives outside of VR, such as a Peloton mobile app-only subscription, which costs $12.99 per month. The subscription model is common in the overall fitness industry—in addition to the examples above, traditional gyms and Fitness+ charge monthly subscriptions.

23. Within's VR app Supernatural is a dedicated fitness app: it was designed specifically for fitness and offers "daily personalized full-body workouts and expert coaching from real-world trainers." Within began developing Supernatural in February 2019, and launched it in the Quest Store on April 23, 2020. Supernatural now offers over 800 fully immersive video workouts set to music in various photorealistic landscapes, such as the Galapagos Islands and the Great Wall of China. Through deals with major music studios, Supernatural sets each workout to songs from A-list artists like Katy Perry, Imagine Dragons, Lady Gaga, and Coldplay. Within optimized the exercise movements in Supernatural through consultations with experts holding PhDs in kinesiology and biomechanics; the workouts are led by personal trainers, calibrated to users' range of motion, mapped out in VR by dance choreographers, and filmed at Within's studio in Los Angeles. Within's founders are experienced directors of interactive music videos. Due to limitations on Within's music licensing rights, Supernatural is only available to Quest headset users in the United States and Canada.

24. Other VR dedicated fitness apps include FitXR, Les Mills Bodycombat, VZfit, VZfit Premium, PowerBeats VR, RealFit, Holofit, Liteboxer, Liteboxer Premium VR, and VRWorkout. Like Supernatural, Liteboxer Premium VR costs $18.99 per month. Les Mills Bodycombat, PowerBeatsVR, and RealFit have respective one-time costs of $29.99, $22.99, and $19.99; Liteboxer and VRWorkout are free; and the other VR dedicated fitness apps charge monthly subscription prices ranging from about $9 to $12. Companies producing VR dedicated fitness apps generally pursue business strategies optimized for growth and market penetration, often at the cost of operating at a loss. These companies expect that high growth and penetration metrics will render them attractive acquisition targets.

25. All of these apps, including Supernatural, were launched within the past five years. New VR dedicated fitness apps are expected to launch in the near future. Supernatural currently possesses an 82.4% share of market revenue among the existing VR dedicated fitness apps (or a 77.6% share of VR apps in the Quest Store's "Fitness and Wellness" category).

26. The FTC's economics expert, Dr. Singer, analyzed the concentration of the VR dedicated fitness app market using the Herfindahl-Hirschman Index ("HHI"). Dr. Singer performed the HHI calculation multiple times to account for different conceptions of the firms contained within the VR dedicated fitness app market. Using a set of firms based off a list of Supernatural competitors provided by Meta to the FTC, Dr. Singer calculated an HHI of 6,917 by measuring each firm's market share of revenue. Then, to capture broader potential set of firms within the VR dedicated fitness app market, Dr. Singer analyzed all apps listed in Meta's Quest Store under its "Fitness & Wellness" category and calculated an HHI of 6,148 (again, based on revenue).

Dr. Singer also calculated HHI using market share of total hours spent and identified outputs 6,307 for the set of firms based off Meta's list and 4,863 for the broader set of "Fitness & Wellness firms." Lastly, Dr. Singer calculated HHI using market share of monthly active users and identified outputs of 3,377 and 2,098 for the two respective sets of firms. Markets are generally considered "highly concentrated" when the HHI is above 2,500 and "moderately concentrated" when the HHI is between 1,500 and 2,500.

D. The Challenged Acquisition

27. Meta and Zuckerberg first expressed interest in acquiring Within as early as February 22, 2021.

28. After Zuckerberg showed some interest in [redacted], Michael Verdu (Vice President of VR Content) investigated and [redacted].

29. On March 11, 2021, Meta employees met to discuss potential VR fitness investments with Mark Rabkin, the head of VR technology at Meta and one of the final decision makers to approve any VR investment. In advance of this meeting, Ananda Dass (Meta's director of non-gaming VR content) and Jane Chiao (business-side employee) prepared a pre-read document analyzing five potential investment options. Shortly before this meeting, on March 4, 2021, Jane Chiao had also prepared a document titled, [redacted]. During the meeting, the attendees decided [redacted].

30. On March 17, 2021, Dass and Chiao summarized the advantages and disadvantages of acquiring Supernatural [redacted]. At this time, they proposed spending the next few months inquiring into [redacted].

31. On April 20, 2021, Melissa Brown (Head of Developer Relations) prepared an executive summary pre-read in advance of Meta's meeting with Within, which was circulated to Verdu and Dass. The executive summary contains analyses into Within's VR portfolio, Supernatural's business model and performance, past partnership with Oculus, long-term goals, and future opportunities with Meta.

32. On April 26, 2021, Brown circulated a [redacted].

33. On May 26, 2021, Anand Dass [redacted]. At that point, Meta's acquisition focus had been primarily on [redacted]. The news that Within may soon be acquired by Apple accelerated Meta's internal decision-making processes to acquire a VR fitness app developer.

34. Frank Casanova (Apple's senior director of augmented reality product marketing) testified that Apple [redacted] Casanova's personal recollection was that [redacted].

35. In mid-July 2021, Meta and Within entered into a non-binding term sheet regarding a potential acquisition. Meta and Within executed the Merger Agreement on October 22, 2021.

E. Beat Saber Expansion Proposal

36. Beat Saber is a VR rhythm game in which players use virtual swords to slash oncoming blocks timed to music. Beat Saber is the most popular and best-selling VR app of all time.

37. Meta acquired Beat Games, the studio that produces Beat Saber, in late 2019.

38. At the time it acquired Beat Games, Meta viewed Beat Saber as a potential "vector into fitness as a game-adjacent use case." There was a continuing internal dialogue at Meta regarding a potential fitness version of Beat Saber, which was referred to as the "perpetual white whale quest to get ... Beat Games to build a fitness version of Beat Saber." The founders of Beat

Games were "warm to the idea" and released a "FitBeat" song for Beat Saber, but the idea otherwise did not gain traction.

39. On February 16, 2021, Rade Stojsavljevic (director of Meta's first party studios) was riding his Peloton bike on a workout with a live DJ spinning music when he came up with the idea of a Peloton partnership with Beat Saber.

40. Shortly thereafter, Stojsavljevic collaborated on a presentation called "Operation Twinkie," in which he proposed repositioning Beat Saber as a fitness app in a partnership with Peloton. The same presentation recommended [redacted]."

41. On March 4, 2021, Chiao responded to comments regarding partnering with Peloton to create VR content, expressing doubts as to the feasibility of repositioning Beat Saber into a fitness app.

42. On March 11, 2021, Stojsavljevic attended the VR fitness investment meeting with Mark Rabkin. Alongside the acquisitions of [redacted] Supernatural, the March 11 meeting concluded that Stojsavljevic was to prepare a presentation to Rabkin to expand Beat Saber to dedicated fitness.

43. On March 15, 2021, Stojsavljevic queried a group chat and solicited feedback on his proposal for a Beat Saber–Peloton partnership. The group members discussed different forms the partnership could take.

44. On March 25, 2021, Stojsavljevic received a presentation from a consultant, [redacted], titled "Beat Saber x Peloton Opportunity Identification." The presentation provided a quote for [redacted] to investigate the Beat Saber and Peloton opportunity, which was to take about 8 weeks and cost $23,500. [redacted]'s proposed research approach included nine action items, as follows: (1) analyze the home fitness market; (2) analyze the Peloton market; (3) assess the Peloton bike capabilities; (4) analyze the current XR[1] fitness market; (5) analyze Beat Saber's current strategy and its Fitbeat song; (6) identify Beat Saber x Peloton opportunities; (7) identify XR fitness opportunities; (8) define the go-to-market approach; and (9) define how to approach Peloton with the partnership. Stojsavljevic ultimately did not engage [redacted] to undertake this research project.

45. Based on the parties' representations and to the best of the Court's review of the evidence, the next reference to the Beat Saber–Peloton proposal was on June 11, 2021, after Meta began pursuing Within as an acquisition target. In a chat, Stojsavljevic briefly mentioned that Chiao and Dass had disagreed with his Beat Saber–Peloton proposal and had wanted to [redacted]. At the evidentiary hearing, Stojsavljevic testified that his enthusiasm for the Beat Saber–Peloton proposal had "slowed down" before Meta's decision to acquire Within. He also testified that he had not undertaken the research project that he had promised Rabkin because he had been busy working on another Meta acquisition.

46. On September 15, 2021, during a pause in Meta's merger negotiations with Within, Jason Rubin—who had just transitioned into his role as the vice president of Metaverse content on August 1, 2021—made comments about Beat Saber in response to the stalled negotiations. Rubin suggested that building "Beat Fitness" could be an alternative to the Within acquisition. He subsequently remarked that repositioning Beat Saber into fitness would be a difficult and delicate project.

[1] The Court understands "XR" to refer generally to virtual reality, augmented reality, and mixed reality.

II. PROCEDURAL HISTORY

Defendants signed an Agreement and Plan of Merger for a proposed acquisition of Within by Meta (the "Acquisition") on October 22, 2021. On July 27, 2022, the FTC filed a complaint for a temporary restraining order and preliminary injunction enjoining the Acquisition. At the time of the FTC's filing, Defendants would have been free to consummate the Acquisition after July 31, 2022. On July 29, 2022, the Court granted the parties' stipulated order preventing Defendants from consummating the Acquisition until after August 6, 2022. On August 5, 2022, the Court granted the parties' second stipulated order and entered a temporary restraining order enjoining the Acquisition until after December 31, 2022. The FTC filed its amended complaint on October 7, 2022 and Defendants moved to dismiss the amended complaint on October 13, 2022 ("MTD"). The Court took the MTD under submission without oral argument on December 2, 2022.

On October 31, 2022, pursuant to the parties' stipulated order, the FTC filed its memorandum in support of its motion for a preliminary injunction (the "Motion"). The evidentiary hearing on the Motion began on December 8, 2022. *** The evidentiary hearing concluded on December 20, 2022 and the Court granted the parties' stipulated order extending the temporary restraining order to enjoin the Acquisition until January 31, 2023.

On January 31, 2023, the FTC filed an emergency motion requesting an extension of the temporary restraining order if the Court either was not prepared to rule on the Motion until after that date or denied the Motion ("Emergency Motion"). The Court's ruling on the Emergency Motion will be filed in a separate order. ***

III. LEGAL CONCLUSIONS

A. Legal Standard

Section 13(b) of the FTC Act provides that "[u]pon a proper showing that, weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest, and after notice to the defendant, a temporary restraining order or a preliminary injunction may be granted without bond." 15 U.S.C. § 53(b)(2). In evaluating a motion for preliminary injunction brought under Section 13(b), courts must "1) determine the likelihood that the Commission will ultimately succeed on the merits and 2) balance the equities." *F.T.C. v. Warner Commc'ns Inc.*, 742 F.2d 1156, 1160 (9th Cir. 1984) (emphasis added) (citing *F.T.C. v. Simeon Mgmt. Corp.*, 532 F.2d 708, 713–14 (9th Cir. 1976)).

The federal court is not tasked with "mak[ing] a final determination on whether the proposed merger violates Section 7, but rather [with making] only a preliminary assessment of the merger's impact on competition." *Warner Commc'ns Inc.*, 742 F.2d at 1162. To obtain a preliminary injunction, the FTC must "raise questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals." Id. (citations omitted) *** .

B. Relevant Market Definition

The first step in analyzing a merger challenge under Section 7 of the Clayton Act is to determine the relevant market. *U.S. v. Marine Bancorporation, Inc.*, 418 U.S. 602, 619 (1974) (citing *E.I. Du Pont*, 353 U.S. 586, 593 (1957)). The relevant market for antitrust purposes is determined by (1)

the relevant product market and (2) the relevant geographic market. *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 324 (1962).

1. Product Market

"The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it." *Brown Shoe*, 370 U.S. at 325. "Within a general product market, 'well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes.'" *Hicks v. PGA Tour, Inc.*, 897 F.3d 1109, 1121 (9th Cir. 2018) (quoting *Brown Shoe*, 370 U.S. at 325). The definition of the relevant market is "basically a fact question dependent upon the special characteristics of the industry involved." *Twin City Sportservice, Inc. v. Charles O. Finley & Co., Inc.*, 676 F.2d 1291, 1299 (9th Cir. 1982). Products need not be fungible to be included in a relevant market, but a relevant market "cannot meaningfully encompass th[e] infinite range" of substitutes for a product. Id. at 1271 (quoting *Times Picayune Publishing Co. v. United States*, 345 U.S. 594, 611, 612 n. 31, (1953)). The overarching goal of market definition is to "recognize competition where, in fact, competition exists." *Brown Shoe*, 370 U.S. at 326.

Courts have used both qualitative and quantitative tools to aid their determinations of relevant markets. A qualitative analysis of the relevant antitrust market, including submarkets, involves "examining such practical indicia as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." *Brown Shoe*, 370 U.S. at 325). A common quantitative metric used by parties and courts to determine relevant markets is the Hypothetical Monopolist Test ("HMT"), as described in the U.S. Department of Justice and the FTC's 2010 Merger Guidelines. U.S. Dep't of Justice & FTC, Horizontal Merger Guidelines ("2010 Merger Guidelines") § 4 (2010).

There is "no requirement to use any specific methodology in defining the relevant market." *Optronic Techs., Inc. v. Ningbo Sunny Elec. Co., Ltd.*, 20 F.4th 466, 482 (9th Cir. 2021). As such, courts have determined relevant antitrust markets using, for example, only the *Brown Shoe* factors, or a combination of the *Brown Shoe* factors and the HMT. *** The FTC proposes a relevant product market consisting of VR dedicated fitness apps, meaning VR apps "designed so users can exercise through a structured physical workout in a virtual setting." Mot. 13. According to the FTC, VR dedicated fitness apps are distinct from (1) other VR apps and (2) other fitness offerings. To differentiate their proposed market from other VR app markets, the FTC claims that VR dedicated fitness apps have distinct customers and pricing strategies. The FTC further argues that VR dedicated fitness apps are in a separate market from other fitness offerings (e.g., gyms, at-home fitness equipment) because they provide users with "fully immersive, 360-degree environments," are fully portable, save space, cost less, and target a different type of consumer. The FTC claims that these qualitative product differences satisfy the *Brown Shoe* practical indicia of a relevant market, and that the Hypothetical Monopolist Test conducted by the FTC's economics expert further confirms the relevant product market definition.

Unsurprisingly, Defendants disagree. They claim that the FTC's proposed market is impermissibly narrow because it excludes "scores of products, services, and apps" that are "reasonably interchangeable" with VR dedicated fitness apps, including dozens of VR apps categorized as "fitness" apps on the Quest platform, fitness apps on gaming consoles and other VR platforms, and non-VR connected fitness products and services. Defendants argue that members of the FTC's proposed market subjectively consider other VR apps and other fitness offerings

to be competing products, and that several such products also possess the very features—portability, immersion, and pricing models—that the FTC highlights as distinguishing or unique to its proposed market. ***

In this case, the Court finds the FTC has made a sufficient evidentiary showing that there exists a well-defined relevant product market consisting of VR dedicated fitness apps.

a. *Brown Shoe* Analysis

The Court first examines in turn each of the *Brown Shoe* factors, i.e., "practical indicia [such] as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." 370 U.S. at 325.

i. Industry or Public Recognition

The evidence indicates that Defendants and other VR dedicated fitness app makers viewed VR dedicated fitness apps as an economic submarket of VR apps. For example, in April 2021, Within represented that fitness could "expand [the] Quest market" to 28 million additional women over the age of 40. Within also estimated the "addressable market" for the purchase of a Quest headset paired with a monthly Supernatural subscription included 101 million people in North America. Within's contemporaneous view of untapped market segments indicates that a "fitness first" app paired with a VR headset—i.e., a VR dedicated fitness app—would be in a distinct segment of the overall VR market. Likewise, as explained in greater detail in the sections below, Meta repeatedly stated that VR dedicated fitness apps constituted a distinct market opportunity within the VR ecosystem due to their unique uses, distinct customers, and distinct prices. And a representative the VR app company Odders Lab testified that the launch of its VR dedicated fitness app did not diminish sales of its VR rhythm app, acknowledging that its VR fitness app "compete[d] more directly with fitness dedicated applications than gaming applications." Industry companies' internal communications showing frequent distinctions between various categories of applications is "strong[ ] support" of a distinct submarket. *Klein*, 580 F.Supp.3d at 758.

Participants in the broader fitness industry also recognized VR fitness as a "separate economic entity." [redacted]. See *United States v. Microsoft Corp.*, 253 F.3d 34, 53 (D.C. Cir. 2001) (rejecting inclusion of middleware products in the relevant market where middleware was a potential, rather than current, competitor). *** Defendants' evidence shows that there is a broad fitness market that includes everything from VR apps to bicycles. This in no way precludes the existence of a submarket constituting a relevant product market for antitrust purposes. *Brown Shoe*, 370 U.S. at 325. *** The Court therefore acknowledges that VR dedicated fitness apps compete for consumers with every manner of exercise (including gyms, bike rides, and connected fitness), but finds that Defendants and the broader fitness industry recognized VR dedicated fitness apps as an economically distinct submarket.

ii. Peculiar Characteristics and Uses

The evidence indicates that VR dedicated fitness apps have several "peculiar characteristics and uses" in comparison to both other VR apps and non-VR fitness offerings. *Brown Shoe*, 370 U.S. at 325. Even assuming "[a]lmost all VR applications require body movement," VR dedicated fitness apps are "specifically marketed to customers for the purpose of exercise." To support that marketing, VR dedicated fitness apps (unlike other VR apps) are often characterized by

their fitness-specific features, such as trainer-led workout regimens, calorie tracking, and the ability to set and track progress toward fitness goals.

The most "peculiar characteristic" of VR dedicated fitness apps in comparison to non-VR fitness offerings is, of course, the VR technology itself. A VR user is "embodied" in a virtual environment. *** The Court finds that no matter how crisp or accurate a video may be, a two-dimensional screen display is inherently far less immersive than a 360-degree environment. The evidence does not suggest—and the Court is not aware of—any other at-home fitness offering that can transport the user in this way. ***

iii. Unique Production Facilities

The parties did not explicitly develop arguments regarding unique production facilities in support of their positions regarding the relevant product market. The Court notes, however, that VR dedicated fitness apps require a unique combination of production inputs. [redacted]. See Singer Report ¶ 82 ("[T]he talent needed to create true triple-A VR experiences is going to be scarce and really valuable in a few years."); Pruett Hr'g Tr. 286:6–8 ("I have an engineering team ... [who] are a group of veteran engineers who are particular experts in our VR technology and our hardware."). Similarly, most VR companies are unlikely to have the fitness expertise and equipment necessary to create content for VR dedicated fitness apps. See Koblin Hr'g Tr. 650:3–12 ("[I]t seemed highly unlikely to me that [Meta] would get into virtual reality fitness ... honestly at that level of depth, it just seemed extremely unlikely that they would hire coaches and build a green screen studio and dive deep into the psychology of what makes fitness fitness.").

Although relevant markets are generally defined by demand-side substitutability, supply-side substitution also informs whether alternative products may be counted in the relevant market. Supply-side substitution focuses on suppliers' "responsiveness to price increases and their ability to constrain anticompetitive pricing by readily shifting what they produce." *RAG-Stiftung*, 436 F.Supp.3d at 293 (citing *Rebel Oil Co. v. Atlantic Richfield Co.*, 51 F.3d 1421, 1436 (9th Cir. 1995) ("reasonable market definition must also be based on 'supply elasticity'")). Here, as explained above, the evidence indicates that neither general fitness firms nor general VR firms have the production facilities to readily produce a substitute VR dedicated fitness app product, even if VR dedicated fitness apps were to raise prices and make market entry more attractive. That existing companies are not easily able to alter their facilities to produce VR dedicated fitness apps is additional evidence that such apps constitute a distinct product market.

iv. Distinct Customers

The FTC proffered evidence showing that users of VR dedicated fitness apps differ from those of other VR apps along multiple axes. Internal evaluations by Meta and Within found that although overall users of VR apps skewed younger and male, users of VR dedicated fitness apps tended to have an older and more female user base. *** The evidence indicates that VR dedicated fitness apps are targeted more toward "fitness strugglers" who have less fitness experience and more difficulty finding motivating fitness products (rather than to individuals who have long-term or well-developed fitness routines.) *** The Court finds the VR dedicated fitness apps have a customer base that is distinct from those of both other VR apps and several other fitness offerings—particularly connected device offerings from companies like Peloton.

v. Distinct Prices

The pricing of VR dedicated fitness apps likewise differs in at least one key respect from other VR apps and non-VR fitness offerings. The main difference in comparison to the former category is that VR dedicated fitness apps are more likely to have a subscription-based pricing model. As one of Within's founders testified, Within's daily release of new workout content requires ongoing revenue, which is supported by a subscription membership. Milk Hr'g Tr. 671:10–19. Likewise, Meta's Director of Content Ecosystem testified that "subscriptions are particularly good monetization strategies for [fitness] applications" because "fitness applications need to produce content on an ongoing basis ... in order to not get boring." Pruett Hr'g Tr. 269:9–23. However, subscription pricing does not provide a clear basis for delineating between VR dedicated fitness apps and other VR apps. Some VR dedicated fitness apps do not charge subscription fees and other VR apps may also be a good fit for subscription pricing. Nonetheless, the evidence indicates that "the majority of the video game applications on the Quest platform are not a good fit for subscriptions" including because "most of them don't have [an] ongoing content pipeline." Pruett Hr'g Tr. 270:12–17.

Many fitness offerings, whether virtual or physical, use subscription models. As Meta noted in its June 2022 white paper to the FTC, Supernatural's "monthly subscription model ... is similar in structure to other connected fitness solutions included specialized equipment solutions (e.g., Peloton, Mirror, Tonal), paid apps (e.g., Apple Fitness+), and other VR fitness apps (e.g., FitXR, Holofit, VZfit), as well as in-person gym memberships (e.g., Equinox, CrossFit, 24 Hour Fitness)." PX0001, at 2. The FTC argues that despite sharing a subscription pricing model, VR dedicated fitness apps tend to be "far less expensive" than "other at-home smart fitness devices." Mot. 14. The evidence supports this assertion with respect to several connected fitness devices—Supernatural, the most expensive VR dedicated fitness app,[6] costs $399 plus $18.99 per month. There are, however, digital fitness options—generally mobile phone apps—with subscriptions "in the sort of $8 to $12 range."

The Court finds that the VR app and non-VR pricing evidence tilts slightly in favor of the existence of a VR dedicated fitness app market. *** However, in light of the evidence that there exist both other VR apps that can strategically employ a subscription model and non-VR fitness offerings that are comparably priced to VR fitness apps, the overall weight of this factor is lessened.

vi. Sensitivity to Price Changes

The sixth *Brown Shoe* factor evaluates the change in sales of a possible substitute product given a change in the price of products within the relevant market. Because this is in essence the same question posed by the HMT, see *FTC v. Staples*, 970 F.Supp. 1066, 1075 (D.D.C. 1997), the Court will not duplicate its analysis here. Drawing from that analysis, the Court finds this factor to be neutral as to the existence of a VR dedicated fitness app market.

vii. Specialized Vendors

The final *Brown Shoe* factor considers whether a product's distribution requires vendors with specialized knowledge or practices. The FTC has not presented evidence that the VR dedicated fitness app market requires specialized vendors.

[6] Some VR dedicated fitness apps charge a one-time price over $18.99, and another VR dedicated fitness app has a free version as well as a premium version priced equally to Supernatural at $18.99 per month. All other VR dedicated fitness apps charge subscriptions lower than $18.99 per month, and one is free.

* * *

For the reasons explained above, the Court finds that the following *Brown Shoe* "practical indicia" support the FTC's assertion that VR dedicated fitness apps constitute the relevant product market: industry or public recognition; peculiar characteristics and uses; unique production facilities; distinct customers; and (to a lesser degree) distinct prices. These factors indicate that VR dedicated fitness apps present in-market firms with an economic opportunity that is distinct from both other VR apps and other fitness offerings. The Court therefore finds that the FTC has met its burden of showing that VR dedicated fitness apps constitute a relevant antitrust product market. *Brown Shoe*, 370 U.S. at 325–28.

b. Hypothetical Monopolist Test (HMT)

In the interests of thoroughness, the Court also addresses the parties' HMT arguments. The HMT is a quantitative tool used by courts to help define a relevant market by determining reasonably interchangeable products. *Optronic Techs., Inc.,* 20 F.4th at 482 n.1. The test asks whether a "hypothetical monopolist that owns a given set of products likely would impose at least a small but significant and nontransitory increase in price (SSNIP) on at least one product in the market, including at least one product sold by one of the merging firms." See 2010 Merger Guidelines § 4.1.1. If enough consumers would respond to a SSNIP—often calculated as a five percent increase in price—by making purchases outside the proposed market definition so as to make the SSNIP not profitable, then the proposed market is defined too narrowly.

The FTC's economics expert, Dr. Singer, conducted a hypothetical monopolist test on the VR dedicated fitness app market. To inform his analysis of the response to a SSNIP in the VR dedicated fitness app market, Dr. Singer commissioned Qualtrics to conduct "a survey of Supernatural users to determine what fitness apps they perceive to be a reasonably close substitutes to Supernatural and to VR dedicated fitness products generally." Id. ¶ 60. Dr. Singer testified that although an economist's natural path would be to collect data about Supernatural customers' transactions and reactions to any price increases, such data was unavailable here because Supernatural has never changed its price from $18.99 per month. The survey was his "next best" option, and the approach is supported by the 2010 Merger Guidelines. Based on his analysis of the survey, Dr. Singer determined that VR dedicated fitness apps constituted a relevant market. *** These questions, among others, suggest that the survey data underlying Dr. Singer's HMT analysis may not be reliable, which in turn casts doubt on the conclusions to be drawn from the HMT. The Court's reservations about the survey do not change its finding that VR dedicated fitness apps constitute a relevant antitrust product market. Because the Court bases its determination of the relevant product market on its *Brown Shoe* analysis rather than the HMT, it need not determine the validity of Dr. Singer's survey methodology. ***

2. Geographic Market

*** The FTC asserts that the United States is the relevant geographic market, and Defendants do not argue to the contrary. *** Accordingly, the relevant antitrust market for the analysis of the competitive impacts of Meta's acquisition of Within is VR dedicated fitness apps in the United States.

C. Substantial Market Concentration

The FTC has challenged Meta's acquisition of Within on the basis that the merger would substantially lessen potential competition. The Supreme Court has taken note of two species of

potential competition theories: actual potential competition and perceived potential competition. See *United States v. Falstaff Brewing Corp.*, 410 U.S. 526 (1973); *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602 (1974). Although the two theories have different elements and are grounded in different presumptions about the market, they share a common requirement: they have "meaning only as applied to concentrated markets." *Marine Bancorporation*, 418 U.S. at 630–31. Because both doctrines posit that potential competitors can or will soon impact the market, there would be no need for concern if the market is already genuinely competitive.

In assessing whether the relevant market is "substantially concentrated," the Supreme Court sets forth a burden-shifting framework. First, the FTC may establish a prima facie case that the relevant market is substantially concentrated by introducing evidence of concentration ratios. Id. at 631. Once established, the burden shifts to the merging companies to "show that the concentration ratios, which can be unreliable indicators of actual market behavior, did not accurately depict the economic characteristics of the [relevant] market." Id. If the prima facie case is not rebutted, then the market is suitable for the potential competition doctrines.

1. Market Concentration Ratios

The Court finds that the FTC has sufficiently presented evidence using concentration ratios as permitted by *Marine Bancorporation*. Here, the FTC has provided the Herfindahl-Hirschman Index ("HHI")—a widely accepted measure of industry concentration frequently used by courts considering antitrust merger and acquisition actions—for the relevant market. The FTC's 2010 Merger Guidelines provide that a market is considered "moderately concentrated" when the HHI exceeds 1500 and "highly concentrated" when it exceeds 2500. 2010 Merger Guidelines § 5.3.

The FTC's expert, Dr. Singer, calculated the HHI multiple times, accounting for different market definitions and stipulations. Dr. Singer first calculated the HHI by measuring each firm's market share using revenue. This yielded an HHI of 6,917, with Supernatural possessing an 82.4% market share. Dr. Singer also calculated the market's HHI using "total hours spent" and "average monthly active users" as metrics and data collected from the Quest Store. The HHI for "total hours spent" was 6,307; and for "monthly active users" was 3,377.

The Court finds that—regardless of the metrics used—every one of these ratios reflect a market concentration well above what the Merger Guidelines have designated as "highly concentrated." Accordingly, the FTC have made their prima facie showing, and the burden shifts to Defendants to "show that the concentration ratios ... did not accurately depict the economic characteristics of the [relevant] market." *Marine Bancorporation*, 418 U.S. at 631. ***

3. Economic Characteristics of the "VR Dedicated Fitness App" Market

The FTC having established a prima facie case of "substantial concentration" using concentration ratios, the burden now shifts to Defendants to rebut that showing that "the concentration ratios ... did not accurately depict the economic characteristics of the [relevant] market." *Marine Bancorporation*, 418 U.S. at 631. The touchstone inquiry, however, appears to be whether the relevant market "is in fact genuinely competitive." *Marine Bancorporation*, 418 U.S. at 631. The Court addresses each argument that Defendants have raised in rebuttal.

The Court first makes an opening observation that there appear to be at least some characteristics of the market that may be difficult to express with concentration ratios. If nothing else, both parties seem to agree that the VR dedicated fitness app market is a nascent and emerging market, which would be an economic characteristic of the market not fully captured by the

concentration ratios. However, the Court must consider whether those characteristics indicate that the market is genuinely competitive.

Nascency. The Court has received conflicting expert evidence from both parties as to whether nascent markets are more or less vulnerable to coordinated oligopolistic behaviors. Dr. Carlton submits that a nascent market with rapidly evolving products is more difficult to coordinate behaviors, while Dr. Singer has asserted that there is no accepted economic theory to support the segmentation of nascent, adolescent, or mature markets.

The evidence presented suggests that companies in the VR dedicated fitness market do not exhibit revenue or profit-maximizing behaviors, such as price competition. Instead, their strategies appear to be optimized for growth and penetration—even if they end up operating at a loss—with the expectation that those qualities will render them an attractive acquisition target. See, e.g., Milk Hr'g Tr. 736:15–21 ("We haven't focused on profitability. We've focused on growth. And it also is important to potential acquirers ... because they're not buying you for the revenue, they're buying you for some larger strategic reason conceivably."); Zyda Hr'g Tr. 1227:18–22, 1228:15–18 ("[S]tartups that work in the VR space can get acquired, and that's pretty much the dream of almost every startup."). It is unclear to the Court how this departure from conventional profit-maximization strategies—an assumption often made in defining antitrust markets, see 2010 Merger Guidelines § 4.1.1 (noting that the HMT "requires [ ] a hypothetical profit-maximizing firm")—should affect the assessment of genuine competition in this market.[8]

Notwithstanding the experts' robust economics discussions, neither party has presented the Court with a working definition of "nascency," such that it can distinguish a nascent market from a more mature market. Rather, the parties appear to use the "nascency" label—however the lines are drawn—as a proxy for other more observable market descriptions, such as highly differentiated products, unstable market shares, and new entrants. Accordingly, the Court will give limited weight to the fact that the VR dedicated fitness market may be characterized as a nascent market and focus instead on the underlying market indicators.

Market Share Volatility. Dr. Carlton claims that the VR dedicated fitness market exhibits changing market shares, but he does not provide any historical data or evidence that the market shares have changed over time. Instead, Dr. Carlton relies on the fact that none of the apps were in existence five years ago, that new entries are occurring, and on Dr. Singer's data on changes in other. But new entrants do not necessarily result in shifting or deconcentrating market shares, and Defendants have not presented evidence of actual historical shifts in shares for the relevant market here. Moreover, [redacted].

New Entrants. Defendants and Dr. Carlton have made much ado about the incoming entrants and the fact that the FTC's relevant market has effectively doubled since the initiated this litigation. Although the "introduction of new firms and fluid condition of market entry and exit can indicate competitive behavior," the bottom line is that these new entrants have not significantly deconcentrated the market, nor do they suggest a trend towards such deconcentration. *Black & Decker*, 430 F.Supp. at 751.

Barriers to Entry. Defendants rely on the new entrants into the market as evidence that barriers to entry are low. However, the number of new entrants "does not belie the substantial entry

[8] Indeed, the many novel questions of law presented by this case may signal an ill fit between these long-standing antitrust doctrines and the structures of modern technology markets.

barriers characteristic of the [relevant] market." *Black & Decker*, 430 F.Supp. at 751. The evidence presented suggest that barriers to entry are existent but are not insurmountable. As the Court discusses further in this order, there are several ingredients required for a potential entrant considering entry into the VR dedicated fitness app entrant, including financial resources, VR engineering resources, fitness experience and content creation, and studio production capabilities. On the other hand, for most potential entrants into any VR app market, Meta provides grants, software development kits, infrastructure code, and even engineering support to third-party VR app developers.

Having considered the VR dedicated fitness app market's nascency, volatility, new entrants, barriers to entry, and price competition, the Court is inclined to find that Defendants have not rebutted the FTC's prima facie case. The Court certainly appreciates that a nascent market with an emerging technology may have some features and market incentives that are not captured by concentration ratios. However, the evidence does not support a finding that the VR dedicated fitness app market exhibits the characteristics or desirable behaviors of a competitive market. And as the Supreme Court noted in *Falstaff Brewing*, the absence of "blatantly anti-competitive effects" may not necessarily preclude the propriety of potential competition theories, because the high degree of market concentration indicates that the "seeds of anti-competitive conduct are present." 410 U.S. 526, 550. That said, because the Court finds infra that the FTC has not satisfied the other elements of the potential competition theories they have brought, the Court need—and does not—decide whether the Defendants' showing here is sufficient to rebut the FTC's prima facie case on substantial concentration.

D. Actual Potential Competition

The FTC first argues that the Acquisition would substantially lessen competition because it deprives the VR dedicated fitness app market of the competition that would have arisen from Meta's independent entry into the market, a theory known as the "actual potential competition" or "actual potential entrant" doctrine. See, e.g., *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 633 (1974). Although the Supreme Court has twice declined to resolve the doctrine's validity when presented, it has nonetheless identified two essential preconditions before the theory can be applied: (1) the alleged potential entrant must have "available feasible means for entering the [relevant] market other than by acquiring [the target company]"; and (2) those "means offer a substantial likelihood of ultimately producing deconcentration of that market or other significant procompetitive effects." Id. The doctrine has since been applied by Courts of Appeal and district courts alike, though the Ninth Circuit has not yet had an opportunity to provide guidance on the actual potential competition theory.

Although "available feasible means" for entry may be established either by de novo entry or a toehold acquisition, the FTC has not argued that Meta could have entered the relevant market through a toehold acquisition, nor does it identify any company in the relevant market that could have served as such a target. ***Accordingly, the Court will only consider whether Meta had "available feasible means" for entering the relevant market de novo.

1. Threshold Issues

Before discussing the evidence, the Court first turns to three threshold disputes of law between the parties, which are: (1) the continued vitality of the actual potential competition theory; (2) the standard of proof the FTC must meet; and (3) the roles and consideration of objective and subjective evidence.

a. Doctrinal Validity

Throughout this litigation, Defendants have sought to cast doubt as to the very existence of the actual potential competition theory because it has never been fully endorsed by the Supreme Court. Notwithstanding Defendants' doubts, this doctrine has been applied by multiple Circuit Courts of Appeal, e.g., *Yamaha Motor Co. v. FTC*, 657 F.2d 971 (8th Cir. 1981); *United States v. Siemens Corp.*, 621 F.2d 499 (2d Cir. 1980); *FTC v. Atl. Richfield Co.*, 549 F.2d 289 (4th Cir. 1977); the Federal Trade Commission itself, *Altria Group, Inc.*, 2022 WL 622476 (Feb. 23, 2022); *B.A.T. Industries*, 1984 WL 565384 (Dec. 17, 1984); and various district courts, including one that ordered divestiture upon a finding of actual potential competition and whose judgment was affirmed by the Supreme Court. *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226 (C.D. Cal. 1973), aff'd sub nom. *Tidewater Oil Co. v. United States*, 418 U.S. 906 (1974). Given the actual potential competition doctrine's consistent, albeit distant, history of judicial recognition, the Court declines to reject the theory outright and will apply the doctrine as developed. To the extent Defendants' motion to dismiss sought dismissal of the FTC's actual potential competition claim on the basis that it is a "dead-letter doctrine," Defendants' motion is DENIED.

b. Standard of Proof

There is less consistency among courts as to the proper standard of proof by which the FTC must prove its case on actual potential competition, and it is an issue of first impression within the Ninth Circuit. The Fourth Circuit has held that the FTC must establish its case with "strict proof." *Atl. Richfield*, 549 F.2d at 295. The Second Circuit has asked whether a defendant "*would likely have* entered the market in the near future." *Tenneco, Inc. v. FTC*, 689 F.2d 346, 352 (2d Cir. 1982) (emphasis added). The Fifth Circuit adopted the "reasonable probability" standard, which it remarked "signifies that an event has a better than fifty percent chance of occurring [with a] 'reasonable' probability represent[ing] an even greater likelihood of the event's occurrence." *Mercantile Texas Corp. v. Bd. of Governors*, 638 F.2d 1255, 1268–69 (5th Cir. 1981). The Eighth Circuit also appeared to adopt the "reasonable probability." *Yamaha Motor*, 657 F.2d at 977 (defining the inquiry as "would [defendant], absent the joint venture, *probably* have entered the [relevant] market independently") (emphasis added). Finally, the FTC itself has unambiguously adopted a "clear proof" standard. *B.A.T. Industries*, 1984 WL 565384, at *10.

In the absence of guiding Ninth Circuit law, the Court begins with *Brown Shoe's* teaching that Section 7 deals with neither certainties nor ephemeral possibilities but rather "probabilities." *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 323 (1962). In the context of an actual potential competition claim, however, the Court must not only consider the effects of future scenarios where the Acquisition occurs and where it is blocked, but it must also gauge the likelihood—in the second scenario—that the blocked would-be acquirer would enter the relevant market independently. Furthermore, the harm to competition the doctrine aims to prevent is not the loss of present competition but rather the potential loss of a future competitor (the acquiring company). Given the many a priori inferences required by the doctrine, the Court is wary of any inquiry that strays too close to the specters of ephemeral possibilities, yet it must nonetheless ensure the standard does not require the FTC to operate on certainties. The Court accordingly holds that the "reasonable probability" standard—as clarified by the Fifth Circuit to suggest a likelihood noticeably greater than fifty percent—is the standard of proof that the FTC must present.

To the extent Defendants' motion to dismiss is based on the assertion that the correct standard of proof is "clear proof," the Court DENIES Defendants' motion.

c. Objective vs. Subjective Evidence

Finally, the Court reaches the parties' disagreement as to the roles of objective and subjective evidence. The FTC asserts that it may meet its burden using solely objective evidence regarding Meta's "overall size, resources, capability, and motivation." Mot. 18–19. Defendants, meanwhile, strenuously emphasize subjective evidence that Meta never had any plan to enter the Relevant Market de novo and would not do so if the Acquisition is blocked.

Courts have uniformly recognized the highly probative value of objective evidence in evaluating whether a potential entrant is reasonably probable to enter the market de novo; the disagreement only arises as to whether plaintiffs can satisfy their burden using only objective evidence and whether subjective evidence should warrant any consideration. *** Many courts have also consulted both objective and subjective evidence in reaching their conclusions. *** Here, the Court will first consider whether the objective evidence presented by the FTC supports the findings and conclusions necessary to satisfy the actual potential competition doctrine. If the objective evidence is weak, inconclusive, or conflicting, the Court will consult subjective evidence to illuminate the ambiguities left by the objective evidence, with the understanding that the subjective evidence cannot overcome any directly conflicting objective evidence.

2. Objective Evidence

Having disposed of the threshold questions, the Court now proceeds to apply the doctrine. The inquiry can be stated as follows: "Is it reasonably probable that Meta would have entered the VR dedicated fitness app market de novo if it was not able to acquire Within?" "In exploring the feasible means of entry alternative to the challenged acquisition, the court must analyze the incentive and capability of the acquiring firm to enter the relevant market." *Black & Decker*, 430 F.Supp. at 755. The Court thus considers in turn the objective evidence on Meta's capabilities and incentives to enter the VR dedicated fitness app market.

a. Capabilities of Entry

There can be no serious dispute that Meta possesses the financial resources to undertake a de novo entry. Meta has spent over $12.4 billion in the most recent fiscal year on its VR business, and it anticipates investing more in the VR space. Unsurprisingly, Meta also enjoys a deep and talented pool of engineers in its Reality Labs Division, who could provide the technical VR expertise to develop a VR dedicated fitness app should Meta so choose. In fact, Meta maintains a team of "veteran engineers who are particular experts in [Meta's] VR technology and hardware" and who work directly with third-party VR app developers to "improve the quality of their software or help them fix bugs or [ ] polish the experience that the developer is building." Pruett Hr'g Tr. 286:4–12. The Court finds that the objective evidence establishes that Meta has the financial resources and ready access to qualified VR engineers to enter the VR dedicated fitness app market de novo.

But financial and engineering capabilities alone are insufficient to conclude it was "reasonably probable" that Meta would enter the VR dedicated fitness app market. Indeed, Meta seems willing to concede—as is supported by the evidence—that it "does not take a large team or substantial resources to make a successful VR app." Defs.' Findings ¶ 53. Instead, courts often counterbalance undisputed financial capabilities with those capabilities unique to the relevant market, rarely relying solely on the potential entrant's substantial wherewithal. The Court here finds that Meta lacked certain capabilities that are unique and critical to the VR dedicated fitness app market. See PX0127, at 7 (noting that Meta "will need to build 4 new [fitness] functions

that are not part of Facebook's pipelines; Content development, instructors, studio production ..., music rights & technology.").

First and foremost, although Meta has an abundance of VR personnel on hand, it lacks the capability to create fitness and workout content, a necessity for any fitness product or market. See PX0111 ("The answer is content creation.... You need that content variety to serve different ability levels, musical tastes, instructor personalities, etc."), Feb. 23, 2021. As a comparison, Supernatural's VR workouts are led by personal trainers and are optimized for VR activity through consultations with experts holding PhDs in kinesiology and biomechanics. Certainly, this absence is not an insurmountable obstacle; Meta could conceivably circumvent it by partnering with an established fitness brand to provide the fitness content, as Odders Lab did with Les Mills.10 FTC's Findings ¶¶ 123, 148. Regardless of any potential workarounds, the objective fact that Meta presently lacks the capability to create fitness content is, at the very least, probative as to the reasonable probability that Meta would enter the VR dedicated fitness app market de novo.

In addition to fitness content, the evidence also indicates that Meta lacked the necessary studio production capabilities to create and film VR workouts. Once again comparing to Supernatural, Within records daily workout classes in its Los Angeles studio, and its founders have directed several interactive music videos. When Meta employees were strategizing VR fitness investments, they recognized that "studio production (e.g. green screen ops, stereoscopic capture, post processing pipelines)" was a new function that was "not part of Facebook's pipelines."11 PX0127, at 7, Mar. 10, 2021. Contrary to the FTC's suggestion, the Court finds that Meta's acquisition of Armature Studio—a third-party VR studio with expertise in co-developing VR apps—does not provide the necessary studio production capabilities to develop a VR dedicated fitness app. The evidence indicates that Armature is very much a game studio, not a production studio [redacted] PX0527, at 6 (listing Armature's [redacted] The FTC highlights an internal Meta presentation that presented Armature as an acquisition target who could "build a fitness-first product based on Beat Saber x their sports experience.") However, the basis for this suggestion comes not from any prior production studio experience but rather Armature's experience developing the rendered VR video game, Sports Scramble. As with Meta's fitness expertise, its lack of production studio capabilities to film a VR fitness workout is a relevant—though less compelling—factor for the Court's "reasonably probable" consideration.

b. Incentives to Enter

In addition to the objective evidence presented of Meta's capabilities of entering the VR dedicated fitness app market, the Court also considers the objective evidence of Meta's incentives and motivations for entering this market.

Users and Growth. The record is replete with evidence supporting Meta's interest in the VR fitness space. Defs.' Findings ¶ 280 ("[E]mployees at Reality Labs were interested in fitness as a promising VR use case"). First, fitness is a use for VR that appeals to a more diverse population, specifically consumers that are female and older. Id. ¶ 280 (citing testimony). This demographic is notably distinct from the typical VR demographic, which tends to skew younger and more male. Fitness is also "retentive," meaning that users will tend to regularly use the product or app. PX0386, at 12 (fitness apps had a "strong [redacted] retention"), Apr. 12, 2022. Meta's internal data also indicated that "deliberate fitness apps" were the "fastest growing segment" with [redacted] year-over-year growth. These promising demographic, use, and growth metrics

are especially important to Meta, because it has "bet[ ] on VR technology as a general computing platform to join today's PCs, laptops, smartphones, and tablets." Defs.' Findings ¶ 44.

Although they undergird Meta's undisputed interest in VR fitness, the aforementioned factors provide limited probative value in assessing Meta's likelihood to enter the VR dedicated fitness app market itself. As the Court established earlier in this section, the relevant inquiry is whether it is "reasonably probable" that Meta would have entered the VR dedicated fitness app market de novo, not whether Meta was excited about or interested in more generally investing in VR fitness. Meta's interest in the promising VR fitness app metrics—diverse appeal, strong user retention, rapid growth—stems from the potential for broader VR adoption and market penetration. And Meta, as a competitor in the VR headset market, benefits from that growth so long as high-quality VR fitness apps exist in the VR ecosystem; Meta need not itself be a player in that ecosystem. This mutually beneficial relationship between the VR platform and third-party VR apps distinguishes this case from other potential competition cases where potential entrants are typically incentivized to enter the relevant market because they are not capturing any of the neighboring market's growth or profitability. The Court accordingly does not find that these specific features of the VR dedicated fitness app market increase the probability that Meta would enter the market de novo, because Meta would enjoy those incentives even if it remained outside the relevant market and provided funding or technical support for in-market VR fitness app developers, as it already does.

Hardware Integration. Apart from the incentives arising from the VR fitness market itself, the evidence also reflects one other incentive that arises from Meta's direct participation in the relevant market. Specifically, entering the VR dedicated fitness app market with its own app would facilitate Meta's subsequent development of fitness-related VR hardware. This is an incentive to "first-party" entry that is acknowledge across multiple instances of internal contemporaneous correspondence at Meta. That said, the evidence also suggests that de novo entry is not strictly necessary to develop fitness hardware, though independent entry into the market could streamline that development.

Profitability. Finally, there is some evidence of the relevant market's profitability and that it [redacted] PX0386, at 12. The profitability of the relevant market is unsurprisingly a relevant incentive that many courts consider. While this factor is often quite salient in other potential competition cases, it is somewhat muted here, [redacted]. PX0062 ("Milk Dep.") 19:8–12. Of course, a market's current profitability does not reflect its future profitability, especially if that market is exhibiting rapid growth as the VR dedicated fitness app market does here. Nonetheless, the fact that [redacted] would indicate that the profitability of the relevant market warrants less consideration than it otherwise would.

* * *

Having reviewed and considered the objective evidence of Meta's capabilities and incentives, the Court is not persuaded that this evidence establishes that it was "reasonably probable" Meta would enter the relevant market. Meta's undisputed financial resources and engineering manpower are counterbalanced by its necessary reliance on external fitness companies or experts to provide the actual workout content and a production studio for filming and post-production. Furthermore, the record is inconclusive as to Meta's incentives to enter the relevant market. There are certainly some incentives for Meta to enter the market de novo, such as a deeper integration between the VR fitness hardware and software. However, it is not clear that Meta's readily apparent excitement about fitness as a core VR use case would necessarily translate to an intent to build its own dedicated fitness app market if it could enter by acquisition.

On balance, the objective evidence does not so "strongly point to the feasibility of entry de novo" that the Court should decline to consider subjective evidence of intent. *Falstaff Brewing*, 410 U.S. at 570.

3. Subjective Evidence

The Court first notes that it will accord little weight to subjective evidence and statements provided by Meta employees during the course of this litigation. Although they are relevant, entitled to some weight, and no doubt offered by persons of character, the bias affiliated with such ex post facto testimony is widely recognized and unavoidable. In reviewing the subjective evidence in the record, the Court will refer primarily to contemporaneous statements made by Meta employees.

The record reveals certain documents created contemporaneously by Meta employees that appear to set forth Meta's overall third-party VR investment strategy, along with individualized analyses of various VR fitness investment options. *** The evidence contained in these strategy documents is consistent—Meta's subjective motivations to enter the relevant market were primarily to (1) better develop VR fitness hardware or (2) ensure the continued existence of a high-quality VR fitness app in the market. The Court notes that these incentives would apply to both entry by acquisition and entry de novo, though perhaps not with equal force.

First, this subjective evidence corroborates the objective evidence that Meta primarily wanted to be a first-party firm in the VR dedicated fitness market so it could improve its VR fitness hardware (e.g., headsets, heart monitor, wrist straps). Second, the evidence also indicates that Meta would want to enter the VR dedicated fitness app market if the availability of VR fitness apps was at risk of becoming constrained and, therefore, Meta could ensure that at least one high-quality VR fitness app remained in the market. Specifically, as early as March 2021, Meta employees were expecting Apple to "lock in" VR fitness content to be exclusive with Apple's VR hardware. This incentive was also corroborated by contemporaneous communications. The evidence also suggests that this incentive was the primary animating factor that ultimately compelled Meta to pursue Within as an acquisition.

Meta's prior ventures into other VR app markets also do not support a subjective intention or proclivity to build its own apps as opposed to an acquisition. Courts have considered a potential entrant's history of acquisitions and expansions in determining its likelihood of de novo entry. The evidence indicates that Meta has tended to build its own VR app where the experience did not call for specialized or substantive content, e.g., Horizon Worlds (a world-building app where other users can create worlds in VR), Horizon Workrooms (a productivity app), Horizon Venues (a live-events app), Horizon Home (social networking app). Meanwhile, Meta has acquired other VR developers where the experience requires content creation from the developer, such as VR video games, as opposed to an app that hosts content created by others. With respect to fitness, the Court finds that VR dedicated fitness is more akin to a gaming app—where the emphasis is on the content created or provided by the developer—than a browser or world-building app, where the value is derived from the users' own creativity rather than the developers'. Accordingly, based on Meta's past entries into VR app markets, the evidence would suggest an interest in entry by acquisition instead of entry de novo.

But even more pertinent than the record of Meta's past entries into VR app markets is the evidence that Meta had consciously considered and appeared doubtful of the proposition to build its own independent VR fitness app. The pre-read strategy document prepared for Mark Rabkin's attention contains a separate section that "[i]t will be hard to build Fitness from

scratch." Specifically, a VR fitness app would require Meta to [redacted] Id. The document also recognized that Meta would have to "build new kinds of expertise at the intersection of software, instructor-led fitness, music, media." Id. The decision not to build Meta's own VR fitness app is corroborated by the lack of any other contemporaneous discussion on the topic. The record does, however, indicate that Meta attempted to gauge whether it could expand Beat Saber together with a fitness partner, a prospect the Court delves into further below.

In sum, the subjective evidence indicates that Meta was subjectively interested in entering the VR dedicated fitness app market itself, either for hardware development or defensive market purposes. However, the Court again notes that these incentives would support both market entry by acquisition and de novo, but the Court's inquiry is only concerned with the feasibility of de novo entry. For instance, even though Meta's concern about [redacted] was an incentive to acquire Within, that incentive does not apply with equal force [redacted]. And, as the Court elaborates below, the evidence shows that all these factors—Meta's capabilities and incentives, both objective and subjective—did not result in Meta ever seriously contemplating a de novo entry, i.e., building its own VR fitness app.

4. Identified Means of Entry

Up to this point, the Court has only addressed Meta's capabilities, incentives, and intent to enter the VR dedicated fitness app market in the abstract. However, an assessment of the probability and feasibility of a hypothetical de novo entry would not be complete without addressing the actual means of entry that Meta considered. Nevertheless, the FTC has implied that the Court may infer that Meta would have entered the market de novo—irrespective of its actual plans for entry—using "available feasible means" unbeknownst to the parties or the Court. See FTC Closing Hr'g Tr. 1494:16–18 ("We don't have to show that Meta actually had a subjective intention to enter the market."). To the extent the FTC implies that—based solely on the objective evidence of Meta's resources and its excitement for VR fitness—it would have inevitably found and implemented some unspecified means to enter the market, the Court finds such a theory to be impermissibly speculative. *** [I]nsofar as the FTC implies Meta could overcome its lack of fitness experience and content creation by hiring experts or partnering with a fitness brand, the suggestion reflects "the kind of unsupported speculation" rejected in *Tenneco*. 689 F.2d at 354 (rejecting the FTC's "conclusion that [potential entrant] would have entered the market de novo with the aid of a license" for the necessary technology).

The Court here does not hold that every case of actual potential competition will require consideration of a potential entrant's actual and subjective plans for entry. See *Falstaff Brewing*, 410 U.S. at 565 ("We have certainly never suggested that subjective evidence of likely future entry is required to make out a § 7 case.") (Marshall, J., concurring). Nor does the Court suggest that a particular entry strategy can only be "reasonably probable" and "feasible" if it has reached a certain inflection point in the firm's decision-making process. Such a conclusion would incentivize corporate gamesmanship and reward decisionmakers for reaching merger decisions hastily without exploring non-merger alternatives. See generally id. at 563–71 (Marshall, J., concurring). However, where the objective evidence is "weak or inconclusive" and does not "strongly point[ ] to the feasibility of entry de novo," id. at 570, it is incumbent on the Court to consider the potential entrant's actual plans of entry for the purposes of ensuring that Section 7 enforcement does not veer into the realm of ephemeral possibilities. As applied here, the Court holds

that the FTC may not rest solely on evidence of Meta's considerable resources and the company's clear zeal for the VR dedicated fitness app market as a whole; the evidence must show that Meta had some feasible and reasonably probable path to de novo entry.

Turning then to the evidence, the record indicates that Meta would only have entered by acquisition or a Beat Saber collaboration with a fitness content creator; the Court is unaware of any evidence that Meta considered building a VR fitness app on its own. In the strategy document that was prepared for the meeting with Mark Rabkin, Meta personnel had outlined and analyzed five options for investing in VR fitness: (1) acquire Within and Supernatural; (2) acquire [redacted]; (3) expand Beat Saber into deliberate fitness, likely by partnering with Peloton; (4) increase funding for development of third-party VR fitness apps; and (5) do nothing and maintain the status quo. Notably, even though Meta personnel had considered the option to increase third-party funding without entering the market and an option to do nothing as comparison, there was never an option for Meta to build its own VR dedicated fitness app to enter the market de novo.

Given the degree of analysis evident from these strategy documents, the Court finds that Meta had only considered the acquisition of Within, the acquisition of [redacted], and the partnership of Beat Saber with Peloton as feasible means to enter the relevant market. These three options, therefore, comprise the universe of "available feasible means" that the Court will consider for the purposes of the FTC's actual potential competition claim.

a. Entry by Acquisition

Meta's first two means of entry into the relevant market were both entries by acquisitions, either [redacted]. The evidentiary record indicates that these two options were both among the earliest proposals presented to Mark Zuckerberg, as well as the last two considered before Meta decided to acquire Within.

The evidence supports a finding that, but for its pursuit of Within as an acquisition, there was a reasonably probability [redacted]. However, the inquiry before the Court is not whether it was reasonably probable that Meta [redacted]. The FTC has argued almost exclusively that Meta's "available feasible means" of entering the relevant market is by de novo entry, not acquisition. The FTC also does not take the position [redacted] that could have also conceivably had procompetitive effects. See, e.g., Mot. 21 (noting that Meta's entry into the market would have "introduce[ed] a strong, well-established new rival to Supernatural and FitXR"); see also *Marine Bancorporation*, 418 U.S. at 625 (defining a toehold acquisition as a "small existing entrant").

Accordingly, the Court does not consider the "reasonable probability" that Meta could have entered the VR dedicated fitness market [redacted] as an "available feasible means" for the purposes of the actual potential competition analysis.

b. Entry by Beat Saber–Peloton Partnership

This brings us to the final means—and the FTC's main theory—by which Meta could have entered the VR dedicated fitness market: expanding its existing rhythm game app Beat Saber into dedicated fitness and partnering with a fitness brand. The FTC claims that Meta scrapped this Beat Saber proposal once it learned that Within was at risk of being acquired by Apple. However, this theory is neither supported by the contemporaneous remarks regarding the Beat Saber proposal nor the timing of the subsequent investigation into this proposal.

First, the evidentiary record is unclear as to what exactly the widely referenced Beat Saber–Peloton proposal would even look like. On some occasions, Stojsavljevic—the proposal's primary advocate—refers to it as a "brand licensing w/ Peloton" or a "co-branding ... Peloton mode inside Beat Saber." PX0144, at 1, Mar. 8, 2021; PX0407, at 1, Mar. 15, 2021. On other occasions, Stojsavljevic considers whether the proposal would be a separate Quest Store app. Michael Verdu—another proponent of expanding Beat Saber into fitness—also recalled that the proposal never reached a point of "understanding what that partnership would look like." Verdu Dep. 201:14–23 ("[I]s it a Peloton-branded headset? Is it Peloton-branded content inside of our headset? Like we didn't even get to the point where we were exploring at that level of detail."). *** Second, the Beat Saber–Peloton proposal did not enjoy uniform or even widespread support among the Meta personnel who were researching VR fitness opportunities. *** Third, the timeline and dearth of contemporaneous internal discussions on the Beat Games–Peloton proposal is inconsistent with the FTC's narrative that the Within acquisition derailed an otherwise full-speed effort to explore the Beat Games proposal.

*** For all these reasons, the Court finds that it was not "reasonably probable" that Meta would have repositioned their top-selling VR app, Beat Saber, into a dedicated fitness app, even assuming that it could have identified a partner willing to provide VR fitness content.

* * *

After reviewing the evidentiary record and the parties' arguments, the Court concludes that it is not "reasonably probable" that Meta would enter the market for VR dedicated fitness apps if it could not consummate the Acquisition. Though Meta boasts considerable financial and VR engineering resources, it did not possess the capabilities unique to VR dedicated fitness apps, specifically fitness content creation and studio production facilities. As a VR platform developer, Meta can enjoy many of the promising benefits of VR fitness growth without itself intervening in the VR fitness app market. Finally, the proposal for Meta to expand Beat Saber into fitness was not "reasonably probable" for a whole host of reasons, in addition to the aforementioned obstacles to Meta's de novo entry.

Accordingly, the Court finds that Meta did not have the "available feasible means" to enter the relevant market other than by acquisition. Because the FTC has not met its burden on this element, the Court does not proceed to the issue of whether Meta's de novo entry was substantially likely to deconcentrate or result in other procompetitive effects in the relevant market.

In so finding, the Court concludes that the FTC has failed to establish a likelihood that it would ultimately succeed on the merits as to its Section 7 claim based on the actual potential competition theory.

E. Perceived Potential Competition

In addition to its claim that the Acquisition would lessen competition pursuant to the actual potential competition theory, the FTC also claims that the Acquisition violates Section 7 under the perceived potential competition theory. Under this theory, the FTC argues that the Acquisition would eliminate the competitive influence that Meta exerts on firms within the relevant market by virtue of its presence on the fringes of the market. See, e.g., *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 559–60 (1973).

To prevail on a claim that the Acquisition would have eliminate perceived potential competition, the FTC must establish—in addition to showing a highly concentrated market, see Section III.C—the following: (1) Meta possessed the "characteristics, capabilities, and economic incentive to render it a perceived potential de novo entrant"; and (2) Meta's "premerger presence on

the fringe of the target market in fact tempered oligopolistic behavior on the part of existing participants in that market." *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 625 (1974). The same objective facts regarding Meta's capability of entering the market under an actual potential competition theory are also "probative of violation of § 7 through loss of a procompetitive on-the-fringe influence." *Falstaff Brewing*, 410 U.S. at 534 n.13. However, whereas a claim for actual potential competition may consider the potential entrant's intent to enter the market, a perceived potential competition claim ignores the potential entrant's subjective intent to enter the market and instead focuses on the subjective perceptions of the in-market firms.

1. Potential Entrant Characteristics

In evaluating the FTC's perceived potential competition claim, the Court considers the same objective evidence regarding Meta's capabilities and incentives to enter the relevant market. Unsurprisingly, and for the same reasons explained above, the objective evidence in the record is insufficient to support a finding that it was "reasonably probable" Meta would enter the relevant market for purposes of the perceived potential competition doctrine.

Nor does the subjective evidence of the in-market firms' perceptions move the needle on this point. Although the FTC produced some evidence that Within co-founders and employees had expressed concern that Beat Saber or its fans could create a fitness version to compete with Supernatural, these statements are mostly stale with some significantly preceding the relevant time period. *** In summary, the evidentiary record indicates that [redacted] This finding, in addition to the overall absence of testimony from other in-market firms, would suggest that the FTC has failed to demonstrate that it was "reasonably probable" that Meta was perceived as a potential competitor into the relevant market. However, even if the FTC had prevailed on this element, the Court is convinced that it did not satisfy the second required showing for a perceived potential competition claim.

2. Tempering Effect

Under the second element of the perceived potential competition claim, the FTC must establish that Meta's "premerger presence on the fringe of the target market *in fact* tempered oligopolistic behavior on the part of existing participants in that market." *Marine Bancorporation*, 418 U.S. at 624–25 (emphasis added). In other words, the FTC must present evidence that it was "reasonably probable" that Meta's presence as a potential competitor had a direct effect on the firms in the VR Dedicated Fitness market.

In setting forth this standard, the Court rejects the FTC's suggestion that it need only provide "[p]robabilistic proof of 'likely influence' on existing competitors." Mot. 21. This interpretation arises from the language used by the Supreme Court in a footnote from *Falstaff Brewing*, specifically "[t]he Government did not produce *direct evidence* of how members of the [relevant] market reacted to potential competition from [the potential entrant], but circumstantial evidence is the lifeblood of antitrust law." 410 U.S. at 534 n.13 (emphasis added). The Court reads this language to mean the FTC need not provide direct evidence of Within adopting its conduct to account for Meta's presence (e.g., a hypothetical internal email at Within expressly communicating fear of Meta's imminent entry and taking actions in anticipation). Direct evidence, however, is distinguishable from evidence of a direct effect experienced within the relevant market (e.g., circumstantial evidence that Within reduced prices shortly after Meta's hypothetical public announcement that it was looking into the VR Dedicated Fitness market). *** [T]he FTC must

produce some evidence—direct or circumstantial—that Meta's presence had a direct effect on the firms in the relevant market.

Under this standard, the FTC's evidence on this element is insufficient. The only evidence that suggests any kind of effect in the relevant market is that Within cited, as reasons not to reduce headcount at Within shortly before launching Supernatural, [redacted]. As noted above, Within and Supernatural had not even entered the relevant market at the time of this presentation. Consequently, this cannot be evidence of a direct effect within the VR dedicated fitness app market; rather, they are the preemptive considerations of a firm contemplating entry into the market. Moreover, the evidence indicates that Within had subsequently changed its perception of Beat Saber and Meta as potential entrants after it had entered the market. Other than this presentation, the FTC suggests that Meta had affected Within based on internal Within communications that they "expect [to] have more competition soon. We need to keep innovating from the foundation we've built." PX0621, at 2, Dec. 8, 2020. Although this is circumstantial evidence that Within was concerned about hypothetical potential entrants, absent further evidence, this email is no basis to infer the critical nexus, i.e., that Meta was one such potential entrant.

The Court recognizes that its interpretation of the "effect" requirement sides with Defendants' position set forth in their Motion to Dismiss. Although the Court ultimately determines that the FTC's evidence has not established that Meta's presence had a direct effect on Within's behavior, it finds that the FTC's pleadings are sufficient. The FTC had alleged that Within was "concerned about making any moves that would hurt its ability to compete against Meta as a potential entrant" and provided an example. At the pleadings stage, this satisfies their burden. Accordingly, the Court DENIES Defendants' motion to dismiss the perceived potential competition claim.

In summary, the Court finds that the objective evidence does not support a reasonable probability that firms in the relevant market perceived Meta as a potential entrant. Even if it did, the Court finds that there is no direct or circumstantial evidence to suggest that Meta's presence did in fact temper oligopolistic behavior or result in any other procompetitive benefits. Accordingly, the FTC has not demonstrated a likelihood of ultimate success as to its Section 7 claim arising from perceived potential competition.

F. Balancing of Equities

Because the FTC has not demonstrated a likelihood of ultimate success on the merits per the first § 13(b) element, the Court need not proceed to the balance the equities in the second portion of the § 13(b) inquiry.

IV. CONCLUSION

Based on the foregoing reasons, the Court ORDERS as follows:

1. Defendants' Motion to Dismiss is DENIED;
2. Defendants' Motion to Strike is DENIED AS MOOT; and
3. Plaintiff's Motion for Preliminary Injunction is DENIED.

IT IS SO ORDERED.

Illumina, Inc. v. Federal Trade Commission

88 F.4th 1036 (5th Cir. 2023)

EDITH BROWN CLEMENT, CIRCUIT JUDGE: The Federal Trade Commission determined that Illumina, Inc.'s acquisition of Grail, Inc. violated Section 7 of the Clayton Act, and therefore ordered that the merger be unwound. Because the Commission applied an erroneous legal standard at the rebuttal stage of its analysis, we VACATE the Commission's order and REMAND for further proceedings.

I.

A.

Founded in 1998, Illumina is a publicly traded, for-profit corporation that specializes in the manufacture and sale of next-generation sequencing ("NGS") platforms. NGS is a method of DNA sequencing that is used in a variety of medical applications. In September 2015, Illumina founded a wholly-owned subsidiary, Grail, which was so-named because its goal was to reach the "Holy Grail" of cancer research—the creation of a multi-cancer early detection ("MCED") test that could identify the presence of multiple types of cancer from a single blood sample.

Grail was incorporated as a separate entity in January 2016. Illumina maintained a controlling stake in the company until February 2017 when, to raise the capital needed to move Grail's MCED test from concept to clinical trials, Illumina decided to bring in outside investors. This spin-off reduced Illumina's equity stake in Grail to 12%. By September 2020, Grail had raised $1.9 billion through a combination of venture capital and strategic partners. Then, on September 20, 2020, Illumina entered into an agreement to re-acquire Grail for $8 billion, with the goal of bringing Grail's now-developed MCED test to market.

The MCED-test industry had changed dramatically between February 2017—when Illumina spun Grail off—and September 2020—when Illumina agreed to re-acquire Grail. Grail's MCED test—which it named Galleri—had acquired a breakthrough device designation from the U.S. Food and Drug Administration ("FDA"), and Grail had published promising results from a clinical study concerning the initial version of Galleri and was undergoing additional clinical studies to validate its updated version. Meanwhile, Thrive Earlier Detection Corporation had announced that the initial version of its own MCED test—CancerSEEK—had also been clinically validated. And other MCED tests—including Singlera Genomics, Inc.'s PanSeer—were in development. All of the MCED tests in development—including Galleri, CancerSEEK, and PanSeer—relied on Illumina's NGS platforms for sequencing, and there were no available alternatives.

Given their reliance on Illumina's NGS platforms, Illumina's customers—both within and without the MCED-test industry—expressed concern about whether they would be able to continue to purchase Illumina's NGS products post-merger on the same terms and conditions as pre-merger. So, Illumina developed a standardized supply contract (the "Open Offer") that it made available to all for-profit U.S. oncology customers on March 30, 2021. The Open Offer is irrevocable, may be accepted by a customer at any time until August 18, 2027, became effective as of the merger's closing, and will remain effective until August 18, 2033. Among other terms, the Open Offer requires Illumina to provide its NGS platforms at the same price and with the same access to services and products that is provided to Grail.

Grail first offered Galleri for commercial sale in April 2021 as a laboratory-developed test.[1] While Galleri is the only NGS-based MCED test currently available on the market, others expect to go to market soon and to directly compete with Galleri. Illumina's NGS platforms are still the only means of sequencing MCED tests and will remain so for the foreseeable future.

B.

On March 30, 2021—the same day Illumina released its Open Offer—the FTC's Complaint Counsel issued a complaint alleging that the Illumina-Grail merger agreement, if consummated, would violate Section 7 of the Clayton Act.[2] The merger was, in fact, consummated on August 18, 2021, but, due to ongoing regulatory review by the European Commission, Illumina held—and continues to hold—Grail as a separate company.

The FTC's Chief Administrative Law Judge ("ALJ") convened an evidentiary hearing on August 24, 2021. In the coming months, the parties developed an extensive evidentiary record consisting of over 4,500 exhibits and the live or deposition testimony of fifty-six fact witnesses and ten experts. Based on this record, the ALJ issued his initial decision on September 1, 2022. The ALJ found that Complaint Counsel failed to prove that the merger was likely to cause a substantial lessening of competition in the market for the research, development, and commercialization of MCED tests. Specifically, the ALJ concluded that Complaint Counsel had not shown a likelihood that Illumina would foreclose against Grail's rivals because Grail has no current competitors in the market to be foreclosed, the MCED tests in development would not be a good substitute for Grail's test, and any foreclosing activities would cause harm to Illumina's NGS-sales business. In any event, the ALJ determined, the Open Offer "effectively constrains Illumina from harming Grail's alleged rivals and rebuts the inference that future harm to Grail's alleged rivals, and thus future harm to competition, is likely."

Complaint Counsel appealed the ALJ's decision to the Commission, and, after oral argument, the Commission reversed. Upon its de novo review, the Commission concluded that the merger was likely to substantially lessen competition in the market for the research, development, and commercialization of MCED tests. The Commission found that the ALJ had factually erred in discussing the capabilities of Grail and other MCED tests in development, improperly focused on foreclosure harm to MCED tests on the market today as opposed to tests in development, and failed to recognize that any losses to Illumina's NGS sales would be more than offset by Illumina's expected gains in clinical testing. The Commission also held that the Open Offer was a remedy that should not be factored into the liability analysis. But the Commission evaluated the Open Offer as rebuttal evidence anyway, finding that the Open Offer failed to rebut Complaint Counsel's prima facie case because it would not "eliminate the effects" of the merger. Finally, the Commission rejected Illumina's constitutional defenses. The Commission therefore ordered Illumina to divest Grail. Illumina now appeals.

[1] The FDA does not review or validate safety or efficacy data of tests sold as laboratory-developed tests. Rather, independent labs self-certify the quality of their own product under the regulatory framework set forth under the Clinical Laboratory Improvement Amendments. For this reason, laboratory-developed tests have lower adoption rates than FDA-approved tests.

[2] For clarity, we use "FTC" when discussing the Federal Trade Commission generally, "Complaint Counsel" when describing the FTC's actions as a party to these adversary proceedings, and "Commission" when referring to the FTC's actions as an adjudicatory body.

II.

We review the Commission's decision, not that of the ALJ. *Impax Laboratories, Inc. v. FTC*, 994 F.3d 484, 491 (5th Cir. 2021). All legal questions pertaining to the Commission's order are reviewed de novo while the Commission's factual findings are reviewed for "substantial evidence." *Chicago Bridge & Iron Co. N.V. v. FTC*, 534 F.3d 410, 422 (5th Cir. 2008). Under this standard, we are bound by the Commission's factual determinations so long as they are supported by "such relevant evidence as a reasonable mind might accept as adequate." *FTC v. Ind. Fed'n of Dentists*, 476 U.S. 447, 454 (1986) (citation omitted). This is so "even if suggested alternative conclusions may be equally or even more reasonable and persuasive." *N. Tex. Specialty Physicians v. FTC*, 528 F.3d 346, 354 (5th Cir. 2008) (internal quotation marks and citation omitted).

III.

Because, as explained below, resolution of Illumina's statutory claims does not "obviate the need to consider" the constitutional issues raised, *United States v. Wells Fargo Bank*, 485 U.S. 351, 354 (1988), we begin with Illumina's four constitutional challenges. Each is foreclosed by Supreme Court authority.

A.

First, Illumina contends that the Commission proceedings were the result of an unconstitutional delegation of legislative power in violation of Article I. Specifically, Illumina claims that Congress delegated to the FTC the power to decide whether to bring antitrust enforcement actions in an administrative proceeding, pursuant to Section 5(b) of the FTC Act, 15 U.S.C. § 45(b), or to bring this same enforcement action in an Article III court pursuant to Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), without providing "any guidance for purposes of deciding between administrative proceedings and federal court."

But as the Supreme Court recently clarified, federal-court actions under Section 13(b) are not the same as administrative proceedings under Section 5(b). Rather, when the FTC goes to federal court under Section 13(b), it is limited to pursuing injunctive relief; to obtain other forms of relief, such as monetary damages, the FTC must resort to administrative proceedings under Section 5(b). *AMG Cap. Mgmt., LLC v. FTC*, 141 S.Ct. 1341, 1348-49 (2021).

Moreover, to the extent that Illumina argues that Congress's directive for the FTC to commence an enforcement action when such a proceeding would be "in the interest of the public" does not provide an "intelligible principle," we disagree. To the contrary, the Supreme Court has repeatedly "found an 'intelligible principle' in various statutes authorizing regulation in the 'public interest.'" *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 474 (2001) (collecting cases).

B.

Second, Illumina claims that the FTC unconstitutionally exercised executive powers while insulated from presidential removal in violation of Article II. But *Humphrey's Executor v. United States* held that the FTC's enabling act did not run afoul of Article II because, essentially, the FTC was vested with quasi-legislative/quasi-judicial authority rather than purely executive authority. 295 U.S. 602, 626-32 (1935). While the Supreme Court has cabined the reach of *Humphrey's Executor* in recent years, it has expressly declined to overrule it. See *Seila Law LLC v. CFPB*, 140 S.Ct. 2183, 2206 (2020); accord *Collins v. Yellin*, 141 S.Ct. 1761, 1783 (2021). Thus, although the FTC's powers may have changed since *Humphrey's Executor* was decided, the question of whether

the FTC's authority has changed so fundamentally as to render *Humphrey's Executor* no longer binding is for the Supreme Court, not us, to answer.

C.

Third, Illumina argues that the FTC violated Illumina's due process rights by serving as both prosecutor and judge. But the Supreme Court has held that administrative agencies can, and often do, investigate, prosecute, and adjudicate rights without violating due process. *Withrow v. Larkin*, 421 U.S. 35, 47, 56 (1975). Of course, if there is evidence that a decisionmaker has "actual bias" against a party, that raises due process concerns. Id. at 47. But courts cannot "presume bias" merely from the institutional structure of an agency. *United States v. Benitez-Villafuerte*, 186 F.3d 651, 660 (5th Cir. 1999). Moreover, this court has already rejected the argument that the FTC's structure, which combines prosecutorial and adjudicative functions, deprives parties of due process. *Gibson v. FTC*, 682 F.2d 554, 559-60 (5th Cir. 1982). Illumina points to no evidence of actual bias and instead takes issue with the FTC's structural design. Whatever merit this argument may have, it is barred by precedent.

D.

Fourth, Illumina claims an equal-protection violation because there is no rational basis for allocating certain antitrust enforcement actions to the FTC and others to the Department of Justice. But rational-basis review is a low bar that is satisfied so long as "there is any reasonably conceivable state of facts that could provide a rational basis for the classification." *FCC v. Beach Commc'ns, Inc.*, 508 U.S. 307, 313 (1993). Here, the FTC and the DOJ have an "interagency clearance process" which allocates antitrust investigations to one agency or the other based primarily on which agency has "expertise in [the] particular industry or market" of the transaction under review. U.S. Gov't Accountability Off., GAO-23-105790, DOJ and FTC Jurisdictions Overlap, But Conflicts Are Infrequent (2023). This is undoubtedly a rational basis for giving one agency the lead over the other.

IV.

We turn now to Illumina's Clayton Act challenge. Section 7 of the Clayton Act prohibits mergers and acquisitions "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition." 15 U.S.C. § 18. To evaluate Section 7 claims, courts apply a burden-shifting framework. See, e.g., *Chicago Bridge*, 534 F.3d at 423; *United States v. AT&T Inc.*, 916 F.3d 1029, 1032 (D.C. Cir. 2019) (applying burden-shifting framework to Section 7 claim concerning vertical merger). Complaint Counsel bears the initial burden to "establish a prima facie case that the merger is likely to substantially lessen competition in the relevant market." *AT&T*, 916 F.3d at 1032. If a prima facie case is made, "the burden shifts to the defendant to present evidence that the prima facie case inaccurately predicts the relevant transaction's probable effect on future competition or to sufficiently discredit the evidence underlying the prima facie case." Id. (internal quotation marks and citations omitted). If such a rebuttal is provided, "the burden of producing additional evidence of anticompetitive effects shifts to the government, and merges with the ultimate burden of persuasion, which remains with the government at all times." Id. (citation omitted). This framework is applied flexibly—"in practice, evidence is often considered all at once and the burdens are often analyzed together." *Chicago Bridge*, 534 F.3d at 424.

A.

We start by reviewing Complaint Counsel's prima facie case. The Commission concluded that Complaint Counsel had carried its burden of (1) identifying the relevant product and geographic market as the market for the research, development, and commercialization of MCED tests in the United States, and (2) showing that the Illumina-Grail merger was likely to substantially lessen competition in this market. We find that these conclusions are supported by substantial evidence.

1.

The first step of the prima facie case requires defining the relevant market—that is, the "line of commerce" and the "section of the country" where the relevant competition occurs. 15 U.S.C. § 18; see also *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 618 (1974) ("Determination of the relevant product and geographic markets is a necessary predicate to deciding whether a merger contravenes the Clayton Act." (internal quotation marks and citation omitted)). The parties agree with the Commission's finding that the relevant geographic market is the United States but disagree as to its determination that the relevant product market is "the research, development, and commercialization of MCED tests."

In antitrust law, the relevant product market is "the area of effective competition," which is typically the "arena within which significant substitution in consumption or production occurs." *Ohio v. Am. Express Co.*, 138 S. Ct. 2274, 2285 (2018) (internal quotation marks and citation omitted). However, the relevant product market must "correspond to the commercial realities of the industry." *Brown Shoe Co. v. United States*, 370 U.S. 294, 336 (1962) (internal quotation marks and citation omitted). So, "courts should combine different products or services into a single market" when necessary to reflect these realities. *Ohio*, 138 S.Ct. at 2285 (alteration adopted) (internal quotation marks and citation omitted).

To determine the boundaries of the relevant product market, the Commission relied on what is known as the "*Brown Shoe*" methodology, which looks to certain "practical indicia" of market demarcation, such as "industry or public recognition of the [market] as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors." *Brown Shoe*, 370 U.S. at 325.

First, the Commission found that MCED tests have "peculiar characteristics and uses" as compared to other current standard-of-care cancer-screening tests. As the Commission explained, cancer is traditionally detected through more invasive procedures, like a tissue biopsy, colonoscopy, or mammography, which often screen for only one type of cancer and only at a later stage of cancer development.

Second, the Commission found that MCED tests are designed for distinct customers—asymptomatic patients as opposed to those with symptoms or a history of cancer. And, as the Commission noted, MCED test developers expect to market their tests to primary care physicians and, in Illumina's case, directly to patients, as opposed to marketing plans for other oncology tests, which focus on sales to oncologists and other cancer specialists.

Third, the Commission found that MCED tests, which will be targeted toward a more general population than traditional cancer-screening tests, will likely have their own distinct pricing strategy. Specifically, MCED tests will need to have particularly low out-of-pocket costs to patients in order to achieve wide acceptance. Other MCED-test developers testified that they

anticipated competing with Grail on price, and evidence in the record showed that Grail understood that lower-priced MCED tests would pose a competitive threat. Finally, the Commission found that "MCED developers, including Grail, see themselves as competing in a distinct market and view each other as key competitors."

Critically, because the Commission viewed the relevant product market as one for the research, development, and commercialization of MCED tests—not the existing commercial market for MCED tests—it based its market definition on what MCED-test developers reasonably sought to achieve, not what they currently had to offer. Each of Illumina's proposed bases for why the Commission's market definition fails springs from the presumption that the Commission should have defined the market based on the products that currently exist, not those that are anticipated or expected. We disagree.

First, Illumina argues that there is no evidence of reasonable interchangeability of use or cross-elasticity of demand between Galleri and other MCED tests in development because the other tests either will not match Galleri's "performance characteristics" or "are years from coming to market." But as the Commission noted, record evidence suggested otherwise—CancerSEEK has been shown to detect eight types of cancer in an asymptomatic screening population while Galleri has only been shown to detect seven. And even if Illumina was correct in its claim that the other MCED tests in development would only be able to detect a subset of the fifty cancer types that Galleri can detect, two products need not be identical to be in the same market; rather, the question is merely whether they are "similar in character or use." *United States v. Anthem, Inc.,* 236 F.Supp.3d 171, 194 (D.D.C) (quoting *FTC v. Staples, Inc.*, 970 F.Supp. 1066, 1074) (D.D.C. 1997), aff'd, 855 F.3d 345 (D.C. Cir. 2017). And the Commission correctly noted that these other tests could still take sales from Galleri (i.e., be substitutes, albeit not perfect substitutes) if they were priced lower.

Nor was the Commission required to mathematically demonstrate cross-elasticity of demand. Indeed, requiring such hard metrics to prove the bounds of a market where only one product has been commercialized but there is indisputably ongoing competition to bring additional products to market would, in effect, prevent research-and-development markets from ever being recognized for antitrust purposes. This, in turn, would directly contravene the purpose of Section 7—"to arrest anticompetitive tendencies in their incipiency." *United States v. Phila. Nat'l Bank*, 374 U.S. 321, 362 (1963) (internal quotation marks and citation omitted).[8]

To be sure, simply labeling a market as one for "research and development" does not relieve Complaint Counsel of its burden to delineate the bounds of a relevant product market. In some circumstances, there may be no firms which can fairly be said to be "competing" in a space. And the mere fact that some company, someday may innovate a competing product in a given market would be too speculative to support a Section 7 claim, lest every acquisition be presumptively unlawful. Cf. *FTC v. Elders Grain, Inc.*, 868 F.2d 901, 906 (7th Cir. 1989) ("Section 7 forbids mergers and other acquisitions the effect of which 'may' be to lessen competition substantially. . . . Of course the word 'may' should not be taken literally, for if it were, every acquisition would be unlawful."). But that is not the case here. While Grail may have the most advanced MCED test, competing tests—particularly CancerSEEK—have been clinically validated, and other developers have concrete plans to begin the trials necessary for FDA approval.

[8] For similar reasons, the Commission was not required to use the hypothetical monopolist test to define the relevant product market. In a research-and-development market where most products have yet to reach the consumer marketplace, there are no prices from which to build a data set, and thus no way to run a hypothetical monopolist test analysis.

Indeed, Grail's own internal documents show that the company viewed itself as being in active competition with these other MCED-test developers.

For similar reasons, Illumina's other arguments—that the Commission misapplied the *Brown Shoe* factors and "baseless[ly]" defined the market to include products in development—also fail. Specifically, Illumina contends that the Commission assessed the *Brown Shoe* "practical indicia" too broadly, examining whether MCED tests were different from other oncology tests rather than whether Galleri was different from other MCED tests in development. But Illumina's proposed approach assesses the indicia far too narrowly. Indeed, under the narrower application urged by Illumina, the relevant market would consist of only one product—Galleri. Antitrust law does not countenance such a cramped view of competition, particularly in a research-and-development market.

2.

With the relevant market established, we next turn to whether Complaint Counsel carried its initial burden of showing that "the proposed merger is likely to substantially lessen competition." *AT&T*, 916 F.3d at 1032 (emphasis omitted). As the Commission recognized, courts have used "two different but overlapping standards for evaluating the likely effect of a vertical transaction": (1) the *Brown Shoe* standard, which requires courts to look (again) at the factors first enunciated in *Brown Shoe* and carried on through its progeny, including *Fruehauf Corp. v. FTC*, 603 F.2d 345, 353 (2d Cir. 1979); and (2) the "ability-and-incentive" standard, which asks whether the merged firm will have both the ability and the incentive to foreclose its rivals, either from sources of supply or from distribution outlets. Commissioner Wilson, concurring in the Commission's decision, argued that there is no *Brown Shoe* standard—only the "ability-and-incentive" test—for vertical mergers in modern antitrust analysis. But we need not resolve this issue because we find that, under either standard, Complaint Counsel established a prima facie case supported by substantial evidence.

a.

We begin by addressing the test upon which all Commissioners agreed—the ability-and-incentive test. Under this framework, courts consider whether the merged firm will have the ability and incentive to foreclose rivals from sources of supply or distribution to determine whether the merger is likely to substantially lessen competition in the relevant market.

Illumina concedes that it would have the ability to foreclose Grail's rivals post-merger. But, in its reply brief, Illumina claims that merely having the ability to foreclose is not enough; rather, the merger must have "increased Illumina's ability to foreclose." But we do not consider arguments raised for the first time on reply. And, in any event, we disagree with Illumina's assertion. As the Commission astutely observed, Illumina was already established as the monopoly supplier of a key input—NGS platforms—to MCED-test developers pre-merger. So, it would have been impossible for Complaint Counsel to show that the merger would increase Illumina's ability to foreclose. Thus, as the Commission explained, requiring such a showing would effectively "per se exempt from the Clayton Act's purview any transaction that involves the acquisition of a monopoly provider of inputs to adjacent markets." We decline to adopt a rule that would have such perverse results.

That leaves incentive to foreclose as the determining factor in evaluating the Illumina-Grail merger under the ability-and-incentive test. As the Commission explained, the degree to which Illumina has an incentive to foreclose Grail's rivals depends upon the balance of two competing

interests: Illumina's interest in maximizing its profits in the downstream market for MCED tests vis-à-vis its ownership interest in Grail versus Illumina's interest in maximizing its profits in the upstream market for NGS platforms vis-à-vis its sales to all MCED-test developers. Foreclosing Grail's rivals would increase the former (by diverting MCED-test sales from competitors to Grail) but decrease the latter (by reducing the total number of MCED tests in the marketplace). So, the Commission reasoned, the greater Illumina's ownership stake in Grail, the more its interest in maximizing downstream profits will outweigh its interest in preserving upstream profits, and thus the more incentive it will have to foreclose. And since the merger would increase Illumina's ownership stake in Grail from 12% to 100%, Illumina would "now earn much more from the sale of a [Grail] test than from the sale of a rival's test" and would therefore "have a significantly greater incentive to foreclose [Grail's] rivals rather than to keep them on a level playing field."

Illumina challenges this conclusion on two bases. First, Illumina argues that, even if the merger would result in Illumina earning larger profits from the sale of a Grail test than the sale of a rival MCED test, that profit differential means nothing without proof of diversion, i.e., Grail's capture of sales lost by rival MCED-test developers. Illumina is correct that diversion is necessary for a vertical merger to give rise to foreclosure incentives. If Illumina forecloses Grail's rivals, preventing them from entering the MCED-test market or lowering their sales, Illumina's NGS-sales revenue generated from those rivals will suffer. Therefore, a foreclosure strategy is only economically rational if Grail can pick up enough of its competitors' lost MCED-test sales to offset the losses to Illumina's NGS-sales revenue. But, Illumina argues, "[b]ecause Galleri is the only test on the market today, there are no sales to divert," so foreclosing Grail's rivals would only harm Illumina's NGS revenue without any concomitant benefit to Grail's MCED-test-sales revenue.

This contention suffers from the same fatal flaw as Illumina's arguments concerning the Commission's market definition—it insists that the Commission must consider only the MCED tests on the market right now, not those likely to be on the market in the future. But the relevant market is not "MCED tests commercialized today," it is the "research, development, and commercialization of MCED tests." And as explained earlier, there is substantial evidence in the record showing that other MCED-test developers are, right now, working on creating tests that will rival Grail's capabilities and that are expected to make it to the market in the near future. And when they do, they would divert sales from Grail—or vice versa, should a foreclosure strategy be pursued.

Illumina's second argument—that harm to Illumina's NGS business from foreclosure of Grail's rivals would outweigh any benefit to Grail's MCED-testing business—is more compelling. Pre-merger, the vast majority of Illumina's revenue—nearly 90% in 2020—was earned through its core business of selling NGS products. And Illumina is right that pursuing a foreclosure strategy threatens material harm to this business in two ways: first, by loss of NGS sales to the foreclosed MCED-test developers, and second, by loss of NGS business in areas outside of cancer detection as a result of reputational damage. But, as the Commission identified, there are two reasons why the risk of such harm is not as great as Illumina claims. First, there are myriad ways in which Illumina could engage in foreclosing behavior without triggering suspicion in other customers, such as by making late deliveries or subtly reducing the level of support services. And second, and more importantly, Illumina's monopoly power in the NGS-platform market means that, even if other customers did learn about Illumina's foreclosing behavior and therefore wanted to take their business elsewhere, they would have nowhere else to turn.

In any event, there is a more fundamental reason why any harm to Illumina's NGS business may not disincentivize Illumina from pursuing a foreclosure strategy against Grail's rivals—the Illumina-Grail merger was the cornerstone of a foundational change in Illumina's business model through which Illumina planned to "transform [itself] into a clinical testing and data driven healthcare company" as opposed to its current iteration as a "life sciences tools & diagnostics company focused on genomics." In other words, Illumina was willing to suffer losses to its NGS-platform sales in order to accelerate the growth of its MCED-test sales because it now viewed the latter, not the former, as its primary (and far more profitable) business. Illumina's own internal projections bear this out, predicting that, although Illumina would lose money in the short term as a result of the merger, by 2035, its "net margin profit pool" for clinical testing services would be nearly eight times the projected profit pool for its NGS-related sales.

In light of the foregoing, the Commission had substantial evidence to support its conclusion that Complaint Counsel made a prima facie showing that, post-merger, Illumina had a significantly increased incentive to crowd out Grail's competitors from the market. MCED testing is a nascent field in which, although only one firm—Grail—has begun to commercialize its product, numerous firms are researching and developing their own products with the end goal of commercialization. And all of the players expect the field to one day generate tens of billions of dollars in yearly revenue. To create and eventually sell this product, each developer will need access to one critical input—NGS platforms. Now, the sole supplier of that input—Illumina—has purchased the first mover in this nascent industry. Given Illumina's monopoly power and shifting business priorities, it was reasonable for the Commission to conclude that Illumina would likely foreclose against Grail's competitors—even at the expense of some short-term profits—to pursue its long-term goal of establishing itself (via Grail) as the market leader in clinical testing.

b.

The Commission also applied the factors first identified in *Brown Shoe*, and later reiterated in *Fruehauf*, to determine whether the Illumina-Grail merger was likely to substantially lessen competition. These factors include:

> [T]he nature and economic purpose of the [transaction], the likelihood and size of any market foreclosure, the extent of concentration of sellers and buyers in the industry, the capital cost required to enter the market, the market share needed by a buyer or seller to achieve a profitable level of production (sometimes referred to as "scale economy"), the existence of a trend toward vertical concentration or oligopoly in the industry, and whether the merger will eliminate potential competition by one of the merging parties. To these factors may be added the degree of market power that would be possessed by the merged enterprise and the number and strength of competing suppliers and purchasers, which might indicate whether the merger would increase the risk that prices or terms would cease to be competitive.

Fruehauf, 603 F.2d at 353. The Commission found that at least four of the factors—likely foreclosure, the nature and purpose of the transaction, the degree of market power possessed by the merged firm, and entry barriers— supported a finding of a probable Section 7 violation. We conclude that the Commission's *Brown Shoe* determination was supported by substantial evidence.

The first factor the Commission relied upon—likelihood of foreclosure—weighs in favor of Complaint Counsel for the reasons set forth in our ability-and-incentive analysis. The second factor—nature and purpose of the transaction—also overlaps significantly with our prior discussion and supports Complaint Counsel: The "nature" of the transaction is the acquisition of a downstream customer by a sole-source supplier, and the "purpose" is to fundamentally transform Illumina's business model such that it would be competing most intensely in the downstream market, i.e., the same market in which it has the ability to foreclose.

As for the third factor—degree of market power—the parties' arguments reflect a broader debate about how to view the potential anticompetitive impact of the merger, which we have now already addressed twice: whether the Commission was required to look at the immediate effect of the merger (in which case, Illumina would be correct to say that the acquisition does not change Grail's share of the MCED-test market because its Galleri test is the only product on the market) or could consider the merger's long-term impact. And as we have already explained, the Commission properly considered the longer-term impact of the merger and found that the merger was likely to lead to a concentration of market power in the merged firm. This factor thus favors Complaint Counsel as well.

Finally, the Commission found that the merger would increase barriers to entry in the relevant market. Specifically, based on testimony from other MCED-test developers and Complaint Counsel's expert witness, the Commission found that rival firms would be disincentivized from investing in MCED-test development post-merger. Illumina suggests that the Commission gave too much weight to this self-interested testimony and too little weight to other record evidence. But even if we would have found a different conclusion to be "more reasonable and persuasive" had we weighed the evidence ourselves, that would not be enough to set aside the Commission's finding on this factor under our deferential "substantial evidence" review.

Nor did the Commission commit legal error by omitting three of the *Brown Shoe* factors from its analysis. There is "no precise formula[]" when it comes to applying these factors. *Fruehauf*, 603 F.2d at 353. Indeed, the Supreme Court has found a vertical merger unlawful by examining only three of the *Brown Shoe* factors. *Ford Motor Co. v. United States*, 405 U.S. 562, 566 (1972) (considering the nature and purpose of the transaction, increased barriers to entry, and increased concentration).

At bottom, the record supports the Commission's findings that the merger will result in the potential foreclosure of a key input by the sole supplier, that it was intended to transform Illumina's business model by shifting its focus from NGS products to clinical testing, and that investment by other MCED-test developers may be chilled, especially given the deferential nature of our review. This was sufficient to support a determination that Complaint Counsel had made a prima facie showing that the merger was likely to substantially lessen competition under the *Brown Shoe* test.

B.

Next, we address the Open Offer—the long-term supply agreement that Illumina offered to rival MCED-test developers. First, we consider where in the Section 7 analysis the Open Offer should be evaluated, and second, we turn to how it should be evaluated.

1.

Based on the record, the parties' arguments, and applicable case law, we see three different options for the point in the Section 7 analysis at which the Open Offer could come into play.

The first option—pressed by Illumina—is to require Complaint Counsel to account for the Open Offer as part of its prima facie case. The second option—adhered to by the Commission's majority opinion—is to only consider the Open Offer at the remedy stage following a finding of liability. The third option—suggested by Commissioner Wilson in her concurring opinion—is to place the burden of showing the Open Offer's competitive effects on Illumina as part of its rebuttal to the prima facie case. As explained below, we agree with Commissioner Wilson.

a.

The parties' divergent views on this issue appear to stem from a disagreement over whether the Open Offer should be treated as a "market reality"—as Illumina contends—or a remedy—as the Commission found. But we do not think that the Open Offer fits neatly into either bucket, and we decline to force it into one.

On the one hand, it is evident that the Open Offer is not just a normal commercial supply agreement but instead a direct response to anticompetitive concerns over the Illumina-Grail merger. The opening sentence of the Open Offer makes this plain; it explains that the Open Offer was made "[i]n connection with Illumina's proposed acquisition of Grail . . . to allay any concerns relating to the [merger], including that Illumina would disadvantage Grail's potential competitors." So, to treat the Open Offer as just another fact of the marketplace seems to miss the forest for the trees.

But, on the other hand, the Open Offer is different in kind from a Commission- or court-ordered "remedy," which, as the Commission itself noted, can be imposed "only on the basis of a violation of the law," i.e., after a finding of liability. See *Gen. Bldg. Contractors Ass'n, Inc. v. Pennsylvania*, 458 U.S. 375, 399 (1982). Indeed, the Open Offer became effective before the evidentiary hearing in this case had even begun and nineteen months before the Commission's liability determination. Thus, the Commission majority's reliance on cases like *Ford Motor Co.*, 405 U.S. at 571.and *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 334 (1961)—which concerned court-ordered divestitures after a finding of Section 7 liability—to support its position that the Open Offer is a remedy is misplaced. So too is its reliance on *United States v. Aetna Inc.*, 240 F.Supp.3d 1 (D.D.C. 2017), and *FTC v. Sysco Corp.*, 113 F.Supp.3d 1 (D.D.C. 2015). To be sure, both *Aetna* and *Sysco*—like this case—involved proposals by the parties, not decrees by the Commission or court. But in both cases, the proposed divestitures were conditional upon the court's liability determination, coming into effect in *Aetna* only if the court found such divestiture "necessary to counteract the merger's anticompetitive effects," 240 F.Supp.3d at 17, and in *Sysco* "if the merger received regulatory approval," 113 F.Supp.3d at 15. No such conditions accompanied the Open Offer.

In this sense, the Open Offer is somewhere in between a fact and a remedy—a post-signing, pre-closing adjustment to the status quo implemented by the merging parties to stave off concerns about potential anticompetitive conduct. Take, for example, the arbitration agreement at issue in *United States v. AT&T, Inc.*, 310 F.Supp.3d 161 (D.D.C. 2018), *aff'd*, 916 F.3d 1029 (D.C. Cir. 2019). That case concerned a Section 7 challenge to the vertical merger between AT&T (which distributes television content via its cable platform DirecTV) and Time Warner (which packages television content via its networks such as TNT, TBS, CNN, and HBO and licenses such networks to distributors). Shortly after the government filed suit, and in an effort to assuage concerns that it would price-discriminate against distributors other than AT&T post-merger, Time Warner made an irrevocable offer to distributors to engage in "baseball style"

arbitration when it came time to renew their licensing agreements. Id. at 184.[14] The government argued that the arbitration agreements should be "ignored" until the remedy stage, but the court disagreed, holding that the agreements would have "real-world effect[s]" that should be considered prior to any liability determination. Id. at 217 n.30.

The Northern District of California reached a similar determination in *FTC v. Microsoft Corp.*, where the court considered a "binding offer" by Microsoft (the details of which are redacted from the opinion) designed to assuage the government's concerns that Microsoft (the manufacturer of the popular Xbox gaming console) would pull certain videogames from competing consoles following its vertical merger with videogame publisher Activision. No. 23-cv-02880-JSC, 2023 WL 4443412, at *15 (N.D. Cal. July 10, 2023). The court rejected the government's argument that, under *du Pont*, Microsoft's offer was merely a "proposed remedy" to be considered after a finding of liability and explained that "offered and executed agreements made before any liability trial, let alone liability finding," should be considered at the liability phase. Id.

The Open Offer is akin to the remedial agreements at issue in *AT&T* and *Microsoft*. And we agree with those courts that such agreements should be addressed at the liability—not remedy—stage of the Section 7 proceedings.

b.

Having determined that the Open Offer should be considered at the liability stage, the question remains: where does it fit within the burden-shifting framework for determining liability? Illumina urges that Complaint Counsel was required to incorporate the Open Offer into its prima facie case. Commissioner Wilson says that the Open Offer only comes into play as part of Illumina's rebuttal to Complaint Counsel's prima facie case. We find the latter approach most compatible with the "flexible framework" at play. See *Chicago Bridge*, 534 F.3d at 424.

As we and our sister circuits have recognized, the burden-shifting framework is "somewhat artificial." *FTC v. Butterworth Health Corp.*, No. 96-2440, 1997 WL 420543, at *1 (6th Cir. July 8, 1997). "Conceptually, this shifting of the burdens of production, with the ultimate burden of persuasion remaining always with the government, conjures up images of a tennis match, where the government serves up its prima facie case, the defendant returns with evidence undermining the government's case, and then the government must respond to win the point." *FTC v. Univ. Health, Inc.*, 938 F.2d 1206, 1219 n.25 (11th Cir. 1991). "In practice, however, the government usually introduces all of its evidence at one time, and the defendant responds in kind." Id. Thus, the "evidence is often considered all at once and the burdens are often analyzed together." *Chicago Bridge*, 534 F.3d at 425. This is particularly true in vertical merger cases. In horizontal merger cases, the government can "use a short cut to establish [its prima facie case] through statistics about the change in market concentration." *AT&T*, 916 F.3d at 1032. No such "short cut" exists in vertical merger cases, and the government "must make a 'fact-specific' showing" even at the prima facie stage. Id.

That is precisely what happened in this case. As the government's brief explains, "[h]ere, Complaint Counsel produced evidence in its case-in-chief that the Open Offer was ineffective, and Illumina attempted to produce contrary evidence in the defense case." The Commission then siloed all of this Open-Offer-related evidence into the rebuttal stage of its analysis. Had

[14] In "baseball style" arbitration, "each party puts forward a final offer before knowing about its counterparty's offer, and the arbitrator chooses between those two." *AT&T*, 310 F.Supp.3d at 217.

the Commission applied the correct standard at the rebuttal stage, there would have been no error in this approach. Indeed, we approved such a methodology in *Chicago Bridge*.

As we explained there, in many Section 7 cases, the "[g]overnment's prima facie case anticipates and addresses the respondent's rebuttal evidence." *Chicago Bridge*, 534 F.3d at 426. In such a situation, the Commission need only "assess[] the rebuttal evidence in light of the prima facie case" rather than switch the burden of production back-and-forth.

2.

At the rebuttal stage of the Section 7 analysis, Illumina bore the burden "to present evidence that the prima facie case inaccurately predicts the relevant transaction's probable effect on future competition." *AT&T*, 916 F.3d at 1032 (internal quotation marks and citation omitted). Because Complaint Counsel preemptively addressed the Open Offer as part of its case-in-chief, Illumina's burden on rebuttal was "heightened." *Chicago Bridge*, 534 F.3d at 426. To be sure, Illumina's burden was only one of production, not persuasion; the burden of persuasion remained with Complaint Counsel at all times. *AT&T*, 916 F.3d at 1032. But to satisfy its burden of production, Illumina was required to do more than simply put forward the terms of the Open Offer; it needed to "*affirmatively show*[]" why the Open Offer undermined Complaint Counsel's prima facie showing to such an extent that there was no longer a probability that the Illumina-Grail merger would "substantially lessen competition." See *United States v. Baker Hughes Inc.*, 908 F.2d 981, 991 (D.C. Cir. 1990) (emphasis added).

This is where the Commission erred. The Commission held Illumina to a rebuttal standard that was incompatible with the plain language of Section 7 of the Clayton Act, which only prohibits transactions that will "substantially" lessen competition. 15 U.S.C. § 18. And this error pervaded the Commission's analysis of the Open Offer, as the Commission invoked the wrong standard in five separate instances. Specifically, the Commission held that Illumina was required to "show that the Open Offer would restore the pre-[merger] level of competition," i.e., "eliminate Illumina's ability to favor Grail and harm Grail's rivals." In effect, Illumina could only rebut Complaint Counsel's showing of a likelihood of a substantial reduction in competition with a showing that, due to the Open Offer, the merger would not lessen competition at all. This was legal error.

The Commission's standard stems from its mistaken belief that the Open Offer is a remedy. Indeed, the source of this total-negation standard is the Supreme Court's holding in *Ford Motor* Co. that "[t]he relief in an antitrust case must be 'effective to redress the violations' and 'to restore competition.'" 405 U.S. at 573 (quoting *du Pont*, 366 U.S. at 326). The District of Columbia applied this remedy-stage standard in its liability-stage analysis in a string of cases, beginning with *Sysco*, 113 F.Supp.3d at 72, continuing in *Aetna*, 240 F.Supp.3d at 60, and then again in *FTC v. RAG-Stiftung*, 436 F.Supp.3d 278, 304 (D.D.C. 2020). But in its most recent case, the District of Columbia reversed course, recognizing that the total-negation standard "contradicts the text of Section 7." *United States v. UnitedHealth Grp. Inc.*, 630 F.Supp.3d 118, 132 (D.D.C. 2022). As that court explained, "the text of Section 7 is concerned only with mergers that 'substantially . . . lessen competition,'" and by requiring on rebuttal a showing that the merger will "preserve exactly the same level of competition that existed before the merger, the Government's proposed standard would effectively erase the word 'substantially' from Section 7." Id. at 133 (quoting 15 U.S.C. § 18).

*** To rebut Complaint Counsel's prima facie case, Illumina was only required to show that the Open Offer sufficiently mitigated the merger's effect such that it was no longer likely to

substantially lessen competition. Illumina was not required to show that the Open Offer would negate the anticompetitive effects of the merger entirely.

C.

Finally, we turn to Illumina's other proffered rebuttal evidence—efficiencies. As it did before the Commission, Illumina contends on appeal that the Illumina-Grail merger would have "result[ed] in significant efficiencies" which would have "easily offset[] the supposed [anticompetitive] harm."[17] To be cognizable as rebuttal evidence, an efficiency must be (1) merger specific, (2) verifiable in its existence and magnitude, and (3) likely to be passed through, at least in part, to consumers. The Commission determined that none of Illumina's proposed efficiencies were cognizable. We find that this conclusion was supported by substantial evidence.

First, Illumina claimed that the merger would reduce (if not eliminate entirely) Grail's obligation to pay Illumina a royalty, which would have generated a significant consumer surplus. The Commission found that this claimed efficiency was neither merger specific nor likely to be passed through to consumers. We find that the former determination was not supported by substantial evidence, but the latter was. The Commission's finding that the royalty reduction was not merger specific was based on evidence demonstrating that Grail had considered other ways to reduce or eliminate the royalty without merging with Illumina, such as a buyout or longer-term supply agreement. But the Commission did not fairly consider evidence that Grail—in coordination with its bankers at Morgan Stanley—had determined that it lacked the leverage necessary to bring Illumina to the table on these alternative proposals, leaving merger as the only realistic option. We therefore cannot conclude that substantial evidence supported this finding.

With respect to pass-through, however, there was substantial evidence to support the Commission's finding that, while Grail could decrease the price of Galleri (i.e., pass some of the benefit through to consumers) following reduction of the royalty, Illumina had not shown a likelihood that Grail would do so. Indeed, as explained earlier, substantial evidence supported the Commission's finding that the merger would increase Illumina's incentive to foreclose against Grail's rivals such that competing MCED tests either never make it to market or the costs of bringing such tests to market increase. In other words, Grail had no reason to pass its royalty-reduction savings through to Galleri's customers because, if any of Grail's competitors actually made it to market, Grail could force those competitors to pass through extra costs to their customers.

Second, Illumina argued that the merger would eliminate double marginalization—i.e., Illumina would no longer charge Grail a margin, as it did before the merger—leading to additional consumer surplus. But Illumina never put forward a proposed model for calculating this benefit, only an "illustrative" one. Illumina does not contest this fact. Rather, Illumina contends that it was Complaint Counsel's burden to model these benefits. But when it comes to efficiencies, "much of the information relating to efficiencies is uniquely in the possession of the merging

[17] The Commission stated that, to rebut the prima facie case, any substantiated efficiencies needed "to offset and reverse the likely anticompetitive effects" of the merger. This standard gives us pause for the same reasons discussed with respect to the standard used to evaluate the Open Offer. But we need not decide whether such a standard is appropriate for evaluating efficiencies because the Commission did not rely on it. Instead, the Commission found that Illumina had failed to substantiate its claimed efficiencies in the first place. We also note that our court has never addressed the threshold question of whether it is proper for a court to take account of a merger's efficiencies as a defense in a Section 7 case.

firms." 4a Areeda & Hovenkamp, Antitrust Law ¶ 970f (citation omitted). It is therefore Illumina—not Complaint Counsel—that "must demonstrate that the intended acquisition would result in significant economies." *Univ. Health*, 938 F.2d at 1223. And because Illumina failed to demonstrate that this proposed efficiency was verifiable, the Commission had substantial evidence in support of its decision not to recognize it.

Third, Illumina contended that the merger would lead to "significant supply chain and operational efficiencies" of approximately $140 million over a ten-year period. But, again, it presented no model by which it calculated this number. And without an underlying model, including the assumptions upon which it was based, the Commission had a sound basis to conclude that Illumina had failed to carry its burden of showing this efficiency was verifiable. See *United States v. H&R Block, Inc.*, 833 F.Supp.2d 36, 91 (D.D.C. 2011) ("[T]he lack of a verifiable method of factual analysis resulting in the cost estimates renders [the proposed efficiency] not cognizable by the Court."). Plus, record evidence showed that Grail was in the process of improving its operations pre-merger, and Illumina had not shown any method of quantifying the incremental value, if any, the merger would provide with respect to these operational efficiencies. Thus, there was not only a verification issue, but a merger-specificity issue as well.

Fourth, Illumina claimed that the merger would result in significant research-and-development efficiencies. But Illumina made no attempt to quantify these claimed efficiencies, instead relying on testimony of its executives that such efficiencies would be achieved. But "[w]hile reliance on the estimation and judgment of experienced executives about costs [or innovation] may be perfectly sensible as a business matter, the lack of a verifiable method of factual analysis . . . renders [the efficiency] not cognizable." *H&R Block*, 833 F.Supp.2d at 91.

Fifth, Illumina argued that due to its "regulatory and market-access expertise," the merger would "accelerate" FDA approval and payer coverage for Galleri. But the Commission, again supported by substantial evidence, found that Illumina had not established that such acceleration would actually occur, much less shown how it would be achieved. For instance, Illumina's own financial modeling of the merger did not assume that Galleri's widespread commercialization would be accelerated. Nor did it account for the costs that would be associated with achieving any such acceleration, such as diverting Illumina personnel to work on Grail projects. And in any event, Illumina had failed to demonstrate that its claimed "regulatory expertise" was superior to that which Grail already possessed. Indeed, Grail had already obtained breakthrough device designation for Galleri on its own. Illumina, on the other hand, had only ever obtained pre-market approval for one Class III NGS-based diagnostic test, and in that instance, a third party sponsored the clinical study upon which approval was granted.

Sixth, Illumina pointed to "international efficiencies," i.e., that the merger would "accelerate the international expansion of Galleri." But as the Commission explained, Illumina "offered no concrete plans regarding countries in which international expansion would occur, how much more quickly the international expansion would occur, how much additional data the international expansion would generate, how much the international efforts would cost, or why such international expansion could only be achieved through a merger."[18]

[18] Because we find that substantial evidence supported the Commission's conclusion that Illumina had failed to substantiate its claimed international efficiencies, we do not address the question of whether it is proper to consider efficiencies outside of the relevant geographic market. But see *Phila. Nat'l Bank*, 374 U.S. at 370 (rejecting contention that "anticompetitive effects in one market could be justified by procompetitive consequences in another").

At bottom, an efficiency defense is very difficult to establish. And substantial evidence supported the Commission's determination that Illumina failed to establish cognizable efficiencies here.

V.

To sum up, Illumina's constitutional challenges to the FTC's authority are foreclosed by binding Supreme Court precedent, and substantial evidence supported the Commission's conclusions that (1) the relevant market is the market for the research, development, and commercialization of MCED tests in the United States; (2) Complaint Counsel carried its initial burden of showing that the Illumina-Grail merger is likely to substantially lessen competition in that market under either the ability-and-incentive test or looking to the *Brown Shoe* factors; and (3) Illumina had not identified cognizable efficiencies to rebut the anticompetitive effects of the merger. However, in considering the Open Offer, the Commission used a standard that was incompatible with the plain language of the Clayton Act. We therefore VACATE the Commission's order and REMAND the case for reconsideration of the effect of the Open Offer under the proper standard.

Merger Guidelines

U.S. Department of Justice and the Federal Trade Commission

Issued: December 18, 2023

1. Overview

These Merger Guidelines identify the procedures and enforcement practices the Department of Justice and the Federal Trade Commission (the "Agencies") most often use to investigate whether mergers violate the antitrust laws. The Agencies enforce the federal antitrust laws, specifically Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2; Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45; and Sections 3, 7, and 8 of the Clayton Act,[1] 15 U.S.C. §§ 14, 18, 19.[2] Congress has charged the Agencies with administering these statutes as part of a national policy to promote open and fair competition, including by preventing mergers and acquisitions that would violate these laws. "Federal antitrust law is a central safeguard for the Nation's free market structures" that ensures "the preservation of economic freedom and our free-enterprise system."[3] It rests on the premise that "[t]he unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions."[4]

Section 7 of the Clayton Act ("Section 7") prohibits mergers and acquisitions where "in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." Competition is a process of rivalry that incentivizes businesses to offer lower prices, improve wages and working conditions, enhance quality and resiliency, innovate, and expand choice, among many other benefits. Mergers that substantially lessen competition or tend to create a monopoly increase, extend, or entrench market power and deprive the public of these benefits. Mergers can lessen competition when they diminish competitive constraints, reduce the number or attractiveness of alternatives available to trading partners, or reduce the intensity with which market participants compete.

Section 7 was designed to arrest anticompetitive tendencies in their incipiency.[5] The Clayton Act therefore requires the Agencies to assess whether mergers present risk to competition. The Supreme Court has explained that "Section 7 itself creates a relatively expansive definition of antitrust liability: To show that a merger is unlawful, a plaintiff need only prove that its effect '*may be* substantially to lessen competition'" or to tend to create a monopoly.[6] Accordingly, the Agencies do not attempt to

[1] As amended under the Celler-Kefauver Antimerger Act of 1950, Pub. L. No. 81-899, 64 Stat. 1125 (1950), and the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a.

[2] Although these Guidelines focus primarily on Section 7 of the Clayton Act, the Agencies consider whether any of these statutes may be violated by a merger. The various provisions of the Sherman, Clayton, and FTC Acts each have separate standards, and one may be violated when the others are not.

[3] *North Carolina State Bd. of Dental Examiners v. FTC*, 574 U.S. 494, 502 (2015).

[4] *NCAA v. Board of Regents*, 468 U.S. 85, 104 n.27 (1984) (quoting *Northern Pac. R. Co. v. United States*, 356 U.S. 1, 4-5 (1958)); *see also NCAA v. Alston*, 141 S. Ct. 2141, 2147 (2021) (quoting *Board of Regents*, 468 U.S. at 104 n.27).

[5] *See, e.g.*, *Brown Shoe Co. v. United States*, 370 U.S. 294, 318 nn.32-33 (1962); *see also United States v. AT&T, Inc.*, 916 F.3d 1029, 1032 (D.C. Cir. 2019) (Section 7 "halt[s] incipient monopolies and trade restraints outside the scope of the Sherman Act." (quoting *Brown Shoe*, 370 U.S. at 318 n.32)); *Saint Alphonsus Medical Center-Nampa v. St. Luke's*, 778 F.3d 775, 783 (9th Cir. 2015) (Section 7 "intended to arrest anticompetitive tendencies in their incipiency." (quoting *Brown Shoe*, 370 U.S. at 322)); *Polypore Intern., Inc. v. FTC*, 686 F.3d 1208, 1213-14 (11th Cir. 2012) (same). Some other aspects of *Brown Shoe* have been subsequently revisited.

[6] *California v. Am. Stores Co.*, 495 U.S. 271, 284 (1990) (quoting 15 U.S.C. § 18 with emphasis) (citing *Brown Shoe*, 370 U.S. at 323).

predict the future or calculate precise effects of a merger with certainty. Rather, the Agencies examine the totality of the evidence available to assess the risk the merger presents.

Competition presents itself in myriad ways. To assess the risk of harm to competition in a dynamic and complex economy, the Agencies begin the analysis of a proposed merger by asking: how do firms in this industry compete, and does the merger threaten to substantially lessen competition or to tend to create a monopoly?

The Merger Guidelines set forth several different analytical frameworks (referred to herein as "Guidelines") to assist the Agencies in assessing whether a merger presents sufficient risk to warrant an enforcement action. These frameworks account for industry-specific market realities and use a variety of indicators and tools, ranging from market structure to direct evidence of the effect on competition, to examine whether the proposed merger may harm competition.

How to Use These Guidelines: When companies propose a merger that raises concerns under one or more Guidelines, the Agencies closely examine the evidence to determine if the facts are sufficient to infer that the effect of the merger may be to substantially lessen competition or to tend to create a monopoly (sometimes referred to as a "prima facie case").[7] **Section 2** describes how the Agencies apply these Guidelines. Specifically, Guidelines 1-6 describe distinct frameworks the Agencies use to identify that a merger raises prima facie concerns, and Guidelines 7-11 explain how to apply those frameworks in several specific settings. In all of these situations, the Agencies will also examine relevant evidence to determine if it disproves or rebuts the prima facie case and shows that the merger does not in fact threaten to substantially lessen competition or tend to create a monopoly. **Section 3** identifies rebuttal evidence that the Agencies consider, and that merging parties can present, to rebut an inference of potential harm under these frameworks.[8] **Section 4** sets forth a non-exhaustive discussion of analytical, economic, and evidentiary tools the Agencies use to evaluate facts, understand the risk of harm to competition, and define relevant markets.

These Guidelines are not mutually exclusive, as a single transaction can have multiple effects or raise concerns in multiple ways. To promote efficient review, for any given transaction the Agencies may limit their analysis to any one Guideline or subset of Guidelines that most readily demonstrates the risks to competition from the transaction.

Guideline 1: Mergers Raise a Presumption of Illegality When They Significantly Increase Concentration in a Highly Concentrated Market. Market concentration is often a useful indicator of a merger's likely effects on competition. The Agencies therefore presume, unless sufficiently disproved or rebutted, that a merger between competitors that significantly increases concentration and creates or further consolidates a highly concentrated market may substantially lessen competition.

Guideline 2: Mergers Can Violate the Law When They Eliminate Substantial Competition Between Firms. The Agencies examine whether competition between the merging parties is substantial since their merger will necessarily eliminate any competition between them.

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[7] *See, e.g.*, *United States v. AT&T, Inc.*, 916 F.3d at 1032 (explaining that a *prima facie* case can demonstrate a "reasonable probability" of harm to competition either through "statistics about the change in market concentration" or a "fact-specific" showing (quoting *Brown Shoe*, 370 U.S. at 323 n.39)); *United States v. Baker Hughes*, 908 F.2d 981, 982-83 (D.C. Cir. 1990).

[8] These Guidelines pertain only to the Agencies' consideration of whether a merger or acquisition may substantially lessen competition or tend to create a monopoly. The consideration of remedies appropriate for mergers that pose that risk is beyond the Merger Guidelines' scope. The Agencies review proposals to revise a merger in order to alleviate competitive concerns consistent with applicable law regarding remedies.

Guideline 3: Mergers Can Violate the Law When They Increase the Risk of Coordination. The Agencies examine whether a merger increases the risk of anticompetitive coordination. A market that is highly concentrated or has seen prior anticompetitive coordination is inherently vulnerable and the Agencies will infer, subject to rebuttal evidence, that the merger may substantially lessen competition. In a market that is not highly concentrated, the Agencies investigate whether facts suggest a greater risk of coordination than market structure alone would suggest.

Guideline 4: Mergers Can Violate the Law When They Eliminate a Potential Entrant in a Concentrated Market. The Agencies examine whether, in a concentrated market, a merger would (a) eliminate a potential entrant or (b) eliminate current competitive pressure from a perceived potential entrant.

Guideline 5: Mergers Can Violate the Law When They Create a Firm That May Limit Access to Products or Services That Its Rivals Use to Compete. When a merger creates a firm that can limit access to products or services that its rivals use to compete, the Agencies examine the extent to which the merger creates a risk that the merged firm will limit rivals' access, gain or increase access to competitively sensitive information, or deter rivals from investing in the market.

Guideline 6: Mergers Can Violate the Law When They Entrench or Extend a Dominant Position. The Agencies examine whether one of the merging firms already has a dominant position that the merger may reinforce, thereby tending to create a monopoly. They also examine whether the merger may extend that dominant position to substantially lessen competition or tend to create a monopoly in another market.

Guideline 7: When an Industry Undergoes a Trend Toward Consolidation, the Agencies Consider Whether It Increases the Risk a Merger May Substantially Lessen Competition or Tend to Create a Monopoly. A trend toward consolidation can be an important factor in understanding the risks to competition presented by a merger. The Agencies consider this evidence carefully when applying the frameworks in Guidelines 1-6.

Guideline 8: When a Merger is Part of a Series of Multiple Acquisitions, the Agencies May Examine the Whole Series. If an individual transaction is part of a firm's pattern or strategy of multiple acquisitions, the Agencies consider the cumulative effect of the pattern or strategy when applying the frameworks in Guidelines 1-6.

Guideline 9: When a Merger Involves a Multi-Sided Platform, the Agencies Examine Competition Between Platforms, on a Platform, or to Displace a Platform. Multi-sided platforms have characteristics that can exacerbate or accelerate competition problems. The Agencies consider the distinctive characteristics of multi-sided platforms when applying the frameworks in Guidelines 1-6.

Guideline 10: When a Merger Involves Competing Buyers, the Agencies Examine Whether It May Substantially Lessen Competition for Workers, Creators, Suppliers, or Other Providers. The Agencies apply the frameworks in Guidelines 1-6 to assess whether a merger between buyers, including employers, may substantially lessen competition or tend to create a monopoly.

Guideline 11: When an Acquisition Involves Partial Ownership or Minority Interests, the Agencies Examine Its Impact on Competition. The Agencies apply the frameworks in Guidelines 1-6 to assess if an acquisition of partial control or common ownership may substantially lessen competition.

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This edition of the Merger Guidelines consolidates, revises, and replaces the various versions of Merger Guidelines previously issued by the Agencies. The revision builds on the learning and experience reflected in those prior Guidelines and successive revisions. These Guidelines reflect the collected experience of the Agencies over many years of merger review in a changing economy and have been refined through an extensive public consultation process.

As a statement of the Agencies' law enforcement procedures and practices, the Merger Guidelines create no independent rights or obligations, do not affect the rights or obligations of private parties, and do not limit the discretion of the Agencies, including their staff, in any way. Although the Merger Guidelines identify the factors and frameworks the Agencies consider when investigating mergers, the Agencies' enforcement decisions will necessarily continue to require prosecutorial discretion and judgment. Because the specific standards set forth in these Merger Guidelines will be applied to a broad range of factual circumstances, the Agencies will apply them reasonably and flexibly to the specific facts and circumstances of each merger.

Similarly, the factors contemplated in these Merger Guidelines neither dictate nor exhaust the range of theories or evidence that the Agencies may introduce in merger litigation. Instead, they set forth various methods of analysis that may be applicable depending on the availability and/or reliability of information related to a given market or transaction. Given the variety of industries, market participants, and acquisitions that the Agencies encounter, merger analysis does not consist of uniform application of a single methodology. The Agencies assess any relevant and meaningful evidence to evaluate whether the effect of a merger may be substantially to lessen competition or to tend to create a monopoly. Merger review is ultimately a fact-specific exercise. The Agencies follow the facts and the law in analyzing mergers as they do in other areas of law enforcement.

These Merger Guidelines include references to applicable legal precedent. References to court decisions do not necessarily suggest that the Agencies would analyze the facts in those cases identically today. While the Agencies adapt their analytical tools as they evolve and advance, legal holdings reflecting the Supreme Court's interpretation of a statute apply unless subsequently modified. These Merger Guidelines therefore reference applicable propositions of law to explain core principles that the Agencies apply in a manner consistent with modern analytical tools and market realities. References herein do not constrain the Agencies' interpretation of the law in particular cases, as the Agencies will apply their discretion with respect to the applicable law in each case in light of the full range of precedent pertinent to the issues raised by each enforcement action.

2. Applying the Merger Guidelines

This section discusses the frameworks the Agencies use to assess whether a merger may substantially lessen competition or tend to create a monopoly.

2.1. Guideline 1: Mergers Raise a Presumption of Illegality When They Significantly Increase Concentration in a Highly Concentrated Market.

Market concentration and the change in concentration due to the merger are often useful indicators of a merger's risk of substantially lessening competition. In highly concentrated markets, a merger that eliminates a significant competitor creates significant risk that the merger may substantially lessen competition or tend to create a monopoly. As a result, a significant increase in concentration in a highly concentrated market can indicate that a merger may substantially lessen competition, depriving the public of the benefits of competition.

The Supreme Court has endorsed this view and held that "a merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market[,] is so inherently likely to lessen competition substantially that it must be enjoined in the absence of [rebuttal] evidence."[9] In the Agencies' experience, this legal presumption provides a highly administrable and useful tool for identifying mergers that may substantially lessen competition.

An analysis of concentration involves calculating pre-merger market shares of products[10] within a relevant market (see Section 4.3 for a discussion of market definition and Section 4.4 for more details on computing market shares). The Agencies assess whether the merger creates or further consolidates a highly concentrated market and whether the increase in concentration is sufficient to indicate that the merger may substantially lessen competition or tend to create a monopoly.[11]

The Agencies generally measure concentration levels using the Herfindahl-Hirschman Index ("HHI").[12] The HHI is defined as the sum of the squares of the market shares; it is small when there are many small firms and grows larger as the market becomes more concentrated, reaching 10,000 in a market with a single firm. Markets with an HHI greater than 1,800 are highly concentrated, and a change of more than 100 points is a significant increase.[13] A merger that creates or further consolidates a highly

[9] *United States v. Phila. Nat'l Bank*, 374 U.S. 321, 363 (1963); *see, e.g.*, *FTC v. v. Hackensack Meridian Health, Inc.*, 30 F.4th 160, 172-73 (3d Cir. 2022); *United States v. AT&T, Inc.*, 916 F.3d at 1032.

[10] These Guidelines use the term "products" to encompass anything that is traded between firms and their suppliers, customers, or business partners, including physical goods, services, or access to assets. Products can be as narrow as an individual brand, a specific version of a product, or a product that includes specific ancillary services such as the right to return it without cause or delivery to the customer's location.

[11] Typically, a merger eliminates a competitor by bringing two market participants under common control. Similar concerns arise if the merger threatens to cause the exit of a current market participant, such as a leveraged buyout that puts the target firm at significant risk of failure.

[12] The Agencies may instead measure market concentration using the number of significant competitors in the market. This measure is most useful when there is a gap in market share between significant competitors and smaller rivals or when it is difficult to measure shares in the relevant market.

[13] For illustration, the HHI for a market of five equal firms is 2,000 ($5 \times 20^2 = 2{,}000$) and for six equal firms is 1,667 ($6 \times 16.67^2 = 1667$).

concentrated market that involves an increase in the HHI of more than 100 points[14] is presumed to substantially lessen competition or tend to create a monopoly.[15] The Agencies also may examine the market share of the merged firm: a merger that creates a firm with a share over thirty percent is also presumed to substantially lessen competition or tend to create a monopoly if it also involves an increase in HHI of more than 100 points.[16]

Indicator	Threshold for Structural Presumption
Post-merger HHI	Market HHI greater than 1,800 AND Change in HHI greater than 100
Merged Firm's Market Share	Share greater than 30% AND Change in HHI greater than 100

When exceeded, these concentration metrics indicate that a merger's effect may be to eliminate substantial competition between the merging parties and may be to increase coordination among the remaining competitors after the merger. This presumption of illegality can be rebutted or disproved. The higher the concentration metrics over these thresholds, the greater the risk to competition suggested by this market structure analysis and the stronger the evidence needed to rebut or disprove it.

2.2. Guideline 2: Mergers Can Violate the Law When They Eliminate Substantial Competition Between Firms.

A merger eliminates competition between the merging firms by bringing them under joint control.[17] If evidence demonstrates substantial competition between the merging parties prior to the

[14] The change in HHI from a merger of firms with shares a and b is equal to $2ab$. For example, in a merger between a firm with 20% market share and a firm with 5% market share, the change in HHI is 2 x 20 x 5 = 200.

[15] The first merger guidelines to reference an HHI threshold were the merger guidelines issued in 1982. These guidelines referred to mergers with HHI above 1,000 as concentrated markets, with HHI between 1,000 and 1,800 as "moderately concentrated" and above 1,800 as "highly concentrated," while they referred to an increase in HHI of 100 as a "significant increase." Each subsequent iteration until 2010 maintained those thresholds. *See* Fed. Trade Comm'n & U.S. Dep't of Justice, Horizontal Merger Guidelines § 1.51 (1997); Fed. Trade Comm'n & U.S. Dep't of Justice, Horizontal Merger Guidelines § 1.51 (1992); U.S. Dep't of Justice, Merger Guidelines § 3(A) (1982). During this time, courts routinely cited to the guidelines and these HHI thresholds in decisions. *See, e.g.*, *Chicago Bridge & Iron Co. N.V. v. FTC*, 534 F.3d 410, 431 (5th Cir. 2008); *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 716 (D.C. Cir. 2001); *FTC v. Univ. Health, Inc.*, 938 F.2d 1206, 1211 (11th Cir. 1991). Although the Agencies raised the thresholds for the 2010 guidelines, based on experience and evidence developed since, the Agencies consider the original HHI thresholds to better reflect both the law and the risks of competitive harm suggested by market structure and have therefore returned to those thresholds.

[16] *Phila. Nat'l Bank*, 374 U.S. at 364-65 ("Without attempting to specify the smallest market share which would still be considered to threaten undue concentration, we are clear that 30% presents that threat.").

[17] The competitive harm from the elimination of competition between the merging firms, without considering the risk of coordination, is sometimes referred to as unilateral effects. The elimination of competition between the merging firms can also lessen competition with and among other competitors. When the elimination of competition between the merging firms

merger, that ordinarily suggests that the merger may substantially lessen competition.[18] Although a change in market structure can also indicate risk of competitive harm (see Guideline 1), an analysis of the existing competition between the merging firms can demonstrate that a merger threatens competitive harm independent from an analysis of market shares.

Competition often involves firms trying to win business by offering lower prices, new or better products and services, more attractive features, higher wages, improved benefits, or better terms relating to various additional dimensions of competition. This can include competition to research and develop products or services, and the elimination of such competition may result in harm even if such products or services are not yet commercially available. The more the merging parties have shaped one another's behavior, or have affected one another's sales, profits, valuation, or other drivers of behavior, the more significant the competition between them.

The Agencies examine a variety of indicators to identify substantial competition. For example:

Strategic Deliberations or Decisions. The Agencies may analyze the extent of competition between the merging firms by examining evidence relating to strategic deliberations or decisions in the regular course of business. For example, in some markets, the firms may monitor each other's pricing, marketing campaigns, facility locations, improvements, products, capacity, output, input costs, and/or innovation plans. This can provide evidence of competition between the merging firms, especially when they react by taking steps to preserve or enhance the competitiveness or profitability of their own products or services.

Prior Merger, Entry, and Exit Events. The Agencies may look to historical events to assess the presence and substantiality of direct competition between the merging firms. For example, the Agencies may examine the competitive impact of recent relevant mergers, entry, expansion, or exit events.

Customer Substitution. Customers' willingness to switch between different firms' products is an important part of the competitive process. Firms are closer competitors the more that customers are willing to switch between their products. The Agencies use a variety of tools, detailed in Section 4.2, to assess customer substitution.

Impact of Competitive Actions on Rivals. When one firm takes competitive actions to attract customers, this can benefit the firm at the expense of its rivals. The Agencies may gauge the extent of competition between the merging firms by considering the impact that competitive actions by one of the merging firms has on the other merging firm. The impact of a firm's competitive actions on a rival is generally greater when customers consider the firm's products and the rival's products to be closer substitutes, so that a firm's competitive action results in greater lost sales for the rival, and when the profitability of the rival's lost sales is greater.

Impact of Eliminating Competition Between the Firms. In some instances, evidence may be available to assess the impact of competition from one firm on the other's actions, such as firm choices

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leads them to compete less aggressively with one another, other firms in the market can in turn compete less aggressively, decreasing the overall intensity of competition.

[18] *See also United States v. First Nat'l Bank & Trust Co. of Lexington*, 376 U.S. 665, 669-70 (1964) (per curiam) ("[I]t [is] clear that the elimination of significant competition between [merging parties] constitutes an unreasonable restraint of trade in violation of § 1 of the Sherman Act. . . . It [can be] enough that the two . . . compete[], that their competition [is] not insubstantial and that the combination [would] put an end to it."); *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d 559, 568-70 (6th Cir. 2014), *cert. denied*, 575 U.S. 996 (2015).

about price, quality, wages, or another dimension of competition. Section 4.2 describes a variety of approaches to measuring such impacts.

Additional Evidence, Tools, and Metrics. The Agencies may use additional evidence, tools, and metrics to assess the loss of competition between the firms. Depending on the realities of the market, different evidence, tools, or metrics may be appropriate.

Section 4.2 provides additional detail about the approaches that the Agencies use to assess competition between or among firms.

2.3. Guideline 3: Mergers Can Violate the Law When They Increase the Risk of Coordination.

The Agencies determine that a merger may substantially lessen competition when it meaningfully increases the risk of coordination among the remaining firms in a relevant market or makes existing coordination more stable or effective.[19] Firms can coordinate across any or all dimensions of competition, such as price, product features, customers, wages, benefits, or geography. Coordination among rivals lessens competition whether it occurs explicitly—through collusive agreements between competitors not to compete or to compete less—or tacitly, through observation and response to rivals. Because tacit coordination often cannot be addressed under Section 1 of the Sherman Act, the Agencies vigorously enforce Section 7 of the Clayton Act to prevent market structures conducive to such coordination.

Tacit coordination can lessen competition even when it does not rise to the level of an agreement and would not itself violate the law. For example, in a concentrated market a firm may forego or soften an aggressive competitive action because it anticipates rivals responding in kind. This harmful behavior is more common the more concentrated markets become, as it is easier to predict the reactions of rivals when there are fewer of them.

To assess the extent to which a merger may increase the likelihood, stability, or effectiveness of coordination, the Agencies often consider three primary factors and several secondary factors. The Agencies may consider additional factors depending on the market.

2.3.A. Primary Factors

The Agencies may conclude that post-merger market conditions are susceptible to coordinated interaction and that the merger materially increases the risk of coordination if any of the three primary factors are present.

Highly Concentrated Market. By reducing the number of firms in a market, a merger increases the risk of coordination. The fewer the number of competitively meaningful rivals prior to the merger, the greater the likelihood that merging two competitors will facilitate coordination. Markets that are highly concentrated after a merger that significantly increases concentration (see Guideline 1) are presumptively susceptible to coordination. If merging parties assert that a highly concentrated market is not susceptible to coordination, the Agencies will assess this rebuttal evidence using the framework

[19] *See Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 229-30 (1993) ("In the § 7 context, it has long been settled that excessive concentration, and the oligopolistic price coordination it portends, may be the injury to competition the Act prohibits.").

described below. Where a market is not highly concentrated, the Agencies may still consider other risk factors.

Prior Actual or Attempted Attempts to Coordinate. Evidence that firms representing a substantial share in the relevant market appear to have previously engaged in express or tacit coordination to lessen competition is highly informative as to the market's susceptibility to coordination. Evidence of failed attempts at coordination in the relevant market suggest that successful coordination was not so difficult as to deter attempts, and a merger reducing the number of rivals may tend to make success more likely.

Elimination of a Maverick. A maverick is a firm with a disruptive presence in a market. The presence of a maverick, however, only reduces the risk of coordination so long as the maverick retains the disruptive incentives that drive its behavior. A merger that eliminates a maverick or significantly changes its incentives increases the susceptibility to coordination.

2.3.B. Secondary Factors

The Agencies also examine whether secondary factors demonstrate that a merger may meaningfully increase the risk of coordination, even absent the primary risk factors. Not all secondary factors must be present for a market to be susceptible to coordination.

Market Concentration. Even in markets that are not highly concentrated, coordination becomes more likely as concentration increases. The more concentrated a market, the more likely the Agencies are to conclude that the market structure suggests susceptibility to coordination.

Market Observability. A market is more susceptible to coordination if a firm's behavior can be promptly and easily observed by its rivals. Rivals' behavior is more easily observed when the terms offered to customers are readily discernible and relatively observable (that is, known to rivals). Observability can refer to the ability to observe prices, terms, the identities of the firms serving particular customers, or any other competitive actions of other firms. Information exchange arrangements among market participants, such as public exchange of information through announcements or private exchanges through trade associations or publications, increase market observability. Regular monitoring of one another's prices or customers can indicate that the terms offered to customers are relatively observable. Pricing algorithms, programmatic pricing software or services, and other analytical or surveillance tools that track or predict competitor prices or actions likewise can increase the observability of the market.

Competitive Responses. A market is more susceptible to coordination if a firm's prospective competitive reward from attracting customers away from its rivals will be significantly diminished by its rivals' likely responses. This is more likely to be the case the stronger and faster the responses from its rivals because such responses reduce the benefits of competing more aggressively. Some factors that increase the likelihood of strong or rapid responses by rivals include: (1) the market has few significant competitors, (2) products in the relevant market are relatively homogeneous, (3) customers find it relatively easy to switch between suppliers, (4) suppliers use algorithmic pricing, or (5) suppliers use meeting-competition clauses. The more predictable are rivals' responses to strategic actions or changing competitive conditions, and the more interactions firms have across multiple markets, the greater the susceptibility to coordination.

Aligned Incentives. Removing a firm that has different incentives from most other firms in a market can increase the risk of coordination. For example, a firm with a small market share may have

less incentive to coordinate because it has more to gain from winning new business than other firms. The same issue can arise when a merger more closely aligns one or both merging firms' incentives with the other firms in the market. In some cases, incentives might be aligned or strengthened when firms compete with one another in multiple markets ("multi-market contact"). For example, firms might compete less aggressively in some markets in anticipation of reciprocity by rivals in other markets. The Agencies examine these and any other market realities that suggest aligned incentives increase susceptibility to coordination.

Profitability or Other Advantages of Coordination for Rivals. The Agencies regard coordinated interaction as more likely to occur when participants in the market stand to gain more from successful coordination. Coordination generally is more profitable or otherwise advantageous for the coordinating firms the less often customers substitute outside the market when firms offer worse terms.

Rebuttal Based on Structural Barriers to Coordination Unique to the Industry. When market structure evidence suggests that a merger may substantially lessen competition through coordination, the merging parties sometimes argue that anticompetitive coordination is nonetheless impossible due to structural market barriers to coordinating. The Agencies consider this rebuttal evidence using the framework in Section 3. In so doing, the Agencies consider whether structural market barriers to coordination are "so much greater in the [relevant] industry than in other industries that they rebut the normal presumption" of coordinated effects.[20] In the Agencies' experience, structural conditions that prevent coordination are exceedingly rare in the modern economy. For example, coordination is more difficult when firms are unable to observe rivals' competitive offerings, but technological change has made this situation less common than in the past and reduced many traditional barriers or obstacles to observing the behavior of rivals in a market. The greater the level of concentration in the relevant market, the greater must be the structural barriers to coordination in order to show that no substantial lessening of competition is threatened.

2.4. Guideline 4: Mergers Can Violate the Law When They Eliminate a Potential Entrant in a Concentrated Market.

Mergers can substantially lessen competition by eliminating a potential entrant. For instance, a merger can eliminate the possibility that entry or expansion by one or both firms would have resulted in new or increased competition in the market in the future. A merger can also eliminate current competitive pressure exerted on other market participants by the mere perception that one of the firms might enter. Both of these risks can be present simultaneously.

A merger that eliminates a potential entrant into a concentrated market can substantially lessen competition or tend to create a monopoly.[21] The more concentrated the market, the greater the magnitude of harm to competition from any lost potential entry and the greater the tendency to create a monopoly. Accordingly, for mergers involving one or more potential entrants, the higher the market concentration, the lower the probability of entry that gives rise to concern.

[20] *See H.J. Heinz Co.*, 246 F.3d at 724.
[21] *United States v. Marine Bancorp.*, 418 U.S. 602, 630 (1974). A concentrated market is one with an HHI greater than 1,000 (See Guideline 1, n.15).

2.4.A. Actual Potential Competition: Eliminating Reasonably Probable Future Entry

In general, expansion into a concentrated market via internal growth rather than via acquisition benefits competition.[22] Merging a current and a potential market participant eliminates the possibility that the potential entrant would have entered on its own—entry that, had it occurred, would have provided a new source of competition in a concentrated market.

To determine whether an acquisition that eliminates a potential entrant into a concentrated market may substantially lessen competition,[23] the Agencies examine (1) whether one or both[24] of the merging firms had a reasonable probability of entering the relevant market other than through an anticompetitive merger, and (2) whether such entry offered a substantial likelihood of ultimately producing deconcentration of the market or other significant procompetitive effects.[25]

Reasonable Probability of Entry. The Agencies' starting point for assessment of a reasonable probability of entry is objective evidence regarding the firm's available feasible means of entry, including its capabilities and incentives. Relevant objective evidence can include, for example, evidence that the firm has sufficient size and resources to enter; evidence of any advantages that would make the firm well-situated to enter; evidence that the firm has successfully expanded into similarly situated markets in the past or already participates in adjacent or related markets; evidence that the firm has an incentive to enter; or evidence that industry participants recognize the company as a potential entrant. This analysis is not limited to whether the company could enter with its pre-merger production facilities, but also considers overall capability, which can include the ability to expand or add to its capabilities on its own or in collaboration with someone other than the acquisition target.

Subjective evidence that the company considered entering absent the merger can also indicate a reasonable probability that the company would have entered without the merger. Subjective evidence that the company considered organic entry as an alternative to merging generally suggests that, absent the merger, entry would be reasonably probable.

Likelihood of Deconcentration or Other Significant Procompetitive Effects. New entry can yield a variety of procompetitive effects, including increased output or investment, higher wages or improved working conditions, greater innovation, higher quality, and lower prices. If the merging firm had a reasonable probability of entering a highly concentrated relevant market, this suggests benefits that would have resulted from its entry would be competitively significant, unless there is substantial direct evidence that the competitive effect would be *de minimis*. To supplement the suggestion that new entry yields procompetitive effects, the Agencies will consider projections of the potential entrant's

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[22] *See Ford Motor Co. v. United States*, 405 U.S. 562, 587 (1972) (referring to the "typical[]" competitive concern when "a potential entrant enters an oligopolistic market by acquisition rather than internal expansion" as being "that such a move has deprived the market of the pro-competitive effect of an increase in the number of competitors").

[23] Harm from the elimination of a potential entrant can occur in markets that do not yet consist of commercial products, even if the market concentration of the future market cannot be measured using traditional means. Where there are few equivalent potential entrants, including one or both of the merging firms, that indicates that the future market, once commercialized, will be concentrated. The Agencies will consider other potential entrants' capabilities and incentives in comparison to the merging potential entrant to assess equivalence.

[24] *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964) (holding that a merger between two firms, each or both of which might have entered the relevant market, could violate Section 7).

[25] *See id.* at 175-76; *Marine Bancorp.*, 418 U.S. at 622, 633 ("[T]he proscription expressed in § 7 against mergers 'when a "tendency" toward monopoly or [a] "reasonable likelihood" of a substantial lessening of competition in the relevant market is shown' applies alike to actual- and potential-competition cases." (quoting *Penn-Olin*, 378 U.S. at 171)); *see also Yamaha Motor Co. v. FTC*, 657 F.2d 971, 980-981 (8th Cir. 1981) (acquisition of potential entrant violated Section 7).

competitive significance, such as market share, its business strategy, the anticipated response of competitors, or customer preferences or interest.

A merger of two potential entrants can also result in a substantial lessening of competition. The merger need not involve a firm that has a commercialized product in the market or an existing presence in the same geographic market. The Agencies analyze similarly mergers between two potential entrants and those involving a current market participant and a potential entrant.

2.4.B. Perceived Potential Competition: Lessening of Current Competitive Pressure

A perceived potential entrant can stimulate competition among incumbents. That pressure can prompt current market participants to make investments, expand output, raise wages, increase product quality, lower product prices, or take other procompetitive actions. The acquisition of a firm that is perceived by market participants as a potential entrant can substantially lessen competition by eliminating or relieving competitive pressure.

To assess whether the acquisition of a perceived potential entrant may substantially lessen competition, the Agencies consider whether a current market participant could reasonably consider one of the merging companies to be a potential entrant and whether that potential entrant has a likely influence on existing competition.[26]

Market Participant Could Reasonably Consider a Firm to Be a Potential Entrant. The starting point for this analysis is evidence regarding the company's capability of entering or applying competitive pressure. Objective evidence is highly probative and includes evidence of feasible means of entry or communications by the company indicating plans to expand or reallocate resources in a way that could increase competition in the relevant market. Objective evidence can be sufficient to find that the firm is a potential entrant; it need not be accompanied by any subjective evidence of current market participants' internal perceptions or direct evidence of strategic reactions to the potential entrant. If such evidence is available, it can weigh in favor of finding that a current market participant could reasonably consider the firm to be a potential entrant.

Likely Influence on Existing Rivals. Direct evidence that the firm's presence or behavior has affected or is affecting current market participants' strategic decisions is not necessary but can establish a showing of a likely influence. Even without such direct evidence, circumstantial evidence that the firm's presence or behavior had an effect on the competitive reactions of firms in the market may also show likely influence. Objective evidence establishing that a current market participant could reasonably consider one of the merging firms to be a potential entrant can also establish that the firm has a likely influence on existing market participants. Subjective evidence indicating that current market participants—including, for example, customers, suppliers, or distributors—internally perceive the merging firm to be a potential entrant can also establish a likely influence.

2.4.C. Distinguishing Potential Entry from Entry as Rebuttal

When evaluating a potentially unlawful merger of current competitors, the Agencies will assess whether entry by other firms would be timely, likely, and sufficient to replace the lost competition using the standards discussed in Section 3.2. The existence of a perceived or actual potential entrant may not meet that standard when considering a merger between firms that already participate in the relevant market. The competitive impact of perceived and actual potential entrants is typically attenuated

[26] *See United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 533-36 (1973); *Marine Bancorp.*, 418 U.S. at 624-25.

compared to competition between two current market participants. However, because concentrated markets often lack robust competition, the loss of even an attenuated source of competition such as a potential entrant may substantially lessen competition in such markets. Moreover, because the Agencies seek to prevent threats to competition in their incipiency, the likelihood of potential entry that could establish that a merger's effect "may be" to substantially lessen competition will generally not equal the likelihood of entry that would rebut a demonstrated risk that competition may be substantially lessened.

2.5. Guideline 5: Mergers Can Violate the Law When They Create a Firm that May Limit Access to Products or Services That Its Rivals Use to Compete.

The Agencies evaluate whether a merger may substantially lessen competition when the merged firm can limit access to a product, service, or route to market[27] that its rivals may use to compete. Mergers involving products or services rivals may use to compete can threaten competition in several ways, for example: (A) the merged firm could limit rivals' access to the products or services, thereby weakening or excluding them, lessening competition; (B) the merged firm may gain or increase access to rivals' competitively sensitive information, thereby facilitating coordination or undermining their incentives to compete; or (C) the threat of limited access can deter rivals and potential rivals from investing.

These problems can arise from mergers involving access to any products, services, or routes to market that rivals use to compete, and that are competitively significant to those rivals, whether or not they involve a traditional vertical relationship such as a supplier and distributor relationship. Many types of related products can implicate these concerns, including products rivals currently or may in the future use as inputs, products that provide distribution services for rivals or otherwise influence customers' purchase decisions, products that provide or increase the merged firm's access to competitively sensitive information about its rivals, or complements that increase the value of rivals' products. Even if the related product is not currently being used by rivals, it might be competitively significant because, for example, its availability enables rivals to obtain better terms from other providers in negotiations. The Agencies refer to any product, service, or route to market that rivals use to compete in that market as a "related product."

The Agencies analyze competitive effects in the relevant market in which the merged firm competes with rivals that use the related product. The Agencies do not always define a market around the related product, although they may do so (see Section 2.5.A.2).

2.5.A. The Risk that the Merged Firm May Limit Access

A merger involving products, services, or routes to market that rivals use to compete may substantially lessen competition when the merged firm has both the ability and incentive to limit access to the related product so as to weaken or exclude some of its rivals (the "dependent" rivals) in the relevant market.

The merged firm could limit access to the related product in different ways. It could deny rivals access altogether, deny access to some features, degrade its quality, worsen the terms on which rivals

[27] A "route to market" refers to any way a firm accesses its trading partners, such as distribution channels, marketplaces, or customers.

can access the related product, limit interoperability, degrade the quality of complements, provide less reliable access, tie up or obstruct routes to market, or delay access to product features, improvements, or information relevant to making efficient use of the product. All these ways of limiting access are sometimes referred to as "foreclosure."[28]

Dependent rivals can be weakened if limiting their access to the related product would make it harder or more costly for them to compete; for example, if it would lead them to charge higher prices or offer worse terms in the relevant market, reduce the quality of their products so that they were less attractive to trading partners, or interfere with distribution so that those products were less readily available. Competition can also be weakened if the merger facilitates coordination among the merged firm and its rivals, for example by giving the merged firm the ability to threaten to limit access to uncooperative rivals.

Rivals or potential rivals may be excluded from the relevant market if limiting their access to the related product could lead them to exit the market or could deter them from entering. For example, potential rivals may not enter if the merged firm ties up or obstructs so many routes to market that the remaining addressable market is too small. Exclusion can arise when a new entrant would need to invest not only in entering the relevant market, but also in supplying its own substitute for the related product, sometimes referred to as two-stage entry or multi-level entry.

Because the merged firm could use its ability to limit access to the related product in a range of ways, the Agencies focus on the overall risk that the merged firm will do so, and do not necessarily identify which precise actions the merged firm would take to lessen competition.

2.5.A.1. Ability and Incentive to Foreclose Rivals

The Agencies assess the merged firm's ability and incentive to substantially lessen competition by limiting access to the related product for a group of dependent rivals in the relevant market by examining four factors.

1. Availability of Substitutes. The Agencies assess the availability of substitutes for the related product. The merged firm is more able to limit access when there are few alternative options to the merged firm's related product, if these alternatives are differentiated in quality, price, or other characteristics, or if competition to supply them is limited.

2. Competitive Significance of the Related Product. The Agencies consider how important the related product is for the dependent firms and the extent to which they would be weakened or excluded from the relevant market if their access was limited.

3. Effect on Competition in the Relevant Market. The Agencies assess the importance of the dependent firms for competition in the relevant market. Competition can be particularly affected when the dependent firms would be excluded from the market altogether.

4. Competition Between the Merged Firm and the Dependent Firms. The merged firm's incentive to limit the dependent firms' access depends on how strongly it competes with them. If the dependent firms are close competitors, the merged firm may benefit from higher sales or prices in the relevant market when it limits their access. The Agencies may also assess the potential for the merged

[28] *See Illumina, Inc. v. FTC*, No. 23-60167, slip op. at 17 (5th Cir. Dec. 15, 2023) ("[T]here are myriad ways in which [the merged firm] could engage in foreclosing behavior . . . such as by making late deliveries or subtly reducing the level of support services.").

firm to benefit from facilitating coordination by threatening to limit dependent rivals' access to the related product. These benefits can make it profitable to limit access to the related product and thereby substantially lessen competition, even though it would not have been profitable for the firm that controlled the related product prior to the merger.

The Agencies assess the extent of competition with rivals and the risk of coordination using analogous methods to the ones described in Guidelines 2 and 3, and Section 4.2.

* * *

In addition to the evidentiary, analytical, and economic tools in Section 4, the following additional considerations and evidence may be important to this assessment:

Barriers to Entry and Exclusion of Rivals. The merged firm may benefit more from limiting access to dependent rivals or potential rivals when doing so excludes them from the market, for example by creating a need for the firm to enter at multiple levels and to do so with sufficient scale and scope (multi-level entry).

Prior Transactions or Prior Actions. If firms used prior acquisitions or engaged in prior actions to limit rivals' access to the related product, or other products its rivals use to compete, that suggests that the merged firm has the ability and incentive to do so. However, lack of past action does not necessarily indicate a lack of incentive in the present transaction because the merger can increase the incentive to foreclose.

Internal Documents. Information from business planning and merger analysis documents prepared by the merging firms might identify instances where the firms believe they have the ability and incentive to limit rivals' access. Such documents, where available, are highly probative. The lack of such documents, however, is less informative.

Market Structure. Evidence of market structure can be informative about the availability of substitutes for the related product and the competition in the market for the related product or the relevant market. (See Section 2.5.A.2)

2.5.A.2. Analysis of Industry Factors and Market Structure

The Agencies also sometimes determine, based on an analysis of factors related to market structure, that a merger may substantially lessen competition by allowing the merged firm to limit access to a related product.[29] The Agencies' assessment can include evidence about the structure, history, and probable future of the market.

Structure of the Related Market. In some cases, the market structure of the related product market can give an indication of the merged firm's ability to limit access to the related product. In these cases, the Agencies define a market (termed the "related market") around the related product (see Section 4.3). The Agencies then define the "foreclosure share" as the share of the related market to which the merged firm could limit access. If the share or other evidence show that the merged firm is

[29] *See Brown Shoe*, 370 U.S. at 328-34; *Illumina*, slip op. at 20-22 ("There is no precise formula when it comes to applying these factors. Indeed, the Supreme Court has found a vertical merger unlawful by examining only three of the *Brown Shoe* factors." (cleaned up)); *Fruehauf Corp. v. FTC*, 603 F.2d 345, 353 (2d Cir. 1979); *U.S. Steel Corp. v. FTC*, 426 F.2d 592, 599 (6th Cir. 1970).

approaching or has monopoly power over the related product, and the related product is competitively significant, those factors alone are a sufficient basis to demonstrate that the dependent firms do not have adequate substitutes and the merged firm has the ability to weaken or exclude them by limiting their access to the related product. (See Considerations 1 and 2 in Section 2.5.A.1).[30]

Structure of the Relevant Market. Limiting rivals' access to the related product will generally have a greater effect on competition in the relevant market if the merged firm and the dependent rivals face less competition from other firms. In addition, the merged firm has a greater incentive to limit access to the dependent firms when it competes more closely with them. Market share and concentration measures for the merged firm, the dependent rivals, and the other firms, can sometimes provide evidence about both issues.

Nature and Purpose of the Merger. When the nature and purpose of the merger is to foreclose rivals, including by raising their costs, that suggests the merged firm is likely to foreclose rivals.

Trend Toward Vertical Integration. The Agencies will generally consider evidence about the degree of integration between firms in the relevant and related markets, as well as whether there is a trend toward further vertical integration and how that trend or the factors driving it may affect competition. A trend toward vertical integration may be shown through, for example: a pattern of vertical integration following mergers by one or both of the merging companies; or evidence that a merger was motivated by a desire to avoid having its access limited due to similar transactions among other companies that occurred or may occur in the future.

* * *

If the parties offer rebuttal evidence, the Agencies will assess it under the approach laid out in Section 3.[31] When assessing rebuttal evidence focused on the reduced profits of the merged firm from limiting access from rivals, the Agencies examine whether the reduction in profits would prevent the full range of reasonably probable strategies to limit access. When evaluating whether this rebuttal evidence is sufficient to conclude that no substantial lessening of competition is threatened by the merger, the Agencies will give little weight to claims that are not supported by an objective analysis, including, for example, speculative claims about reputational harms. Moreover, the Agencies are unlikely to credit claims or commitments to protect or otherwise avoid weakening the merged firm's rivals that do not align with the firm's incentives. The Agencies' assessment will be consistent with the principle that firms act to maximize their overall profits and valuation rather than the profits of any particular business

[30] *See Brown Shoe*, 370 U.S. at 328 ("If the share of the market foreclosed is so large that it approaches monopoly proportions, the Clayton Act will, of course, have been violated . . . ."). The Agencies will generally infer, in the absence of countervailing evidence, that the merging firm has or is approaching monopoly power in the related product if it has a share greater than 50% of the related product market. A merger involving a related product with share of less than 50% may still substantially lessen competition, particularly when that related product is important to its trading partners.

[31] A common rebuttal argument is that the merger would lead to vertical integration of complementary products and as a result, "eliminate double marginalization," since in specific circumstances such a merger can confer on the merged firm an incentive to decrease prices to purchasers. The Agencies examine whether elimination of double marginalization satisfies the approach to evaluating procompetitive efficiencies in Section 3.3, including examining: (a) whether the merged firm will be more vertically integrated as a result of the merger, for example because it increases the extent to which it uses internal production of an input when producing output for the relevant market; (b) whether contracts short of a merger have eliminated or could eliminate double marginalization such that it would not be merger-specific, and (c) whether the merged firm has the incentive to reduce price in the relevant market given that such a reduction would reduce sales by the merged firm's rivals in the relevant market, which would in turn lead to reduced revenue and margin on sales of the related product to the dependent rivals.

unit. A merger may substantially lessen competition or tend to create a monopoly regardless of the claimed intent of the merging companies or their executives. (See Section 4.1)

If the merged firm has the ability and incentive to limit access to the related product and lessen competition in the relevant market, there are many ways it could act on those incentives. The merging parties may put forward evidence that there are no reasonably probable ways in which they could profitably limit access to the related product and thereby make it harder for rivals to compete, or that the merged firm will be more competitive because of the merger.

2.5.B. Mergers Involving Visibility into Rivals' Competitively Sensitive Information

If rivals would continue to access or purchase a related product controlled by the merged firm post-merger, the merger can substantially lessen competition if the merged firm would gain or increase visibility into rivals' competitively sensitive information. This situation could arise in many settings, including, for example, if the merged firm learns about rivals' sales volumes or projections from supplying an input or a complementary product; if it learns about promotion plans and anticipated product improvements or innovations from its role as a distributor; or if it learns about entry plans from discussions with potential rivals about compatibility or interoperability with a complementary product it controls. A merger that gives the merged firm increased visibility into competitively sensitive information could undermine rivals' ability or incentive to compete aggressively or could facilitate coordination.

Undermining Competition. The merged firm might use visibility into a rival's competitively sensitive information to undermine competition from the rival. For example, the merged firm's ability to preempt, appropriate, or otherwise undermine the rival's procompetitive actions can discourage the rival from fully pursuing competitive opportunities. Relatedly, rivals might refrain from doing business with the merged firm rather than risk that the merged firm would use their competitively sensitive business information to undercut them. Those rivals might become less-effective competitors if they must rely on less-preferred trading partners or accept less favorable trading terms because their outside options have worsened or are more limited.

Facilitating Coordination. A merger that provides access to rivals' competitively sensitive information might facilitate coordinated interaction among firms in the relevant market by allowing the merged firm to observe its rivals' competitive strategies faster and more confidently. (See Guideline 3.)

2.5.C. Mergers that Threaten to Limit Rivals' Access and Thereby Create Barriers to Entry and Competition

When a merger gives a firm the ability and incentive to limit rivals' access, or where it gives the merged firm increased visibility into its rivals' competitively sensitive information, the merger may create entry barriers as described above. In addition, the merged firm's rivals might change their behavior because of the risk that the merged firm could limit their access. That is, the risk that the merger will give a firm the ability and incentive to limit rivals' access or will give the merged firm increased visibility into sensitive information can dissuade rivals from entering the market or expanding their operations.

Rivals or potential rivals that face the threat of foreclosure, or the risk of sharing sensitive information with rivals, may reduce investment or adjust their business strategies in ways that lessen competition. Firms may be reluctant to invest in a market if their success is dependent on continued supply from a rival, particularly because the merged firm may become more likely to foreclose its

competitor as that competitor becomes more successful. Firms may use expensive strategies to try to reduce their dependence on the merged firm, weakening the competitiveness of their products and services. Even if the merged firm does not deliberately seek to weaken rivals, rivals or potential rivals may fear that their access will be limited if the merged firm decides to use its own products exclusively. These effects may occur irrespective of the merged firm's incentive to limit access and are greater as the merged firm gains greater control over more important inputs that those rivals use to compete.

2.6. Guideline 6: Mergers Can Violate the Law When They Entrench or Extend a Dominant Position.

The Agencies consider whether a merger may entrench or extend an already dominant position. The effect of such mergers "may be substantially to lessen competition" or "may be . . . to tend to create a monopoly" in violation of Section 7 of the Clayton Act. Indeed, the Supreme Court has explained that a merger involving an "already dominant[] firm may substantially reduce the competitive structure of the industry by raising entry barriers."[32] The Agencies also evaluate whether the merger may extend that dominant position into new markets.[33] Mergers that entrench or extend a dominant position can also violate Section 2 of the Sherman Act.[34] At the same time, the Agencies distinguish anticompetitive entrenchment from growth or development as a consequence of increased competitive capabilities or incentives.[35] The Agencies therefore seek to prevent those mergers that would entrench or extend a dominant position through exclusionary conduct, weakening competitive constraints, or otherwise harming the competitive process.

To undertake this analysis, the Agencies first assess whether one of the merging firms has a dominant position based on direct evidence or market shares showing durable market power. For example, the persistence of market power can indicate that entry barriers exist, that further entrenchment may tend to create a monopoly, and that there would be substantial benefits from the emergence of new competitive constraints or disruptions. The Agencies consider mergers involving dominant firms in the context of evidence about the sources of that dominance, focusing on the extent to which the merger relates to, reinforces, or supplements these sources.

Creating or preserving dominance and the profits it brings can be an important motivation for a firm to undertake an acquisition as well as a driver of the merged firm's behavior after the acquisition. In particular, a firm may be willing to undertake costly short-term strategies in order to increase the chance that it can enjoy the longer-term benefits of dominance. A merger that creates or preserves dominance may also reduce the merged firm's longer-term incentives to improve its products and services.

A merger can result in durable market power and long-term harm to competition even when it initially provides short-term benefits to some market participants. Thus, the Agencies will consider not just the impact of the merger holding fixed factors like product quality and the behavior of other industry participants, but they may also consider the (often longer term) impact of the merger on market

[32] *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 577-578 (1967); *see, e.g.*, *Fruehauf*, 603 F.2d at 353 (the "entrenchment of a large supplier or purchaser" can be an "essential" showing of a Section 7 violation).
[33] *Ford*, 405 U.S. at 571 (condemning acquisition by dominant firm to obtain a foothold in another market when coupled with incentive to create and maintain barriers to entry into that market).
[34] *See, e.g.*, *United States v. Grinnell Corp.*, 384 U.S. 563 (1966) (acquisitions are among the types of conduct that may violate the Sherman Act).
[35] *See*, *e.g.*, *id.* at 570-71.

power and industry dynamics. Important dynamic competitive effects can arise through the entry, investment, innovation, and terms offered by the merged firm and other industry participants, even when the Agencies cannot predict specific reactions and responses with precision. If the ultimate result of the merger is to protect or preserve dominance by limiting opportunities for rivals, reducing competitive constraints, or preventing competitive disruption, then the Agencies will approach the merger with a heightened degree of scrutiny. The degree of scrutiny and concern will increase in proportion to the strength and durability of the dominant firm's market power.

2.6.A. Entrenching a Dominant Position

Raising Barriers to Entry or Competition. A merger may create or enhance barriers to entry or expansion by rivals that limit the capabilities or competitive incentives of other firms. Barriers to entry can entrench a dominant position even if the nature of future entry is uncertain, if the identities of future entrants are unknown, or if there is more than one mechanism through which the merged firm might create entry barriers. Some examples of ways in which a merger may raise barriers to entry or competition include:

- *Increasing Switching Costs.* The costs associated with changing suppliers (often referred to as switching costs) can be an important barrier to competition. A merger may increase switching costs if it makes it more difficult for customers to switch away from the dominant firm's product or service, or when it gives the dominant firm control of something customers use to switch providers or of something that lowers the overall cost to customers of switching providers. For example, if a dominant firm merges with a complementary product that interoperates with the dominant firm's competitors, it could reduce interoperability, harming competition for customers who value the complement.

- *Interfering With the Use of Competitive Alternatives.* A dominant position may be threatened by a service that customers use to work with multiple providers of similar or overlapping bundles of products and services. If a dominant firm acquires a service that supports the use of multiple providers, it could degrade its utility or availability or could modify the service to steer customers to its own products, entrenching its dominant position. For example, a closed messaging communication service might acquire a product that allowed users to send and receive messages over several competing services through a single user interface, which facilitates competition. The Agencies would examine whether the acquisition would entrench the messaging service's market power by leading the merged firm to degrade the product or otherwise reduce its effectiveness as a cross-service tool, thus reducing competition.

- *Depriving Rivals of Scale Economies or Network Effects.* Scale economies and network effects can serve as a barrier to entry and competition. Depriving rivals of access to scale economies and network effects can therefore entrench a dominant position. If a merger enables a dominant firm to reduce would-be rivals' access to additional scale or customers by acquiring a product that affects access such as a customer acquisition channel, the merged firm can limit the ability of rivals to improve their own products and compete more effectively.[36] Limiting access by rivals to customers in the short run can lead to long run entrenchment of a dominant position and tend to create monopoly power.

[36] The Agencies' focus here is on the artificial acquisition of network participants that occurs directly as a result of the merger, as opposed to future network growth that may occur through competition on the merits.

For example, if two firms operate in a market in which network effects are significant but in which rivals voluntarily interconnect, their merger can create an entity with a large enough user base that it may have the incentive to end voluntary interconnection. Such a strategy can lessen competition and harm trading partners by creating or entrenching dominance in this market. This can be the case even if the merging firms did not appear to have a dominant position prior to the merger because their interoperability practices strengthened rivals.

Eliminating a Nascent Competitive Threat. A merger may involve a dominant firm acquiring a nascent competitive threat—namely, a firm that could grow into a significant rival, facilitate other rivals' growth, or otherwise lead to a reduction in its power.[37] In some cases, the nascent threat may be a firm that provides a product or service similar to the acquiring firm that does not substantially constrain the acquiring firm at the time of the merger but has the potential to grow into a more significant rival in the future. In other cases, factors such as network effects, scale economies, or switching costs may make it extremely difficult for a new entrant to offer all of the product features or services at comparable quality and terms that an incumbent offers. The most likely successful threats in these situations can be firms that initially avoid directly entering the dominant firm's market, instead specializing in (a) serving a narrow customer segment, (b) offering services that only partially overlap with those of the incumbent, or (c) serving an overlapping customer segment with distinct products or services.

Firms with niche or only partially overlapping products or customers can grow into longer-term threats to a dominant firm. Once established in its niche, a nascent threat may be able to add features or serve additional customer segments, growing into greater overlap of customer segments or features over time, thereby intensifying competition with the dominant firm. A nascent threat may also facilitate customers aggregating additional products and services from multiple providers that serve as a partial alternative to the incumbent's offering. Thus, the success and independence of the nascent threat may both provide for a direct threat of competition by the niche or nascent firm and may facilitate competition or encourage entry by other, potentially complementary providers that may provide a partial competitive constraint. In this way, the nascent threat supports what may be referred to as "ecosystem" competition. In this context, ecosystem competition refers to a situation where an incumbent firm that offers a wide array of products and services may be partially constrained by other combinations of products and services from one or more providers, even if the business model of those competing services is different.

Nascent threats may be particularly likely to emerge during technological transitions. Technological transitions can render existing entry barriers less relevant, temporarily making incumbents susceptible to competitive threats. For example, technological transitions can create temporary opportunities for entrants to differentiate or expand their offerings based on their alignment with new technologies, enabling them to capture network effects that otherwise insulate incumbents from competition. A merger in this context may lessen competition by preventing or delaying any such beneficial shift or by shaping it so that the incumbent retains its dominant position. For example, a dominant firm might seek to acquire firms to help it reinforce or recreate entry barriers so that its dominance endures past the technological transition. Or it might seek to acquire nascent threats that might otherwise gain sufficient customers to overcome entry barriers. In evaluating the potential for entrenching dominance, the Agencies take particular care to preserve opportunities for more competitive markets to emerge during such technological shifts.

[37] The Agencies assess acquisitions of nascent competitive threats by non-dominant firms under the other Guidelines.

Separate from and in addition to its Section 7 analysis, the Agencies will consider whether the merger violates Section 2 of the Sherman Act. For example, under Section 2 of the Sherman Act, a firm that may challenge a monopolist may be characterized as a "nascent threat" even if the impending threat is uncertain and may take several years to materialize.[38] The Agencies assess whether the merger is reasonably capable of contributing significantly to the preservation of monopoly power in violation of Section 2, which turns on whether the acquired firm is a nascent competitive threat.[39]

2.6.B. Extending a Dominant Position into Another Market

The Agencies also examine the risk that a merger could enable the merged firm to extend a dominant position from one market into a related market, thereby substantially lessening competition or tending to create a monopoly in the related market. For example, the merger might lead the merged firm to leverage its position by tying, bundling, conditioning, or otherwise linking sales of two products. A merger may also raise barriers to entry or competition in the related market, or eliminate a nascent competitive threat, as described above. For example, prior to a merger, a related market may be characterized by scale economies but still experience moderate levels of competition. If the merged firm takes actions to induce customers of the dominant firm's product to also buy the related product from the merged firm, the merged firm may be able to gain dominance in the related market, which may be supported by increased barriers to entry or competition that result from the merger.

These concerns can arise notwithstanding that the acquiring firm already enjoys the benefits associated with its dominant position. The prospect of market power in the related market may strongly affect the merged firm's incentives in a way that does not align with the interests of its trading partners, both in terms of strategies that create dominance for the related product and in the form of reduced incentives to invest in its products or provide attractive terms for them after dominance is attained. In some cases, the merger may also further entrench the firm's original dominant position, for example if future competition requires the provision of both products.

* * *

If the merger raises concerns that its effect may be to entrench or extend a dominant position, then any claim that the merger also provides competitive benefits will be evaluated under the rebuttal framework in Section 3. For example, the framework of Section 3 would be used to evaluate claims that a merger would generate cost savings or quality improvements that would be passed through to make their products more competitive or would otherwise create incentives for the merged firm to offer better terms. The Agencies' analysis will consider the fact that the incentives to pass through benefits to customers or offer attractive terms are affected by competition and the extent to which entry barriers insulate the merged firm from effective competition. It will also consider whether any claimed benefits are specific to the merger, or whether they could be instead achieved through contracting or other means.

[38] *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) (en banc) (per curiam).
[39] *See id*. at 79 ("[I]t would be inimical to the purpose of the Sherman Act to allow monopolists free reign to squash nascent, albeit unproven, competitors at will. . . .").

2.7. Guideline 7: When an Industry Undergoes a Trend Toward Consolidation, the Agencies Consider Whether It Increases the Risk a Merger May Substantially Lessen Competition or Tend to Create a Monopoly.

The recent history and likely trajectory of an industry can be an important consideration when assessing whether a merger presents a threat to competition. The Supreme Court has explained that "a trend toward concentration in an industry, whatever its causes, is a highly relevant factor in deciding how substantial the anticompetitive effect of a merger may be."[40] It has also underscored that "Congress intended Section 7 to arrest anticompetitive tendencies in their incipiency.[41] The Agencies therefore examine whether a trend toward consolidation in an industry would heighten the competition concerns identified in Guidelines 1-6.

The Agencies therefore closely examine industry consolidation trends in applying the frameworks above. For example:

Trend Toward Concentration. If an industry has gone from having many competitors to becoming concentrated, it may suggest greater risk of harm, for example, because new entry may be less likely to replace or offset the lessening of competition the merger may cause. Among other implications, in the context of a trend toward concentration, the Agencies identify a stronger presumption of harm from undue concentration (see Guideline 1), and a greater risk of substantially lessening competition when a merger eliminates competition between the merging parties (see Guideline 2) or increases the risk of coordination (see Guideline 3).

Trend Toward Vertical Integration. The Agencies will generally consider evidence about the degree of integration between firms in the relevant and related markets and whether there is a trend toward further vertical integration. If a merger occurs amidst or furthers a trend toward vertical integration, the Agencies consider the implications for the competitive dynamics of the industry moving forward. For example, a trend toward vertical integration could magnify the concerns discussed in Guideline 5 by making entry at a single level more difficult and thereby preventing the emergence of new competitive threats over time.

Arms Race for Bargaining Leverage. The Agencies sometimes encounter mergers through which the merging parties would, by consolidating, gain bargaining leverage over other firms that they transact with. This can encourage those other firms to consolidate to obtain countervailing leverage, encouraging a cascade of further consolidation. This can ultimately lead to an industry where a few powerful firms have leverage against one another and market power over would-be entrants or over trading partners in various parts of the value chain. For example, distributors might merge to gain leverage against suppliers, who then merge to gain leverage against distributors, spurring a wave of mergers that lessen competition by increasing the market power of both. This can exacerbate the problems discussed in Guidelines 1-6, including by increasing barriers to single-level entry, encouraging coordination, and discouraging disruptive innovation.

[40] *United States v. Pabst Brewing*, 384 U.S. 546, 552-53 (1966).
[41] *Phila. Nat'l Bank*, 374 U.S. at 362 (quoting *Brown Shoe*, 370 U.S. at 317).

***Multiple Mergers*.** The Agencies sometimes see multiple mergers at once or in succession by different players in the same industry. In such cases, the Agencies may examine multiple deals in light of the combined trend toward concentration.

2.8. Guideline 8: When a Merger is Part of a Series of Multiple Acquisitions, the Agencies May Examine the Whole Series.

A firm that engages in an anticompetitive pattern or strategy of multiple acquisitions in the same or related business lines may violate Section 7.[42] In these situations, the Agencies may evaluate the series of acquisitions as part of an industry trend (see Guideline 7) or evaluate the overall pattern or strategy of serial acquisitions by the acquiring firm collectively under Guidelines 1-6.

In expanding antitrust law beyond the Sherman Act through passage of the Clayton Act, Congress intended "to permit intervention in a cumulative process when the effect of an acquisition may be a significant reduction in the vigor of competition, even though this effect may not be so far-reaching as to amount to a combination in restraint of trade, create a monopoly, or constitute an attempt to monopolize."[43] As the Supreme Court has recognized, a cumulative series of mergers can "convert an industry from one of intense competition among many enterprises to one in which three or four large [companies] produce the entire supply."[44] Accordingly, the Agencies will consider individual acquisitions in light of the cumulative effect of related patterns or business strategies.

The Agencies may examine a pattern or strategy of growth through acquisition by examining both the firm's history and current or future strategic incentives. Historical evidence focuses on the strategic approach taken by the firm to acquisitions (consummated or not), both in the markets at issue and in other markets, to reveal any overall strategic approach to serial acquisitions. Evidence of the firm's current incentives includes documents and testimony reflecting its plans and strategic incentives both for the individual acquisition and for its position in the industry more broadly. Where one or both of the merging parties has engaged in a pattern or strategy of pursuing consolidation through acquisition, the Agencies will examine the impact of the cumulative strategy under any of the other Guidelines to determine if that strategy may substantially lessen competition or tend to create a monopoly.

2.9. Guideline 9: When a Merger Involves a Multi-Sided Platform, the Agencies Examine Competition Between Platforms, on a Platform, or to Displace a Platform.

Platforms provide different products or services to two or more different groups or "sides" who may benefit from each other's participation. Mergers involving platforms can threaten competition, even when a platform merges with a firm that is neither a direct competitor nor in a traditional vertical relationship with the platform. When evaluating a merger involving a platform, the Agencies apply Guidelines 1-6 while accounting for market realities associated with platform competition. Specifically,

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[42] Such strategies may also violate Section 2 of the Sherman Act and Section 5 of the FTC Act. Fed. Trade Comm'n, *Policy Statement Regarding the Scope of Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act*, at 12-14 & nn.73 & 82 (Nov. 10, 2022) (noting that "a series of . . . acquisitions . . . that tend to bring about the harms that the antitrust laws were designed to prevent" has been subject to liability under Section 5).

[43] H.R. Rep. No. 81-1191, at 8 (1949).

[44] *See Brown Shoe*, 370 U.S. at 334 (citing S. Rep. No. 81-1775, at 5 (1950); H.R. Rep. No. 81-1191, at 8 (1949)).

the Agencies consider competition *between* platforms, competition *on* a platform, and competition to *displace* the platform.

Multi-sided platforms generally have several attributes in common, though they can also vary in important ways. Some of these attributes include:

- Platforms have multiple sides. On each side of a platform, platform participants provide or use distinct products and services.[45] Participants can provide or use different types of products or services on each side.
- A platform operator provides the core services that enable the platform to connect participant groups across multiple sides. The platform operator controls other participants' access to the platform and can influence how interactions among platform participants play out.
- Each side of a platform includes platform participants. Their participation might be as simple as using the platform to find other participants, or as involved as building platform services that enable other participants to connect in new ways and allow new participants to join the platform.
- Network effects occur when platform participants contribute to the value of the platform for other participants and the operator. The value for groups of participants on one side may depend on the number of participants either on the same side (direct network effects) or on the other side(s) (indirect network effects).[46] Network effects can create a tendency toward concentration in platform industries. Indirect network effects can be asymmetric and heterogeneous; for example, one side of the market or segment of participants may place relatively greater value on the other side(s).
- A conflict of interest can arise when a platform operator is also a platform participant. The Agencies refer to a "conflict of interest" as the divergence that can arise between the operator's incentives to operate the platform as a forum for competition and its incentive to operate as a competitor on the platform itself. As discussed below, a conflict of interest sometimes exacerbates competitive concerns from mergers.

Consistent with the Clayton Act's protection of competition "in any line of commerce," the Agencies will seek to prohibit a merger that harms competition within a relevant market for any product or service offered on a platform to any group of participants—i.e., around one side of the platform (see Section 4.3).[47]

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[45] For example, on 1990s operating-system platforms for personal computer (PC) software, software developers were on one side, PC manufacturers on another, and software purchasers on another.

[46] For example, 1990s PC manufacturers, software developers, and consumers all contributed to the value of the operating system platform for one another.

[47] In the limited scenario of a "special type of two-sided platform known as a 'transaction' platform," under Section 1 of the Sherman Act, a relevant market encompassing both sides of a two-sided platform may be warranted. *Ohio v. American Express Co.*, 138 S. Ct. 2274, 2280 (2018). This approach to Section 1 of the Sherman Act is limited to platforms with the "key feature . . . that they cannot make a sale to one side of the platform without simultaneously making a sale to the other." *Id.* Because "they cannot sell transaction services to [either user group] individually . . . transaction platforms are better understood as supplying only one product—transactions." *Id.* at 2286. This characteristic is not present for many types of two-sided or multi-sided platforms; in addition, many platforms offer simultaneous transactions as well as other products and services, and further they may bundle these products with access to transact on the platform or offer quantity discounts.

The Agencies protect competition *between* platforms by preventing the acquisition or exclusion of other platform operators that may substantially lessen competition or tend to create a monopoly. This scenario can arise from various types of mergers:

A. Mergers involving two platform operators eliminate the competition between them. In a market with a platform, entry or growth by smaller competing platforms can be particularly challenging because of network effects. A common strategy for smaller platforms is to specialize, providing distinctive features. Thus, dominant platforms can lessen competition and entrench their position by systematically acquiring firms competing with one or more sides of a multi-sided platform while they are in their infancy. The Agencies seek to stop these trends in their incipiency.

B. A platform operator may acquire a platform participant, which can entrench the operator's position by depriving rivals of participants and, in turn, depriving them of network effects. For example, acquiring a major seller on a platform may make it harder for rival platforms to recruit buyers. The long-run benefits to a platform operator of denying network effects to rival platforms create a powerful incentive to withhold or degrade those rivals' access to platform participants that the operator acquires. The more powerful the platform operator, the greater the threat to competition presented by mergers that may weaken rival operators or increase barriers to entry and expansion.

C. Acquisitions of firms that provide services that facilitate participation on multiple platforms can deprive rivals of platform participants. Many services can facilitate such participation, such as tools that help shoppers compare prices across platforms, applications that help sellers manage listings on multiple platforms, or software that helps users switch among platforms.

D. Mergers that involve firms that provide other important inputs to platform services can enable the platform operator to deny rivals the benefits of those inputs. For example, acquiring data that helps facilitate matching, sorting, or prediction services may enable the platform to weaken rival platforms by denying them that data.

The Agencies protect competition *on* a platform in any markets that interact with the platform. When a merger involves a platform operator and platform participants, the Agencies carefully examine whether the merger would create conflicts of interest that would harm competition. A platform operator that is also a platform participant may have a conflict of interest whereby it has an incentive to give its own products and services an advantage over other participants competing on the platform. Platform operators must often choose between making it easy for users to access their preferred products and directing those users to products that instead provide greater benefit to the platform operator. Merging with a firm that makes a product offered on the platform may change how the platform operator balances these competing interests. For example, the platform operator may find it is more profitable to give its own product greater prominence even if that product is inferior or is offered on worse terms after the merger—and even if some participants leave the platform as a result.[48] This can harm competition in

[48] However, few participants will leave if, for example, the switching costs are relatively high or if the advantaged product is a small component of the overall set of services those participants access on the platform. Moreover, in the long run few participants will leave if scale economies, network effects, or entry barriers enable the advantaged product to eventually gain market power of its own, with rivals of the advantaged product exiting or becoming less attractive. After these dynamics play

the product market for the advantaged product, where the harm to competition may be experienced both on the platform and in other channels.

The Agencies protect competition to *displace* the platform or any of its services. For example, new technologies or services may create an important opportunity for firms to replace one or more services the incumbent platform operator provides, shifting some participants to partially or fully meet their needs in different ways or through different channels. Similarly, a non-platform service can lessen dependence on the platform by providing an alternative to one or more functions provided by the platform operators. When platform owners are dominant, the Agencies seek to prevent even relatively small accretions of power from inhibiting the prospects for displacing the platform or for decreasing dependency on the platform.

In addition, a platform operator that advantages its own products that compete *on* the platform can lessen competition *between* platforms and to *displace* the platform, as the operator may both advantage its own product or service, and also deprive rival platforms of access to it, limiting those rivals' network effects.

2.10. Guideline 10: When a Merger Involves Competing Buyers, the Agencies Examine Whether It May Substantially Lessen Competition for Workers, Creators, Suppliers, or Other Providers.

A merger between competing buyers may harm sellers just as a merger between competing sellers may harm buyers.[49] The same—or analogous—tools used to assess the effects of a merger of sellers can be used to analyze the effects of a merger of buyers, including employers as buyers of labor. Firms can compete to attract contributions from a wide variety of workers, creators, suppliers, and service providers. The Agencies protect this competition in all its forms.

A merger of competing buyers can substantially lessen competition by eliminating the competition between the merging buyers or by increasing coordination among the remaining buyers. It can likewise lead to undue concentration among buyers or entrench or extend the position of a dominant buyer. Competition among buyers can have a variety of beneficial effects analogous to competition among sellers. For example, buyers may compete by raising the payments offered to suppliers, by expanding supply networks, through transparent and predictable contracting, procurement, and payment practices, or by investing in technology that reduces frictions for suppliers. In contrast, a reduction in competition among buyers can lead to artificially suppressed input prices or purchase volume, which in turn reduces incentives for suppliers to invest in capacity or innovation. Labor markets are important buyer markets. The same general concerns as in other markets apply to labor markets where employers are the buyers of labor and workers are the sellers. The Agencies will consider whether workers face a risk that the merger may substantially lessen competition for their labor.[50] Where a merger between

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out, the platform operator could advantage its own products without losing as many participants, as there would be fewer alternative products available through other channels.

[49] *See, e.g.*, *Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co.*, 334 U.S. 219, 235-36 (1948) ("The [Sherman Act] does not confine its protection to consumers, or to purchasers, or to competitors, or to sellers. . . . The Act is comprehensive in its terms and coverage, protecting all who are made victims of the forbidden practices by whomever they may be perpetrated.").
[50] *See, e.g.*, *Alston*, 141 S. Ct. 2141 (applying the Sherman Act to protect workers from an employer-side agreement to limit compensation).

employers may substantially lessen competition for workers, that reduction in labor market competition may lower wages or slow wage growth, worsen benefits or working conditions, or result in other degradations of workplace quality.[51] When assessing the degree to which the merging firms compete for labor, evidence that a merger may have any one or more of these effects can demonstrate that substantial competition exists between the merging firms.

Labor markets frequently have characteristics that can exacerbate the competitive effects of a merger between competing employers. For example, labor markets often exhibit high switching costs and search frictions due to the process of finding, applying, interviewing for, and acclimating to a new job. Switching costs can also arise from investments specific to a type of job or a particular geographic location. Moreover, the individual needs of workers may limit the geographical and work scope of the jobs that are competitive substitutes.

In addition, finding a job requires the worker and the employer to agree to the match. Even within a given salary and skill range, employers often have specific demands for the experience, skills, availability, and other attributes they desire in their employees. At the same time, workers may seek not only a paycheck but also work that they value in a workplace that matches their own preferences, as different workers may value the same aspects of a job differently. This matching process often narrows the range of rivals competing for any given employee. The level of concentration at which competition concerns arise may be lower in labor markets than in product markets, given the unique features of certain labor markets. In light of their characteristics, labor markets can be relatively narrow.

The features of labor markets may in some cases put firms in dominant positions. To assess this dominance in labor markets (see Guideline 6), the Agencies often examine the merging firms' power to cut or freeze wages, slow wage growth, exercise increased leverage in negotiations with workers, or generally degrade benefits and working conditions without prompting workers to quit.

If the merger may substantially lessen competition or tend to create a monopoly in upstream markets, that loss of competition is not offset by purported benefits in a separate downstream product market. Because the Clayton Act prohibits mergers that may substantially lessen competition or tend to create a monopoly in *any* line of commerce and in *any* section of the country, a merger's harm to competition among buyers is not saved by benefits to competition among sellers. That is, a merger can substantially lessen competition in one or more buyer markets, seller markets, or both, and the Clayton Act protects competition in any one of them.[52] If the parties claim any benefits to competition in a relevant buyer market, the Agencies will assess those claims using the frameworks in Section 3.

Just as they do when analyzing competition in the markets for products and services, the Agencies will analyze labor market competition on a case-by-case basis.

[51] A decrease in wages is understood as relative to what would have occurred in the absence of the transaction; in many cases, a transaction will not reduce wage levels, but rather slow wage growth. Wages encompass all aspects of pecuniary compensation, including benefits. Job quality encompasses non-pecuniary aspects that workers value, such as working conditions and terms of employment.

[52] Often, mergers that harm competition among buyers also harm competition among sellers as a result. For example, when a monopsonist lowers purchase prices by decreasing input purchases, they will generally decrease sales in downstream markets as well. (See Section 4.2.D)

2.11. Guideline 11: When an Acquisition Involves Partial Ownership or Minority Interests, the Agencies Examine Its Impact on Competition.

In many acquisitions, two companies come under common control. In some situations, however, the acquisition of less-than-full control may still influence decision-making at the target firm or another firm in ways that may substantially lessen competition. Acquisitions of partial ownership or other minority interests may give the investor rights in the target firm, such as rights to appoint board members, observe board meetings, influence the firm's ability to raise capital, impact operational decisions, or access competitively sensitive information. The Agencies have concerns with both cross-ownership, which refers to holding a non-controlling interest in a competitor, as well as common ownership, which occurs when individual investors hold non-controlling interests in firms that have a competitive relationship that could be affected by those joint holdings.

Partial acquisitions that do not result in control may nevertheless present significant competitive concerns. The acquisition of a minority position may permit influence of the target firm, implicate strategic decisions of the acquirer with respect to its investment in other firms, or change incentives so as to otherwise dampen competition. The post-acquisition relationship between the parties and the independent incentives of the parties outside the acquisition may be important in determining whether the partial acquisition may substantially lessen competition. Such partial acquisitions are subject to the same legal standard as any other acquisition.[53]

The Agencies recognize that cross-ownership and common ownership can reduce competition by softening firms' incentives to compete, even absent any specific anticompetitive act or intent. While the Agencies will consider any way in which a partial acquisition may affect competition, they generally focus on three principal effects:

First, a partial acquisition can lessen competition by giving the partial owner the ability to influence the competitive conduct of the target firm.[54] For example, a voting interest in the target firm or specific governance rights, such as the right to appoint members to the board of directors, influence capital budgets, determine investment return thresholds, or select particular managers, can create such influence. Additionally, a nonvoting interest may, in some instances, provide opportunities to prevent, delay, or discourage important competitive initiatives, or otherwise impact competitive decision making. Such influence can lessen competition because the partial owner could use its influence to induce the target firm to compete less aggressively or to coordinate its conduct with that of the acquiring firm.

Second, a partial acquisition can lessen competition by reducing the incentive of the acquiring firm to compete.[55] Acquiring a minority position in a rival might blunt the incentive of the partial owner to compete aggressively because it may profit through dividend or other revenue share even when it loses business to the rival. For example, the partial owner may decide not to develop a new product feature to win market share from the firm in which it has acquired an interest, because doing so will

[53] *See United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. 586, 592 (1957) ("[A]ny acquisition by one corporation of all or any part of the stock of another corporation, competitor or not, is within the reach of [Section 7 of the Clayton Act] whenever the reasonable likelihood appears that the acquisition will result in a restraint of commerce or in the creation of a monopoly of any line of commerce.").
[54] *See United States v. Dairy Farmers of Am., Inc.*, 426 F.3d 850, 860-61 (6th Cir. 2005).
[55] *See Denver & Rio Grande v. United States*, 387 U.S. 485, 504 (1967) (identifying Section 7 concerns with a 20% investment).

reduce the value of its investment in its rival. This reduction in the incentive of the acquiring firm to compete arises even when it cannot directly influence the conduct or decision making of the target firm.

Third, a partial acquisition can lessen competition by giving the acquiring firm access to non-public, competitively sensitive information from the target firm. Even absent any ability to influence the conduct of the target firm, access to competitively sensitive information can substantially lessen competition through other mechanisms. For example, it can enhance the ability of the target and the partial owner to coordinate their behavior and make other accommodating responses faster and more targeted. The risk of coordinated effects is greater if the transaction also facilitates the flow of competitively sensitive information from the investor to the target firm. Even if coordination does not occur, the partial owner may use that information to preempt or appropriate a rival's competitive business strategies for its own benefit. If rivals know their efforts to win trading partners can be immediately appropriated, they may see less value in taking competitive actions in the first place, resulting in a lessening of competition.

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The analyses above address common scenarios that the Agencies use to assess the risk that a merger may substantially lessen competition or tend to create a monopoly. However, they are not exhaustive. The Agencies have in the past encountered mergers that lessen competition through mechanisms not covered above. For example:

A. A merger that would enable firms to avoid a regulatory constraint because that constraint was applicable to only one of the merging firms;

B. A merger that would enable firms to exploit a unique procurement process that favors the bids of a particular competitor who would be acquired in the merger; or

C. In a concentrated market, a merger that would dampen the acquired firm's incentive or ability to compete due to the structure of the acquisition or the acquirer.

As these scenarios and these Guidelines indicate, a wide range of evidence can show that a merger may lessen competition or tend to create a monopoly. Whatever the sources of evidence, the Agencies look to the facts and the law in each case.

Whatever frameworks the Agencies use to identify that a merger may substantially lessen competition or tend to create a monopoly, they also examine rebuttal evidence under the framework in Section 3.

3. Rebuttal Evidence Showing that No Substantial Lessening of Competition is Threatened by the Merger

The Agencies may assess whether a merger may substantially lessen competition or tend to create a monopoly based on a fact-specific analysis under any one or more of the Guidelines discussed above.[56] The Supreme Court has determined that analysis should consider "other pertinent factors" that may "mandate[] a conclusion that no substantial lessening of competition [is] threatened by the acquisition."[57] The factors pertinent to rebuttal depend on the nature of the threat to competition or tendency to create a monopoly resulting from the merger.

Several common types of rebuttal and defense evidence are subject to legal tests established by the courts. The Agencies apply those tests consistent with prevailing law, as described below.

3.1. Failing Firms

When merging parties suggest the weak or weakening financial position of one of the merging parties will prevent a lessening of competition, the Agencies examine that evidence under the "failing firm" defense established by the Supreme Court. This defense applies when the assets to be acquired would imminently cease playing a competitive role in the market even absent the merger.

As set forth by the Supreme Court, the failing firm defense has three requirements:

A. "[T]he evidence show[s] that the [failing firm] face[s] the grave probability of a business failure."[58] The Agencies typically look for evidence in support of this element that the allegedly failing firm would be unable to meet its financial obligations in the near future. Declining sales and/or net losses, standing alone, are insufficient to show this requirement.

B. "The prospects of reorganization of [the failing firm are] dim or nonexistent."[59] The Agencies typically look for evidence suggesting that the failing firm would be unable to reorganize successfully under Chapter 11 of the Bankruptcy Act, taking into account that "companies reorganized through receivership, or through [the Bankruptcy Act] often emerge[] as strong competitive companies."[60] Evidence of the firm's actual attempts to resolve its debt with creditors is important.

C. "[T]he company that acquires the failing [firm] or brings it under dominion is the only available purchaser."[61] The Agencies typically look for evidence that a company has made unsuccessful good-faith efforts to elicit reasonable alternative offers that pose a less severe danger to competition than does the proposed merger.[62]

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[56] *See United States v. AT&T, Inc.*, 916 F.3d at 1032.
[57] *See United States v. Gen. Dynamics Corp.*, 415 U.S. 486, 498 (1974); *Baker Hughes*, 908 F.2d at 990 (quoting *General Dynamics* and describing its holding as permitting rebuttal based on a "finding that 'no substantial lessening of competition occurred or was threatened by the acquisition'").
[58] *Citizen Publ'g Co. v. United States*, 394 U.S. 131, 138 (1969).
[59] *Id*.
[60] *Id*.
[61] *Id.* at 136-39 (quoting *Int'l Shoe Co. v. FTC*, 280 U.S. 291, 302 (1930)).
[62] Any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets will be regarded as a reasonable alternative offer. Parties must solicit reasonable alternative offers before claiming that the business is failing.

Although merging parties sometimes argue that a poor or weakening position should serve as a defense even when it does not meet these elements, the Supreme Court has "confine[d] the failing company doctrine to its present narrow scope."[63] The Agencies evaluate evidence of a failing firm consistent with this prevailing law.[64]

3.2. Entry and Repositioning

Merging parties sometimes raise a rebuttal argument that a reduction in competition resulting from the merger would induce entry or repositioning[65] into the relevant market, preventing the merger from substantially lessening competition or tending to create a monopoly in the first place. This argument posits that a merger may, by substantially lessening competition, make the market more profitable for the merged firm and any remaining competitors, and that this increased profitability may induce new entry. To evaluate this rebuttal evidence, the Agencies assess whether entry induced by the merger would be "timely, likely, and sufficient in its magnitude, character, and scope to deter or counteract the competitive effects of concern."[66]

Timeliness. To show that no substantial lessening of competition is threatened by a merger, entry must be rapid enough to replace lost competition before any effect from the loss of competition due to the merger may occur. Entry in most industries takes a significant amount of time and is therefore insufficient to counteract any substantial lessening of competition that is threatened by a merger. Moreover, the entry must be durable: an entrant that does not plan to sustain its investment or that may exit the market would not ensure long-term preservation of competition.

Likelihood. Entry induced by lost competition must be so likely that no substantial lessening of competition is threatened by the merger. Firms make entry decisions based on the market conditions they expect once they participate in the market. If the new entry is sufficient to counteract the merger's effect on competition, the Agencies analyze why the merger would induce entry that was not planned in pre-merger competitive conditions.

The Agencies also assess whether the merger may increase entry barriers. For example, the merging firms may have a greater ability to discourage or block new entry when combined than they would have as separate firms. Mergers may enable or incentivize unilateral or coordinated exclusionary

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Liquidation value is the highest value the assets could command outside the market. If a reasonable alternative offer was rejected, the parties cannot claim that the business is failing.

[63] *Citizen Publ'g*, 394 U.S. at 139.

[64] The Agencies do not normally credit claims that the assets of a division would exit the relevant market in the near future unless: (1) applying cost allocation rules that reflect true economic costs, the division has a persistently negative cash flow on an operating basis, and such negative cash flow is not economically justified for the firm by benefits such as added sales in complementary markets or enhanced customer goodwill; and (2) the owner of the failing division has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its assets in the relevant market and pose a less severe danger to competition than does the proposed acquisition. Because firms can allocate costs, revenues, and intra-company transactions among their subsidiaries and divisions, the Agencies require evidence that is not solely based on management plans that could have been prepared for the purpose of demonstrating negative cash flow or the prospect of exit from the relevant market.

[65] Repositioning is a supply-side response that is evaluated like entry. If repositioning requires movement of assets from other markets, the Agencies will consider the costs and competitive effects of doing so. Repositioning that would reduce competition in the markets from which products or services are moved is not a cognizable rebuttal for a lessening of competition in the relevant market.

[66] *FTC v. Sanford Health*, 926 F.3d 959, 965 (8th Cir. 2019).

strategies that make entry more difficult. Entry can be particularly challenging when a firm must enter at multiple levels of the market at sufficient scale to compete effectively.

Sufficiency. Even where timely and likely, the prospect of entry may not effectively prevent a merger from threatening a substantial lessening of competition. Entry may be insufficient due to a wide variety of constraints that limit an entrant's effectiveness as a competitor. Entry must at least replicate the scale, strength, and durability of one of the merging parties to be considered sufficient. The Agencies typically do not credit entry that depends on lessening competition in other markets.

As part of their analysis, the Agencies will consider the economic realities at play. For example, lack of successful entry in the past will likely suggest that entry may be slow or difficult. Recent examples of entry, whether successful or unsuccessful, provide the starting point for identifying the elements of practical entry barriers and the features of the industry that facilitate or interfere with entry. The Agencies will also consider whether the parties' entry arguments are consistent with the rationale for the merger or imply that the merger itself would be unprofitable.

3.3. Procompetitive Efficiencies

The Supreme Court has held that "possible economies [from a merger] cannot be used as a defense to illegality."[67] Competition usually spurs firms to achieve efficiencies internally, and firms also often work together using contracts short of a merger to combine complementary assets without the full anticompetitive consequences of a merger.

Merging parties sometimes raise a rebuttal argument that, notwithstanding other evidence that competition may be lessened, evidence of procompetitive efficiencies shows that no substantial lessening of competition is in fact threatened by the merger. This argument asserts that the merger would not substantially lessen competition in any relevant market in the first place.[68] When assessing this argument, the Agencies will not credit vague or speculative claims, nor will they credit benefits outside the relevant market that would not prevent a lessening of competition in the relevant market. Rather, the Agencies examine whether the evidence[69] presented by the merging parties shows each of the following:

Merger Specificity. The merger will produce substantial competitive benefits that could not be achieved without the merger under review.[70] Alternative ways of achieving the claimed benefits are considered in making this determination. Alternative arrangements could include organic growth of one of the merging firms, contracts between them, mergers with others, or a partial merger involving only those assets that give rise to the procompetitive efficiencies.

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[67] *Phila. Nat'l Bank*, 374 U.S. at 371; *Procter & Gamble Co.*, 386 U.S. at 580 ("Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition.").

[68] *United States v. Anthem*, 855 F.3d 345, 353-55 (D.C. Cir. 2017) (although efficiencies not a "defense" to antitrust liability, evidence sometimes used "to rebut a prima facie case"); *Saint Alphonsus Medical Center-Nampa*, 778 F.3d at 791 ("The Clayton Act focuses on competition, and the claimed efficiencies therefore must show that the prediction of anticompetitive effects from the prima facie case is inaccurate.").

[69] In general, evidence related to efficiencies developed prior to the merger challenge is much more probative than evidence developed during the Agencies' investigation or litigation.

[70] If inter-firm collaborations are achievable by contract, they are not merger specific. The Agencies will credit the merger specificity of efficiencies only in the presence of evidence that a contract to achieve the asserted efficiencies would not be practical. *See Anthem*, 855 F.3d at 357.

Verifiability. These benefits are verifiable, and have been verified, using reliable methodology and evidence not dependent on the subjective predictions of the merging parties or their agents. Procompetitive efficiencies are often speculative and difficult to verify and quantify, and efficiencies projected by the merging firms often are not realized. If reliable methodology for verifying efficiencies does not exist or is otherwise not presented by the merging parties, the Agencies are unable to credit those efficiencies.

Prevents a Reduction in Competition. To the extent efficiencies merely benefit the merging firms, they are not cognizable. The merging parties must demonstrate through credible evidence that, within a short period of time, the benefits will prevent the risk of a substantial lessening of competition in the relevant market.

Not Anticompetitive. Any benefits claimed by the merging parties are cognizable only if they do not result from the anticompetitive worsening of terms for the merged firm's trading partners.[71]

Procompetitive efficiencies that satisfy each of these criteria are called cognizable efficiencies. To successfully rebut evidence that a merger may substantially lessen competition, cognizable efficiencies must be of a nature, magnitude, and likelihood that no substantial lessening of competition is threatened by the merger in any relevant market. Cognizable efficiencies that would not prevent the creation of a monopoly cannot justify a merger that may tend to create a monopoly.

[71] The Agencies will not credit efficiencies if they reflect or require a decrease in competition in a separate market. For example, if input costs are expected to decrease, the cost savings will not be treated as an efficiency if they reflect an increase in monopsony power.

4. Analytical, Economic, and Evidentiary Tools

The analytical, economic, and evidentiary tools that follow can be applicable to many parts of the Agencies' evaluation of a merger as they apply the factors and frameworks discussed in Sections 2 and 3.

4.1. Sources of Evidence

This subsection describes the most common sources of evidence the Agencies draw on in a merger investigation. The evidence the Agencies rely upon to evaluate whether a merger *may* substantially lessen competition or tend to create a monopoly is weighed based on its probative value. In assessing the available evidence, the Agencies consider documents, testimony, available data, and analysis of those data, including credible econometric analysis and economic modeling.

Merging Parties. The Agencies often obtain substantial information from the merging parties, including documents, testimony, and data. Across all of these categories, evidence created in the normal course of business is more probative than evidence created after the company began anticipating a merger review. Similarly, the Agencies give less weight to predictions by the parties or their employees, whether in the ordinary course of business or in anticipation of litigation, offered to allay competition concerns. Where the testimony of outcome-interested merging party employees contradicts ordinary course business records, the Agencies typically give greater weight to the business records.

Evidence that the merging parties intend or expect the merger to lessen competition, such as plans to coordinate with other firms, raise prices, reduce output or capacity, reduce product quality or variety, lower wages, cut benefits, exit a market, cancel plans to enter a market without a merger, withdraw products or delay their introduction, or curtail research and development efforts after the merger, can be highly informative in evaluating the effects of a merger on competition. The Agencies give little weight, however, to the lack of such evidence or the expressed contrary intent of the merging parties.

Customers, Workers, Industry Participants, and Observers. Customers can provide a variety of information to the Agencies, ranging from information about their own purchasing behavior and choices to their views about the effects of the merger itself. The Agencies consider the relationship between customers and the merging parties in weighing customer evidence. The ongoing business relationship between a customer and a merging party may discourage the customer from providing evidence inconsistent with the interests of the merging parties.

Workers and representatives from labor organizations can provide information regarding, among other things, wages, non-wage compensation, working conditions, the individualized needs of workers in the market in question, the frictions involved in changing jobs, and the industry in which they work.

Similarly, other suppliers, indirect customers, distributors, consultants, and industry analysts can also provide information helpful to a merger inquiry. As with other interested parties, the Agencies give less weight to evidence created in anticipation of a merger investigation and more weight to evidence developed in the ordinary course of business.

Market Effects in Consummated Mergers. Evidence of observed post-merger price increases or worsened terms is given substantial weight. A consummated merger, however, may substantially lessen competition even if such effects have not yet been observed, perhaps because the merged firm may be aware of the possibility of post-merger antitrust review and is therefore moderating its conduct.

Consequently, in evaluating consummated mergers, the Agencies also consider the same types of evidence when evaluating proposed mergers.

***Econometric Analysis and Economic Modeling*.** Econometric analysis of data and other types of economic modeling can be informative in evaluating the potential effects of a merger on competition. The Agencies give more weight to analysis using high quality data and adhering to rigorous standards. But the Agencies also take into account that in some cases, the availability or quality of data or reliable modeling techniques might limit the availability and relevance of econometric modeling. When data is available, the Agencies recognize that the goal of economic modeling is not to create a perfect representation of reality, but rather to inform an assessment of the likely change in firm incentives resulting from a merger.

Transaction Terms. The financial terms of the transaction may also be informative regarding a merger's impact on competition. For example, a purchase price that exceeds the acquired firm's stand-alone market value can sometimes indicate that the acquiring firm is paying a premium because it expects to be able to benefit from reduced competition.

4.2. Evaluating Competition Among Firms

This subsection discusses evidence and tools the Agencies look to when assessing competition among firms. The evidence and tools in this section can be relevant to a variety of settings, for example: to assess competition between rival firms (Guideline 2); the ability and incentive to limit access to a product rivals use to compete (Guideline 5); or for market definition (Section 4.3), for example when carrying out the Hypothetical Monopolist Test (Section 4.3.A).

For clarity, the discussion in this subsection often focuses on competition between two suppliers of substitute products that set prices. Analogous analytic tools may also be relevant in more general settings, for example when considering: competition among more than two suppliers; competition among buyers or employers to procure inputs and labor; competition that derives from customer willingness to buy in different locations; and competition that takes place in dimensions other than price or when terms are determined through, for example, negotiations or auctions.

Guideline 2 describes how different types of evidence can be used in assessing the potential harm to competition from a merger; some portions of Guideline 2 that are relevant in other settings are repeated below.

4.2.A. Generally Applicable Considerations

The Agencies may consider one or more of the following types of evidence, tools, and metrics when assessing the degree of competition among firms:

***Strategic Deliberations or Decisions*.** The Agencies may analyze the extent of competition among firms, for example between the merging firms, by examining evidence of their strategic deliberations or decisions in the regular course of business. For example, in some markets, the firms may monitor each other's pricing, marketing campaigns, facility locations, improvements, products, capacity, output, input costs, and/or innovation plans. This can provide evidence of competition between the merging firms, especially when they react by taking steps to preserve or enhance the competitiveness or profitability of their own products or services.

Prior Merger, Entry, and Exit Events. The Agencies may look to historical events to assess the presence and substantiality of direct competition between the merging firms. For example, the Agencies may examine the impact of recent relevant mergers, entry, expansion, or exit events on the merging parties or their competitive behavior.

Customer Substitution. Customers' willingness to switch between different firms' products is an important part of the competitive process. Firms are closer competitors the more that customers are willing to switch between their products, for example because they are more similar in quality, price, or other characteristics.

Evidence commonly analyzed to show the extent of substitution among firms' products includes: how customers have shifted purchases in the past in response to relative changes in price or other terms and conditions; documentary and testimonial evidence such as win/loss reports, evidence from discount approval processes, switching data, customer surveys, as well as information from suppliers of complementary products and distributors; objective information about product characteristics; and market realities affecting the ability of customers to switch.

Impact of Competitive Actions on Rivals. When one firm takes competitive actions to attract customers, this can benefit the firm at the expense of its rivals. The Agencies may gauge the extent of competition among firms by considering the impact that competitive actions by one firm have on the others. The impact of a firm's competitive actions on a rival generally depends on how many sales a rival would lose as a result of the competitive actions, as well as the profitability of those lost sales. The Agencies may use margins to measure the profitability of the sale a rival would have made.[72]

Impact of Eliminating Competition Between the Firms. In some instances, evidence may be available to assess the impact of competition from one or more firms on the other firms' actions, such as firm choices about price, quality, wages, or another dimension of competition. This can be gauged by comparing the two firms' actions when they compete and make strategic choices independently against the actions the firms might choose if they acted jointly. Actual or predicted changes in these results of competition, when available, can indicate the degree of competition between the firms.

To make this type of comparison, the Agencies sometimes rely on economic models. Often, such models consider the firms' incentives to change their actions in one or more selected dimensions, such as price, in a somewhat simplified scenario. For example, a model might focus on the firms' short-run incentives to change price, while abstracting from a variety of additional competitive forces and dimensions of competition, such as the potential for firms to reposition their products or for the merging firms to coordinate with other firms. Such a model may incorporate data and evidence in order to produce quantitative estimates of the impact of the merger on firm incentives and corresponding choices. This type of exercise is sometimes referred to by economists as "merger simulation" despite the fact that the hypothetical setting considers only selected aspects of the loss of competition from a merger. The Agencies use such models to give an indication of the scale and importance of competition, not to precisely predict outcomes.

[72] The margin on incremental units is the difference between incremental revenue (often equal to price) and incremental cost on those units. The Agencies may use accounting data to measure incremental costs, but they do not necessarily rely on accounting margins recorded by firms in the ordinary course of business because such margins often do not align with the concept of incremental cost that is relevant in economic analysis of a merger.

4.2.B. Considerations When Terms Are Set by Firms

The Agencies may use various types of evidence and metrics to assess the strength of competition among firms that set terms to their customers. Firms might offer the same terms to different customers or different terms to different groups of customers.

Competition in this setting can lead firms to set lower prices or offer more attractive terms when they act independently than they would in a setting where that competition was eliminated by a merger. When considering the impact of competition on the incentives to set price, to the extent price increases on one firm's products would lead customers to switch to products from another firm, their merger will enable the merged firm to profit by unilaterally raising the price of one or both products above the pre-merger level. Some of the sales lost because of the price increase will be diverted to the products of the other firm, and capturing the value of these diverted sales can make the price increase profitable even though it would not have been profitable prior to the merger.

A measure of customer substitution between firms in this setting is the diversion ratio. The diversion ratio from one product to another is a metric of how customers likely would substitute between them. The diversion ratio is the fraction of unit sales lost by the first product due to a change in terms, such as an increase in its price, that would be diverted to the second product. The higher the diversion ratio between two products made by different firms, the stronger the competition between them.

A high diversion ratio between the products owned by two firms can indicate strong competition between them even if the diversion ratio to another firm is higher. The diversion ratio from one of the products of one firm to a group of products made by other firms, defined analogously, is sometimes referred to as the aggregate diversion ratio or the recapture rate.

A measure of the impact on rivals of competitive actions is the value of diverted sales from a price increase. The value of sales diverted from one firm to a second firm, when the first firm raises its price on one of its products, is equal to the number of units that would be diverted from the first firm to the second, multiplied by the difference between the second firm's price and the incremental cost of the diverted sales. To interpret the magnitude of the value of diverted sales, the Agencies may use as a basis of comparison either the incremental cost to the second firm of making the diverted sales, or the revenues lost by the first firm as a result of the price increase. The ratio of the value of diverted sales to the revenues lost by the first firm can be an indicator of the upward pricing pressure that would result from the loss of competition between the two firms. Analogous concepts can be applied to analyze the impact on rivals of worsening terms other than price.

4.2.C. Considerations When Terms Are Set Through Bargaining or Auctions

In some industries, buyers and sellers negotiate prices and other terms of trade. In bargaining, buyers commonly negotiate with more than one seller and may play competing sellers off against one another. In other industries, sellers might sell their products, or buyers might procure inputs, using an auction. Negotiations may involve aspects of an auction as well as aspects of one-on-one negotiation. Competition among sellers can significantly enhance the ability of a buyer to obtain a result more favorable to it, and less favorable to the sellers, compared to a situation where the elimination of competition through a merger prevents buyers from playing those sellers off against each other in negotiations.

Sellers may compete even when a customer does not directly play their offers against each other. The attractiveness of alternative options influences the importance of reaching an agreement to the

negotiating parties and thus the terms of the agreement. A party that has many attractive alternative trading partners places less importance on reaching an agreement with any one particular trading partner than a party with few attractive alternatives. As alternatives for one party are eliminated (such as through a merger), the trading partner gains additional bargaining leverage reflecting that loss of competition. A merger between sellers may lessen competition even if the merged firm handles negotiations for the merging firms' products separately.

Thus, qualitative or quantitative evidence about the leverage provided to buyers by competing suppliers may be used to assess the extent of competition among firms in this setting. Analogous evidence may be used when analyzing a setting where terms are set using auctions, for example, procurement auctions where suppliers bid to serve a buyer. If, for some categories of procurements, certain suppliers are often among the most attractive to the buyer, competition among that group of suppliers is likely to be strong.

Firms sometimes keep records of the progress and outcome of individual sales efforts, and the Agencies may use these data to generate measures of the extent to which customers would likely substitute between the two firms. Examples of such measures might include a diversion ratio based on the rate at which customers would buy from one firm if the other one was not available, or the frequency with which the two firms bid on contracts with the same customer.

4.2.D. Considerations When Firms Determine Capacity and Output

In some markets, the choice of how much to produce (output decisions) or how much productive capacity to maintain (capacity decisions) are key strategic variables. When a firm decreases output, it may lose sales to rivals, but also drive up prices. Because a merged firm will account for the impact of higher prices across all of the merged firms' sales, it may have an incentive to decrease output as a result of the merger. The loss of competition through a merger of two firms may lead the merged firm to leave capacity idle, refrain from building or obtaining capacity that would have been obtained absent the merger, lay off or stop hiring workers, or eliminate pre-existing production capabilities. A firm may also divert the use of capacity away from one relevant market and into another market so as to raise the price in the former market. The analysis of the extent to which firms compete may differ depending on how a merger between them might create incentives to suppress output.

Competition between merging firms is greater when (1) the merging firms' market shares are relatively high; (2) the merging firms' products are relatively undifferentiated from each other; (3) the market elasticity of demand is relatively low; (4) the margin on the suppressed output is relatively low; and (5) the supply responses of non-merging rivals are relatively small. Qualitative or quantitative evidence may be used to evaluate and weigh each of these factors.

In some cases, competition between firms—including one firm with a substantial share of the sales in the market and another with significant excess capacity to serve that market—can prevent an output suppression strategy from being profitable. This can occur even if the firm with the excess capacity has a relatively small share of sales, as long as that firm's ability to expand, and thus keep prices from rising, makes an output suppression strategy unprofitable for the firm with the larger market share.

4.2.E. Considerations for Innovation and Product Variety Competition

Firms can compete for customers by offering varied and innovative products and features, which could range from minor improvements to the introduction of a new product category. Features can include new or different product attributes, services offered along with a product, or higher-quality services standing alone. Customers value the variety of products or services that competition generates, including having a variety of locations at which they can shop.

Offering the best mix of products and features is an important dimension of competition that may be harmed as a result of the elimination of competition between the merging parties.

When a firm introduces a new product or improves a product's features, some of the sales it gains may be at the expense of its rivals, including rivals that are competing to develop similar products and features. As a result, competition between firms may lead them to make greater efforts to offer a variety of products and features than would be the case if the firms were jointly owned, for example, if they merged. The merged firm may have a reduced incentive to continue or initiate development of new products that would have competed with the other merging party, but post-merger would "cannibalize" what would be its own sales.[73] A service provider may have a reduced incentive to continue valuable upgrades offered by the acquired firm. The merged firm may have a reduced incentive to engage in disruptive innovation that would threaten the business of one of the merging firms. Or it may have the incentive to change its product mix, such as by ceasing to offer one of the merging firms' products, leaving worse off the customers who previously chose the product that was eliminated. For example, competition may be harmed when customers with a preference for a low-price option lose access to it, even if remaining products have higher quality.

The incentives to compete aggressively on innovation and product variety depend on the capabilities of the firms and on customer reactions to the new offerings. Development of new features depends on having the appropriate expertise and resources. Where firms are two of a small number of companies with specialized employees, development facilities, intellectual property, or research projects in a particular area, competition between them will have a greater impact on their incentives to innovate.

Innovation may be directed at outcomes beyond product features; for example, innovation may be directed at reducing costs or adopting new technology for the distribution of products.

4.3. Market Definition

The Clayton Act protects competition "in any line of commerce in any section of the country."[74] The Agencies engage in a market definition inquiry in order to identify whether there is any line of commerce or section of the country in which the merger may substantially lessen competition or tend to create a monopoly. The Agencies identify the "area of effective competition" in which competition may be lessened "with reference to a product market (the 'line of commerce') and a geographic market (the 'section of the country.')."[75] The Agencies refer to the process of identifying market(s) protected by the Clayton Act as a "market definition" exercise and the markets so defined as "relevant antitrust markets,"

[73] Sales "cannibalization" refers to a situation where customers of a firm substitute away from one of the firm's products to another product offered by the same firm.
[74] 15 U.S.C. § 18.
[75] *Brown Shoe*, 370 U.S. at 324.

or simply "relevant markets." Market definition can also allow the Agencies to identify market participants and measure market shares and market concentration.

A relevant antitrust market is an area of effective competition, comprising both product (or service) and geographic elements. The outer boundaries of a relevant product market are determined by the "reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it."[76] Within a broad relevant market, however, effective competition often occurs in numerous narrower relevant markets.[77] Market definition ensures that relevant antitrust markets are sufficiently broad, but it does not always lead to a single relevant market. Section 7 of the Clayton Act prohibits any merger that may substantially lessen competition "in any line of commerce" and in "any section of the country," and the Agencies protect competition by challenging a merger that may lessen competition in any one or more relevant markets.

Market participants often encounter a range of possible substitutes for the products of the merging firms. However, a relevant market cannot meaningfully encompass that infinite range of substitutes.[78] There may be effective competition among a narrow group of products, and the loss of that competition may be harmful, making the narrow group a relevant market, even if competitive constraints from significant substitutes are outside the group. The loss of both the competition between the narrow group of products and the significant substitutes outside that group may be even more harmful, but that does not prevent the narrow group from being a market in its own right.

Relevant markets need not have precise metes and bounds. Some substitutes may be closer, and others more distant, and defining a market necessarily requires including some substitutes and excluding others. Defining a relevant market sometimes requires a line-drawing exercise around product features, such as size, quality, distances, customer segment, or prices. There can be many places to draw that line and properly define a relevant market. The Agencies recognize that such scenarios are common, and indeed "fuzziness would seem inherent in any attempt to delineate the relevant . . . market."[79] Market participants may use the term "market" colloquially to refer to a broader or different set of products than those that would be needed to constitute a valid relevant antitrust market.

The Agencies rely on several tools to demonstrate that a market is a relevant antitrust market. For example, the Agencies may rely on any one or more of the following to identify a relevant antitrust market.

A. Direct evidence of substantial competition between the merging parties can demonstrate that a relevant market exists in which the merger may substantially lessen competition and can be sufficient to identify the line of commerce and section of the country affected by a merger, even if the metes and bounds of the market are only broadly characterized.

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[76] *Id.* at 325.

[77] *Id.* ("[W]ithin [a] broad market, well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes."). Multiple overlapping markets can be appropriately defined relevant markets. For example, a merger to monopoly for food worldwide would lessen competition in well-defined relevant markets for, among others, food, baked goods, cookies, low-fat cookies, and premium low-fat chocolate chip cookies. Illegality in any of these in any city or town comprising a relevant geographic market would suffice to prohibit the merger, and the fact that one area comprises a relevant market does not mean a larger, smaller, or overlapping area could not as well.

[78] *United States v. Cont'l Can Co.*, 378 U.S. 441, 449 (1964); *see also FTC v. Advoc. Health Care Network*, 841 F.3d 460, 469 (7th Cir. 2016) ("A geographic market does not need to include all of the firm's competitors; it needs to include the competitors that would substantially constrain the firm's price-increasing ability." (cleaned up)).

[79] *Phila. Nat'l Bank*, 374 U.S. at 360 n.37.

B. Direct evidence of the exercise of market power can demonstrate the existence of a relevant market in which that power exists. This evidence can be valuable when assessing the risk that a dominant position may be entrenched, maintained, or extended, since the same evidence identifies market power and can be sufficient to identify the line of commerce and section of the country affected by a merger, even if the metes and bounds of the market are only broadly characterized.

C. A relevant market can be identified from evidence on observed market characteristics ("practical indicia"), such as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.[80] Various practical indicia may identify a relevant market in different settings.

D. Another common method employed by courts and the Agencies is the hypothetical monopolist test.[81] This test examines whether a proposed market is too narrow by asking whether a hypothetical monopolist over this market could profitably worsen terms significantly, for example, by raising price. An analogous hypothetical monopsonist test applies when considering the impact of a merger on competition among buyers.

The Agencies use these tools to define relevant markets because they each leverage market realities to identify an area of effective competition.

Section 4.3.A below describes the Hypothetical Monopolist Test in greater detail. Section 4.3.B addresses issues that may arise when defining relevant markets in several specific scenarios.

4.3.A. The Hypothetical Monopolist Test

This Section describes the Hypothetical Monopolist Test, which is a method by which the Agencies often define relevant antitrust markets. As outlined above, a relevant antitrust market is an area of effective competition. The Hypothetical Monopolist/Monopsonist Test ("HMT") evaluates whether a group of products is sufficiently broad to constitute a relevant antitrust market. To do so, the HMT asks whether eliminating the competition among the group of products by combining them under the control of a hypothetical monopolist likely would lead to a worsening of terms for customers. The Agencies generally focus their assessment on the constraints from competition, rather than on constraints from regulation, entry, or other market changes. The Agencies are concerned with the impact on economic incentives and assume the hypothetical monopolist would seek to maximize profits.

When evaluating a merger of sellers, the HMT asks whether a hypothetical profit-maximizing firm, not prevented by regulation from worsening terms, that was the only present and future seller of a group of products ("hypothetical monopolist") likely would undertake at least a small but significant and non-transitory increase in price ("SSNIP") or other worsening of terms ("SSNIPT") for at least one

[80] *Brown Shoe*, 370 U.S. at 325, *quoted in United States v. U.S. Sugar Corp.*, 73 F.4th 197, 204-07 (3d Cir. 2023) (affirming district court's application of *Brown Shoe* practical indicia to evaluate relevant product market that included, based on the unique facts of the industry, those distributors who "could counteract monopolistic restrictions by releasing their own supplies").

[81] *See FTC v. Penn State Hershey Med. Center*, 838 F.3d 327, 338 (3d Cir. 2016). While these guidelines focus on applying the hypothetical monopolist test in analyzing mergers, the test can be adapted for similar purposes in cases involving alleged monopolization or other conduct. *See, e.g.*, *McWane, Inc. v. FTC*, 783 F.3d 814, 829-30 (11th Cir. 2015).

product in the group.[82] For the purpose of analyzing this issue, the terms of sale of products outside the candidate market are held constant. Analogously, when considering a merger of buyers, the Agencies ask the equivalent question for a hypothetical monopsonist. This Section often focuses on merging sellers to simplify exposition.

4.3.B. Implementing the Hypothetical Monopolist Test

The SSNIPT. A SSNIPT may entail worsening terms along any dimension of competition, including price (SSNIP), but also other terms (broadly defined) such as quality, service, capacity investment, choice of product variety or features, or innovative effort.

Input and Labor Markets. When the competition at issue involves firms buying inputs or employing labor, the HMT considers whether the hypothetical monopsonist would undertake at least a SSNIPT, such as a decrease in the offered price or a worsening of the terms of trade offered to suppliers, or a decrease in the wage offered to workers or a worsening of their working conditions or benefits.

The Geographic Dimension of the Market. The hypothetical monopolist test is generally applied to a group of products together with a geographic region to determine a relevant market, though for ease of exposition the two dimensions are discussed separately, with geographic market definition discussed in Section 4.3.D.2.

Negotiations or Auctions. The HMT is stated in terms of a hypothetical monopolist *undertaking* a SSNIPT. This covers settings where the hypothetical monopolist sets terms and makes them worse. It also covers settings where firms bargain, and the hypothetical monopolist would have a stronger bargaining position that would likely lead it to extract a SSNIPT during negotiations, or where firms sell their products in an auction, and the bids submitted by the hypothetical monopolist would result in the purchasers of its products experiencing a SSNIPT.

Benchmark for the SSNIPT. The HMT asks whether the hypothetical monopolist likely would worsen terms relative to those that likely would prevail absent the proposed merger. In some cases, the Agencies will use as a benchmark different outcomes than those prevailing prior to the merger. For example, if outcomes are likely to change absent the merger, e.g., because of innovation, entry, exit, or exogenous trends, the Agencies may use anticipated future outcomes as the benchmark. Or, if suppliers in the market are coordinating prior to the merger, the Agencies may use a benchmark that reflects conditions that would arise if coordination were to break down. When evaluating whether a merging firm is dominant (Guideline 6), the Agencies may use terms that likely would prevail in a more competitive market as a benchmark.[83]

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[82] If the pricing incentives of the firms supplying the products in the group differ substantially from those of the hypothetical monopolist, for reasons other than the latter's control over a larger group of substitutes, the Agencies may instead employ the concept of a hypothetical profit-maximizing cartel comprised of the firms (with all their products) that sell the products in the candidate market. This approach is most likely to be appropriate if the merging firms sell products outside the candidate market that significantly affect their pricing incentives for products in the candidate market. This could occur, for example, if the candidate market is one for durable equipment and the firms selling that equipment derive substantial net revenues from selling spare parts and service for that equipment. Analogous considerations apply when considering a SSNIPT for terms other than price.

[83] In the entrenchment context, if the inquiry is being conducted after market or monopoly power has already been exercised, using prevailing prices can lead to defining markets too broadly and thus inferring that dominance does not exist when, in

Magnitude of the SSNIPT. What constitutes a "small but significant" worsening of terms depends upon the nature of the industry and the merging firms' positions in it, the ways that firms compete, and the dimension of competition at issue. When considering price, the Agencies will often use a SSNIP of five percent of the price charged by firms for the products or services to which the merging firms contribute value. The Agencies, however, may consider a different term or a price increase that is larger or smaller than five percent.[84]

The Agencies may base a SSNIP on explicit or implicit prices for the firms' specific contribution to the value of the product sold, or an upper bound on the firms' specific contribution, where these can be identified with reasonable clarity. For example, the Agencies may derive an implicit price for the service of transporting oil over a pipeline as the difference between the price the pipeline firm paid for oil at one end and the price it sold the oil for at the other and base the SSNIP on this implicit price.

4.3.C. Evidence and Tools for Carrying Out the Hypothetical Monopolist Test

Section 4.2 describes some of the qualitative and quantitative evidence and tools the Agencies can use to assess the extent of competition among firms. The Agencies can use similar evidence and analogous tools to apply the HMT, in particular to assess whether competition among a set of firms likely leads to better terms than a hypothetical monopolist would undertake.

To assess whether the hypothetical monopolist likely would undertake at least a SSNIP on one or more products in the candidate market, the Agencies sometimes interpret the qualitative and quantitative evidence using an economic model of the profitability to the hypothetical monopolist of undertaking price increases; the Agencies may adapt these tools to apply to other forms of SSNIPTs.

One approach utilizes the concept of a "recapture rate" (the percentage of sales lost by one product in the candidate market, when its price alone rises, that is recaptured by other products in the candidate market). A price increase is profitable when the recapture rate is high enough that the incremental profits from the increased price plus the incremental profits from the recaptured sales going to other products in the candidate market exceed the profits lost when sales are diverted outside the candidate market. It is possible that a price increase is profitable even if a majority of sales are diverted outside the candidate market, for example if the profits on the lost sales are relatively low or the profits on the recaptured sales are relatively high.

Sometimes evidence is presented in the form of "critical loss analysis," which can be used to assess whether undertaking at least a SSNIPT on one or more products in a candidate market would raise or lower the hypothetical monopolist's profits. Critical loss analysis compares the magnitude of the two offsetting effects resulting from the worsening of terms. The "critical loss" is defined as the number of lost unit sales that would leave profits unchanged. The "predicted loss" is defined as the number of unit sales that the hypothetical monopolist is predicted to lose due to the worsening of terms. The worsening of terms raises the hypothetical monopolist's profits if the predicted loss is less than the

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fact, it does. The problem with using prevailing prices to define the market when a firm is already dominant is known as the "Cellophane Fallacy."

[84] The five percent price increase is not a threshold of competitive harm from the merger. Because the five percent SSNIP is a minimum expected effect of a hypothetical monopolist of an *entire* market, the actual predicted effect of a merger within that market may be significantly lower than five percent. A merger within a well-defined market that causes undue concentration can be illegal even if the predicted price increase is well below the SSNIP of five percent.

critical loss. While this "breakeven" analysis differs somewhat from the profit-maximizing analysis called for by the HMT, it can sometimes be informative.

The Agencies require that estimates of the predicted loss be consistent with other evidence, including the pre-merger margins of products in the candidate market used to calculate the critical loss. Unless the firms are engaging in coordinated interaction, high pre-merger margins normally indicate that each firm's product individually faces demand that is not highly sensitive to price. Higher pre-merger margins thus indicate a smaller predicted loss as well as a smaller critical loss. The higher the pre-merger margin, the smaller the recapture rate[85] necessary for the candidate market to satisfy the hypothetical monopolist test. Similar considerations inform other analyses of the profitability of a price increase.

4.3.D. Market Definition in Certain Specific Settings

This Section provides details on market definition in several specific common settings. In much of this section, concepts are presented for the scenario where the merger involves sellers. In some cases, clarifications are provided as to how the concepts apply to merging buyers; in general, the concepts apply in an analogous way.

4.3.D.1. Targeted Trading Partners

If the merged firm could profitably target a subset of customers for changes in prices or other terms, the Agencies may identify relevant markets defined around those targeted customers. The Agencies may do so even if firms are not currently targeting specific customer groups but could do so after the merger.

For targeting to be feasible, two conditions typically must be met. First, the suppliers engaging in targeting must be able to set different terms for targeted customers than other customers. This may involve identification of individual customers to which different terms are offered or offering different terms to different types of customers based on observable characteristics.[86] Markets for targeted customers need not have precise metes and bounds. In particular, defining a relevant market for targeted customers sometimes requires a line-drawing exercise on observable characteristics. There can be many places to draw that line and properly define a relevant market. Second, the targeted customers must not be likely to defeat a targeted worsening of terms by arbitrage (e.g., by purchasing indirectly from or through other customers). Arbitrage may be difficult if it would void warranties or make service more difficult or costly for customers, and it is inherently impossible for many services. Arbitrage on a modest scale may be possible but sufficiently costly or limited, for example due to transaction costs or search costs, that it would not deter or defeat a discriminatory pricing strategy.

If prices are negotiated or otherwise set individually, for example through a procurement auction, there may be relevant markets that are as narrow as an individual customer. Nonetheless, for analytic convenience, the Agencies may define cluster markets for groups of targeted customers for whom the

[85] The recapture rate is sometimes referred to as the aggregate diversion ratio, defined in Section 4.2.B.

[86] In some cases, firms offer one or more versions of products or services defined by their characteristics (where brand might be a characteristic). When customers can select among these products and terms do not vary by customer, the Agencies will typically define markets based on products rather than the targeted customers. In such cases, relevant antitrust markets may include only some of the differentiated products, for example products with only "basic" features, or products with "premium features." The tools described in Section 4.2 can be used to assess competition among differentiated products.

conditions of competition are reasonably similar. (See Section 4.3.D.4 for further discussion of cluster markets.)

Analogous considerations arise for a merger involving one or more buyers or employers. In this case, the analysis considers whether buyers target suppliers, for example by paying targeted suppliers or workers less, or by degrading the terms of supply contracts for targeted suppliers. Arbitrage would involve a targeted supplier selling to the buyer indirectly, through a different supplier who could obtain more favorable terms from the buyer.

If the HMT is applied in a setting where targeting of customers is feasible, it requires that a hypothetical profit-maximizing firm that was the only present or future seller of the relevant product(s) to customers in the targeted group would undertake at least a SSNIPT on some, though not necessarily all, customers in that group. The products sold to those customers form a relevant market if the hypothetical monopolist likely would undertake at least a SSNIPT despite the potential for customers to substitute away from the product or to take advantage of arbitrage. In this exercise, the terms of sale for products sold to all customers outside the region are held constant.

4.3.D.2. Geographic Markets

A relevant antitrust market is an area of effective competition, comprising both product (or service) and geographic elements. A market's geography depends on the limits that distance puts on some customers' willingness or ability to substitute to some products, or some suppliers' willingness or ability to serve some customers. Factors that may limit the geographic scope of the market include transportation costs, language, regulation, tariff and non-tariff trade barriers, custom and familiarity, reputation, and local service availability.

4.3.D.2.a. Geographic Markets Based on the Locations of Suppliers

The Agencies sometimes define geographic markets as regions encompassing a group of supplier locations. When they do, the geographic market's scope is determined by customers' willingness to switch between suppliers. Geographic markets of this type often apply when customers receive goods or services at suppliers' facilities, for example when customers buy in-person from retail stores. A single firm may offer the same product in a number of locations, both within a single geographic market or across geographic markets; customers' willingness to substitute between products may depend on the location of the supplier. When calculating market shares, sales made from supplier locations in the geographic market are included, regardless of whether the customer making the purchase travelled from outside the boundaries of the geographic market (see Section 4.4 for more detail about calculating market shares).

If the HMT is used to evaluate the geographic scope of the market, it requires that a hypothetical profit-maximizing firm that was the only present or future supplier of the relevant product(s) at supplier locations in the region likely would undertake at least a SSNIPT in at least one location. In this exercise, the terms of sale for products sold to all customers at facilities outside the region are typically held constant.[87]

[87] In some circumstances, as when the merging parties operate in multiple geographies, if applying the HMT, the Agencies may apply a "Hypothetical Cartel" framework for market definition, following the approach outlined in Section 4.3.A, n.81.

4.3.D.2.b. Geographic Markets Based on Targeting of Customers by Location

When targeting based on customer location is feasible (see Section 4.3.D.1), the Agencies may define geographic markets as a region encompassing a group of customers.[88] For example, geographic markets may sometimes be defined this way when suppliers deliver their products or services to customers' locations, or tailor terms of trade based on customers' locations. Competitors in the market are firms that sell to customers that are located in the specified region. Some suppliers may be located outside the boundaries of the geographic market, but their sales to customers located within the market are included when calculating market shares (see Section 4.4 for more detail about calculating market shares).

If prices are negotiated individually with customers that may be targeted, geographic markets may be as narrow as individual customers. Nonetheless, the Agencies often define a market for a cluster of customers located within a region if the conditions of competition are reasonably similar for these customers. (See Section 4.3.D.4 for further discussion of cluster markets.)

A firm's attempt to target customers in a particular area with worsened terms can sometimes be undermined if some customers in the region substitute by travelling outside it to purchase the product. Arbitrage by customers on a modest scale may be possible but sufficiently costly or limited that it would not deter or defeat a targeting strategy.[89]

If the HMT is used to evaluate market definition when customers may be targeted by location, it requires that a hypothetical profit-maximizing firm that was the only present or future seller of the relevant product(s) to customers in the region likely would undertake at least a SSNIPT on some, though not necessarily all, customers in that region. The products sold in that region form a relevant market if the hypothetical monopolist would undertake at least a SSNIPT despite the potential for customers to substitute away from the product or to locations outside the region. In this exercise, the terms of sale for products sold to all customers outside the region are held constant.[90]

4.3.D.3. Supplier Responses

Market definition focuses solely on demand substitution factors, that is, on customers' ability and willingness to substitute away from one product or location to another in response to a price increase or other worsening of terms. Supplier responses may be considered in the analysis of competition between firms (Guideline 2 and Section 4.2), entry and repositioning (Section 3.2), and in calculating market shares and concentration (Section 4.4).

4.3.D.4. Cluster Markets

A relevant antitrust market is generally a group of products that are substitutes for each other. However, when the competitive conditions for multiple relevant markets are reasonably similar, it may be appropriate to aggregate the products in these markets into a "cluster market" for analytic convenience, even though not all products in the cluster are substitutes for each other. For example, competing hospitals may each provide a wide range of acute health care services. Acute care for one health issue is not a substitute for acute care for a different health issue. Nevertheless, the Agencies may

[88] For customers operating in multiple locations, only those customer locations within the targeted region are included in the market.

[89] Arbitrage by suppliers is a type of supplier response and is thus not considered in market definition. (See Section 4.3.D.3)

[90] In some circumstances, as when the merging parties operate in multiple geographies, the Agencies may apply a "Hypothetical Cartel" framework for market definition, as described in Section 4.3.A, n.81.

aggregate them into a cluster market for acute care services if the conditions of competition are reasonably similar across the services in the cluster.

The Agencies need not separately analyze market definition for each product included in the cluster market, and market shares will typically be calculated for the cluster market as a whole.

Analogously, the Agencies sometimes define a market as a cluster of targeted customers (see Section 4.3.D.1) or a cluster of customers located in a region (see Section 4.3.D.2.b).

4.3.D.5. Bundled Product Markets

Firms may sell a combination of products as a bundle or a "package deal," rather than offering products "*a la carte*," that is, separately as standalone products. Different bundles offered by the same or different firms might package together different combinations of component products and therefore be differentiated according to the composition of the bundle. If the components of a bundled product are also available separately, the bundle may be offered at a price that represents a discount relative to the sum of the *a la carte* product prices.

The Agencies take a flexible approach based on the specific circumstances to determine whether a candidate market that includes one or more bundled products, standalone products, or both is a relevant antitrust market. In some cases, a relevant market may consist of only bundled products. A market composed of only bundled products might be a relevant antitrust market even if there is significant competition from the unbundled products. In other cases, a relevant market may include both bundled products and some unbundled component products.

Even in cases where firms commonly sell combinations of products or services as a bundle or a "package deal," relevant antitrust markets do not necessarily include product bundles. In some cases, a relevant market may be analyzed as a cluster market, as discussed in Section 4.3.D.4.

4.3.D.6. One-Stop Shop Markets

In some settings, the Agencies may consider a candidate market that includes one or more "one-stop shops," where customers can select a combination of products to purchase from a single seller, either in a single purchase instance or in a sequence of purchases. Products are commonly sold at a one-stop shop when customers value the convenience, which might arise because of transaction costs or search costs, savings of time, transportation costs, or familiarity with the store or web site.

A multi-product retailer such as a grocery store or online retailer is an example of a one-stop shop. Customers can select a particular basket of groceries from a range of available goods and different customers may select different baskets. Some customers may make multiple stops at specialty shops (e.g., butcher, baker, greengrocer), or they may do the bulk of their shopping at a one-stop shop (the grocery store) but also shop at specialty shops for particular product categories.

There are several ways in which markets may be defined in one-stop shop settings, depending on market realities, and the Agencies may further define more than one relevant antitrust market for a particular merger. For example, a relevant market may consist of only one-stop shops, even if there is significant competition from specialty shops; or it may include both one-stop shops and specialty shops. When a product category is sold by both one-stop shops and specialty suppliers (such as a type of produce sold in grocery stores and produce stands), the Agencies may define relevant antitrust markets for the product category sold by a particular type of supplier, or it may include multiple types of suppliers.

4.3.D.7. Market Definition When There is Harm to Innovation

When considering harm to competition in innovation, market definition may follow the same approaches that are used to analyze other dimensions of competition. In the case where a merger may substantially lessen competition by decreasing incentives to innovate, the Agencies may define relevant antitrust markets around the products that would result from that innovation if successful, even if those products do not yet exist.[91] In some cases, the Agencies may analyze different relevant markets when considering innovation than when considering other dimensions of competition.

4.3.D.8. Market Definition for Input Markets and Labor Markets

The same market definition tools and principles discussed above can be used for input markets and labor markets, where labor is a particular type of input. In input markets, firms compete with each other to attract suppliers, including workers. Therefore, input suppliers are analogous to customers in the discussions above about market definition. In defining relevant markets, the Agencies focus on the alternatives available to input suppliers. An antitrust input market consists of a group of products and a geographic area defined by the location of the buyers or input suppliers. Just as buyers of a product may consider products to be differentiated according to the brand or the identity of the seller, suppliers of a product or service may consider different buyers to be differentiated. For example, if the suppliers are contractors, they may have distinct preferences about who they provide services to, due to different working conditions, location, reliability of buyers in terms of paying invoices on time, or the propensity of the buyer to make unexpected changes to specifications.

The HMT considers whether a hypothetical monopsonist likely would undertake a SSNIPT, such as a reduction in price paid for inputs, or imposing less favorable terms on suppliers. (See Section 4.2.C for more discussion about competition in settings where terms are set through auctions and negotiations, as is common for input markets.)

When defining a market for labor the Agencies will consider the job opportunities available to workers who supply a relevant type of labor service, where worker choice among jobs or between geographic areas is the analog of consumer choices among products and regions when defining a product market. The Agencies may consider workers' willingness to switch in response to changes to wages or other aspects of working conditions, such as changes to benefits or other non-wage compensation, or adoption of less flexible scheduling. Depending on the occupation, alternative job opportunities might include the same occupation with alternative employers, or alternative occupations. Geographic market definition may involve considering workers' willingness or ability to commute, including the availability of public transportation. The product and geographic market definition may involve assessing whether workers may be targeted for less favorable wages or other terms of employment according to factors such as education, experience, certifications, or work locations. The Agencies may define cluster markets for different jobs when firms employ workers in a variety of jobs characterized by similar competitive conditions (see Section 4.3.D.4).

4.4. Calculating Market Shares and Concentration

This subsection further describes how the Agencies calculate market shares and concentration metrics.

[91] *See Illumina*, slip op. at 12 (affirming a relevant market defined around "what . . . developers reasonably sought to achieve, not what they currently had to offer").

As discussed above, the Agencies may use evidence about market shares and market concentration as part of their analysis. These structural measures can provide insight into the market power of firms as well as into the extent to which they compete. Although any market that is properly identified using the methods in Section 4.3 is valid, the extent to which structural measures calculated in that market are probative in any given context depends on a number of considerations. The following market considerations affect the extent to which structural measures are probative in any given context.[92]

First, structural measures may be probative if the market used to estimate them includes the products that are the focus of the competitive concern that the structural inquiry intends to address. For example, the concentration measures discussed in Guideline 1 will be most probative about whether the merger eliminates substantial competition between the merging parties when calculated on a market that includes at least one competing product from each merging firm.

Second, the market used to estimate shares should be broad enough that it contains sufficient additional products so that a loss of competition among all the suppliers of the products in the market would lead to significantly worse terms for at least some customers of at least one product. Markets identified using the various tools in Section 4.3 can satisfy this condition—for example, all markets that satisfy the HMT do so.

Third, the competitive significance of the parties may be understated by their share when calculated on a market that is broader than needed to satisfy the considerations above, particularly when the market includes products that are more distant substitutes, either in the product or geographic dimension, for those produced by the parties.

4.4.A. Market Participants

All firms that currently supply products (or consume products, when buyers merge) in a relevant market are considered participants in that market. Vertically integrated firms are also included to the extent that their inclusion accurately reflects their competitive significance. Firms not currently supplying products in the relevant market, but that have committed to entering the market in the near future, are also considered market participants.

Firms that are not currently active in a relevant market, but that very likely would rapidly enter with direct competitive impact in the event of a small but significant change in competitive conditions, without incurring significant sunk costs, are also considered market participants. These firms are termed "rapid entrants." Sunk costs are entry or exit costs that cannot be recovered outside a relevant market. Entry that would take place more slowly in response to a change in competitive conditions, or that requires firms to incur significant sunk costs, is considered in Section 3.2.

Firms that are active in the relevant product market but not in the relevant geographic market may be rapid entrants. Other things equal, such firms are most likely to be rapid entrants if they are already active in geographies that are close to the geographic market. Factors such as transportation

[92] For simplicity, the discussion in the text focuses on the case where concerns arise that involve competition among the suppliers of products; analogous considerations may also arise for suppliers of services, or when concerns arise about competition among buyers of a product or service, or when analyzing market shares in certain specific settings (see Section 4.3.D).

costs are important; or for services or digital goods, other factors may be important, such as language or regulation.

In markets for relatively homogeneous goods where a supplier's ability to compete depends predominantly on its costs and its capacity, and not on other factors such as experience or reputation in the relevant market, a supplier with efficient idle capacity, or readily available "swing" capacity currently used in adjacent markets that can easily and profitably be shifted to serve the relevant market, may be a rapid entrant. However, idle capacity may be inefficient, and capacity used in adjacent markets may not be available, so a firm's possession of idle or swing capacity alone does not make that firm a rapid entrant.

4.4.B. Market Shares

The Agencies normally calculate product market shares for all firms that currently supply products (or consume products, when buyers merge) in a relevant market, subject to the availability of data. The Agencies measure each firm's market share using metrics that are informative about the market realities of competition in the particular market and firms' future competitive significance. When interpreting shares based on historical data, the Agencies may consider whether significant recent or reasonably foreseeable changes to market conditions suggest that a firm's shares overstate or understate its future competitive significance.

How market shares are calculated may further depend on the characteristics of a particular market, and on the availability of data. Moreover, multiple metrics may be informative in any particular case. For example:

- Revenues in a relevant market often provide a readily available basis on which to compute shares and are often a good measure of attractiveness to customers.
- Unit sales may provide a useful measure of competitive significance in cases where one unit of a low-priced product can serve as a close substitute for one unit of a higher-priced product. For example, a new, much less expensive product may have great competitive significance if it substantially erodes the revenues earned by older, higher-priced products, even if it earns relatively low revenues.
- Revenues earned from recently acquired customers (or paid to recently acquired buyers, in the case of merging buyers) may provide a useful measure of competitive significance of firms in cases where trading partners sign long-term contracts, face switching costs, or tend to re-evaluate their relationships only occasionally.
- Measures based on capacities or reserves may be used to calculate market shares in markets for homogeneous products where a firm's competitive significance may derive principally from its ability and incentive to rapidly expand production in a relevant market in response to a price increase or output reduction by others in that market (or to rapidly expand its purchasing in the case of merging buyers).
- Non-price indicators, such as number of users or frequency of use, may be useful indicators in markets where price forms a relatively small or no part of the exchange of value.

Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.

429 U.S. 477 (1977)

Mr. JUSTICE MARSHALL delivered the opinion of the Court: This case raises important questions concerning the interrelationship of the antimerger and private damages action provisions of the Clayton Antitrust Act.

I

Petitioner is one of the two largest manufacturers of bowling equipment in the United States. Respondents are three of the 10 bowling centers owned by Treadway Companies, Inc. Since 1965, petitioner has acquired and operated a large number of bowling centers, including six in the markets in which respondents operate. Respondents instituted this action contending that these acquisitions violated various provisions of the antitrust laws.

In the late 1950's, the bowling industry expanded rapidly, and petitioner's sales of lanes, automatic pinsetters, and ancillary equipment rose accordingly.[1] Since this equipment requires a major capital expenditure $12,600 for each lane and pinsetter, most of petitioner's sales were for secured credit.

In the early 1960's, the bowling industry went into a sharp decline. Petitioner's sales quickly dropped to preboom levels. Moreover, petitioner experienced great difficulty in collecting money owed it; by the end of 1964 over $100,000,000, or more than 25%, of petitioner's accounts were more than 90 days delinquent. Repossessions rose dramatically, but attempts to sell or lease the repossessed equipment met with only limited success.[2] Because petitioner had borrowed close to $250,000,000 to finance its credit sales, it was, as the Court of Appeals concluded, "in serious financial difficulty." *NBO Industries Treadway Cos., Inc. v. Brunswick Corp.*, 523 F.2d 262, 267 (CA3 1975).

To meet this difficulty, petitioner began acquiring and operating defaulting bowling centers when their equipment could not be resold and a positive cash flow could be expected from operating the centers. During the seven years preceding the trial in this case, petitioner acquired 222 centers, 54 of which it either disposed of or closed. These acquisitions made petitioner by far the largest operator of bowling centers, with over five times as many centers as its next largest competitor. Petitioner's net worth in 1965 was more than eight times greater, and its gross revenue more than seven times greater, than the total for the 11 next largest bowling chains. Nevertheless, petitioner controlled only 2% of the bowling centers in the United States.

At issue here are acquisitions by petitioner in the three markets in which respondents are located: Pueblo, Colo., Poughkeepsie, N.Y., and Paramus, N.J. In 1965, petitioner acquired one defaulting center in Pueblo, one in Poughkeepsie, and two in the Paramus area. In 1969, petitioner acquired a third defaulting center in the Paramus market, and in 1970 petitioner acquired a fourth. Petitioner closed its Poughkeepsie center in 1969 after three years of unsuccessful operation; the Paramus center acquired in 1970 also proved unsuccessful, and in March 1973 petitioner gave notice that it would cease operating the center when its lease expired. The other four centers were operational at the time of trial.

Respondents initiated this action in June 1966, alleging, inter alia, that these acquisitions might substantially lessen competition or tend to create a monopoly in violation of § 7 of the Clayton

[1] Sales of automatic pinsetters, for example, went from 1,890 in 1956, to 16,288 in 1961.

[2] Repossessions of pinsetters increased from 300 in 1961 to 5,996 in 1965. In 1963, petitioner resold over two-thirds of the pinsetters repossessed; more typically, only one-third were resold, and in 1965, less than one-quarter were resold.

Act, 15 U.S.C. § 18. Respondents sought damages, pursuant to § 4 of the Act, 15 U.S.C. § 15, for three times "the reasonably expectable profits to be made (by respondents) from the operation of their bowling centers." Respondents also sought a divestiture order, an injunction against future acquisitions, and such "other further and different relief" as might be appropriate under § 16 of the Act, 15 U.S.C. § 26. ***

Trial was held in the spring of 1973, following an initial mistrial due to a hung jury. To establish a § 7 violation, respondents sought to prove that because of its size, petitioner had the capacity to lessen competition in the markets it had entered by driving smaller competitors out of business. To establish damages, respondents attempted to show that had petitioner allowed the defaulting centers to close, respondents' profits would have increased. At respondents' request, the jury was instructed in accord with respondents' theory as to the nature of the violation and the basis for damages. The jury returned a verdict in favor of respondents in the amount of $2,358,030, which represented the minimum estimate by respondents of the additional income they would have realized had the acquired centers been closed. As required by law, the District Court trebled the damages. It also awarded respondents costs and attorneys' fees totaling $446,977.32, and, sitting as a court of equity, it ordered petitioner to divest itself of the centers involved here, *Treadway Cos. v. Brunswick Corp.*, 389 F.Supp. 996 (N.J. 1974). Petitioner appealed. ***

II

The issue for decision is a narrow one. Petitioner does not presently contest the Court of Appeals' conclusion that a properly instructed jury could have found the acquisitions unlawful. Nor does petitioner challenge the Court of Appeals' determination that the evidence would support a finding that had petitioner not acquired these centers, they would have gone out of business and respondents' income would have increased. Petitioner questions only whether antitrust damages are available where the sole injury alleged is that competitors were continued in business, thereby denying respondents an anticipated increase in market shares.

To answer that question it is necessary to examine the antimerger and treble-damages provisions of the Clayton Act. Section 7 of the Act proscribes mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly." It is, as we have observed many times, a prophylactic measure, intended "primarily to arrest apprehended consequences of intercorporate relationships before those relationships could work their evil" *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 597 (1957).

Section 4, in contrast, is in essence a remedial provision. It provides treble damages to "(a)ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws" Of course, treble damages also play an important role in penalizing wrongdoers and deterring wrongdoing, as we also have frequently observed. *Perma Life Mufflers v. International Parts Corp.*, 392 U.S. 134, 139 (1968). It nevertheless is true that the treble-damages provision, which makes awards available only to injured parties, and measures the awards by a multiple of the injury actually proved, is designed primarily as a remedy.

Intermeshing a statutory prohibition against acts that have a potential to cause certain harms with a damages action intended to remedy those harms is not without difficulty. Plainly, to recover damages respondents must prove more than that petitioner violated § 7, since such proof establishes only that injury may result. Respondents contend that the only additional element they need demonstrate is that they are in a worse position than they would have been had petitioner not committed those acts. The Court of Appeals agreed, holding compensable any

loss "causally linked" to "the mere presence of the violator in the market." 523 F.2d, at 272-273. Because this holding divorces antitrust recovery from the purposes of the antitrust laws without a clear statutory command to do so, we cannot agree with it.

Every merger of two existing entities into one, whether lawful or unlawful, has the potential for producing economic readjustments that adversely affect some persons. But Congress has not condemned mergers on that account; it has condemned them only when they may produce anticompetitive effects. Yet under the Court of Appeals' holding, once a merger is found to violate § 7, all dislocations caused by the merger are actionable, regardless of whether those dislocations have anything to do with the reason the merger was condemned. This holding would make § 4 recovery entirely fortuitous, and would authorize damages for losses which are of no concern to the antitrust laws.

Both of these consequences are well illustrated by the facts of this case. If the acquisitions here were unlawful, it is because they brought a "deep pocket" parent into a market of "pygmies." Yet respondents' injury the loss of income that would have accrued had the acquired centers gone bankrupt bears no relationship to the size of either the acquiring company or its competitors. Respondents would have suffered the identical "loss" but no compensable injury had the acquired centers instead obtained refinancing or been purchased by "shallow pocket" parents as the Court of Appeals itself acknowledged. Thus, respondents' injury was not of "the type that the statute was intended to forestall," *Wyandotte Co. v. United States*, 389 U.S. 191, 202 (1967).

But the antitrust laws are not merely indifferent to the injury claimed here. At base, respondents complain that by acquiring the failing centers petitioner preserved competition, thereby depriving respondents of the benefits of increased concentration. The damages respondents obtained are designed to provide them with the profits they would have realized had competition been reduced. The antitrust laws, however, were enacted for "the protection of competition not competitors," *Brown Shoe Co. v. United States*, 370 U.S., at 320. It is inimical to the purposes of these laws to award damages for the type of injury claimed here. ***

We therefore hold that the plaintiffs to recover treble damages on account of § 7 violations, they must prove more than injury causally linked to an illegal presence in the market. Plaintiffs must prove antitrust injury, which is to say injury of the type the antitrust laws were intended to prevent and that flows from that which makes defendants' acts unlawful. The injury should reflect the anticompetitive effect either of the violation or of anticompetitive acts made possible by the violation. It should, in short, be "the type of loss that the claimed violations . . . would be likely to cause." *Zenith Radio Corp. v. Hazeltine Research*, 395 U.S., at 125.

This does not necessarily mean, as the Court of Appeals feared, 523 F.2d at 272, that § 4 plaintiffs must prove an actual lessening of competition in order to recover. The short-term effect of certain anticompetitive behavior predatory below-cost pricing, for example may be to stimulate price competition. But competitors may be able to prove antitrust injury before they actually are driven from the market and competition is thereby lessened. Of course, the case for relief will be strongest where competition has been diminished.

III

We come, then, to the question of appropriate disposition of this case. At the very least, petitioner is entitled to a new trial, not only because of the instructional errors noted by the Court of Appeals that are not at issue here, but also because the District Court's instruction as to the

basis for damages was inconsistent with our holding as outlined above. Our review of the record, however, persuades us that a new trial on the damages claim is unwarranted. Respondents based their case solely on their novel damages theory which we have rejected. While they produced some conclusory testimony suggesting that in operating the acquired centers petitioner had abused its deep pocket by engaging in anticompetitive conduct, they made no attempt to prove that they had lost any income as a result of such predation. Rather, their entire proof of damages was based on their claim to profits that would have been earned had the acquired centers closed. Since respondents did not prove any cognizable damages and have not offered any justification for allowing respondents, after two trials and over 10 years of litigation, yet a third opportunity to do so, it follows that, petitioner is entitled, in accord with its motion made pursuant to Rule 50(b), to judgment on the damages claim notwithstanding the verdict.

Respondents' complaint also prayed for equitable relief, and the Court of Appeals held that if respondents established a § 7 violation, they might be entitled to an injunction against "those practices by which a deep pocket market entrant harms competition." 523 F.2d, at 279. Because petitioner has not contested this holding, respondents remain free, on remand, to seek such a decree.

The judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Apple Inc. v. Pepper

587 U.S. 273 (U.S. 2019)

JUSTICE KAVANAUGH delivered the opinion of the Court: In 2007, Apple started selling iPhones. The next year, Apple launched the retail App Store, an electronic store where iPhone owners can purchase iPhone applications from Apple. Those "apps" enable iPhone owners to send messages, take photos, watch videos, buy clothes, order food, arrange transportation, purchase concert tickets, donate to charities, and the list goes on. "There's an app for that" has become part of the 21st-century American lexicon.

In this case, however, several consumers contend that Apple charges too much for apps. The consumers argue, in particular, that Apple has monopolized the retail market for the sale of apps and has unlawfully used its monopolistic power to charge consumers higher-than-competitive prices.

A claim that a monopolistic retailer (here, Apple) has used its monopoly to overcharge consumers is a classic antitrust claim. But Apple asserts that the consumer-plaintiffs in this case may not sue Apple because they supposedly were not "direct purchasers" from Apple under our decision in *Illinois Brick Co. v. Illinois,*431 U.S. 720, 745-746 (1977). We disagree. The plaintiffs purchased apps directly from Apple and therefore are direct purchasers under *Illinois Brick*. At this early pleadings stage of the litigation, we do not assess the merits of the plaintiffs' antitrust claims against Apple, nor do we consider any other defenses Apple might have. We merely hold that the *Illinois Brick* direct-purchaser rule does not bar these plaintiffs from suing Apple under the antitrust laws. We affirm the judgment of the U.S. Court of Appeals for the Ninth Circuit.

I

In 2007, Apple began selling iPhones. In July 2008, Apple started the App Store. The App Store now contains about 2 million apps that iPhone owners can download. By contract and through technological limitations, the App Store is the only place where iPhone owners may lawfully buy apps.

For the most part, Apple does not itself create apps. Rather, independent app developers create apps. Those independent app developers then contract with Apple to make the apps available to iPhone owners in the App Store.

Through the App Store, Apple sells the apps directly to iPhone owners. To sell an app in the App Store, app developers must pay Apple a $ 99 annual membership fee. Apple requires that the retail sales price end in $ 0.99, but otherwise allows the app developers to set the retail price. Apple keeps 30 percent of the sales price, no matter what the sales price might be. In other words, Apple pockets a 30 percent commission on every app sale.

In 2011, four iPhone owners sued Apple. They allege that Apple has unlawfully monopolized "the iPhone apps aftermarket." App. to Pet. for Cert. 53a. The plaintiffs allege that, via the App Store, Apple locks iPhone owners "into buying apps only from Apple and paying Apple's 30% fee, even if" the iPhone owners wish "to buy apps elsewhere or pay less." *Id.,* at 45a. According to the complaint, that 30 percent commission is "pure profit" for Apple and, in a competitive environment with other retailers, "Apple would be under considerable pressure to substantially lower its 30% profit margin." *Id.,* at 54a-55a. The plaintiffs allege that in a competitive market, they would be able to "choose between Apple's high-priced App Store and less costly alternatives." *Id.,* at 55a. And they allege that they have "paid more for their iPhone apps than they would have paid in a competitive market." *Id.,* at 53a.

Apple moved to dismiss the complaint, arguing that the iPhone owners were not direct purchasers from Apple and therefore may not sue. In *Illinois Brick,* this Court held that direct purchasers may sue antitrust violators, but also ruled that indirect purchasers may not sue. The District Court agreed with Apple and dismissed the complaint. According to the District Court, the iPhone owners were not direct purchasers from Apple because the app developers, not Apple, set the consumers' purchase price.

The Ninth Circuit reversed. The Ninth Circuit concluded that the iPhone owners were direct purchasers under *Illinois Brick* because the iPhone owners purchased apps directly from Apple. According to the Ninth Circuit, *Illinois Brick* means that a consumer may not sue an alleged monopolist who is two or more steps removed from the consumer in a vertical distribution chain. See *In re Apple iPhone Antitrust Litig.,* 846 F. 3d 313, 323 (2017). Here, however, the consumers purchased directly from Apple, the alleged monopolist. Therefore, the Ninth Circuit held that the iPhone owners could sue Apple for allegedly monopolizing the sale of iPhone apps and charging higher-than-competitive prices. *Id.,* at 324. We granted certiorari. 585 U.S. ___ (2018).

II

A

The plaintiffs' allegations boil down to one straightforward claim: that Apple exercises monopoly power in the retail market for the sale of apps and has unlawfully used its monopoly power to force iPhone owners to pay Apple higher-than-competitive prices for apps. According to the plaintiffs, when iPhone owners want to purchase an app, they have only two options: (1) buy

the app from Apple's App Store at a higher-than-competitive price or (2) do not buy the app at all. Any iPhone owners who are dissatisfied with the selection of apps available in the App Store or with the price of the apps available in the App Store are out of luck, or so the plaintiffs allege.

The sole question presented at this early stage of the case is whether these consumers are proper plaintiffs for this kind of antitrust suit—in particular, our precedents ask, whether the consumers were "direct purchasers" from Apple. *Illinois Brick,* 431 U.S. at 745-746. It is undisputed that the iPhone owners bought the apps directly from Apple. Therefore, under *Illinois Brick,* the iPhone owners were direct purchasers who may sue Apple for alleged monopolization.

That straightforward conclusion follows from the text of the antitrust laws and from our precedents.

First is text: Section 2 of the Sherman Act makes it unlawful for any person to "monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations." 26 Stat. 209, 15 U.S.C. § 2. Section 4 of the Clayton Act in turn provides that "*any person* who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue ... the defendant ... and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." 38 Stat. 731, 15 U.S.C. § 15(a) (emphasis added). The broad text of § 4—"any person" who has been "injured" by an antitrust violator may sue—readily covers consumers who purchase goods or services at higher-than-competitive prices from an allegedly monopolistic retailer.

Second is precedent: Applying § 4, we have consistently stated that "the immediate buyers from the alleged antitrust violators" may maintain a suit against the antitrust violators. *Kansas v. UtiliCorp United Inc.,* 497 U.S. 199, 207 (1990); see also *Illinois Brick,* 431 U.S. at 745-746. At the same time, incorporating principles of proximate cause into § 4, we have ruled that *indirect* purchasers who are two or more steps removed from the violator in a distribution chain may not sue. Our decision in *Illinois Brick* established a bright-line rule that authorizes suits by *direct* purchasers but bars suits by *indirect* purchasers. *Id.,* at 746.

The facts of *Illinois Brick* illustrate the rule. Illinois Brick Company manufactured and distributed concrete blocks. Illinois Brick sold the blocks primarily to masonry contractors, and those contractors in turn sold masonry structures to general contractors. Those general contractors in turn sold their services for larger construction projects to the State of Illinois, the ultimate consumer of the blocks.

The consumer State of Illinois sued the manufacturer Illinois Brick. The State alleged that Illinois Brick had engaged in a conspiracy to fix the price of concrete blocks. According to the complaint, the State paid more for the concrete blocks than it would have paid absent the pricefixing conspiracy. The monopoly overcharge allegedly flowed all the way down the distribution chain to the ultimate consumer, who was the State of Illinois.

This Court ruled that the State could not bring an antitrust action against Illinois Brick, the alleged violator, because the State had not purchased concrete blocks directly from Illinois Brick. The proper plaintiff to bring that claim against Illinois Brick, the Court stated, would be an entity that had purchased directly from Illinois Brick.

The bright-line rule of *Illinois Brick,* as articulated in that case and as we reiterated in *UtiliCorp,* means that indirect purchasers who are two or more steps removed from the antitrust violator

in a distribution chain may not sue. By contrast, direct purchasers—that is, those who are "the immediate buyers from the alleged antitrust violators"—may sue. *UtiliCorp,* 497 U.S. at 207.

For example, if manufacturer A sells to retailer B, and retailer B sells to consumer C, then C may not sue A. But B may sue A if A is an antitrust violator. And C may sue B if B is an antitrust violator. That is the straightforward rule of *Illinois Brick*. See *Loeb Industries, Inc. v. Sumitomo Corp.,* 306 F.3d 469, 481-482 (C.A.7 2002) (Wood, J.).

In this case, unlike in *Illinois Brick,* the iPhone owners are not consumers at the bottom of a vertical distribution chain who are attempting to sue manufacturers at the top of the chain. There is no intermediary in the distribution chain between Apple and the consumer. The iPhone owners purchase apps directly from the retailer Apple, who is the alleged antitrust violator. The iPhone owners pay the alleged overcharge directly to Apple. The absence of an intermediary is dispositive. Under *Illinois Brick,* the iPhone owners are direct purchasers from Apple and are proper plaintiffs to maintain this antitrust suit.

B

All of that seems simple enough. But Apple argues strenuously against that seemingly simple conclusion, and we address its arguments carefully. For this kind of retailer case, Apple's theory is that *Illinois Brick* allows consumers to sue only the party who sets the retail price, whether or not that party sells the good or service directly to the complaining party. Apple says that its theory accords with the economics of the transaction. Here, Apple argues that the app developers, not Apple, set the retail price charged to consumers, which according to Apple means that the consumers may not sue Apple.

We see three main problems with Apple's "who sets the price" theory.

First, Apple's theory contradicts statutory text and precedent. As we explained above, the text of § 4 broadly affords injured parties a right to sue under the antitrust laws. And our precedent in *Illinois Brick* established a bright-line rule where direct purchasers such as the consumers here may sue antitrust violators from whom they purchased a good or service. *Illinois Brick,* as we read the opinion, was not based on an economic theory about who set the price. Rather, *Illinois Brick* sought to ensure an effective and efficient litigation scheme in antitrust cases. To do so, the Court drew a bright line that allowed direct purchasers to sue but barred indirect purchasers from suing. When there is no intermediary between the purchaser and the antitrust violator, the purchaser may sue. *** Apple's theory would require us to rewrite the rationale of *Illinois Brick* and to gut the longstanding bright-line rule.

To the extent that *Illinois Brick* leaves any ambiguity about whether a direct purchaser may sue an antitrust violator, we should resolve that ambiguity in the direction of the statutory text. And under the text, direct purchasers from monopolistic retailers are proper plaintiffs to sue those retailers.

Second, in addition to deviating from statutory text and precedent, Apple's proposed rule is not persuasive economically or legally. Apple's effort to transform *Illinois Brick* from a direct-purchaser rule to a "who sets the price" rule would draw an arbitrary and unprincipled line among retailers based on retailers' financial arrangements with their manufacturers or suppliers.

In the retail context, the price charged by a retailer to a consumer is often a result (at least in part) of the price charged by the manufacturer or supplier to the retailer, or of negotiations between the manufacturer or supplier and the retailer. Those agreements between manufacturer or supplier and retailer may take myriad forms, including for example a markup pricing model

or a commission pricing model. In a traditional markup pricing model, a hypothetical monopolistic retailer might pay $ 6 to the manufacturer and then sell the product for $ 10, keeping $ 4 for itself. In a commission pricing model, the retailer might pay nothing to the manufacturer; agree with the manufacturer that the retailer will sell the product for $ 10 and keep 40 percent of the sales price; and then sell the product for $ 10, send $ 6 back to the manufacturer, and keep $ 4. In those two different pricing scenarios, everything turns out to be economically the same for the manufacturer, retailer, and consumer.

Yet Apple's proposed rule would allow a consumer to sue the monopolistic retailer in the former situation but not the latter. In other words, under Apple's rule a consumer could sue a monopolistic retailer when the retailer set the retail price by marking up the price it had paid the manufacturer or supplier for the good or service. But a consumer could not sue a monopolistic retailer when the manufacturer or supplier set the retail price and the retailer took a commission on each sale.

Apple's line-drawing does not make a lot of sense, other than as a way to gerrymander Apple out of this and similar lawsuits. In particular, we fail to see why the form of the upstream arrangement between the manufacturer or supplier and the retailer should determine whether a monopolistic retailer can be sued by a downstream consumer who has purchased a good or service directly from the retailer and has paid a higher-than-competitive price because of the retailer's unlawful monopolistic conduct. As the Court of Appeals aptly stated, "the distinction between a markup and a commission is immaterial." 846 F.3d at 324. *** If a retailer has engaged in unlawful monopolistic conduct that has caused consumers to pay higher-than-competitive prices, it does not matter how the retailer structured its relationship with an upstream manufacturer or supplier—whether, for example, the retailer employed a markup or kept a commission.

To be sure, if the monopolistic retailer's conduct has not caused the consumer to pay a higher-than-competitive price, then the plaintiff's damages will be zero. Here, for example, if the competitive commission rate were 10 percent rather than 30 percent but Apple could prove that app developers in a 10 percent commission system would always set a higher price such that consumers would pay the same retail price regardless of whether Apple's commission was 10 percent or 30 percent, then the consumers' damages would presumably be zero. But we cannot assume in all cases—as Apple would necessarily have us do—that a monopolistic retailer who keeps a commission does not ever cause the consumer to pay a higher-than-competitive price. We find no persuasive legal or economic basis for such a blanket assertion.

In short, we do not understand the relevance of the upstream market structure in deciding whether a downstream consumer may sue a monopolistic retailer. Apple's rule would elevate form (what is the precise arrangement between manufacturers or suppliers and retailers?) over substance (is the consumer paying a higher price because of the monopolistic retailer's actions?). If the retailer's unlawful monopolistic conduct caused a consumer to pay the retailer a higher-than-competitive price, the consumer is entitled to sue the retailer under the antitrust laws.

Third, if accepted, Apple's theory would provide a roadmap for monopolistic retailers to structure transactions with manufacturers or suppliers so as to evade antitrust claims by consumers and thereby thwart effective antitrust enforcement.

Consider a traditional supplier-retailer relationship, in which the retailer purchases a product from the supplier and sells the product with a markup to consumers. Under Apple's proposed rule, a retailer, instead of buying the product from the supplier, could arrange to sell the product for the supplier without purchasing it from the supplier. In other words, rather than paying the

supplier a certain price for the product and then marking up the price to sell the product to consumers, the retailer could collect the price of the product from consumers and remit only a fraction of that price to the supplier.

That restructuring would allow a monopolistic retailer to insulate itself from antitrust suits by consumers, even in situations where a monopolistic retailer is using its monopoly to charge higher-than-competitive prices to consumers. We decline to green-light monopolistic retailers to exploit their market position in that way. We refuse to rubber-stamp such a blatant evasion of statutory text and judicial precedent.

In sum, Apple's theory would disregard statutory text and precedent, create an unprincipled and economically senseless distinction among monopolistic retailers, and furnish monopolistic retailers with a how-to guide for evasion of the antitrust laws.

C

In arguing that the Court should transform the direct-purchaser rule into a "who sets the price" rule, Apple insists that the three reasons that the Court identified in *Illinois Brick* for adopting the direct-purchaser rule apply to this case—even though the consumers here (unlike in *Illinois Brick*) were direct purchasers from the alleged monopolist. The *Illinois Brick* Court listed three reasons for barring indirect-purchaser suits: (1) facilitating more effective enforcement of antitrust laws; (2) avoiding complicated damages calculations; and (3) eliminating duplicative damages against antitrust defendants.

As we said in *UtiliCorp,* however, the bright-line rule of *Illinois Brick* means that there is no reason to ask whether the rationales of *Illinois Brick* "apply with equal force" in every individual case. 497 U.S. at 216. We should not engage in "an unwarranted and counterproductive exercise to litigate a series of exceptions." *Id.,* at 217.

But even if we engage with this argument, we conclude that the three *Illinois Brick* rationales—whether considered individually or together—cut strongly in the plaintiffs' favor here, not Apple's.

First, Apple argues that barring the iPhone owners from suing Apple will better promote effective enforcement of the antitrust laws. Apple posits that allowing only the upstream app developers—and not the downstream consumers—to sue Apple would mean more effective enforcement of the antitrust laws. We do not agree. Leaving consumers at the mercy of monopolistic retailers simply because upstream suppliers could *also* sue the retailers makes little sense and would directly contradict the longstanding goal of effective private enforcement and consumer protection in antitrust cases.

Second, Apple warns that calculating the damages in successful consumer antitrust suits against monopolistic retailers might be complicated. It is true that it may be hard to determine what the retailer would have charged in a competitive market. Expert testimony will often be necessary. But that is hardly unusual in antitrust cases. *Illinois Brick* is not a get-out-of-court-free card for monopolistic retailers to play any time that a damages calculation might be complicated. *Illinois Brick* surely did not wipe out consumer antitrust suits against monopolistic retailers from whom the consumers purchased goods or services at higher-than-competitive prices. Moreover, the damages calculation may be just as complicated in a retailer markup case as it is in a retailer commission case. Yet Apple apparently accepts consumers suing monopolistic retailers in a retailer markup case. If Apple accepts that kind of suit, then Apple should also accept consumers suing monopolistic retailers in a retailer commission case.

Third, Apple claims that allowing consumers to sue will result in "conflicting claims to a common fund—the amount of the alleged overcharge." *Illinois Brick,* 431 U.S. at 737. Apple is incorrect. This is not a case where multiple parties at different levels of a distribution chain are trying to all recover the same passed-through overcharge initially levied by the manufacturer at the top of the chain. If the iPhone owners prevail, they will be entitled to the *full amount* of the unlawful overcharge that they paid to Apple. The overcharge has not been passed on by anyone to anyone. Unlike in *Illinois Brick,* there will be no need to "trace the effect of the overcharge through each step in the distribution chain." 431 U.S. at 741.

It is true that Apple's alleged anticompetitive conduct may leave Apple subject to multiple suits by different plaintiffs. But *Illinois Brick* did not purport to bar multiple liability that is unrelated to passing an overcharge down a chain of distribution. *** Multiple suits are not atypical when the intermediary in a distribution chain is a bottleneck monopolist or monopsonist (or both) between the manufacturer on the one end and the consumer on the other end. A retailer who is both a monopolist and a monopsonist may be liable to different classes of plaintiffs—both to downstream consumers and to upstream suppliers—when the retailer's unlawful conduct affects both the downstream and upstream markets.

Here, some downstream iPhone consumers have sued Apple on a monopoly theory. And it could be that some upstream app developers will also sue Apple on a monopsony theory. In this instance, the two suits would rely on fundamentally different theories of harm and would not assert dueling claims to a "common fund," as that term was used in *Illinois Brick*. The consumers seek damages based on the difference between the price they paid and the competitive price. The app developers would seek lost profits that they could have earned in a competitive retail market. *Illinois Brick* does not bar either category of suit.

In short, the three *Illinois Brick* rationales do not persuade us to remake *Illinois Brick* and to bar direct-purchaser suits against monopolistic retailers who employ commissions rather than markups. The plaintiffs seek to hold retailers to account if the retailers engage in unlawful anticompetitive conduct that harms consumers who purchase from those retailers. That is why we have antitrust law.

* * *

*** The consumers here purchased apps directly from Apple, and they allege that Apple used its monopoly power over the retail apps market to charge higher-than-competitive prices. Our decision in *Illinois Brick* does not bar the consumers from suing Apple for Apple's allegedly monopolistic conduct. We affirm the judgment of the U.S. Court of Appeals for the Ninth Circuit.

It is so ordered.

JUSTICE GORSUCH, with whom THE CHIEF JUSTICE, JUSTICE THOMAS, and JUSTICE ALITO join, dissenting: More than 40 years ago, in *Illinois Brick Co. v. Illinois,* 431 U.S. 720 (1977), this Court held that an antitrust plaintiff can't sue a defendant for overcharging *someone else* who might (or might not) have passed on all (or some) of the overcharge to him. *Illinois Brick* held that these convoluted "pass on" theories of damages violate traditional principles of proximate causation and that the right plaintiff to bring suit is the one on whom the overcharge immediately and surely fell. Yet today the Court lets a pass-on case proceed. It does so by recasting *Illinois Brick* as a rule forbidding only suits where the plaintiff does not contract directly with the defendant. This replaces a rule of proximate cause and economic reality with an easily manipulated and formalistic rule of contractual privity. That's not how antitrust law is supposed to

work, and it's an uncharitable way of treating a precedent which—whatever its flaws—is far more sensible than the rule the Court installs in its place.

II

*** The lawsuit before us depends on just the sort of pass-on theory that *Illinois Brick* forbids. The plaintiffs bought apps from third-party app developers (or manufacturers) in Apple's retail Internet App Store, at prices set by the developers. The lawsuit alleges that Apple is a monopolist retailer and that the 30% commission it charges developers for the right to sell through its platform represents an anticompetitive price. The problem is that the 30% commission falls initially on the developers. So if the commission is in fact a monopolistic overcharge, the *developers* are the parties who are directly injured by it. Plaintiffs can be injured *only* if the developers are able and choose to pass on the overcharge to them in the form of higher app prices that the developers alone control. Plaintiffs admitted as much in the district court, where they described their theory of injury this way: "[I]f Apple tells the developer ... we're going to take this 30 percent commission ... what's the developer going to do? The developer is going to increase its price to cover Apple's ... demanded profit."

Because this is *exactly* the kind of "pass-on theory" *Illinois Brick* rejected, it should come as no surprise that the concerns animating that decision are also implicated. Like other pass-on theories, plaintiffs' theory will necessitate a complex inquiry into how Apple's conduct affected third-party pricing decisions. And it will raise difficult questions about apportionment of damages between app developers and their customers, along with the risk of duplicative damages awards. If anything, plaintiffs' claims present these difficulties even more starkly than did the claims at issue in *Illinois Brick*.

Consider first the question of causation. To determine if Apple's conduct damaged plaintiffs at all (and if so, the magnitude of their damages), a court will first have to explore whether and to what extent each individual app developer was able—and then opted—to pass on the 30% commission to its consumers in the form of higher app prices. Sorting this out, if it can be done at all, will entail wrestling with "'complicated theories'" about "how the relevant market variables would have behaved had there been no overcharge." *Illinois Brick,* 431 U.S. at 741-743. Will the court hear testimony to determine the market power of each app developer, how each set its prices, and what it might have charged consumers for apps if Apple's commission had been lower? Will the court also consider expert testimony analyzing how market factors might have influenced developers' capacity and willingness to pass on Apple's alleged monopoly overcharge? And will the court then somehow extrapolate its findings to all of the tens of thousands of developers who sold apps through the App Store at different prices and times over the course of years?

This causation inquiry will be complicated further by Apple's requirement that all app prices end in $ 0.99. As plaintiffs acknowledge, this rule has caused prices for the "vast majority" of apps to "cluster" at exactly $ 0.99. And a developer charging $ 0.99 for its app can't raise its price by just enough to recover the 30-cent commission. Instead, if the developer wants to pass on the commission to consumers, it has to more than double its price to $ 1.99 (doubling the commission in the process), which could significantly affect its sales. In short, because Apple's 99-cent rule creates a strong disincentive for developers to raise their prices, it makes plaintiffs' pass-on theory of injury even harder to prove. Yet the court will have to consider all of this when determining what damages, if any, plaintiffs suffered as a result of Apple's allegedly excessive 30% commission.

Plaintiffs' claims will also necessitate "massive efforts to apportion the recovery among all potential plaintiffs that could have absorbed part of the overcharge," including both consumers and app developers. *Illinois Brick,* 431 U.S. at 737. If, as plaintiffs contend, Apple's 30% commission is a monopolistic overcharge, then the app developers have a claim against Apple to recover whatever portion of the commission they did not pass on to consumers. *** So courts will have to divvy up the commissions Apple collected between the developers and the consumers. To do that, they'll have to figure out which party bore what portion of the overcharge in every purchase. And if the developers bring suit separately from the consumers, Apple might be at risk of duplicative damages awards totaling more than the full amount it collected in commissions. To avoid that possibility, it may turn out that the developers are necessary parties who will have to be joined in the plaintiffs' lawsuit. See Fed. Rule Civ. Proc. 19(a)(1)(B).

III

The United States and its antitrust regulators agree with all of this, so how does the Court reach such a different conclusion? Seizing on *Illinois Brick*'s use of the shorthand phrase "direct purchasers" to describe the parties immediately injured by the monopoly overcharge in that case, the Court (re)characterizes *Illinois Brick* as a rule that anyone who purchases goods directly from an alleged antitrust violator can sue, while anyone who doesn't, can't. Under this revisionist version of *Illinois Brick,* the dispositive question becomes whether an "intermediary in the distribution chain" stands between the plaintiff and the defendant. And because the plaintiff app purchasers in this case happen to have purchased apps directly from Apple, the Court reasons, they may sue.

This exalts form over substance. Instead of focusing on the traditional proximate cause question where the alleged overcharge is first (and thus surely) felt, the Court's test turns on who happens to be in privity of contract with whom. *** To evade the Court's test, all Apple must do is amend its contracts. Instead of collecting payments for apps sold in the App Store and remitting the balance (less its commission) to developers, Apple can simply specify that consumers' payments will flow the other way: directly to the developers, who will then remit commissions to Apple. No antitrust reason exists to treat these contractual arrangements differently, and doing so will only induce firms to abandon their preferred—and presumably more efficient—distribution arrangements in favor of less efficient ones, all so they might avoid an arbitrary legal rule.

Nor does *Illinois Brick* come close to endorsing such a blind formalism. Yes, as the Court notes, the plaintiff in *Illinois Brick* did contract directly with an intermediary rather than with the putative antitrust violator. But *Illinois Brick*'s rejection of pass-on claims, and its explanation of the difficulties those claims present, had nothing to do with privity of contract. Instead and as we have seen, its rule and reasoning grew from the "general tendency of the law ... not to go beyond" the party that first felt the sting of the alleged overcharge, and from the complications that can arise when courts attempt to discern whether and to what degree damages were passed on to others. The Court today risks replacing a cogent rule about proximate cause with a pointless and easily evaded imposter. We do not usually read our own precedents so uncharitably.

Maybe the Court proceeds as it does today because it just disagrees with *Illinois Brick.* After all, the Court not only displaces a sensible rule in favor of a senseless one; it also proceeds to question each of *Illinois Brick*'s rationales—doubting that those directly injured are always the best plaintiffs to bring suit, that calculating damages for pass-on plaintiffs will often be unduly complicated, and that conflicting claims to a common fund justify limiting who may sue. The

Court even tells us that any "ambiguity" about the permissibility of pass-on damages should be resolved "in the direction of the statutory text," ignoring that *Illinois Brick* followed the well-trodden path of construing the statutory text in light of background common law principles of proximate cause. Last but not least, the Court suggests that the traditional understanding of *Illinois Brick* leads to "arbitrary and unprincipled" results. It asks us to consider two hypothetical scenarios that, it says, prove the point. The first is a "markup" scenario in which a monopolistic retailer buys a product from a manufacturer for $ 6 and then decides to sell the product to a consumer for $ 10, applying a supracompetitive $ 4 markup. The second is a "commission" scenario in which a manufacturer directs a monopolistic retailer to sell the manufacturer's product to a consumer for $ 10 and the retailer keeps a supracompetitive 40% commission, sending $ 6 back to the manufacturer. The two scenarios are economically the same, the Court asserts, and forbidding recovery in the second for lack of proximate cause makes no sense.

But there is nothing arbitrary or unprincipled about *Illinois Brick*'s rule or results. The notion that the causal chain must stop somewhere is an ancient and venerable one. As with most any rule of proximate cause, reasonable people can debate whether *Illinois Brick* drew exactly the right line in cutting off claims where it did. But the line it drew is intelligible, principled, administrable, and far more reasonable than the Court's artificial rule of contractual privity. Nor do the Court's hypotheticals come close to proving otherwise. In the first scenario, the markup falls initially on the consumer, so there's no doubt that the retailer's anticompetitive conduct proximately caused the consumer's injury. Meanwhile, in the second scenario the commission falls initially on the manufacturer, and the consumer won't feel the pain unless the manufacturer can and does recoup some or all of the elevated commission by raising its own prices. In *that* situation, the manufacturer is the directly injured party, and the difficulty of disaggregating damages between those directly and indirectly harmed means that the consumer can't establish proximate cause under traditional principles.

*** Without any invitation or reason to revisit our precedent, and with so many grounds for caution, I would have thought the proper course today would have been to afford *Illinois Brick* full effect, not to begin whittling it away to a bare formalism. I respectfully dissent.

United States v. New York Great Atlantic & Pacific Tea Co.

173 F.2d 79 (7th Cir. 1949)

MINTON, CIRCUIT JUDGE: This case comes to us on appeal from the Eastern District of Illinois. The defendant The New York Great Atlantic & Pacific Tea Company, Inc., herein called A&P, several of its subsidiary and affiliated companies, and certain officers of the A&P chain were found guilty by the District Court of a conspiracy to restrain and to monopolize trade, in violation of Sections 1 and 2 of the Sherman Act, 15 U.S.C.A. §§ 1, 2. The defendants Carl Byoir, the public relations counsel of A&P, and Business Organization, Inc., a corporation through which Byoir conducted such public relations, were also found guilty. *** This is a charge of a conspiracy to restrain trade and to monopolize. Some of the things done by the defendants, when examined and considered separately may be perfectly legal, but when used to promote or further a conspiracy to do an unlawful thing, that which when considered alone is lawful, when used to further the conspiracy becomes unlawful.

The issue is whether there is substantial evidence to show a conspiracy by the defendants to restrain and monopolize trade in commerce in food and food products by controlling the terms and conditions upon which the defendants and their competitors might do business and by oppressing competitors through the abuse of the defendants' mass buying and selling power. The Government insists that this case is not an attack upon A&P because of its size or integration and the power that may rightly go with such size and integration, but it is an attack upon the abuse of that power.

There is substantial evidence in this voluminous record to show the following. The A&P system is comprised of fourteen corporations, twelve of which were named defendants and three of which defendants were ultimately acquitted. The system is completely integrated, both horizontally and vertically. A&P is engaged in the food industry as buyer, manufacturer, processor, broker, and retailer. It operates 5,800 retail stores in forty states and the District of Columbia, and thirty-seven warehouses serve these stores.

The top holding company is the defendant A&P, a New York corporation. The George H. Hartford Trust, of which John A. and George L. Hartford are trustees, owns approximately ninety-nine per cent of A&P. This top holding company owns and controls the whole hierarchy, with very tight control in the hands of the Hartfords. The wholesale warehouses and retail operation of the A&P system are divided up into divisions, units, and stores. The division presidents control the policy of the system, but the Hartfords control the appointment of the division presidents. The Hartfords sit with them in the quarterly division policy making meetings and are a dominating influence at these meetings. On the whole, it is a well disciplined organization, from top to bottom. Ultimate control of buying, with unimportant exceptions, is centralized in headquarters of A&P. In this way, A&P controls the buying policy for the entire system and hence the purchase price of its merchandise. This centralized control also gives A&P control of such things as advertising allowances and label and bag allowances, which are related to the buying.

The buying policy of A&P was to so use its power as to get a lower price on its merchandise than that obtained by its competitors. This policy, as implemented by "direct buying," was referred to by the top officers of A&P as a two-price level, the lower for A&P and the higher for its competitors. It used its large buying power to coerce suppliers to sell to it at a lower price than to its competitors on the threat that it would place such suppliers on its private blacklist if they did not conform, or that A&P would go into the manufacturing business in competition with the recalcitrant suppliers.

The following are some of the techniques used by A&P to get a lower price than its competitors. As early as about 1925, A&P sent its buyers into the field to buy merchandise for it under strict control of headquarters. These buyers were on A&P's payroll and were operating out of its establishments, in offices mostly under their individual names. Their primary object was to get the merchandise for A&P as cheaply as they could, and for this the supplier was compelled, if he obtained the business, to pay A&P a seller's brokerage of from one to five per cent. These so-called brokerage fees went into the coffers of A&P as a further reduction in price. Except on brokerage received from meat packers, which was outlawed in 1934, this system continued until 1936, when it was made illegal by the Robinson-Patman Act, 15 U.S.C.A. §§ 13, 13a, 13b, 21a. In 1935, gross revenues from this source amounted to $2,500,000.

After 1936, the buyers, instead of getting credit for alleged brokerage, induced their suppliers to reduce their price further to A&P by the amount of the brokerage fee. Thus the allowance became a markdown of the price on the invoice. This was called net buying. When this was outlawed by a decision of the Third Circuit upholding a cease and desist order of the Federal Trade Commission directed at this practice, A&P adopted a policy of direct buying. It thereafter would buy from no one who sold through a broker. Not only would it not buy from suppliers who offered to sell to it through brokers; it would not buy from a supplier who sold to anyone else through brokers. This clearly affected the business of brokers, who resisted as best they could, and as one of the defendant officers said, "these brokers are dieing (sic) hard." This policy also affected the trade that was unable to buy directly. Suppliers were in effect told that if they did not sell direct to all customers, A&P would withdraw its patronage. This policy of direct buying was broadcast to all the trade in a national press release by A&P, and A&P continued to get its usual lower price, which was supposed to be justified by cost savings in such direct buying and because A&P bought in large quantities. This system continued until the trial.

A substantial amount of the discounts A&P received rarely bore a relationship to cost savings. A&P got the largest discount on the basis of "large quantities" purchased, but as pointed out by A&P's attorney, the use of the expression "large quantities" was "definitely misleading." The large discounts A&P got were not for taking large quantities at one time but were based on a large volume purchased over a period of time and delivered in many small shipments. The defendants' attorneys pointed out to them that, "A large volume ordered out in many small shipments rarely involves any savings in and of itself * * *." Whatever the system used or by whatever name designated, A&P always wound up with a buying price advantage. This price advantage given A&P by the suppliers was, it is fairly inferable, not "twice blessed" like the quality of mercy that "droppeth as the gentle rain from heaven." It did not bless "him that gives and him that takes." Only A&P was blessed, and the supplier had to make his profit out of his other customers at higher prices, which were passed on to the competition A&P met in the retail field.

One cannot escape the conclusion on the very substantial evidence here, as one follows the devious manipulations of A&P to get price advantages, that it succeeded in obtaining preferential discounts not by force of its large purchasing power and the buying advantage which goes therewith, but through its abuse of that power by the threats to boycott suppliers and place them on its individual blacklist, and by threats to go into the manufacturing and processing business itself, since it already possessed a considerable establishment and experience that would enable it to get quickly and successfully into such business if a recalcitrant supplier, processor, or manufacturer did not yield. The A&P organization was urged to keep secret whatever

preferences it received. These predatory discounts and other preferences amounted to 22.15% of A&P's total profits in 1939; 22.47% in 1940; and 24.59% in 1941.

The influence of this ruthless force in the food buying field was also used to compel suppliers to discontinue practices in their business which might be detrimental to A&P. For instance, some A&P suppliers were making store door deliveries to A&P competitors. Since A&P had to deliver to its own store doors from the warehouses it maintained, it was unable to get the full benefit of its warehousing policy if the suppliers continued the store door deliveries. A&P forced some manufacturers to "widen the spread" between store door deliveries and warehouse deliveries and thus perpetuated its purchasing advantage. Also, it forced other suppliers to discontinue merchandising by aid of premiums given the customers. A&P did not want to be bothered with the premium details, and it did not want its competitors to have the advantage thereof, so it forced many suppliers to give up the premium aid to merchandising.

To do their buying of fruits, vegetables, and produce, A&P set up a wholly-owned subsidiary, the Atlantic Commission Company, herein referred to as ACCO. It acted as buyer for A&P and selling and buying broker for the rest of the trade, and for this latter service, ACCO received the usual broker's fees which went into the pocket of A&P since the latter was the sole owner of ACCO. ACCO was the largest single operator in its field. For a time it took brokerage from the seller for the merchandise it sold to A&P. These funds went, of course, to A&P. That system was abandoned. But the technique used by A&P in the purchase of merchandise other than fresh fruits, vegetables, and produce, in order to receive preferential treatment as to price, was used by ACCO in its field and with like success.

*** ACCO's aggressiveness and insistence upon its prerogative to fix prices unilaterally are evidenced by a statement of the defendant Baum, an executive officer and director of ACCO:

> "* * * it will be necessary for your shippers to accept the price we place on this merchandise at the time of arrival and discontinue this bartering over 5¢ differential and if the shippers find that this procedure is not in accordance with their ideas or they are not given a fair deal on the average over a period of time then of course it is their privilege to discontinue these arrival sales or price arrivals."

*** From this evidence, we see that ACCO collected brokerage from the trade, which increased the price to A&P's competitors, and the brokerage went into A&P's coffers to increase its competitive advantage. Secondly, ACCO got the best quality for A&P and passed on the inferior to A&P's competitors and, of course, ACCO got preferential treatment as to prices under one scheme or another. ACCO's profits constituted 5.08% of A&P's total profit in 1939; 5.62% in 1940; and 7.16% in 1941.

Closely related to the policy and the purpose to establish a two-price level by the abuse of its power and position, A&P by the same methods forced its suppliers to give it advertising and space allowances that bore no relation to the cost of the service rendered in the matter of advertising or display of merchandise in A&P's stores. *** The profits from these allowances were substantial and amounted in 1939 to 5.93% of A&P's total profit; in 1940 to 6.23%; and in 1941 to 5.46%.

Another but smaller item was the bag and label allowances. A&P furnished bags and labels to processors and manufacturers, for which it received an allowance. For instance, in the canning industry, the standard allowance for labels was $1.50 per thousand, but A&P insisted upon and received $2 per thousand. It was claimed that A&P's labels were more attractive and expensive. However that may be, the fact remains that A&P was not in the label business any more than it was in the advertising business, but it managed in both to realize a substantial difference

between the cost to it and what it realized out of the transaction from other suppliers. Everything was grist to the mill that was grinding down prices to A&P to enable it to maintain the two-price level to its advantage. The bag and label allowances amounted in 1939 to .83% of the total profit of A&P; in 1940 to .75%; and in 1941 to .38%.

As we have indicated, A&P owned and controlled, through the vertical integration of its system, certain corporations that were engaged in the manufacturing and processing of merchandise for sale by A&P in its stores. For instance, the defendant The Quaker Maid Company, Inc., made many items sold in A&P retail stores. The defendant White House Milk Company, Inc., manufactured canned milk. The defendant Nakat Packing Corporation canned fish. These companies were satellites of the A&P system. Their products were sold only to A&P stores and were invoiced at a markup above the cost of production. These corporations were tools in the hands of A&P, used and useful in maintaining the two-price level to enable it to maintain its position of dominance in the retail food business. Whatever the spread between cost to these defendants in processing and manufacturing and what they invoiced the goods to A&P for, was credited on the books to A&P. This, of course, was a bookkeeping transaction between A&P and its satellites and was a paper profit which eventually went to reduce the cost of the products to the retail stores when allocated to their credit on a fair method of allocation based upon use employed by the retail stores. In fact, all the paper profits of these manufacturing and processing satellites, together with the real profits of ACCO, the preferential discounts and buying allowances, the advertising allowances, the bag and label allowances, and certain other profits and gains throughout the system, were all kept track of by a system of what the defendants designate statistical accounting, for their own guidance to enable them to determine what the satellites, departments within the system as well as the retail stores, were doing. These accumulated profits and allowances at headquarters amounted in 1939 to 93.69% of A&P's total profits; in 1940 to 90.63%; and in 1941 to 89.02%. The difference between these accumulated profits and allowances and the total profits left the profits shown by the retail stores to be 6.31% in 1939; 9.37% in 1940; and 10.98% in 1941.

No question is raised about the fairness of the method of allocation of the accumulated profits and allowances. When made, they have the effect of reducing to the retail stores the cost of merchandise sold. It is the predatory method through which this accumulation of profits and allowances is obtained and not the method of allocation or statistical handling of them that is challenged by the Government. With this large fund accumulated at the buying and supplying level and allocated to the advantage of low cost of merchandise to the retail or selling level, A&P's enormous power or advantage over competitors emerges more clearly when we consider the evidence on the retail level. Here the price advantage A&P has enjoyed through the coercive use of its power enables it to undersell its competitors and to pick and choose the locations in which the price advantage shall be used. For instance, if a division, unit, or store is selected for attention, whether on the basis of its experience historically in that community or some other basis sufficient to the policy makers of A&P, these policy makers have only to give their attention to gross profit percentages. If Area X is having a tough experience competitionwise, or the area looks prospective in which to increase the volume of business, the gross profit percentage in this area is lowered. This lowers the price at which goods may be sold and the volume increases at the expense of somebody. Sometimes the gross profit rate is fixed so low that the store runs below the cost of operation, even with all the advantage derived by the store in reduction of the cost of its merchandise occasioned by the headquarters' allocation of its predatory profits and accumulations. When the gross profit rate is reduced in Area X, it is an almost

irresistible conclusion that A&P had the power to compensate for any possible decline in net profits by raising the gross profit rate and retail prices in Area Y, where it was in a competitive position to do so. The record is replete with instances of deliberate reductions of gross profit rates in selected areas. Thus Area Y, at the desire of the policy makers of A&P, can be brought to aid in the struggle in Area X, which in numerous instances, as the record shows, sustained heavy net losses for periods extending over a substantial number of consecutive years. There must inevitably be a compensation somewhere in the system for a loss somewhere else, as the overall policy of the company is to earn $7 per share per annum on its stock.

On this record it seems apparent that the goal of the conspiracy to establish a two-price level at the buying level, which enables A&P to meet its competitors with an enormous advantage at the retail level, has been realized.

When Congress enacted the Sherman Act it did not undertake to regulate business in commerce, which so often leads to price or rate fixing. Just a few years before the Sherman Act was enacted, Congress passed the Interstate Commerce Act, 49 U.S.C.A. § 1 et seq., whereby it did fix rates through an instrumentality of its own creation and within limits which Congress prescribed. The Sherman Act sought to avoid, not only for reasons of policy but for considerations of power, any regulation of business not in the category with railroads, which were supposed to be affected with the public interest, and to establish a punitive or corrective system for other business in commerce. Congress evidently believed that if competition were preserved in this field, free enterprise would regulate itself. The purpose of Congress was to see to it that competition was not destroyed. To this end, in the most comprehensive and sensitive terms, Congress provided among other things that a conspiracy to restrain trade in commerce and to monopolize it in part should be a criminal offense. That is the offense of which these defendants stand convicted.

No court has yet said that the accumulation and use of great power is unlawful per se. Bigness is no crime, although "size is itself an earmark of monopoly power. For size carries with it an opportunity for abuse." *United States v. Paramount Pictures*, 334 U.S. 131, 174. That there was an accumulation of great power by A&P cannot be denied. How it used that power is the question. When A&P did not get the preferential discount or allowance it demanded, it did not simply exercise its right to refuse to contract with the supplier. It went further and served notice on the supplier that if that supplier did not meet the price dictated by A&P, not only would the supplier lose the business at the moment under negotiation, but it would be put upon the unsatisfactory list or private blacklist of A&P and could expect no more business from the latter. This was a boycott and in and of itself is a violation of the Sherman Act. *Fashion Originators Guild v. Federal Trade Comm.*, 312 U.S. 457.

While it is not necessary to constitute a violation of Sections 1 and 2 of the Sherman Act that a showing be made that competitors were excluded by the use of monopoly power, there is evidence in this record of how some local grocers were quickly eliminated under the lethal competition put upon them by A&P when armed with its monopoly power. As the evidence showed in this case, A&P received quantity discounts that bore no relation to any cost savings to the supplier. While A&P tried to rig up various contracts with its suppliers that would give the suppliers a semblance of compliance with the Robinson-Patman Act, by colorably relating the discriminatory preferences allowed to cost savings, the primary consideration with A&P seemed to be to get the discounts, lawfully, if possible, but to get them at all events. The conclusion is inescapable on this record that A&P was encouraging its suppliers to violate the Robinson-Patman Act. The unlawful discounts were to be received by A&P as its due, regardless.

Whether or not A&P in inducing and knowingly receiving these price discriminations was in violation of the Robinson-Patman Act, as its suppliers certainly were, the advantage which A&P thereby obtained from its competitors is an unlawful restraint in itself. The purpose of these unlawful preferences and advantages was to carry out the avowed policy of A&P to maintain this two-price level which could not help but restrain trade and tend toward monopoly. Furthermore, to obtain these preferences, pressure was put on suppliers not by the use but by the abuse of A&P's tremendous buying power. The means as well as the end were unlawful. With the concessions on the buying level acquired by the predatory application of its massed purchasing power, A&P was enabled to pressure its competitors on the selling level even to the extent of selling below cost and making up the loss in areas where competitive conditions were more favorable. The inevitable consequence of this whole business pattern is to create a chain reaction of ever-increasing selling volume and ever-increasing requirements and hence purchasing power for A&P, and for its competitors hardships not produced by competitive forces, and, conceivably, ultimate extinction. Under all the cases, this is a result which Sections 1 and 2 of the Sherman Act were designed to circumvent.

*** On the whole record, we think that there is substantial evidence to support the finding as to the guilt of all the defendants. The other errors complained of have all been considered and found unsubstantial, and the judgment is affirmed.

U.S. Wholesale Outlet & Distribution, Inc. v. Innovation Ventures, LLC

89 F.4th 1126 (9th Cir. 2023)

MILLER, CIRCUIT JUDGE, as to Parts I and II: This appeal arises out of an action under the Robinson-Patman Price Discrimination Act, 15 U.S.C. §§ 13–13b, 21a. The jury returned a verdict for the defendants, and the district court denied the plaintiffs' requested injunctive relief. The plaintiffs challenge various jury instructions as well as the denial of injunctive relief. We affirm in part and vacate, reverse, and remand in part.

I

Living Essentials, LLC, produces 5-hour Energy, a caffeinated drink sold in 1.93-ounce bottles. Living Essentials sells 5-hour Energy to various purchasers, including wholesalers, retailers, and individual consumers.

This case concerns Living Essentials' sales of 5-hour Energy to two sets of purchasers. One purchaser is the Costco Wholesale Corporation, which purchases 5-hour Energy for resale at its Costco Business Centers—stores geared toward "Costco business members," such as restaurants, small businesses, and other retailers, but open to any person with a Costco membership. The other purchasers, whom we will refer to as "the Wholesalers," are seven California wholesale businesses that buy 5-hour Energy for resale to convenience stores and grocery stores, among other retailers. The Wholesalers allege that Living Essentials has offered them less favorable pricing, discounts, and reimbursements than it has offered Costco.

During the time period at issue here, Living Essentials charged the Wholesalers a list price of $1.45 per bottle of "regular" and $1.60 per bottle of "extra-strength" 5-hour Energy, while Costco paid a list price of ten cents per bottle less: $1.35 and $1.50, respectively. Living Essentials also provided the Wholesalers and Costco with varying rebates, allowances, and discounts affecting the net price of each bottle. For example, the Wholesalers received a 7-cent per bottle "everyday discount," a 2 percent discount for prompt payment, and discounts for bottles sold

from 5-hour Energy display racks. Meanwhile, Costco received a 1 percent prompt-pay discount; a spoilage discount to cover returned, damaged, and stolen goods; a 2 percent rebate on total sales for each year from 2015 to 2018; payments for displaying 5-hour Energy at the highly visible endcaps of aisles and fences of the store; and various advertising payments.

Living Essentials also participated in Costco's Instant Rebate Coupon (IRC) program. Under that program, Costco sent monthly mailers to its members with redeemable coupons for various products. About every other month, Costco would offer its members an IRC worth $3.60 to $7.20 per 24-pack of 5-hour Energy—a price reduction of 15 to 30 cents per bottle. The customer would redeem the IRC from Costco at the register when buying the 24-pack, and Living Essentials would reimburse Costco for the face value of the 5-hour Energy IRCs redeemed that month. Over the course of the seven-year period at issue here, Living Essentials reimbursed Costco for about $3 million in redeemed IRCs.

In February 2018, the Wholesalers brought this action against Living Essentials and its parent company, Innovation Ventures, LLC, in the Central District of California, alleging that by offering more favorable prices, discounts, and reimbursements to Costco, Living Essentials had violated the Robinson-Patman Act, which prohibits sellers of goods from discriminating among competing buyers in certain circumstances. The Wholesalers sought damages under section 2(a) of the Act and an injunction under section 2(d).

Section 2(a)—referred to as such because of its original place in the Clayton Act, see *Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 175 (2006)—bars a seller from discriminating in price between competing purchasers of commodities of like grade and quality. 15 U.S.C. § 13(a). One form of prohibited discrimination under section 2(a) is secondary-line price discrimination, "which means a seller gives one purchaser a more favorable price than another." *Aerotec Int'l, Inc. v. Honeywell Int'l, Inc.*, 836 F.3d 1171, 1187 (9th Cir. 2016). To establish secondary-line discrimination, a plaintiff must show that (1) the challenged sales were made in interstate commerce; (2) the items sold were of like grade and quality; (3) the seller discriminated in price between the disfavored and the favored buyer; and (4) "'the effect of such discrimination may be . . . to injure, destroy, or prevent competition' to the advantage of a favored purchaser." *Volvo*, 546 U.S. at 176–77 (quoting 15 U.S.C. § 13(a)). The fourth component of that test, the element at issue in this case, ensures that section 2(a) "does not ban all price differences," but rather "proscribes 'price discrimination only to the extent that it threatens to injure competition.'" Id. at 176 (quoting *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 220 (1993)).

Section 2(d) makes it unlawful for a manufacturer to discriminate in favor of one purchaser by making "payment[s]" to that purchaser "in connection with the . . . sale, or offering for sale of any products . . . unless such payment or consideration is available on proportionally equal terms to all other customers competing in the distribution of such products." 15 U.S.C. § 13(d). To prevail on a claim for injunctive relief under section 2(d), the plaintiff must establish that it is in competition with the favored buyer, and "must show a threat of antitrust injury," *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104, 122 (1986), but it need not make "a showing that the illicit practice has had an injurious or destructive effect on competition." *FTC v. Simplicity Pattern Co.*, 360 U.S. 55, 65 (1959).

On summary judgment, the district court found that the Wholesalers had proved the first three elements of their section 2(a) claim—that the products were distributed in interstate commerce, of like grade and quality, and sold at different prices to Costco and to the Wholesalers.

The parties proceeded to try to a jury the fourth element of section 2(a), whether there was a competitive injury, and to try to the court the section 2(d) claim for injunctive relief.

At trial, the parties focused on whether the Wholesalers and Costco were in competition. The Wholesalers introduced numerous emails from Living Essentials employees discussing the impact of Costco's pricing on the Wholesalers' sales. Additionally, they presented the testimony of a marketing expert who opined that the Wholesalers and the Costco Business Centers were in competition. The expert based that opinion on the companies' geographic proximity and on interviews he conducted in which the Wholesalers' proprietors stated that they lost sales due to Costco's lower prices. Living Essentials primarily relied on the testimony of an expert who reviewed sales data and opined that buyers of 5-hour Energy are not price sensitive and do not treat the Wholesalers and Costco Business Centers as substitutes; for that reason, he concluded that the Wholesalers and Costco Business Centers were not competitors.

The district court instructed the jury that section 2(a) required the Wholesalers to show that Living Essentials made "reasonably contemporaneous" sales to them and to Costco at different prices. The Wholesalers objected. They agreed that the instruction correctly stated the law but argued that "[t]here is literally no evidence to suggest that Living Essentials' sales of 5-Hour Energy to Costco and Plaintiffs occurred at anything other than the same time over the entire 7-year period." The court nevertheless gave the proposed instruction, telling the jury that "[e]ach Plaintiff must prove that the sales being compared were reasonably contemporaneous." The instruction directed the jury to find for Living Essentials if it determined "that the sales compared are sufficiently isolated in time or circumstances that they cannot be said to have occurred at approximately the same time for a Plaintiff." The instruction also listed a number of factors for the jury to consider in its evaluation, such as "[w]hether market conditions changed during the time between the sales."

The district court further instructed the jury that the Wholesalers had to prove that any difference in prices could not be justified as "functional discounts" to compensate Costco for marketing or promotional functions that it performed. The Wholesalers again objected. As with the instruction on reasonably contemporaneous sales, the Wholesalers agreed that the instruction was a correct statement of the law, but they argued that there was "a complete absence of evidence" of any savings for Living Essentials or costs for Costco in performing the alleged functions justifying the discount. Rejecting that argument, the court instructed the jury that Living Essentials claimed that "its lower prices to Costco are justified as functional discounts," which the court defined as discounts "given by a seller to a buyer based on the buyer's performance of certain functions for the seller's product." The instructions explained that while the Wholesalers had "the ultimate burden to prove that defendant's lower prices were not justified as a functional discount," Living Essentials had the burden of production and so "must present proof" that "(1) Costco actually performed the promotional, marketing, and advertising services" it claimed to perform and "(2) the amount of the discount was a reasonable reimbursement for the actual functions performed by Costco." The instructions told the jury to find for Living Essentials if it found that the price discrimination was "justified as a functional discount."

The jury returned a verdict for Living Essentials on the section 2(a) claim. The court then denied the Wholesalers' request for injunctive relief under section 2(d). The court reasoned that "the jury implicitly found no competition existed between [the Wholesalers] and Costco, and the Court is bound by that finding." In addition, the court concluded, based on its own independent review of the evidence, that the Wholesalers had "failed to prove by a preponderance of the evidence that they competed with Costco for resale" of 5-hour Energy.

II

We begin by considering the jury instructions on reasonably contemporaneous sales and functional discounts. *** The question before us is whether the district court abused its wide discretion in finding that there was any foundation for giving the instructions. We conclude that it did not.

A

The Wholesalers argue that the district court abused its discretion in instructing the jury on reasonably contemporaneous sales because "there was no legitimate dispute" that the Wholesalers carried their burden on that requirement.

To establish a prima facie case under section 2(a), a plaintiff must show that the discriminating seller made one sale to the disfavored purchaser and one sale to the favored purchaser "within approximately the same period of time." *Texas Gulf Sulphur Co. v. J.R. Simplot Co.*, 418 F.2d 793, 807 (9th Cir. 1969) (quoting *Tri-Valley Packing Ass'n v. FTC*, 329 F.2d 694, 709 (9th Cir. 1964)). In other words, it must establish "[t]wo or more contemporaneous sales by the same seller." *Rutledge v. Electric Hose & Rubber Co.*, 511 F.2d 668, 677 (9th Cir. 1975). That requirement ensures that the challenged price discrimination is not the result of a seller's lawful response to a change in economic conditions between the sales to the favored and disfavored purchasers. *Texas Gulf Sulphur Co.*, 418 F.2d at 806.

As we have explained, the Wholesalers do not argue that the district court's instructions on reasonably contemporaneous sales misstated the law. Instead, they contend that they so clearly carried their burden on this element that the district court should have found the element satisfied rather than asking the jury to decide it. In the Wholesalers' view, "there was no dispute ... that [Living Essentials] had made thousands of contemporaneous sales to Costco and to all seven Plaintiffs."

The Wholesalers' position appears to be that when the plaintiff has the burden of proving an element of its case, a district court should decline to instruct the jury on that element if the court determines the plaintiff has proved it too convincingly. We are unaware of any authority for that proposition. To the contrary, our cases that have rejected proposed jury instructions have done so because the party bearing the burden presented too little evidence to justify the instruction, not too much. *** But although the Wholesalers did move for judgment as a matter of law, they have not challenged the denial of that motion on appeal. The Wholesalers may not bypass that procedure by challenging a jury instruction on an element of their prima facie case.

Even if it could be error to instruct the jury on an element that a plaintiff obviously proved, the proof here was far from obvious. The Wholesalers might be right that the evidence established reasonably contemporaneous sales, but during the trial, they did not explain how it did so. In their written objection to the instructions, the Wholesalers stated that "[t]here is literally no evidence to suggest" that the compared sales were not contemporaneous, and in their oral objection, they similarly declared that there was "no dispute" on the issue. The first and last time the Wholesalers mentioned the requirement to the jury was during closing argument, when they said that the "[t]he sales were made continuously to Costco and to plaintiffs over the entire seven years." Despite those confident assertions, the Wholesalers did not direct the district court to any evidence to substantiate their claim.

The Wholesalers did not point to any evidence of reasonably contemporaneous sales until their post-trial motion for judgment as a matter of law. Because that motion was not available to the district court when the court instructed the jury, it cannot be a basis for concluding that

the court abused its discretion. In any event, the motion did not clearly identify any reasonably contemporaneous sales. Instead, the Wholesalers merely referred to Exhibit 847, a series of spreadsheets introduced by Living Essentials that spans more than 100,000 cells cataloguing seven years' worth of Living Essentials' sales to all purchasers, including Costco and the Wholesalers. The motion presented a modified version of that exhibit that included only Living Essentials' sales to Costco and the Wholesalers, omitting sales to other purchasers. But that (relatively) pared-down version—itself more than 200 pages long—was never presented to the jury. Even that version is hardly self-explanatory, and the Wholesalers made little effort to explain it: They did not point to any specific pair of sales that were reasonably contemporaneous.

Indeed, even on appeal, the Wholesalers have not identified any pair of sales that would satisfy their burden. The most they have argued is that the column entitled "Document Date" reflects the date of the invoice, so in their view the spreadsheets speak for themselves in showing "thousands of spot sales to Costco and Plaintiffs." At no time have the Wholesalers shown that there were two or more sales between Living Essentials and both Costco and each plaintiff that were reasonably contemporaneous such that changing market conditions or other factors did not affect the pricing.

The Wholesalers complain that they are being unfairly faulted for not more thoroughly arguing "the incorrectly instructed point to the jury." That complaint reflects a misunderstanding of their burden. To take the issue away from the jury, it was the Wholesalers' burden to make—and support—the argument that the sales were reasonably contemporaneous. Perhaps, when it developed the jury instructions, the district court could have reviewed all of the evidence, located Exhibit 847 (the full version, not the more focused one the Wholesalers submitted later), and then identified paired transactions for each Wholesaler from the thousands upon thousands of cells it contained. *** There may have been a needle—or even many needles—in the haystack of sales data. It was not the district court's job to hunt for them.

Significantly, the district court identified factors that might have influenced the pricing between sales, including that "the overall sales of 5-hour Energy in California were declining." That trend could potentially explain why two differently priced sales resulted from "diverse market conditions rather than from an intent to discriminate." *Texas Gulf Sulphur Co.*, 418 F.2d at 806. The timing of the disputed sales is unclear, so it could be that the Wholesalers bought the product during periods of higher market pricing that Costco avoided. The possibility that sales were not reasonably contemporaneous has "some foundation in the evidence," and that is enough. With only the Wholesalers' conclusory assertions, an unexplained mass of spreadsheets, and Living Essentials' evidence of changing market conditions before it, the district court did not abuse its discretion in instructing the jury on this disputed element of the Wholesalers' prima facie case.

B

The Wholesalers next argue that the district court abused its discretion in giving the functional-discount instruction.

The Supreme Court has held that when a purchaser performs a service for a supplier, the supplier may lawfully provide that purchaser with a "reasonable" reimbursement, or a "functional discount," to compensate the purchaser for "its role in the supplier's distributive system, reflecting, at least in a generalized sense, the services performed by the purchaser for the supplier." *Texaco Inc. v. Hasbrouck*, 496 U.S. 543, 562, 571 n.11 (1990). For example, the Court has

held that a "discount that constitutes a reasonable reimbursement for the purchasers' actual marketing functions will not violate the Act." Id. at 571.

Separately, the Robinson-Patman Act contains a statutory affirmative defense for cost-justified price differences, or "differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery." 15 U.S.C. § 13(a). The functional-discount doctrine is different because it requires only a "reasonable," not an exact, relationship between the services performed and the discounts given. *Hasbrouck*, 496 U.S. at 561 & n.18. Also, in contrast to the cost-justification defense, it is the plaintiff's burden to prove that the price discrimination was not the result of a lawful functional discount. Id. at 561 n.18. But the doctrine applies "[o]nly to the extent that a buyer *actually* performs certain functions, assuming all the risk, investment, and costs involved." Id. at 560–61. And it does not "countenance a functional discount completely untethered to either the supplier's savings or the wholesaler's costs" Id. at 563.

The Wholesalers do not dispute that the jury instructions accurately stated the law governing functional discounts. Instead, they argue that the district court should not have given a functional-discount instruction because the doctrine does not apply "as *between* favored and disfavored wholesalers" and because the discounts given to Costco bore no relationship to Living Essentials' savings or Costco's costs in performing the alleged functions. We find neither argument persuasive.

The Wholesalers are correct that selective reimbursements may create liability for the supplier under section 2(d) if the supplier fails to offer them "on proportionally equal terms to all other" competing purchasers. 15 U.S.C. § 13(d). Nevertheless, purchasers at the same level of trade may receive different functional discounts if they perform different functions. A functional discount may compensate a purchaser for "assuming all the risk, investment, and costs involved" with "perform[ing] certain functions," *Hasbrouck*, 496 U.S. at 560–61, and "*[e]ither* because of this additional cost or because competing buyers do not function at the same level," James F. Rill, *Availability and Functional Discounts Justifying Discriminatory Pricing*, 53 Antitrust L.J. 929, 934 (1985) (emphasis added), a functional discount "negates the probability of competitive injury, an element of a prima facie case of violation," *Hasbrouck*, 496 U.S. at 561 n.18 (quoting Rill, supra, at 935). Conversely, even where customers do operate at different levels of trade, a discount may violate the Robinson-Patman Act if it does not reflect the cost of performing an actual function.

In all section 2(a) cases, a plaintiff "ha[s] the burden of proving . . . that the discrimination had a prohibited effect on competition." *Hasbrouck*, 496 U.S. at 556. To the extent that a "legitimate functional discount," id. at 561 n.18, compensates a buyer for "*actually* perform[ing] certain functions, assuming all the risk, investment, and costs involved," id. at 560 (citation omitted), no such effect can be shown.

Here, the competitive-injury element was the subject of dispute at trial. Because Living Essentials offered evidence that it compensated Costco for performing certain functions and assuming certain risks (which would eliminate a competitive injury), the Wholesalers had the burden of showing that those functions and risks did not justify the discounted price that Costco received—whether or not Costco and the Wholesalers were at the same level of trade.

The Wholesalers also argue that even if the functional-discount instruction was legally available to Living Essentials, the district court still abused its discretion in giving the instruction because there was no foundation in the evidence to support it. In fact, Living Essentials presented evidence that Costco performed several marketing and other functions that could have been compensated for by a functional discount. For example, Costco promoted 5-hour Energy

by giving the product prime placement in aisle endcaps and along the fence by the stores' entrances; it created and circulated advertisements and mailers; it provided delivery and online sales for 5-hour Energy; and it contracted for a flat "spoilage allowance" rather than requiring Living Essentials to deal with spoilage issues as they arose. In addition to providing those services, Costco allowed Living Essentials to participate in its IRC program, in which Costco sent out bi-monthly mailers with coupons for 5-hour Energy, among other products, to its members. The member would redeem the coupon at the register, and Costco would advance the discount to the buyer on behalf of Living Essentials, record the transaction, and then collect the total discount from Living Essentials at the end of each period.

Living Essentials testified that Costco received "allowance[s]" in relation to its placement services because Costco was "performing a service for us." As to Costco's advertising and IRC services, Living Essentials testified that they allowed it to reach some 40 million Costco members, whom it could not otherwise reach "with one payment." Finally, in the case of the spoilage discount, Living Essentials explained that by providing a flat, upfront discount in exchange for Costco's assumption of the risk of loss and spoilage, Living Essentials avoided having to negotiate case-by-case with Costco over product loss.

The Wholesalers argue that the functional discount defense is unavailable because Living Essentials separately compensated Costco for promotional, marketing, and advertising services, so "the entirety of the price-gap cannot be chalked up to a unitary 'functional discount.'" They cite spreadsheets showing that Costco was paid for endcap promotions, advertising, and IRCs. But those spreadsheets do not show that Living Essentials' separate payments to Costco fully compensated it for those services. They therefore do not foreclose the possibility that some additional discount might have reflected reasonable compensation for the services.

More generally, the Wholesalers argue that even if Costco's services were valuable, "Living Essentials introduced zero evidence that its lower prices to Costco bore any relationship to either" Living Essentials' savings or Costco's costs. In fact, there is evidence in the record from which it is possible to infer such a relationship. For instance, Living Essentials presented testimony that Costco's performance of advertising functions—especially the 40-million-member mailers as well as endcap and fence placement programs—gave it "a tremendous amount of reach and awareness," which Living Essentials would otherwise have had to purchase separately. The record thus supported the conclusion that Living Essentials provided Costco "a functional discount that constitutes a reasonable reimbursement for [its] actual marketing functions." *Hasbrouck*, 496 U.S. at 571.

To be sure, the evidence did not establish a particularly precise relationship between the discounts and Costco's services, and it was open to the Wholesalers to argue that the discounts were so "untethered to either the supplier's savings or the wholesaler's costs" as not to qualify as functional discounts. *Hasbrouck*, 496 U.S. at 563. But it was the jury's role, not ours, to decide which party had the better interpretation of the evidence. The only question before us is whether the district court abused its discretion in determining that there was enough evidence to justify giving an instruction on functional discounts. Because at least some evidence supported the instruction, we conclude that there was no abuse of discretion.

The Wholesalers separately argue that the district court erred in denying their pre-verdict motion for judgment as a matter of law to exclude the functional-discount defense. Because the Wholesalers did not renew that argument in their post-verdict motion under Federal Rule of Civil Procedure 50(b), they failed to preserve the issue for appeal.

III

Finally, the Wholesalers challenge the district court's denial of injunctive relief under section 2(d). ***

A

Under section 2(d), it is unlawful for a seller to pay "anything of value to or for the benefit of a customer" for "any services or facilities furnished by or through such customer in connection with the . . . sale" of the products unless the payment "is available on proportionally equal terms to all other customers competing in the distribution of such products." 15 U.S.C. § 13(d); *Tri-Valley Packing Ass'n*, 329 F.2d at 707–08. In enacting the Robinson-Patman Act, "Congress sought to target the perceived harm to competition occasioned by powerful buyers, rather than sellers; specifically, Congress responded to the advent of large chainstores, enterprises with the clout to obtain lower prices for goods than smaller buyers could demand." *Volvo*, 546 U.S. at 175 (citing 14 Herbert Hovenkamp, Antitrust Law ¶ 2302 (2d ed. 2006)). In other words, Congress meant to prevent an economically powerful customer like a chain store from extracting a better deal from a seller at the expense of smaller businesses.[1]

The key issue in this case is whether Costco and the Wholesalers (both customers of Living Essentials) are "customers competing" with each other as to resales of 5- hour Energy for purposes of section 2(d). The FTC has interpreted the statutory language in section 2(d) to mean that customers are in competition with each other when they "compete in the resale of the seller's products of like grade and quality at the same functional level of distribution." 16 C.F.R. § 240.5.[2]

Our interpretation of "customers competing," as used in 15 U.S.C. § 13(d), is consistent with the FTC's. We have held that, to establish that "two customers are in general competition," it is "sufficient" to prove that: (1) one customer has outlets in "geographical proximity" to those of the other; (2) the two customers "purchased goods of the same grade and quality from the seller within approximately the same period of time"; and (3) the two customers are operating "on a particular functional level such as wholesaling or retailing." *Tri-Valley Packing Ass'n*, 329 F.2d at 708. Under these circumstances, "[a]ctual competition in the sale of the seller's goods may then be inferred." Id. We reasoned that this interpretation was consistent with "the underlying purpose of section 2(d)," which is to "require sellers to deal fairly with their customers who are in competition with each other, by refraining from making allowances to one such customer unless making it available on proportionally equal terms to the others." *Tri-Valley Packing Ass'n*, 329 F.2d at 708. Because sellers, in order to avoid violating section 2(d), must "assume that all of their direct customers who are in functional competition in the same geographical area, and who buy the seller's products of like grade and quality within approximately the same period of time, are in actual competition with each other in the distribution of these products," courts must make the same assumption of competition "in determining whether there has been a violation." Id. at 709. Applying this rule, *Tri-Valley* held that two wholesalers that received canned goods from the same supplier and sold them in the same geographical area

[1] To avoid confusion, we refer to the seller or supplier of a product as the "seller," the seller's customers as "customers," and those who buy from the seller's customers as "buyers."

[2] Although the FTC Guides that "provide assistance to businesses seeking to comply with sections 2(d) and 2(e)," 16 C.F.R. § 240.1, do not have the force of law, "we approach the [Guides] with the deference due the agency charged with day-to-day administration of the Act," *FTC v. Fred Meyer, Inc.*, 390 U.S. 341, 355 (1968).

would be in "actual competition" if the wholesalers had purchased the canned goods at approximately the same time. If this final criterion were met, then "a section 2(d) violation would be established" because the canned-good supplier gave one wholesaler a promotional allowance, but did not offer the same allowance to the other wholesaler. Id.

In considering the third prong of the *Tri-Valley* test—whether the two customers are operating "on a particular functional level such as wholesaling or retailing," id. at 708—we ask whether customers are actually functioning as wholesalers or retailers with respect to resales of a particular product to buyers, regardless of how they describe themselves or their activities. See *Feesers, Inc. v. Michael Foods, Inc.*, 498 F.3d 206, 214 (3d Cir. 2007) ("[T]he relevant question is whether two companies are in 'economic reality acting on the same distribution level,' rather than whether they are both labeled as 'wholesalers' or 'retailers.'") (citation omitted).

In listing the factors to consider in determining whether customers are competing, *Tri-Valley* did not include the manner in which customers operate. It makes sense that operational differences are not significant in making this determination, given that the Robinson-Patman Act was enacted to protect small businesses from the harm to competition caused by the large chain stores, notwithstanding the well-understood operational differences between the two. See, e.g., *Innomed Labs, LLC v. ALZA Corp.*, 368 F.3d 148, 160 (2d Cir. 2004) (explaining that chain stores have a more integrated distribution apparatus than smaller businesses and are able to "undersell their more traditional competitors"). Thus, courts have indicated that potential operational differences are not relevant to determining whether two customers compete for resales to the same group of buyers. In *Simplicity Pattern Co.*, the Supreme Court held that competition in the sale of dress patterns existed between variety stores that "handle and sell a multitude of relatively low-priced articles," and the more specialized fabric stores, which "are primarily interested in selling yard goods" and handled "patterns at no profit or even at a loss as an accommodation to their fabric customers and for the purpose of stimulating fabric sales." 360 U.S. at 59–60. The Court noted that the manner in which these businesses offered the merchandise to buyers was different, because the variety stores "devote the minimum amount of display space consistent with adequate merchandising—consisting usually of nothing more than a place on the counter for the catalogues, with the patterns themselves stored underneath the counter," while "the fabric stores usually provide tables and chairs where the customers may peruse the catalogues in comfort and at their leisure." Id. at 60. Nevertheless, the Court held there was no question that there was "actual competition between the variety stores and fabric stores," given that they were selling an "identical product [patterns] to substantially the same segment of the public." Id. at 62.

Similarly, in *Feesers*, the "different character" of two businesses that bought egg and potato products from a food supplier did not affect the analysis of whether they were in actual competition. 498 F.3d at 214 n.9. Although the businesses operated and interacted with their clients in different ways—one was a "full line distributor of food and food related products" while the other was a "food service management company"—the court held that "[t]he threshold question is whether a reasonable factfinder could conclude [the two customers] directly compete for resales [of the food supplier's] products among the same group of [buyers]." Id.

An assumption underlying the *Tri-Valley* framework is that two customers in the same geographic area are competing for resales to the same buyer or group of buyers. However, the Supreme Court has identified an unusual circumstance when that assumption does not hold

true and customers who resell the same product at the same functional level in the same geographic area are not in competition because they are not reselling to the same buyer. See *Volvo*, 546 U.S. at 175.

In *Volvo*, Volvo dealers (customers of Volvo, the car manufacturer and seller) resold trucks through a competitive bidding process, where retail buyers described their specific product requirements and invited bids from selected dealers of different manufacturers. 546 U.S. at 170. Only after a Volvo dealer was invited to bid did it request discounts or concessions from Volvo as part of preparing the bid. Volvo dealers typically did not compete with each other in this situation. Because the plaintiff in *Volvo* (a Volvo dealer) could not show that it and another Volvo dealer were invited by the same buyer to submit bids, there was no competition between Volvo dealers, and therefore no section 2(a) violation (which requires competition and potential competitive injury). Id. Moreover, because the plaintiff did not ask for price concessions from Volvo until after the buyer invited it to bid, id., (and no other Volvo dealer had been invited to bid) there could be no section 2(a) violation. Recognizing that the fact pattern in *Volvo* was different from a traditional Robinson-Patman Act "chainstore paradigm" case, where large chain stores were competing with small businesses for buyers, id. at 178, the Court "declin[ed] to extend Robinson-Patman's governance" to cases with facts like those in *Volvo*, id. at 181; see also *Feesers*, 498 F.3d at 214 (suggesting that there may be no actual competition where customers are selling to "two separate and discrete groups" of buyers).

B

We now turn to the question whether Costco and the Wholesalers were in actual competition.

It is undisputed that Costco and the Wholesalers were customers of Living Essentials and purchased goods of the same grade and quality. Further, the district court found that the Wholesalers' businesses were in geographic proximity to the Costco Business Centers, the only outlets that sold 5-hour Energy. It held that there "was at least one Costco Business Center in close proximity to each of the [Wholesalers] or their customers." Living Essentials and Judge Miller's dissent seemingly argue that this finding is clearly erroneous, because the maps in the record are ambiguous and the Wholesalers' expert, Dr. Frazier, is unreliable, because he "did not calculate the distance or drive time[s] between the stores" and did not conduct customer surveys. We disagree. "Where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous." *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 574 (1985). Therefore, we defer to the district court's fact-finding notwithstanding the alleged ambiguity in the evidence. Further, the district court could reasonably reject Living Essentials' critique of Dr. Frazier's methodology.

We next consider whether Costco and the Wholesalers operated at different functional levels with respect to resales of 5-hour Energy. The district court found that they did operate at different functional levels, and therefore competed for different customers of 5-hour Energy. In so holding, the district court abused its discretion because its ruling was based on both legal and factual errors.

First, the district court erred as a matter of law in concluding that, because the jury found in favor of Living Essentials on the section 2(a) claim, the jury made an implicit factual finding that there was no competition between Costco and the Wholesalers. As we have explained, to prevail on a section 2(a) claim, the Wholesalers had to show that the Wholesalers and Costco were in competition with each other, and that discriminatory price concessions or discounts caused a potential injury to competition. Therefore, in rejecting the Wholesalers' claim, the jury

could have determined that the Wholesalers and Costco were competing, but there was no potential harm to competition. Because the jury did not necessarily find that the Wholesalers and Costco were not competing, the district court erred by holding that the jury had made an implicit finding of no competition.

Second, the district court erred in holding that Costco and the Wholesalers did not operate at the same functional level. The district court stated that Costco was a retailer and made the vast majority of its sales to the ultimate consumer. This finding is unsupported by the record, which contains no evidence that Costco sold 5-hour Energy to consumers. Rather, the evidence supports the conclusion that Costco sold 5-hour Energy to retailers. First, Living Essentials' Vice President of Sales, Scott Allen, testified that from 2013 to 2016, only Costco Business Centers, which target retailers, and not regular Costco stores, which target consumers, carried 5-hour Energy. Another Living Essentials employee, Larry Fell, testified that 90 percent of all Costco Business Center clients were businesses, and that Costco Business Centers targeted mom-and-pop convenience stores and small grocery stores. Allen also testified that Costco Business Centers sold 5-hour Energy in 24-packs, which Living Essentials packages for sale to businesses rather than to consumers. This evidence supports the conclusion that Costco sold 24-packs of 5-hour Energy to retailers, and there is no evidence supporting the district court's conclusion that Costco sold 5-hour Energy to consumers. Therefore, as a matter of "economic reality," both Costco and the Wholesalers were wholesalers of 5-hour Energy. The district court clearly erred by holding otherwise.

Because the evidence shows that Costco and the Wholesalers operated at the same functional level in the same geographic area, if the Wholesalers and Costco purchased 5-hour Energy within approximately the same period of time, this confluence of facts is sufficient to establish that Costco and the Wholesalers are in actual competition with each other in the distribution of 5-hour Energy.

C

Judge Miller's dissent argues that Costco and the Wholesalers are not in actual competition because they did not compete in the resales of 5-hour Energy to the same buyers. The dissent bases this argument on evidence in the record that Costco and the Wholesalers had "substantial differences in operations" and that buyers did not treat Costco and the Wholesalers as substitute supply sources of 5-hour Energy. We disagree with both arguments.

First, the differences in operations that Judge Miller's dissent cites, such as differences in the availability of in-store credit, negotiated prices, or different retail-oriented accessories such as 5-hour Energy display racks, are not relevant to determining whether Costco and the Wholesalers are "customers competing" under 15 U.S.C. § 13(d). As explained above, customers may compete for purposes of section 2(d) even if they operate in different manners.

In addition to precedent, FTC guidance indicates that customers are in competition with each other when they "compete in the resale of the seller's products of like grade and quality at the same functional level of distribution," regardless of the manner of operation. 16 C.F.R. § 240.5. For example, a discount department store may be competing with a grocery store for distribution of laundry detergent. See id. (Example 3).

Second, Judge Miller's dissent argues that Costco and the Wholesalers may not be in actual competition because it is not clear they sold to the same buyers. In making this argument, the dissent and Living Essentials primarily rely on Living Essentials' economic expert, Dr. Darrel Williams, who testified that Costco and the Wholesalers were not in competition because their

buyers did not treat Costco and the Wholesalers as substitute supply sources. Dr. Williams based this conclusion on evidence that the Wholesalers' buyers continued to purchase 5-hour Energy from the Wholesalers regardless of changes in relative prices between the Wholesalers and Costco. This argument fails, however, because the question whether one business lost buyers to another does not shed light on whether the businesses are in competition, but only on whether there has been an injury to competition. Therefore, Dr. Williams's testimony about a lack of switching between Costco and the Wholesalers does not undermine the Wholesalers' claim that they are in competition with Costco for resales of 5-hour Energy.

Finally, Judge Miller's dissent relies on *Volvo* for the argument that even when the criteria in *Tri-Valley* are met for actual competition, a seller can show that the two customers are not in actual competition because "markets can be segmented by more than simply functional level, geography, and grade and quality of goods." But *Volvo* is inapposite. In *Volvo*, the customers (Volvo dealers) did not offer the same product to buyers in the same geographical area (i.e., the *Tri-Valley* scenario). Rather, it was the buyer who chose the customers from whom it solicited bids for a possible purchase. Since the buyer at issue in *Volvo* did not solicit bids from competing Volvo dealers, they were not in competition, and so a section 2(a) violation was not possible. In short, *Volvo* tells us that there may be circumstances where the evidence shows that each customer is selling to a "separate and discrete" buyer, as in *Volvo*, or to a separate and discrete group of buyers, eliminating the possibility of competition between customers. But there is no evidence supporting such a conclusion here. Instead, this case is a typical chainstore-paradigm case where the Wholesalers and Costco carried and resold an inventory of 5-hour Energy to all comers.

Because the district court erred by finding that Costco and the Wholesalers operated at different functional levels and competed for different customers with respect to 5-hour Energy, it abused its discretion in denying injunctive relief to the Wholesalers on that basis. We therefore vacate the district court's holding as to section 2(d) and reverse and remand for the district court to consider whether Costco and the Wholesalers purchased 5-hour Energy from Living Essentials "within approximately the same period of time" in light of the record (the only remaining *Tri-Valley* requirement), *Tri-Valley Packing Ass'n*, 329 F.2d at 709, or whether the Wholesalers have otherwise proved their section 2(d) claim.

AFFIRMED IN PART; VACATED, REVERSED, AND REMANDED IN PART.

GILMAN, CIRCUIT JUDGE, concurring in part and dissenting in part: Contrary to the majority's decision, I am of the opinion that the district court abused its discretion in giving the "reasonably contemporaneous" instruction to the jury. I would therefore reverse the judgment of the court and remand for a new trial on the Wholesalers' Section 2(a) claim with a properly instructed jury. On the other hand, I agree with the majority that the court did not abuse its discretion in giving the "functional discount" jury instruction. Finally, I agree with the majority that the court abused its discretion in finding that Costco and the Wholesalers operated at different functional levels. In sum, I concur in vacating the court's denial of the Wholesalers' Section 2(d) claim for injunctive relief and would go further in granting a new trial on the Wholesalers' Section 2(a) claim.

The Wholesalers' secondary-line price-discrimination claim under Section 2(a) requires them to show that: (1) the challenged sales were made in interstate commerce; (2) the items sold were of like grade and quality; (3) the defendant-seller discriminated in price between favored and disfavored purchasers; and (4) "'the effect of such discrimination may be . . . to injure, destroy,

or prevent competition' to the advantage of a favored purchaser." *Volvo Trucks N. Am, Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 176–77 (2006) (quoting 15 U.S.C. § 13(a)).

Secondary-line price discrimination is unlawful "only to the extent that the differentially priced product or commodity is sold in a 'reasonably comparable' transaction." *Aerotec Int'l, Inc. v. Honeywell Int'l, Inc.*, 836 F.3d 1171, 1188 (9th Cir. 2016) (citing *Tex. Gulf Sulphur Co. v. J.R. Simplot Co.*, 418 F.2d 793, 807 (9th Cir. 1969)). To be reasonably comparable, the transactions in question must, among other things, occur "within approximately the same period of time," such that the challenged price discrimination is not a lawful response to changing economic conditions. *Tex. Gulf Sulphur*, 418 F.2d at 807 (quoting *Tri-Valley Packing Ass'n v. FTC*, 329 F.2d 694, 709 (9th Cir. 1964)). A plaintiff must show at least two contemporaneous sales by the same seller to a favored purchaser and a disfavored purchaser to make a Section 2(a) claim.

The Wholesalers challenge as discriminatory thousands of sales of 5-Hour Energy that Living Essentials made to Costco over the course of seven years. Living Essentials also made thousands of sales to the Wholesalers over the same time period, many of which occurred on the very same day as sales to Costco. Trial Exhibit 847, a spreadsheet of all of Living Essentials' sales during the relevant time period, documents each of these transactions (approximately 95,000 transactions in total).

Although the spreadsheet is extensive, it is fairly self-explanatory, not an "unexplained mass" as it is characterized by the majority. Each transaction appears on a separate line, with the date, the name of the buyer, the type of buyer ("wholesaler" or "Costco," for example), the number of bottles purchased, and the price all clearly indicated. This evidence establishes that thousands of sales to Costco and to the Wholesalers occurred in close proximity over the course of the entire seven-year period, which more than satisfies the Robinson-Patman Act's requirement that the challenged sales be reasonably contemporaneous.

Yet the majority concludes that the Wholesalers failed to meet their burden to establish contemporaneous sales because they "did not direct the district court to any evidence to substantiate their claim" until their post-trial motion for judgment as a matter of law, and even then the Wholesalers failed to "clearly identify any reasonably contemporaneous sales." The majority concedes that "[t]here may have been a needle—or even many needles—in the haystack of sales data." But the majority concludes that "[i]t was not the district court's job to hunt for them." In fact, however, there were many thousands of needles (contemporaneous sales data) in the evidentiary haystack of Trial Exhibit 847, so the court did not have to "hunt for them"—the data was staring the court in the face for all to see.

Moreover, by focusing only on whether the Wholesalers "identified any pair of sales that would satisfy their burden," the majority fails to account for the full record in the trial court. The comprehensive sales data was referenced frequently at trial—indeed it was the centerpiece of much of the proceedings. To offer just one example, Living Essentials' expert witness, Dr. Williams, engaged in an extensive analysis of the "sales data" by "look[ing] at every single day between 2012 and 2018."

In light of this evidence, I see no justification to characterize the transactions in this case as anything other than reasonably contemporaneous. And I am not aware of any authority supporting the proposition that the sufficiency of the evidence for a jury instruction turns on how thoroughly counsel discussed certain evidence at trial, so long as it is properly admitted (which is the case here). Nor did Living Essentials offer any contrary evidence to place the issue back in dispute. In other words, giving the contemporaneous-sales instruction was unwarranted be-

cause the Wholesalers introduced unrefuted evidence that the sales were in fact contemporaneous. As the Wholesalers rightly pointed out, "[t]here is literally no evidence to suggest that Living Essentials' sales of 5-Hour Energy to Costco and Plaintiffs occurred at anything other than the same time."

The majority disagrees, holding that the district court properly ruled that the price differential could be explained (and therefore rendered lawful) by the fact that sales of 5- Hour Energy were declining overall. They further speculate that the Wholesalers might have "bought the product during periods of higher market pricing that Costco avoided." But declining overall sales is a market condition that would have affected all purchasers for resale and, more importantly, the price differential remained consistent throughout the seven-year period over which the Wholesalers and Costco bought 5-Hour Energy from Living Essentials. The record provides no basis to support the proposition that fluctuations in demand could account for price differentials between transactions that occurred on the same day.

*** Faced with the evidence outlined above, no reasonable juror could conclude that the transactions in this case were other than contemporaneous. No separation in time between transactions can account for the difference between the higher price offered to the Wholesalers and the lower price offered to Costco. That is what matters for the purposes of the Robinson-Patman Act, which targets price discrimination between "competing customers," *England v. Chrysler Corp.*, 493 F.2d 269, 272 (9th Cir. 1974), in "*comparable transactions*," *Tex. Gulf Sulphur Co. v. J.R. Simplot Co.*, 418 F.2d 793, 806 (9th Cir. 1969) (emphasis in original) (quoting *FTC v. Borden Co.*, 383 U.S. 637, 643 (1966)), in order to combat "the perceived harm to competition occasioned by powerful buyers," *Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 175 (2006).

The Wholesalers clearly objected to the "reasonably contemporaneous" instruction, and I find no evidence to support giving that instruction. I am therefore of the opinion that so instructing the jury was an abuse of the district court's discretion. And the Wholesalers need not have challenged the district court's denial of their entire post-trial renewed motion for judgment as a matter of law in order for us to remand for a new trial on the basis of this instructional error; the very fact that they "objected at the time of trial on grounds that were sufficiently precise to alert the district court to the specific nature of the defect" is sufficient. See *Merrick v. Paul Revere Life Ins. Co.*, 500 F.3d 1007, 1015 (9th Cir. 2007) (internal quotation marks omitted); see also Fed. R. Civ. P. 51.

Nor was the district court's error harmless. In the event of instructional error, prejudice is presumed, and "the burden shifts to [the prevailing party] to demonstrate that it is more probable than not that the jury would have reached the same verdict had it been properly instructed." *BladeRoom Grp. Ltd. v. Emerson Elec. Co.*, 20 F.4th 1231, 1243 (9th Cir. 2021) (quoting *Clem*, 566 F.3d at 1182). In this case, the jury was told to "find for the Defendants" if it determined that Living Essentials' sales to the Wholesalers and to Costco were not reasonably contemporaneous. And Living Essentials highlighted these instructions in their closing argument, calling the Wholesalers' failure to present evidence of contemporaneous sales "fatal to their claim." There is "no way to know whether the jury would [have] return[ed] the same [verdict] if the district court" had not given the "reasonably contemporaneous" instruction. See id. at 1244–45. I would therefore reverse the judgment of the court and remand for a new trial on the Wholesalers' Section 2(a) claim with a properly instructed jury.

MILLER, CIRCUIT JUDGE, dissenting in part: I agree that the district court did not abuse its discretion in instructing the jury on the section 2(a) claims, but I do not agree that the district court erred in rejecting the section 2(d) claims. I would affirm the judgment in its entirety.

Under section 2(d), if two or more customers of a seller compete with each other to distribute that seller's products, the seller may not pay either customer "for any services or facilities furnished by or through such customer in connection with the . . . sale" of the products unless the payment "is available on proportionally equal terms to all other customers competing in the distribution of such products." 15 U.S.C. § 13(d); see *Tri-Valley Packing Ass'n v. FTC*, 329 F.2d 694, 707–08 (9th Cir. 1964). Unlike section 2(a), section 2(d) does not require "a showing that the illicit practice has had an injurious or destructive effect on competition." *FTC v. Simplicity Pattern Co.*, 360 U.S. 55, 65 (1959). But it does demand that the favored and the disfavored customer be "competing" with each other. 15 U.S.C. § 13(d).

The district court did not clearly err in finding that the Wholesalers failed to establish by a preponderance of the evidence that they were competing with Costco. (The district court was wrong to suggest that the jury's verdict compelled this conclusion, but the court expressly stated that its finding also rested on an "independent review of the evidence," and we may uphold it on that basis.) We have previously held that "customers who are in functional competition in the same geographical area, and who buy the seller's products of like grade and quality within approximately the same period of time, are in actual competition with each other in the distribution of these products." *Texas Gulf Sulphur Co. v. J.R. Simplot Co.*, 418 F.2d 793, 807 (9th Cir. 1969) (quoting *Tri-Valley Packing Ass'n*, 329 F.2d at 709). We have not set out a definitive definition of "functional competition," and the Wholesalers argue that they need only show a "'competitive nexus,' whereby 'as of the time the price differential was imposed, the favored and disfavored purchasers competed at the same functional level, i.e., all wholesalers or all retailers, and within the same geographic market.'" (quoting *Best Brands Beverage, Inc. v. Falstaff Brewing Corp.*, 842 F.2d 578, 585 (2d Cir. 1987)).

Such a capacious understanding of competition is foreclosed by the Supreme Court's decision in *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164 (2006). There, the Court clarified that a common position in the supply chain in a shared geographical market is not sufficient, by itself, to establish actual competition. Id. at 179 ("That Volvo dealers may bid for sales in the same geographic area does not import that they in fact competed for the same customer-tailored sales."). Thus, it is not enough to point to evidence of "sales in the same geographic area." Id. Instead, the evidence must show that the disfavored buyer "compete[d] with beneficiaries of the alleged discrimination for the same customer." Id. at 178. Consistent with *Volvo*, other circuits have held that "two parties are in competition only where, after a 'careful analysis of each party's customers,' we determine that the parties are 'each directly after the same dollar.'" *Feesers, Inc. v. Michael Foods, Inc.*, 591 F.3d 191, 197 (3d Cir. 2010) (quoting *Feesers, Inc. v. Michael Foods, Inc.*, 498 F.3d 206, 214 (3d Cir. 2007)).

In this case, Living Essentials presented evidence of substantial differences in operations that suggests that the Wholesalers and Costco were not competing "for the same customer." *Volvo*, 546 U.S. at 178. For example, unlike Costco, most of the Wholesalers sold 5-hour Energy only in store, negotiated pricing with their customers—offering in-house credit and different prices for 5-hour Energy—and sold only to retailers, not to end-consumers. Meanwhile, Costco Business Centers sold both in store and online at set prices to any consumer with a Costco membership, some of whom were end-consumers; in addition, they carried fewer than half of the 5-hour Energy flavors carried by the Wholesalers, and they did not sell 5-hour Energy display

racks or other retailer-oriented accessories for Living Essentials. It is true that Costco Business Centers sold most of their 5-hour Energy to retailers. But it is far from clear that Costco sold to the same retailers as the Wholesalers. The Wholesalers' distinct features, such as their credit and wider inventory, may well have appealed to different customers.

Expert testimony corroborated that evidence. The parties offered dueling experts on the issue of competition. For the Wholesalers, Dr. Gary Frazier, a marketing expert, opined that the purchasers did compete based on his review of emails sent by Living Essentials' employees discussing sales, the testimony of six of the seven Wholesalers, and maps showing the locations of the Wholesalers, their customers, and the seven Costco Business Centers. But on cross-examination, Dr. Frazier acknowledged that he did not speak with any of the Wholesalers' customers, and that the maps on which he relied included all of the Wholesalers' customers in a cluster of unlabeled dots without regard to whether the customer ever purchased 5-hour Energy or the actual travel time for the customer to get to a Wholesaler versus one of the seven Costco Business Centers. The district court found that the Costco Business Centers and the Wholesalers were in close proximity to each other, and I do not question that finding. But the court was not required to accept Dr. Frazier's inference that their 5-hour Energy customers were the same.

For Living Essentials, Dr. Darrel Williams, an expert in industrial organization and economics, testified that a "necessary condition for competition is that the buyers consider the two sellers substitute[s]," and he opined that this "necessary condition" was absent. After analyzing Living Essentials' sales records, the sales data provided by four of the Wholesalers, and the Wholesalers' customer data, Dr. Williams concluded that the Wholesalers did not compete with Costco for sales of 5-hour Energy. His analysis showed that even though some Wholesalers priced 5-hour Energy above the prices of other Wholesalers and Costco, the Wholesalers' customers did not switch to the seller with the cheapest product; from the lack of any economically significant customer loss, he inferred that the Wholesalers' customers did not treat Costco as a substitute supplier of 5-hour Energy. He determined that the maximum level of customer switching across the Wholesalers and Costco was ten times lower than the switching attributable to ordinary customer "churn," and that even the opening of three new Costco Business Centers had no statistically significant effect on the Wholesalers' 5-hour Energy sales. Dr. Williams posited that operating differences between the Wholesalers and Costco might explain why their customers differed. He reasoned that the Wholesalers might draw customers interested in buying on credit or in the unique products the Wholesalers offer. In its ruling on the Wholesalers' motion for judgment as a matter of law, the district court summarized this testimony by explaining that "[b]ecause customers are presumed to purchase a product at the lowest available price, the jury could reasonably conclude this evidence tended to show Costco and Plaintiffs did not compete for the same customers."

The Wholesalers respond that Dr. Williams's testimony goes only to whether there was competitive injury, not whether there was competition in the first place. But that is a misreading of the testimony. Based on his conclusion that the Wholesalers' customers were not sensitive to the price of 5-hour Energy, Dr. Williams opined that the Wholesalers and Costco did not compete "for the same customer." *Volvo*, 546 U.S. at 178. To be sure, the district court was not required to credit Living Essentials' evidence and Dr. Williams's economic analysis of the sales data over the Wholesalers' evidence and Dr. Frazier's examination of emails and maps. But it did not clearly err in doing so and in finding that the Wholesalers failed to carry their burden.

In reversing the denial of an injunction, the court deems all of the evidence of lack of actual competition—and the district court's findings based on that evidence—to be irrelevant. It relies

on our decision in *Tri-Valley Packing*, in which we said that where two direct customers of a seller both "operat[e] solely on the same functional level," if "one has outlets in such geographical proximity to those of the other as to establish that the two customers are in general competition, and . . . the two customers purchased goods of the same grade and quality from the seller within approximately the same period of time," then it is not necessary to trace the seller's goods "to the shelves of competing outlets of the two in order to establish competition." 329 F.2d at 708. Instead, "[a]ctual competition in the sale of the seller's goods may then be inferred." Id.

As the court reads *Tri-Valley Packing*, the "confluence of facts" of operating on the same functional level, being in geographic proximity, and reselling goods of like grade and quality is sufficient to conclusively establish competition, making any other evidence irrelevant. But what we said in *Tri-Valley Packing* is that actual competition "may . . . be inferred," 329 F.2d at 708, not that it "shall be irrebuttably presumed."

Nowhere in *Tri-Valley Packing* did we say that a defendant is barred from rebutting the inference of competition by presenting evidence that two resellers at the same functional level and in the same geographic area are not, in fact, in actual competition with each other. If we had, our insistence in *Tri-Valley Packing* on a showing of "functional competition," which I have already discussed, would have been superfluous. 329 F.2d at 709. Reading *Tri-Valley Packing* in that way is contrary to the economic reality that markets can be segmented by more than simply functional level, geography, and grade and quality of goods. Some differences in operations may not matter to customers, but others are undoubtedly significant. (In the New York geographic market, you can order a Coke both at Le Bernardin and at McDonald's, but no one thinks they are engaged in actual competition.)

The court's approach is also contrary to *Volvo*, which says that section 2(d) requires competition "for the same customer." 546 U.S. at 178. It is contrary to the decisions of other circuits that have recognized that finding competition requires "a careful analysis of each party's customers," not the application of a categorical rule. *Feesers, Inc.*, 591 F.3d at 197 (internal quotation marks omitted). And it is unsupported by the Federal Trade Commission's interpretation of section 2(d). In regulations defining "competing customers," the FTC gives the following illustrative example: "B manufactures and sells a brand of laundry detergent for home use. In one metropolitan area, B's detergent is sold by a grocery store and a discount department store." 16 C.F.R. § 240.5. Under the court's reading of *Tri-Valley Packing*, the grocery store and the discount department store would necessarily be in competition with each other. But that is not how the FTC sees it. Instead, the agency says, "*If* these stores compete with each other, any allowance, service or facility that B makes available to the grocery store should also be made available on proportionally equal terms to the discount department store." Id. (emphasis added). The presence or absence of competition must be assessed based on the facts.

The district court appropriately reviewed all of the evidence in making a finding that Living Essentials had not established competition. Because that finding was not clearly erroneous, I would affirm the judgment in its entirety.

Deslandes v. McDonald's USA LLC

81 F.4th 699 (7th Cir. 2023)

EASTERBROOK, CIRCUIT JUDGE: Until recently, every McDonald's franchise agreement contained an anti-poach clause. Each franchise operator promised not to hire any person employed by a different franchise, or by McDonald's itself, until six months after the last date that person had worked for McDonald's or another franchise. A related clause barred one franchise from soliciting another's employee. We use "anti-poach clause" or "no-poach clause" to refer to these collectively.

Plaintiffs in this suit under § 1 of the Sherman Act, 15 U.S.C. § 1, worked for McDonald's franchises while these clauses were in force and were unable to take higher-paying offers at other franchises. They contend that the no-poach clause violates the antitrust laws. If this clause holds down the price of labor by reducing competition for fast-food workers, that could benefit owners—and conceivably consumers too. But the antitrust laws prohibit monopsonies, just as they prohibit monopolies. See *NCAA v. Alston*, ___ U.S. ___ (2021).

Claims under § 1 fall into two principal categories: naked restraints, akin to cartels, are unlawful per se, while other restraints are evaluated under the Rule of Reason. (The quick-look approach, see *NCAA v. University of Oklahoma*, 468 U.S. 85 (1984), is a subset of analysis under the Rule of Reason.) The district court rejected plaintiffs' per se theory after stating that the anti-poach clause is not a naked restraint but is ancillary to each franchise agreement—and, as every new restaurant expands output, the restraint is justified.

The court deemed the complaint deficient under the Rule of Reason because it does not allege that McDonald's and its franchises collectively have power in the market for restaurant workers' labor. Market power is essential to any claim under the Rule of Reason. See *Ohio v. American Express Co.*, ___ U.S. ___ (2018); *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 885-86 (2007). The absence of such an allegation rendered the claim implausible, the court held. See *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) (establishing the plausibility requirement for antitrust complaints). The judge invited plaintiffs to file an amended complaint alleging market power. After they declined to do so, the judge dismissed the complaint with prejudice, ending the suit.

On appeal plaintiffs assert that they didn't "really" waive or forfeit their opportunity to allege market power, but the district court's contrary conclusion is not an abuse of discretion. Plaintiffs also contend that the existence of market power is too obvious to need allegations and proof, but that line of argument depends on treating "workers at McDonald's" as an economic market. That's not sound. People who work at McDonald's one week can work at Wendy's the next, and the reverse. People entering the labor market can choose where to go—and fast-food restaurants are only one of many options. If wages are too low at one chain, people can choose other employers. The mobility of workers—both from one employer to another and from one neighborhood to another —makes it impossible to treat employees at a single chain as a market.

The district judge found it undisputed that within three miles of Deslandes's home there are between 42 and 50 quick-service restaurants as well as two McDonald's franchises, and that within ten miles of her home there are 517 quick-service restaurants. This is not a situation in which a court can treat employment for a single enterprise as a market all its own. So the Rule of Reason is out of this suit, and, as quick-look analysis is part of the Rule of Reason, it is out too.

But the district judge jettisoned the per se rule too early. The complaint alleges a horizontal restraint, and market power is not essential to antitrust claims involving naked agreements among competitors. See, e.g., *Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46 (1990).

An agreement among competitors is not naked if it is ancillary to the success of a cooperative venture. Consider a partnership to practice law. The partners devote their time to the law firm and pool their revenues; that's a horizontal agreement. The partners also promise not to compete with the law firm by taking their own clients. That agreement is lawful because the promise to devote all legal time to the firm's business helps each law firm compete against its rivals; in antitrust jargon, the no-compete pledge is ancillary to the venture in the sense that it makes the partnership more effective when competing in the market for legal services. See *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1, 9 (1979).

The complaint alleges that McDonald's operates many restaurants itself or through a subsidiary, and that it enforced the no-poach clause at those restaurants. This made the arrangement horizontal: workers at franchised outlets could not move to corporate outlets, or the reverse. See *Interstate Circuit, Inc. v. United States*, 306 U.S. 208 (1939).

Still, the district court thought that the anti-poach clause is justified as an ancillary restraint. The court deemed the restraint ancillary because it appeared in franchise agreements—and each agreement expands the output of burgers and fries. (We need not consider the possibility that new franchises replace old ones, so that "new franchise" need not imply "more output," though this may need attention later.)

One problem with this approach is that it treats benefits to consumers (increased output) as justifying detriments to workers (monopsony pricing). That's not right; it is equivalent to saying that antitrust law is unconcerned with competition in the markets for inputs, and *Alston* establishes otherwise.

Another problem with using the appearance of a clause in a contract that, on the whole, increases output, is that the clause may have nothing to do with the output. A "restraint does not qualify as 'ancillary' merely because it accompanies some other agreement that is itself lawful." Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶ 1908b (4th ed. 2022). Is there some reason to think that a no-poach clause promotes the production of restaurant food? Maybe it just takes advantage of workers' sunk costs and helps each business's bottom line, without adding to output.

What we mean is this: People who choose to work at McDonald's or one of its franchises acquire business-specific (or location-specific) skills. Employees may choose to work for less than their marginal product in order to compensate the employer for the training. In a competitive market, workers recover these investments as their wages rise over time, in response to their greater productivity. But if McDonald's specifies a limited number of classifications of workers (something the complaint also alleges), that may delay promotion and frustrate workers' ability to recoup their investments in training. One way to obtain a higher salary, after paying for one's own training through lower wages, is to seek employment at another similar business where the skills can be put to use at the market wage. Deslandes alleges that this is what she tried to do, only to be blocked by the no-poach clause. And if this is what the no-poach agreement does—if it prevents workers from reaping the gains from skills they learned by agreeing to work at lower wages at the outset of their employment—then it does not promote output. It promotes profits, to be sure, as franchises capitalize on workers' sunk costs. But it does not promote output and so cannot be called "ancillary" in the sense antitrust law uses that term.

Common training and job classifications could in principle justify restraints on poaching. Suppose Franchise A hires workers and pays for necessary training, rather than requiring the workers to cover their own training costs through lower wages. During training in this approach, the wage exceeds the worker's productivity, but after training the worker produces enough value to pay back the costs of training and allow A to recoup the "excess" wage during training time. A needs to keep the worker for this to pay off. If Franchise B offers no training but a higher wage, this will be attractive to the worker who was trained at A, and B can make a profit from free riding on A's investment. B can do this because the restaurants have the same layout, tasks, and so on. In these circumstances a ban on poaching could allow A to recover its training costs and thus make training worthwhile to both franchise and worker. It would not imply monopsony. But eventually the cost of training will have been amortized, and a ban on transfer to another restaurant after that threshold could be understood as an antitrust problem.

So what was the no-poach clause doing? Was it protecting franchises' investments in training, or was it allowing them to appropriate the value of workers' own investments? That question can't be answered by observing that any given franchise contract, viewed by itself, expands the output of food. Why did the clause have a national scope, preventing a restaurant in North Dakota from hiring a worker in North Carolina, when the market for restaurant jobs is local? Why did the restriction last as long as the employment (plus six months), rather than be linked to any estimate of the time a franchise would need to recover its investments in training? If the answer to some of these questions depends (as McDonald's asserts) on the fact that the system as a whole advertises for workers and wants to prevent some outlets from free riding on the contributions of others, how do the terms of the no-poach clause reflect this objective?

These are all potentially complex questions, which cannot be answered by looking at the language of the complaint. They require careful economic analysis. More than that: the classification of a restraint as ancillary is a defense, and complaints need not anticipate and plead around defenses. Some language in the district court's opinions suggests that a complaint must contain enough to win, but that is not so. It suffices, *Twombly* holds, to make out a plausible claim, and this complaint does so. Nor need a complaint plead law or match facts to elements of legal theories. Once a complaint has identified a plausible antitrust claim, further development requires discovery, economic analysis, and potentially a trial.

Plaintiffs sought class certification, and the district court said no. The court may think it wise to reconsider in light of the need for a remand and the analysis in this opinion.

The judgment is vacated and the case is remanded for further proceedings.

RIPPLE, CIRCUIT JUDGE, concurring: I join the opinion and the judgment of the court. The issue presented by this case is an important and timely one. I therefore write separately to make clear my understanding of what we decide, and do not decide, today.

Our opinion sends the ancillary restraint defense back to the district court for further analysis. It makes clear that, in further proceedings before the district court, the defendants bear the burden of establishing that the no-poaching clause in the franchise agreement qualifies as an ancillary restraint. It further suggests the sort of inquiry that the district court should undertake in considering this question. Our opinion's discussion of these perspectives hopefully will be helpful to the district court and to the parties. However, I do not understand the court's opinion to assess in any definitive way the merits of any of these suggested avenues of further economic analysis, nor do I understand the court to preclude other approaches that the parties believe pertinent and that the district court believes relevant.

Nor do I read the court's discussion as addressing the relative usefulness of the various considerations that it discusses. As I understand the court's opinion, it leaves the district court, with the assistance of the parties, to determine the relative importance of these considerations and to identify those issues worthy of its prime attention. For instance, the district court might determine that the scope and duration of the restriction in question reduces substantially the need for extended economic analysis of other "potentially complex questions." Op. 705. If the restriction cannot be justified because of its scope and duration, it is difficult to see how it can be reasonably necessary to the achievement of the procompetitive objectives of the franchise agreement. If we are to retain the benefits of applying a per se analysis to horizontal agreements, we need to ensure that our adjudication of possible defenses is a focused one.

Perhaps most importantly, I do not understand the court to question the continued vitality of the rule that the ancillary restraint defense requires that the defendants establish both that the restriction in question be "subordinate and collateral," *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 224 (D.C. Cir. 1986), to a "legitimate business collaboration" among the defendants, and be reasonably necessary to achieve a procompetitive objective of the franchise agreement. This rule is well-established, and I do not understand this opinion to weaken surreptitiously a principle upon which the bench and bar rely.

Meyer v. Kalanick

174 F.Supp.3d 817 (S.D.N.Y. 2016)

JED S. RAKOFF, DISTRICT JUDGE: On December 16, 2015, plaintiff Spencer Meyer, on behalf of himself and those similarly situated, filed this putative antitrust class action lawsuit against defendant Travis Kalanick, CEO and co-founder of Uber Technologies, Inc. ("Uber"). Mr. Meyer's First Amended Complaint, filed on January 29, 2016, alleged that Mr. Kalanick had orchestrated and facilitated an illegal price-fixing conspiracy in violation of Section 1 of the federal Sherman Antitrust Act, 15 U.S.C. § 1, and the New York State Donnelly Act, New York General Business Law § 340. See First Amended Complaint ("Am. Compl."), Dkt. 26, ¶¶ 120-140. Plaintiff claimed, in essence, that Mr. Kalanick, while disclaiming that he was running a transportation company, had conspired with Uber drivers to use Uber's pricing algorithm to set the prices charged to Uber riders, thereby restricting price competition among drivers to the detriment of Uber riders, such as plaintiff Meyer.

On February 8, 2016, defendant Kalanick moved to dismiss the Amended Complaint. Plaintiff opposed on February 18, 2016; defendant replied on February 25, 2016; and oral argument was held on March 9, 2016. Having considered all of the parties' submissions and arguments, the Court hereby denies defendant's motion to dismiss.

In ruling on a motion to dismiss, the Court accepts as true the factual allegations in the complaint and draws all reasonable inferences in favor of the plaintiff. *** In the antitrust context, stating a claim under Section 1 of the Sherman Act "requires a complaint with enough factual matter (taken as true) to suggest that an agreement was made. Asking for plausible grounds to infer an agreement does not impose a probability requirement at the pleading stage; it simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal agreement." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 556 (2007).

The relevant allegations of the Amended Complaint are as follows. Uber, founded in 2009, is a technology company that produces an application for smartphone devices ("the Uber App")

that matches riders with drivers (called "driver-partners"). Uber states that it is not a transportation company and does not employ drivers. Defendant Kalanick, in addition to being the co-founder and CEO of Uber, is a driver who has used the Uber app. Plaintiff Meyer is a resident of Connecticut, who has used Uber car services in New York.

Through the Uber App, users can request private drivers to pick them up and drive them to their desired location. Uber facilitates payment of the fare by charging the user's credit card or other payment information on file. Uber collects a percentage of the fare as a software licensing fee and remits the remainder to the driver. Drivers using the Uber app do not compete on price and cannot negotiate fares with drivers for rides. Instead, drivers charge the fares set by the Uber algorithm. Though Uber claims to allow drivers to depart downward from the fare set by the algorithm, there is no practical mechanism by which drivers can do so. Uber's "surge pricing" model, designed by Mr. Kalanick, permits fares to rise up to ten times the standard fare during times of high demand. Plaintiff alleges that the drivers have a "common motive to conspire" because adhering to Uber's pricing algorithm can yield supra-competitive prices, Am. Compl. ¶ 90, and that if the drivers were acting independently instead of in concert, "some significant portion" would not agree to follow the Uber pricing algorithm.

Plaintiff further claims that the drivers "have had many opportunities to meet and enforce their commitment to the unlawful agreement." Am. Compl. ¶ 92. Plaintiff alleges that Uber holds meetings with potential drivers when Mr. Kalanick and his subordinates decide to offer Uber App services in a new geographic location. Uber also organizes events for its drivers to get together, such as a picnic in September 2015 in Oregon with over 150 drivers and their families in attendance, and other "partner appreciation" events in places including New York City. See id. ¶ 41. Uber provides drivers with information regarding upcoming events likely to create high demand for transportation and informs the drivers what their increased earnings might have been if they had logged on to the Uber App during busy periods. Moreover, plaintiff alleges, in September 2014 drivers using the Uber App in New York City colluded with one another to negotiate the reinstitution of higher fares for riders using Uber-BLACK and UberSUV services (certain Uber car service "experiences"). Mr. Kalanick, as Uber's CEO, directed or ratified negotiations between Uber and these drivers, and Uber ultimately agreed to raise fares.

As to market definition, plaintiff alleges that Uber competes in the "relatively new mobile app-generated ride-share service market," of which Uber has an approximately 80% market share. Amended Complaint ¶¶ 94-95. Uber's chief competitor in this market, Lyft, has only a 20% market share, and a third competitor, Sidecar, left the market at the end of 2015. Although, plaintiff contends, neither taxis nor traditional cars for hire are reasonable substitutes for mobile app-generated ride-share service, Uber's own experts have suggested that in certain cities in the U.S., Uber captures 50% to 70% of business customers in the combined market of taxis, cars for hire, and mobile-app generated ride-share services. See id. ¶ 107.

Plaintiff claims to sue on behalf of the following class: "all persons in the United States who, on one or more occasions, have used the Uber App to obtain rides from uber driver-partners and paid fares for their rides set by the Uber pricing algorithm," with certain exclusions, such as Mr. Kalanick. See id. ¶ 13. Plaintiff also identifies a "subclass" of riders who have paid fares based on surge pricing. Plaintiff alleges that he and the putative class have suffered antitrust injury because, were it not for Mr. Kalanick's conspiracy to fix the fares charged by Uber drivers, drivers would have competed on price and Uber's fares would have been "substantially lower." See id. ¶ 109. Plaintiff also contends that Mr. Kalanick's design has reduced output and that, as

"independent studies have shown," the effect of surge pricing is to lower demand so that prices remain artificially high. Am. Compl. ¶ 110. Based on these allegations, plaintiff claims that Mr. Kalanick has violated the Sherman Act, 15 U.S.C. § 1, and the Donnelly Act, New York General Business Law § 340. ***

In the instant case, the Court finds that plaintiff has adequately pled both a horizontal and a vertical conspiracy. As to the horizontal conspiracy, plaintiff alleges that Uber drivers agree to participate in a conspiracy among themselves when they assent to the terms of Uber's written agreement (the "Driver Terms") and accept riders using the Uber App. See Am. Compl. ¶¶ 70-71. In doing so, plaintiff indicates, drivers agree to collect fares through the Uber App, which sets fares for all Uber drivers according to the Uber pricing algorithm. In plaintiff's view, Uber drivers forgo competition in which they would otherwise have engaged because they "are guaranteed that other Uber drivers will not undercut them on price." See id. ¶ 72; Memorandum of Law in Opposition to Defendant Travis Kalanick's Motion to Dismiss ("Pl. Opp.Br."), Dkt. 33, at 11. Without the assurance that all drivers will charge the price set by Uber, plaintiff contends, adopting Uber's pricing algorithm would often not be in an individual driver's best interest, since not competing with other Uber drivers on price may result in lost business opportunities. See Am. Compl. ¶ 72. The capacity to generate "supra-competitive prices" through agreement to the Uber pricing algorithm thus provides, according to plaintiff, a "common motive to conspire" on the part of Uber drivers. See Amended Complaint ¶ 90. Plaintiff also draws on its allegations about meetings among Uber drivers and the "September 2014 conspiracy," in which Uber agreed to reinstitute higher fares after negotiations with drivers, to bolster its claim of a horizontal conspiracy. In plaintiff's view, defendant Kalanick is liable as the organizer of the price-fixing conspiracy and as an Uber driver himself.

Defendant Kalanick argues, however, that the drivers' agreement to Uber's Driver Terms evinces no horizontal agreement among drivers themselves, as distinct from vertical agreements between each driver and Uber. See Memorandum of Law in Support of Defendant Travis Kalanick's Motion to Dismiss ("Def.Br."), Dkt. 28, at 9, 12-13; Transcript of Oral Argument dated March 9, 2016 ("Tr.") 3:19-22. According to Mr. Kalanick, drivers' individual decisions to enter into contractual arrangements with Uber constitute mere independent action that is insufficient to support plaintiff's claim of a conspiracy. See Def. Br. at 9. Defendant asserts that the most "natural" explanation for drivers' conduct is that each driver "independently decided it was in his or her best interest to enter a vertical agreement with Uber," and doing so could be in a driver's best interest because, for example, Uber matches riders with drivers and processes payment. See Def. Br. at 12-13. In defendant's view, the fact that "a condition of [the agreement with Uber] was that the driver-partner agree to use Uber's pricing algorithm" does not diminish the independence of drivers' decisions. See id. at 13. It follows, defendant contends, that such vertical arrangements do not support a horizontal conspiracy claim.

The Court, however, is not persuaded to dismiss plaintiff's horizontal conspiracy claim. In *Interstate Circuit v. United States*, 306 U.S. 208 (1939), the Supreme Court held that competing movie distributors had unlawfully restrained trade when they each agreed to a theater operator's terms, including price restrictions, as indicated in a letter addressed to all the distributors. For an illegal conspiracy to exist, the Supreme Court stated:

> It was enough that, knowing that concerted action was contemplated and invited, the distributors gave their adherence to the scheme and participated in it. ... Acceptance by competitors, without previous agreement, of an invitation to participate in a plan, the

> necessary consequence of which, if carried out, is restraint of interstate commerce, is sufficient to establish an unlawful conspiracy under the Sherman Act.

Interstate Circuit, 306 U.S. at 226-27. Much more recently, the Second Circuit stated:

> [C]ourts have long recognized the existence of "hub-and-spoke" conspiracies in which an entity at one level of the market structure, the "hub," coordinates an agreement among competitors at a different level, the "spokes." These arrangements consist of both vertical agreements between the hub and each spoke and a horizontal agreement among the spokes to adhere to the [hub's] terms, often because the spokes would not have gone along with [the vertical agreements] except on the understanding that the other [spokes] were agreeing to the same thing.

United States v. Apple, Inc., 791 F.3d 290, 314 (2d Cir. 2015), (internal citation and quotation marks omitted);.

In this case, plaintiff has alleged that drivers agree with Uber to charge certain fares with the clear understanding that all other Uber drivers are agreeing to charge the same fares. See Amended Complaint ¶¶ 70-71. These agreements are organized and facilitated by defendant Kalanick, who as at least an occasional Uber driver, is also a member of the horizontal conspiracy. See id. ¶ 76, 84.

On a motion to dismiss, the Court is required to draw all reasonable inferences in plaintiff's favor. Given this standard, the Court finds that plaintiffs have plausibly alleged a conspiracy in which drivers sign up for Uber precisely "on the understanding that the other [drivers] were agreeing to the same" pricing algorithm, and in which drivers' agreements with Uber would "be against their own interests were they acting independently." *Apple*, 791 F.3d at 314, 320. Further, drivers' ability to benefit from reduced price competition with other drivers by agreeing to Uber's Driver Terms plausibly constitutes "a common motive to conspire." *Apex Oil Co. v. DiMauro*, 822 F.2d 246, 254 (2d Cir. 1987). The fact that drivers may also, in signing up for Uber, seek to benefit from other services that Uber provides, such as connecting riders to drivers and processing payment, is not to the contrary. Of course, whether plaintiff's allegations are in fact accurate is a different matter, to be left to the fact-finding process.

The Court's conclusion that plaintiff has alleged a plausible horizontal conspiracy is bolstered by plaintiff's other allegations concerning agreement among drivers. Plaintiff, as noted supra, contends that Uber organizes events for drivers to get together, and, more importantly, that Mr. Kalanick agreed to raise fares following drivers' efforts to negotiate higher rates in September 2014. While it is true that these allegations about agreements among drivers reaching even beyond acceptance of Uber's Driver Terms are not extensive, nonetheless, they provide additional support for a horizontal conspiracy, and plaintiff need not present a direct, "smoking gun" evidence of a conspiracy, particularly at the pleading stage. *Mayor & City Council of Baltimore, Md. v. Citigroup, Inc.*, 709 F.3d 129, 136 (2d Cir. 2013).

More basically, it is well to remember that a Sherman Act conspiracy is but one form of conspiracy, a concept that is as ancient as it is broad. It is fundamental to the law of conspiracy that the agreements that form the essence of the misconduct are not to be judged by technical niceties but by practical realities. Sophisticated conspirators often reach their agreements as much by the wink and the nod as by explicit agreement, and the implicit agreement may be far more potent, and sinister, just by virtue of being implicit. *** In the instant case, Uber's digitally decentralized nature does not prevent the App from constituting a "marketplace" through which Mr. Kalanick organized a horizontal conspiracy among drivers.

Defendant argues, however, that plaintiff's alleged conspiracy is "wildly implausible" and "physically impossible," since it involves agreement "among hundreds of thousands of independent transportation providers all across the United States." Def. Br. at 1. Yet as plaintiff's counsel pointed out at oral argument, the capacity to orchestrate such an agreement is the "genius" of Mr. Kalanick and his company, which, through the magic of smartphone technology, can invite hundreds of thousands of drivers in far-flung locations to agree to Uber's terms. The advancement of technological means for the orchestration of large-scale price-fixing conspiracies need not leave antitrust law behind. The fact that Uber goes to such lengths to portray itself—one might even say disguise itself—as the mere purveyor of an "app" cannot shield it from the consequences of its operating as much more.

Recent jurisprudence on vertical resale price maintenance agreements does not, as defendant would have it, undermine plaintiff's claim of an illegal horizontal agreement. In *Leegin*, the Supreme Court held that resale price maintenance agreements—e.g., a retailer's agreement with a manufacturer not to discount the manufacturer's goods beneath a certain price—are to be judged by the rule of reason, unlike horizontal agreements to fix prices, which are per se illegal. See *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 886 (2007). The Court cited various "procompetitive justifications for a manufacturer's use of resale price maintenance," id. at 889, and concluded that although this practice may also have anticompetitive effects, the rule of reason is the best approach to distinguishing resale price maintenance agreements that violate the antitrust laws from those that do not.

Here, unlike in *Leegin*, Uber is not selling anything to drivers that is then resold to riders. Moreover, the justifications for rule of reason treatment of resale price maintenance agreements offered in *Leegin* are not directly applicable to the instant case. In particular, the Court's attention has not been drawn to concerns about free-riding Uber drivers, or to efforts that Uber drivers could make to promote the App that will be under-provided if Uber does not set a pricing algorithm. While Mr. Kalanick asserts that Uber's pricing algorithm facilitates its market entry as a new brand, this observation—which is fairly conclusory—does not rule out a horizontal conspiracy among Uber drivers, facilitated by Mr. Kalanick both as Uber's CEO and as a driver himself. The Court therefore finds that plaintiff has adequately pleaded a horizontal antitrust conspiracy under Section 1 of the Sherman Act.

As to plaintiff's claim of a vertical conspiracy, a threshold question is whether plaintiff has alleged a vertical conspiracy in the Amended Complaint, which defendant denies. Although plaintiff's allegations of a vertical conspiracy are much more sparse than his contentions about a horizontal conspiracy, the Court finds that the Amended Complaint adequately pleads a vertical conspiracy between each driver and Mr. Kalanick. In particular, plaintiff alleges that "[a]ll of the independent driver-partners have agreed to charge the fares set by Uber's pricing algorithm," Am. Compl. ¶ 68, and that Mr. Kalanick designed this business model, see id. ¶¶ 76, 78. The Amended Complaint also includes several allegations that would be pertinent to a rule of reason, vertical price-fixing theory. Under the Sherman Act count, plaintiff states that the "unlawful arrangement consists of a series of agreements between Kalanick and each of the Uber driver-partners, as well as a conscious commitment among the Uber driver-partners to the common scheme of adopting the Uber pricing algorithm ..." Am. Compl. ¶ 124. Plaintiff claims that Mr. Kalanick is per se liable as organizer of the conspiracy and as an occasional Uber driver, and then states that "[i]n the alternative, Kalanick is also liable under Section 1 of the Sherman

Act under a 'quick look' or 'rule of reason' analysis." Id. ¶ 130. In the Court's view, these allegations of legal theory, when coupled with the allegations of pertinent facts, are sufficient to plead a vertical conspiracy theory.

The question, then, is whether this theory is plausible under a "rule of reason" analysis. Under this analysis, "plaintiff bears the initial burden of showing that the challenged action has had an actual adverse effect on competition as a whole in the relevant market." *Capital Imaging Associates, P.C. v. Mohawk Valley Med. Associates, Inc.*, 996 F.2d 537, 543 (2d Cir. 1993). "To survive a Rule 12(b)(6) motion to dismiss, an alleged product market must bear a rational relation to the methodology courts prescribe to define a market for antitrust purposes—analysis of the interchangeability of use or the cross-elasticity of demand, and it must be plausible." *Todd v. Exxon Corp.*, 275 F.3d 191, 200 (2d Cir. 2001) (internal citation and quotation marks omitted).

As to market definition, plaintiff defines the relevant market as the "mobile app-generated ride-share service market." Am. Compl. ¶ 94. Plaintiff alleges that Uber has an approximately 80% market share in the United States in this market; Uber's chief competitor Lyft has nearly a 20% market share; and a third competitor, Sidecar, left the market at the end of 2015. Id. ¶¶ 95-97. Plaintiff then explains that traditional taxi service is not a reasonable substitute for Uber, since, for example, rides generated by a mobile app can be arranged at the push of a button and tracked on riders' mobile phones; riders need not carry cash or a credit card, or, upon arrival, spend time paying for the ride; and riders can rate drivers and see some information on them before entering the vehicle. Indeed, plaintiff claims, Uber has itself stated that it does not view taxis as ride-sharing competition.

Plaintiff also alleges that traditional cars for hire are not reasonable substitutes, since they generally need to be scheduled in advance for prearranged locations. However, plaintiff nevertheless contends that "Uber has obtained a significant share of business in the combined markets of taxis, cars for hire, and mobile-app generated ride-share services," and that Uber's own experts have suggested that in some U.S. cities, Uber has 50% to 70% of business customers "among all types of rides," which seems to refer to these combined markets. Id. ¶ 107.

Defendant contests plaintiff's proposed market definition, arguing that plaintiff provides inadequate justification for the exclusion not just of taxis and car services, but also of public transit such as subways and buses, personal vehicle use, and walking. See Def. Br. at 18; Def. Reply Br. at 8. In defendant's view, "[e]ach of these alternatives is a clear substitute for the services provided by driver-partners." Def. Br. at 18.

One could argue this either way (and defendant's attorneys are encouraged to hereinafter walk from their offices to the courthouse to put their theory to the test). But for present purposes, plaintiff has provided plausible explanations for its proposed market definition, and the accuracy of these explanations may be tested through discovery and, if necessary, trial. "Market definition is a deeply fact-intensive inquiry [and] courts [therefore] hesitate to grant motions to dismiss for failure to plead a relevant product market." *Chapman v. New York State Div. for Youth*, 546 F.3d 230, 238 (2d Cir. 2008). Plaintiff's allegation that Uber—an industry member—recognizes that it does not compete with taxis, see Am. Compl. ¶ 105, also deserves consideration. The Court finds that plaintiff has pleaded a plausible relevant product market.

The Court further finds that plaintiff has adequately pleaded adverse effects in the relevant market. Specifically, plaintiff pleads that "Kalanick's actions have further restrained competition by decreasing output," Am. Compl. ¶ 110 (citing "independent studies"); "Uber's market posi-

tion has already helped force Sidecar out of the marketplace," id. ¶ 102; "Uber's dominant position and considerable name recognition has also made it difficult for potential competitors to enter the marketplace," id. ¶ 103.

Defendant counters that Uber provides many pro-competitive benefits, see Def. Reply Br. at 9, and also disputes the conclusions that plaintiff purports to draw from the cited studies. See Def. Letter. Defendant's counter-assertions, while certainly well worth a fact-finder's consideration, do not persuade the Court to grant a motion to dismiss. The Court hence determines that plaintiff has plausibly pleaded adverse effects in the relevant market. Consequently, the Court finds that plaintiff has presented a plausible claim of a vertical conspiracy under Section 1 of the Sherman Act. *** For these reasons, the Court denies defendant Kalanick's motion to dismiss. ***

Philadelphia Taxi Ass'n, Inc. v. Uber Technologies, Inc.

886 F.3d 332 (3rd Cir. 2018)

RENDELL, CIRCUIT JUDGE: Philadelphia taxicab drivers, aggrieved by the influx of taxis hailed at the touch of an app on one's phone, brought this antitrust action to protest the entry of Appellee Uber Technologies, Inc. ("Uber") into the Philadelphia taxicab market. The Philadelphia Taxi Association ("PTA"), along with 80 individual taxicab companies (collectively, "Appellants"), appeal the District Court's dismissal of their Second Amended Complaint ("SAC") alleging one count of attempted monopolization under Section 2 of the Sherman Act, 15 U.S.C. § 2, and seeking injunctive relief and treble damages under Section 4 of the Clayton Act, 15 U.S.C. § 15.

Appellants urge us to reverse the District Court's Order, contending that Uber violated the antitrust laws because its entry into the Philadelphia taxicab market was illegal, predatory, and led to a sharp drop in the value of taxicab medallions as well as a loss of profits. They contend that this is evidence that Uber's operation in Philadelphia was anticompetitive and caused them to suffer an antitrust injury. However, the conduct they allege falls short of the conduct that would constitute an attempted monopoly in contravention of the antitrust laws. Thus, we will affirm the District Court's dismissal of the SAC for failure to state a claim for attempted monopolization and failure to state an antitrust injury.

I. Background & Procedural History

From March of 2005 to October of 2014, taxicabs operating in Philadelphia were required to have a medallion and a certificate of public convenience, issued by the Philadelphia Parking Authority ("PPA"). Medallions are property and are often pledged as collateral to borrow funds to finance the purchase of the cab or to "upgrade and improve the operations of taxicabs." 53 Pa. C.S.A. § 5712(a). Once medallion-holders comply with the obligatory standards for taxicabs, they may obtain a certificate of public convenience. Those standards, which provide for safety and uniformity among taxicabs, require vehicles to be insured and in proper condition, and mandate that drivers are paid the prevailing minimum wage, are proficient in English, and have the appropriate drivers' licenses.

As alleged in the SAC, when the medallion system was mandated in Philadelphia in 2005, a medallion was worth only $65,000. In October of 2014, there were approximately 500 taxicab companies in Philadelphia. Together, 7,000 drivers held 1610 medallions, each valued at an average of $545,000. Appellants are 80 of those 500 companies, which collectively hold 240 of

the 1610 medallions, as well as PTA, which was incorporated to advance the legal interests of its members—the 80 individual medallion taxicab companies.

Uber began operating in Philadelphia in October of 2014 without securing medallions or certificates of public convenience for its vehicles. While a potential rider can avail himself of a medallion taxicab by calling a dispatcher or hailing an available cab, to use Uber, he can download the Uber application onto his mobile phone and request that the vehicle come to his location, wherever he is. Passengers enter payment information, which is retained by Uber and automatically processed at the end of each ride. Uber does not own or assume legal responsibility for the vehicles or their operation, nor does it hire the drivers as its employees. Uber did not pay fines to the PPA or comply with its regulations when it first entered the Philadelphia taxi market, as is otherwise required for medallion taxicabs. Appellants maintain that this rendered Uber's operation illegal, and enabled the company to cut operating costs considerably.

In October of 2016, the Pennsylvania state legislature passed a law approving Uber's operation in Philadelphia, under the authority of the PPA. The law, which went into effect in November of 2016, allows the PPA to regulate both medallion taxicab companies and Transportation Network Companies ("TNCs")—a classification that includes Uber and other vehicle-for-hire companies that operate through digital apps—in Philadelphia. TNCs must now obtain licenses to operate and comply with certain requirements, including insurance obligations and safety standards for drivers and vehicles. The law also exempts TNCs from disclosing the number of drivers or vehicles operating in the city, and allows TNCs to set their own fares, unlike medallion taxicab companies, which comply with established rates, minimum wages, and have a limited number of vehicles and medallions operating at once in Philadelphia.

Before this law passed, in Uber's first two years in Philadelphia, nearly 1200 medallion taxicab drivers left their respective companies and began to drive for Uber. In those two years, there were 1700 Uber drivers and vehicles operating in Philadelphia, serving over 700,000 riders, for more than one million trips. Simultaneously, medallion taxi rides reduced by about 30 percent, and thus Appellants experienced a 30 percent decrease in earnings. The value of each medallion dropped significantly, to approximately $80,000 in November of 2016. Fifteen percent of medallions have been confiscated by the lenders due to default by drivers.

The PTA and 75 individual taxicab companies filed a Complaint, alleging three counts: attempted monopolization under Section 2 of the Sherman Act, tortious interference with contract under Pennsylvania law, and unfair competition under Pennsylvania law. Uber moved to dismiss the Complaint.

Appellants, the PTA and now 80 individual taxicab companies, then filed an Amended Complaint, alleging the same three counts. Uber moved to dismiss the Amended Complaint. The District Court granted the dismissal, without prejudice. The District Court noted that Plaintiffs alleged merely harm to their business after Uber entered the Philadelphia taxicab market, and that Plaintiffs pointed to Uber's supposed illegal participation in the taxicab market as evidence of attempted monopolization. However, the District Court concluded that these harms are "not the type of injuries that antitrust laws were intended to prevent, and thus do not establish antitrust standing." *Phila. Taxi Ass'n, Inc. v. Uber Techs., Inc.*, 218 F.Supp.3d 389, 392 (E.D. Pa. 2016). The Court also dismissed the state law claims, for failure to plead the proper elements of an unfair competition or a tortious interference claim.

Appellants then filed the SAC, alleging one count of attempted monopolization under Section 2 of the Sherman Act and seeking treble damages under Section 4 of the Clayton Act. Uber responded with a Motion to Dismiss, which the District Court granted, with prejudice. The

District Court held that Appellants, in spite of multiple opportunities for amendment, had pled no antitrust injury sufficient for antitrust standing, and were unlikely to cure the lack of standing with any amendments to the SAC. The Court also held that the PTA could not satisfy the requirements for associational standing because the association's members lacked standing to sue on their own. ***

III. Discussion

*** If the challenged conduct has an effect on "prices, quantity or quality of goods or services," *Mathews v. Lancaster Gen. Hosp.*, 87 F.3d 624, 641 (3d Cir. 1996), we will find a violation of antitrust laws only when that effect harms the market, and thereby harms the consumer.

Anticompetitive conduct is the hallmark of an antitrust claim. An allegation of anticompetitive conduct is necessary both to: (1) state a claim for attempted monopolization; and (2) aver that a private plaintiff has suffered an antitrust injury. Appellants' SAC, however, is deficient in averring conduct that is, in fact, anticompetitive.

While our caselaw is unresolved regarding which to address first—an antitrust violation or an antitrust injury—we need not resolve that here, because Appellants' claim fails on both counts. We begin by discussing how Appellants' allegations in the SAC fall short of demonstrating anticompetitive conduct, and thus fail to state a claim for attempted monopolization, and then discuss how in the alternative, Appellants fail to allege antitrust injury to have antitrust standing. For both reasons, we affirm the judgment of the District Court dismissing the SAC with prejudice.

A. Attempted Monopolization

To prevail on a claim under Sherman Act Section 2 for attempted monopolization, a plaintiff must prove: "(1) that the defendant has engaged in predatory or anticompetitive conduct with (2) a specific intent to monopolize and (3) a dangerous probability of achieving monopoly power." *Mylan Pharm. Inc. v. Warner Chilcott Pub. Ltd. Co.*, 838 F.3d 421, 433 (3d Cir. 2016) (quoting *Broadcom Corp. v. Qualcomm Inc.*, 501 F.3d 297, 317 (3d Cir. 2007). *** Liability hinges on whether valid business reasons, as part of the ordinary competitive process, can explain the defendant's actions that resulted in a dangerous probability of achieving monopoly power. See *Avaya Inc., RP v. Telecom Labs, Inc.*, 838 F.3d 354, 393 (3d Cir. 2016).

In the SAC, Appellants allege that Uber: (1) flooded the market with non-medallion taxicabs, entered the market illegally without purchasing medallions, operated at a lower cost by failing to comply with statutory requirements and regulations, and lured away drivers from Individual Plaintiffs, which allegedly impaired the competitive market for medallion taxicabs; (2) knew of PPA's regulatory jurisdiction over vehicles for hire, purposefully ignored or avoided the regulations and rulings of the Court of Common Pleas, and thereby excluded rivals from competing in the taxicab market; and (3) is dangerously close to achieving monopoly power with its market share and by operating in an unfair playing field with the "financial ability" to be the only market player and to destroy competitors' business. SAC ¶ 83. Appellants also complain that the new legislation authorizing the TNCs' operation would facilitate the creation of an illegal monopoly.

We find that the SAC fails to plausibly allege any of the three elements of an attempted monopolization claim.

1. Anticompetitive Conduct

Allegations of purportedly anticompetitive conduct are meritless if those acts would cause no deleterious effect on competition. This is where the SAC falters: Appellants set forth a litany of ways in which Uber's entry into the market has harmed Appellants' business and their investment in medallions; yet none of the allegations demonstrate a harmful effect on competition.

To determine whether conduct is anticompetitive, "courts must look to the monopolist's conduct taken as a whole rather than considering each aspect in isolation." *LePage's Inc. v. 3M*, 324 F.3d 141, 162 (3d Cir. 2003) (en banc).

Here, Appellants claim that Uber inundated the Philadelphia taxicab market illegally with their non-medallion vehicles. They contend that Uber's entry into the market was predatory because it failed to comply with statutory and regulatory requirements, failed to purchase medallions, failed to pay drivers a minimum wage, and failed to obtain the proper insurance, among other actions. All of these actions, Appellants assert, enabled Uber to operate at a significantly lower cost than the medallion companies, and thereby acquire a stronghold in the Philadelphia taxicab market.

Appellants also maintain that Uber "flooded" the Philadelphia taxicab market by improperly luring drivers away from medallion companies, including Individual Plaintiffs. Appellants cite Uber's practice of sending representatives to 30th Street Station and the Philadelphia International Airport, where medallion taxicab drivers often congregate, to disseminate information about its services and to recruit potential drivers. They argue that Uber promised new drivers financial inducements, such as reimbursements for the cost of gasoline, as an incentive to leave their medallion companies and instead drive for Uber.

Considering the averments regarding Uber's conduct in their totality, Uber's elimination of medallion taxicab competition did not constitute anticompetitive conduct violative of the antitrust laws.

First, inundating the Philadelphia taxicab market with Uber vehicles, even if it served to eliminate competitors, was not anticompetitive. Rather, this bolstered competition by offering customers lower prices, more available taxicabs, and a high-tech alternative to the customary method of hailing taxicabs and paying for rides. It is well established that lower prices, as long as they are not predatory, benefit consumers—"regardless of how those prices are set." *Atl. Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990). "Cutting prices in order to increase business often is the very essence of competition." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 592 (1986). Thus, lost business alone cannot be deemed a consequence of "anticompetitive" acts by the defendant. See *Atl. Richfield*, 495 U.S. at 337.

Second, Uber's ability to operate at a lower cost is not anticompetitive. Running a business with greater economic efficiency is to be encouraged, because that often translates to enhanced competition among market players, better products, and lower prices for consumers. Even if Uber were able to cut costs by allegedly violating PPA regulations, Appellants cannot use the antitrust laws to hold Uber liable for these violations absent proof of anticompetitive conduct. Even unlawful conduct is "of no concern to the antitrust laws" unless it produces an anticompetitive effect. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 487 (1977).

Finally, hiring rivals may be anticompetitive, but only in certain cases. For example, if rival employees were hired in an attempt to exclude competitors from the market for some basis

other than efficiency or merit, such as to acquire monopoly power or to merely deny the employees to the rival, this could violate the antitrust laws if injurious to the rival and to competition at large.

However, Appellants acknowledge that the nearly 1200 medallion taxicab drivers that Uber recruited did not remain idle, but rather they drove for Uber. In sum, what Appellants allege does not give rise to an inference of anticompetitive or exclusionary conduct and suggests, if anything, that Uber's ability to attract these drivers was due to its cost efficiency and competitive advantage.

Thus, the SAC is devoid of allegations of truly anticompetitive conduct.

2. Specific Intent to Monopolize

Appellants allege specific intent to monopolize from Uber's knowledge that the PPA maintained regulatory authority over vehicles-for-hire, and its choice to avoid regulation by being a TNC that neither owned vehicles nor employed drivers. They also point to Uber's alleged willful disregard of the rulings of the Court of Common Pleas. Appellants' claim, in essence, is that Uber's knowledge that their operation was illegal reveals a specific intent to monopolize.

"[I]n a traditional § 2 claim, a plaintiff would have to point to specific, egregious conduct that evinced a predatory motivation and a specific intent to monopolize." *Avaya*, 838 F.3d at 406 (citing *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 456 (1993)). ***

While Uber's alleged conduct might have formed the basis of a regulatory violation, its knowledge of existing regulations alone cannot reasonably be said to demonstrate specific intent to monopolize. Further, Uber's choice to distinguish itself from other vehicles-for-hire, eschewing medallions in favor of independent drivers who operate their own cars at will, can instead be reasonably viewed as "predominantly motivated by legitimate business aims." *Times Picayune Publ'g Co. v. United States*, 345 U.S. 594, 627 (1953). Appellants have not averred any other motive. The allegations suggest that these business choices allowed Uber to operate more efficiently, and to offer a service that consumers find attractive, thus enabling it to acquire a share of the Philadelphia taxicab market.

Thus, Uber's alleged competitive strategy of creating a vehicle-for-hire business model, presumably to acquire customers, does not reflect specific intent to monopolize. Accordingly, Appellants have failed to allege specific intent on Uber's part.

3. Dangerous Probability of Achieving Monopoly Power

We held in *Broadcom Corp. v. Qualcomm Inc.* that because the dangerous probability standard is a complex and "fact-intensive" inquiry, courts "typically should not resolve this question at the pleading stage 'unless it is clear on the face of the complaint that the "dangerous probability" standard cannot be met as a matter of law.'" 501 F.3d at 318-19 (quoting *Brader v. Allegheny Gen. Hosp.*, 64 F.3d 869, 877 (3d Cir. 1995)).

We may consider factors such as "significant market share coupled with anticompetitive practices, barriers to entry, the strength of competition, the probable development of the industry, and the elasticity of consumer demand" to determine whether dangerous probability was alleged in the pleadings. Id. Entry barriers include "regulatory requirements, high capital costs, or technological obstacles[] that prevent new competition from entering a market." Id. at 307 (citations omitted). "No single factor is dispositive." Id. at 318.

Appellants argue that Uber has a dangerous probability of achieving monopoly power because it has pushed numerous competitors out of the market. As discussed, however, the SAC fails

to allege anticompetitive practices by Uber. Nor does the SAC mention Uber's market share; it merely suggests that Uber and medallion taxicabs had similar numbers of vehicles operating in Philadelphia as of October 2016. This allegation falls short of indicating Uber's market share in the context of all the competitors in the Philadelphia taxicab market, such as other TNCs.

Similarly, the SAC makes no allegation of current barriers to entry or weak competition from other market participants. Appellants make the bold allegation that Uber holds the power to raise barriers to entry in the market, without any factual support. In fact, the SAC alleges that Uber was readily able to enter the Philadelphia market. *** Surely other competitors, such as Lyft, are able to enter without difficulty, as well.

Nor does the SAC describe any potentially harmful industry developments. It only vaguely claims that Uber may be able to drive out competition and raise entry barriers. Appellants assert in the SAC that once Uber becomes the dominant competitor, it would be able to charge higher prices, and consumers who do not own smartphones would be deprived of the ability to hail taxis on the street. Absent any allegations of a dangerous probability of achieving monopoly power, this argument fails. And, as counsel for Uber stated at oral argument, if Uber raised its prices, this would encourage other rivals to enter the market and charge lower prices, battling Uber through price competition.

Because the elements of attempted monopolization are often interdependent, proof of one element may provide "permissible inferences" of other elements. *Broadcom*, 501 F.3d at 318 (quoting *Barr Labs., Inc. v. Abbott Labs.*, 978 F.2d 98, 112 (3d Cir. 1992)). Even so, none of the other elements of attempted monopolization allow us to infer a dangerous probability that Uber will achieve monopoly power. Acknowledging *Broadcom's* reticence to resolve the dangerous probability question at the pleadings stage, we nevertheless find that the SAC does not allege any of the relevant factors to prove that Uber had a dangerous probability of achieving monopoly power.

In sum, Appellants have failed to set forth a plausible claim of attempted monopolization under Section 2 of the Sherman Act, as a matter of law.

III. Antitrust Standing

Alternatively, Appellants' antitrust claim fails for lack of antitrust standing, which is a threshold requirement in any antitrust case. *** Of the requirements for antitrust standing, antitrust injury is "a necessary but insufficient condition," and is the only requirement in dispute here. *Barton & Pittinos, Inc. v. SmithKline Beecham Corp.*, 118 F.3d 178, 182 (3d Cir. 1997).

In *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.,* the Supreme Court rejected the notion that antitrust injury could be alleged by a private plaintiff averring that it would have fared better without the defendant's alleged conduct. 429 U.S. 477. Rather, the plaintiff must prove the existence of an antitrust injury, which is an "injury of the type the antitrust laws were intended to prevent and that flows from that which makes defendants' acts unlawful." *Id.* at 489. The injury must "reflect the anticompetitive effect either of the violation or of anticompetitive acts made possible by the violation." *W. Penn*, 627 F.3d at 101 (quoting *Brunswick*, 429 U.S. at 489).

Compensating plaintiffs injured by the effects of truly anticompetitive conduct serves the purpose of antitrust laws, namely, to foster competition. Thus, the antitrust injury requirement ensures that damages are only awarded for losses that "correspond[] to the rationale for finding a violation of the antitrust laws in the first place." *Atl. Richfield*, 495 U.S. at 342. That is, there must be a causal link between the alleged injury and an antitrust violation's anticompetitive effects.

Appellants decry Uber's entry into Philadelphia as a campaign to inflict economic harm and to cause Appellants to lose their market share. They argue that all vehicles-for-hire legally operating in Philadelphia, and the riding public, have been harmed by Uber's allegedly illegal presence in Philadelphia between October of 2014 and October of 2016, when TNCs were officially permitted to operate. Appellants allege that they experienced financial harm and a reduced market share through fewer drivers, medallion cabs sitting idle, a decline in ridership, and loss of medallion value. The effect of the decrease in earnings, Appellants argue, is that taxicab companies are nearing default on their medallions and are close to being driven out of business.

Appellants allege their own injury, namely, financial hardship. Tellingly, they fail to aver an antitrust injury, such as a negative impact on consumers or to competition in general, let alone any link between this impact and the harms Appellants have suffered. Perhaps this is because Appellants cannot do so. According to Appellants' own pleadings, Uber's entry into the Philadelphia market, regardless of its legality, *increased* the number of vehicles-for-hire available to consumers and product differentiation in the market, thereby *increasing* competition.

The facts of *Brunswick* illustrate this point. *** Similarly here, Appellants urge the application of antitrust laws for the express *opposite* purpose of antitrust laws: to compensate for their loss of profits due to increased competition from Uber. However, harm to Appellants' business does not equal harm to competition. "Conduct that merely harms competitors, ... while not harming the competitive process itself, is not anticompetitive." *Broadcom*, 501 F.3d at 308. Were we to award Appellants antitrust damages to compensate for their financial injuries, we would condemn vigorous competition, rather than encourage it.

Without demonstrating a harmful effect on price, such as predatory or monopoly pricing, Appellants instead argue that Uber's ability to operate at a lower cost caused Appellants economic harm and caused Appellants to lose their market share. But Appellants never argue that the lower cost—evidence of *increased* competition—failed to result in lower prices for consumers. "A plaintiff who wants ... less competition or higher prices, that would injure consumers, does not suffer antitrust injury." *U.S. Gypsum Co. v. Ind. Gas Co.*, 350 F.3d 623, 627 (7th Cir. 2003).

Nor do Appellants aver a negative effect on the availability of taxicab services. Appellants themselves admit that Uber's 1700 vehicles took over 700,000 riders on more than one million trips in its first two years in Philadelphia, while the number of medallion cabs allegedly decreased by at least 15 percent, or roughly 240 vehicles, from its peak of 1610. Thus, the SAC alleges an increase in the availability of vehicles-for-hire for Philadelphia passengers.

Appellants also insist that Uber's alleged illegal presence in Philadelphia caused an antitrust violation. They attempt to circumvent the antitrust injury requirement by focusing on how Uber's purportedly illegal operation enabled it to cut costs and increase its market share. But again, the Supreme Court has squarely rejected illegal conduct as a basis for antitrust injury. A competitor's illegal presence in a market is not a *per se* antitrust violation, and any resulting injury is alone insufficient for a private plaintiff to state an antitrust injury. *Atl. Richfield*, 495 U.S. at 334 (quoting *Brunswick*, 429 U.S. at 489).

Finally, Appellants do not cite any case in support of the contention that Uber's violation of state regulations, even if that gave Uber a competitive advantage, renders its operation in violation of antitrust laws. Even if we were to find Uber's operation in Philadelphia unlawful in its first two years, we would do so under PPA regulations, and not under antitrust laws. Ultimately, Uber's presence in the market, as alleged, created *more* competition for medallion taxicabs, not

less, and thus Uber's so—called "predation"—operating without medallions or certificates of public convenience—does not give rise to an antitrust injury.

In sum, we affirm the dismissal of the SAC for the additional reason that it fails to assert an antitrust injury. ***

V. Conclusion

Appellants may have been better off, financially, if Uber had not entered the Philadelphia taxicab market. However, Appellants have no right to exclude competitors from the taxicab market, even if those new entrants failed to obtain medallions or certificates of public convenience. See *Ill. Transp. Trade Ass'n v. City of Chicago*, 839 F.3d 594, 597 (7th Cir. 2016) (Posner, J.).

If medallion taxicabs could prevent TNCs from entering the Philadelphia market, and if incumbents could prevent new entrants or new technologies from competing because they fear loss of profits, then "economic progress might grind to a halt." Id. at 596-97. "Instead of taxis we might have horse and buggies; instead of the telephone, the telegraph; instead of computers, slide rules." Id. at 597.

Absent any allegations of anticompetitive conduct, Appellants fail to allege any of the elements for a claim for attempted monopolization under Section 2 of the Sherman Act and fail to allege antitrust standing.

For the foregoing reasons, the judgment of the District Court is AFFIRMED.

Chamber of Commerce of the United States of America v. City of Seattle

890 F.3d 769 (9th Cir. 2018)

M. SMITH, CIRCUIT JUDGE: On December 14, 2015, the Seattle City Council enacted into law Ordinance 124968, an Ordinance Relating to Taxicab, Transportation Network Company, and For-Hire Vehicle Drivers (Ordinance). The Ordinance was the first municipal ordinance of its kind in the United States, and authorizes a collective-bargaining process between "driver coordinators"—like Uber Technologies (Uber), Lyft, Inc. (Lyft), and Eastside for Hire, Inc. (Eastside)—and independent contractors who work as for-hire drivers. The Ordinance permits independent-contractor drivers, represented by an entity denominated an "exclusive driver representative," and driver coordinators to agree on the "nature and amount of payments to be made by, or withheld from, the driver coordinator to or by the drivers." Seattle, Wash., Municipal Code § 6.310.735(H)(1). This provision of the Ordinance is the crux of this case.

Acting on behalf of its members Uber, Lyft, and Eastside, Plaintiff-Appellant the Chamber of Commerce of the United States of America, together with Plaintiff-Appellant Rasier, LLC, a subsidiary of Uber (collectively, the Chamber), sued Defendants-Appellees the City of Seattle, the Seattle Department of Finance and Administrative Services (the Department), and the Department's Director, Fred Podesta (collectively, the City), challenging the Ordinance on federal antitrust and labor law grounds. First, the Chamber asserts that the Ordinance violates, and is preempted by, section 1 of the Sherman Antitrust Act, 15 U.S.C. § 1, because the Ordinance sanctions price-fixing of ride-referral service fees by private cartels of independent-contractor drivers. Second, the Chamber claims that the Ordinance is preempted by the National Labor Relations Act (NLRA), 29 U.S.C. §§ 151-169, under *Machinists* and *Garmon* preemption.

The district court dismissed the case, holding that the state-action immunity doctrine exempts the Ordinance from preemption by the Sherman Act, and that the NLRA does not preempt the Ordinance. The Chamber appealed both holdings.

We have jurisdiction over this appeal pursuant to 28 U.S.C. § 1291. We reverse the district court's dismissal of the Chamber's federal antitrust claims, and remand the federal antitrust claims to the district court for further proceedings. We also affirm the district court's dismissal of the Chamber's NLRA preemption claims.

FACTUAL AND PROCEDURAL BACKGROUND

A. Ride-Referral Companies

Eastside is the largest dispatcher of taxicab and for-hire vehicles in the Pacific Northwest. Eastside provides licensed taxicab and for-hire vehicle drivers with dispatch, advertising, payment processing, and other administrative services, in exchange for a weekly fee, payable by drivers to Eastside. Relying on advertising and a preexisting client base, Eastside generates transportation requests from passengers, who call, text-message, or email Eastside to request a ride. Eastside then refers ride requests to drivers through a mobile data terminal. If a passenger uses a credit card to pay a driver, Eastside processes the transaction and remits the payment to the driver. The drivers who pay for Eastside's services are independent contractors—Eastside does not dictate how the drivers operate their transportation businesses. For example, some drivers own licensed vehicles, whereas others lease them.

Uber and Lyft, founded in 2009 and 2012, respectively, have ushered ride-referral services into the digital age. Uber and Lyft have developed proprietary smartphone applications (apps) that enable an online platform, or digital marketplace, for ride-referral services, often referred to as "ridesharing" services. After downloading the Uber or Lyft app onto their smartphones, riders request rides through the app, which transmits ride requests to available drivers nearby. Drivers are free to accept or ignore a ride request. If a driver accepts a ride request, he or she is matched electronically with the rider, and then proceeds to the rider's location and fulfills the ride request. If a driver ignores a ride request, the digital platform transmits the request to another nearby driver. Drivers may cancel a ride request, even after initially accepting it, at any point prior to the commencement of the ride. Riders, too, may decide whether or not to accept a ride from any of the drivers contacted through the app. After a ride is completed, riders pay drivers via the Uber or Lyft app, using a payment method, such as a credit card, placed on file with Uber or Lyft.

Uber and Lyft's business models have facilitated the rise of the so-called "gig economy." In order to receive ride requests through the apps, drivers contract with, and pay a technology licensing fee to, Uber or Lyft. These licensing fees are a percentage of riders' paid fares: Uber and Lyft subtract their technology licensing fees from riders' payments, and remit the remainder to drivers. Drivers' contractual agreements with either Uber or Lyft are not exclusive—in fact, many drivers use several ridesharing apps and even operate multiple apps simultaneously. Drivers may use the Uber and Lyft apps for however long and whenever they wish, if they wish to use them at all.

B. The Ordinance

On December 14, 2015, the Seattle City Council adopted Ordinance 124968. The stated purpose of the Ordinance is to "allow[] taxicab, transportation network company, and for-hire

vehicle drivers ('for-hire drivers') to modify specific agreements collectively with the entities that hire, direct, arrange, or manage their work," in order to "better ensure that [for-hire drivers] can perform their services in a safe, reliable, stable, cost-effective, and economically viable manner." Seattle, Wash., Ordinance 124968, pmbl.

The Ordinance requires "driver coordinators" to bargain collectively with for-hire drivers. Id. § 1(I). A "driver coordinator" is defined as "an entity that hires, contracts with, or partners with for-hire drivers for the purpose of assisting them with, or facilitating them in, providing for-hire services to the public." Seattle, Wash., Municipal Code § 6.310.110. The Ordinance applies only to drivers who contract with a driver coordinator "other than in the context of an employer-employee relationship"—in other words, the Ordinance applies only to independent contractors. Id. § 6.310.735(D).

The collective-bargaining process begins with the election of a "qualified driver representative," or QDR. Id. §§ 6.310.110, 6.310.735(C). An entity seeking to represent for-hire drivers operating within Seattle first submits a request to the Director of Finance and Administrative Services (the Director) for approval to be a QDR. Id. § 6.310.735(C). Once approved by the City, the QDR must notify the driver coordinator of its intent to represent the driver coordinator's for-hire drivers. Id. § 6.310.735(C)(2).

Upon receiving proper notice from the QDR, the driver coordinator must provide the QDR with the names, addresses, email addresses, and phone numbers of all "qualifying drivers." Id. § 6.310.735(D). This disclosure requirement applies only to driver coordinators that have "hired, contracted with, partnered with, or maintained a contractual relationship or partnership with, 50 or more for-hire drivers in the 30 days prior to the commencement date" set by the Director. Id.

The QDR then contacts the qualifying drivers to solicit their interest in being represented by the QDR. Id. § 6.310.735(E). Within 120 days of receiving the qualifying drivers' contact information, the QDR submits to the Director statements of interest from qualifying drivers indicating that they wish to be represented by the QDR in collective-bargaining negotiations with the driver coordinator. Id. § 6.310.735(F)(1). If a majority of qualifying drivers consent to representation by the QDR, the Director certifies the QDR as the "exclusive driver representative" (EDR) for all for-hire drivers for that particular driver coordinator. Id. § 6.310.735(F)(2).

Once the Director certifies the EDR,

> the driver coordinator and the EDR shall meet and negotiate in good faith certain subjects to be specified in rules or regulations promulgated by the Director including, but not limited to, best practices regarding vehicle equipment standards; safe driving practices; the manner in which the driver coordinator will conduct criminal background checks of all prospective drivers; *the nature and amount of payments to be made by, or withheld from, the driver coordinator to or by the drivers*; minimum hours of work, conditions of work, and applicable rules.

Id. § 6.310.735(H)(1) (emphasis added).

If an agreement is reached, the driver coordinator and the EDR submit the written agreement to the Director. Id. § 6.310.735(H)(2). The Director reviews the agreement for compliance with the Ordinance and Chapter 6.310 of the Seattle Municipal Code, which governs taxicabs and for-hire vehicles. Id. In conducting this review, the Director is to "ensure that the substance of the agreement promotes the provision of safe, reliable, and economical for-hire transportation

services and otherwise advance[s] the public policy goals set forth in Chapter 6.310 and in the [Ordinance]." Id.

The Director's review is not limited to the parties' submissions or the terms of the proposed agreement. Id. Rather, the Director may gather and consider additional evidence, conduct public hearings, and request information from the EDR and the driver coordinator. Id.

The agreement becomes final and binding on all parties if the Director finds the agreement compliant. Id. § 6.310.735(H)(2)(a). The agreement does not take effect until the Director makes such an affirmative determination. Id. § 6.310.735(H)(2)(c). If the Director finds the agreement noncompliant, the Director remands it to the parties with a written explanation of the agreement's failures, and may offer recommendations for remedying the agreement's inadequacies. Id. § 6.310.735(H)(2)(b).

If the driver coordinator and the EDR do not reach an agreement, "either party must submit to interest arbitration upon the request of the other," in accordance with the procedures and criteria specified in the Ordinance. Id. § 6.310.735(I). The interest arbitrator must propose an agreement compliant with Chapter 6.310 and in line with the City's public policy goals. Id. § 6.310.735(I)(2). The term of an agreement proposed by the interest arbitrator may not exceed two years. Id.

The interest arbitrator submits the proposed agreement to the Director, who reviews the agreement for compliance with the Ordinance and Chapter 6.310, in the same manner the Director reviews an agreement proposed by the parties. Id. § 6.310.735(I)(3).

The parties may discuss additional terms and propose amendments to an approved agreement. Id. § 6.310.735(J). The parties must submit any proposed amendments to the Director for approval. Id. The Director has the authority to withdraw approval of an agreement during its term, if the Director finds that the agreement no longer complies with the Ordinance or furthers the City's public policy goals. Id. § 6.310.735(J)(1). ***

ANALYSIS

I. State-Action Immunity Does Not Protect the Ordinance from Preemption by Section 1 of the Sherman Act.

We turn first to the Chamber's federal antitrust claims, and hold that the Ordinance does not meet the requirements for state-action immunity.

A. Preemption

In determining whether the Sherman Act preempts a state or local law pursuant to the Supremacy Clause, we apply the principles of conflict preemption. "As in the typical pre-emption case, the inquiry is whether there exists an irreconcilable conflict between the federal and state [or local] regulatory schemes." *Rice v. Norman Williams Co.*, 458 U.S. 654, 659 (1982).

A state or local law, "when considered in the abstract, may be condemned under the antitrust laws," and thus preempted, "only if it mandates or authorizes conduct that necessarily constitutes a violation of the antitrust laws in all cases, or if it places irresistible pressure on a private party to violate the antitrust laws in order to comply with the statute." Id. at 661. "Such condemnation will follow under [section] 1 of the Sherman Act when the conduct contemplated by the statute is in all cases a per se violation." Id. However, "[i]f the activity addressed by the statute does not fall into that category, and therefore must be analyzed under the rule of reason, the statute cannot be condemned in the abstract." Id. Unlike the categorical analysis under the

per se rule of illegality, "[a]nalysis under the rule of reason requires an examination of the circumstances underlying a particular economic practice, and therefore does not lend itself to a conclusion that a statute is facially inconsistent with federal antitrust laws." Id. In short, the Ordinance may be preempted facially by federal antitrust law if it authorizes a per se violation of section 1 of the Sherman Act, but not if it must be analyzed under the rule of reason. ***

Here, the district court assumed, without deciding, "that collusion between independent economic actors to set the prices they will accept for their services in the market is a per se antitrust violation." On appeal, the City acknowledges that it "did not challenge the Chamber's contention that collective negotiations regarding topics such as payments to drivers could, absent *Parker* immunity, constitute per se antitrust violations." Because the district court dismissed the Chamber's federal antitrust claims solely on the basis of state-action immunity, we limit our analysis to that issue. We accept, without reaching the merits of the question, that the Ordinance authorizes a per se antitrust violation. The parties may address on remand which mode of antitrust analysis—the per se rule of illegality or the rule of reason—applies.

B. The Requirements for State-Action Immunity

The state-action immunity doctrine derives from *Parker v. Brown*, 317 U.S. 341 (1943). In *Parker*, the Supreme Court held that "because 'nothing in the language of the Sherman Act ... or in its history' suggested that Congress intended to restrict the sovereign capacity of the States to regulate their economies, the Act should not be read to bar States from imposing market restraints 'as an act of government.'" *FTC v. Phoebe Putney Health Sys., Inc.*, 568 U.S. 216, 224 (2013) (quoting *Parker*, 317 U.S. at 350, 352). Following *Parker*, the Supreme Court has, "under certain circumstances," extended immunity from federal antitrust laws to "nonstate actors carrying out the State's regulatory program." Id. at 224-25.

State-action immunity is the exception rather than the rule. *** The Supreme Court uses a two-part test, sometimes referred to as the *Midcal* test, to "determin[e] whether the anticompetitive acts of private parties are entitled to immunity." Id. First, "the challenged restraint [must] be one clearly articulated and affirmatively expressed as state policy," and second, "the policy [must] be actively supervised by the State." Id. (quoting *Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980)).

"Because municipalities and other political subdivisions are not themselves sovereign, state-action immunity under *Parker* does not apply to them directly." Id. As such, "immunity will only attach to the activities of local governmental entities if they are undertaken pursuant to a 'clearly articulated and affirmatively expressed' state policy to displace competition." Id. at 226, (quoting *Cmty. Commc'ns Co. v. Boulder*, 455 U.S. 40, 52 (1982)). Local governmental entities, "unlike private parties, . . . are not subject to the 'active state supervision requirement' because they have less of an incentive to pursue their own self-interest under the guise of implementing state policies." Id. (quoting *Town of Hallie v. City of Eau Claire*, 471 U.S. 34, 46-47 (1985)). "Where state or municipal regulation by a private party is involved, however, active state supervision must be shown, even where a clearly articulated state policy exists." *Hallie*, 471 U.S. at 46 n.10.

i. The Clear-Articulation Test

We conclude that the anticompetitive restraint challenged in this case fails the first prong of the *Midcal* test. The State of Washington has not "clearly articulated and affirmatively expressed" a state policy authorizing private parties to price-fix the fees for-hire drivers pay to companies like Uber or Lyft in exchange for ride-referral services.

The clear-articulation test is met "if the anticompetitive effect was the 'foreseeable result' of what the State authorized." *Phoebe Putney*, 568 U.S. at 226-27 (quoting *Hallie*, 471 U.S. at 42). "'[T]o pass the "clear articulation" test,' a state legislature need not 'expressly state in a statute or its legislative history that the legislature intends for the delegated action to have anticompetitive effects.'" Id. at 226 (alteration in original) (quoting *Hallie*, 471 U.S. at 43). ***

Our inquiry with respect to the clear-articulation test is a precise one. "[T]he relevant question is whether the regulatory structure which has been adopted by the state has *specifically authorized the conduct* alleged to violate the Sherman Act." *Cost Mgmt. Servs., Inc. v. Wash. Nat. Gas Co.*, 99 F.3d 937, 942 (9th Cir. 1996) (emphasis added). The state's authorization must be plain and clear: The relevant statutory provisions must "'plainly show' that the [state] legislature *contemplated* the sort of activity that is challenged," which occurs where they "confer 'express authority to take action that *foreseeably* will result in anticompetitive effects.'" *Hass v. Or. State Bar*, 883 F.2d 1453, 1457 (9th Cir. 1989) (first emphasis added) (quoting *Hallie*, 471 U.S. at 43-44). The state, in its sovereign capacity, must "clearly intend[] to displace competition in a particular field with a regulatory structure ... in the relevant market." *S. Motor Carriers Rate Conference, Inc. v. United States*, 471 U.S. 48, 64 (1985).

Once we determine that there is express state authorization, we then turn to the concept of foreseeability, which "is to be used in deciding the *reach* of antitrust immunity that stems from an *already authorized* monopoly, price regulation, or other disruption in economic competition." *Shames*, 626 F.3d at 1084 (second emphasis added). A foreseeable result cannot circumvent the requirement that there be express authorization in the first place: "[A] foreseeable result cannot create state authorization itself," but must itself stem from express authorization, which is "the necessary predicate for the Supreme Court's foreseeability test." Id. (quoting *Columbia Steel Casting Co. v. Portland Gen. Elec. Co.*, 111 F.3d 1427, 1444 (9th Cir. 1996)). We must be careful not to "appl[y] the concept of 'foreseeability' from [the] clear-articulation test too loosely." *Phoebe Putney*, 568 U.S. at 229.

Applying these principles to the Ordinance, we conclude that the clear-articulation requirement has not been satisfied. The state statutes relied upon by the City Council in enacting the Ordinance—Revised Code of Washington sections 46.72.001, 46.72.160, 81.72.200, and 81.72.210—do not "plainly show" that the Washington legislature "contemplated" allowing for-hire drivers to price-fix their compensation. Nor is such an anticompetitive result foreseeable.

We examine the state statutes in turn. First, Revised Code of Washington section 46.72.001 provides:

> The legislature finds and declares that privately operated for hire transportation service is a vital part of the transportation system within the state. Consequently, the safety, reliability, and stability of privately operated for hire transportation services are matters of statewide importance. The regulation of privately operated for hire transportation services is thus an essential governmental function. Therefore, it is the intent of the legislature to permit political subdivisions of the state to regulate for hire transportation services without liability under federal antitrust laws.

Id.

That the Washington state legislature "inten[ded] ... to permit political subdivisions of the state to regulate for hire transportation services without liability under federal antitrust laws," id., is insufficient to bring the Ordinance within the protective ambit of state-action immunity. We are mindful of the Supreme Court's instruction that "a State may not confer antitrust immunity on private persons by fiat," *Ticor Title*, 504 U.S. at 633, and that a "State may not validate

a municipality's anticompetitive conduct simply by declaring it to be lawful," *Hallie*, 471 U.S. at 39. Rather, it must first meet the *Midcal* requirements: A state "may displace competition with active state supervision [only] if the displacement is both intended by the State and implemented in its specific details." *Ticor Title*, 504 U.S. at 633. We may not "defer[] to private pricefixing arrangements under the general auspices of state law," but instead must ensure that the "precondition[s] for immunity from federal law," such as "[a]ctual state involvement," are met. Id. After all, "[i]mmunity is conferred out of respect for ongoing regulation by the State, not out of respect for the economics of price restraint." Id.

The plain language of the statute centers on the provision of "privately operated for hire transportation services," Wash. Rev. Code § 46.72.001, not the contractual payment arrangements between for-hire drivers and driver coordinators for use of the latter's smartphone apps or ride-referral services. Although driver coordinators like Uber and Lyft contract with providers of transportation services, they do not fulfill the requests for transportation services—the drivers do. Nothing in the statute evinces a clearly articulated state policy to displace competition in the market for ride-referral service fees charged by companies like Uber, Lyft, and Eastside. In other words, although the statute addresses the provision of transportation services, it is silent on the issue of compensation contracts between for-hire drivers and driver coordinators. To read into the plain text of the statute implicit state authorization and intent to displace competition with respect to for-hire drivers' compensation would be to apply the clear-articulation test "too loosely." *Phoebe Putney*, 568 U.S. at 229. ***

The regulation of rates in one area—i.e., the regulation of rates charged to passengers for transportation services—does not confer the shield of state-action immunity onto anticompetitive conduct in a related market—i.e., price-fixing the fees for-hire drivers pay to Uber and Lyft in order to use their digital platforms.

In cases in which the Supreme Court found the clear-articulation test to be satisfied, the initial state authorization clearly contemplated and plainly encompassed the challenged anticompetitive conduct. *** Tellingly, Uber and Lyft did not exist when the Washington statutes were enacted. The very concept of digital ridesharing services was probably well beyond the imaginations of lawmakers two to three decades ago, much less foreseeable. But the fact that technology has advanced leaps and bounds beyond the contemplation of the state legislature is not, on its own, the dispositive factor in our holding today. Digital platforms like Uber and Lyft have become "highly interconnected with modern economic and social life," *Fields v. Twitter, Inc.*, 881 F.3d 739, 749 (9th Cir. 2018), and present novel challenges and contexts for regulation. Nevertheless, it is not our role to make policy judgments properly left to the Washington state legislature. Instead, we must tread carefully in the area of state-action immunity, lest "a broad interpretation of the doctrine ... inadvertently extend immunity to anticompetitive activity which the states did not intend to sanction," or "a broad application of the doctrine ... impede states' freedom by threatening to hold them accountable for private activity they do not condone 'whenever they enter the realm of economic regulation.'" *Cost Mgmt. Servs.*, 99 F.3d at 941 (quoting *Ticor Title*, 504 U.S. at 635-36).

Applying governing law, we hold that the clear-articulation requirement for state-action immunity is not satisfied in this case.

ii. The Active-Supervision Requirement

We next hold that the Ordinance does not meet the active-supervision requirement for *Parker* immunity.

"The active supervision requirement demands ... 'that state officials have and exercise power to review particular anticompetitive acts of private parties and disapprove those that fail to accord with state policy.'" *N.C. State Bd. of Dental Examiners v. FTC*, ____ U.S. ____ (2015) (quoting *Patrick v. Burget*, 486 U.S. 94, 101 (1988)). Because "[e]ntities purporting to act under state authority might diverge from the State's considered definition of the public good" and "[t]he resulting asymmetry between a state policy and its implementation can invite private self-dealing," the active-supervision requirement "seeks to avoid this harm by requiring the State to review and approve interstitial policies made by the entity claiming immunity." Id.

As a threshold matter, we first clarify that the active-supervision requirement applies to this case. It is settled law that "active state supervision is not a prerequisite to exemption from the antitrust laws where the actor is a municipality rather than a private party." *Hallie*, 471 U.S. at 47. However, where, as here, "state or municipal regulation by a private party is involved, . . . active state supervision must be shown, even where a clearly articulated state policy exists." Id. at 46 n.10 (citing *S. Motor Carriers*, 471 U.S. at 62).

Southern Motor Carriers is illustrative. *** Likewise here, private parties—for-hire drivers and driver coordinators—are permitted to set rates collectively and submit them to the Director for approval. Accordingly, the active-supervision requirement applies.

The involvement of private parties in municipal regulation renders this case ineligible for the municipality exception outlined in *Hallie*: "*Hallie* explained that '[w]here the actor is a municipality, there is little or no danger that it is involved in a private price-fixing arrangement. The only real danger is that it will seek to further purely parochial public interests at the expense of more overriding state goals.'" *Dental Examiners*, 135 S.Ct. at 1112 (alteration in original) (quoting *Hallie*, 471 U.S. at 47). In contrast, this case presents a scenario in which the City authorizes collective price-fixing by private parties, which the Director evaluates and ratifies. The amount of discretion the Ordinance confers upon private actors is far from trivial.

Having decided that the active-supervision requirement applies to this case, we turn to examine whether it is met. Clearly, it is not. It is undisputed that the State of Washington plays no role in supervising or enforcing the terms of the City's Ordinance.

The City cites no controlling authority to support its argument that the Supreme Court uses the word "State" simply "as shorthand for the State and all its agents, including municipalities." The Supreme Court has stated repeatedly that active supervision must be "by the State itself." *Midcal*, 445 U.S. at 105.

We take it as a given that the Supreme Court means what it states. In *Hallie*, the Supreme Court stated that "[w]here state or municipal regulation by a private party is involved, however, active state supervision must be shown." 471 U.S. at 46 n.10. In the first clause, the Supreme Court used "state or municipal," thus drawing a disjunctive difference between the two words. In the second clause, it used only "state." It is highly improbable that the Supreme Court chose to distinguish between states and municipalities in the beginning of the sentence, only to conflate the two in the latter part of the sentence.

Moreover, the City's interpretation of the Supreme Court's use of "State" collapses the specific distinction the Supreme Court has drawn between cities, which are not sovereign entities, and states, which are. Sovereign capacity matters. Indeed, the very origins of *Parker* immunity stem from respect for the states' sovereign capacity to regulate their economies. *Phoebe Putney*, 568 U.S. at 224. A "substate governmental entity" is simply not equivalent to a state: "Because municipalities and other political subdivisions are not themselves sovereign, state-action immunity under *Parker* does not apply to them directly." *Phoebe Putney*, 568 U.S. at 225. Unlike a

state, a municipality may invoke the protective cloak of *Parker* immunity under "the narrow exception *Hallie* identified" not because it is sovereign, but because there is "little or no danger that it is involved in a private price-fixing arrangement"; the fact that "municipalities are electorally accountable and lack the kind of private incentives characteristic of active participants in the market"; and the "substantially reduc[ed] ... risk that [a municipality] would pursue private interests while regulating any single field." *Dental Examiners*, 135 S.Ct. at 1112-13 (quoting *Hallie*, 471 U.S. at 47). All of the reasons justifying the *Hallie* exception are eviscerated by the involvement of private parties in this case.

In concluding that the active-supervision requirement is not satisfied in this case, we do not disturb *Hallie's* well-settled rule that municipal actors need not meet the active-supervision requirement. See *Hallie*, 471 U.S. at 47. Rather, following *Hallie*, we hold that in this case, in which private actors exercise substantial discretion in setting the terms of municipal regulation, "active state supervision must be shown." Id. at 46 n.10. Because the distinction between states and municipalities is of crucial importance for purposes of state-action immunity, we reject the City's invitation to treat the two entities interchangeably.

II. The Ordinance Is Not Preempted by the National Labor Relations Act.

We next hold that the Ordinance is not preempted by the NLRA under either *Machinists* or *Garmon* preemption. ***

CONCLUSION

For the foregoing reasons, we reverse the district court's dismissal of the Chamber's federal antitrust claims, and remand the federal antitrust claims to the district court for further proceedings. We also affirm the district court's dismissal of the Chamber's NLRA preemption claims. ***

Minn-Chem, Inc. v. Agrium Inc.

683 F.3d 845 (7th Cir. 2012) (en banc)

WOOD, CIRCUIT JUDGE: Potash, a naturally occurring mineral used in agricultural fertilizers and other products, is produced and sold in a global market. In this case, the plaintiffs, U.S. companies that are direct and indirect purchasers of potash, accuse several global producers of price-fixing in violation of the U.S. antitrust laws. See 15 U.S.C. §§ 1 et seq. The district court denied the defendants' motion to dismiss the complaint, but it certified its ruling for interlocutory appeal under 28 U.S.C. § 1292(b). We agreed with that court's assessment of the importance of the issues presented and accepted the appeal. A panel of the court concluded that the complaint failed to meet the requirements of the Foreign Trade Antitrust Improvements Act of 1982 (FTAIA), 15 U.S.C. § 6a, and it thus voted to reverse. *Minn-Chem, Inc. v. Agrium Inc.*, 657 F.3d 650 (7th Cir. 2011). We then decided to rehear the case en banc. We hold first that the FTAIA's criteria relate to the merits of a claim, and not to the subject-matter jurisdiction of the court. We therefore overrule our earlier *en banc* decision in *United Phosphorus, Ltd. v. Angus Chem. Co.*, 322 F.3d 942 (7th Cir. 2003). We then address the applicable standards for antitrust cases involving import commerce and the restrictions imposed by the FTAIA. We conclude that the district court correctly ruled that the complaint does state a claim under the federal antitrust laws.

I

The district court's opinion details the critical facts alleged in the Complaint, see *In re Potash Antitrust Litig.*, 667 F. Supp. 2d 907, 915-19 (N.D. Ill. 2009), but for convenience we briefly summarize them here. The term "potash" refers to mineral and chemical salts that are rich in potassium. It is mined from naturally occurring ore deposits and its primary use is in agricultural fertilizers, but it is also used in the production of such varied products as glass, ceramics, soaps, and animal feed supplements. Importantly for our later antitrust analysis, potash is a homogeneous commodity: One manufacturer's supply is interchangeable with another's. As a result, buyers choose among suppliers based largely on price. Markets for this type of product are especially vulnerable to price-fixing.

We focus our analysis on the Direct Purchaser Amended Consolidated Class Action Complaint (referred to here simply as the Complaint), because the complaint filed by the indirect potash purchasers focuses primarily on state law remedies (since indirect purchasers are not entitled to sue for damages under the federal antitrust laws, see *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 729 (1977)). The Complaint alleges that the world's potash reserves are confined to a handful of areas, with over half of global capacity located in just two regions—Canada and the former Soviet Union (in particular, Russia and Belarus). Commercially, the industry has been dominated by a small group of companies that market, sell, and distribute potash. The key actors are:

- Potash Corporation of Saskatchewan (Canada) Inc. and its U.S. subsidiary Potash Sales (USA), Inc. (collectively PCS), the world's largest producer of potash;
- Mosaic Company and Mosaic Crop Nutrition (Mosaic) a Delaware company headquartered in Minnesota, number three globally;
- Agrium Inc. and Agrium U.S. Inc. (Agrium), a Canadian corporation and its wholly owned U.S. subsidiary;

- Uralkali, a Russian joint venture headquartered in Moscow; fifth largest in the world and holder of a one-half interest in JSC Belarusian Potash Company (Belarusian Potash), which acts as the exclusive distributor of potash for Uralkali;
- Belaruskali, a Belarusian company and the owner of the other one-half interest in Belarusian Potash, which, as it is for Uralkali, is Belaruskali's exclusive distributor;
- Silvinit, a Russian company that sells potash throughout the world, including the United States; and
- IPC, another Russian company, which is Silvinit's exclusive distributor.

The Complaint alleges that as of 2008, these seven entities produced approximately 71% of the world's potash.

In 2008, the United States consumed 6.2 million tons of potash. Of that total, 5.3 million tons were imports, and PCS, Mosaic, Agrium, and Belarusian Potash (acting for both Uralkali and Belaruskali, its equal and joint owners) were responsible for the lion's share of those sales. Data for other years covered by the Complaint are comparable.

The total world market for potash, in which the United States is an important consumer (second only to China, Complaint ¶51), is allegedly under the thumb of a global cartel consisting primarily of the companies listed above. This cartel restrained global output of potash in order to inflate prices. The cartel members used a rolling strategy: They would first negotiate prices in Brazil, India, and China (Complaint ¶111), and then use those prices as benchmarks for sales to U.S. customers. (Complaint ¶¶117-121). For example, in May 2004, the cartel arranged for prices to increase by $20 per ton for some foreign customers; shortly thereafter, prices in the United States went up by precisely the same amount.

The cartel initiated a sustained and successful effort to drive prices up beginning in mid-2003; by 2008 potash prices had increased at least 600%. The plaintiffs assert that this increase cannot be explained by a significant uptick in demand, changes in the cost of production, or other changes in input costs. In fact, U.S. consumption of fertilizer, of which potash is a consistent part, remained relatively steady throughout the period covered by this case; demand declined somewhat in 2008 but then returned to normal levels in 2009. One might think that the decrease in demand in 2008 was because of the increase in price, but the slippage in demand did not build up over the entire Class Period and appears to have been only temporary, and is thus not correlated to potash price movements. Furthermore, the specific allegation in the Complaint that a $100 per ton increase in the price of potash adds only $0.03 to the production cost of a bushel of corn suggests that demand for potash is inelastic. Complaint ¶54. Prices for potash rose and stayed high, increasing even while fertilizer prices declined. Based on World Bank statistics, average fertilizer price indices rose from 1.0 to 2.2, and then fell back to 1.0 in 2008, while potash price indices started in 2008 at 1.0 and rose to 3.5 by the end of the year. Earnings by cartel members reinforce this picture of financial gain even in the face of waning demand: PCS posted first-quarter income figures in 2008 that tripled its previous-year figure, while Mosaic's earnings for that quarter were up more than tenfold over the year before.

The Complaint goes into detail about ways in which the defendants managed their collective output. (A cartel will always try to restrict output to the level where marginal cost equals marginal revenue, but in the real world, this normally requires constant adjustment.) For example, when global demand for potash declined in 2005, rather than decreasing its price, PCS announced that it was shutting down three of its mines in November and December 2005 for

"inventory control purposes." Complaint ¶88. This action had the effect of removing 1.34 million tons of potash from the world market. At the same time, rather than jumping into the gap this drastic cutback created, Mosaic announced that it too was implementing temporary cutbacks that would remove an additional 200,000 tons from the market. These (allegedly) coordinated and deep reductions continued into 2006. In the first three months of that year, PCS reduced output from 2.4 million tons to 1.3 million tons, removing yet another 1.1 million tons from the market, or the equivalent of 32 weeks of mining. Uralkali reduced its output by 200,000 tons, and Belaruskali cut its exports back by 50%, or 250,000 tons. In the second quarter of that year, Silvinit followed suit with mine stoppages that removed about 100,000 tons from the market. Collectively, these three companies removed over half a million tons of potash from the market in early 2006. See Complaint ¶¶88-93. Their compatriots applauded the "discipline" of the former Soviet Union producers, "noting that many years earlier when demand for potash declined those same producers had sought to maintain volume over price and flooded the market with excess supply." Complaint ¶93.

China was a particular target of the cartel's efforts, given its importance as a consumer. The shortages created by Uralkali's and PCS's supply restrictions in the first half of 2006 induced China to accept an increase in the price of potash. Shortly thereafter, a similar price increase was implemented throughout the world. Complaint ¶95. Comparable actions took place in 2007, as the Complaint rehearses in detail. The plaintiffs assert that a number of the defendants had excess capacity throughout the period between 2003 and mid-2009 (which represents the Class Period defined in ¶1 of the Complaint). PCS, for instance, had a utilization rate of only 54% to 69%, and Uralkali bragged in December 2007 that it had the "ability to add significant capacity on the cheapest basis vs. global peers." Complaint ¶¶133-134. This pattern of restrained output made it possible for the cartel to maintain its inflated prices, but the excess capacity inevitably gave its members an easy opportunity to cheat, and so the group had to coordinate to ensure that its price control efforts were not undermined.

The Complaint also points to several ways in which the cartel members had the opportunity to cooperate, to conspire on future actions, and to monitor one another's actions for possible cheating. First, the major suppliers participated in joint ventures that facilitated coordination. PCS, Agrium, and Mosaic were joint venturers and equal shareholders in Canpotex Ltd., a Canadian company that sold, marketed, and distributed potash throughout the world excluding the United States. Through that vehicle, those three companies had access to one another's sensitive production and pricing information. Canpotex in turn entered into cooperative marketing agreements with the Russian and Belarusian entities. As part of those deals, Canpotex agreed to market Uralkali potash outside North America and Europe. For their part, the former Soviet producers coordinated their sales and marketing through Belarusian Potash. That joint venture, formed between Uralkali and Belaruskali in 2005, supplied 34% of the market for potash by the following year. Complaint ¶26. Silvinit has sought to join the venture, and one of its owners (with a 20% share) owns 60% of the stock of Uralkali.

Beyond the access created by these structural relations among the entities, there were other more immediate opportunities to collude. The defendants routinely held meetings during the Class Period and engaged in an exchange program through which senior executives from each visited the others' plants. These meetings gave the defendants an opportunity to exchange sensitive information. Critically, one such meeting of the key players at PCS, Canpotex, Mosaic, Uralkali, Belaruskali, and Silvinit—mostly at the presidential level—took place in October 2005. As we described above, in the very next month, November 2005, PCS and Mosaic announced

significant production cutbacks; the others followed suit with additional supply reductions through the beginning of 2006.

In addition, all of the defendants are members of the International Fertilizer Industry Association and the Fertilizer Institute, and they regularly attended those trade organizations' conferences. During one such meeting in Turkey, in May 2007, the defendants announced an additional price increase.

The Complaint contains, in its 165 paragraphs, many more details, which we discuss as needed below. What we have said here, however, is enough to set the stage for the two legal issues before us: how the FTAIA should be interpreted, and whether the district court correctly allowed this case to go forward.

II

Whether this case can be entertained by a court in the United States turns on the global reach of the antitrust laws, and to a significant degree on the Foreign Trade Antitrust Improvements Act of 1982, 15 U.S.C. § 6a. Before delving into the FTAIA's requirements, however, we take this opportunity to revisit the question whether that law affects the subject-matter jurisdiction of the district court or if, on the other hand, it relates to the scope of coverage of the antitrust laws. Nine years ago, in *United Phosphorus v. Angus Chemical*, the en banc court concluded that the former interpretation was correct. 322 F.3d 942, 952 (7th Cir. 2003). In so doing, we relied on the legislative history of the statute, the vocabulary used by a number of commentators, and a number of court decisions that used the word "jurisdiction" in describing the requirement that challenged conduct must affect interstate or import commerce in specified ways.

Since that decision, the Supreme Court has emphasized the need to draw a careful line between true jurisdictional limitations and other types of rules. Thus, in *Morrison v. National Australia Bank Ltd.*, 130 S.Ct. 2869 (2010), which dealt with the securities laws, the Court squarely rejected the notion that the extraterritorial reach of § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), raises a question of subject-matter jurisdiction. *Id.* at 2877. "[T]o ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question. Subject-matter jurisdiction, by contrast, refers to a tribunal's power to hear a case." *Id.* (citing [cases]). Notably, what may have been thought a nascent idea at the time *United Phosphorus* was decided *** has now become a firmly established principle of statutory construction. ***

The Supreme Court's decision in *Morrison*, we believe, provides all the guidance we need to conclude that, like § 10(b) of the Exchange Act, the FTAIA sets forth an element of an antitrust claim, not a jurisdictional limit on the power of the federal courts. As the Court put it, limitations on the extraterritorial reach of a statute describe what conduct the law purports to regulate and what lies outside its reach. The Supreme Court itself used much the same language with respect to the antitrust laws in its decision in *F. Hoffman-La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155 (2004), which dealt specifically with the FTAIA. The Court spoke, for example, of the FTAIA's "removing from the Sherman Act's reach" certain types of conduct, *id.* at 161, and whether it was reasonable under the facts presented there "to apply this law to conduct that is significantly foreign," *id.* at 166. Even if one thought the language in *Empagran* to be less than dispositive, we can now see no way to distinguish this case from *Morrison*.

We add briefly that the interpretation we adopt today—that the FTAIA spells out an element of a claim—is the one that is both more consistent with the language of the statute and sounder from a procedural standpoint. When Congress decides to strip the courts of subject-matter jurisdiction in a particular area, it speaks clearly. The FTAIA, however, never comes close to

using the word "jurisdiction" or any commonly accepted synonym. Instead, it speaks of the "conduct" to which the Sherman Act (or the Federal Trade Commission Act) applies. This is the language of elements, not jurisdiction.

From a procedural standpoint, this means that a party who wishes to contest the propriety of an antitrust claim implicating foreign activities must, at the outset, use Federal Rule of Civil Procedure 12(b)(6), not Rule 12(b)(1). This is not a picky point that is of interest only to procedure buffs. Rather, this distinction affects how disputed facts are handled, and it determines when a party may raise the point. While "it is the burden of the party who seeks the exercise of jurisdiction in his favor clearly to allege facts demonstrating that he is a proper party to invoke judicial resolution," *FW/PBS, Inc. v. City of Dallas*, 493 U.S. 215, 231 (1990) (citations and quotation marks omitted), we "accept as true all of the allegations contained in a complaint," *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (citing *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007)) subject, of course, to the limitations articulated in those cases. Likewise, subject-matter jurisdiction must be secure at all times, regardless of whether the parties raise the issue, and no matter how much has been invested in a case. By contrast, a motion to dismiss for failure to state a claim may only be brought as late as trial. FED. R. CIV. P. 12(h)(2). Although this is a significant difference, we note that foreign connections of the kind at issue here are unlikely to be difficult to detect, and so we are confident that parties who want to argue that a particular claim fails the requirements of the FTAIA will be able to do so within these generous time limits.

III

Having established that the FTAIA relates to the merits of a claim, rather than the subject-matter jurisdiction of the court, we can now turn to the principal issues in this appeal. We consider first how the statute should be interpreted and then, on that understanding of the law, we decide whether the district court correctly found that the Complaint stated a claim that could go forward.

A

Although the FTAIA has been parsed in a number of judicial opinions, including notably *Empagran*, we think it important to begin with the language of the statute, in order to place our discussion of these decisions in context. We note that the 1982 legislation that we are examining actually amended both the Sherman Act, see 15 U.S.C. § 6a, and the Federal Trade Commission Act, see 15 U.S.C. § 45(a)(3), using identical language. That fact is important insofar as it underscores the generality of the issue we face: The statute applies not only to private actions, such as this one, but also to actions brought by the two federal agencies entrusted with the enforcement of the antitrust laws. Since it is the Sherman Act that applies to our case, however, from this point forward we cite only its provision. It reads as follows:

> § 6a. Conduct involving trade or commerce with foreign nations
>
> Sections 1 to 7 of this title [i.e., the Sherman Act] shall not apply to conduct involving trade or commerce (other than import trade or import commerce) with foreign nations unless—
>
> (1) such conduct has a direct, substantial, and reasonably foreseeable effect—
>
> (A) on trade or commerce which is not trade or commerce with foreign nations, or on import trade or import commerce with foreign nations; or
>
> (B) on export trade or export commerce with foreign nations, of a person engaged in such trade or commerce in the United States; and

(2) such effect gives rise to a claim under the provisions of sections 1 to 7 of this title, other than this section.

If sections 1 to 7 of this title apply to such conduct only because of the operation of paragraph (1)(B), then sections 1 to 7 of this title shall apply to such conduct only for injury to export business in the United States.

The opening phrase (sometimes referred to as a chapeau in international circles) reflects Congress's effort to indicate that the Sherman Act does not apply to every arrangement that literally can be said to involve trade or commerce with foreign nations. As the Supreme Court stressed in *Empagran*, the public recognition of this limitation was inspired largely by international comity. But, by inserting the parenthetical "other than import trade or import commerce" in the chapeau, Congress recognized that there was no need for this self-restraint with respect to imports, even though they represent part of the foreign commerce of the United States. Although some, including the Third Circuit in *Animal Science*, have referred to this as the "import exception," that is not an accurate description. Import trade and commerce are excluded at the outset from the coverage of the FTAIA in the same way that domestic interstate commerce is excluded. This means only that conduct in both domestic and import trade is subject to the Sherman Act's general requirements for effects on commerce, not to the special requirements spelled out in the FTAIA. Where the FTAIA does apply, it "remov[es] from the Sherman Act's reach . . . commercial activities taking place abroad, unless those activities adversely affect . . . imports to the United States" *Empagran*, 542 U.S. at 161. The Court's decision in *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993), suggests a pragmatic reason for this distinction: The applicability of U.S. law to transactions in which a good or service is being sent directly into the United States, with no intermediate stops, is both fully predictable to foreign entities and necessary for the protection of U.S. consumers. Foreigners who want to earn money from the sale of goods or services in American markets should expect to have to comply with U.S. law.

Next, we come to the statute's treatment of non-import, non-domestic commerce. *Empagran* explained that the FTAIA handles that problem by "lay[ing] down a general rule placing all (nonimport) activity involving foreign commerce outside the Sherman Act's reach . . . [and then] bring[ing] such conduct back within" the Act provided that it meets the two criteria provided. *Id.* at 162. The first criterion dictates the kinds of effects that truly foreign commerce must have in the U.S. market. Conduct "involving trade or commerce . . . with foreign nations" must have "a direct, substantial, and reasonably foreseeable effect" on either [A] U.S. domestic commerce (phrased awkwardly as "trade or commerce which is not trade or commerce with foreign nations") or U.S. import commerce, or [B] the export trade or commerce of a U.S. exporter. See § 6a(1). The export trade provision plays no part in our case, and so we do not address it further here. The second criterion, which was the focus of *Empagran*, is that the direct, substantial and foreseeable effect shown under subpart (1) must give rise to a substantive claim under the Sherman Act. The reason this was important in *Empagran* is that the plaintiffs there were foreign purchasers of allegedly price-fixed products that were sold in foreign markets. The Court held that their claims fell outside the scope of the Sherman Act. In our case, by contrast, the plaintiffs are all U.S. purchasers, and so the particular problem addressed in *Empagran* does not arise here.

Thus, before we can address the merits of the complaint, we must address two distinct questions of statutory interpretation. The first is how to define pure import commerce—that is, the kind of commerce that is not subject to the special rules created by the FTAIA. Second, we must explore the FTAIA's standards further and explain what it takes to show that foreign

conduct has a direct, substantial, and reasonably foreseeable effect on U.S. domestic or import commerce.

1

There can be no question that the import commerce exclusion puts some of the conduct alleged in the Complaint outside the special rules created in the FTAIA for Sherman Act claims. The plaintiffs are U.S. entities that have purchased potash directly from members of the alleged cartel. The defendant members of the cartel are all located outside the United States. Those transactions that are directly between the plaintiff purchasers and the defendant cartel members are the import commerce of the United States in this sector.

The FTAIA does not require any special showing in order to bring these transactions back into the Sherman Act, as *Empagran* put it, because they were never removed from the statute. That does not mean, however, that plaintiffs are home free. Rather, we must still apply the rules governing import commerce for purposes of the antitrust laws. For several decades, the leading authority on this subject was Judge Learned Hand's opinion for the Second Circuit in *United States v. Aluminum Co. of America*, 148 F.2d 416, 444 (2d Cir. 1945) (*Alcoa*). There the court (sitting as a court of last resort because the Supreme Court lacked a quorum) held that the Sherman Act covers imports when actual and intended effects on U.S. commerce have been shown. In *Hartford Fire*, the Supreme Court confirmed this rule, stating that "the Sherman Act covers foreign conduct producing a substantial intended effect in the United States." 509 U.S. at 797. The Third Circuit has suggested that this standard is met where "the defendants' conduct target[s] import goods or services." *Animal Science*, 654 F.3d at 470.

As noted, the Complaint before us alleges import transactions. Thus, the only outstanding question is whether this import trade has been substantially and intentionally affected by an anticompetitive arrangement (i.e., something that would violate the U.S. antitrust laws). There is nothing particularly "international" about that question. Effects on commerce are a part of every Sherman Act case. See, *e.g.*, *Hartford Fire*, *supra* (import commerce); *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322 (1991) (interstate commerce). We address the adequacy of the Complaint under the Sherman Act in more detail below.

2

As we already have observed, trade involving only foreign sellers and domestic buyers (i.e., import trade) is not subject to the FTAIA's extra layer of protection against Sherman Act claims implicating foreign activities. Some of the activities alleged in the Complaint, however, may be best understood as sufficiently outside the arena of simple import transactions as to require application of the FTAIA. For example, Canpotex is the unified marketing and sales agent for Agrium, Mosaic and PCS in all markets except Canada and the United States, yet its actions are an important part of the alleged scheme to set inflated benchmark prices. Presumably, in order to avoid *Illinois Brick's* prohibition on "pass on" antitrust damages, 431 U.S. at 728, the plaintiffs are seeking to hold firms like Canpotex jointly and severally liable for any damages the direct sellers might be ordered to pay, perhaps under a conspiracy theory. If this were an action by the Department of Justice or the Federal Trade Commission, we would not need to worry about *Illinois Brick*, but regardless of whether the case is brought by the government or in private litigation, it is essential to meet the criteria spelled out by the FTAIA. We thus take a closer look at what kind of conduct "involve[s] trade or commerce . . . with foreign nations" and what

showing is necessary to demonstrate "direct, substantial and reasonably foreseeable" effects on domestic [*i.e.,* "not trade or commerce with foreign nations"] or import commerce.

The first question—whether the conduct alleged in this case "involves" foreign commerce—is readily answered. The Complaint alleges an international cartel in a commodity, and it asserts that the cartel succeeded in raising prices for direct U.S. purchasers of the product, potash. This alleged arrangement plainly involves foreign commerce, and so we move immediately to the second inquiry—the task of parsing the statute's central requirements. As *Empagran* put it, after excluding foreign activities from the scope of the Sherman Act, the FTAIA brings back into the statute's reach conduct that has a "direct, substantial, and reasonably foreseeable effect" on domestic or import commerce.

The potash cartel described in the Complaint is one for which the requirements of substantiality and foreseeability are easily met. There is little dispute that the Complaint has alleged substantial effects: The Complaint alleges that 5.3 million tons of potash were imported into the United States in 2008 alone, and the Complaint elsewhere asserts that the vast majority of these imports came from the defendants. From 2003 to 2008, the price of potash increased by over 600%. We do not need to belabor the point. These allegations easily satisfy the requirement to show substantial effects in the U.S. market. Wherever the floor may be, it is so far below these numbers that we do not worry about it here.

Foreseeability is equally straightforward. It is objectively foreseeable that an international cartel with a grip on 71% of the world's supply of a homogeneous commodity will charge supracompetitive prices, and in the absence of any evidence showing that arbitrage is impossible (and there is none here), those prices (net of shipping costs) will be uniform throughout the world. Higher prices cannot be divorced from reductions in supply, and so the effects alleged here are a rationally expected outcome of the conduct stated in the Complaint.

The question that has caused more discussion among various courts and commentators is what it takes to show "direct" effects. One school of thought, launched by the Ninth Circuit's split decision in *United States v. LSL Biotechs.*, 379 F.3d 672 (9th Cir. 2004), has borrowed the definition of the word "direct" that the Supreme Court adopted for a different statute, the Foreign Sovereign Immunities Act (FSIA), 28 U.S.C. § 1605(a)(2). The word appears in the exception for foreign sovereign immunity that applies for commercial activity that takes place outside the territory of the United States when "that act causes a direct effect in the United States." In that setting, the Court held that an effect is "direct" if it "follows as an immediate consequence of the defendant's . . . activity." *Id.* at 618. The other school of thought has been articulated by the Department of Justice's Antitrust Division, which takes the position that, for FTAIA purposes, the term "direct" means only "a reasonably proximate causal nexus." Makan Delrahim, Drawing the Boundaries of the Sherman Act: Recent Developments in the Application of the Antitrust Laws to Foreign Conduct, 61 N.Y.U. ANN. SURV. AM. L. 415, 430 (2005) (remarks of the Deputy Assistant Attorney General); Brief for Appellant United States of America 38 in *United States v. LSL Biotechs.*, *supra*, available at http://www.justice.gov/atr/cases/f200200/200243.pdf (directness is a synonym for proximate cause).

In our view, the Ninth Circuit jumped too quickly to the assumption that the FSIA and the FTAIA use the word "direct" in the same way. Critically, the Supreme Court in *Weltover* reached its definition of "direct" for FSIA purposes only after refusing to import from the legislative history of that statute the notion that an effect is "direct" only if it is both "substantial" and "foreseeable." 504 U.S. at 617. "[W]e reject," it said, "the suggestion that § 1605(a)(2) contains any unexpressed requirement of 'substantiality' or 'foreseeability.'" *Id.* at 618. Only then did the

Court endorse the appellate court's definition that an effect is "direct" if it follows "as an immediate consequence" of the defendant's activity. *Id.*

No one needs to read the words "substantial" and "foreseeable" into the FTAIA. Congress put them there, and in so doing, it signaled that the word "direct" used along with them had to be interpreted as part of an integrated phrase. Superimposing the idea of "immediate consequence" on top of the full phrase results in a stricter test than the complete text of the statute can bear. To demand a foreseeable, substantial, and "immediate" consequence on import or domestic commerce comes close to ignoring the fact that straightforward import commerce has already been excluded from the FTAIA's coverage.

We are persuaded that the Department of Justice's approach is more consistent with the language of the statute. The word "direct" addresses the classic concern about remoteness—a concern, incidently, that has been at the forefront of international antitrust law at least since Judge Hand wrote in *Alcoa* that "[w]e should not impute to Congress an intent to punish all whom its courts can catch, for conduct which has no consequences within the United States." 148 F.2d at 443; see also *LSL Biotechs.*, 379 F.3d at 683-91 (Aldisert, J., dissenting) (tracing the history of the FTAIA's effects test through *Alcoa*). Just as tort law cuts off recovery for those whose injuries are too remote from the cause of an injury, so does the FTAIA exclude from the Sherman Act foreign activities that are too remote from the ultimate effects on U.S. domestic or import commerce.

This understanding of the FTAIA should allay any concern that a foreign company that does any import business at all in the United States would violate the Sherman Act whenever it entered into a joint-selling arrangement overseas regardless of its impact on the American market. A number of safeguards exist to protect against that risk. If the hypothetical foreign company is engaged in direct import sales, it must naturally comply with U.S. law just as all of its domestic competitors do. If its foreign sales do not meet the threshold for "effects" on import or domestic commerce established by cases such as *Hartford Fire* and *Summit Health*, then, for those transactions, it has nothing to worry about. If the hypothetical foreign company is engaged in the kind of conduct outside the United States that the FTAIA addresses, then its actions can be reached only if there are direct, substantial, and reasonably foreseeable effects. This is a standard with teeth ***.

Empagran is consistent with the interpretation we adopt here. While it holds that the U.S. antitrust laws are not to be used for injury to foreign customers, it goes on to reaffirm the well-established principle that the U.S. antitrust laws reach foreign conduct that harms U.S. commerce:

> [O]ur courts have long held that application of our antitrust laws to foreign anticompetitive conduct is nonetheless reasonable, and hence consistent with principles of prescriptive comity, insofar as they reflect a legislative effort to redress domestic antitrust injury that foreign anticompetitive conduct has caused.

Empagran, 542 U.S. at 165. Finally, we note that § 6a(2) will protect many a foreign defendant. No matter what the quality of the foreign conduct, the statute will not cover it unless the plaintiff manages to state a claim under the Sherman Act. In this connection, we point out that a great many joint-selling arrangements are legal, efficiency-enhancing structures. See, *e.g.*, *Texaco Inc. v. Dagher*, 547 U.S. 1 (2006); *Broadcast Music, Inc. v. Columbia Broadcasting Sys.*, Inc., 441 U.S. 1 (1979).

B

Having described the requirements for both simple import commerce and the FTAIA, our final task is to measure the Complaint against these standards. In particular, we must decide whether the plaintiffs have plausibly alleged that the defendants' conduct took place either in import commerce and are thus subject to the more general rules of *Hartford Fire* for effects on commerce, or if they have in whole or in part described conduct subject to the FTAIA, and if so, whether the allegations describe direct, substantial, and foreseeable effects on domestic or import commerce.

1

In our view, much of the Complaint alleges straightforward import transactions. Under *Hartford Fire* the plaintiffs thus must allege that the conduct of the foreign cartel members was (1) meant to produce and (2) did in fact produce some substantial effect in the United States. The Complaint contains ample material supporting both of those points.

The plaintiffs describe a tight-knit global cartel, similar to OPEC in its heyday, that restrained global output of potash so that prices throughout this homogeneous world market would remain artificially high. Just like the raisin producers in California in the famous state-action antitrust case, *Parker v. Brown*, 317 U.S. 341 (1943), who controlled 90% of the world market in raisins, the alleged cartel members here control a comparable share of the world market in potash. The purpose of this cartel was to inflate the profits of its members. Its alleged effect was substantial. The United States, according to the Complaint, is one of the two largest consumers of potash in the world, and approximately 85% of U.S. potash comes from overseas. From 2003 to 2008, the price of potash increased six-fold. The inference from these allegations is not just plausible but compelling that the cartel meant to, and did in fact, keep prices artificially high in the United States.

2

We turn next to an analysis of the conduct that falls outside the import exclusion to determine whether it may nevertheless be subject to the Sherman Act under the FTAIA. For example, the Complaint alleges that Canpotex, a Canadian entity that does not sell directly into the United States, restricted supply during a period of especially difficult price negotiations with China. This supply restriction compelled Chinese buyers to accept a price increase. Complaint ¶94. We assume for present purposes that none of this literally involved import trade. Our discussion, however, is rooted in the facts of this Complaint. In that connection, it is important to recall that the FTAIA itself demands that the facts of each case must be evaluated for compliance with its demands. We thus address only the situation before us, in which several members of the cartel sold directly into the United States and others allegedly worked with them in connection with those efforts. The question before us is thus whether the allegations in the plaintiffs' Complaint describe conduct that had a direct, substantial, and reasonably foreseeable effect on domestic or import commerce by, for example, setting a benchmark price intended to govern later U.S. sales.

As we noted above, the effects of the supply restriction on U.S. potash prices were foreseeable. So too were the effects of forcing foreign purchasers to accept higher prices in a commoditized and cartelized market: Either someone in the cartel would cheat, or a new entrant would begin to arbitrage its purchases, or, as the plaintiffs allege, the cartel would succeed in pushing prices up across all of its markets, including the United States. And, as we have explained, there is every reason to infer that any such effects in the U.S. potash market were substantial.

We turn to the question whether these effects are "direct," as we have defined the term. The plaintiffs allege that the defendants would first negotiate prices in Brazil, India, and China, and then they would use those prices for sales to U.S. customers. The alleged supply reductions led to price hikes in these foreign markets, and those increases showed up almost immediately in the prices of U.S. imports. The defendants do not suggest that the potash market is insulated from these effects by regulatory structures or other arrangements, and even if they did, that would be no reason to dismiss the Complaint outright. To the contrary, the plaintiffs have alleged that the cartel established benchmark prices in markets where it was relatively free to operate, and it then applied those prices to its U.S. sales. (Benchmark prices set in one market for general use are common: think, for instance of the London Interbank Offered Rate (LIBOR), in the credit market; the Brent Crude price, formally used for North Sea oil but in general use in oil markets; or even the Medicare Fee Schedule, which though technically only for Medicare reimbursements, has widespread effects on the healthcare market.) It is no stretch to say that the foreign supply restrictions, and the concomitant price increases forced upon the Chinese purchasers, were a direct—that is, proximate—cause of the subsequent price increases in the United States.

The allegations in the Complaint state a claim, as required by Federal Rule of Civil Procedure 8, and thus are enough to withstand a motion to dismiss under Rule 12(b)(6), as interpreted by the Supreme Court in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). The Complaint is not defeated by the defendants' contention that the alleged cartel was not efficacious. See *In re High Fructose Corn Syrup Antitrust Litig.*, 295 F.3d 651, 656 (7th Cir. 2002). We are also satisfied that the allegations suffice, at this stage, to support a plausible story of concerted action. See *In re Text Messaging Antitrust Litig.*, 630 F.3d 622 (7th Cir. 2010). We stress, however, that our evaluation throughout has proceeded exclusively on the face of the Complaint. Nothing we have said should be understood as a prediction of the facts that may turn up in discovery, nor are we opining about the likely fate of any possible defenses. In particular, the defendants mentioned in their opposition to the petition for rehearing en banc that some of their actions were undertaken with the approval of foreign governments (*e.g.,* Canada's). We express no opinion on either the contours or the likely success of any such argument. Similarly, we do not have before us any question about the court's personal jurisdiction over the various defendants. Cf. *J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S.Ct. 2780 (2011). We are not faced with the question of whether the actions of the non-selling defendants, such as Canpotex, fall outside the substantive scope of Sherman Act § 1 (as opposed to the law's territorial reach), nor have the defendants argued that Congress as a matter of U.S. law has no constitutional power to enact laws with some extraterritorial effect. These or other theories may all be important to explore as the case goes forward, but they do not provide a reason to throw out the case on the grounds that the plaintiffs failed to show either that the challenged transactions occurred in import commerce or that they had a direct, substantial, and reasonably foreseeable effect on either the domestic or import commerce of the United States.

IV

Foreign cartels, especially those over natural resources that are scarce in the United States and that are traded in a unified international market, have often been the target of either governmental or private litigation. The host country for the cartel will often have no incentive to prosecute it. Canada and Russia, here (just like California in *Parker*), would logically be pleased to reap economic rents from other countries; their losses from higher prices for the potash used in their own fertilizers are more than made up by the gains from the cartel price their exporters

collect. Export cartels are often exempt from a country's antitrust laws: the United States does just that, through its Webb-Pomerene Associations, see 15 U.S.C. §§ 61 *et seq*., and Export Trading Companies, see 15 U.S.C. §§ 4001 *et seq*. This case is actually the mirror image of the situation described in *Empagran*, where the foreign country whose consumers are hurt would have been the better enforcer. It is the U.S. authorities or private plaintiffs who have the incentive—and the right—to complain about overcharges paid as a result of the potash cartel, and whose interests will be sacrificed if the law is interpreted not to permit this kind of case.

The world market for potash is highly concentrated, and customers located in the United States account for a high percentage of sales. This is not a House-that-Jack-Built situation in which action in a foreign country filters through many layers and finally causes a few ripples in the United States. To the contrary: foreign sellers allegedly created a cartel, took steps outside the United States to drive the price up of a product that is wanted in the United States, and then (after succeeding in doing so) sold that product to U.S. customers. The payment of overcharges by those customers was objectively foreseeable, and the amount of commerce is plainly substantial. We AFFIRM the order of the district court denying the motion to dismiss for failure to state a claim.

Motorola Mobility LLC v. AU Optronics Corp.

775 F.3d 816 (7th Cir. 2015)

POSNER, CIRCUIT JUDGE: *** Motorola, the plaintiff-appellant, and its ten foreign subsidiaries, buy liquid-crystal display (LCD) panels and incorporate them into cellphones manufactured by Motorola or the subsidiaries. The suit accuses foreign manufacturers of the panels of having violated section 1 of the Sherman Act, 15 U.S.C. § 1, by agreeing with each other on the prices they would charge for the panels. Those manufacturers are the defendants-appellees.

The appeal does not concern all the allegedly price-fixed LCD panels. (We'll drop "allegedly" and "alleged," for simplicity, and assume that the panels were indeed pricefixed—a plausible assumption since defendant AU Optronics has been convicted of participating in a criminal conspiracy to fix the price of panel components of the cellphones manufactured by Motorola's foreign subsidiaries. *United States v. Hsiung*, 758 F.3d 1074 (9th Cir. 2014).) About 1 percent of the panels sold by the defendants to Motorola and its subsidiaries were bought by, and delivered to, Motorola in the United States for assembly here into cellphones; to the extent that the prices of the panels sold to Motorola had been elevated by collusive pricing by the manufacturers, Motorola has a solid claim under section 1 of the Sherman Act. The other 99 percent of the cartelized components, however, were bought and paid for by, and delivered to, foreign subsidiaries (mainly Chinese and Singaporean) of Motorola. Forty-two percent of the panels were bought by the subsidiaries and incorporated by them into cellphones that the subsidiaries then sold to and shipped to Motorola for resale in the United States. Motorola did none of the manufacturing or assembly of these phones. The sale of the panels to these subsidiaries is the focus of this appeal.

Another 57 percent of the panels, also bought by Motorola's foreign subsidiaries, were incorporated into cellphones abroad and sold abroad. As neither those cellphones nor their panel components entered the United States, they never became a part of domestic U.S. commerce, see 15 U.S.C. § 6a, and so, as we're about to see, can't possibly support a Sherman Act claim.

Motorola says that *it* "purchased over $5 billion worth of LCD panels from cartel members [i.e., the defendants] for use in its mobile devices." That's a critical misstatement. All but 1 percent of the purchases were made by Motorola's foreign subsidiaries. The subsidiaries are not Motorola; they are owned by Motorola. Motorola and its subsidiaries do not, as it argues in its opening brief, function "as a 'single enterprise.'" And from this we can begin to see the oddity of this case. If a firm is injured by unlawful acts of other firms, the firm may have a cause of action against the injurers but the firm's owner does not. The victims of the price fixing of LCD panels were Motorola's foreign subsidiaries. Motorola itself, along with U.S. purchasers of cellphones incorporating those panels, were at most derivative victims.

The district judge ruled that Motorola's suit, insofar as it relates to the 99 percent of panels purchased by the foreign subsidiaries, is barred by 15 U.S.C. §§ 6a(1)(A), (2), which are sections of the Foreign Trade Antitrust Improvements Act, 15 U.S.C. § 6a. That act that has been interpreted, for reasons of international comity (that is, good relations among nations), to limit the extraterritorial application of U.S. antitrust law. Sections 6a(1)(A) and (2) provide that the Sherman Act "shall not apply to conduct involving trade or commerce (other than import trade or import commerce) with foreign nations unless ... such conduct has a direct, substantial, and reasonably foreseeable effect ... on trade or commerce which is not trade or commerce with foreign nations, or on import trade or import commerce with foreign nations," and also, in either case, unless the "effect [on import trade or domestic commerce] gives rise to a claim" under federal antitrust law. See, e.g., *F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, 542 U.S. 155, 161-62 (2004); *Minn-Chem, Inc. v. Agrium, Inc.*, 683 F.3d 845, 853-54 (7th Cir. 2012) (en banc).

It is essential to understand that these are two requirements. There must be a direct, substantial, and reasonably foreseeable effect on U.S. domestic commerce—the domestic American economy, in other words—and the effect must give rise to a federal antitrust claim. The first requirement, if proved, establishes that there is an antitrust violation; the second determines who may bring a suit based on it.

Had the defendants conspired to sell LCD panels to Motorola in the United States at inflated prices, they would be subject to the Sherman Act because of the exception in the Foreign Trade Antitrust Improvements Act for importing. That is the 1 percent, which is not involved in the appeal. Regarding the 42 percent, Motorola is wrong to argue that it is import commerce. It was Motorola, rather than the defendants, that imported these panels into the United States, as components of the cellphones that its foreign subsidiaries manufactured abroad and sold and shipped to it. So it first must show that the defendants' price fixing of the panels that they sold abroad and that became components of cellphones also made abroad but imported by Motorola into the United States had "a direct, substantial, and reasonably foreseeable effect" on commerce within the United States. The panels—57 percent of the total—that never entered the United States neither affected domestic U.S. commerce nor gave rise to a cause of action under the Sherman Act.

If the prices of the components were indeed fixed, there would be an effect on domestic U.S. commerce. And that effect would be foreseeable (because the defendants knew that Motorola's foreign subsidiaries intended to incorporate some of the panels into products that Motorola would resell in the United States), could be substantial, and might well be direct rather than "remote," the word we used in *Minn-Chem, Inc. v. Agrium, Inc., supra*, 683 F.3d at 856-57, to denote effects that the statutory requirement of directness excludes.

The price fixers had, it is true, been selling the panels not in the United States but abroad, to foreign companies (the Motorola subsidiaries) that incorporated them into cellphones that the

foreign companies then exported to the United States for resale by the parent company, Motorola. The effect of fixing the price of a component on the price of the final product was therefore less direct than the conduct in *Minn-Chem,* where "foreign sellers allegedly created a cartel, took steps outside the United States to drive the price up of a product that is wanted in the United States, and then (after succeeding in doing so) *sold that product to U.S. customers*." *Id.* at 860 (emphasis added). But at the same time the facts of this case are not equivalent to what we said in *Minn-Chem* would *definitely* block liability under the Sherman Act: the "situation in which action in a foreign country filters through many layers and finally causes a few ripples in the United States." *Id.* In this case components were sold by their manufacturers to the foreign subsidiaries, which incorporated them into the finished product and sold the finished product to Motorola for resale in the United States. This doesn't seem like "many layers," resulting in just "a few ripples" in the United States cellphone market, though, as we'll see, the ripple effect probably was modest. We'll assume that the requirement of a direct, substantial, and reasonably foreseeable effect on domestic commerce has been satisfied, as in *Minn-Chem* and *Lotes Co. v. Hon Hai Precision Industry Co.*, 753 F.3d 395, 409-13 (2d Cir. 2014).

What trips up Motorola's suit is the statutory requirement that the effect of anticompetitive conduct on domestic U.S. commerce give rise to an antitrust cause of action. 15 U.S.C. § 6a(2). The conduct increased the cost to Motorola of the cellphones that it bought from its foreign subsidiaries, but the cartel-engendered price increase in the components and in the price of cellphones that incorporated them occurred entirely in foreign commerce.

We have both direct purchasers—Motorola's foreign subsidiaries—from the price fixers, and two tiers of indirect purchasers: Motorola, insofar as the foreign subsidiaries passed on some or all of the increased cost of components to Motorola, and Motorola's cellphone customers, insofar as Motorola raised the resale price of its cellphones in an attempt to offload the damage to it from the price fixing to its customers. According to Motorola's damages expert, B. Douglas Bernheim, the company raised the price of its cellphones in the United States by *more* than the increased price charged to it by its foreign subsidiaries. We have no information about whether Motorola lost customers as a result—it may not have, if other cellphone sellers raised their prices as well. Perhaps because Motorola may actually have profited from the price fixing of the LCD panels, it has waived any claim that the price fixing affected the price that Motorola's foreign subsidiaries charged, or were told by Motorola to charge, for the cellphones that they sold their parent. (We'll come back to the issue of waiver.)

Whether or not Motorola was harmed indirectly, the immediate victims of the price fixing were its foreign subsidiaries, see *F. Hoffmann-La Roche Ltd. v. Empagran S.A.*, supra, 542 U.S. at 173-75, and as we said in the *Minn-Chem* case "U.S. antitrust laws are not to be used for injury to foreign customers," 683 F.3d at 858. Motorola's subsidiaries are governed by the laws of the countries in which they are incorporated and operate; and "a corporation is not entitled to establish and use its affiliates' separate legal existence for some purposes, yet have their separate corporate existence disregarded for its own benefit against third parties." *Disenos Artisticos E Industriales, S.A. v. Costco Wholesale Corp.*, 97 F.3d 377, 380 (9th Cir. 1996). For example, although for antitrust purposes Motorola contends that it and its subsidiaries are one (the "it" we referred to earlier), for tax purposes its subsidiaries are distinct entities paying foreign rather than U.S. taxes.

Distinct in *uno*, distinct in *omnibus*. Having submitted to foreign law, the subsidiaries must seek relief for restraints of trade under the law either of the countries in which they are incorporated

or do business or the countries in which their victimizers are incorporated or do business. The parent has no right to seek relief on their behalf in the United States.

Motorola wants us to treat it and all of its foreign subsidiaries as a single integrated enterprise, as if its subsidiaries were divisions rather than foreign corporations. But American law does not collapse parents and subsidiaries (or sister corporations) in that way. Some foreign nations, it is true, treat multinational enterprises as integrated units. *** But the United States and other developed countries refused to buy that theory. They insisted, and continue to insist, that corporate formalities should be respected unless one of the recognized justifications for piercing the veil, or otherwise deeming a parent and a subsidiary one, is present. None is present in this case.

This is thus a case of derivative injury, and derivative injury rarely gives rise to a claim under antitrust law, for example by an owner or employee of, or an investor in, a company that was the target of, and was injured by, an antitrust violation. *Mid-State Fertilizer Co. v. Exchange National Bank of Chicago*, 877 F.2d 1333, 1335-36 (7th Cir. 1989); see generally *Brunswick Corp. v. Pueblo Bowl-O-Mat*, 429 U.S. 477 (1977). Those derivative victims are said to lack "antitrust standing." Often, as in the example just given, their claims would be redundant, because if the direct victim received full compensation there would be no injury to the owner, employee, or investor—he or it would probably be as well off as if the antitrust violation had never occurred. If Motorola's foreign subsidiaries have been injured by violations of the antitrust laws of the countries in which they are domiciled, they have remedies; if the remedies are inadequate, or if the countries don't have or don't enforce antitrust laws, these are consequences that Motorola committed to accept by deciding to create subsidiaries that would be governed by the laws of those countries. (An important, and highly relevant, application of the concept of "antitrust standing" is the indirect-purchaser doctrine of the *Illinois Brick* case, discussed below.)

No doubt Motorola thinks U.S. antitrust remedies more fearsome than those available to its foreign subsidiaries under foreign laws. But that's just to say that Motorola is asserting a right to forum shop. Should some foreign country in which one of its subsidiaries operates have stronger antitrust remedies than the United States does, Motorola would tell that subsidiary to sue under the antitrust law of that country.

A related flaw in Motorola's case is its collision with the indirect-purchaser doctrine of *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977), which forbids a customer of the purchaser who paid a cartel price to sue the cartelist, even if his seller—the direct purchaser from the cartelist—passed on to him some or even all of the cartel's elevated price. Motorola's subsidiaries were the direct purchasers of the price-fixed LCD panels, Motorola and its customers indirect purchasers of the panels. Confusingly, at the oral argument Motorola's able counsel stated his approval of the *Illinois Brick* doctrine, yet Motorola's briefs assert, albeit without any basis that we can see, that the Foreign Trade Antitrust Improvements Act, because it does not mention *Illinois Brick* (or the indirect-purchaser doctrine, announced in that case), is not subject to it.

Because it is difficult to assess the impact of a price increase at one level of distribution on prices and profits at a subsequent level, and thus to apportion damages between direct and indirect (i.e., subsequent) purchasers (here, between Motorola's subsidiaries, Motorola the parent, and Motorola's cellphone customers), the indirect-purchaser doctrine cuts off analysis at the first level. This may result in a windfall for the direct purchaser, but preserves the deterrent effect of antitrust damages liability while eliding complex issues of apportionment. In this case the first sale was to a foreign subsidiary of Motorola that could sue the price fixers under the law of the country of which the subsidiary was a citizen, or the law of the countries of which

the price fixers were citizens (or a country of which a particular price fixer that the subsidiary decided to sue was a citizen). Motorola, the American parent, the harm to which from the price fixing would be so difficult to estimate, could not sue under federal antitrust law.

Speaking of the difficulty of estimating harm to Motorola, we point out that although this suit is more than five years old there is a remarkable dearth of evidence from which to infer actual harm to Motorola. Its briefs lack the numbers one would need to infer, let alone to quantify, such harm. But the report of Motorola's expert witness on damages, B. Douglas Bernheim, provides a basis for informed speculation. Suppose hypothetically that a cellphone costs a Motorola foreign subsidiary $100 to manufacture, and the subsidiary sells it to Motorola for $120 to cover the costs of assembling the components that go to make up the cellphone, and of shipment. Motorola in turn resells the cellphone to American consumers for $150. One of the components costs the subsidiary $10 (10 percent of the total cost of the cellphone—this appears to be an approximately accurate estimate for the LCD panels installed in the cellphones). The manufacturers of that component form a cartel and raise the price to $12, a 20 percent increase. Now the cost of making the cellphone is $102, and to reflect this cost increase Motorola could be expected to direct the subsidiary to raise its price to Motorola from $120 to, say, $122. What would Motorola do next? It would like to maintain its profit margin, and so we might expect it to raise its resale price—the price of its cellphones to the American consumer—from $150 to $152. That would be only a 1.33 percent increase. Would Motorola lose sales and therefore profits? Who knows? The price increase is tiny, and competitors might think it more profitable to match it than to undercut it; they might think their sales would not fall appreciably and that their profit margins would be slightly higher. This would be an example of tacit collusion, which is not an antitrust violation.

It is uncertainties like these that confirm the wisdom of the indirect-purchaser doctrine of *Illinois Brick*.

Motorola claims that it told the subsidiaries how much they could pay the cartel sellers for the panels—that its subsidiaries "issued purchase orders at the price and quantity determined by Motorola in the United States" and that therefore Motorola was the real buyer of the panels and so the panels were really imported directly into the United States rather than being sold abroad to the subsidiaries. In other words, Motorola is pretending that its foreign subsidiaries are divisions rather than subsidiaries. But Motorola can't just ignore its corporate structure whenever it's in its interests to do so. It can't pick and choose from the benefits and burdens of United States corporate citizenship. It isn't claiming that its foreign subsidiaries owe taxes to the United States instead of to the foreign countries in which they are incorporated, countries that may have lower tax rates, or be less efficient at tax collection. It isn't claiming that its foreign subsidiaries are bound by the workplace safety or labor laws of the United States. Having chosen to conduct its LCD purchases through legally distinct entities organized under foreign law, it cannot now impute to itself the harm suffered by them.

Motorola insists that it was the "target" of the price fixers—that they "integrated themselves into the design of Motorola's U.S. products, and intentionally manipulated Motorola's price negotiations by illegally exchanging Motorola-specific information." But this is just inflated rhetoric used to describe, what is obvious, that firms engaged in the price fixing of a component are critically interested in the market demand for the finished product—knowledge of that demand is essential to deciding on the optimal price of the component. If the price fixers are too greedy and fix a very high price for the component, this may result in so high a price for the

finished product that the sales of that product will fall and with it the purchases of the component and quite possibly the profits of the price fixers.

Motorola's "target" theory of antitrust liability would nullify the doctrine of *Illinois Brick*. For we've just seen that in deciding how much to charge the direct purchaser, a cartel would always want to estimate the price at which the direct purchaser would resell in order to capture some or all of the resale profits. There is nothing unusual about firms' trying to pass on cost increases to their buyers; the buyers are hurt but as long as *Illinois Brick* is the law their hurt doesn't give them an antitrust case of action. Thus in asking us not to "ignore the injuries defendants knowingly caused to Motorola's U.S. business through their deliveries abroad," Motorola ignores the fact that a cartel almost always *knowingly* causes injury to indirect purchasers, yet those purchasers are barred from suit by *Illinois Brick* and the doctrine of antitrust standing that the rule of that case instantiates.

It's true that the opinion in *Illinois Brick* states that a "situation in which market forces have been superseded and the pass-on defense might be permitted is where the direct purchaser is owned or controlled by its customer." *Id.* at 736 n. 16. But "might be" is not "is," and the distinction is significant in this case. Although Motorola, the "customer," owns its foreign subsidiaries—the "direct purchasers" of the components—they are incorporated under and regulated by foreign law. What remedies they may have, if they overpay for inputs that they buy abroad, are determined not by U.S. antitrust law but by the law of the countries in which the subsidiaries are incorporated and of which they are therefore citizens of, or the law of the countries in which the price fixers they bought from operate, or of the countries in which the purchases were made. And that is quite apart from *Illinois Brick* or other sources of U.S. antitrust law

But supposing this is wrong and Motorola is correct that it and its subsidiaries "are one," there was no sale by the subsidiaries to Motorola. Instead the component manufacturers (the price fixers) sold components to "the one," which assembled them into cellphones, and "the one" sold the cellphones to U.S. consumers. The sales to consumers would therefore have been the first sales in the United States—the first in domestic commerce, since "the one" bought the price-fixed components abroad. Remember that the Foreign Trade Antitrust Improvements Act requires that the effect of an anticompetitive practice on domestic U.S. commerce must, to be subject to the Sherman Act, give rise to an antitrust cause of action. "The one" (Motorola and its foreign subsidiaries conceived of as a single entity) would have been injured abroad when "it" purchased the price-fixed components.

Motorola makes a last attempt to wiggle out from under *Illinois Brick* by arguing that there should be an exception to the indirect-purchaser doctrine for any case in which applying the doctrine would prevent any American company from suing. But Motorola insists that it dictates the price at which it buys cellphones from its subsidiaries, and it would be odd to think that Motorola could obtain antitrust damages on the basis of its own pricing decisions.

In any event Motorola waived in the district court any argument that it could base damages on the effect of the cartel's pricing of components on the cost to Motorola of cellphones incorporating those components. It argued only that its foreign subsidiaries overpaid for the LCD panels. How the overcharge may have affected Motorola's cellphone business because of the component price fixing was a path that Motorola stepped off of after the pleadings. Its *complaint* alleged that it paid more for cellphones that it purchased from its subsidiaries, but it then dropped the point in favor of arguing (as it did for example in a brief opposing summary judgment) that "this 'effect'—the approval of a single, artificially-inflated LCD panel price in the

United States—proximately caused all of Motorola's damages, because that same artificially-inflated price applied wherever and whenever a Motorola facility placed a purchase order and paid for a panel." But Motorola's damages expert, Bernheim, discussed only the damages that Motorola's foreign subsidiaries incurred from having to overpay for LCD panels. He made no attempt to estimate the increase in the price paid by Motorola for finished cellphones. Motorola even refused to respond to one of the defendants' requests for an admission by saying: "Motorola is not basing its claims on the purchase of finished LCD Products [i.e., cellphones]."

There is still more that is wrong with Motorola's case. Nothing is more common nowadays than for products imported to the United States to include components that the producers bought from foreign manufacturers. Even Motorola acknowledges "that a substantial percentage of U.S. manufacturers utilize global supply chains and foreign subsidiaries to effectively compete in the global economy." Some of those foreign manufacturers are located in countries that do not have or, more commonly, do not enforce antitrust laws consistently or uniformly, or whose antitrust laws are more lenient than ours, especially when it comes to remedies, notably punitive damages (such as the treble-damages antitrust remedy authorized by section 4 of the Clayton Act, 15 U.S.C. § 15). As a result, the prices of many products exported to the United States doubtless are elevated to some extent by price fixing or other anticompetitive acts that would be punished in proceedings under the Sherman Act if committed in the United States. Motorola argues that "the district court's ruling would allow foreign cartelists to come to the United States" and "unfairly overcharge U.S. manufacturers." Not true; the defendants did not sell in the United States and, if they were overcharging, they were overcharging other foreign manufacturers—the Motorola subsidiaries.

The Supreme Court has warned that rampant extraterritorial application of U.S. law "creates a serious risk of interference with a foreign nation's ability independently to regulate its own commercial affairs." *F. Hoffmann-La Roche Ltd. v. Empagran S.A., supra*, 542 U.S. at 165. The Foreign Trade Antitrust Improvements Act has been interpreted to prevent such "unreasonable interference with the sovereign authority of other nations." *Id.* at 164. The position for which Motorola contends would if adopted enormously increase the global reach of the Sherman Act, creating friction with many foreign countries and "resent[ment at] the apparent effort of the United States to act as the world's competition police officer," a primary concern motivating the Foreign Trade Antitrust Improvements Act. *United Phosphorus, Ltd. v. Angus Chemical Co.*, 322 F.3d 942, 960-62 (7th Cir. 2003) (en banc) (dissenting opinion), overruled on other grounds by *Minn-Chem, Inc. v. Agrium, Inc., supra*. It is a concern to which Motorola is—albeit for understandable financial reasons—oblivious.

Motorola's foreign subsidiaries were injured in foreign commerce—in dealings with other foreign companies—and to give Motorola rights to take the place of its foreign companies and sue on their behalf under U.S. antitrust law would be an unjustified interference with the right of foreign nations to regulate their own economies. The foreign subsidiaries can sue under foreign law—are we to *presume* the inadequacy of the antitrust laws of our foreign allies? Would such a presumption be consistent with international comity, or more concretely with good relations with allied nations in a world in turmoil? To quote from the *Empagran* opinion again, "Why should American law supplant, for example, Canada's or Great Britain's or Japan's own determination about how best to protect Canadian or British or Japanese customers from anticompetitive conduct engaged in significant part by Canadian or British or Japanese or other foreign companies?" 542 U.S. at 165.

So Motorola's suit has no merit, but it remains to note the amicus curiae brief filed by the Justice Department with endorsements by officials from the FTC, the State Department, and the Department of Commerce. Although an earlier such brief had urged us to vacate our original decision (which we did), and we assumed the Department wanted us to reverse the district court's grant of partial summary judgment in favor of the defendants, there is no such contention in its present brief. It asks us only to "hold that the conspiracy to fix the price of LCD panels had a direct, substantial, and reasonably foreseeable effect on U.S. import and domestic commerce in cellphones incorporating these panels." The brief argues that the criminal and injunctive provisions of the Sherman Act, which of course are provisions that the Justice Department enforces, are applicable to the conduct of the defendants. The brief is less than sanguine on whether Motorola can obtain damages. The indirect-purchaser doctrine is applicable only to damages suits, and the brief disclaims taking any position on the applicability of the doctrine to this case. It goes so far as to say that "permitting Motorola to recover on all its claims because it purchased some panels in import commerce would allow recovery for independently caused foreign injuries on the basis of happenstance."

All that the government wants from us is a disclaimer that a ruling against Motorola would interfere with criminal and injunctive remedies sought by the government against antitrust violations by foreign companies. The government's concern relates to the requirement of the Foreign Trade Antitrust Improvements Act that foreign anticompetitive conduct have a direct, substantial, and reasonably foreseeable effect on domestic U.S. commerce to be actionable under the Sherman Act. If price fixing by the component manufacturers had the requisite statutory effect on cellphone prices in the United States, the Act would not block the Department of Justice from seeking criminal or injunctive remedies. Indeed, we noted earlier that the Department successfully prosecuted AU Optronics for criminal price-fixing of the LCD panels sold to Motorola's foreign subsidiaries. But the Department does not suggest that the defendants' conduct gave rise to an antitrust damages remedy for Motorola.

Motorola has lost its best friend.

That's something of a surprise but a bigger surprise, given that representatives of the State and Commerce Departments have signed on to the Justice Department's brief, is the absence of any but glancing references to the concerns that our foreign allies have expressed with rampant extraterritorial enforcement of our antitrust laws. We asked the government's lawyer at the oral argument about those concerns, and he replied that the Justice Department has worked out a modus vivendi with foreign countries regarding the Department's antitrust proceedings against foreign companies. We have no reason to doubt this. Again private damages actions went unmentioned.

The United States has entered into bilateral cooperation agreements with the European Union, and with Canada and other countries. Both the Justice Department and the Federal Trade Commission now work with their foreign counterparts in major antitrust cases. No longer is the United States "the world's competition policeman," as it used to be called, because other nations have stricter antitrust laws, in some respects, than ours. Motorola's inability to mount the kind of private antitrust suit that it is attempting in this case does not foredoom the use of antitrust law to prevent and punish the kind of foreign cartelization harmful to Motorola's subsidiaries. The Justice Department, at least, seems confident that effective governmental remedies remain—and, as mentioned, the Department was successful in its criminal prosecution against AU Optronics for conduct that Motorola seeks, improperly as we believe, to recover damages for in this case.

Of course Motorola wants damages for its subsidiaries, rather than just a cessation of the cartel activities that are hurting them. And foreign antitrust laws rarely authorize private damages actions. But as we said earlier, that's just to say that Motorola is asserting a right to forum shop; that if some foreign country in which one of its subsidiaries operates happened to provide a more generous private damages remedy than American antitrust law provides, Motorola would direct that subsidiary to seek that remedy in that country. ***

The district court's grant of partial summary judgment in favor of the defendants is AFFIRMED.

United States v. Microsoft Corp.

253 F.3d 34 (D.C. Cir. 2001)

PER CURIAM: Microsoft Corporation appeals from judgments of the District Court finding the company in violation of § § 1 and 2 of the Sherman Act and ordering various remedies.

The action against Microsoft arose pursuant to a complaint filed by the United States and separate complaints filed by individual States. The District Court determined that Microsoft had maintained a monopoly in the market for Intel-compatible PC operating systems in violation of § 2; attempted to gain a monopoly in the market for internet browsers in violation of § 2; and illegally tied two purportedly separate products, Windows and Internet Explorer ("IE"), in violation of § 1. *United States v. Microsoft Corp.*, 87 F.Supp.2d 30 (D.D.C. 2000) ("Conclusions of Law"). The District Court then found that the same facts that established liability under § § 1 and 2 of the Sherman Act mandated findings of liability under analogous state law antitrust provisions. *Id.* To remedy the Sherman Act violations, the District Court issued a Final Judgment requiring Microsoft to submit a proposed plan of divestiture, with the company to be split into an operating systems business and an applications business. *United States v. Microsoft Corp.*, 97 F.Supp.2d 59, 64-65 (D.D.C. 2000) ("Final Judgment"). The District Court's remedial order also contains a number of interim restrictions on Microsoft's conduct.

*** After carefully considering the voluminous record on appeal—including the District Court's *Findings of Fact* and *Conclusions of Law*, the testimony and exhibits submitted at trial, the parties' briefs, and the oral arguments before this court—we find that some but not all of Microsoft's liability challenges have merit. Accordingly, we affirm in part and reverse in part the District Court's judgment that Microsoft violated § 2 of the Sherman Act by employing anticompetitive means to maintain a monopoly in the operating system market; we reverse the District Court's determination that Microsoft violated § 2 of the Sherman Act by illegally attempting to monopolize the internet browser market; and we remand the District Court's finding that Microsoft violated § 1 of the Sherman Act by unlawfully tying its browser to its operating system. Our judgment extends to the District Court's findings with respect to the state law counterparts of the plaintiffs' Sherman Act claims.

We also find merit in Microsoft's challenge to the Final Judgment embracing the District Court's remedial order. There are several reasons supporting this conclusion. First, the District Court's Final Judgment rests on a number of liability determinations that do not survive appellate review; therefore, the remedial order as currently fashioned cannot stand. Furthermore, we would vacate and remand the remedial order even were we to uphold the District Court's liability determinations in their entirety, because the District Court failed to hold an evidentiary hearing to address remedies specific factual disputes.

Finally, we vacate the Final Judgment on remedies, because the trial judge engaged in impermissible ex parte contacts by holding secret interviews with members of the media and made numerous offensive comments about Microsoft officials in public statements outside of the courtroom, giving rise to an appearance of partiality. Although we find no evidence of actual bias, we hold that the actions of the trial judge seriously tainted the proceedings before the District Court and called into question the integrity of the judicial process. We are therefore constrained to vacate the Final Judgment on remedies, remand the case for reconsideration of the remedial order, and require that the case be assigned to a different trial judge on remand. We believe that this disposition will be adequate to cure the cited improprieties.

In sum, for reasons more fully explained below, we affirm in part, reverse in part, and remand in part the District Court's judgment assessing liability. We vacate in full the Final Judgment

embodying the remedial order and remand the case to a different trial judge for further proceedings consistent with this opinion.

I. INTRODUCTION

A. Background

In July 1994, officials at the Department of Justice ("DOJ"), on behalf of the United States, filed suit against Microsoft, charging the company with, among other things, unlawfully maintaining a monopoly in the operating system market through anticompetitive terms in its licensing and software developer agreements. The parties subsequently entered into a consent decree, thus avoiding a trial on the merits. See *United States v. Microsoft Corp.*, 56 F.3d 1448 (D.C. Cir. 1995) ("Microsoft I"). Three years later, the Justice Department filed a civil contempt action against Microsoft for allegedly violating one of the decree's provisions. On appeal from a grant of a preliminary injunction, this court held that Microsoft's technological bundling of IE 3.0 and 4.0 with Windows 95 did not violate the relevant provision of the consent decree. *United States v. Microsoft Corp.*, 147 F.3d 935 (D.C. Cir. 1998) ("Microsoft II"). We expressly reserved the question whether such bundling might independently violate § § 1 or 2 of the Sherman Act.

On May 18, 1998, shortly before issuance of the *Microsoft II* decision, the United States and a group of State plaintiffs filed separate (and soon thereafter consolidated) complaints, asserting antitrust violations by Microsoft and seeking preliminary and permanent injunctions against the company's allegedly unlawful conduct. ***

II. MONOPOLIZATION

Section 2 of the Sherman Act makes it unlawful for a firm to "monopolize." 15 U.S.C. § 2. The offense of monopolization has two elements: "(1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966). The District Court applied this test and found that Microsoft possesses monopoly power in the market for Intel-compatible PC operating systems. Focusing primarily on Microsoft's efforts to suppress Netscape Navigator's threat to its operating system monopoly, the court also found that Microsoft maintained its power not through competition on the merits, but through unlawful means. Microsoft challenges both conclusions.

*** We begin by considering whether Microsoft possesses monopoly power, *see infra* Section II.A, and finding that it does, we turn to the question whether it maintained this power through anticompetitive means. Agreeing with the District Court that the company behaved anticompetitively, *see infra* Section II.B, and that these actions contributed to the maintenance of its monopoly power, *see infra* Section II.C, we affirm the court's finding of liability for monopolization.

A. Monopoly Power

While merely possessing monopoly power is not itself an antitrust violation, it is a necessary element of a monopolization charge. The Supreme Court defines monopoly power as "the power to control prices or exclude competition." *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956). More precisely, a firm is a monopolist if it can profitably raise prices substantially above the competitive level. Where evidence indicates that a firm has in fact profitably done so, the existence of monopoly power is clear. Because such direct proof is only

rarely available, courts more typically examine market structure in search of circumstantial evidence of monopoly power. Under this structural approach, monopoly power may be inferred from a firm's possession of a dominant share of a relevant market that is protected by entry barriers. "Entry barriers" are factors (such as certain regulatory requirements) that prevent new rivals from timely responding to an increase in price above the competitive level.

The District Court considered these structural factors and concluded that Microsoft possesses monopoly power in a relevant market. Defining the market as Intel-compatible PC operating systems, the District Court found that Microsoft has a greater than 95% share. It also found the company's market position protected by a substantial entry barrier. ***

1. Market Structure

a. Market definition

"Because the ability of consumers to turn to other suppliers restrains a firm from raising prices above the competitive level," *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 218 (D.C. Cir. 1986), the relevant market must include all products "reasonably interchangeable by consumers for the same purposes." *du Pont*, 351 U.S. at 395. In this case, the District Court defined the market as "the licensing of all Intel-compatible PC operating systems worldwide," finding that there are "currently no products—and ... there are not likely to be any in the near future—that a significant percentage of computer users worldwide could substitute for [these operating systems] without incurring substantial costs." *Conclusions of Law*, at 36. Calling this market definition "far too narrow," Microsoft argues that the District Court improperly excluded three types of products: non-Intel compatible operating systems (primarily Apple's Macintosh operating system, Mac OS), operating systems for non-PC devices (such as handheld computers and portal websites), and "middleware" products, which are not operating systems at all.

We begin with Mac OS. Microsoft's argument that Mac OS should have been included in the relevant market suffers from a flaw that infects many of the company's monopoly power claims: the company fails to challenge the District Court's factual findings, or to argue that these findings do not support the court's conclusions. The District Court found that consumers would not switch from Windows to Mac OS in response to a substantial price increase because of the costs of acquiring the new hardware needed to run Mac OS (an Apple computer and peripherals) and compatible software applications, as well as because of the effort involved in learning the new system and transferring files to its format. *** Microsoft neither points to evidence contradicting the District Court's findings nor alleges that supporting record evidence is insufficient. And since Microsoft does not argue that even if we accept these findings, they do not support the District Court's conclusion, we have no basis for upsetting the court's decision to exclude Mac OS from the relevant market.

Microsoft's challenge to the District Court's exclusion of non-PC based competitors, such as information appliances (handheld devices, etc.) and portal websites that host serverbased software applications, suffers from the same defect: the company fails to challenge the District Court's key factual findings. *** Again, because Microsoft does not argue that the District Court's findings do not support its conclusion that information appliances and portal websites are outside the relevant market, we adhere to that conclusion.

This brings us to Microsoft's main challenge to the District Court's market definition: the exclusion of middleware. Because of the importance of middleware to this case, we pause to explain what it is and how it relates to the issue before us.

Operating systems perform many functions, including allocating computer memory and controlling peripherals such as printers and keyboards. Operating systems also function as platforms for software applications. They do this by "exposing"—*i.e.,* making available to software developers—routines or protocols that perform certain widely-used functions. These are known as Application Programming Interfaces, or "APIs." For example, Windows contains an API that enables users to draw a box on the screen. Software developers wishing to include that function in an application need not duplicate it in their own code. Instead, they can "call"—*i.e.,* use—the Windows API. Windows contains thousands of APIs, controlling everything from data storage to font display.

Every operating system has different APIs. Accordingly, a developer who writes an application for one operating system and wishes to sell the application to users of another must modify, or "port," the application to the second operating system. This process is both timeconsuming and expensive.

"Middleware" refers to software products that expose their own APIs. Because of this, a middleware product written for Windows could take over some or all of Windows's valuable platform functions—that is, developers might begin to rely upon APIs exposed by the middleware for basic routines rather than relying upon the API set included in Windows. If middleware were written for multiple operating systems, its impact could be even greater. The more developers could rely upon APIs exposed by such middleware, the less expensive porting to different operating systems would be. Ultimately, if developers could write applications relying exclusively on APIs exposed by middleware, their applications would run on any operating system on which the middleware was also present. Netscape Navigator and Java—both at issue in this case—are middleware products written for multiple operating systems.

Microsoft argues that, because middleware could usurp the operating system's platform function and might eventually take over other operating system functions (for instance, by controlling peripherals), the District Court erred in excluding Navigator and Java from the relevant market. The District Court found, however, that neither Navigator, Java, nor any other middleware product could now, or would soon, expose enough APIs to serve as a platform for popular applications, much less take over all operating system functions. Again, Microsoft fails to challenge these findings, instead simply asserting middleware's "potential" as a competitor. The test of reasonable interchangeability, however, required the District Court to consider only substitutes that constrain pricing in the reasonably foreseeable future, and only products that can enter the market in a relatively short time can perform this function. Whatever middleware's ultimate potential, the District Court found that consumers could not now abandon their operating systems and switch to middleware in response to a sustained price for Windows above the competitive level. Nor is middleware likely to overtake the operating system as the primary platform for software development any time in the near future. ***

b. Market power

Having thus properly defined the relevant market, the District Court found that Windows accounts for a greater than 95% share. The court also found that even if Mac OS were included, Microsoft's share would exceed 80%. Microsoft challenges neither finding, nor does it argue that such a market share is not predominant. Cf. *Grinnell*, 384 U.S. at 571 (87% is predominant);

Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 481 (1992) (80%); *du Pont*, 351 U.S. at 379 (75%).

Instead, Microsoft claims that even a predominant market share does not by itself indicate monopoly power. *** In this case, however, the District Court was not misled. Considering the possibility of new rivals, the court focused not only on Microsoft's present market share, but also on the structural barrier that protects the company's future position. That barrier—the "applications barrier to entry"—stems from two characteristics of the software market: (1) most consumers prefer operating systems for which a large number of applications have already been written; and (2) most developers prefer to write for operating systems that already have a substantial consumer base. This "chicken-and-egg" situation ensures that applications will continue to be written for the already dominant Windows, which in turn ensures that consumers will continue to prefer it over other operating systems. ***

Microsoft does not dispute that Windows supports many more applications than any other operating system. It argues instead that "[i]t defies common sense" to suggest that an operating system must support as many applications as Windows does (more than 70,000, according to the District Court, *id.* § 40) to be competitive. Consumers, Microsoft points out, can only use a very small percentage of these applications. As the District Court explained, however, the applications barrier to entry gives consumers reason to prefer the dominant operating system even if they have no need to use all applications written for it:

> The consumer wants an operating system that runs not only types of applications that he knows he will want to use, but also those types in which he might develop an interest later. Also, the consumer knows that if he chooses an operating system with enough demand to support multiple applications in each product category, he will be less likely to find himself straitened later by having to use an application whose features disappoint him. Finally, the average user knows that, generally speaking, applications improve through successive versions. He thus wants an operating system for which successive generations of his favorite applications will be released—promptly at that. The fact that a vastly larger number of applications are written for Windows than for other PC operating systems attracts consumers to Windows, because it reassures them that their interests will be met as long as they use Microsoft's product.

Findings of Fact § 37. Thus, despite the limited success of its rivals, Microsoft benefits from the applications barrier to entry. ***

Microsoft next argues that the applications barrier to entry is not an entry barrier at all, but a reflection of Windows' popularity. It is certainly true that Windows may have gained its initial dominance in the operating system market competitively—through superior foresight or quality. But this case is not about Microsoft's initial acquisition of monopoly power. It is about Microsoft's efforts to maintain this position through means other than competition on the merits. Because the applications barrier to entry protects a dominant operating system irrespective of quality, it gives Microsoft power to stave off even superior new rivals. The barrier is thus a characteristic of the operating system market, not of Microsoft's popularity, or, as asserted by a Microsoft witness, the company's efficiency.

Finally, Microsoft argues that the District Court should not have considered the applications barrier to entry because it reflects not a cost borne disproportionately by new entrants, but one borne by all participants in the operating system market. According to Microsoft, it had to make major investments to convince software developers to write for its new operating system, and it continues to "evangelize" the Windows platform today. Whether costs borne by all market

participants should be considered entry barriers is the subject of much debate. We need not resolve this issue, however, for even under the more narrow definition it is clear that there are barriers. When Microsoft entered the operating system market with MS-DOS and the first version of Windows, it did not confront a dominant rival operating system with as massive an installed base and as vast an existing array of applications as the Windows operating systems have since enjoyed. Moreover, when Microsoft introduced Windows 95 and 98, it was able to bypass the applications barrier to entry that protected the incumbent Windows by including APIs from the earlier version in the new operating systems. See *id.* § 44. This made porting existing Windows applications to the new version of Windows much less costly than porting them to the operating systems of other entrants who could not freely include APIs from the incumbent Windows with their own.

2. Direct Proof

Having sustained the District Court's conclusion that circumstantial evidence proves that Microsoft possesses monopoly power, we turn to Microsoft's alternative argument that it does not behave like a monopolist. Claiming that software competition is uniquely "dynamic," Appellant's Opening Br. at 84 (quoting *Findings of Fact* § 59), the company suggests a new rule: that monopoly power in the software industry should be proven directly, that is, by examining a company's actual behavior to determine if it reveals the existence of monopoly power. According to Microsoft, not only does no such proof of its power exist, but record evidence demonstrates the absence of monopoly power. The company claims that it invests heavily in research and development, *id.* at 88-89 (citing Direct Testimony of Paul Maritz § 155, reprinted in 6 J.A. at 3698 (testifying that Microsoft invests approximately 17% of its revenue in R&D)), and charges a low price for Windows (a small percentage of the price of an Intel-compatible PC system and less than the price of its rivals, *id.* at 90 (citing *Findings of Fact* § § 19, 21, 46)).

Microsoft's argument fails because, even assuming that the software market is uniquely dynamic in the long term, the District Court correctly applied the structural approach to determine if the company faces competition in the short term. Structural market power analyses are meant to determine whether potential substitutes constrain a firm's ability to raise prices above the competitive level; only threats that are likely to materialize in the relatively near future perform this function to any significant degree. The District Court expressly considered and rejected Microsoft's claims that innovations such as handheld devices and portal websites would soon expand the relevant market beyond Intel-compatible PC operating systems. Because the company does not challenge these findings, we have no reason to believe that prompt substitutes are available. The structural approach, as applied by the District Court, is thus capable of fulfilling its purpose even in a changing market. Microsoft cites no case, nor are we aware of one, requiring direct evidence to show monopoly power in any market. We decline to adopt such a rule now. ***

B. Anticompetitive Conduct

As discussed above, having a monopoly does not by itself violate § 2. A firm violates § 2 only when it acquires or maintains, or attempts to acquire or maintain, a monopoly by engaging in exclusionary conduct "as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident." *Grinnell*, 384 U.S. at 571; see also *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 430 (2d Cir. 1945) (Hand, J.) ("The successful competitor, having been urged to compete, must not be turned upon when he wins.").

In this case, after concluding that Microsoft had monopoly power, the District Court held that Microsoft had violated § 2 by engaging in a variety of exclusionary acts (not including predatory pricing), to maintain its monopoly by preventing the effective distribution and use of products that might threaten that monopoly. Specifically, the District Court held Microsoft liable for: (1) the way in which it integrated IE into Windows; (2) its various dealings with Original Equipment Manufacturers ("OEMs"), Internet Access Providers ("IAPs"), Internet Content Providers ("ICPs"), Independent Software Vendors ("ISVs"), and Apple Computer; (3) its efforts to contain and to subvert Java technologies; and (4) its course of conduct as a whole. Upon appeal, Microsoft argues that it did not engage in any exclusionary conduct.

Whether any particular act of a monopolist is exclusionary, rather than merely a form of vigorous competition, can be difficult to discern: the means of illicit exclusion, like the means of legitimate competition, are myriad. The challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts, which reduce social welfare, and competitive acts, which increase it.

From a century of case law on monopolization under § 2, however, several principles do emerge. First, to be condemned as exclusionary, a monopolist's act must have an "anticompetitive effect." That is, it must harm the competitive process and thereby harm consumers. In contrast, harm to one or more competitors will not suffice. "The [Sherman Act] directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself." *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 458 (1993).

Second, the plaintiff, on whom the burden of proof of course rests must demonstrate that the monopolist's conduct indeed has the requisite anticompetitive effect. In a case brought by a private plaintiff, the plaintiff must show that its injury is "of 'the type that the statute was intended to forestall,'" *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 487-88 (1977) (quoting *Wyandotte Transp. v. United States*, 389 U.S. 191, 202 (1967)); no less in a case brought by the Government, it must demonstrate that the monopolist's conduct harmed competition, not just a competitor.

Third, if a plaintiff successfully establishes a prima facie case under § 2 by demonstrating anticompetitive effect, then the monopolist may proffer a "procompetitive justification" for its conduct. See *Eastman Kodak*, 504 U.S. at 483. If the monopolist asserts a procompetitive justification—a nonpretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal—then the burden shifts back to the plaintiff to rebut that claim.

Fourth, if the monopolist's procompetitive justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit. In cases arising under § 1 of the Sherman Act, the courts routinely apply a similar balancing approach under the rubric of the "rule of reason." ***

Finally, in considering whether the monopolist's conduct on balance harms competition and is therefore condemned as exclusionary for purposes of § 2, our focus is upon the effect of that conduct, not upon the intent behind it. Evidence of the intent behind the conduct of a monopolist is relevant only to the extent it helps us understand the likely effect of the monopolist's conduct. ***

With these principles in mind, we now consider Microsoft's objections to the District Court's holding that Microsoft violated § 2 of the Sherman Act in a variety of ways.

1. Licenses Issued to Original Equipment Manufacturers

The District Court condemned a number of provisions in Microsoft's agreements licensing Windows to OEMs, because it found that Microsoft's imposition of those provisions (like many of Microsoft's other actions at issue in this case) serves to reduce usage share of Netscape's browser and, hence, protect Microsoft's operating system monopoly. The reason market share in the browser market affects market power in the operating system market is complex, and warrants some explanation.

Browser usage share is important because, as we explained in Section II.A above, a browser (or any middleware product, for that matter) must have a critical mass of users in order to attract software developers to write applications relying upon the APIs it exposes, and away from the APIs exposed by Windows. Applications written to a particular browser's APIs, however, would run on any computer with that browser, regardless of the underlying operating system. "The overwhelming majority of consumers will only use a PC operating system for which there already exists a large and varied set of ... applications, and for which it seems relatively certain that new types of applications and new versions of existing applications will continue to be marketed...." *Findings of Fact* § 30. If a consumer could have access to the applications he desired—regardless of the operating system he uses—simply by installing a particular browser on his computer, then he would no longer feel compelled to select Windows in order to have access to those applications; he could select an operating system other than Windows based solely upon its quality and price. In other words, the market for operating systems would be competitive.

Therefore, Microsoft's efforts to gain market share in one market (browsers) served to meet the threat to Microsoft's monopoly in another market (operating systems) by keeping rival browsers from gaining the critical mass of users necessary to attract developer attention away from Windows as the platform for software development. Plaintiffs also argue that Microsoft's actions injured competition in the browser market—an argument we will examine below in relation to their specific claims that Microsoft attempted to monopolize the browser market and unlawfully tied its browser to its operating system so as to foreclose competition in the browser market. In evaluating the § 2 monopoly maintenance claim, however, our immediate concern is with the anticompetitive effect of Microsoft's conduct in preserving its monopoly in the operating system market.

In evaluating the restrictions in Microsoft's agreements licensing Windows to OEMs, we first consider whether plaintiffs have made out a prima facie case by demonstrating that the restrictions have an anticompetitive effect. In the next subsection, we conclude that plaintiffs have met this burden as to all the restrictions. We then consider Microsoft's proffered justifications for the restrictions and, for the most part, hold those justifications insufficient.

a. Anticompetitive effect of the license restrictions

The restrictions Microsoft places upon Original Equipment Manufacturers are of particular importance in determining browser usage share because having an OEM pre-install a browser on a computer is one of the two most cost-effective methods by far of distributing browsing software. (The other is bundling the browser with internet access software distributed by an IAP.) The District Court found that the restrictions Microsoft imposed in licensing Windows to OEMs prevented many OEMs from distributing browsers other than IE. In particular, the District Court condemned the license provisions prohibiting the OEMs from: (1) removing any

desktop icons, folders, or "Start" menu entries; (2) altering the initial boot sequence; and (3) otherwise altering the appearance of the Windows desktop.

The District Court concluded that the first license restriction—the prohibition upon the removal of desktop icons, folders, and Start menu entries—thwarts the distribution of a rival browser by preventing OEMs from removing visible means of user access to IE. The OEMs cannot practically install a second browser in addition to IE, the court found, in part because "[p]re-installing more than one product in a given category ... can significantly increase an OEM's support costs, for the redundancy can lead to confusion among novice users." That is, a certain number of novice computer users, seeing two browser icons, will wonder which to use when and will call the OEM's support line. Support calls are extremely expensive and, in the highly competitive original equipment market, firms have a strong incentive to minimize costs.

Microsoft denies the "consumer confusion" story; it observes that some OEMs do install multiple browsers and that executives from two OEMs that do so denied any knowledge of consumers being confused by multiple icons. *** Other testimony, however, supports the District Court's finding that fear of such confusion deters many OEMs from pre-installing multiple browsers. Accordingly, we reject Microsoft's argument that we should vacate the District Court's *Finding of Fact* 159 as it relates to consumer confusion.

As noted above, the OEM channel is one of the two primary channels for distribution of browsers. By preventing OEMs from removing visible means of user access to IE, the license restriction prevents many OEMs from pre-installing a rival browser and, therefore, protects Microsoft's monopoly from the competition that middleware might otherwise present. Therefore, we conclude that the license restriction at issue is anticompetitive. We defer for the moment the question whether that anticompetitive effect is outweighed by Microsoft's proffered justifications.

The second license provision at issue prohibits OEMs from modifying the initial boot sequence—the process that occurs the first time a consumer turns on the computer. Prior to the imposition of that restriction, "among the programs that many OEMs inserted into the boot sequence were Internet sign-up procedures that encouraged users to choose from a list of IAPs assembled by the OEM." Microsoft's prohibition on any alteration of the boot sequence thus prevents OEMs from using that process to promote the services of IAPs, many of which—at least at the time Microsoft imposed the restriction—used Navigator rather than IE in their internet access software. Microsoft does not deny that the prohibition on modifying the boot sequence has the effect of decreasing competition against IE by preventing OEMs from promoting rivals' browsers. Because this prohibition has a substantial effect in protecting Microsoft's market power, and does so through a means other than competition on the merits, it is anticompetitive. Again the question whether the provision is nonetheless justified awaits later treatment.

Finally, Microsoft imposes several additional provisions that, like the prohibition on removal of icons, prevent OEMs from making various alterations to the desktop: Microsoft prohibits OEMs from causing any user interface other than the Windows desktop to launch automatically, from adding icons or folders different in size or shape from those supplied by Microsoft, and from using the "Active Desktop" feature to promote third-party brands. These restrictions impose significant costs upon the OEMs; prior to Microsoft's prohibiting the practice, many OEMs would change the appearance of the desktop in ways they found beneficial.

The dissatisfaction of the OEM customers does not, of course, mean the restrictions are anticompetitive. The anticompetitive effect of the license restrictions is, as Microsoft itself recognizes, that OEMs are not able to promote rival browsers, which keeps developers focused upon the APIs in Windows. This kind of promotion is not a zero-sum game; but for the restrictions in their licenses to use Windows, OEMs could promote multiple IAPs and browsers. By preventing the OEMs from doing so, this type of license restriction, like the first two restrictions, is anticompetitive: Microsoft reduced rival browsers' usage share not by improving its own product but, rather, by preventing OEMs from taking actions that could increase rivals' share of usage.

b. Microsoft's justifications for the license restrictions

Microsoft argues that the license restrictions are legally justified because, in imposing them, Microsoft is simply "exercising its rights as the holder of valid copyrights." Microsoft also argues that the licenses "do not unduly restrict the opportunities of Netscape to distribute Navigator in any event."

Microsoft's primary copyright argument borders upon the frivolous. The company claims an absolute and unfettered right to use its intellectual property as it wishes: "[I]f intellectual property rights have been lawfully acquired," it says, then "their subsequent exercise cannot give rise to antitrust liability." Appellant's Opening Br. at 105. That is no more correct than the proposition that use of one's personal property, such as a baseball bat, cannot give rise to tort liability. As the Federal Circuit succinctly stated: "Intellectual property rights do not confer a privilege to violate the antitrust laws." *In re Indep. Serv. Orgs. Antitrust Litig.*, 203 F.3d 1322, 1325 (Fed. Cir. 2000). ***

The only license restriction Microsoft seriously defends as necessary to prevent a "substantial alteration" of its copyrighted work is the prohibition on OEMs automatically launching a substitute user interface upon completion of the boot process. We agree that a shell that automatically prevents the Windows desktop from ever being seen by the user is a drastic alteration of Microsoft's copyrighted work, and outweighs the marginal anticompetitive effect of prohibiting the OEMs from substituting a different interface automatically upon completion of the initial boot process. We therefore hold that this particular restriction is not an exclusionary practice that violates § 2 of the Sherman Act. ***

Apart from copyright, Microsoft raises one other defense of the OEM license agreements: It argues that, despite the restrictions in the OEM license, Netscape is not completely blocked from distributing its product. That claim is insufficient to shield Microsoft from liability for those restrictions because, although Microsoft did not bar its rivals from all means of distribution, it did bar them from the cost-efficient ones.

In sum, we hold that with the exception of the one restriction prohibiting automatically launched alternative interfaces, all the OEM license restrictions at issue represent uses of Microsoft's market power to protect its monopoly, unredeemed by any legitimate justification. The restrictions therefore violate § 2 of the Sherman Act.

2. Integration of IE and Windows

Although Microsoft's license restrictions have a significant effect in closing rival browsers out of one of the two primary channels of distribution, the District Court found that "Microsoft's executives believed ... its contractual restrictions placed on OEMs would not be sufficient in

themselves to reverse the direction of Navigator's usage share. Consequently, in late 1995 or early 1996, Microsoft set out to bind [IE] more tightly to Windows 95 as a technical matter."

Technologically binding IE to Windows, the District Court found, both prevented OEMs from pre-installing other browsers and deterred consumers from using them. In particular, having the IE software code as an irremovable part of Windows meant that pre-installing a second browser would "increase an OEM's product testing costs," because an OEM must test and train its support staff to answer calls related to every software product preinstalled on the machine; moreover, pre-installing a browser in addition to IE would to many OEMs be "a questionable use of the scarce and valuable space on a PC's hard drive."

Although the District Court, in its Conclusions of Law, broadly condemned Microsoft's decision to bind "Internet Explorer to Windows with ... technological shackles," its *Findings of Fact* in support of that conclusion center upon three specific actions Microsoft took to weld IE to Windows: excluding IE from the "Add/Remove Programs" utility; designing Windows so as in certain circumstances to override the user's choice of a default browser other than IE; and commingling code related to browsing and other code in the same files, so that any attempt to delete the files containing IE would, at the same time, cripple the operating system. As with the license restrictions, we consider first whether the suspect actions had an anticompetitive effect, and then whether Microsoft has provided a procompetitive justification for them.

a. Anticompetitive effect of integration

As a general rule, courts are properly very skeptical about claims that competition has been harmed by a dominant firm's product design changes. In a competitive market, firms routinely innovate in the hope of appealing to consumers, sometimes in the process making their products incompatible with those of rivals; the imposition of liability when a monopolist does the same thing will inevitably deter a certain amount of innovation. This is all the more true in a market, such as this one, in which the product itself is rapidly changing. Judicial deference to product innovation, however, does not mean that a monopolist's product design decisions are *per se* lawful.

The District Court first condemned as anticompetitive Microsoft's decision to exclude IE from the "Add/Remove Programs" utility in Windows 98. Microsoft had included IE in the Add/Remove Programs utility in Windows 95, but when it modified Windows 95 to produce Windows 98, it took IE out of the Add/Remove Programs utility. This change reduces the usage share of rival browsers not by making Microsoft's own browser more attractive to consumers but, rather, by discouraging OEMs from distributing rival products. Because Microsoft's conduct, through something other than competition on the merits, has the effect of significantly reducing usage of rivals' products and hence protecting its own operating system monopoly, it is anticompetitive; we defer for the moment the question whether it is nonetheless justified.

Second, the District Court found that Microsoft designed Windows 98 "so that using Navigator on Windows 98 would have unpleasant consequences for users" by, in some circumstances, overriding the user's choice of a browser other than IE as his or her default browser. Plaintiffs argue that this override harms the competitive process by deterring consumers from using a browser other than IE even though they might prefer to do so, thereby reducing rival browsers' usage share and, hence, the ability of rival browsers to draw developer attention away from the APIs exposed by Windows. Microsoft does not deny, of course, that overriding the user's preference prevents some people from using other browsers. Because the override reduces rivals' usage share and protects Microsoft's monopoly, it too is anticompetitive.

Finally, the District Court condemned Microsoft's decision to bind IE to Windows 98 "by placing code specific to Web browsing in the same files as code that provided operating system functions." Putting code supplying browsing functionality into a file with code supplying operating system functionality "ensure[s] that the deletion of any file containing browsing-specific routines would also delete vital operating system routines and thus cripple Windows...." As noted above, preventing an OEM from removing IE deters it from installing a second browser because doing so increases the OEM's product testing and support costs; by contrast, had OEMs been able to remove IE, they might have chosen to pre-install Navigator alone.

In view of the contradictory testimony in the record, some of which supports the District Court's finding that Microsoft commingled browsing and non-browsing code, we cannot conclude that the finding was clearly erroneous. Accordingly, we reject Microsoft's argument that we should vacate *Finding of Fact* 159 as it relates to the commingling of code, and we conclude that such commingling has an anticompetitive effect; as noted above, the commingling deters OEMs from pre-installing rival browsers, thereby reducing the rivals' usage share and, hence, developers' interest in rivals' APIs as an alternative to the API set exposed by Microsoft's operating system.

b. Microsoft's justifications for integration

Microsoft proffers no justification for two of the three challenged actions that it took in integrating IE into Windows—excluding IE from the Add/Remove Programs utility and commingling browser and operating system code. *** As for the other challenged act that Microsoft took in integrating IE into Windows—causing Windows to override the user's choice of a default browser in certain circumstances—Microsoft argues that it has "valid technical reasons." Specifically, Microsoft claims that it was necessary to design Windows to override the user's preferences when he or she invokes one of "a few" out "of the nearly 30 means of accessing the Internet." *** The plaintiff bears the burden not only of rebutting a proffered justification but also of demonstrating that the anticompetitive effect of the challenged action outweighs it. In the District Court, plaintiffs appear to have done neither, let alone both; in any event, upon appeal, plaintiffs offer no rebuttal whatsoever. Accordingly, Microsoft may not be held liable for this aspect of its product design.

3. Agreements with Internet Access Providers

The District Court also condemned as exclusionary Microsoft's agreements with various IAPs. The IAPs include both Internet Service Providers, which offer consumers internet access, and Online Services ("OLSs") such as America Online ("AOL"), which offer proprietary content in addition to internet access and other services.***

The District Court condemned Microsoft's actions in (1) offering IE free of charge to IAPs and (2) offering IAPs a bounty for each customer the IAP signs up for service using the IE browser. In effect, the court concluded that Microsoft is acting to preserve its monopoly by offering IE to IAPs at an attractive price. Similarly, the District Court held Microsoft liable for (3) developing the IE Access Kit ("IEAK"), a software package that allows an IAP to "create a distinctive identity for its service in as little as a few hours by customizing the [IE] title bar, icon, start and search pages," and (4) offering the IEAK to IAPs free of charge, on the ground that those acts, too, helped Microsoft preserve its monopoly. Conclusions of Law, at 41-42. Finally, the District Court found that (5) Microsoft agreed to provide easy access to IAPs' services from the Windows desktop in return for the IAPs' agreement to promote IE exclusively and to keep

shipments of internet access software using Navigator under a specific percentage, typically 25%. We address the first four items—Microsoft's inducements—and then its exclusive agreements with IAPs.

Although offering a customer an attractive deal is the hallmark of competition, the Supreme Court has indicated that in very rare circumstances a price may be unlawfully low, or "predatory." Plaintiffs argued before the District Court that Microsoft's pricing was indeed predatory; but instead of making the usual predatory pricing argument—that the predator would drive out its rivals by pricing below cost on a particular product and then, sometime in the future, raise its prices on that product above the competitive level in order to recoup its earlier losses—plaintiffs argued that by pricing below cost on IE (indeed, even paying people to take it), Microsoft was able simultaneously to preserve its stream of monopoly profits on Windows, thereby more than recouping its investment in below-cost pricing on IE. The District Court did not assign liability for predatory pricing, however, and plaintiffs do not press this theory on appeal.

The rare case of price predation aside, the antitrust laws do not condemn even a monopolist for offering its product at an attractive price, and we therefore have no warrant to condemn Microsoft for offering either IE or the IEAK free of charge or even at a negative price. Likewise, as we said above, a monopolist does not violate the Sherman Act simply by developing an attractive product.

We turn now to Microsoft's deals with IAPs concerning desktop placement. Microsoft concluded these exclusive agreements with all "the leading IAPs," including the major OLSs. The most significant of the OLS deals is with AOL, which, when the deal was reached, "accounted for a substantial portion of all existing Internet access subscriptions and ... attracted a very large percentage of new IAP subscribers." Under that agreement Microsoft puts the AOL icon in the OLS folder on the Windows desktop and AOL does not promote any non-Microsoft browser, nor provide software using any non-Microsoft browser except at the customer's request, and even then AOL will not supply more than 15% of its subscribers with a browser other than IE. ***

In this case, plaintiffs challenged Microsoft's exclusive dealing arrangements with the IAPs under both § § 1 and 2 of the Sherman Act. The District Court, in analyzing the § 1 claim, stated, "unless the evidence demonstrates that Microsoft's agreements excluded Netscape altogether from access to roughly forty percent of the browser market, the Court should decline to find such agreements in violation of § 1." The court recognized that Microsoft had substantially excluded Netscape from "the most efficient channels for Navigator to achieve browser usage share," and had relegated it to more costly and less effective methods (such as mass mailing its browser on a disk or offering it for download over the internet); but because Microsoft has not "completely excluded Netscape" from reaching any potential user by some means of distribution, however ineffective, the court concluded the agreements do not violate § 1. Conclusions of Law, at 53. Plaintiffs did not cross-appeal this holding.

Turning to § 2, the court stated: "the fact that Microsoft's arrangements with various [IAPs and other] firms did not foreclose enough of the relevant market to constitute a § 1 violation in no way detracts from the Court's assignment of liability for the same arrangements under § 2. ... [A]ll of Microsoft's agreements, including the non-exclusive ones, severely restricted Netscape's access to those distribution channels leading most efficiently to the acquisition of browser usage share."

On appeal Microsoft argues that "courts have applied the same standard to alleged exclusive dealing agreements under both Section 1 and Section 2," Appellant's Opening Br. at 109, and it argues that the District Court's holding of no liability under § 1 necessarily precludes holding it liable under § 2. The District Court appears to have based its holding with respect to § 1 upon a "total exclusion test" rather than the 40% standard drawn from the caselaw. Even assuming the holding is correct, however, we nonetheless reject Microsoft's contention.

The basic prudential concerns relevant to § § 1 and 2 are admittedly the same: exclusive contracts are commonplace—particularly in the field of distribution—in our competitive, market economy, and imposing upon a firm with market power the risk of an antitrust suit every time it enters into such a contract, no matter how small the effect, would create an unacceptable and unjustified burden upon any such firm. At the same time, however, we agree with plaintiffs that a monopolist's use of exclusive contracts, in certain circumstances, may give rise to a § 2 violation even though the contracts foreclose less than the roughly 40% or 50% share usually required in order to establish a § 1 violation.

In this case, plaintiffs allege that, by closing to rivals a substantial percentage of the available opportunities for browser distribution, Microsoft managed to preserve its monopoly in the market for operating systems. The IAPs constitute one of the two major channels by which browsers can be distributed. Microsoft has exclusive deals with "fourteen of the top fifteen access providers in North America [, which] account for a large majority of all Internet access subscriptions in this part of the world." By ensuring that the "majority" of all IAP subscribers are offered IE either as the default browser or as the only browser, Microsoft's deals with the IAPs clearly have a significant effect in preserving its monopoly; they help keep usage of Navigator below the critical level necessary for Navigator or any other rival to pose a real threat to Microsoft's monopoly.

Plaintiffs having demonstrated a harm to competition, the burden falls upon Microsoft to defend its exclusive dealing contracts with IAPs by providing a procompetitive justification for them. Significantly, Microsoft's only explanation for its exclusive dealing is that it wants to keep developers focused upon its APIs—which is to say, it wants to preserve its power in the operating system market. That is not an unlawful end, but neither is it a procompetitive justification for the specific means here in question, namely exclusive dealing contracts with IAPs. Accordingly, we affirm the District Court's decision holding that Microsoft's exclusive contracts with IAPs are exclusionary devices, in violation of § 2 of the Sherman Act.

4. Dealings with Internet Content Providers, Independent Software Vendors, and Apple Computer

The District Court held that Microsoft engages in exclusionary conduct in its dealings with ICPs, which develop websites; ISVs, which develop software; and Apple, which is both an OEM and a software developer. The District Court condemned Microsoft's deals with ICPs and ISVs, stating: "By granting ICPs and ISVs free licenses to bundle [IE] with their offerings, and by exchanging other valuable inducements for their agreement to distribute, promote[,] and rely on [IE] rather than Navigator, Microsoft directly induced developers to focus on its own APIs rather than ones exposed by Navigator."

With respect to the deals with ICPs, the District Court's findings do not support liability. After reviewing the ICP agreements, the District Court specifically stated that "there is not sufficient evidence to support a finding that Microsoft's promotional restrictions actually had a

substantial, deleterious impact on Navigator's usage share." Because plaintiffs failed to demonstrate that Microsoft's deals with the ICPs have a substantial effect upon competition, they have not proved the violation of the Sherman Act.

As for Microsoft's ISV agreements, however, the District Court did not enter a similar finding of no substantial effect. The District Court described Microsoft's deals with ISVs as follows:

> In dozens of "First Wave" agreements signed between the fall of 1997 and the spring of 1998, Microsoft has promised to give preferential support, in the form of early Windows 98 and Windows NT betas, other technical information, and the right to use certain Microsoft seals of approval, to important ISVs that agree to certain conditions. One of these conditions is that the ISVs use Internet Explorer as the default browsing software for any software they develop with a hypertext-based user interface. Another condition is that the ISVs use Microsoft's "HTML Help," which is accessible only with Internet Explorer, to implement their applications' help systems.

The District Court further found that the effect of these deals is to "ensure [ ] that many of the most popular Web-centric applications will rely on browsing technologies found only in Windows," *id.* § 340, and that Microsoft's deals with ISVs therefore "increase[ ] the likelihood that the millions of consumers using [applications designed by ISVs that entered into agreements with Microsoft] will use Internet Explorer rather than Navigator."

The District Court did not specifically identify what share of the market for browser distribution the exclusive deals with the ISVs foreclose. Although the ISVs are a relatively small channel for browser distribution, they take on greater significance because, as discussed above, Microsoft had largely foreclosed the two primary channels to its rivals. In that light, one can tell from the record that by affecting the applications used by "millions" of consumers, Microsoft's exclusive deals with the ISVs had a substantial effect in further foreclosing rival browsers from the market. *** Because, by keeping rival browsers from gaining widespread distribution (and potentially attracting the attention of developers away from the APIs in Windows), the deals have a substantial effect in preserving Microsoft's monopoly, we hold that plaintiffs have made a prima facie showing that the deals have an anticompetitive effect.

Of course, that Microsoft's exclusive deals have the anticompetitive effect of preserving Microsoft's monopoly does not, in itself, make them unlawful. A monopolist, like a competitive firm, may have a perfectly legitimate reason for wanting an exclusive arrangement with its distributors. Accordingly, Microsoft had an opportunity to, but did not, present the District Court with evidence demonstrating that the exclusivity provisions have some such procompetitive justification. On appeal Microsoft likewise does not claim that the exclusivity required by the deals serves any legitimate purpose; instead, it states only that its ISV agreements reflect an attempt "to persuade ISVs to utilize Internet-related system services in Windows rather than Navigator." As we explained before, however, keeping developers focused upon Windows—that is, preserving the Windows monopoly—is a competitively neutral goal. Microsoft having offered no procompetitive justification for its exclusive dealing arrangements with the ISVs, we hold that those arrangements violate § 2 of the Sherman Act. ***

Finally, the District Court held that Microsoft's dealings with Apple violated the Sherman Act. Apple is vertically integrated: it makes both software (including an operating system, Mac OS), and hardware (the Macintosh line of computers). Microsoft primarily makes software, including, in addition to its operating system, a number of popular applications. One, called "Office," is a suite of business productivity applications that Microsoft has ported to Mac OS. The District

Court found that "ninety percent of Mac OS users running a suite of office productivity applications [use] Microsoft's Mac Office." Further, the District Court found that:

> In 1997, Apple's business was in steep decline, and many doubted that the company would survive much longer.... [M]any ISVs questioned the wisdom of continuing to spend time and money developing applications for the Mac OS. Had Microsoft announced in the midst of this atmosphere that it was ceasing to develop new versions of Mac Office, a great number of ISVs, customers, developers, and investors would have interpreted the announcement as Apple's death notice.

Microsoft recognized the importance to Apple of its continued support of Mac Office.

In June 1997 Microsoft Chairman Bill Gates determined that the company's negotiations with Apple '"have not been going well at all.... Apple let us down on the browser by making Netscape the standard install.' Gates then reported that he had already called Apple's CEO ... to ask 'how we should announce the cancellation of Mac Office....'" The District Court further found that, within a month of Gates' call, Apple and Microsoft had reached an agreement pursuant to which

> Microsoft's primary obligation is to continue releasing up-to-date versions of Mac Office for at least five years.... [and] Apple has agreed ... to "bundle the most current version of [IE] ... with [Mac OS]"... [and to] "make [IE] the default [browser]".... Navigator is not installed on the computer hard drive during the default installation, which is the type of installation most users elect to employ.... [The] Agreement further provides that ... Apple may not position icons for nonMicrosoft browsing software on the desktop of new Macintosh PC systems or Mac OS upgrades.

The agreement also prohibits Apple from encouraging users to substitute another browser for IE, and states that Apple will "encourage its employees to use [IE]."

*** Because Microsoft's exclusive contract with Apple has a substantial effect in restricting distribution of rival browsers, and because (as we have described several times above) reducing usage share of rival browsers serves to protect Microsoft's monopoly, its deal with Apple must be regarded as anticompetitive. Microsoft offers no procompetitive justification for the exclusive dealing arrangement. It makes only the irrelevant claim that the IE-for-Mac Office deal is part of a multifaceted set of agreements between itself and Apple, see Appellant's Opening Br. at 61 ("Apple's 'browsing software' obligation was [not] the quid pro quo for Microsoft's Mac Office obligation[;] ... all of the various obligations ... were part of one 'overall agreement' between the two companies."); that does not mean it has any procompetitive justification. Accordingly, we hold that the exclusive deal with Apple is exclusionary, in violation of § 2 of the Sherman Act.

5. Java

Java, a set of technologies developed by Sun Microsystems, is another type of middleware posing a potential threat to Windows' position as the ubiquitous platform for software development. The Java technologies include: (1) a programming language; (2) a set of programs written in that language, called the "Java class libraries," which expose APIs; (3) a compiler, which translates code written by a developer into "bytecode"; and (4) a Java Virtual Machine ("JVM"), which translates bytecode into instructions to the operating system. *Id.* § 73. Programs calling upon the Java APIs will run on any machine with a "Java runtime environment," that is, Java class libraries and a JVM.

In May 1995 Netscape agreed with Sun to distribute a copy of the Java runtime environment with every copy of Navigator, and "Navigator quickly became the principal vehicle by which

Sun placed copies of its Java runtime environment on the PC systems of Windows users." Microsoft, too, agreed to promote the Java technologies—or so it seemed. For at the same time, Microsoft took steps "to maximize the difficulty with which applications written in Java could be ported from Windows to other platforms, and vice versa." Specifically, the District Court found that Microsoft took four steps to exclude Java from developing as a viable cross-platform threat: (a) designing a JVM incompatible with the one developed by Sun; *** [and] (c) deceiving Java developers about the Windows-specific nature of the tools it distributed to them *** .

a. The incompatible JVM

The District Court held that Microsoft engaged in exclusionary conduct by developing and promoting its own JVM. Conclusions of Law, at 43- 44. Sun had already developed a JVM for the Windows operating system when Microsoft began work on its version. The JVM developed by Microsoft allows Java applications to run faster on Windows than does Sun's JVM, but a Java application designed to work with Microsoft's JVM does not work with Sun's JVM and vice versa. The District Court found that Microsoft "made a large investment of engineering resources to develop a high-performance Windows JVM," and, "[b]y bundling its ... JVM with every copy of [IE] ... Microsoft endowed its Java runtime environment with the unique attribute of guaranteed, enduring ubiquity across the enormous Windows installed base." As explained above, however, a monopolist does not violate the antitrust laws simply by developing a product that is incompatible with those of its rivals. See *supra* Section II.B.1. In order to violate the antitrust laws, the incompatible product must have an anticompetitive effect that outweighs any procompetitive justification for the design. Microsoft's JVM is not only incompatible with Sun's, it allows Java applications to run faster on Windows than does Sun's JVM. Microsoft's faster JVM lured Java developers into using Microsoft's developer tools, and Microsoft offered those tools deceptively, as we discuss below. The JVM, however, does allow applications to run more swiftly and does not itself have any anticompetitive effect. Therefore, we reverse the District Court's imposition of liability for Microsoft's development and promotion of its JVM. ***

c. Deception of Java developers

Microsoft's "Java implementation" included, in addition to a JVM, a set of software development tools it created to assist ISVs in designing Java applications. The District Court found that, not only were these tools incompatible with Sun's cross-platform aspirations for Java—no violation, to be sure—but Microsoft deceived Java developers regarding the Windows-specific nature of the tools. Microsoft's tools included "certain 'keywords' and 'compiler directives' that could only be executed properly by Microsoft's version of the Java runtime environment for Windows." That is, developers who relied upon Microsoft's public commitment to cooperate with Sun and who used Microsoft's tools to develop what Microsoft led them to believe were cross-platform applications ended up producing applications that would run only on the Windows operating system. *** Microsoft's conduct related to its Java developer tools served to protect its monopoly of the operating system in a manner not attributable either to the superiority of the operating system or to the acumen of its makers, and therefore was anticompetitive. Unsurprisingly, Microsoft offers no procompetitive explanation for its campaign to deceive developers. Accordingly, we conclude this conduct is exclusionary, in violation of § 2 of the Sherman Act. ***

C. Causation

As a final parry, Microsoft urges this court to reverse on the monopoly maintenance claim, because plaintiffs never established a causal link between Microsoft's anticompetitive conduct, in particular its foreclosure of Netscape's and Java's distribution channels, and the maintenance of Microsoft's operating system monopoly. *** Microsoft's concerns over causation have more purchase in connection with the appropriate remedy issue, i.e., whether the court should impose a structural remedy or merely enjoin the offensive conduct at issue. As we point out later in this opinion, divestiture is a remedy that is imposed only with great caution, in part because its long-term efficacy is rarely certain. Absent some measure of confidence that there has been an actual loss to competition that needs to be restored, wisdom counsels against adopting radical structural relief. But these queries go to questions of remedy, not liability. In short, causation affords Microsoft no defense to liability for its unlawful actions undertaken to maintain its monopoly in the operating system market.

III. ATTEMPTED MONOPOLIZATION

Microsoft further challenges the District Court's determination of liability for "attempt[ing] to monopolize ... any part of the trade or commerce among the several States." 15 U.S.C. § 2 (1997). To establish a § 2 violation for attempted monopolization, "a plaintiff must prove (1) that the defendant has engaged in predatory or anticompetitive conduct with (2) a specific intent to monopolize and (3) a dangerous probability of achieving monopoly power." *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 456 (1993). Because a deficiency on any one of the three will defeat plaintiffs' claim, we look no further than plaintiffs' failure to prove a dangerous probability of achieving monopoly power in the putative browser market. ***

At the outset we note a pervasive flaw in the District Court's and plaintiffs' discussion of attempted monopolization. Simply put, plaintiffs have made the same argument under two different headings—monopoly maintenance and attempted monopolization. They have relied upon Microsoft's § 2 liability for monopolization of the operating system market as a presumptive indicator of attempted monopolization of an entirely different market. The District Court implicitly accepted this approach: It agreed with plaintiffs that the events that formed the basis for the § 2 monopolization claim "warrant[ed] additional liability as an illegal attempt to amass monopoly power in 'the browser market.'" Thus, plaintiffs and the District Court failed to recognize the need for an analysis wholly independent of the conclusions and findings on monopoly maintenance. ***

To establish a dangerous probability of success, plaintiffs must as a threshold matter show that the browser market can be monopolized, *i.e.*, that a hypothetical monopolist in that market could enjoy market power. This, in turn, requires plaintiffs (1) to define the relevant market and (2) to demonstrate that substantial barriers to entry protect that market. Because plaintiffs have not carried their burden on either prong, we reverse without remand. ***

Any doubt that we may have had regarding remand instead of outright reversal on the barriers to entry question was dispelled by plaintiffs' arguments on attempted monopolization before this court. Not only did plaintiffs fail to articulate a website barrier to entry theory in either their brief or at oral argument, they failed to point the court to evidence in the record that would support a finding that Microsoft would likely erect significant barriers to entry upon acquisition of a dominant market share.

Plaintiffs did not devote the same resources to the attempted monopolization claim as they did to the monopoly maintenance claim. But both claims require evidentiary and theoretical

rigor. Because plaintiffs failed to make their case on attempted monopolization both in the District Court and before this court, there is no reason to give them a second chance to flesh out a claim that should have been fleshed out the first time around. Accordingly, we reverse the District Court's determination of § 2 liability for attempted monopolization.

IV. TYING

Microsoft also contests the District Court's determination of liability under § 1 of the Sherman Act. The District Court concluded that Microsoft's contractual and technological bundling of the IE web browser (the "tied" product) with its Windows operating system ("OS") (the "tying" product) resulted in a tying arrangement that was *per se* unlawful. We hold that the rule of reason, rather than *per se* analysis, should govern the legality of tying arrangements involving platform software products. The Supreme Court has warned that "'[i]t is only after considerable experience with certain business relationships that courts classify them as *per se* violations....'" *Broad. Music, Inc. v. CBS*, 441 U.S. 1, 9 (1979) (quoting *United States v. Topco Assocs.*, 405 U.S. 596, 607-08 (1972)). While every "business relationship" will in some sense have unique features, some represent entire, novel categories of dealings. As we shall explain, the arrangement before us is an example of the latter, offering the first up-close look at the technological integration of added functionality into software that serves as a platform for third-party applications. There being no close parallel in prior antitrust cases, simplistic application of *per se* tying rules carries a serious risk of harm. Accordingly, we vacate the District Court's finding of a *per se* tying violation and remand the case. Plaintiffs may on remand pursue their tying claim under the rule of reason.

The facts underlying the tying allegation substantially overlap with those set forth in Section II.B in connection with the § 2 monopoly maintenance claim. The key District Court findings are that (1) Microsoft required licensees of Windows 95 and 98 also to license IE as a bundle at a single price; (2) Microsoft refused to allow OEMs to uninstall or remove IE from the Windows desktop; (3) Microsoft designed Windows 98 in a way that withheld from consumers the ability to remove IE by use of the Add/Remove Programs utility; and (4) Microsoft designed Windows 98 to override the user's choice of default web browser in certain circumstances. The court found that these acts constituted a *per se* tying violation. Although the District Court also found that Microsoft commingled operating system-only and browser-only routines in the same library files, it did not include this as a basis for tying liability despite plaintiffs' request that it do so.

There are four elements to a *per se* tying violation: (1) the tying and tied goods are two separate products; (2) the defendant has market power in the tying product market; (3) the defendant affords consumers no choice but to purchase the tied product from it; and (4) the tying arrangement forecloses a substantial volume of commerce.

Microsoft does not dispute that it bound Windows and IE in the four ways the District Court cited. Instead it argues that Windows (the tying good) and IE browsers (the tied good) are not "separate products," and that it did not substantially foreclose competing browsers from the tied product market. ***

We first address the separate-products inquiry, a source of much argument between the parties and of confusion in the cases. Our purpose is to highlight the poor fit between the separate-products test and the facts of this case. We then offer further reasons for carving an exception to the *per se* rule when the tying product is platform software. In the final section we discuss the District Court's inquiry if plaintiffs pursue a rule of reason claim on remand.

A. Separate-Products Inquiry Under the *Per se* Test

The requirement that a practice involve two separate products before being condemned as an illegal tie started as a purely linguistic requirement: unless products are separate, one cannot be "tied" to the other. Indeed, the nature of the products involved in early tying cases—intuitively distinct items such as a movie projector and a film—led courts either to disregard the separate-products question or to discuss it only in passing. It was not until *Times-Picayune Publishing Co. v. United States*, 345 U.S. 594 (1953), that the separate-products issue became a distinct element of the test for an illegal tie. Even that case engaged in a rather cursory inquiry into whether ads sold in the morning edition of a paper were a separate product from ads sold in the evening edition.

The first case to give content to the separate-products test was *Jefferson Parish*, 466 U.S. 2. That case addressed a tying arrangement in which a hospital conditioned surgical care at its facility on the purchase of anesthesiological services from an affiliated medical group. The facts were a challenge for casual separate-products analysis because the tied service—anesthesia—was neither intuitively distinct from nor intuitively contained within the tying service—surgical care. ***

The *Jefferson Parish* Court resolved the matter in two steps. First, it clarified that "the answer to the question whether one or two products are involved" does not turn "on the functional relation between them. ..." *Jefferson Parish*, 466 U.S. at 19. In other words, the mere fact that two items are complements, that "one ... is useless without the other," does not make them a single "product" for purposes of tying law. Second, reasoning that the "definitional question [whether two distinguishable products are involved] depends on whether the arrangement may have the type of competitive consequences addressed by the rule [against tying]," *Jefferson Parish*, 466 U.S. at 21 the Court decreed that "no tying arrangement can exist unless there is a sufficient demand for the purchase of anesthesiological services separate from hospital services to identify a distinct product market in which it is efficient to offer anesthesiological services separately from hospital service," *id.* at 21-22. ***

To understand the logic behind the Court's consumer demand test, consider first the postulated harms from tying. The core concern is that tying prevents goods from competing directly for consumer choice on their merits, *i.e.,* being selected as a result of "buyers' independent judgment," *id.* at 13 (internal quotes omitted). With a tie, a buyer's "freedom to select the best bargain in the second market [could be] impaired by his need to purchase the tying product, and perhaps by an inability to evaluate the true cost of either product...." *Id.* at 15. Direct competition on the merits of the tied product is foreclosed when the tying product either is sold only in a bundle with the tied product or, though offered separately, is sold at a bundled price, so that the buyer pays the same price whether he takes the tied product or not. In both cases, a consumer buying the tying product becomes entitled to the tied product; he will therefore likely be unwilling to buy a competitor's version of the tied product even if, making his own price/quality assessment, that is what he would prefer.

But not all ties are bad. Bundling obviously saves distribution and consumer transaction costs. This is likely to be true, to take some examples from the computer industry, with the integration of math co-processors and memory into microprocessor chips and the inclusion of spell checkers in word processors. Bundling can also capitalize on certain economies of scope. A possible example is the "shared" library files that perform OS and browser functions with the very same lines of code and thus may save drive space from the clutter of redundant routines and memory

when consumers use both the OS and browser simultaneously. Indeed, if there were no efficiencies from a tie (including economizing on consumer transaction costs such as the time and effort involved in choice), we would expect distinct consumer demand for each individual component of every good. In a competitive market with zero transaction costs, the computers on which this opinion was written would only be sold piecemeal—keyboard, monitor, mouse, central processing unit, disk drive, and memory all sold in separate transactions and likely by different manufacturers.

Recognizing the potential benefits from tying, the Court in *Jefferson Parish* forged a separate-products test that, like those of market power and substantial foreclosure, attempts to screen out false positives under *per se* analysis. The consumer demand test is a rough proxy for whether a tying arrangement may, on balance, be welfare-enhancing, and unsuited to *per se* condemnation. In the abstract, of course, there is always direct separate demand for products: assuming choice is available at zero cost, consumers will prefer it to no choice. Only when the efficiencies from bundling are dominated by the benefits to choice for enough consumers, however, will we actually observe consumers making independent purchases. In other words, perceptible separate demand is inversely proportional to net efficiencies. On the supply side, firms without market power will bundle two goods only when the cost savings from joint sale outweigh the value consumers place on separate choice. So bundling by all competitive firms implies strong net efficiencies. If a court finds either that there is no noticeable separate demand for the tied product or, there being no convincing direct evidence of separate demand, that the entire "competitive fringe" engages in the same behavior as the defendant, then the tying and tied products should be declared one product and *per se* liability should be rejected. ***

With this background, we now turn to the separate products inquiry before us. The District Court found that many consumers, if given the option, would choose their browser separately from the OS. Turning to industry custom, the court found that, although all major OS vendors bundled browsers with their OSs, these companies either sold versions without a browser, or allowed OEMs or end-users either not to install the bundled browser or in any event to "uninstall" it. The court did not discuss the record evidence as to whether OS vendors other than Microsoft sold at a bundled price, with no discount for a browserless OS, perhaps because the record evidence on the issue was in conflict.

Microsoft does not dispute that many consumers demand alternative browsers. But on industry custom Microsoft contends that no other firm requires non-removal because no other firm has invested the resources to integrate web browsing as deeply into its OS as Microsoft has. Microsoft contends not only that its integration of IE into Windows is innovative and beneficial but also that it requires non-removal of IE. In our discussion of monopoly maintenance we find that these claims fail the efficiency balancing applicable in that context. But the separate-products analysis is supposed to perform its function as a proxy without embarking on any direct analysis of efficiency. Accordingly, Microsoft's implicit argument—that in this case looking to a competitive fringe is inadequate to evaluate fully its potentially innovative technological integration, that such a comparison is between apples and oranges—poses a legitimate objection to the operation of *Jefferson Parish's* separate-products test for the *per se* rule.

In fact there is merit to Microsoft's broader argument that *Jefferson Parish's* consumer demand test would "chill innovation to the detriment of consumers by preventing firms from integrating into their products new functionality previously provided by standalone products—and hence, by definition, subject to separate consumer demand." Appellant's Opening Br. at 69. The *per se* rule's direct consumer demand and indirect industry custom inquiries are, as a general matter,

backward-looking and therefore systematically poor proxies for overall efficiency in the presence of new and innovative integration. The direct consumer demand test focuses on historic consumer behavior, likely before integration, and the indirect industry custom test looks at firms that, unlike the defendant, may not have integrated the tying and tied goods. Both tests compare incomparables—the defendant's decision to bundle in the presence of integration, on the one hand, and consumer and competitor calculations in its absence, on the other. If integration has efficiency benefits, these may be ignored by the *Jefferson Parish* proxies. Because one cannot be sure beneficial integration will be protected by the other elements of the *per se* rule, simple application of that rule's separate-products test may make consumers worse off. ***

B. *Per se* Analysis Inappropriate for this Case.

We now address directly the larger question as we see it: whether standard *per se* analysis should be applied "off the shelf" to evaluate the defendant's tying arrangement, one which involves software that serves as a platform for third-party applications. There is no doubt that "[i]t is far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable '*per se*.'" *Jefferson Parish*, 466 U.S. at 9. But there are strong reasons to doubt that the integration of additional software functionality into an OS falls among these arrangements. Applying *per se* analysis to such an amalgamation creates undue risks of error and of deterring welfare-enhancing innovation. ***

These arguments all point to one conclusion: we cannot comfortably say that bundling in platform software markets has so little "redeeming virtue," *N. Pac. Ry.*, 356 U.S. at 5, and that there would be so "very little loss to society" from its ban, that "an inquiry into its costs in the individual case [can be] considered [ ] unnecessary." *Jefferson Parish*, 466 U.S. at 33-34 (O'Connor, J., concurring). We do not have enough empirical evidence regarding the effect of Microsoft's practice on the amount of consumer surplus created or consumer choice foreclosed by the integration of added functionality into platform software to exercise sensible judgment regarding that entire class of behavior. ***

C. On Remand

Should plaintiffs choose to pursue a tying claim under the rule of reason, we note the following for the benefit of the trial court:

First, on remand, plaintiffs must show that Microsoft's conduct unreasonably restrained competition. Meeting that burden "involves an inquiry into the actual effect" of Microsoft's conduct on competition in the tied good market, *Jefferson Parish*, 466 U.S. at 29, the putative market for browsers. To the extent that certain aspects of tying injury may depend on a careful definition of the tied good market and a showing of barriers to entry other than the tying arrangement itself, plaintiffs would have to establish these points. But plaintiffs were required—and had every incentive—to provide both a definition of the browser market and barriers to entry to that market as part of their § 2 attempted monopolization claim; yet they failed to do so. Accordingly, on remand of the § 1 tying claim, plaintiffs will be precluded from arguing any theory of harm that depends on a precise definition of browsers or barriers to entry (for example, network effects from Internet protocols and extensions embedded in a browser) other than what may be implicit in Microsoft's tying arrangement.

Of the harms left, plaintiffs must show that Microsoft's conduct was, on balance, anticompetitive. Microsoft may of course offer procompetitive justifications, and it is plaintiffs' burden to show that the anticompetitive effect of the conduct outweighs its benefit.

Second, the fact that we have already considered some of the behavior plaintiffs allege to constitute tying violations in the monopoly maintenance section does not resolve the § 1 inquiry. The two practices that plaintiffs have most ardently claimed as tying violations are, indeed, a basis for liability under plaintiffs' § 2 monopoly maintenance claim. These are Microsoft's refusal to allow OEMs to uninstall IE or remove it from the Windows desktop, and its removal of the IE entry from the Add/Remove Programs utility in Windows 98. In order for the District Court to conclude these practices also constitute § 1 tying violations, plaintiffs must demonstrate that their benefits—if any—are outweighed by the harms in the tied product market. If the District Court is convinced of net harm, it must then consider whether any additional remedy is necessary.

In Section II.B we also considered another alleged tying violation—the Windows 98 override of a consumer's choice of default web browser. We concluded that this behavior does not provide a distinct basis for § 2 liability because plaintiffs failed to rebut Microsoft's proffered justification by demonstrating that harms in the operating system market outweigh Microsoft's claimed benefits. On remand, however, although Microsoft may offer the same procompetitive justification for the override, plaintiffs must have a new opportunity to rebut this claim, by demonstrating that the anticompetitive effect in the browser market is greater than these benefits.

Finally, the District Court must also consider an alleged tying violation that we did not consider under § 2 monopoly maintenance: price bundling. First, the court must determine if Microsoft indeed price bundled—that is, was Microsoft's charge for Windows and IE higher than its charge would have been for Windows alone? This will require plaintiffs to resolve the tension between *Findings of Fact* § § 136-37, which Microsoft interprets as saying that no part of the bundled price of Windows can be attributed to IE, and Conclusions of Law, at 50, which says the opposite.

If there is a positive price increment in Windows associated with IE (we know there is no claim of price predation), plaintiffs must demonstrate that the anticompetitive effects of Microsoft's price bundling outweigh any procompetitive justifications the company provides for it. In striking this balance, the District Court should consider, among other things, indirect evidence of efficiency provided by "the competitive fringe." Although this inquiry may overlap with the separate-products screen under the *per se* rule, that is not its role here. Because courts applying the rule of reason are free to look at both direct and indirect evidence of efficiencies from a tie, there is no need for a screening device as such; thus the separate-products inquiry serves merely to classify arrangements as subject to tying law, as opposed to, say, liability for exclusive dealing.

If OS vendors without market power also sell their software bundled with a browser, the natural inference is that sale of the items as a bundle serves consumer demand and that unbundled sale would not, for otherwise a competitor could profitably offer the two products separately and capture sales of the tying good from vendors that bundle. It does appear that most if not all firms have sold a browser with their OSs at a bundled price *** .

Of course price bundling by competitive OS makers would tend to exonerate Microsoft only if the sellers in question sold their browser/OS combinations exclusively at a bundled price. If a competitive seller offers a discount for a browserless version, then—at least as to its OS and

browser—the gains from bundling are outweighed by those from separate choice. The evidence on discounts appears to be in conflict. Compare Direct Testimony of Richard Schmalensee § 241, reprinted in 7 J.A. at 4315, with 1/6/99 pm Tr. at 42 (trial testimony of Franklin Fisher). If Schmalensee is correct that nearly all OS makers do not offer a discount, then the harm from tying—obstruction of direct consumer choice—would be theoretically created by virtually all sellers: a customer who would prefer an alternate browser is forced to pay the full price of that browser even though its value to him is only the increment in value over the bundled browser. (The result is similar to that from non-removal, which forces consumers who want the alternate browser to surrender disk space taken up by the unused, bundled browser.) If the failure to offer a price discount were universal, any impediment to direct consumer choice created by Microsoft's price-bundled sale of IE with Windows would be matched throughout the market; yet these OS suppliers on the competitive fringe would have evidently found this price bundling on balance efficient. If Schmalensee's assertions are ill-founded, of course, no such inference could be drawn.

V. TRIAL PROCEEDINGS AND REMEDY

Microsoft additionally challenges the District Court's procedural rulings on two fronts. First, with respect to the trial phase, Microsoft proposes that the court mismanaged its docket by adopting an expedited trial schedule and receiving evidence through summary witnesses. Second, with respect to the remedies decree, Microsoft argues that the court improperly ordered that it be divided into two separate companies. Only the latter claim will long detain us. The District Court's trial-phase procedures were comfortably within the bounds of its broad discretion to conduct trials as it sees fit. We conclude, however, that the District Court's remedies decree must be vacated for three independent reasons: (1) the court failed to hold a remedies-specific evidentiary hearing when there were disputed facts; (2) the court failed to provide adequate reasons for its decreed remedies; and (3) this Court has revised the scope of Microsoft's liability and it is impossible to determine to what extent that should affect the remedies provisions. ***

We vacate the District Court's remedies decree for the additional reason that the court has failed to provide an adequate explanation for the relief it ordered. The Supreme Court has explained that a remedies decree in an antitrust case must seek to "unfetter a market from anticompetitive conduct," *Ford Motor Co.,* 405 U.S. at 577, to "terminate the illegal monopoly, deny to the defendant the fruits of its statutory violation, and ensure that there remain no practices likely to result in monopolization in the future," *United States v. United Shoe Mach. Corp.,* 391 U.S. 244, 250 (1968); *see also United States v. Grinnell Corp.,* 384 U.S. 563, 577 (1966).

The District Court has not explained how its remedies decree would accomplish those objectives. Indeed, the court devoted a mere four paragraphs of its order to explaining its reasons for the remedy. They are: (1) Microsoft "does not yet concede that any of its business practices violated the Sherman Act"; (2) Microsoft "continues to do business as it has in the past"; (3) Microsoft "has proved untrustworthy in the past"; and (4) the Government, whose officials "are by reason of office obliged and expected to consider—and to act in—the public interest," won the case, "and for that reason alone have some entitlement to a remedy of their choice." *Final Judgment,* at 62-63. Nowhere did the District Court discuss the objectives the Supreme Court deems relevant.

Quite apart from its procedural difficulties, we vacate the District Court's final judgment in its entirety for the additional, independent reason that we have modified the underlying bases

of liability. Of the three antitrust violations originally identified by the District Court, one is no longer viable: attempted monopolization of the browser market in violation of Sherman Act § 2. One will be remanded for liability proceedings under a different legal standard: unlawful tying in violation of § 1. Only liability for the § 2 monopoly maintenance violation has been affirmed—and even that we have revised. ***

In short, we must vacate the remedies decree in its entirety and remand the case for a new determination. This court has drastically altered the District Court's conclusions on liability. On remand, the District Court, after affording the parties a proper opportunity to be heard, can fashion an appropriate remedy for Microsoft's antitrust violations. In particular, the court should consider which of the decree's conduct restrictions remain viable in light of our modification of the original liability decision. While the task of drafting the remedies decree is for the District Court in the first instance, because of the unusually convoluted nature of the proceedings thus far, and a desire to advance the ultimate resolution of this important controversy, we offer some further guidance for the exercise of that discretion.

As a general matter, a district court is afforded broad discretion to enter that relief it calculates will best remedy the conduct it has found to be unlawful. This is no less true in antitrust cases. *See, e.g., Ford Motor Co.,* 405 U.S. at 573 ("The District Court is clothed with 'large discretion' to fit the decree to the special needs of the individual case."). And divestiture is a common form of relief in successful antitrust prosecutions: it is indeed "the most important of antitrust remedies." *See, e.g., United States v. E.I. du Pont de Nemours & Co.,* 366 U.S. 316, 331 (1961).

On remand, the District Court must reconsider whether the use of the structural remedy of divestiture is appropriate with respect to Microsoft, which argues that it is a unitary company. By and large, cases upon which plaintiffs rely in arguing for the split of Microsoft have involved the dissolution of entities formed by mergers and acquisitions. On the contrary, the Supreme Court has clarified that divestiture "has traditionally been the remedy for Sherman Act violations whose heart is intercorporate *combination and control,*" *du Pont,* 366 U.S. at 329 (emphasis added), and that "[c]omplete divestiture is particularly appropriate where asset or stock *acquisitions* violate the antitrust laws," *Ford Motor Co.,* 405 U.S. at 573 (emphasis added).

One apparent reason why courts have not ordered the dissolution of unitary companies is logistical difficulty. As the court explained in *United States v. ALCOA,* 91 F.Supp. 333, 416 (S.D.N.Y. 1950), a "corporation, designed to operate effectively as a single entity, cannot readily be dismembered of parts of its various operations without a marked loss of efficiency." A corporation that has expanded by acquiring its competitors often has preexisting internal lines of division along which it may more easily be split than a corporation that has expanded from natural growth. Although time and corporate modifications and developments may eventually fade those lines, at least the identifiable entities preexisted to create a template for such division as the court might later decree. With reference to those corporations that are not acquired by merger and acquisition, Judge Wyzanski accurately opined in *United Shoe*:

> United conducts all machine manufacture at one plant in Beverly, with one set of jigs and tools, one foundry, one laboratory for machinery problems, one managerial staff, and one labor force. It takes no Solomon to see that this organism cannot be cut into three equal and viable parts.

United States v. United Shoe Machine Corp., 110 F.Supp. 295, 348 (D. Mass. 1953).

Depending upon the evidence, the District Court may find in a remedies proceeding that it would be no easier to split Microsoft in two than United Shoe in three. Microsoft's Offer of Proof in response to the court's denial of an evidentiary hearing included proffered testimony

from its President and CEO Steve Ballmer that the company "is, and always has been, a unified company without free-standing business units. Microsoft is not the result of mergers or acquisitions." Microsoft further offered evidence that it is "not organized along product lines," but rather is housed in a single corporate headquarters and that it has

> only one sales and marketing organization which is responsible for selling all of the company's products, one basic research organization, one product support organization, one operations department, one information technology department, one facilities department, one purchasing department, one human resources department, one finance department, one legal department and one public relations department.

Defendant's Offer of Proof at 23-26, *reprinted in* 4 J.A. at 2764-67. If indeed Microsoft is a unitary company, division might very well require Microsoft to reproduce each of these departments in each new entity rather than simply allocate the differing departments among them.

In devising an appropriate remedy, the District Court also should consider whether plaintiffs have established a sufficient causal connection between Microsoft's anticompetitive conduct and its dominant position in the OS market. "Mere existence of an exclusionary act does not itself justify full feasible relief against the monopolist to create maximum competition." 3 Areeda and Hovenkamp, Antitrust Law § 650a, at 67. Rather, structural relief, which is "designed to eliminate the monopoly altogether ... require[s] a clearer indication of a *significant causal connection* between the conduct and creation or maintenance of the market power." *Id.* § 653b, at 91-92 (emphasis added). Absent such causation, the antitrust defendant's unlawful behavior should be remedied by "an injunction against continuation of that conduct." *Id.* § 650a, at 67.

As noted above, *see supra* Section II.C, we have found a causal connection between Microsoft's exclusionary conduct and its continuing position in the operating systems market only through inference. *See* 3 Areeda and Hovenkamp, Antitrust Law § 653(b), at 91-92 (suggesting that "more extensive equitable relief, particularly remedies such as divestiture designed to eliminate the monopoly altogether, ... require a clearer indication of significant causal connection between the conduct and creation or maintenance of the market power"). Indeed, the District Court expressly did not adopt the position that Microsoft would have lost its position in the OS market but for its anticompetitive behavior. *Findings of Fact* § 411 ("There is insufficient evidence to find that, absent Microsoft's actions, Navigator and Java already would have ignited genuine competition in the market for Intel-compatible PC operating systems."). If the court on remand is unconvinced of the causal connection between Microsoft's exclusionary conduct and the company's position in the OS market, it may well conclude that divestiture is not an appropriate remedy. While we do not undertake to dictate to the District Court the precise form that relief should take on remand, we note again that it should be tailored to fit the wrong creating the occasion for the remedy.

In sum, we vacate the District Court's remedies decree for three reasons. First, the District Court failed to hold an evidentiary hearing despite the presence of remedies-specific factual disputes. Second, the court did not provide adequate reasons for its decreed remedies. Finally, we have drastically altered the scope of Microsoft's liability, and it is for the District Court in the first instance to determine the propriety of a specific remedy for the limited ground of liability which we have upheld. ***

VII. CONCLUSION

The judgment of the District Court is affirmed in part, reversed in part, and remanded in part. We vacate in full the Final Judgment embodying the remedial order, and remand the case to the

District Court for reassignment to a different trial judge for further proceedings consistent with this opinion.

Federal Trade Commission v. Qualcomm Incorporated

969 F.3d 974 (9th Cir. 2020)

CALLAHAN, CIRCUIT JUDGE. This case asks us to draw the line between *anti*competitive behavior, which is illegal under federal antitrust law, and *hyper*competitive behavior, which is not. The Federal Trade Commission ("FTC") contends that Qualcomm Incorporated ("Qualcomm") violated the Sherman Act, 15 U.S.C. §§ 1, 2, by unreasonably restraining trade in, and unlawfully monopolizing, the code division multiple access ("CDMA") and premium long-term evolution ("LTE") cellular modem chip markets. After a ten-day bench trial, the district court agreed and ordered a permanent, worldwide injunction prohibiting several of Qualcomm's core business practices. We granted Qualcomm's request for a stay of the district court's injunction pending appeal. *FTC v. Qualcomm Inc.*, 935 F.3d 752 (9th Cir. 2019). At that time, we characterized the district court's order and injunction as either "a trailblazing application of the antitrust laws" or "an improper excursion beyond the outer limits of the Sherman Act." *Id.* at 757. We now hold that the district court went beyond the scope of the Sherman Act, and we reverse.

I

A

Founded in 1985, Qualcomm dubs itself "the world's leading cellular technology company." Over the past several decades, the company has made significant contributions to the technological innovations underlying modern cellular systems, including third-generation ("3G") CDMA and fourth-generation ("4G") LTE cellular standards—the standards practiced in most modern cellphones and "smartphones." Qualcomm protects and profits from its technological innovations through its patents, which it licenses to original equipment manufacturers ("OEMs") whose products (usually cellphones, but also smart cars and other products with cellular applications) practice one or more of Qualcomm's patented technologies.

Qualcomm's patents include cellular standard essential patents ("SEPs"), non-cellular SEPs, and non-SEPs. Cellular SEPs are patents on technologies that international standard-setting organizations ("SSOs") choose to include in technical standards practiced by each new generation of cellular technology. . . . Cellular SEPs are necessary to practice a particular cellular standard. Because SEP holders could prevent industry participants from implementing a standard by selectively refusing to license, SSOs require patent holders to commit to license their SEPs on fair, reasonable, and nondiscriminatory ("FRAND") terms before their patents are incorporated into standards.

. . . . Rather than license its patents individually, Qualcomm generally offers its customers various "patent portfolio" options, whereby the customer/licensee pays for and receives the right to practice all three types of Qualcomm patents (SEPs, non-cellular SEPs, and non-SEPs).

Qualcomm's patent licensing business is very profitable, representing around two-thirds of the company's value. But Qualcomm is no one-trick pony. The company also manufactures and sells cellular modem chips, the hardware that enables cellular devices to practice CDMA and premium LTE technologies and thereby communicate with each other across cellular networks. This makes Qualcomm somewhat unique in the broader cellular services industry. Companies such as Nokia, Ericsson, and Interdigital have comparable SEP portfolios but do not compete with Qualcomm in the modem chip markets. On the other hand, Qualcomm's

main competitors in the modem chip markets—companies such as MediaTek, HiSilicon, Samsung LSI, ST-Ericsson, and VIA Telecom (purchased by Intel in 2015)—do not hold or have not held comparable SEP portfolios.

Like its licensing business, Qualcomm's modem chip business has been very successful. From 2006 to 2016, Qualcomm possessed monopoly power in the CDMA modem chip market, including over 90% of market share. From 2011 to 2016, Qualcomm possessed monopoly power in the premium LTE modem chip market, including at least 70% of market share. During these timeframes, Qualcomm leveraged its monopoly power to "charge monopoly prices on [its] modem chips." *Qualcomm*, 411 F.Supp.3d at 800. Around 2015, however, Qualcomm's dominant position in the modem chip markets began to recede, as competitors like Intel and MediaTek found ways to successfully compete. Based on projections from 2017 to 2018, Qualcomm maintains approximately a 79% share of the CDMA modem chip market and a 64% share of the premium LTE modem chip market.

B

Qualcomm licenses its patent portfolios exclusively at the OEM level, setting the royalty rates on its CDMA and LTE patent portfolios as a percentage of the end-product sales price. This practice is not unique to Qualcomm. As the district court found, "[f]ollowing Qualcomm's lead, other SEP licensors like Nokia and Ericsson have concluded that licensing only OEMs is more lucrative, and structured their practices accordingly." OEM-level licensing allows these companies to obtain the maximum value for their patented technologies while avoiding the problem of patent exhaustion, whereby "the initial authorized [or licensed] sale of a patented item terminates all patent rights to that item." *Quanta Comput., Inc. v. LG Elecs., Inc.*, 553 U.S. 617, 625 (2008). Due to patent exhaustion, if Qualcomm licensed its SEPs further "upstream" in the manufacturing process to competing chip suppliers, then its patent rights would be exhausted when these rivals sold their products to OEMs. OEMs would then have little incentive to pay Qualcomm for patent licenses, as they could instead become "downstream" recipients of the already exhausted patents embodied in these rivals' products.

Because rival chip manufacturers practice many of Qualcomm's SEPs by necessity, Qualcomm offers these companies what it terms "CDMA ASIC Agreements," wherein Qualcomm promises not to assert its patents in exchange for the company promising not to sell its chips to unlicensed OEMs. . . .

Qualcomm reinforces these practices with its so-called "no license, no chips" policy, under which Qualcomm refuses to sell modem chips to OEMs that do not take licenses to practice Qualcomm's SEPs. Otherwise, because of patent exhaustion, OEMs could decline to take licenses, arguing instead that their purchase of chips from Qualcomm extinguished Qualcomm's patent rights with respect to any CDMA or premium LTE technologies embodied in the chips. This would not only prevent Qualcomm from obtaining the maximum value for its patents, it would result in OEMs having to pay more money (in licensing royalties) to purchase and use a competitor's chips, which are unlicensed. Instead, Qualcomm's practices, taken together, are "chip supplier neutral"—that is, OEMs are required to pay a per-unit licensing royalty to Qualcomm for its patent portfolios regardless of which company they choose to source their chips from.

Although Qualcomm's licensing and modem chip businesses have made it a major player in the broader cellular technology market, the company is not an OEM. That is, Qualcomm

does not manufacture and sell cellphones and other end-use products (like smart cars) that consumers purchase and use. Thus, it does not "compete"—in the antitrust sense—against OEMs like Apple and Samsung in these product markets. Instead, these OEMs are Qualcomm's *customers*.

C

* * *

Qualcomm's competitors in the modem chip markets contend that Qualcomm's business practices, in particular its refusal to license them, have hampered or slowed their ability to develop and retain OEM customer bases, limited their growth, delayed or prevented their entry into the market, and in some cases forced them out of the market entirely. These competitors contend that this result is not just anticompetitive, but a violation of Qualcomm's contractual commitments to two cellular SSOs . . . to license its SEPs "to all applicants" on FRAND terms. . . .

In 2011 and 2013, Qualcomm signed agreements with Apple under which Qualcomm offered Apple billions of dollars in incentive payments contingent on Apple sourcing its iPhone modem chips exclusively from Qualcomm and committing to purchase certain quantities of chips each year. Again, rivals such as Intel—as well as Apple itself, which was interested in using Intel as an alternative chip supplier—complained that Qualcomm was engaging in anticompetitive business practices designed to maintain its monopolies in the CDMA and premium LTE modem chip markets while making it impossible for rivals to compete. In 2014, Apple decided to terminate these agreements and source its modem chips from Intel for its 2016 model iPhone.

D

In January 2017, the FTC sued Qualcomm for equitable relief, alleging that Qualcomm's interrelated policies and practices excluded competitors and harmed competition in the modem chip markets, in violation § 5(a) of the FTC Act, 15 U.S.C. § 45(a), and §§ 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2. After a ten-day bench trial, the district court concluded that "Qualcomm's licensing practices are an unreasonable restraint of trade under § 1 of the Sherman Act and exclusionary conduct under § 2 of the Sherman Act." The district court ordered a permanent, worldwide injunction prohibiting Qualcomm's core business practices. * * *

II * * *

A

. . . [N]ovel business practices—*especially* in technology markets—should not be "conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." *Microsoft*, 253 F.3d at 91. . . ; *see also* Rachel S. Tennis & Alexander Baier Schwab, *Business Model Innovation and Antitrust Law*, 29 Yale J. on Reg. 307, 319 (2012) (explaining how "antitrust economists, and in turn lawyers and judges, tend to treat novel products or business practices as anticompetitive" and "are likely to decide cases wrongly in rapidly changing dynamic markets," which can have long-lasting effects particularly in technological markets, where innovation "is essential to economic growth and social welfare" and "an erroneous decision will deny large consumer benefits").

Regardless of whether the alleged antitrust violation involves concerted anticompetitive conduct under § 1 or independent anticompetitive conduct under § 2, the three-part burden-shifting test under the rule of reason is essentially the same. . . . Under § 1, "the plaintiff has the initial burden to prove that the challenged restraint has a substantial anticompetitive effect that harms consumers in the relevant market". . . . "If the plaintiff carries its burden, then the burden shifts to the defendant to show a procompetitive rationale for the restraint". . . . "If the defendant makes this showing, then the burden shifts back to the plaintiff to demonstrate that the procompetitive efficiencies could be reasonably achieved through less anticompetitive means."

Likewise, "if a plaintiff successfully establishes a *prima facie* case under § 2 by demonstrating anticompetitive effect, then the monopolist may proffer a 'procompetitive justification' for its conduct." *Microsoft*, 253 F.3d at 59. "If the monopolist asserts a procompetitive justification—a nonpretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, greater efficiency or enhanced consumer appeal—then the burden shifts back to the plaintiff to rebut that claim." *Id.* If the plaintiff cannot rebut the monopolist's procompetitive justification, "then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit." *Id.*

The similarity of the burden-shifting tests under §§ 1 and 2 means that courts often review claims under each section simultaneously. . . . However, although the tests are largely similar, a plaintiff may not use *indirect* evidence to prove unlawful monopoly maintenance via anticompetitive conduct under § 2. . . .

B

A threshold step in any antitrust case is to accurately define the relevant market, which refers to "the area of effective competition." *Am. Express*, 138 S.Ct. at 2285 (citation omitted). . . .

Here, the district court correctly defined the relevant markets as "the market for CDMA modem chips and the market for premium LTE modem chips." Nevertheless, its analysis of Qualcomm's business practices and their anticompetitive impact looked beyond these markets to the much larger market of cellular services generally. Thus, a substantial portion of the district court's ruling considered alleged economic harms to OEMs—who are Qualcomm's *customers*, not its competitors—resulting in higher prices to consumers. These harms, even if real, are not "anticompetitive" in the antitrust sense—at least not *directly*—because they do not involve restraints on trade or exclusionary conduct in "the area of effective competition." *Am. Express*, 138 S.Ct. at 2285.

* * *

III

Accordingly, we reframe the issues to focus on the impact, if any, of Qualcomm's practices in the area of effective competition: the markets for CDMA and premium LTE modem chips. Thus, we begin by examining the district court's conclusion that Qualcomm has an antitrust duty to license its SEPs to its direct competitors in the modem chip markets.

* * *

A

"As the Supreme Court has repeatedly emphasized, there is 'no duty to deal under the terms and conditions preferred by [a competitor's] rivals[.]" Likewise, "the Sherman Act 'does not restrict the long recognized right of [a] trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal.'" *Trinko*, 540 U.S. at 408 (alteration in original). . . .

The one, limited exception to this general rule that there is no antitrust duty to deal comes under the Supreme Court's decision in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985). There, the Court held that a company engages in prohibited, anticompetitive conduct when (1) it "unilateral[ly] terminat[es] . . . a voluntary and profitable course of dealing"; (2) "the only conceivable rationale or purpose is 'to sacrifice short-term benefits in order to obtain higher profits in the long run from the exclusion of competition'"; and (3) the refusal to deal involves products that the defendant already sells in the existing market to other similarly situated customers. The Supreme Court later characterized the *Aspen Skiing* exception as "at or near the outer boundary of § 2 liability." *Trinko*, 540 U.S. at 409.

The district court's conclusion that Qualcomm's refusal to provide exhaustive SEP licenses to rival chip suppliers meets the *Aspen Skiing* exception ignores critical differences between Qualcomm's business practices and the conduct at issue in *Aspen Skiing*, and it ignores the Supreme Court's subsequent warning in *Trinko* that the *Aspen Skiing* exception should be applied only in rare circumstances. . . .

First, the district court was incorrect that "Qualcomm terminated a 'voluntary and profitable course of dealing'" with respect to its previous practice of licensing at the chip-manufacturer level. In support of this finding, the district court cited a single piece of record evidence: an email from a Qualcomm lawyer regarding 3%-royalty-bearing licenses for modem chip suppliers. But this email was sent in 1999, seven years before Qualcomm gained monopoly power in the CDMA modem chip market. Furthermore, Qualcomm claims that it never granted exhaustive licenses to rival chip suppliers. Instead, as the 1999 email suggests, it entered into "non-exhaustive, royalty-bearing agreements with chipmakers that explicitly did not grant rights to the chipmaker's customers."

According to Qualcomm, it ceased this practice in response to developments in patent law's exhaustion doctrine, which made it harder for Qualcomm to argue that it could provide "non-exhaustive" licenses in the form of royalty agreements. Nothing in the record or in the district court's factual findings rebuts these claims. The FTC offered no evidence that, from the time Qualcomm first gained monopoly power in the modem chip market in 2006 until now, it ever had a practice of providing exhaustive licenses at the modem chip level rather than the OEM level.

Second, Qualcomm's rationale for "switching" to OEM-level licensing was not "to sacrifice short-term benefits in order to obtain higher profits in the long run from the exclusion of competition," the second element of the *Aspen Skiing* exception. Instead, Qualcomm responded to the change in patent-exhaustion law by choosing the path that was "far more lucrative," both in the short term *and* the long term, regardless of any impacts on competition. The district court itself acknowledged that this was Qualcomm's purpose, observing: "Following Qualcomm's lead, other SEP licensors like Nokia and Ericsson have concluded that licensing only OEMs is more lucrative, and structured their practices accordingly."

Finally, unlike in *Aspen Skiing*, the district court found no evidence that Qualcomm singles out any specific chip supplier for anticompetitive treatment in its SEP-licensing. In *Aspen*

Skiing, the defendant refused to sell its lift tickets to a smaller, rival ski resort even as it sold the same lift tickets to any other willing buyer (including any *other* ski resort); moreover, this refusal was designed specifically to put the smaller, nearby rival out of business. Qualcomm applies its OEM-level licensing policy equally with respect to all competitors in the modem chip markets and declines to enforce its patents against these rivals even though they practice Qualcomm's patents (royalty-free). . . .

As none of the required elements for the *Aspen Skiing* exception are present, let alone all of them, the district court erred in holding that Qualcomm is under an antitrust duty to license rival chip manufacturers. We hold that Qualcomm's OEM-level licensing policy, however novel, is not an anticompetitive violation of the Sherman Act.

B

Conceding error in the district court's conclusion that Qualcomm is subject to an antitrust duty to deal under *Aspen Skiing*, the FTC contends that this court may nevertheless hold that Qualcomm engaged in anticompetitive conduct in violation of § 2. This is so, the FTC urges, because

> "Qualcomm entered into a voluntary contractual commitment to deal with its rivals as part of the SSO process, which is itself a derogation from normal market competition," and (2) Qualcomm's breach of this contractual commitment "satisfies traditional Section 2 standards [in that] it 'tends to impair the opportunities of rivals and . . . does not further competition on the merits.'"

We disagree.

Even if the district court is correct that Qualcomm is contractually obligated via its SSO commitments to license rival chip suppliers—a conclusion we need not and do not reach—the FTC still does not satisfactorily explain how Qualcomm's alleged breach of this contractual commitment *itself* impairs the opportunities of rivals. It argues the breach "facilitat[es] Qualcomm's collection of a surcharge from rivals' customers." Appellee's Br. at 77. But this refers to a distinct business practice, licensing royalties, and alleged harm to OEMs, not rival chipmakers. In any case, Qualcomm's royalties are "chip-supplier neutral" because Qualcomm collects them from *all* OEMs that license its patents, not just "rivals' customers." The FTC argues that Qualcomm's breach directly impacts rivals by "otherwise deterring [their] entry and investment." But this ignores that Qualcomm's "CDMA ASIC Agreements" functionally act as de facto licenses ("no license, no problem") by allowing competitors to practice Qualcomm's SEPs (royalty-free) before selling their chips to downstream OEMs. Furthermore, in order to make out a § 2 violation, the anticompetitive harm identified must be to *competition itself*, not merely to competitors. The FTC identifies no such harm to competition.

The FTC's conclusion that OEM-level licensing does not further competition on the merits is not only belied by MediaTek and Intel's entries into the modem chip markets in the 2015–2016 timeframe, it also gives inadequate weight to Qualcomm's reasonable, procompetitive justification that licensing at the OEM and chip-supplier levels simultaneously would require the company to engage in "multi-level licensing," leading to inefficiencies and less profit. Qualcomm's procompetitive justification is supported by at least two other companies—Nokia and Dolby—with similar SEP portfolios to Qualcomm's. More critically, this part of the FTC's argument skips ahead to an examination of Qualcomm's procompetitive justifications, failing to recognize that the burden does not shift to Qualcomm to provide such

justifications unless and until the FTC meets its initial burden of proving anticompetitive harm. Because the FTC has not met its initial burden under the rule of reason framework, we are less critical of Qualcomm's procompetitive justifications for its OEM-level licensing policy—which, in any case, appear to be reasonable and consistent with current industry practice. * * *

Finally, we note the persuasive policy arguments of several academics and practitioners with significant experience in SSOs, FRAND, and antitrust enforcement, who have expressed caution about using the antitrust laws to remedy what are essentially contractual disputes between private parties engaged in the pursuit of technological innovation. * * *

C

We next address the district court's primary theory of anticompetitive harm: Qualcomm's imposition of an "anticompetitive surcharge" on rival chip suppliers via its licensing royalty rates. According to the district court, Qualcomm's unreasonably high royalty rates enable Qualcomm to control rivals' prices because Qualcomm receives the royalty even when an OEM uses one of Qualcomm's rival's chips. Thus, the "all-in" price of any modem chip sold by one of Qualcomm's rivals effectively includes two components: (1) the nominal chip price; and (2) Qualcomm's royalty surcharge.

This central component of the district court's ruling is premised on the district court's findings that Qualcomm's royalty rates are (1) "unreasonably high" because they are improperly based on Qualcomm's monopoly chip market share and handset price instead of the "fair value of Qualcomm's patents," and (2) anticompetitive because they raise costs to OEMs, who pass the extra costs along to consumers and are forced to invest less in other handset features. . . .

We hold that the district court's "anticompetitive surcharge" theory fails to state a cogent theory of anticompetitive harm. . . .

1

First, the district court's determination that Qualcomm's royalty rates are "unreasonable" because they are based on handset prices misinterprets Federal Circuit law regarding "the patent rule of apportionment" and the smallest salable patent-practicing unit ("SSPPU"). The district court observed "that 'it is generally required that royalties be based not on the entire product, but instead on the [SSPPU].'" *Qualcomm*, 411 F.Supp.3d at 783.

Even if we accept that the modem chip in a cellphone is the cellphone's SSPPU, the district court's analysis is still fundamentally flawed. No court has held that the SSPPU concept is a per se rule for "reasonable royalty" calculations; instead, the concept is used as a tool in jury cases to minimize potential jury confusion when the jury is weighing complex expert testimony about patent damages. * * *

A second problem with the district court's "unreasonable royalty rate" conclusion is that it erroneously assumes that royalties are "anticompetitive"—in the antitrust sense—unless they precisely reflect a patent's current, intrinsic value and are in line with the rates other companies charge for their own patent portfolios. Neither the district court nor the FTC provides any case law to support this proposition, which sounds in patent law, not antitrust law. . . . We decline to adopt a theory of antitrust liability that would presume anticompetitive conduct any time a company could not prove that the "fair value" of its SEP portfolios corresponds

to the prices the market appears willing to pay for those SEPs in the form of licensing royalty rates.

Finally, even assuming that a deviation between licensing royalty rates and a patent portfolio's "fair value" could amount to "anticompetitive harm" in the antitrust sense, the primary harms the district court identified here were to the OEMs who agreed to pay Qualcomm's royalty rates—that is, Qualcomm's *customers*, not its *competitors*. These harms were thus located outside the "areas of effective competition"—the markets for CDMA and premium LTE modem chips—and had no direct impact on competition in those markets. *See Rambus*, 522 F.3d at 464 (noting that if a practice "raises the price secured by a seller" or otherwise harms customers, "but does so without harming competition, it is beyond the antitrust laws' reach").

2

Regardless of the "reasonableness" of Qualcomm's royalty rates, the district court erred in finding that these royalties constitute an "artificial surcharge" on rivals' chip sales. In *Caldera, Inc. v. Microsoft Corp.*, 87 F.Supp.2d 1244 (D. Utah 1999), the primary case relied upon by the district court for its surcharging theory, Microsoft required OEMs "to pay [it] a royalty on every machine the OEM shipped regardless of whether the machine contained MS DOS or another operating system." This resulted in OEMs having to pay two royalties instead of one for a portion of their product base unless they chose to exclusively install Microsoft's operating system in their products. Microsoft's policy thus had "the practical effect of exclusivity," as it imposed a naked tax on rivals' software even when the end-product—an individual computer installed with a non-Microsoft operating system—contained no added value from Microsoft. . . .

Qualcomm's licensing royalties are qualitatively different from the per-unit operating-system royalties at issue in *Caldera*. When Qualcomm licenses its SEPs to an OEM, those patent licenses have value—indeed, they are necessary to the OEM's ability to market and sell its cellular products to consumers—regardless of whether the OEM uses Qualcomm's modem chips or chips manufactured and sold by one of Qualcomm's rivals. And unlike *Caldera*, where OEMs who installed non-Microsoft operating systems in some of their products were required to pay royalties for both the actual operating system *and* MS DOS (which was not installed), here OEMs do not pay twice for SEP licenses when they use non-Qualcomm modem chips. Thus, unlike Microsoft's practice, Qualcomm's practice does not have the "practical effect of exclusivity". . . .

In its complaint and in its briefing, the FTC suggests that Qualcomm's royalty rates impose an anticompetitive surcharge on its rivals' sales not for the reasons at play in *Caldera*, but rather because Qualcomm uses its licensing royalties to charge anticompetitive, ultralow prices on its own modem chips—pushing out rivals by squeezing their profit margins and preventing them from making necessary investments in research and development. But this type of "margin squeeze" was rejected as a basis for antitrust liability in *linkLine*. 555 U.S. at 451–52, 457. There, multiple digital subscriber line ("DSL") high-speed internet service providers complained that AT&T was selling them access to AT&T's must-have telephone lines and facilities at inflated wholesale rates and then shifting those increased profits to charge ultra-low rates for DSL services at retail, effectively squeezing these DSL competitors out of the market. The Court rejected the plaintiffs' assertion of anticompetitive harm, holding that AT&T was under no antitrust duty to deal with its competitors on the wholesale level, and

that the plaintiffs failed to introduce evidence of predatory pricing (that is, charging below cost) at the retail level.

Here, not only did the FTC offer no evidence that Qualcomm engaged in predatory pricing, the district court's entire antitrust analysis is premised on the opposite proposition: that Qualcomm "charge[s] monopoly prices on modem chips." Indeed, the district court faulted Qualcomm for lowering its prices only when other companies introduced CDMA modem chips to the market to effectively compete. We agree with Qualcomm that this is exactly the type of "garden-variety price competition that the law encourages," and are aware of no authority holding that a monopolist may not lower its rates in response to a competitor's entry into the market with a lower-priced product.

D

As with its critique of Qualcomm's royalty rates, the district court's analysis of Qualcomm's "no license, no chips" policy focuses almost exclusively on alleged "anticompetitive harms" to OEMs—that is, impacts outside the relevant antitrust market. The district court labeled Qualcomm's policy "anticompetitive conduct against OEMs" and an "anticompetitive practice[] in patent license negotiations." But the district court failed to identify how the policy directly impacted Qualcomm's competitors or distorted "the area of effective competition." *Am. Express*, 138 S.Ct. at 2285.

* * *

According to the FTC, the problem with "no license, no chips" is that, under the policy, "Qualcomm will not sell chips to a cellphone [OEM] like Apple or Samsung unless the OEM agrees to a license that requires it to pay a substantial per-phone surcharge *even on phones that use rivals' chips*." But this argument is self-defeating: if the condition imposed on gaining access to Qualcomm's chip supply applies regardless of whether the OEM chooses Qualcomm or a competitor (in fact, this appears to be the essence of Qualcomm's policy), then the condition by definition does not distort the "area of effective competition" or impact competitors. At worst, the policy raises the "all-in" price that an OEM must pay for modem chips (chipset + licensing royalties) regardless of which chip supplier the OEM chooses to source its chips from. As we have already discussed, whether that all-in price is reasonable or unreasonable is an issue that sounds in patent law, not antitrust law. Additionally, it involves potential harms to Qualcomm's *customers*, not its competitors, and thus falls outside the relevant antitrust markets.

* * *

E

Having addressed the primary components of the district court's antitrust ruling with respect to Qualcomm's general business practices, we now address the district court's more specific finding that from 2011 to 2015, Qualcomm violated both sections of the Sherman Act by signing "exclusive deals" with Apple that "foreclosed a 'substantial share' of the [CDMA] modem chip market." * * *

Qualcomm argues that its agreements with Apple were "volume discount contracts, not exclusive dealings contracts." Unlike exclusive dealing arrangements, "volume discount contracts are legal under antitrust law . . . [b]ecause the contracts do not preclude consumers from using other . . . services." Likewise, conditional agreements that provide "substantial discounts to customers that actually purchase[] a high percentage of their . . . requirements from"

a firm are not exclusive dealing arrangements, de facto or actual, unless they "prevent[] the buyer from purchasing a given good from any other vendor." *** * ***

There is some merit in the district court's conclusion that the Apple agreements were structured more like exclusive dealing contracts than volume discount contracts. However, we do not agree that these agreements had the actual or practical effect of substantially foreclosing competition in the CDMA modem chip market, or that injunctive relief is warranted.

During the relevant time period (2011–2015), the record suggests that the only serious competition Qualcomm faced with respect to the Apple contracts was from Intel, a company from whom Apple had considered purchasing modem chips prior to signing the 2013 agreement with Qualcomm. The district court made no finding that any other specific competitor or potential competitor was affected by either of Qualcomm's agreements with Apple, and it is undisputed that Intel won Apple's business *the very next year*, in 2014, when Apple's engineering team unanimously recommended that the company select Intel as an alternative supplier of modem chips. The district court found that "Qualcomm's exclusive deals . . . delayed Intel's ability to sell modem chips to Apple until September 2016." There is no indication in the record, however, that Intel was a viable competitor to Qualcomm prior to 2014–2015, or that the 2013 agreement delayed Apple's transition to Intel by any more than one year. Given these undisputed facts, we conclude that the 2011 and 2013 agreements did not have the actual or practical effect of substantially foreclosing competition in the CDMA modem chip market. * * *

We therefore **REVERSE** the district court's judgment and **VACATE** its injunction as well as its partial grant of summary judgment.