UNTYING THE KNOT

The Case for Overruling Jefferson Parish

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The *Jefferson-Parish* test for whether a tying arrangement violates the antitrust law should be abandoned. It should be replaced with a rule of reason analysis that examines whether there are adverse economic effects that outweigh potential economic benefits. There is widespread support in the modern antitrust and economics literature for adopting a rule of reason approach to tying and virtually no support for treating tying as *per se* unlawful by firms with market power.[1] Analyzing tying under a rule of reason would help complete the economic rationalization of antitrust law that started with *Sylvania* and under which *per se* treatment has been narrowed mainly to hard-core cartel behavior that has no pro-competitive benefits. Such a rule of reason analysis should be structured to screen out cases in which there is no plausible basis for believing that tying could have an adverse effect on long-run consumer welfare and should require plaintiffs to demonstrate rather than assume adverse effects from tying.

The Supreme Court should take the next opportunity to heed the advice Justice O'Connor and three other Justices offered more than twenty years ago regarding tying doctrine: "The time has therefore come to abandon the "per se" label and refocus the inquiry on the adverse economic effects, and the potential economic benefits, that the tie may have."[2] The enforcement agencies should support the effort to overrule *Jefferson Parish* and subject tying to the rule of reason. This would give the Supreme Court additional confidence in ending the *per se* treatment of tying which it has supported, despite profound reservations, because of longstanding judicial and legislative hostility towards tying.

This paper explains the basis in modern economics and antitrust analysis for overruling *Jefferson Parish.*

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[1] For further discussion David Evans, "Tying: The Poster Child for Antitrust Modernization" in (Robert W. Hahn, ed.), *Antitrust Policy and Vertical Restraints* (Washington, DC: Brookings Institution Press, 2006). A review of more than 100 papers in the last decade in the economics and legal literature found only one that supported a *per se* approach to tying. No economist to my knowledge has come to the defense of either the Jefferson Parish test or a *per se* illegal approach.

[2] *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 9 (1984). Justice O'Connor's Concurring Opinion at p. 58.

A Short History of Tying Jurisprudence

The Supreme Court was not receptive to tying claims at the turn of the 20th century. In *Henry v. A. B. Dick Co.*, decided in 1912, the Court encountered tying in a patent infringement claim. A. B. Dick required customers of its patented mimeograph machine to use its unpatented ink. It sued a distributor of a competitor's ink for contributory patent infringement on the grounds the distributor knew that this would induce the customer to violate the terms of the contract that permitted it to use the patented product. The Court found for A. B. Dick.[3]

In *United States v. Winslow*, decided in 1913, the government had argued that the vertical merger creating the United Shoe Machinery Company violated the Sherman Act. The concern was that the combination of three previously separate shoe machine manufacturers that each had substantial shares of machines used at different levels of the production process (and did not compete with each other) was harmful to competition. The Court ruled against the government, finding that combining the previously separate machinery was not anticompetitive: "It is as lawful for one corporation to make every part of a steam engine and to put the machine together as it would be for one to make the boilers and another to make the wheels."[4]

Around this same time a sharply divided U.S. Supreme Court enunciated the "rule of reason" in *Standard Oil* and *American Tobacco*. It did not go over well in the executive and legislative branches of the government. Some thought it broadened the Sherman Act and was judicial usurpation. Others thought it narrowed the regulation of competitive behavior too much. And still others bemoaned the lack of a clear definition of unlawful conduct that would guide businessmen.[5] Antitrust was a central issue in the Presidential campaign of 1912. The Republican, Democratic, and Progressive parties all adopted platforms calling for additional antitrust legislation. In 1914, the Federal Trade

[3] *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912).
[4] *United States v. Winslow*, 227 U.S. 202 (1913).
[5] Gilbert Montague, "Antitrust Laws and the Federal Trade Commission," *Columbia Law Review* 27 (June 1927): 650-78, p. 651-653

Commission and Clayton Acts emerged from what former President (and later Chief Justice) Taft referred to as the "hysterical condition of the public mind" in reaction to the rule of reason.[6]

Section 3 of the Clayton Act made it unlawful to condition the sale of one good on the requirement that the purchaser not buy or use another good to the extent this resulted in the substantial lessening of competition or tended to create a monopoly. United Shoe Machinery was very much on the minds of those who supported this "anti-tying provision." Representative Mitchell's view is typical of the Congressional record that led to the passage of Section 3:

> [Monopoly] has been built up by these 'tying' contracts so that in order to get one machine one must take all of the essential machines, or practically all. Independent companies who have sought to enter the field have found that the markets have been preempted. . . . The manufacturers do not want to break their contracts with these giant monopolies, because, if they should attempt to install machinery, their business might be jeopardized and all of the machinery now leased by these giant monopolies would be removed from their places of business. No situation cries more urgently for relief than does this situation, and this bill seeks to prevent exclusive 'tying' contracts that have brought about a monopoly, alike injurious to the small dealers, to the manufacturers, and grossly unfair to those who seek to enter the field of competition and to the millions of consumers.

The Court subsequently took its lead from this legislative hostility to tying contracts. In *Motion Picture Patents Co.*, decided in 1917, it overruled the holding in *A. B. Dick.* Patent holders were no longer permitted to require purchasers to take another product as a condition of buying the patented product. While the Court did not rely on the Clayton Act in reaching its findings, it noted that the Clayton Act "confirmed" the Court's conclusion and that it was "a most persuasive expression of the public policy of our country with respect to the question before us."[7] In *United Shoe Machinery* (1922) the Court found that the company's leases violated Section 3 of the Clayton Act by effectively restricting customers from leasing machines from competitors.[8]

A quarter century passed before the Court considered tying under the Sherman Act and home-grown hostility towards tying emerged. In its 1947 *International Salt*

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[6] *Id.*, p. 655
[7] *Motion Picture Patents Corp. v. Universal Film Mfg. Corp.*, 243 U.S. 502, 517-18 (1917).
[8] *United Shoe Mach.Corp. v. United States,* 258 U.S. 451 (1922)

decision the Court considered an arrangement under which International Salt conditioned the lease of its patented machines on the requirement that the lessee purchase all salt used in the leased machines from the company. The Court found that such tying was a *per se* violation of Section 1 of the Sherman Act as well as a violation of the Clayton Act.[9] In *Standard Oil*, issued two years later, Justice Frankfurter, writing a majority decision in which he was joined by four other Justices, concluded that "[t]ying arrangements serve hardly any purpose beyond the suppression of competition."[10] The *per se* prohibition against tying expanded the scope for claiming unlawful tying well beyond the patent misuse area and the sorts of contracts that could be found unlawful under Section 3 of the Clayton Act.

That view persisted for three more decades until *U.S. Steel v. Fortner Enterprises* which went up to the Court twice. U.S. Steel offered cut-rate financing to developers who also purchased its pre-fabricated houses. In *Fortner I,* four Justices dissented from the majority holding—that tying arrangements involving credit were no different from tying of other goods and services—on the grounds that the tie-in may serve legitimate purposes.[11] The case was remanded to a bench trial. The plaintiff prevailed and the case found its way to the Court again. In *Fortner II*, issued in 1977, the Court rejected the plaintiff's argument that there was an unlawful tie because it had failed to show that the defendant had market power. The plaintiff had proved "nothing more than a willingness to provide cheap financing in order to sell expensive houses." [12]

Seven years later a sharply divided Court ruled on *Jefferson Parish.* A four-judge minority wanted to scrap the *per se* approach in favor of a rule of reason approach that would consider whether the practice had adverse economic effects and weigh these against the pro-competitive benefits. The five-judge majority, however, decided to stick with the *per se* on the grounds 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*.'"[13] They pointed to the Court's own history of *per se* condemnation which went back to

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[9] *International Salt Co. v. United States,* 332 U.S. 392 (1947).
[10] *Standard Oil Co. v. United States,* 337 U.S. 293, 305 (1949), p. 11.
[11] *Fortner Enterprises, Inc. v. United States Steel Corp. et al.,* 394 U.S. 495 (1969).
[12] *United States Steel Corp. et al. v. Fortner Enterprises, Inc.,* 429 U.S. 610 (1977).
[13] *Jefferson Parish Hospital Dist. No. 2 v. Hyde,* 466 U.S. 2, 9 (1984).

1947 and the legislative hostility to tying embodied in the passage of Section 3 of the Clayton Act.

Nevertheless, reaffirming the view from *Fortner I and II*, the Court unanimously rejected the view that tying can serve no legitimate purpose. The five-judge majority decision observed that,

> It is clear, however, that not every refusal to sell two products separately can be said to restrain competition. If each of the products may be purchased separately in a competitive market, one seller's decision to sell the two in a single package imposes no unreasonable restraint on either market.... Buyers often find package sales attractive; a seller's decision to offer such packages can merely be an attempt to compete effectively -- conduct that is entirely consistent with the Sherman Act.
> It strove instead to reign in the *per se* approach by building on *Fortner II.*

Essentially, the majority limited *per se* liability to those situations in which the defendant could force a significant number of consumers to take something they would have otherwise obtained from another producer. The existence of market power in the tying market was the bedrock of this inquiry.

In 2006 the Supreme Court had the opportunity to revisit the issue in *Illinois Tool Works Inc., v. Independent Ink.*[14] In *Jefferson Parish* the Court had assumed that patents necessarily conferred market power. In *Illinois Tool Works* it overruled itself noting that Congress, the antitrust enforcement agencies, and most economists recognized that patents do not necessarily confer market power and that the plaintiff must prove this rather than just assume it. Therefore, for the purposes of Sherman Section 1 the plaintiff must demonstrate that the defendant has market power in the patent tying product. As a result, the *Jefferson Parish* test applies to patented and unpatented products.

Tying now lives in its own special purgatory of antitrust jurisprudence. The practice is not strictly *per se* unlawful because, unlike hard-core price fixing, the courts inquire into market power and whether the practice actually prevents consumers from taking a competing product. Yet the practice is not really considered under the rule of reason because plaintiffs have no serious obligation to establish anticompetitive effects and defendants have little opportunity to establish efficiencies. As Justice O'Connor noted in her concurring opinion in *Jefferson Parish,* " [T]ying doctrine incurs the costs of

[14] *Illinois Tool Works Inc., v. Independent Ink, Inc.,* 126 S. Ct. 1281 (2005).

a rule-of-reason approach without achieving its benefits: the doctrine calls for the extensive and time-consuming economic analysis characteristic of the rule of reason, but then may be interpreted to prohibit arrangements that economic analysis would show to be beneficial."[15] That is the knot that needs to be untied.

The State of Antitrust Knowledge on Tying

Economists have studied the purposes and effects of tying for more than a century. A two-part article in the December 1913 and January 1914 issues of the *Journal of Political Economy* explained that tying contracts involving shoe machineries was a standard practice in the industry well before the emergence of United Shoe Machinery as a dominant firm and described the legitimate business purposes that these contracts solved.[16] Four propositions can be stated with some confidence based on the scholarly literature in economics and the modern approach to antitrust analysis.

- First, tying is widespread among firms with little market power and is therefore presumptively pro-competitive. Tying promotes lower costs and improved valued and thereby increases long-run consumer welfare. Tying also enables firms with little market power to engage in price discrimination which economists recognize does not generally decrease long-run consumer welfare.
- Second, tying has the same ability to generate efficiencies for firms with more market power as for firms with less market power. Moreover, firms with market power lack the incentive or ability to use tying as an anticompetitive strategy in a wide variety of circumstances. Tying is therefore presumptively pro-competitive for firms with market power or monopoly power.
- Third, in some circumstances, however, firms with market power in the tying product can use tying to exclude competitors in the market for the tied product or the tying product and thereby reduce long-run consumer welfare.

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[15] *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 9 (1984). Justice O'Connor's Concurring Opinion at p.57.
[16] R. Roe, "The United Shoe Machinery Company, Pt. 1-11" *Journal of Political Economy* 21: 938-53 (1913); R. Roe, "The United Shoe Machinery Company - Concluded" *Journal of Political Economy* 22: 43-63 (1914).

Therefore, one cannot exclude the possibility that a firm with market power may use tying in ways that have adverse economic effects.

- Fourth, tests based on mere market power, such as *Jefferson Parish*, will systematically condemn tying arrangements that are on balance pro-competitive since market power is just one of many necessary conditions for anticompetitive tying to occur. A structured rule of reason test can more accurately distinguish anticompetitive from pro-competitive tying by imposing screens for the necessary conditions that must be satisfied for firms to have the incentive or ability to engage in anticompetitive tying and requiring that plaintiffs demonstrate rather than merely assume that tying by firms with market power has adverse economic effects.

1. Tying is presumptively pro-competitive. Tying is a pervasive economic phenomenon as the Court has recognized on several occasions now.[17] There are two broad explanations for this.

The first economic explanation for tying is that it is a competitive response to demand and cost considerations.[18] On the cost side, producers save on packaging costs and can provide more reliable products through combinations. On the demand side, consumers value being able to obtain products combined together in a package because it reduces transaction costs or provides other conveniences. More broadly, tying is part of the firm's overall decisions concerning architecting products and product lines based on demand and cost considerations.[19]

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[17] See, *United States Steel Corp. et al. v. Fortner Enterprises, Inc.*, 429 U.S. 610 (1977); *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 9 (1984); *Illinois Tool Works Inc., v. Independent Ink, Inc.*, 126 S. Ct. 1281 (2005).

[18] Dennis Carlton & Jeffrey M. Perloff, *Modern Industrial Organization 4th ed.*, at p. 319-320 (2005); Jean Tirole, "The Analysis of Tying Cases: A Primer," *Competition Policy International* 1: 1 (Spring 2005). Yannis Bakos & Erik Brynjolfsson, "Bundling Information Goods: Pricing, Profits, and Efficiency," *Management Science* 45(12) 1613-1630 (1999); G. Eppen, W. Hanson, & R. Martin, "Bundling – new products, new markets, low risk," *Sloan Management Review*, 32, 7-14 (Summer 1991).

[19] David Evans & Michael Salinger, "An Empirical Analysis of Bundling and Tying: Over-the-Counter Pain Relief and Cold Medicines," in (J. Pil Choi, ed.), *Recent Developments in Antitrust: Theory and Evidence* (Massachusetts: MIT Press, 2006); David S. Evans and Michael A. Salinger, "Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law," *Yale Journal on Regulation*, Vol. 22, No. 1, Winter 2005; David S. Evans and Michael A. Salinger, "The Role of Cost in Determining When Firms Offer Bundles," *Journal of Industrial Economics*, forthcoming (July 2006); David S. Evans, and Karen Webster, "The Architecture of Product Offerings" (January 2006).

The second economic explanation for tying is that it enables firms to increase profits through various forms of price discrimination. The term "price discrimination" is pejorative and the practice is frowned on under Section 2 of the Clayton Act. However, it is generally recognized by economists that price discrimination is a common method used by firms in competitive markets to increase profits by tailoring prices and product offerings to consumers' willingness to pay.[20] Price discrimination is particularly helpful for firms that seek profits to cover their fixed costs of production or to obtain a return on their investment in research and development. It is an especially common practice for owners of intellectual property which have comparatively high fixed costs and low marginal costs of production. Most importantly, economists do not generally regard price discrimination as a weapon that dominant firms can use to engage in anticompetitive strategies.[21]

2. Tying is presumptively competitive even when engaged in by a firm with monopoly power. The efficiency explanations for tying are just as true for a firm with monopoly power as they are for a firm that faces significant competition. When we observe a practice in competitive markets we can conclude with great assurance that it is efficient and benefits consumers in the long run. If it was not efficient it could not survive for long; competition among firms trying to provide the best products for consumers at the lowest costs would drive it out. Business practices that yield efficiencies when firms face more competition continue to yield efficiencies when firms face less competition.[22]

It is possible that as firms acquire market power they also acquire the incentive and ability to use an ordinarily efficient practice for anticompetitive ends. We know, however, from the Chicago single-monopoly profit theorem that firms do not have

[20] In his majority opinion in *Illinois Tool Works*, Justice Stevens noted that "...while price discrimination may provide evidence of market power, particularly if buttressed by evidence that the patentee has charged an above-market price for the tied package, see, e.g., 10 Areeda ¶1769c, it is generally recognized that it also occurs in fully competitive markets, see, e.g., Baumol & Swanson, The New Economy and Ubiquitous Competitive Price Discrimination: Identifying Defensible Criteria of Market Power, 70 Antitrust L. J. 661, 666 (2003); 9 Areeda ¶1711; Landes & Posner 374–375." *Illinois Tool Works Inc., v. Independent Ink, Inc.,* 126 S. Ct. 1281 (2005), p. 1292. Also see the discussion of price discrimination in Carlton & Perloff, *supra* note 18 , at p. 301-308.

[21] See Carlton & Perloff, supra note 18, at 321-322, 306-307.

[22] David Evans & A. Jorge Padilla, "Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach," *University of Chicago Law Review* 72: 73 (Winter 2005); Richard A. Epstein, "Monopoly Dominance or Level Playing Field? The New Antitrust Paradox," *University of Chicago Law Review* 72: 49 (Winter 2005)

increased incentives to use tying for anticompetitive ends in an important class of cases.[23] When the tied and tying products are consumed in fixed proportions—which was the case with *United Shoe Machinery* mentioned above[24]—a monopolist can obtain the maximum monopoly profit for the bundle by charging the monopoly price for the tying product and can derive no further gain through tying.

Take the case in which a firm has a monopoly in ***A*** and consumers use the monopoly product ***A*** and another product ***B*** in fixed proportions. Examples include cars and radios, computers and microprocessors, and shoes and shoe laces. The marginal cost of supplying ***B*** is c, which equals its price under competitive supply, p_c. Consumers have a final demand for the combined product ***A+B***. The monopolist maximizes profit by determining the profit-maximizing price for this combination p_m. That gives the monopolist the most profit it could possibly obtain. The monopolist can achieve this profit in several ways.

- Offer the bundle at a combined price p_m.
- Offer ***A*** only at a price p_m-c and have consumers purchase ***B*** from competitive suppliers.
- Offer ***A*** at a price of p_m-c and ***B*** at a price of c along with the other competitive suppliers.

From the monopolist's standpoint, it has nothing to gain by getting a monopoly in ***B***. It would still collect the same monopoly profit based on the combined price of p_m.[25] Nor is monopoly leveraging costless. If there is no efficiency justification for the tie then consumers would prefer to obtain the tying product without the tied product. Forcing

[23] Ward S. Bowman Jr., "Tying Arrangements and the Leveraging Problem, " *Yale Law Journal* 67 : 19 (1957), at p. 21; Richard Posner, "The Chicago School of Antitrust Analysis," *University of Pennsylvania Law Review* 127: 925 (1979); Herbert Hovenkamp, "Post-Chicago Antitrust: A Review and Critique," *Columbia Business Law Review* (2001): 257, at p. 320-21; Keith N. Hylton, *Antitrust Law: Economic Theory and Common Law Evolution* 196, 280-81 (Cambridge University Press, 2003).

[24] Aaron Director and Edward H Levi, "Law and the Future: Trade Regulation," *Northwestern University Law Review* 51: 281-96 (May-June 1956). I discuss strategies to maintain a monopoly in the tying market below.

[25] The only incentive for the monopolist in this example is to make sure that some firm is selling ***B*** competitively. It wants to avoid what economists call the "double monopoly markup" problem. If another firm had a monopoly in ***B*** that firm would restrict the output of ***B*** and raise its price above c. That would tend to reduce the sales of ***A*** and hurt the ***A*** monopoly's profits. So in this case monopoly ***A*** has an incentive to create competition in ***B***. It might do that, perhaps, by producing ***B*** itself. See the discussion of "double monopoly markup" in Carlton & Perloff, *supra* note 18, at 415.

consumers to take a product they do not want reduces their demand and willingness to pay for the bundle.[26]

The single-monopoly profit theorem does not hold strictly for those cases in which the components of a bundle are not used in fixed proportions—as was the case in *A. B. Dick* (mimeograph machines and ink) and *International Salt* (industrial salt machinery and salt). In those cases the tying product can be used to increase monopoly profit through price discrimination. Albert R. Dick, the founder of the mimeograph machine company, explained that they had required customers to purchase their ink because it enabled the company to increase the price to larger customers without raising it much to smaller customers as well as avoid situations in which their machines did not work properly because of the use of inferior supplies. As he said, "It occurred to us that if we could insure to ourselves the sale of the supplies we would not only be able to secure the profit which we were entitled to, but we would be able to give the users the highest grade of materials, which are necessary to produce the best results, and thus not only keep the machines in more constant use in the hands of the users but give them better satisfaction in every way."[27] Dick claimed at least that they were losing money on the machines before implementing this price discrimination scheme.

3. Tying can be used to maintain or acquire monopoly power under specific conditions. Economists have identified two scenarios in which monopoly firms have the incentive and the ability to tie their monopoly product ***A*** to a product ***B*** that is not a monopoly product. The crux of both scenarios is that there are scale economies in the production of ***B***. By foreclosing enough demand to competing producers of ***B,*** the monopolist denies them scale economies and captures the ***B*** market.[28]

In these cases it is possible to identify situations in which (1) the monopolist finds that it is profitable to tie ***B*** to ***A*** to foreclose the market to competing ***B*** suppliers and (2) raise the price of ***B*** higher than it would be in the absence of this foreclosure and (3)

[26] For a formal discussion, see Michael D. Whinston, "Tying, Foreclosure, and Exclusion," *American Economic Review* 80: 837 (1990), at p. 851-852. For a discussion of other conditions when the single monopoly profit theorem does not hold (when there is a threat of later entry into the initially monopolized product) see, Dennis W. Carlton & Michael Waldman, "The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries," *Rand Journal of Economics* 33: 194 (2002).

[27] John Paul Stevens, "Tying Arrangements," Conference on the Antitrust Laws and the Attorney General's Committee Report (1955), p. 143, fn. 16.

[28] Jean Tirole, "The Analysis of Tying Cases: A Primer," *Competition Policy International* 1:1 (2005).

thereby reduce consumer welfare. Carlton and Perloff give the example of a hotel on an island whose guests like to play tennis.[29] By tying the use of the hotel to the use of a tennis club the hotel can deny enough volume to other tennis clubs and end up with a tennis club monopoly. It will then be able to charge guests and non-guests a higher price for playing tennis.

It is also possible to find situations in which the monopolist finds it beneficial to monopolize the ***B*** market because it is possible that the ***B*** producers will evolve over time into competitors. Therefore, the monopolist engages in foreclosure to prevent an erosion of its profits in ***A*** rather than to obtain profits in ***B***.[30] That was the theory behind the antitrust case against Microsoft involving an internet browser. Microsoft, the argument went, saw Netscape as a potential software platform rival to Windows. Rather than risk the Netscape browser evolving into a competitive threat to Windows, Microsoft tried to eliminate Netscape through tying.[31]

Economists who have authored papers identifying these possible anticompetitive uses of tying have been careful to note that they are special cases and that one would need to determine whether the conditions under which they could occur apply in the particular case in question. For example, in his article on tying and foreclosure, Whinston notes that, "while the analysis vindicates the leverage hypothesis on a positive level, its normative implications are less clear. Even in the simple models considered here, which ignore a number of other possible motivations for the practice, the impact of this exclusion on welfare is uncertain."[32] Carlton and Waldman also caution that "trying to turn the theoretical possibility for harm shown here into a prescriptive theory of antitrust enforcement is a difficult task."[33]

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[29] Carlton & Perloff, *supra* note 18, at 389.
[30] Carlton & Waldman, *supra* note 26.
[31] See David Evans, Albert Nichols & Richard Schmanlensee, "An Analysis of the Government's Economic Case in U.S. v. Microsoft," *Antitrust Bulletin* (Summer 2001); David Evans, Albert Nichols & Richard Schmalensee, "U.S. v. Microsoft: Did Consumers Win?," *Journal of Competition Law and Economics* 1(3), 497–539 (2005)
[32] See, Whinston, *supra* note 26, at p. 855-6. Also see, Michael D. Whinston, "Exclusivity and Tying in U.S. v. Microsoft: What We Know, and Don't Know," *Journal of Economic Perspectives* 15: 79 (2001), "What is striking about the area of exclusive contracts and tying, however, is how little the current literature tells us about what these effects are likely to be. This state of (non) knowledge is, I think, responsible to a significant degree for the very strong but differing beliefs that economists often have about whether exclusive contracts and tying are likely to have welfare-reducing anticompetitive effects."
[33] Carlton & Waldman, *supra* note 26, p. 215.

Three observations about these theories on the anti-competitive use of tying are worth keeping in mind. First, the tying strategies used by the would-be monopolist in these theories are costly. The monopolist provides a suboptimal package to consumers (it denies them choices they would like to have) and therefore sacrifices profits. It must weigh these losses against future gains resulting from foreclosure. Second, these tying strategies only work if the monopolist can foreclose competition in the tied-good market, or at least substantially reduce it. The success of the strategy, therefore, depends on the existence of barriers to entry into the tied good market. Third, foreclosure of competition in the tied good market does not necessarily lead to lower consumer welfare. Therefore even when the conditions under which these theories apply hold true we cannot necessarily assume that antitrust intervention is warranted.

4. Market-power based tests cannot distinguish pro-competitive from anti-competitive ties. The second and third proposition above demonstrate that it is not possible to distinguish between anti-competitive and pro-competitive tying based solely on whether firm has mere market power in the tying good. First, there is no basis for concluding that the reasons that competitive firms engage in tying do not apply when a firm crosses some market power threshold. Second, for cases covered by the single-monopoly profit theorem there is little basis for concluding that tying may be used as an anticompetitive strategy even if the firm engaging in tying has market power. Third, market power is one of several necessary conditions, and is not a sufficient condition, for the specific economic theories that find that it is possible to use tying to maintain or acquire a monopoly.

The *Jefferson Parish* test, applied strictly, condemns tying arrangements that generate efficiencies on net for consumers, through better product offerings, lower prices, and lower transactions costs, and that enable firms, especially intellectual property holders, to recover their fixed costs through variable pricing schemes. As Justice O'Connor noted, the Court's tying doctrine "may be interpreted to prohibit arrangements that economic analysis would show to be beneficial." The rule of reason test, on the other hand, by construction, requires the plaintiff to specify the adverse economic effects of tying, permits the defendant to document efficiencies from tying, and enables the

finder of fact to weigh the pro-competitive and anti-competitive effects of tying arrangements.

Although a rule of reason test is preferable to the *Jefferson Parish* test the four propositions presented above could support a more radical departure from the existing case law: tying should be *per se* lawful. Tying is a pervasive practice among competitive firms, there is no economic basis for presuming that tying is a plausible anticompetitive strategy in most circumstances, and economists have found no operational test for identifying anticompetitive tying. Since the Supreme Court would appear unlikely to make this longer leap from *per se* illegality to *per se* legality this paper only argues for analyzing tying under the rule of reason.

That the rule of reason analysis should, however, be structured to minimize errors costs and reduce the cost of judicial administration and should recognize that tying is presumptively pro-competitive.[34] Plaintiffs should not be able to survive summary judgment unless they can demonstrate that there are two separate products, that the defendant has significant market power in the tying market, and that the defendant can exclude a significant amount of competition in the tied market to achieve an anticompetitive strategy. Plaintiffs should have to be able to demonstrate that the tying practice had or will have adverse effects on long-run consumer welfare.[35]

Tying and the Rationalization of Antitrust Law

The *Jefferson Parish* test approach to tying does not fit with modern antitrust jurisprudence.

The Supreme Court has moved most everything except hard-core price fixing and purely horizontal territorial allocation and non-compete agreements out of the *per se* category over the last three decades. The *Sylvania* decision reversed the long-standing precedent that exclusive territories for distributors were a *per se* violation of the antitrust

[34] Frank H. Easterbrook, "The Limits of Antitrust", *Texas Law Review* 63 (1): 37 (1984); Evans & Padilla, *supra* note 22.

[35] See David S. Evans, Christian Ahlborn, and A. Jorge Padilla, "The Antitrust Economics of Tying: A Farewell to Per Se Illegality," *The Antitrust Bulletin* (Spring-Summer 2004), for further discussion of a structured rule of reason approach.

laws.[36] A few years later the scope of the *per se* rule was curtailed even further when in *BMI* the Supreme Court ruled that even some price fixing arrangements may have efficiency justifications which would warrant their analysis under the rule of reason.[37] Finally in *State Oil v. Khan* in 1997, the Supreme Court unanimously decided that maximum resale price maintenance was not *per se* illegal and that it should be analyzed under rule of reason.[38]

Generally, the Supreme Court, as well as lower courts, have moved the antitrust laws to a sound modern economic footing even when that has required—as it often has—overturning the Court's older jurisprudence. Economists have noted the increasing use of sophisticated economic analysis by the U.S. courts in deciding antitrust cases since the 1970s.[39] R. Hewitt Pate, the Assistant Attorney General for the Antitrust Division, recently remarked that :

> "[a]s the sophistication of economic analysis increased, our Supreme Court began to reexamine some of these precedents and return to fundamental principles of competition and consumer welfare. In *GTE Sylvania*, the Court overruled *Schwinn*, and in *State Oil v. Khan*, it overruled *Albrecht*...in *Matsushita*, the Court poured cold water on theories of liability that make little economic sense, and it expressed skepticism of liability theories based on price cutting, which is often 'the very essence of competition.'"[40]

Jefferson Parish stands apart. The Supreme Court majority in that case deserves some credit of course. For more than thirty years the Court had spoken of tying in the same way that it has spoken of hard-core price fixing. The majority soundly rejected the view that tying never had merit as a business practice and required evidence that the tying firm had appreciable economic power. Unfortunately, the market-power based test it adopted is illogical and incoherent as an economic matter. One can see this plainly from its application to the tying of surgical and anesthesiology services at issue in the case.

Jefferson Parish Hospital, outside New Orleans, entered into an exclusive agreement with a group of anesthesiologists to provide anesthesiology services at the

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[36] *Continental T.V. v. GTE Sylvania,* 433 U.S. 36 (1977).
[37] *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.,* 441 U.S. 1 (1979).
[38] *State Oil Co. v. Khan,* 522 U.S. 3 (1997),
[39] See, William E. Kovacic and Carl Shapiro, "Antitrust Policy: A Century of Economic and Legal Thinking," *Journal of Economic Perspectives* 14(1): 43-60 (Winter 2000).
[40] R. Hewitt Pate, "Antitrust Law In The U.S. Supreme Court," Address by Assistant Attorney General, Antitrust Division, U.S. Department of Justice at the British Institute of International and Comparative Law Conference London, England (May 11, 2004)

hospital. When a doctor scheduled his patient for surgery at the hospital he had to pick—or recommend to the patient—an anesthesiologist from one of these anesthesiologists. A competing group of anesthesiologists claimed that Jefferson Parish Hospital was engaging in an anticompetitive tie in violation of Section 1 of the Sherman Act.

Jefferson Parish Hospital argued at trial that this exclusive arrangement enabled it to operate more efficiently and provide better patient care. The District Court accepted its business justifications. The Appeals Court did not. Nor it appears did the Supreme Court which considered efficiencies as part of the single-products analysis; the Court put special weight on the fact that other hospitals allowed patients to bring in their own anesthesiologists.

The Supreme Court decided that Jefferson Parish Hospital had not engaged in unlawful tying because it did not have significant market power in the market for hospital services. If Jefferson Parish was not trying to leverage market power from hospital services to anesthesiology services, what was it doing? It would seem that the most plausible explanation is that it believed that it could obtain efficiencies—and better patient care—by having an exclusive arrangement with a group of anesthesiologists.

Under the *Jefferson Parish* analysis, one assesses whether there is market power in the tying product only after determining that there are two separate products rather than one. Thus one examines market power after the single-product analysis that some have argued is a proxy for assessing whether there are efficiencies.[41] But once one has rejected efficiencies as an explanation for the practice one is always left with a puzzle if the defendant lacks market power.

The most plausible explanation for the tying practice engaged in by *Jefferson Parish* and by other defendants that have prevailed because they lack market power is that the tying practice provides efficiencies or facilitates price discrimination. That fact highlights the more serious problem with the *Jefferson Parish* test. There is no basis for believing that practices that are efficient in the absence of market power are not efficient in the presence of market power. Nor is there any basis for believing that practices that are efficient in the absence of market power transform themselves into anticompetitive weapons in the presence of market power.

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[41] See discussion of the separate products test in *US v. Microsoft,* 253 F.3d 34, (DC Cir., 2001), p. 128.

In *Jefferson Parish* the Supreme Court tied itself in knots. It tried to reconcile an archaic and misguided hostility towards tying with the plain fact that tying is a widely used and obviously efficient business practice. The time has come—and indeed is long over due—to cut the knot by overruling the *Jefferson Parish* test and analyzing tying arrangements under rule of reason.