JOURNAL OF LAW, ECONOMICS & POLICY

VOLUME 9 WINTER 2013 NUMBER 2

JOURNAL OF LAW, ECONOMICS & POLICY

VOLUME 9 | WINTER 2013 | NUMBER 2

Journal of Law, Economics & Policy

Volume 9 | Winter 2013 | Number 2

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ANTITRUST FOR HIGH-TECH AND LOW: REGULATION, INNOVATION, AND RISK

Ronald A. Cass[*]

I. ANTITRUST'S REGULATORY RISK

Speaking against a measure that would apply antitrust law to the railroad industry, Senator Mike Lee declared "federal and state agencies enforce antitrust laws in order to forestall the need for burdensome and long-lasting government regulation."[1] Senator Lee's objection to rules that would add overlapping layers of legal control under the jurisdiction of different administrative officers is certainly sensible, but the apparent dichotomy he draws between government enforcement of antitrust laws and "burdensome and long-lasting government regulation" is not.

Government enforcement of antitrust laws carries risks very similar to other forms of regulation. In addition to very serious problems defining meaningfully the conduct that contravenes antitrust law, there are considerable difficulties attached to, and risks associated with, government's implementation of the law. Government antitrust enforcement requires discretionary selection among an extraordinary range of possible targets, imposes significant burdens on companies that are under investigation or subject to suit, invites efforts by individual firms to motivate officials to deploy resources against rivals, and can seriously disrupt competition among firms.

Understanding the regulatory implications of antitrust enforcement is especially critical now that antitrust authorities are bringing or considering bringing antitrust enforcement cases against a substantial number of leading firms in high-technology industries. Among the companies publicly identified as actual or potential antitrust targets in recent months are Facebook, Apple, Yahoo, Google, IBM, AT&T, Microsoft, and Intel. Antitrust authorities need to exercise special care in making enforcement decisions with respect to high-technology industries, starting with appreciation of the potential pitfalls of all regulatory schemes, including antitrust. Traditional problems of regulation generally, and of antitrust enforcement specifically,

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[1] Mike Lee, *Railroad Antitrust Floor Statement*, MIKE LEE US SENATOR FOR UTAH BLOG (Mar. 07, 2012), http://www.lee.senate.gov/public/index.cfm/blog?ID=47b9cc27-2400-4f23-84d7-876221362d59.

are exaggerated in high-technology sectors, where antitrust enforcers' abilities to understand and predict industry evolution are most limited and where enforcement actions are most likely to rest on debatable predicates about the effects of specific conduct.

Rather than demonstrating special caution in venturing into this set of cases, however, antitrust enforcers seem anxious to engage the leading high-technology firms while markets are evolving at a rapid pace. The principal theories supporting aggressive use of antitrust laws to constrain dominant firms in high-technology or other "network industries" provide both malleable bases for enforcement and misleading predictions of the costs and benefits of enforcement. The problem arises in part because, while the concerns over network effects are dynamic, the principal tools for antitrust analysis—especially respecting definition of the relevant market—are static. These tools almost inevitably orient enforcers' decisions toward excessive concern with one part of what, rightly understood, is a much larger competitive picture, even though the composition of the larger picture is difficult to predict. Examination of some past government enforcement decisions is instructive for the risks such decisions entail, factors that should be considered in making such decisions, and presumptions that should guide decision-makers.

II. REGULATION: FORMS AND FAILURES

Antitrust as a form of economic regulation fits comfortably within the range of government controls over economic activity. Old-style regulation primarily consisted of class-based restrictions—the feudal system—exclusive licenses for certain occupations—the guild system—or religiously inspired restraints on practices such as money lending. By and large, these forms of regulation limited efficient economic activity, either in service of religious scruples, or as a means of shifting economic rewards to favored individuals or classes. Technological and sociological changes led Western nations to embrace relatively unfettered economies based on private property and market-based competition. This upended most of the older forms of regulation, but the personal interests that supported limiting entry to occupations and constraining some specific economic behaviors did not disappear. Partly for that reason and partly for reasons related to limitations on knowledge, experience demonstrates the difficulty of matching effective regulatory tools to actual problems and regulation notoriously risks creating new problems that are worse than those that intervention was intended to cure.

Modern economic regulations can be sorted into four broad classes. First, occupational regulations or occupational licensing schemes restrict entry into an astounding array of economic activities. By the middle of the 20th century in the United States, such regulations were imposed on hundreds of occupations, including "beekeepers, embalmers, lightning rod salespersons, barbers, septic tank cleaners, taxidermists, tattooers, tourist guides, cotton classers, textbook sellers—and lawyers."[2] A second class of regulation consists of special obligations imposed on specific industries, often combined with entry restrictions as well. Examples have included airline, train, and trucking regulation, as well as regulation of radio and television—the provinces of many of Washington, D.C.'s historic "alphabet agencies" (for example, CAB, ICC, FCC).[3] Within that second class are industries that are regarded as "natural monopolies." Also included are industries where only one firm efficiently can serve a market, including many utilities—delivery or transmission of cable television services, natural gas, electricity, and landline telephony are examples, or at least that was the theoretical argument for their regulation. A third category consists of health and safety regulations, such as those overseen by the Food and Drug Administration or the U.S. Department of Agriculture. Lastly there is a set of "fair play" regulations—prohibitions on fraudulent practices, cheating on weights and measures, and a variety of other "unfair" business practices, such as misrepresentation, mislabeling, and trademark violations.

All of the forms of regulation have been criticized as less congruent with public welfare than regulations' proponents assert. Argument over precise measures of public welfare, or over the bona fides of the concept of a collective welfare, can be set aside for now; the relevant point is not the details of any measure of public good, but the degree of divergence between regulatory schemes and any thoughtful definition of public good. Milton Friedman, for instance, gave a savagely clear-eyed review of occupational licensure, observing that licensure typically reduces options for the least knowledgeable and most impecunious members of society—those it ostensibly serves—and is supported not by them, but by members of the licensed profession whose status and incomes correlate positively with limitations on entry.[4] Even the most seemingly laudable efforts to protect the public against fraudulent or dangerous services through the institution of licensing screens turn out in practice, to have unattractive side-effects. Of course, Friedman's explanation is that the supposed side-effects, in reality, are often the primary goals of the licensing system, keeping competitive provision of services at bay, necessarily limiting options, raising prices, and leading to problems of access and allocation.

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2 RONALD A. CASS ET AL., ADMINISTRATIVE LAW: CASES & MATERIALS 829 (6th ed. 2011) (citing Walter Gellhorn, *The Abuse of Occupational Licensing*, 44 U. CHI. L. REV. 6 (1976)); AM. ENTER. INST. FOR PUB. POLICY RESEARCH, OCCUPATIONAL LICENSURE AND REGULATION 2 (Simon Rottenberg ed., 1980).

3 Civil Aeronautics Board, Interstate Commerce Commission, and Federal Communications Commission.

4 *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 138-60 (1962); *see also* WALTER GELLHORN, INDIVIDUAL FREEDOM AND GOVERNMENT RESTRAINTS 106-51 (1956).

Similarly, the second class of regulations—industry-specific regulations—have been the subject of any number of scathing critiques.[5] Many of these start with the assumption of public-interested intent in the initiation and general design of the regulations, but conclude that even the smartest and most public-spirited central decision-makers lack the ability to accumulate and evaluate the massive amounts of changeable, real-time information needed to craft and implement effective regulations. The "law of unintended consequences" does not guarantee that regulatory initiatives will produce results worse than the initial situation, but unforeseen effects of regulation very often produce problems that are bigger, more complex, and more pervasive than the problems regulatory designers had in mind.

Not to be left out, health and safety regulation has also been shown to have substantial flaws, including, in many cases, a strong bias against new products and technologies.[6] Even fair play regulations, such as those embodied in numerous securities and banking rules, can misalign incentives and generate unforeseen risks. Many analyses of the periodic financial crises and stock crashes trace back, at least in part, to misdirected regulations.[7]

As Alred Kahn observed after reviewing the extensive literature on regulations (primarily, but not exclusively, of the second class):

> A consensus was emerging in the early 1970s among disinterested students that regulation had suppressed innovation, sheltered inefficiency, encouraged a wage/price spiral, promoted severe misallocation of resources by throwing prices out of alignment with marginal costs, encouraged competition in wasteful, cost-inflating ways, and denied the public the variety of price and quality choices that a competitive market would have provided.[8]

In addition to the litany of complaints Dr. Kahn provides, regulation commonly encourages rent-seeking behavior that is both wasteful in itself and, when successful, influences government officials to act in ways that harm

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5 *See, e.g.*, Paul Joskow & Nancy L. Rose, *The Effects of Economic Regulation*, *in* 2 HANDBOOK OF INDUSTRIAL ORGANIZATION 1450 (Richard Schmalensee & Robert Willig eds., 1989); Robert Spann & Edward Erickson, *The Economics of Railroading: The Beginnings of Cartelization*, 1 BELL J. ECON. & MGMT. SCI. 227 (1970); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). For the difficulties of translating economic learning about efficient pricing for a regulated industry into practical applications, see generally BRIDGER MITCHELL & INGO VOGELSANG, TELECOMMUNICATIONS PRICING: THEORY AND PRACTICE (1991).

6 *See, e.g.*, BRUCE A. ACKERMAN & WILLIAM T. HASSLER, CLEAN COAL/DIRTY AIR: OR HOW THE CLEAN AIR ACT BECAME A MULTIBILLION-DOLLAR BAIL-OUT FOR HIGH-SULFUR COAL PRODUCERS AND WHAT SHOULD BE DONE ABOUT IT (1981); Sam Peltzman, *An Evaluation of Consumer Protection Legislation: The 1962 Drug Amendments*, 81 J. POL. ECON. 1049 (1973).

7 *See*, *e.g.*, RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

8 ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS, at xvi (1988).

the public.[9] Critics of industrial regulation, including industry or enterprise support programs referred to as "industrial policy," point to both of these negatives—the costs associated with unintended consequences of regulatory interventions and the costs of rent-seeking—as reasons for resisting this form of regulation.

III. ANTITRUST ENFORCEMENT: REASONS AND RISKS

Antitrust law, in contrast to standard industrial regulation, has been lauded frequently as America's fundamental economic charter—one that provides salutary ground rules for business. That sentiment has been voiced even by strong critics of most economic regulatory initiatives.[10] The classic statement, endlessly repeated, is Justice Hugo Black's declaration that "The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade."[11]

Application of antitrust laws by government officials, however, has the same risks and problems associated with other forms of regulation, including other "fair play" regulations.[12] It requires considerable information on how particular firms and particular markets work, on the effect of particular business practices, and on the costs and benefits of intervening to stop a particular practice as opposed to allowing market forces to limit its effects. Over time, some practices—horizontal price-fixing cartels, for example—have been evaluated sufficiently often in a sufficiently broad set of contexts so as to allow relative confidence in concluding that they are very often likely to produce consumer harm that is not readily limited by market forces.[13] However, an array of other practices cannot be classified as detri-

9 *See* Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291, 291 (1974) (noting that in some instances rent seeking takes the form of bribery, corruption, smuggling and black markets). *See generally* Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807, 807 (1975) (concluding that "public regulation is probably a larger source of social costs than private monopoly."). Admittedly, there may be a bit of a "chicken-and-egg" problem in determining whether private investments in rent-seeking induce wasteful government behavior or whether, instead, causality runs in the opposite direction. *See* Douglas Ginsburg, *A New Economic Theory of Regulation: Rent Extraction Rather Than Rent Creation*, 97 MICH. L. REV. 1771 (1999) (reviewing FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION (1997)); Fred McChesney, *Rent Creation Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987).

10 *See, e.g.*, RICHARD A. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE (1976).

11 N. Pac. Ry. v. United States, 356 U.S. 1, 4 (1958).

12 *See generally* THE CAUSES AND CONSEQUENCES OF ANTITRUST: THE PUBLIC CHOICE PERSPECTIVE (Fred S. McChesney & William F. Shugart II eds., 1995) [hereinafter CAUSES AND CONSEQUENCES].

13 While the presumption of harm from horizontal price-fixing is justified, that does not mean that such behavior is always harmful.

mental in the same way. Many settings require considerable information that is likely beyond government officials' reach to evaluate the costs and benefits of enforcement activity.

Indeed, in one sense, antitrust enforcement may be even more problematic than many types of industry regulation. Government antitrust enforcement necessarily requires selection of enforcement targets. Depending on the degree to which the conduct that might trigger enforcement is clearly circumscribed, this selection process could give administrators greater discretion than many regulatory programs entail; in fact, that is what has occurred in at least one major segment of antitrust enforcement.

Given the state of the law, and even more so, of theory and international practice,[14] on the "monopoly" or "dominance" side of antitrust (competition) law, officials now enjoy a relatively open field in selecting enforcement targets. This is the case even though this is precisely the part of antitrust law where legal actions are most difficult to defend as preventing or limiting consumer harm. Academic theories designed to combat perceived—and to some extent, no doubt, real—limitations on classical economic analysis of business competition in imperfectly competitive markets posit that firms can advantage themselves and harm others by engaging in conduct that does not seem problematic in a clear way—in the way in which a price-fixing cartel would be—but, nonetheless, has the effect of "raising rivals' costs."[15] That impact on competitors' prospects, in turn, can help expand or maintain a leading firm's dominant position—the raising-rivals' costs analysis would make this a presumptive violation of monopolization or abuse-of-dominance provisions in antitrust law.[16]

Almost any conduct by a leading firm, however, can have the effect of raising rivals' costs.[17] While additional screens can be used to restrict the impact of what is essentially an open door to enforcement prospects, the tests that have been put forward do not provide sufficiently clear and exact-

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14 *See* Ronald A. Cass, *Competition in Antitrust Regulation: Law Beyond Limits*, 6 J. COMPETITION L. & ECON. 119, 121 (2010).

15 *See* Steven C. Salop & David Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267, 267 (1983).

16 *See*, *e.g.*, Thomas G. Krattenmaker & Steven C. Salop, *Analyzing Anticompetitive Exclusion*, 56 ANTITRUST L.J. 71, 73 (1987); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209, 223-30 (1986); Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards and Microsoft*, 7 GEO. MASON L. REV. 617, 626-27 (1999).

17 *See*, *e.g.*, Ronald A. Cass & Keith N. Hylton, *Preserving Competition: Economic Analysis, Legal Standards, and Microsoft*, 8 GEO. MASON L. REV. 1, 11-14 (1999) (describing, inter alia, a complaint by Salop & Romaine that Microsoft's contracts with firms using its PC operating system did not all expire on the same date (creating a coordination problem and raising entry costs for makers of competing operating systems in violation of the antitrust laws) and explaining how changing Microsoft's approach would have a similar impact on rivals' costs and provide the same basis for alleging a violation of the antitrust laws).

ing limitations on this concept so as to put effective bounds around the set of acts that can trigger antitrust enforcement activity.[18] Therefore, under theories like raising-rivals' costs, antitrust enforcement authorities can essentially initiate action against any leading firm for conduct that, on its face, is not readily distinguished from the ordinary business operations of a competitive firm.[19] This broad discretion creates considerable risk that the process of picking and choosing among potential targets will distort competition in much the same way that implementing highly targeted, or firm-specific, industrial policy might.[20]

In rapidly changing high-technology industries, the problems can be especially acute and can threaten innovation as well as competition. High-technology industries are often characterized by large up-front investments in research and development, intense competition for breakthrough innovations, large economies of scale, and potential "network effects" that produce big gains over some time period for the most successful innovators. These are the characteristics of "winner-take-all" or "winner-take-most" markets.[21] For some antitrust scholars and enforcement authorities, these characteristics make it especially critical to take action swiftly to prevent entrenchment of a dominant firm's position or its expansion—into other product or geographic markets or through increased market share—beyond the ambit of existing leadership.[22] For those antitrust enthusiasts, the fear is that network effects will provide a ratchet toward ever increasing domi-

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18 *Compare* Salop & Romaine, *supra* note 16, *with* Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 SO. CAL. L. REV. 657, 660 (2001), Frank H. Easterbrook, *Allocating Antitrust Decisionmaking Tasks*, 76 GEO. L.J. 305 (1987), *and* Frank H. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135 (1984). *See also* Kenneth G. Elzinga & David Mills, *Predatory Pricing and Strategic Theory*, 89 GEO. L.J. 2475 (2001); William H. Page, *Microsoft and the Limits of Antitrust*, 6 J. COMPETITION L. & ECON. 33 (2010).

19 *See* Cass & Hylton, *supra* note 17.

20 For evidence that competitive rivals seek just that result from public antitrust enforcement and at times are effective in helping to obtain it, see William H. Page, *Microsoft and the Public Choice Critique of Antitrust*, 44 ANTITRUST BULL. 5, 11 (1999).

21 *See*, *e.g.*, Nicholas Economides, *The Economics of Networks*, 14 INT'L J. INDUS. ORG. 675 (1996).

22 *See*, *e.g.*, Michael Katz & Carl Shapiro, *Antitrust in Software Markets*, *in* COMPETITION, INNOVATION AND THE MICROSOFT MONOPOLY: ANTITRUST IN THE DIGITAL MARKETPLACE 29 (Jeffrey A. Eisenach & Thomas M. Lenard eds., 1999); Jonathan Baker, *"Dynamic Competition" Does Not Excuse Monopolization*, 4 COMPETITION POL'Y INT'L 243 (2008); Joel Klein & Preeta Bansal, *International Antitrust Enforcement in the Computer Industry*, 41 VILL. L. REV. 173 (1996); Mark Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CALIF. L. REV. 479 (1998); Daniel Rubinfeld, Deputy Assistant Attorney Gen., Antitrust Div., U.S. Dep't of Justice, Competition, Innovation, and Antitrust Enforcement in Dynamic Network Industries (Mar. 24, 1998) (addressed to the Software Publishers Association), *available at* http://www.justice.gov/atr/public/speeches/1611.htm; Christine Varney, Assistant Attorney Gen., Antitrust Div., U.S. Dep't of Justice, Address to the Center for American Progress (May 11, 2009), *available at* http://www.justice.gov/atr/public/speeches/245711.pdf.

nance and ever decreasing competition: the more valuable it is for people to share the same network—physical, technological, or social—the more different things will be drawn into the orbit of the dominant firm, just as astronomical entities with greater masses inevitably exert stronger attractive powers on other objects in space.[23] The message from these scholars and officials is that it is best to err on the side of enforcement.

The characteristics that often lead to dominance within a particular market sector, however, invite investments not only in contesting the initial innovation. They also invite finding follow-on improvements and, even more so, in discovering the next game-changing innovation, something that can come at unpredictable times from unpredictable sources and can swiftly upend market expectations.[24] Even markets that are not "contestable" in the immediate term—in the sense of firms being able to enter on a temporary basis to constrain pricing flexibility, even, theoretically, in a monopoly market[25]—may in fact be contested in a more meaningful way at each critical stage of development. These markets may be especially contested if one recognizes that the relevant market over the longer term encompasses the next generation of products that will supplant the current generation.[26] That recognition keeps temporarily successful firms wary of losing their position as market leaders at the same time that leading firms appear sufficiently dominant over a market segment to attract both complaints from rivals and antitrust attention from government officials.

If successful firms trying to stay on top in industries that can change rapidly and unpredictably often become targets for antitrust scrutiny, rational calculations of innovation costs—investments that help firms succeed—will necessarily include the (discounted) cost of contesting antitrust challenges, as well as the costs of directly pursuing innovation. Antitrust inquiries can exact extraordinarily high costs from target firms both in direct expenditures and in distraction from core business operations.[27] That is true even for inquiries that do not result in suits, as enterprises facing the possibility of a long, expensive lawsuit—and, if the suit is lost, a potentially expensive and disruptive remedy—obviously will respond by trying both to persuade enforcement authorities that their conduct has been lawful and to

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23 *See*, *e.g.*, Lemley & McGowan, *supra* note 22.

24 *See generally* Cass & Hylton, *supra* note 17 (discussing the side of network effects not emphasized by antitrust enthusiasts).

25 *See* WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982).

26 *See, e.g.*, John A. Norton & Frank M. Bass, *A Diffusion Theory Model of Adoption and Substitution for Successive Generations of High Technology Products*, 33 MGMT. SCI. 1069, 1069 (1987).

27 As discussed in the following section, IBM is an example of both of these points: responding to the litigation brought by the United States in the late 1960s cost the firm over $1 billion, which would be the equivalent of approximately $4 to $5 billion in 2010, and led to management decisions that cost the firm even more out of concern over their effect on both the immediate and potential future antitrust litigation.

avoid conduct that will increase the prospect of an action being filed. Both the direct and indirect costs of reacting to the enforcers' inquiries can be extremely large. While rivals will applaud such impositions on a leading enterprise, there often is little reason to expect that these inquiries will be socially beneficial, at least if pursued beyond an initial, cursory review.[28]

Furthermore, the costs of antitrust inquiries and prosecutions by enforcement authorities will influence behavior of prospective targets before any specific investigation is begun. As the expected costs associated with antitrust investigations and litigation rise, incentives decline for investment in the activities that will generate potential antitrust enforcement including investments in initial innovation, follow-on improvements, and aggressive competitive conduct—often exactly the sort of conduct that results in lower prices, improved products, and reduced costs of acquisition, access or operation for consumers. "Aggressive competition" may sound problematic to antitrust enforcers and antitrust-enthusiast academic theorists. Imagine, however, a business that wants to succeed by offering not the "lowest prices guaranteed" but just "low-ish prices, sometimes." There is a considerable difference to consumers from the contrasting approaches indicated by those different undertakings, and consumers tend to benefit from the more aggressively competitive approach. Excessively vigorous antitrust enforcement activity inevitably translates into insufficiently vigorous competition in exactly the markets that the enforcers and theorists want to make competitive.[29]

In addition to the problems caused by the investigations and suits themselves—problems that exist even if suits are not won by the government or, indeed, if they are not brought after serious, extensive investigation—there is a special problem that needs to be considered in cases where the government wins by succeeding at judgment or by inducing settlement that is something other than an effective capitulation by the prosecution. In cases where the government succeeds in its suit, the question of remedies becomes acute: what remedy will prevent the problems the government has identified, deter similar offending conduct in the future, and make the market work better for consumers? In fast-moving high-technology industries, that is not an easy question to answer. Imposing a remedy that looks essentially like a version of industrial regulation, as the European Commission did in its litigation against Microsoft, or breaking up a company, as occurred with AT&T following its 1984 settlement with the U.S. Department

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28 *See infra* Section III.

29 Not only will potential target firms behave in ways that are less conducive to providing lower prices—and other benefits—to consumers, so will other firms. Similar strategic interactions are observed in many aspects of behavior addressed by antitrust law. *See, e.g.*, KEITH N. HYLTON, ANTITRUST LAW: ECONOMIC THEORY AND COMMON LAW EVOLUTION 223-26 (2003); Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263, 264 (1981) (concluding that antitrust law should not take predation seriously).

of Justice (DOJ), even if sometimes beneficial, inevitably has costs for consumers and for society, and these costs can exceed the costs of tolerating "abuses" by the dominant firm.

The remedial question has been tackled by others[30] and will not be the focus of this paper. Instead, the focal point here is the question of what government enforcement authorities should be doing when considering whether to bring enforcement actions. The suspicion of wrongdoing is not uncommon in any competitive business setting, but it is another matter altogether to find real problems that violate the law and will not be corrected by ordinary market forces, or will not be moderated sufficiently to substantially lower the potential benefit from government-initiated antitrust intervention. Looking at some examples of past government assessments of potential antitrust targets suggests lessons for future decisions.

IV. GHOSTS OF ANTITRUST PAST

Four notable antitrust enforcement initiatives targeting iconic American enterprises—IBM, Microsoft, General Motors, and AT&T—provide a window into the way that government enforcement efforts function and the sorts of considerations and information available to enforcement officials when they are making their decisions. These four episodes include three long-running antitrust actions and one instance in which the government decided against litigation after years of investigating and gearing up for a prosecution.

A. *The IBM Case*

The paradigmatic case for ill-conceived antitrust enforcement may be the action filed against IBM as President Lyndon Johnson's administration departed in 1969. This was the Ramsey Clark Justice Department's signature antitrust enforcement action. The DOJ accused IBM of illegally monopolizing the market for computers. A great deal has been written about the substantive side of the case, which, among other things, rested on the government's assertion that IBM violated section 2 of the Sherman Act by bundling sales of its mainframe computers with sales of software and maintenance services.[31] There is a great deal to criticize in the concept at

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30 *See, e.g.*, RICHARD A. EPSTEIN, ANTITRUST CONSENT DECREES IN THEORY AND PRACTICE: WHY LESS IS MORE (2007); RICHARD A. POSNER, ANTITRUST LAW 266-86 (2d ed. 2001) [hereinafter ANTITRUST II]; Robert Crandall & Charles Jackson, *Antitrust in High Technology Industries* (2010), *available at* http://techpolicyinstitute.org/files/crandalljackson%20antitrust_in_high_tech3.pdf.

31 *See generally* FRANKLIN M. FISHER, JOHN J. MCGOWAN & JOEN E. GREENWOOD, FOLDED, SPINDLED, AND MUTILATED: ECONOMIC ANALYSIS AND *U.S. v. IBM* (1983).

the heart of the IBM case, given the almost universal use of similar bundling practices even in the most aggressively competitive markets, and the evidence that these practices often benefit consumers.[32] Even for those who are not entirely sold on the arguments against tying theory in general, the central assertions in the *IBM* case seem questionable.[33]

Even more problematic, however, was the government's position on the relevant market within which IBM operated and which it was asserted to monopolize. The DOJ defined the market narrowly to include only general purpose electronic digital computers, a definition that excluded a large number of other computers. That market definition did not take account of the reality of competition in the marketplace from numerous machines that, if not providing the same computational heft as IBM's mainframes, nonetheless offered computing options that in combination could certainly substitute for mainframes.[34] Undoubtedly, the suggested market definition was useful strategically. However, the definition also probably fit the sincere views of those in the DOJ overseeing the case that IBM was in fact a heavyweight astride the computer market and actively working to prevent others from competing effectively.

The DOJ's view of the market was demonstrably too narrow to capture the actual competitive conditions among those providing and utilizing computing equipment. More importantly, this view seriously misjudged the way the computer market, more broadly conceived, was evolving. Judge Michael Boudin (a former antitrust litigator and prominent antitrust official), writing shortly after the case had ended, explained the difference between what the officials saw and what was actually occurring and about to occur in the market:

> When the government began its investigation, IBM appeared to be an even more powerful figure, operating in a narrower market, than it is today. In the mid-1960's, IBM was triumphing over such other giants as RCA and General Electric in the production of mainframe computers. Newer competitors, including leasing companies and specialized computer companies, had barely begun to emerge. Mini- and microcomputers, product lines in which IBM

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32 *See*, *e.g.*, ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 375-81 (1978); FISHER ET AL., *supra* note 31; HYLTON, *supra* note 29, at 279–301; POSNER, *supra* note 30, at 205-07; Gregory Sidak, *An Antitrust Rule for Software Integration*, 18 YALE J. REG. 1, 8-9 (2001); Ronald A. Cass & Keith N. Hylton, *Tying Doctrine: Changing Views*, NAT'L L.J. (June 28, 2004), *available* at http://rule-of-law.us/tying-doctrine-changing-views-from-national-law-journal-june-28-2004/. *But see* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397 (2009); Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 AM. ECON. REV. 837 (1990).

33 *See*, *e.g.*, William E. Kovacic, *Failed Expectations: The Troubled Past and Uncertain Future of the Sherman Act as a Tool for Deconcentration,* 74 IOWA L. REV. 1105 (1989); John E. Lopatka, United States v. IBM: *A Monument to Arrogance*, 68 ANTITRUST L.J. 145 (2000).

34 *See, e.g.*, FISHER ET AL., *supra* note 31, at 61-75.

> has been less dominant (though gaining fast), had not yet posed their present challenge. Distributed data processing was just developing, as was foreign competition.[35]

From the vantage of twenty years after the government's capitulation in the *IBM* case, it is clear that IBM's early success in smaller computers, as noted by Judge Boudin, did not last, making the lasting dominance of IBM over computing hypothesized by the government at the start of the antitrust case even less sensible. It is also clear today just how much the development of smaller computers was able to replace functions formerly performed by mainframes, despite the supposition that there was not real competition between them.[36]

In addition to the weakness of the underlying allegations from an economic perspective, those who have studied the *IBM* case have reported the toll the case took on the company.[37] Financially, the case was a significant drain on the company, costing IBM approximately $1 billion, a figure that would be equivalent to between $4 and $5 billion today.[38] Waldman supposes that making such an enormous investment in developing a suitable PC operating system would have completely changed the fortunes of IBM and Microsoft.[39] It follows as well that this might have altered the fortunes of the entire array of computer makers tied to the evolution of Microsoft's operating systems.

More significant than the draw on IBM's funds were two other byproducts of the antitrust litigation. The first of these byproducts was the distraction of IBM's executives from planning and executing functions necessary to IBM's long-term business interests. The second was the active discouragement of decisions that would have benefitted the business but might have triggered further antitrust action.[40] The government collected more than 750 million documents, pried into every aspect of the firm's operations, and threatened to impose severe sanctions on the firm for practices

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35 Michael Boudin, Book Review, 97 HARV. L. REV. 835, 838 (1984) (reviewing FRANKLIN M. FISHER, JOHN J. MCGOWAN & JOEN E. GREENWOOD, FORENSIC ECONOMICS FOLDED, SPINDLED, AND MUTILATED: ECONOMIC ANALYSIS AND *U.S. v. IBM* (1983)).

36 This occurred both through rapid increases in the computational power and date storage capacities of the smaller computers and through developments such as linked-distributed computation that changed the way computers are used.

37 *See* PAUL CARROLL, BIG BLUES: THE UNMAKING OF IBM (1993); Don E. Waldman, *The Rise and Fall of IBM*, *in* MARKET DOMINANCE: HOW FIRMS GAIN, HOLD, OR LOSE IT AND THE IMPACT ON ECONOMIC PERFORMANCE 131, 140-41 (David I. Rosenbaum ed., 1998); Crandall & Jackson, *supra* note 30; William E. Kovacic, *Designing Antitrust Remedies for Dominant Firm Misconduct*, 31 CONN. L. REV. 1285, 1289-90 (1999).

38 *See* Waldman, *supra* note 37, at 141 (citing Neil B. Niman & Manley R. Irwin, *Computers*, *in* THE STRUCTURE OF AMERICAN INDUSTRY 157, 157 (Walter Adams & James Brock eds., 1995)) (calculation of current value, based on inflation rate, by author).

39 *Id.*

40 CARROLL, *supra* note 37, at 57.

that seem indistinguishable from what competitors normally do. This was an inquiry that "paralyzed IBM."[41] Bill Kovacic noted both the inhibition on aggressive competition and the distraction from focusing on the core business considerations, stating "[t]he diversion of firm personnel to support the case, as well as the time employees spend in casual conversation or mental speculation about the status of the case, silently bleeds the company's creative resources and blurs its competitive vision."[42]

It is not possible to know what would have happened without the antitrust suit. Perhaps IBM would have moved aggressively to develop a better operating system for smaller computers. Perhaps IBM would have invested in Microsoft. Perhaps it would not have allowed Microsoft to enjoy free rein in licensing the operating system they collaborated on to others or would have insisted on a share of the proceeds from that part of the business. What is clear is that the market was evolving in ways that undermined the position of dominance IBM had enjoyed and that this evolution had roots that predated the case and also was affected by, decisions reached during and after the litigation.[43] DOJ lawyers plainly did not foresee those developments, which led to an unnecessary suit and ultimately the decision to abandon the case, even if the legal precedents may have provided some prospect of success in court.[44] Judge Boudin summarized the saga:

> *United States v. IBM* appears in retrospect to be one of the great misadventures in antitrust litigation. After thirteen years of discovery and trial, a legal cast of thousands, and millions of dollars in litigation costs, the United States obtained dismissal of its own complaint and conceded that its case was 'without merit.'[45]

In the end, the case stands for the proposition that government officials, even with the benefit of extensive investigation and expertise, are unlikely to appreciate the most important sources of competition to enterprises that dominate a particular market and are especially prone to ill-advised interventions based on theoretical objections to market structure.[46]

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41 *See* James P. Pinkerton, *Government Rides Roughshod Over the Bills*, LA TIMES (Oct. 22, 1998), http://articles.latimes.com/1998/oct/22/local/me-34999.

42 Kovacic, *supra* note 37, at 1289.

43 *See generally* Crandall & Jackson, *supra* note 30 (detailing some of the predictions made by players in the computing hardware and software businesses—including Gordon Moore's eponymous law respecting computing power and prices—and the investments in the mini-computer side of the market that were being made, but not necessarily recognized or appreciated, by those engaged in the IBM antitrust battle).

44 Boudin, *supra* note 35, at 839-40.

45 *Id.* at 835.

46 *See* Cass, *supra* note 14, at 134.

B. *The Microsoft Case*

Conventional antitrust wisdom has it that the government's case against Microsoft Corporation was essentially a reprise of the *IBM* case three decades later. It was a sort of karmic turn in the evolution of computing, so far as Microsoft's success can be traced to IBM's leaders' fears of further attention from antitrust enforcers if the company pushed forward with investments in firms or technologies that might compete with IBM's. This view of the *Microsoft* case is only partially correct, but the case does share some common ground with *IBM*.

Like *IBM*, *Microsoft* was a case developed by the Federal Trade Commission (FTC) and DOJ that challenged the then-dominant technology company in the area of computing that looked destined to dominate that sector for the foreseeable future. The DOJ asserted that a variety of Microsoft's contracting and licensing practices unduly restricted rivals' ability to compete.[47] Like *IBM*, the government's case viewed Microsoft's conduct largely through the lens of its impact on competitors, with assertions of consumer harm developed as derivative of the limitations on competing businesses. And like *IBM*, the government's case rested on a relatively narrow market definition, looking only at operating systems running on IBM-compatible personal computers—a definition that, for instance, excluded Apple's operating system.

In *Microsoft*, while the first iteration of the government's enforcement effort focused exclusively on contract and licensing issues, the second round, which came in the late 1990s, alleged that Microsoft violated the Sherman Act by including an Internet browser in its operating system and by offering the browser free of charge. This count was similar to the charge that IBM had unlawfully bundled together its hardware, software, and services, but moved beyond *IBM* by pinning the government's arguments more fully to the concept that network effects explain both the motivation for Microsoft's conduct and the harm done by it to competition in the market.

As with *IBM*, the *Microsoft* litigation has spawned considerable argument regarding the economic and legal theories that underlay the government's case, or, more accurately, cases.[48] Some of the government's assertions about Microsoft's contracting practices and license terms demonstrate

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47 Complaint, United States v. Microsoft, 87 F. Supp. 2d 30 (D.D.C. 2000) (No. 98-1232), *available at* http://www.justice.gov/atr/cases/f1700/1763.htm.

48 *See*, *e.g.*, MICROSOFT, ANTITRUST AND THE NEW ECONOMY: SELECTED ESSAYS (David S. Evans ed., 2002); STAN J. LIEBOWITZ & STEPHEN MARGOLIS, WINNERS, LOSERS & MICROSOFT: COMPETITION AND ANTITRUST IN HIGH TECHNOLOGY (1999); WILLIAM H. PAGE & JOHN E. LOPATKA, THE MICROSOFT CASE: ANTITRUST, HIGH TECHNOLOGY, AND CONSUMER WELFARE (2007); TRIAL AND ERROR: *UNITED STATES V. MICROSOFT* (Paul Beckner & Erick R. Gustafson eds., 2000); Salop & Romaine, *supra* note 16.

the incredibly flexible nature of the raising rivals' costs approach, leaving Microsoft subject to challenge no matter what it did in making some business decisions.[49] Assertions respecting the bundling of a browser with the PC operating system had the quality both of at least arguable internal inconsistency—essentially making Microsoft guilty of over-charging and under-charging for its operating system—and of freezing development of Microsoft's most important product, depriving it of the ability to include features routinely incorporated in competing operating systems. The government's reliance on network effects arguments has been challenged as well on grounds that it endeavored to lower the bar for finding a Sherman Act § 2 violation and that it mischaracterized the operation of the market. Network effects may explain some of the working of the computer operating system market, but not all; scholars point out, for example, that these effects did not suffice to induce consumers to use Microsoft's Internet browser when that browser did not work well enough to satisfy their needs.[50] Moreover, if the PC operating system market is characterized by strong network effects, much of the observed market outcomes would occur naturally, regardless of the course Microsoft charted.[51] While the case had a number of twists and turns, culminating in a nominal win for the government, the most far-reaching conclusions were not upheld. In particular, the test on tying, argued by the government, was rejected by the U.S. Court of Appeals for the D.C. Circuit.[52] The appellate court's decision crafted a special rule for tying in computer software cases, one that created a substantially higher hurdle for the government than prior precedents suggested and certainly far higher than the rule urged by the government and accepted by the District Judge.[53] Academic argument regarding the right test continues, but the government has not won a major tying decision in the aftermath of *Microsoft* and no doubt will face an uphill battle on that front in any high-technology case, not only in cases involving computer software.

Above all, the *Microsoft* case should be seen as another example of the difficulty of predicting the evolution of markets and the strong likelihood that government antitrust enforcers will take too-limited a view of the scope of market competition, reflected in too-narrow a definition of the relevant product market. As Crandall and Jackson explain, the market definition urged by the government and adopted by the district court looks unduly narrow in at least two critical respects. First, the definition artificially omits features that are routinely included in operating systems from Microsoft,

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49 *See* Cass & Hylton, *supra* note 17, at 19.

50 *See* LIEBOWITZ & MARGOLIS, *supra* note 47.

51 *See* Nicholas Economides, *The Microsoft Antitrust Case: A Case Study for MBA Students*, Apr. 2003, at 10.

52 *See* United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001), *cert. denied*, 534 U.S. 952 (2001).

53 United States v. Microsoft Corp., 87 F. Supp. 2d 30, 47-51 (D.D.C. 2000).

Apple, GNU/Linux, and other major sources of PC operating system software.[54] That was true at the beginning of the Microsoft case and has become even more evident over time as operating systems increasingly incorporate additional features valued by users. Crandall and Jackson suggest the state of play in operating systems as of 2010, using Apple's product as an example:

> Currently, Apple's OS X includes a calculator, a chess game, the *New Oxford American Dictionary* and *Oxford American Writer's Thesaurus*, a DVD player, a font manager, media center software (Front Row), a personal calendar application, Apple's iTunes digital jukebox, email software, software for limited editing of PDF files, the Safari web browser, a simple text editor that includes such features as smart quotes and kerning, a backup application, a data and equation graphing application, and an X11 windowing package.[55]

The expansion of operating systems mirrors the evolution of other products, especially complex, high-technology products. These products frequently include features valued by a large number of consumers in order to raise the value of the product and decrease search and acquisition costs. The smartphone is an example, consisting of a cell phone, an Internet browser, calculator, camera, calendar, note pad, address book, alarm clock, and dozens of other features. Conceiving it as a phone with other features grafted on misses the point—consumers value a product that has the other features embedded as well, much as automobile purchasers value being able to acquire a product that already has a music system, navigation system, climate control, and other features that go beyond the drive train, chassis, and engine.[56]

The second dimension in which the government's market definition was too narrow looks to products that either did not exist at the time the *Microsoft* case was initiated, or that seemed to the untrained eye to have been very distant from the world inhabited by PC operating systems. Crandall and Jackson point to the roles that tablets and smartphones play today, functioning in ways that overlap with PCs; the operating systems running on those devices necessarily are competitive in significant measure with the operating systems running on PCs.[57] In fact, recent studies show that the

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54 *See* Crandall & Jackson, *supra* note 30, at 13.

55 *Id.*

56 *See*, *e.g.*, Ginny Miles, *Smartphones of the Future: How They Will Look, What They Will Do*, PC WORLD (Aug. 10, 2011, 6:00 PM), http://www.pcworld.com/article/237610/smartphones_of_the_future_how_they_will_look_what_they_will_do.html; *Best Smartphones*, CONSUMER SEARCH, http://www.consumersearch.com/cell-phones/best-smartphones (last visited Oct. 28, 2012); *see also Smartphones*, FINDTHEBEST, http://smartphones.findthebest.com/ (last visited Oct. 28, 2012).

57 Crandall & Jackson, *supra* note 30, at 36-37.

majority of time spent on smartphones now is devoted to activities other than telephone conversations.[58]

The same point holds for other products, such as servers, and for cloud computing as well, which increasingly offers an alternative to the PC and to a variety of features typically included in the PC operating system. The smarter the cloud and the more consumers rely on it, the less they need similar applications in a PC or its operating system. Although the government drew a picture of Microsoft as a company without serious competition, the company's leaders recognized that the next generation of high-technology firms—companies like Google—had the potential to turn the Internet into a substitute for much of what was being done by the PC and the systems that make it run.[59] As with IBM, no one can say what Microsoft would have done without the distraction and concerns introduced by the various antitrust actions it faced at home and abroad.[60] Nevertheless, it is plain that the

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58 *See*, *e.g.*, Geetika Rustagi, *Women Talk More on Phone Than Men: Nielsen Survey*, LIVE MINT & WALL ST. J. (May 15, 2012, 11:14 PM), http://www.livemint.com/2012/05/15231401/Women-talk-more-on-phone-Niel.html (demonstrating that Indian men spend 80% of their time on smartphones performing other activities, with women spending 75%); *New Media Trend Watch: Canada*, EUROPEAN TRAVEL COMMISSION, http://www.newmediatrendwatch.com/markets-by-country/11-long-haul/45-canada?showall=1 (last updated Oct. 8, 2012) (demonstrating that Canadian smartphone users spend more than half their time on uses other than talking).

59 Memorandum from Bill Gates to Microsoft Employees on the "Internet Tidal Wave" (1995), *available at* http://www.justice.gov/atr/cases/exhibits/20.pdf (discussing how the potential the Internet posed to up-end traditional models of computing was seen as a plea for taking over the Internet browser market, and thus a piece of the picture being put together by antitrust enforcers and Microsoft competitors depicting a monopolist bent on eliminating rivals through tie-ins and other means). In fact, it is more evidence of prescience that the threats to PC-based software would come from outside the market for those products as drawn by antitrust enforcers. As with IBM, seeing the sources of competitive perils is not the same as being able to address them effectively, especially when confronted with serious legal risks. *See also* United States v. Microsoft Corp., 84 F. Supp. 2d 9, 29 (D.D.C. 1999); Dylan Love, *This 1995 Memo From Bill Gates Predicts Smartphones, Web Videos, And Internet Ads*, BUSINESS INSIDER (July 28, 2011), http://articles.businessinsider.com/2011-07-28/tech/29989218_1_web-videos-acrobat-files-home-pages; Benjamin J. Romano, *Gates' Big-picture Memos Shaped Microsoft, Changed Tech World*, SEATTLE TIMES (June 27, 2008), http://seattletimes.com/html/microsoft/2008020208_microsoft27.html; Shaun Usher, *The Internet Tidal Wave*, LETTERS OF NOTE (July 22, 2011), http://www.lettersofnote.com/2011/07/internet-tidal-wave.html; *May 26, 1995: Gates, Microsoft Jump on 'Internet Tidal Wave'*, WIRED (May 26, 2010), http://www.wired.com/thisdayintech/2010/05/0526bill-gates-internet-memo/.

60 Some commentators assert that without the Microsoft antitrust case, Google would not have been created or, at a minimum, would not have flourished. *See* David Streitfeld & Edward Wyatt, *U.S. Escalates Google Case by Hiring Noted Outside Lawyer*, NY TIMES (Apr. 26, 2012), http://www.nytimes.com/2012/04/27/technology/google-antitrust-inquiry-advances.html?pagewanted=all. *But see Larry Page and Sergey Brin Biography*, ENCYCLOPEDIA OF WORLD BIOGRAPHY, http://www.notablebiographies.com/news/Ow-Sh/Page-Larry-and-Brin-Sergey.html (last visited Oct. 28, 2012) (noting that the creation of the basic algorithm at the heart of Google's success and the founding of the company antedate the filing of the major antitrust action by the DOJ in May 1998). Whether Google would have succeeded to the extent it has, is conjecture, but it

real competitive threat to the company came from innovations that lay outside the market as government officials saw it.

C. *General Motors—The Case That Wasn't*

Well before Microsoft was under antitrust scrutiny, indeed, before it was incorporated, antitrust enforcers were taking a long, serious look at another company that seemed to be an unstoppable colossus, due in large measure to network effects. The company was General Motors (GM). From the mid-1930s to the mid-1970s, GM was the dominant automobile firm in the U.S. and, at least for most of this period, the world.[61] It was the largest corporation, measured by sales or profits, year after year.[62] GM was not merely a corporate giant; it was gigantic by almost any measure for any enterprise. In 1965, for example, revenues at GM "exceeded the combined general revenues of the state and local governments of New York, New Jersey, Pennsylvania, Ohio, Delaware, and the six New England states."[63]

General Motors accounted for between 40% and 50% of automobile sales in the U.S. during this forty-year stretch.[64] Its success was attributed, among other things, to what are often termed indirect network effects—effects dependent on the number of people using a product or service but not necessarily on the ability of those people to interconnect directly with one another.[65] GM had a large network of dealers, including dedicated after-purchase service expertise, which was a critical consideration for many consumers in choosing which automobile to buy. Not surprisingly, when buying a car, consumers want assurance that there will be sufficient quantities of parts available for repairs far into the future and that repairs services will be available at locations convenient to them. The larger the number of

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simply reveals the difficulty of knowing how markets would develop without the government handicapping one player.

61 Lawrence J. White, *The Rise and Fall of Ford and General Motors in the U.S. Automobile Industry: A Tale Twice Told*, *in* MARKET DOMINANCE 109, 120-21 (David Ira Rosenbaum ed., 1998).

62 *1955: Full List*, CNNMONEY.COM, http://money.cnn.com/magazines/fortune/fortune500_archive/full/1955/ (last visited Oct. 28, 2012) (listing U.S. corporations by revenues and profits, years 1955-2005).

63 MORTON MINTZ & JERRY S. COHEN, AMERICA, INC.: WHO OWNS AND OPERATES THE UNITED STATES 6 (1971) (citing *The Massive Statistics of General Motors*, FORTUNE, July 15, 1966) (this collection of states included three of the top five by population and five of the top ten, not to mention America's (and the world's) largest city).

64 *See* White, *supra* note 61, at 119-23.

65 *See* Stanley M. Besen & Joseph Farrell, *Choosing How to Compete: Strategies and Tactics in Standardization*, J. ECON. PERSPS., SPRING 1994, at 117, 127-30 (discussing different network effects). *See generally* Jeffrey Rohlfs, *A Theory of Interdependent Demand for a Communications Service*, 5 BELL J. ECON. & MGMT. SCI. 16 (1974) (analyzing the economic theory of interdependent demand created when the utility of the subscribers to a communications service increase as more people subscribe to the service).

cars sold by a given company, the easier it is to support a repair network. Conversely, the larger the repair network, the more valuable the car, other things being equal, and the easier it is to make additional sales.[66] Those who were thinking about the economics of the car market in the 1950s, 1960s, and 1970s did not conclude that network effects in the automobile business inevitably led to a tipping point that would send all or almost all the purchasers to the company with the most sales and service franchises. But commentators did conclude that considerations flowing from economies of scale affecting service availability and related matters helped limit the number of car companies that could compete effectively—not coincidentally, offering an explanation for the continuing decline of companies over that period.[67] In the mid-1960s and again in the mid-1970s, federal antitrust enforcement authorities—first in the DOJ, then in the FTC—were concerned enough with the concentration of the automobile industry among the "Big Three" U.S. automakers, and with GM's dominance in particular, to reach at least tentative decisions to file charges against GM for unlawful monopolization and to seek a breakup of the company.[68]

The cases were prepared after decades of GM's dominance and, simultaneously, the Big Three—GM, Ford, and Chrysler—American car companies' market share stayed at 80% to 90% of the U.S. market. But, as Tim Muris, former FTC Chairman, notes, the antitrust enforcers' concerns about enduring market dominance were oddly timed, to say the least.[69] The issue here was not one of market definition but of understanding the dynamics of the market. One of the key assumptions behind the move to break up GM was that foreign automakers would not provide significant competition to domestic products in the U.S. market. The assumption was based on retrospective evaluation of the U.S. automobile market and personal experience of a small number of government officials based on the East Coast. However, the information needed to at least generate some skepticism about the foreign-cars-don't-matter assumption was not inaccessible, as illustrated by Muris's description of his reaction at the time:

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[66] Max Schanzenbach, *Network Effects and Antitrust Law: Predation, Affirmative Defenses, and the Case of U.S. v. Microsoft*, 2002 STAN. TECH. L. REV. 4, ¶¶ 57-58 (Nov. 25, 2002), http://stlr.stanford.edu/pdf/schanzenbach-network-effects.pdf (discussing the essence of the First Circuit's decision in Grappone, Inc. v. Subaru of New England, Inc., 858 F.2d 792 (1st Cir. 1988)).

[67] *See* John S. McGee, *Economies of Size in Auto Body Manufacture*, 16 J. L. & ECON. 239, 262-64 (1973); White, *supra* note 61, at 120 (the decline of alternatives to the leading U.S. automobile makers over much of the period seemed to be a continuation of a trend that held from the early 1920s, when there were roughly ninety U.S. automakers).

[68] *See* Timothy J. Muris, *Improving the Economic Foundations of Competition Policy*, 12 GEO. MASON L. REV. 1, 3-5 (2003); William G. Shepherd, *Antitrust Repelled, Inefficiency Endured: Lessons of IBM and General Motors for Future Antitrust Policies*, 39 ANTITRUST BULL. 203, 206-07 (1994).

[69] Muris, *supra* note 68, at 4-5.

> Having grown up in California, where foreign cars were increasingly prominent, I found this conclusion bizarre. At that time, I owned a Toyota Corolla; like many other baby boomers, I did not own an American-made car until I discovered the SUV in the 1990s, when I also purchased a Saturn.[70]

As the last round of charges was being prepared, import shares in the U.S. car market were rising rapidly, and would continue to rise steadily over the next decade before pausing, then rising again. Imports accounted for an average of less than 1% of U.S. car sales between 1946 and 1955 and roughly 6% between 1956 and 1965, but that figure rose to more than 10% between 1966 and 1970, more than 15% between 1971 and 1975, over 20% between 1976 and 1980, and more than 25% between 1981 and 1985. By 2009, non-American brands accounted for over half the U.S. automobile market; GM, Ford, and Chrysler (which had been bought and sold by German automaker Daimler Benz, and in 2009 was acquired by Italian automaker Fiat) together accounted for the same share of the market that GM alone had commanded thirty years earlier, with Honda's U.S. sales exceeding Chrysler's, and Toyota's surpassing Ford's.[71]

Changing reputations for service and quality and changing demands for fuel efficient vehicles no doubt played a role in the movement among brands' market shares.[72] While these were not entirely predictable in 1965, by 1975 there certainly was enough evidence that these factors were sources of potentially significant changes in the U.S. car market and in the fortunes of GM and other U.S. car companies. As Muris notes, that was not sufficient to keep the antitrust enforcers from trying to move forward, though by the early 1980s the changes taking place in the market were sufficiently clear to end the effort to break up GM. At that time, the company had, between 1970 and 1980, slid from first to eighth place in the ranking of most valuable American firms. When the financial crisis hit in 2008–2009, GM appealed to the government for an infusion of federal funds to keep the company afloat.[73] By that time, the antitrust authorities were making their final effort to end what they saw as GM's long-run dominance. In other words, its run was coming to an end.

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70 *Id*. at 5.

71 *See*, *e.g.,* Todd Lassa, *U.S. Market Share for the Top Five Auto Makers: Closing in on Europe's 18-18-18 Model?*, MOTOR TREND, Feb. 2012, at 21.

72 *See*, *e.g.*, Chyi-Ing Lin et. al., *Product Quality, Gasoline Prices, and Japanese Shares in the U.S. Automobile Market*, 2 INT'L J. BUS. 61, 61-62, 75 (1997); White, *supra* note 61, at 121-25.

73 *See*, *e.g.*, Bill Vlasic, *GM, Once a Powerhouse, Pleads for Bailout*, N.Y. TIMES (Nov. 11, 2008), http://www.nytimes.com/2008/11/12/business/12auto.html.

D. *The AT&T Case*

Another major case for government antitrust enforcement was the long-running investigation and litigation against AT&T, culminating in the Modified Final Judgment of the District Court in 1982 and the firm's breakup in 1984. The case, filed in 1974, asserted that AT&T, the dominant telephone company for a century, had suppressed competition in the long-distance and terminal equipment markets. The divestiture of various parts of "Ma Bell's" operations separated its businesses into regional holding companies that oversaw local telephone services and a core set of long-distance and research functions.[74]

The goal for antitrust authorities was to inject increased competition into the long-distance telephone services market and bring down long-distance costs. In that respect, the litigation may have succeeded, if judged only by the change in market shares post-breakup. AT&T went from more than 90% of long-distance revenues in 1984 to less than 40% in 2000.[75] How much of this change can be connected to the antitrust case and its remedy, however, is questionable. As Eli Noam has argued, there is ample reason to think that similar changes could have occurred in other ways.[76] During the post-divestiture period, the market was changing in several dimensions, most notably the technology for delivering communications services and the nature of demand for those services. Within a few years, pieces of the broken up system began recombining, and twenty years on, one of the original "Baby Bell" regional operating companies acquired what remained of AT&T (and changed its name to keep the iconic label).

What made this case exceptional, more than anything else, was that the pricing of the market that the antitrust officials targeted—telephone services—was controlled primarily by other government officials. AT&T was a regulated monopoly. Its prices and practices were subject to government supervision. And the conduct that was deemed suspect by antitrust enforcers was directly responsive to decisions of the FCC and, to some extent, the courts. For decades, the FCC had followed a policy of pushing telecommunications providers, primarily AT&T and other components of its Bell system, to provide "universal service" at relatively uniform rates, regardless of geography and actual costs. That policy meant that the telephone compa-

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74 *See* United States v. Am. Tel. & Tel. Co., 552 F. Supp. 131 (D.C. Cir. 1982). For an overview of the case, see BREAKING UP BELL: ESSAYS ON INDUSTRIAL ORGANIZATION AND REGULATION 41-43 (David Evans ed., 1983) [hereinafter BREAKING UP BELL], and CHANGING THE RULES: TECHNOLOGICAL CHANGE, INTERNATIONAL COMPETITION AND REGULATION IN COMMUNICATIONS 114-16 (Robert Crandall & Kenneth Flamm eds., 1989).

75 *See* Crandall & Jackson, *supra* note 30, at 15.

76 *See* Eli M. Noam, *Did AT&T Die in Vain? An Empirical Comparison of AT&T and Bell Canada,* 61 FED. COMM. L.J. 119, 131-32 (2008).

nies used funds provided by higher charges for long-distance services to subsidize services for rural and other higher-cost users.[77]

When the technology of long-distance service began to change in the 1950s and 1960s, AT&T naturally resisted steps that would have facilitated competition. Increased competitive provision of long-distance services would have had the effect of eroding the revenue source for the subsidies without limiting the obligation to subsidize high-cost users. The typical regulatory response against such "cream-skimming," real or perceived, is to restrict competition.[78] But the FCC and the courts permitted competitive entry in relatively high-revenue facets of the market, setting up the steps taken by AT&T to protect its revenue stream.[79]

The FCC's continued imposition of subsidy arrangements without insulation of the supporting revenue stream had the following consequences: first, AT&T took steps to disadvantage its rivals in the competitive part of the market—to protect the revenues used, among other things, for the cross-subsidy; second, antitrust officials brought the litigation aimed, among other things, at preventing that response; and, third, AT&T repeatedly asked the FCC either to relieve it of expensive obligations toward subsidized customers or to impose similar obligations on competitors.[80] It is not clear that the defense AT&T mounted, rooted in the reasoning that significant portions of the telephone industry arguably constitute a natural monopoly, at least within the set of technologies in use at the time of the litigation, was

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77 *See*, *e.g.*, KAHN, *supra* note 8, vol. II, at 147-52; MITCHELL & VOGELSANG, *supra* note 5, at 162-63.

78 *See, e.g.*, KAHN, *supra* note 8, vol. II, at 7-10.

79 *See*, *e.g.*, *In re* Specialized Common Carrier Servs., 29 F.C.C.2d 870 (1971), *aff'd sub nom.* Washington Utils. & Transp. Comm'n v. FCC, 513 F.2d 1142 (9th Cir. 1975); *In re* Applications of Microwave Commc'ns, Inc., 18 F.C.C.2d 953 (1969), *aff'd*, 21 F.C.C.2d 190 (1970).

80 Hush-A-Phone Corp. v. United States, 238 F.2d 266, 267 (D.C. Cir. 1956) (providing an example of how AT&T tried to prevent loss of its monopoly power through equipment components); *In re* AT&T Co. for A Declaratory Ruling & Expedited Relief, 67 F.C.C.2d 1455 (1978), *rev'd sub nom.* MCI Telecomms. Corp. v. F.C.C., 580 F.2d 590 (D.C. Cir. 1978); *In re* MCI Telecomms. Corp. Investigation into the Lawfulness of Tariff FCC No. 1 Insofar As It Purports to Offer Execunet Serv., 60 F.C.C.2d 25, 34 (1976), *rev'd sub nom.* MCI Telecomms. Corp. v. F.C.C., 561 F.2d 365 (D.C. Cir. 1977); *In re* Econ. Implications & Interrelationships Arising from Policies & Practices Relating to Customer Interconnection, Jurisdictional Separations & Rate Structures, 61 F.C.C.2d 766, 768 (1976) ("The telephone industry further contends that so-called 'specialized' services such as private line service and terminal equipment leasing presently generate revenues substantially in excess of their direct costs . . . ."); *In re* Bell Sys. Tariff Offerings of Local Distrib. Facilities for Use by Other Common Carriers; Letter of Chief, Common Carrier Bureau, Dated October 19, 1973, to Laurence E. Harris, Vice President, MCI Telecomms. Corp., 46 F.C.C.2d 413 (1974); *In re* Establishment of Policies & Procedures for Consideration of Applications to Provide Specialized Common Carrier Services in the Domestic Pub. Point-to-Point Microwave Radio Serv. & Proposed Amendments to Parts 21, 43 & 61 of the Comm'n's Rules, 33 F.C.C.2d 408 (1972); *In re* Use of the Carterfone Device in Message Toll Tel. Serv., 13 F.C.C.2d 420, 421 (1968).

sound.[81] At the same time, there is a considerable question as to whether the underlying case brought against AT&T stood on solid economic and legal ground.[82] The government had sufficient difficulty establishing its original claims that, part-way through the litigation, it shifted position, reframing a key claim as the novel assertion that AT&T's prices were set "without regard to cost," as opposed to the well-established legal ground that the prices were predatory.[83] Whether or not the industry, in relevant part, constituted a natural monopoly, it is questionable how competing firms would have fared afterward if not given preferential treatment for an extended period, including, for many years, access to facilities that AT&T had an obligation to provide.

In a real sense, the antitrust suit was the product of a sharp difference of visions between antitrust enforcement officials and officials charged with regulating the telecommunications industry. The technology of the industry was changing, and within a generation the seemingly inevitable and indestructible monopoly of AT&T had ended, victim of shifts to cellular telephony, enhanced data communications, and changing cost structures for communication, as well as a dramatically changed regulatory environment. Whether the regulatory authorities did well or poorly, it is doubtful that antitrust authorities had better information or better legal basis for endeavoring to remake the industry.

V. LESSONS AND SUGGESTIONS

The four antitrust cases discussed in Part IV share the characteristics of a great deal of industry regulation. All four episodes targeted firms that had become leaders in their industries, selections based in part on the supposition that the firms' leadership was being extended or expanded due to conduct that disadvantaged competitors. That behavior is not atypical for regulatory agencies, which are commonly responsive to concerns of com-

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81 *See*, *e.g.*, David S. Evans & James J. Heckman, *Natural Monopoly*, *in* BREAKING UP BELL, *supra* note 74, at 140-48*; see also* PETER W. HUBER ET AL., GEODESIC NETWORK II: 1993 REPORT ON COMPETITION IN THE TELEPHONE INDUSTRY (1992).

82 *See*, *e.g.*, William A. Brock, *Pricing, Predation, and Entry Barriers in Regulated Industries*, *in* BREAKING UP BELL, *supra* note 74, at 191-226; Jordan Jay Hillman, *Telecommunications Deregulation: The Martyrdom of the Regulated Monopolist*, 79 NW. U. L. REV. 1183, 1186-87 (1984); Paul W. MacAvoy & Kenneth Robinson, *Winning by Losing: The AT&T Settlement and Its Impact on Telecommunications*, 1 YALE J. ON REG. 1, 2 (1983) ("[W]e analyze the legal merits of the suit and conclude that had the case proceeded to judgment, AT&T probably would have avoided liability and, even in the event of liability, divestiture."); Stephen G. Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 CAL. L. REV. 1005, 1019-21 (1987) ("All in all, there is considerable empirical evidence suggesting that AT&T probably enjoys no significant cost advantage in supplying service.").

83 *See*, *e.g.*, William A. Brock & David S. Evans, *Predation: A Critique of the Government's Case in* US v. AT&T, *in* BREAKING UP BELL, *supra* note 74, at 51-54.

petitors in regulated industries; indeed, such concerns are the genesis for much of the body of regulations in fields outside antitrust.[84] Furthermore, in all but one of the antitrust cases discussed here, the conduct at issue looked a great deal like ordinary competitive conduct.[85] In particular, use of networks to promote business dealings is neither nefarious nor confined to monopolies, and bundling features or products together is a nearly ubiquitous practice, utilized by businesses in the most highly competitive fields as well as by dominant firms.[86]

Much like any other government official who faces arguments against regulatory intervention as a matter of course, antitrust enforcement officials commonly tend to discount arguments against government engagement in a particular matter. That suggests, in particular, skepticism regarding assertions by enforcement targets that challenged conduct is pro-competitive. Naturally, companies that are under investigation will claim that their conduct increases efficiency, reduces cost, or raises value to consumers. Those are the explanations that generally defeat antitrust actions. At the same time, the arguments against the efficiency or consumer benefit of the targets' actions should be viewed with equal skepticism, as they are pushed principally by people with every bit as great an interest in slanting the argument.

This stand-off makes the predispositions of the government enforcement officials, who are supposed to be the honest brokers in sorting through the arguments, critical. While the theories available to explain the data are important,[87] the officials' own inclinations often are conclusive in selecting among competing theories. These inclinations, in a wide array of cases, provide alternative views on what conduct is problematic, why, and what risks attend intervening or leaving markets to sort things out. There is no need for officials to be consciously self-interested or, indeed, to think of anything but their view of what best serves the public, for their personal inclinations to be critical to decision outcomes. As with other contested decisions, the availability of different potential constructs increases the importance of other influences, and the more balanced the contest among

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84 *See* FRIEDMAN, *supra* note 4; Krueger, *supra* note 9, at 291-303; Stigler, *supra* note 5, at 3-21.

85 The one exception is AT&T, which was acting not in a manner that looks like ordinary competition, but in a manner that seemed responsive to special constraints and inducements of regulation.

86 *See*, *e.g.*, BORK, *supra* note 32, at 375-81; Cass & Hylton, *supra* note 32; HYLTON, *supra* note 29, at 279–301; POSNER, *supra* note 30, at 205-07; Sidak, *supra* note 32, at 8-9. In fact, such practices at times are responses to competition, not evidence of its absence. *See*, *e.g.*, Hal R. Varian, *Market Structure in the Network Age*, *in* UNDERSTANDING THE DIGITAL ECONOMY: DATA, TOOLS, AND RESEARCH 140-41 (Erik Brynjolfsson & Brian Kahin eds., 2000).

87 As noted earlier, theories like raising rivals' costs have no doubt affected analysis of antitrust cases by government enforcement officials. It takes a plausible theory to sell an argument. But the degree of plausibility needed for any given theory depends on the skepticism or receptivity of the official who must decide the matter.

those constructs, the larger the role that other factors will play.[88] It is often the case that institutional factors and personal interests produce subtle biases in officials' policy judgments.

Critics will inevitably complain of policy bias, no matter what position particular officials take, but the likely systematic tilt over time in antitrust will be toward excessive, not insufficient, enforcement. Antitrust enforcement officials often are better served personally if they take a skeptical view of pro-competitive arguments, as there is apt to be greater reward for being at the forefront of high-profile antitrust cases than for being the person who consistently rejected the cases as based on inadequate information and insufficiently strong theoretical basis for finding harm to competition and consumers.[89] Although there is benefit to ending bad cases as well as to bringing them, few former officials become well-known for failing to be involved in significant cases. And in a global market for regulation, including antitrust enforcement, the most aggressive regulators tend to be the ones who are the most well-known and the most in demand.[90] The most important cautions, thus, concern problems that arise from "false positives" of enforcement.[91] With this in mind, the overarching caution to antitrust enforcers that emerges from the cases reviewed above is against presuming that the obvious, common-sense boundaries around a market—what led to the description of IBM as dominating the market for computing, or Microsoft the market for PC operating systems, or GM the U.S. auto market, or AT&T the market for telephone services—appropriately set the field of vision for antitrust enforcement, much less the artificially circumscribed market definitions that enforcers will urge when a case has been initiated. The market boundaries that so often are taken for granted frequently fail to capture the most important sources of competition.[92] While this is true even

88 *See*, *e.g.*, RONALD A. CASS, THE RULE OF LAW IN AMERICA 88-89 (2001); FREDERICK SCHAUER, PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND LIFE 191-96 (1993); Arthur D. Hellman, *Precedent, Predictability, and Federal Appellate Structure*, 60 U. PITT. L. REV. 1029, 1107-08 (1999); Gregory Sisk et al., *Charting the Influences on the Judicial Mind: An Empirical Study of Judicial Reasoning*, 73 N.Y.U. L. REV. 1377, 1498-1500 (1998); Pablo Spiller & Matthew Spitzer, *Judicial Choice of Legal Doctrines*, 8 J.L. ECON. & ORG. 8, 12 (1992).

89 *See*, *e.g.*, Malcolm B. Coate et al., *Bureaucracy and Politics in FTC Merger Challenges*, *in* CAUSES AND CONSEQUENCES, *supra* note 12, at 213-30; Roger L. Faith et al., *The Antitrust Pork Barrel*, *in* CAUSES AND CONSEQUENCES, *supra* note 12, at 201-12.

90 *See*, *e.g.*, Cass, *supra* note 14, at 137. See Glen O. Robinson, *The Federal Communications Commission: An Essay on Regulatory Watchdogs*, 64 VA. L. REV. 169, 183-89 (1978), for an explanation of the role that staff, as opposed to political appointees, play in this process.

91 *See*, *e.g.*, Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 14-17 (1984).

92 *See*, *e.g.*, Raymond S. Hartman et al., *Assessing Market Power in Regimes of Rapid Technological Change*, 2 INDUS. & CORP. CHANGE 317 (1993); Michael L. Katz & Howard A. Shelanski, *"Schumpeterian" Competition and Antitrust Policy in High-Tech Markets*, 14 COMPETITION 47, 60 (2005); Christopher Pleatsikas & David J. Teece, *The Analysis of Market Definition and Market Power in the Context of Rapid Innovation,* 19 INT'L J. INDUS. ORG. 665, 665 (2001).

in markets as "old-line" and seemingly simple as the auto market, it is even more likely to be true in high-technology industries where, almost by definition, new innovations will revise established assumptions.

The market definition problem reflects more than the fact that officials frequently cannot see the changes coming that will dramatically alter competitive conditions in an industry. Almost no one, even those most intimately engaged in the industry itself, is apt to make good predictions about which technologies will succeed or what the ultimate scope of a new technology will be. The most obvious proof of this assertion is a quick check on stock values. For example, IBM's market capitalization in 1987 reached more than $100 billion, at a time when Microsoft's was only $3 billion.[93] A decade later, Microsoft's exceeded $145 billion—a nearly fifty-fold increase—just edging out IBM—whose value rose during that period at a rate about 1/100 of Microsoft's rise.[94] At the same time, in 1997, Apple's capitalization was only around $2 billion, less than 2% of Microsoft's value, and it was just $7 billion in 2001 when Microsoft's capitalization stood at $332 billion, a figure slightly over 2% percent of Microsoft's market cap.[95] Yet by April 2012, when Microsoft's value was $235 billion, Apple's value hit a peak of around $600 billion, more than double the value of Microsoft and the highest value of any firm on the planet. Those who saw those changes coming would have bought Microsoft stock in the 1980s and Apple stock in the 1990s—by the boatload. There are not many folks—in or out of government—who were that prescient.

The more trenchant flaw in antitrust enforcement is not officials' failure to identify specific market changes or specific companies that will dramatically rise or fall in value. Rather, the larger problem is that it is exceedingly difficult for government officials to discern the critical factors that explain what actually makes a particular firm dominant, the factors that affect the durability of dominance, or the kinds of change in the market—

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93 *See* RICHARD S. TEDLOW, THE WATSON DYNASTY: THE FIERY REIGN AND TROUBLED LEGACY OF IBM'S FOUNDING FATHER AND SON 265 (2003); *Billionaires List: Hall of Fame*, FORBES (Mar. 26, 2012), http://www.forbes.com/forbes/2012/0326/billionaires-12-list-gates-mars-newhouse-hall-of-fame.html.

94 *See* Bill Rigby, *IBM Passes Microsoft Market Cap After 15 Years*, REUTERS (May 23, 2011, 7:00 PM), http://www.reuters.com/article/2011/05/23/us-usa-stocks-ibm-idUSTRE74M4KL20110523; *Microsoft—Market Capitalization—1997,* WIKINVEST, http://www.wikinvest.com/stock/Microsoft_(MSFT)/Data/Market _Capitalization/1997?ref=chart (last visited Nov. 3, 2012).

95 *See Apple—Market Capitalization—1997*, WIKINVEST, http://www.wikinvest.com/stock/Apple_(AAPL)/Data/Market_Capitalization/1997 (last visited Nov. 3, 2012); *Apple—Market Capitalization—2001*, WIKINVEST, http://www.wikinvest.com/stock/Apple_(AAPL)/Data/ Market_Capitalization/2001 (last visited Nov. 3, 2012); *Microsoft—Market Capitalization—2001*, WIKINVEST, http://www.wikinvest.com/stock/Microsoft_(MSFT) /Data/Market_Capitalization/2001 (last visited Nov. 3, 2012).

either on the demand side or the supply side—that could dramatically erode that dominance.[96] Those who were pushing for antitrust restraints on IBM, Microsoft, GM, and AT&T viewed network effects as the primary source of dominance. This was asserted as the reason that each company would not only continue to dominate a particular market segment, but also the reason each company would be able to increase its presence in that segment or spread its dominance across different products and services. As previously noted, however, network effects also can have just the opposite effect: they can be the reason that a firm's dominance comes to an end, as the success of a dominant firm can spur investment in competing technologies, including technologies that will tap network effects to replace the successful product or service based on established technology.

In this respect, the current high-technology focus of section 2 antitrust enforcement is especially striking. The list of potential enforcement targets includes an array of firms that were not in existence when the DOJ was suing IBM. Facebook, which is just taking its stock public as this is written, was launched in 2004; Google dates from 1998; Amazon was founded in 1994; Apple, though started in the mid-1970s, was on the brink of bankruptcy in 1997 before its resurgence—making this a reasonable date to think of it as being reborn. Each firm has a business that arguably benefits greatly from network effects.[97] At the same time, these businesses are also built on technologies that have evolved rapidly, generating new markets or replacing older technologies once considered durably dominant.[98]

Despite the networks they have established, each of these businesses is also notable for the relative ease with which consumers can switch from one provider or technology to another—allowing consumers to substitute one product or service for another or, in many cases, to add additional products or services from multiple providers at minimal or zero cost. Just as consumers can add new browsers at the touch of a button and can use multiple browsers on their PCs, they can easily switch among search engines and social media. Search is especially easy to diversify, and consumers frequently use different search engines when seeking different types of

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96 This follows from the broader observation that it is far easier to describe what behavior succeeds in markets than to explain why it succeeds. *See*, *e.g.*, Easterbrook, *supra* note 91, at 4. Even then, when behavior is complex, it generally will be difficult to explain the exact contours of the successful behavior.

97 See PHIL SIMON, THE AGE OF THE PLATFORM: HOW AMAZON, APPLE, FACEBOOK AND GOOGLE HAVE REDEFINED BUSINESS (2011), for an example of less technical presentations of this point. *See also* Fred Vogelstein, *Network Effects and Global Domination*, WIRED (May 17, 2012), http://www.wired.com/business/2012/05/network-effects-and-global-domination-the-facebook-strategy/.

98 The electronic search market, for example, was modest and relatively little-known outside specialized areas (for example, as adjuncts to other research tools in the legal or medical profession) prior to Google, and use of the internet as an encompassing social network was almost completely undeveloped prior to Facebook. In each case, technological innovations provided critical impetus for the establishment of widely recognized and utilized markets.

information, such as switching to a specialized search engine for music or travel.[99] Similarly, consumers also can be connected to more than one social network.[100] Unlike computer hardware—IBM's principal domain and the focus of the DOJ suit—consumers do not need to make huge investments in equipment or in special tailoring of goods and services for most of the products and services that are currently holding antitrust enforcers' attention. Even more than with the firms challenged before, these are markets in which new firms and ideas come along quickly and take hold fast. Facebook, for example, in only eight years went from a concept that did not make sense to many people over the age of forty to a business with more than 900 million users.[101]

Of course, it is not enough to tell antitrust enforcers to "just say no" to dominance cases (*pace*, Nancy Reagan). Enforcement officials charged with implementing the law do not have the luxury of assessing the law's net benefit and deciding to put it on the shelf if the net effect is negative, not positive, for society. Yet, like other prosecutors, antitrust enforcers have wide latitude in choosing when to take action and their decisions should be sensitive to such societal effects.

The question, then, is what should officials do when asked to look at claims against leading firms in arenas where evolving market conditions might make intervention unnecessary at best and counterproductive at worst? There have been efforts under both Democrat and Republican administrations to incorporate a dynamic analysis, of sorts, into the evaluation of markets and the calculation of appropriate government action.[102] However, these efforts have been partial and incomplete. They have not focused primarily on dynamic analysis as a commitment to attending the prospects, means, and extent to which broader competitive forces and innovations constrain the behavior and effects of dominant firms. Instead, much of the analytical effort has been devoted to exposing reasons for doubting static

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99 *See* Matt Asay, *Why Grill Google Over Web Dominance? It Has None*, REGISTER (Oct. 4, 2011), http://www.theregister.co.uk/2011/10/04/google_anti_trust_yesterdays_news/ ("Google may own the 'index search market,' but think about where people go to search for people (Facebook or LinkedIn), facts (Wikipedia), restaurants (Zagat (now owned by Google), Yelp, OpenTable), travel (Kayak, Travelocity, Expedia, Orbitz) and property (Zillow, Realtor.com) to name just a few.").

100 For example, think of the Facebook user who also is connected through Linked-In for business associates. If that user is moderately technologically oriented, they could additionally turn to Twitter for sharing some spur-of-the-moment thoughts more directly or immediately, Flickr for photos, and so on.

101 *See* Shai Ahmed, *Facebook a Passing Fad? 900 Million People Can't Be Wrong: CEO*, CNBC (May 15, 2012), http://www.cnbc.com/id/47425068/Facebook_a_Fad_900_Million_People_Can_t_Be_Wrong_CEO.

102 *See*, *e.g.*, U.S. DEP'T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 24-27 (2008), *available at* http://www.justice.gov/atr/public/reports/236681.pdf [hereinafter SINGLE-FIRM CONDUCT] (withdrawn May 2009); U.S. DEP'T OF JUSTICE & FEDERAL TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 27-29 (2010), *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf [hereinafter HORIZONTAL MERGER GUIDELINES].

indications that markets are competitive rather than to identify the ways in which dynamic changes will increase competition and correct perceived distortions.[103]

Despite these efforts, the dominant direction of dynamic market forces' effects, especially those aligned with innovation, is toward greater constraints than a static analysis will perceive.[104] However, the critical question for enforcement officials generally will be the effects' magnitude, something for which analytical tools are still deficient. On that score, even careful attention to dynamic issues may not be availing. After all, the problem is not so much inattention to the possibility that there will be constraints on market leaders that are not readily visible to the regulators, but rather the relative impenetrability of serious analysis of what dynamic effects will be.

With that limitation in mind, the best advice for antitrust enforcement officials is not a set of rigid rules, but a set of cautions. Here are four of them:

First, antitrust enforcers should be wary of starting proceedings, tempting as it is to make that the standard result in difficult cases. Like setting up a committee in academic life, it is easy to see this as a compromise between rash action and inaction, a result that has the appearance of doing something, but without the ill effects of doing the wrong thing. That is why setting up a committee is the institutional default in academic life. This view is illusory: instituting a formal investigation always has consequences. Instituting an investigation of single-firm conduct burdens the company and prejudices market competition. Enforcers should make saying *no* the default, not saying *yes* to a first step on the theory that, it is just a first step.

Second, enforcement officials should only start proceedings if they are persuaded that there is very strong evidence *already available* on four counts: (1) The evidence should show that the market at issue is not only dominated by a given enterprise, but that it looks extremely doubtful that forces at play outside that market's narrow confines have the prospect of significantly altering the current market model or of replacing the relevant product or service for at least a significant number of users or consumers. (2) The evidence already available also should be clear that the target firm's behavior is very likely to serve predominantly to undercut market forces rather than to provide improvements to customers or generate efficiencies for the firm. (3) Further, there should be strong evidence that the conduct

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103 *See*, *e.g.*, SINGLE-FIRM CONDUCT, *supra* note 102, at 26; HORIZONTAL MERGER GUIDELINES, *supra* note 102, at 23-24; Jay Ezrielev & Janusz Ordover, *The 2010 Horizontal Merger Guidelines: Static Compass in a Dynamic World?*, ANTITRUST SOURCE, Oct. 2010, http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/Oct10_Ezrielev10_21.authcheckdam.pdf.

104 *See*, *e.g.*, Hartman et al., *supra* note 92, at 317; J. Gregory Sidak & David J. Teece, *Dynamic Competition in Antitrust Law*, 5 J. COMPETITION L. & ECON. 581, 581 (2009); David J. Teece & Mary Coleman, *The Meaning of Monopoly: Antitrust Analysis in High-Technology Industries*, 43 ANTITRUST BULL. 801, 827 (1998).

to be investigated harms consumers in a legally significant manner. (4) Finally, a remedy that could be easily implemented for the ostensibly harmful conduct should exist and it should benefit consumers more, or harm consumers less, than allowing market forces to continue to evolve. In thinking about this, officials should take account of the fact that any remedy will be remote in time and probably will not be implemented exactly in the way envisioned. Put differently, present departures from ideal markets should not be compared to hypothesized ideal solutions.

Note that when considering instituting an investigation, rather than filing charges, sufficient indication on all four counts should *already* be available—it is not enough to imagine that the information will be developed during the investigation. It is too easy to assert that the information will be found during an investigation—the incentives for rivals to make that claim are too great—for that to suffice to initiate action that can have dramatic costs for the target firm as well as substantial effects on competition among firms. For that reason, there should be a burden of persuasion for enforcement officials to start a proceeding and for the officials to take a proceeding to the next stage.

Third, enforcement officials should be open to the notion that they have missed something in looking at the considerations above, especially number one in the list of factors that should be demonstrated before acting. The most significant lesson of past antitrust cases is that officials often see a market that is either static or sufficiently stable over time such that it seems unlikely to change in ways that will significantly alter the fortunes of a dominant firm or the options for price and quality enjoyed by consumers. Officials see this even when investments have been made that will produce technologies that will upset current market realities and expectations. That lesson was born out in each of the cases discussed in Part IV. A good practice is to find out which technologies or enterprises target firm leaders identify as threats to the firm or its industry and what leaders in other firms say has the potential to replace the product or service at issue. Officials should take those concerns and hopes seriously; these often will turn out to be more instructive than carefully crafted extrapolations from industry trends and published forecasts.

Fourth, and finally, when applying the lessons to high-technology industries, where significant investments are made in research and development, where new products can suddenly emerge that alter perceptions of what is possible, or enjoyable, and where consumer tastes can shift rapidly, officials should be especially cautious. These are markets where it is particularly difficult to maintain dominance, where sustained leadership over some time frame most likely indicates strong efficiencies, also called strong consumer value, and where innovations are not yet recognized as significant. These markets can offer the strongest constraints on dominant firm behavior and the most important challenges to crafting a meaningful remedy that does more than disadvantage an individual contestant in a changing world.

The ghosts of antitrust past do not have to be mirror images of the future. However, they send a strong caution signal to officials contemplating single-firm enforcement actions, in high-technology markets most significantly of all. Antitrust officials ignore the lessons of the past at their peril, and ours.

THE EVOLUTION OF PRODUCT SEARCH

Michael R. Baye, Babur De los Santos, & Matthijs R.Wildenbeest[*]

This paper examines the evolution of product search. We provide an overview of product search in the pre-internet era and discuss how online search evolved from directory-based search in the early 1990s to "vertical" search engines by the late 1990s. We also document the prominence of price comparison sites in the mid-2000s and the challenges these platforms faced through 2010. We then use comScore qSearch data to closely examine trends in product search between 2010 and 2012. We find that today, the vast majority of shoppers conduct product searches at retailer sites and other marketplaces, whereas traditional price comparison sites have become less important.

INTRODUCTION

Product information—the prices, attributes, and availability of products sold by different sellers—is important for the functioning of competitive markets. Product information may be transmitted to consumers through the marketing efforts of firms; it may be acquired directly by consumers who spend time and other resources searching for a product, or both. Since the gathering and dissemination of information through marketing and search is costly, rational economic actors typically stop short of gathering—or providing—full information about products.[1]

During the course of human history, numerous innovations have dramatically reduced market participants' costs of acquiring and transmitting product information.[2] This paper discusses some of these innovations, including the evolution of product search on the internet. Consumers have

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[1] *See* George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 222 (1961). This article is regarded as the seminal work in this line of research.

[2] For example, innovations in transportation—buggies, automobiles, roads, and highways—and modes of communication—newspapers, billboards, the telephone, radio, television, and the internet—made it easier for consumers to search for products and for sellers to transmit product information to consumers.

clearly benefited from their ability to more easily search for products online. Thanks to innovations that have reduced consumers' costs of locating products online and to the heightened competition brought on by these innovations, consumers have enjoyed quantifiable increases in welfare because of lower prices[3] and greater product variety.[4]

Our paper is organized as follows: Section I discusses product search in the pre-internet era, including some of the economics literature developed in that era that shaped our understanding of the role that search costs play in the formation of market prices. Section II examines the early beginnings of online product search during the 1990s, which began with directories and catalogues of sites, such as Yahoo!, and web search engines, such as Lycos and Excite, and quickly evolved into "vertical" search engines, such as Dealtime and mySimon, which searched subsets of the growing number of webpages. Section III examines product search between 2000 and 2010—a period in which product search platforms evolved to overcome significant problems with the technologies that were used in the 1990s to fetch product information for consumers.

Section IV uses comScore's qSearch data to examine trends in product search between 2010 and 2012. Consistent with the earlier evolution, the data reveal that traditional price comparison sites, which include players like PriceGrabber, Shopping.com, Dealtime, Shopper.com, Google Product Search, and Bing Shopping, are becoming less important. Indeed, product searches at traditional retailers such as Walmart, online retailers such as Amazon, and other online marketplaces such as eBay dwarf those at comparison sites. Furthermore, the share of product searches performed at price comparison sites relative to other vertical sites has declined since 2010. The most recent data suggest that product search has evolved to the point where the vast majority of consumers conduct product searches at retailer and marketplace sites, such as Walmart, Amazon, and eBay.

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3 *See* Michael R. Baye, John Morgan & Patrick Scholten, *The Value of Information in an Online Consumer Electronics Market,* 22 J. PUB. POL'Y & MARKETING 17, 18 (2003); Jeffrey R. Brown & Austan Goolsbee, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry*, 110 J. POL. ECON. 481, 487-88 (2002) (analyzing the prices of term life policies and how they respond over time as their buyers begin using the Internet); *see also* NASH-EQUILLIBRIUM.COM, http://www.nash-equilibrium.com/Data.php?measure1=Value_of_Information&measure2=&limit=99999 (last visited Oct. 23, 2012) (documenting that consumers using price comparison sites to purchase at the lowest price rather than average price saved about 16%, a trend that stayed consistent throughout the 2000s).

4 See Erik Brynjolfsson, Yu (Jeffrey) Hu & Michael D. Smith, *Consumer Surplus in the Digital Economy: Estimating the Value of Increased Product Variety at Online Booksellers*, 49 MGMT. SCI. 1580 (2003) (showing that the increase in the product variety in books—owing to the ease with which online shoppers can locate books—increased consumer welfare by about $1 billion in 2000). This may not seem like a staggering number, but considering the U.S. Census Bureau reported that online retail sales of *all* goods and services in 2000 totaled only $27 billion, $1 billion in additional consumer surplus within the book segment alone is substantial.

The apparent decline in the relative importance of traditional price comparison sites is even more pronounced when one includes searches on platforms such as Craigslist, which is branded currently as a marketplace for used products, jobs, and other services. In light of Craigslist's number of users, it is potentially well-positioned to expand its listings to include both new and used products, as both Amazon and eBay have done in recent years. Amazon initially sold books from its own inventory. Today, it sells general merchandise not only from its own inventory, but new and used products for Amazon Marketplace sellers as well. Likewise, eBay began as an auction site that brought buyers and sellers of used products together. By the beginning of 2012, 70% of eBay's listings were for new products, and over 60% of its listings charged a fixed price rather than using an auction.[5]

Finally, the Concluding Remarks discuss several challenges in accurately measuring online product search. Among these challenges is the fact that a growing number of "searches" on traditional retailers' sites are not included in traditional data because they are "menu"- or "icon"-driven actions rather than textual searches. Additionally, the comScore qSearch data does not account for searches on the growing number of "closed" systems—devices using Amazon's Price Check App, Apple's iTunes Store, or the Best Buy App, for instance. For these reasons, measures of product search based on browser behavior may understate the importance of product search on retailer sites and online marketplaces.

I. PRODUCT SEARCH BEFORE THE INTERNET

At the dawn of civilization—long before the internet, cars, phones, and before the emergence of money as a medium of exchange—a hunter wishing to acquire grain in exchange for game had to search for someone wishing to exchange grain for meat. The hunter's costs of locating the right trading partner—search costs in this barter economy—included the calories lost carrying meat from camp-to-camp in an attempt to identify a potential trading partner. As Jevons noted over a century ago, "There may be many people wanting, and many possessing those things wanted; but to allow of an act of barter, there must be a double coincidence, which will rarely happen."[6] In the history of humankind, the very first innovation that substan-

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5 *See* Alice Hines, *eBay's 'Buy It New' Rebranding Angers Devoted Used Goods Sellers*, DAILY FINANCE (Nov. 11, 2011), http://www.dailyfinance.com/2011/11/02/ebays-buy-it-new-rebranding-angers-devoted-used-goods-sellers/.

6 WILLIAM STANLEY JEVONS, MONEY AND THE MECHANISM OF EXCHANGE 3 (2d ed. 1876).

tially reduced the cost of product search was the invention of money as a medium of exchange.[7]

Even after the emergence of money as a medium of exchange, product search was still very costly by today's standards. Over time, advances in transportation technologies, such as buggies and automobiles, and communication technologies, such as newspapers, telephones, and the yellow pages, reduced consumers' costs of seeking different sellers to compare prices and other product attributes.

The economics literature on product search predates the internet; it began in 1961 when Nobel Laureate George Stigler quipped that "[information] occupies a slum dwelling in the town of economics."[8] Since then, thousands of theoretical and empirical papers relating to the economics of information have been published.[9] One of the central themes of this literature is that consumer search costs give retailers market power—sometimes even monopoly power. A second theme is that reductions in search costs induce consumers to search more intensely for better deals. To the extent that reductions in search costs heighten competition among retailers, this reduces retailers' market power and increases consumer welfare.

II. THE BEGINNINGS OF ONLINE PRODUCT SEARCH

With the exception of the invention of money as a medium of exchange, the internet arguably has reduced product search costs more than any other innovation in the history of humankind. Today, the internet permits buyers to quickly and easily locate the best deals and expands competition to sellers that may be located far from a given consumer's domicile.[10] But this was not the case at the dawn of the internet. In June 1993, there were only about 130 "dot-com" websites. By the end of 1996 there were about 650,000,[11] and by the end of the decade, the internet contained mil-

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7 *See generally* Karl Brunner & Allan H. Meltzer, *The Uses of Money: Money in the Theory of an Exchange Economy*, 61 AM. ECON. REV. 784 (1971) (analyzing the individual and social choice of the assets used as money, the services money provides, the relation of these services to the choice of a monetary unit, and some implications); Nobuhiro Kiyotaki & Randall Wright, *A Search-Theoretic Approach to Monetary Economics*, 83 AM. ECON. REV. 63 (1993) (applying a search-theoretic equilibrium model to formalize the essential function of money as a medium of exchange).

8 Stigler, *supra* note 1, at 213.

9 *See generally* Michael R. Baye, John Morgan & Patrick Scholten, *Information, Search, and Price Dispersion*, *in* HANDBOOK IN ECONOMICS AND INFORMATION SYSTEMS 323 (T. Hendershott ed., 2006) (surveying the empirical literature on information, search, and price dispersion).

10 Michael R. Baye & John Morgan, *Information Gatekeepers on the Internet and the Competitiveness of Homogeneous Product Markets*, 91 AM. ECON. REV. 454, 454 (2001).

11 Clifford Lynch, *Searching the Internet*, SCIENTIFIC AMERICAN, Mar. 1997, at 52, 53.

lions of sites.[12] The growing number of websites—coupled with growth in the number of pages at each site—made it difficult for users to locate product and other information about potential sellers. To make matters even worse, the rapid growth of content on the internet was exceeding content organizers' abilities to categorize it.

Most websites developed in the early- to mid-1990s were built around the page model, which led content organizers to build content directories. For example, Yahoo! and LookSmart developed algorithms that crawled the web, grouped pages around similar content, and displayed directories of pages that attempted to organize content into hierarchical categories.[13] A shopper wishing to locate a computer game, for example, had to commit to a particular category, such as "Computers and the Internet," "Entertainment," or "Recreation and Sports," and navigate down that category. This made it costly for users to switch to a different top-level category or change search strategies midstream. Essentially, the directory format required users to employ a sequential search strategy—that is, sequentially clicking on categories and making a decision to "continue" or "stop" this particular search strategy after each new page in the hierarchy was reached.[14]

Web search engines, such as Excite, Webcrawler, Lycos, and AltaVista, were in their infancy during the mid- to late-1990s and were not particularly adept at performing product searches. "Even the best algorithms for ranking texts in order of relevance [were] unreliable when queries contain[ed] just a handful of search terms."[15] This unreliability—combined with (1) the staggering growth in pages that web search engines had to "crawl" and index, and (2) the fact that at this time the internet was little more than a "chaotic repository for the collective output of the world's digital 'printing presses'"[16] rather than a venue for overcoming the "coincidence of wants" problem of potential buyers and sellers—helped fuel "vertical" product search engines. Vertical search engines targeted a smaller number of sites with similar content, such as news, travel, or retailer websites, and thus held the promise of providing consumers with superior search results for specific types of search, including product search.[17] Rowley notes that

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12 This is measured by the number of servers. *See* Bernardo A. Huberman & Lada A. Adamic, *Evolutionary Dynamics of the World Wide Web* (1999), *available at* http://arxiv.org/abs/cond-mat/9901071v2.

13 For example, see Marti A. Hearst, *Interfaces for Searching the Web*, SCIENTIFIC AMERICAN, Mar. 1997, at 52, 68-72.

14 For a survey of the literature on sequential and fixed-sample sized search, see Baye et al., *supra* note 9.

15 Hearst, *supra* note 13, at 71.

16 Lynch, *supra* note 11, at 52.

17 For purposes of this paper, product search excludes search for services such as news, travel, or employment. We note that the online travel booking site, Expedia.com, was launched by a division within Microsoft in 1996, and was spun off from Microsoft three years later. *See Company*, EXPEDIA, INC., http://www.expediainc.com/company.cfm (last visited Dec. 19, 2012).

some web search engines, such as Excite, automatically interpreted some searches, such as "flowers," as a product search and diverted the query to a vertical search engine, like Jango, to return product search results.[18]

The genesis of online product search began with the emergence of price comparison sites. PriceWatch—established in 1995 and still in existence today—brands itself as "The Web's very first price comparison site."[19] Several other price comparison sites were launched in the mid-1990s, including BargainFinder.com, Killerapp.com, and BargainBot. Early price comparison sites were essentially "shopbots," short for shopping robots, that crawled a handful of specific retailer sites on the web to "scrape" or extract product information. This information was then displayed to consumers searching for a particular product on the comparison site. BargainFinder, for instance, was a comparison site specializing in music (at the time, CDs).[20] It searched only eight music retailers' websites and returned product information in the form of prices for titles queried by consumers.

The early price comparison sites faced a number of challenges. Textual queries by consumers searching for product information needed to be matched with data obtained from the webpages of retailers containing product information related to the query, and shopbots were far from perfect in matching consumer intent with metadata extracted from sellers' webpages. Retailers' sites were not structured in a manner that allowed shopbots to accurately identify the specific product a given consumer was searching for. As a result, it was not uncommon for a search on a comparison site to return "no results" or only a single result. Some retailers, fearful of the competitive effects of providing consumers with comparative price information, blocked shopbots from accessing their sites.[21]

First-generation price comparison sites had limited product breadth; they tended to specialize in specific product segments, such as books on BargainBot's website or music on BargainFinder's website. They frequently returned irrelevant results, inaccurate prices, and lists of sellers that did not actually have the item in stock. For example, a product search for "Palm V" at mySimon returned a list of merchants selling this item as well as merchants selling accessories for the Palm V, such as carrying cases, cradles, chargers, and so on.[22] All of these factors made it difficult for con-

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[18] Jennifer Rowley, *Product Search in e-shopping: A Review and Research Propositions*, 17 J. CONSUMER MKTG. 20, 30 (2000).

[19] *See* PRICEWATCH, http://www.pricewatch.com/ (last visited Dec. 19, 2012).

[20] *See* Kristen Lieb, *Bargain Finder Generates Some Heat*, BILLBOARD, May 1996, at 76.

[21] For evidence that this actually happened, see Marti A. Hearst, *Interfaces for Searching the Web*, SCIENTIFIC AMERICAN, Mar. 1997, at 71.

[22] Michael R. Baye, John Morgan & Patrick Scholten, *Price Dispersion in the Small and in the Large: Evidence from an Internet Price Comparison Site*, 52 J. INDUS. ECON. 463, 475 (2004).

sumers to use comparison sites to obtain accurate, apples-to-apples comparisons of the prices that different sellers charged for the same product.

The fact that first-generation price comparison sites lacked relationships with sellers led to other problems as well, such as the inclusion of unscrupulous merchants in search results and outdated product information. Growth in internet connectivity rapidly expanded the universe of retailers with websites that needed cataloging, and this made it difficult for shopbots to provide shoppers with accurate and up-to-date product information. As Baye, Morgan, and Scholten noted, "there were nearly 10,000 consumer electronics retail establishments in the United States in 1997. Each of these stores could, in principle, advertise their prices on price comparison sites . . ."[23] Additionally, first-generation price comparison sites focused almost exclusively on price. Price is certainly an important component of purchase decisions, but other factors—notably shipping costs, the seller's reputation, product availability, and product attributes—are also important.

In short, while the "noisy" product search results at comparison sites were superior to the results obtainable through web search engines, further innovations were needed to overcome the problems of irrelevant search results, outdated product and price information, the inclusion of unscrupulous merchants, and so on.

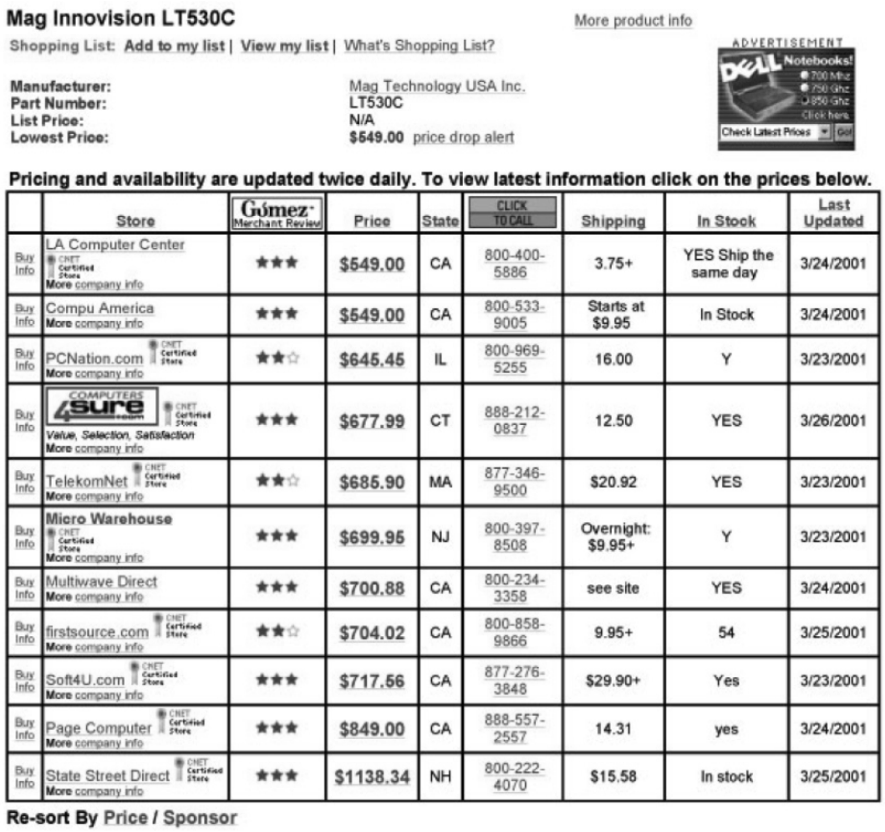
III. EVOLVING SOLUTIONS: THE FIRST DECADE OF THE MILLENNIA

The growing number of sellers wishing to reach consumers, coupled with the growing number of pages to scour, created two problems for product search platforms. First, different web pages had different formats; the code a search platform needed to extract information from one retailer's website might not work at other sites. This exacerbated the problems discussed above, such as product searches returning irrelevant results. Second, there was an allocation problem. With tens of thousands of products—and thousands of firms selling a given product—who gets the scarce real estate on results pages following product searches? The poor performance of comparison sites using shopbot technologies, together with this allocation problem, resulted in the evolution of comparison sites based on "crawls" to websites. At these sites, sellers "opted in" by inserting their own data and agreeing to pay listing and/or click-through fees.[24]

23 Baye et al., *supra* note 3, at 17.

24 Michael R. Baye, Cathy Gao & John Morgan, *On the Optimality of Clickthrough Fees in Online Markets*, 121 ECON. J. 340, 341-42 (2011).

Figure 1. Screenshot from the Price Comparison Site, Shopper.com, Circa 2001



Mag Innovision LT530C

More product info

Shopping List: Add to my list | View my list | What's Shopping List?

ADVERTISEMENT
DELL Notebooks!
700 Mhz
750 Ghz
850 Ghz
Click here
Check Latest Prices
Go!

Manufacturer: Mag Technology USA Inc.
Part Number: LT530C
List Price: N/A
Lowest Price: $549.00 price drop alert

Pricing and availability are updated twice daily. To view latest information click on the prices below.

	Store	Gómez Merchant Review	Price	State	CLICK TO CALL	Shipping	In Stock	Last Updated
Buy Info	LA Computer Center CNET Certified Store More company info	★★★	$549.00	CA	800-400-5886	3.75+	YES Ship the same day	3/24/2001
Buy Info	Compu America More company info	★★★	$549.00	CA	800-533-9005	Starts at $9.95	In Stock	3/24/2001
Buy Info	PCNation.com CNET Certified Store More company info	★★☆	$645.45	IL	800-969-5255	16.00	Y	3/23/2001
Buy Info	COMPUTERS 4sure.com CNET Certified Store Value, Selection, Satisfaction More company info	★★★	$677.99	CT	888-212-0837	12.50	YES	3/26/2001
Buy Info	TelekomNet CNET Certified Store More company info	★★☆	$685.90	MA	877-346-9500	$20.92	YES	3/23/2001
Buy Info	Micro Warehouse CNET Certified Store More company info	★★★	$699.95	NJ	800-397-8508	Overnight: $9.95+	Y	3/23/2001
Buy Info	Multiwave Direct More company info	★★★	$700.88	CA	800-234-3358	see site	YES	3/24/2001
Buy Info	firstsource.com CNET Certified Store More company info	★★☆	$704.02	CA	800-858-9866	9.95+	54	3/25/2001
Buy Info	Soft4U.com CNET Certified Store More company info	★★★	$717.56	CA	877-276-3848	$29.90+	Yes	3/23/2001
Buy Info	Page Computer CNET Certified Store More company info	★★★	$849.00	CA	888-557-2557	14.31	yes	3/24/2001
Buy Info	State Street Direct CNET Certified Store More company info	★★★	$1138.34	NH	800-222-4070	$15.58	In stock	3/25/2001

Re-sort By Price / Sponsor

Shopper.com—a site owned and operated by CNET.com and whose screenshot from 2001 is displayed in Figure 1—is a prime example of such a comparison site. In contrast to first-generation comparison sites relying on shopbot technology, merchants on Shopper.com input their own prices along with the SKU of the product.[25] This innovation went a long way toward solving some of the problems encountered by first-generation comparison sites. First, because merchants input their own data into the comparison site's system, the comparison site could display results from its own database rather than crawling the web. This helped ensure that prices, product availability, and other information were reliable and up-to-date. Second, SKU matching virtually eliminated irrelevant results in product searches. This gave this generation of price comparison sites a significant advantage over web search engines as well as first-generation comparison sites based on shopbot technologies. Finally, the universe of potential

[25] Baye et al., *supra* note 22.

sellers was no longer limited to sites actually crawled by comparison sites; retailers were free to choose whether or not to participate in the listings at a particular price comparison site. This significantly increased the number of sellers included in search results at comparison sites. During 2000 and 2001, for instance, a product search at Shopper.com returned an average of seventeen retailers selling the exact same product, and for some products, as many as eighty retailers chose to be included in the list.[26] These innovations, combined with other innovations such as more up-to-date shipping cost information, seller ratings, and the incentives of these platforms to weed out unscrupulous sellers to protect the reputation of their sites (the sites increasingly were supported by click-through fees paid by merchants[27]), rapidly made price comparison sites the "go to" place to find product information—much to the chagrin of traditional shopping portals such as Yahoo!, AOL, and MSN.

In December 2002, Google entered the comparison space with the launch of Froogle.[28] Unlike an evolving number of comparison sites, however, Froogle relied more heavily on shopbot technology rather than establishing relationships with retailers. Presumably, Google surmised that it could leverage its prowess in web search into product search. Apparently this strategy did not work; Google subsequently rebranded its product search offering as "Google Product Search" and—nearly ten years after its initial launch—announced that it was moving to the product listing model that many other comparison sites had been using since at least 2001. According to Google:

> We believe that having a commercial relationship with merchants will encourage them to keep their product information fresh and up to date. Higher quality data—whether it's accurate prices, the latest offers or product availability—should mean better shopping results for users, which in turn should create higher quality traffic for merchants.[29]

By the mid-2000s, price comparison sites had evolved from sites specializing in books, music, or consumer electronics products, to sites with comprehensive product listings that also included clothing, jewelry, appliances, home and garden tools, food baskets, and dozens of other product categories.[30] Shopping.com was the leading price comparison site, with 15

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26 *Id.* at 470-72.

27 Baye et al., *supra* note 24, at 342-43.

28 *Our History in Depth*, GOOGLE, http://www.google.com/about/company/history/#2002 (last visited Aug. 20, 2012).

29 Sameer Samat, *Building a Better Shopping Experience*, GOOGLE COM. BLOG (May 31, 2012), http://googlecommerce.blogspot.com/2012/05/building-better-shopping-experience.html#!/2012/05/building-better-shopping-experience.html.

30 Mylene Mangalindan, *The Next Generation of Price-Comparison Sites; As Competition Heats Up, Services Add Protection from Fraud, Bigger Discounts,* WALL ST. J. (Sept. 14, 2005), http://online.wsj.com/article/0,,SB112666188907540017,00.html.

million unique visitors in September 2004; the only other product search sites with more traffic were eBay, Amazon, and Yahoo! Shopping.[31]

Thanks in part to the snail's pace with which traditional retailers were moving into the online channel, price comparison sites became "white hot"[32] targets of numerous acquisitions.[33] Acquirers were hoping to leverage their knowledge of online markets, expand the depth and breadth of product listings, and—more generally—profit from their perception that comparison sites would become dominant platforms for conducting product searches and generating online sales. Unfortunately for some of these firms, these expectations were not realized. Yahoo! purchased Kelkoo in March 2004 for $598 million but sold it November 2008 for $125 million; E.W. Scripps purchased Shopzilla for $525 million in June 2005 and sold it in June 2011 for $165 million.[34]

By 2010, traditional retailers came to understand the value of their own information—information not only about prices and inventories, but about different brands, styles, and qualities of similar and complementary products. Traditional retailers followed the lead of Amazon and eBay to create search environments with a blend of "textual," "icon," and "menu" interfaces, and tools such as "recommendations." Thanks to their ability to provide more nuanced information,[35] these product search platforms began to attract greater numbers of users. Additionally, unlike some price comparison sites that had not invested in their own brand identity, and therefore did not receive significant direct traffic but relied on referrals from other sites and web search engines, traditional retailers benefited from their historical investments in brand-name recognition.

By the end of 2010, a variety of competing product search platforms had evolved, each with different strengths and weaknesses. They provided users with similar, but differentiated, search experiences. Moving into the second decade of the millennium, platform competition for users interested in conducting product searches was best viewed as differentiated product competition.

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31 Initial Public Offering of Shopping.com, NASDAQ.COM (Oct. 25, 2004), http://www.nasdaq.com/markets/ipos/filing.ashx?filingid=3042420.

32 Matt Rand, *Comparison Shopping on Sale*, FORBES (Dec. 14, 2005), http://www.forbes.com/2005/12/14/bow05121401.html/.

33 For example, E.W. Scripps acquired Shopzilla; eBay purchased Shopping.com; Experian acquired PriceGrabber; Yahoo! acquired Kelkoo.

34 *See* Kevin Woodward, *Scripps Sells Shopzilla for $165 Million*, INTERNET RETAILER (Apr. 29, 2011), http://www.internetretailer.com/2011/04/29/scripps-sells-shopzilla-165-million.

35 "The importance of non-price information about product attributes is now widely recognized." *See* Alizon Luna, *Guided Product Search: How Product Attributes Help Online Retailers Increase Sales*, CHANNEL INTELLIGENCE (Apr. 2007), http://www.channelintelligence.com/resources/Documents/CIWhitePaper_ProductAttributes_May2007.pdf.

IV. POST-2010 TRENDS IN ONLINE PRODUCT SEARCH

This section uses monthly data on consumer search behavior to analyze the evolution of product search in the U.S. between October 2010 and June 2012. Our data analysis is based on the qSearch dataset we obtained from comScore—a leading internet marketing firm that tracks the online browsing activity of 2 million users within the U.S. The qSearch database tracks users' web-search behavior at about 200 online properties, primarily through traditional search boxes and drop-down menus.[36] These 200 properties are broken down into about 1,800 domains and sublevel domains. For example, eBay is one of these 200 properties, and it operates a number of domains, including eBay.com, (the eBay site in the U.S.), Shopping.com, which eBay acquired in 2005,[37] and Dealtime.com, a service of Shopping.com.[38] Amazon is another property tracked by qSearch, and its domains include the U.S. site of Amazon.com, Zappos.com, IMDb.com, and Abebooks.com.

Our analysis exclusively focuses on vertical product search—searches by shoppers seeking to purchase one or more products. Unfortunately, comScore's qSearch data do not indicate the number of *product* searches on a given platform; they simply measure the total number of searches on each platform. For example, qSearch measures the total number of searches on web search engines, but it does not indicate how many of these searches are product searches, navigational searches, weather or news-related searches, and so on. Our analysis therefore excludes these and other sites that consumers primarily use to conduct non-product searches. Other examples of excluded sites are sites that provide general information, such as Wikipedia, USAToday, IMDb.com, Weather.com, and Dictionary.com, and social network sites, such as Facebook and Google+. We also exclude searches for services, such as searches on travel or job-related sites like Expedia.com and Monster.com.

While we do not include searches on web search engines, such as Google.com and Bing.com, or map and broadcast sites, such as Google Maps, Bing Maps, YouTube, and Netflix, we do include searches on sublevel domains explicitly related to product search, such as Google Product Search and Bing Shopping. Additionally, while searches on general

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36 According to comScore's qSearch documentation, a search is defined as: (1) a user interaction where the user is presented with a search result page containing results that match the consumer's search intent; (2) the search result page allows the user the ability to refine or change their search parameters; and (3) the search can be initiated from a drop-down or by clicking a link, as long as first two rules are satisfied. *See* qSearch, COMSCORE, http://www.comscore.com/Products/Audience_Analytics/qSearch.

37 Press Release, eBay Completes Acquisition of Shopping.com, EBAY INC. (Aug. 30, 2005), http://investor.ebay.com/releasedetail.cfm?releaseid=171732.

38 *See About Dealtime.com*, DEALTIME, http://www.dealtime.com/sc/aboutDealtime (last visited Dec. 19, 2012).

corporate websites, such as Apple.com, are excluded, we do include searches on product-related sublevel domains of these sites, such as the Apple Store.

We reviewed the 1,800 sites tracked in the qSearch database and organized product searches at these sites into three broad categories: searches on (1) price comparison sites, (2) retailer sites, and (3) marketplace/other sites.[39] Price comparison sites include sites such as PriceGrabber, Bing Shopping, and Google Product Search; these sites typically do not sell products or fulfill orders but instead present shoppers with a list of prices that different sellers charge for a given product. As discussed earlier, this price information is typically bundled with other information—including shipping costs, the reputation of the seller, and other product characteristics—to aid shoppers with their purchase decisions. When a consumer clicks on a particular retailer listed at a price comparison site, she is typically directed to that retailer's site to complete the transaction.

Retailer sites include the online arms of traditional retailers, such as Best Buy, Walmart, and Target, as well as pure online retailers, such as Zappos.com. Unlike price comparison sites, these sites typically sell products from the company's inventory. The third category—marketplace/other sites—includes marketplaces like eBay.com, coupon and deal sites such as coupons.com and slickdeals.net, and review sites such as epinions.com. Sites within this category are highly differentiated and evolving. The most prominent site in this category is eBay.com. Unlike retailers, it does not sell products from its own inventory. Unlike price comparison sites, transactions typically take place on the platform rather than at the site of an individual retailer. We note that eBay and many other sites in this category now have features that permit shoppers to compare the prices—along with other characteristics, such as rebates—of products sold by different sellers. However, sites in this category differ from traditional price comparison sites in that price comparisons are not the central focus of these sites. Rather, this relatively new feature is an example of the continuing evolution of product search environments at marketplace/other sites.

It is important to note that some properties operate product search sites that span more than one of these three categories. For example, searches on eBay's Shopping.com and Dealtime.com sites are included in the price comparison site category, while searches on eBay's main U.S. site, eBay.com, are included in the marketplace category. As another example, searches on Amazon's Zappos.com site are included in the retailer site category; searches on Amazon's Abebooks.com site are included in the price comparison site category.[40]

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39 Appendix A1 provides a list of the sites included in our analysis.

40 Recall that searches on Amazon's IMDb.com site, a general information site about movies, are excluded from our analysis.

With a few exceptions, the data permit us to assign product searches on sites tracked by qSearch into one of the three categories. One notable exception is Amazon; the qSearch data do not permit us to decompose searches on Amazon.com into the "retailer sites" and "marketplace/other sites" categories. Amazon has evolved such that it is both an online retailer—it sells products from its own inventory—and a marketplace—it fulfills orders for its Amazon Marketplace sellers. Today, product searches on Amazon.com typically return products sold by Amazon as well as products sold by its Marketplace Sellers. For purposes of our analysis, all searches on Amazon.com are allocated to the "retailer site" category regardless of whether the searches were related to its own products or products sold by marketplace sellers.

Figure 2 displays the evolution of product search, measured in millions of search visits, for each of the three categories between October 2010 and June 2012.[41] Several features are worth noting. As would be expected, there is some seasonal variation in search visits during the sampling period, most notably the increases during December. Second, the overall number of search visits at price comparison sites remained fairly constant over this period, starting with 73 million search visits in October 2010 and ending with 75 million search visits in June 2012. In contrast, the number of search visits at retailer sites increased by about 300% during the period, from 98 million in October 2010 to 298 million in June 2012. Likewise, search visits at marketplace/other sites increased from 174 million in October 2010 to 244 million in June 2012. On balance, Figure 2 shows that: (1) retailer sites, marketplace/other sites received significantly more search visits than price comparison sites; (2) retailer sites, marketplace/other sites enjoyed significant growth over the past two years; and (3) searches at price comparison sites have remained fairly flat over the past two years, and actually declined during the first half of 2012.

The patterns of product search presented in Figure 2 suggest that shoppers are increasingly viewing retailer and marketplace sites as the "go to" places for conducting product searches. In particular, recall that a successful product search at a price comparison site ultimately directs a shopper to a retailer's site where consumers may engage in additional product search. Since product searches at price comparison sites are stable over the period, Figure 2 suggests that the growth in product searches at retailer and marketplace sites does not stem from increases in referrals from comparison sites, but from shoppers directly going to retailer and marketplace sites to conduct product searches.

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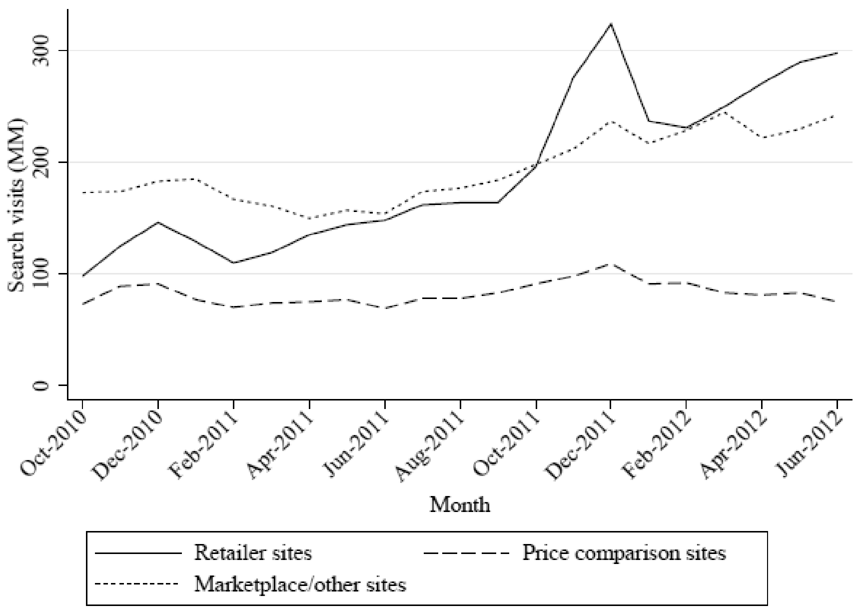
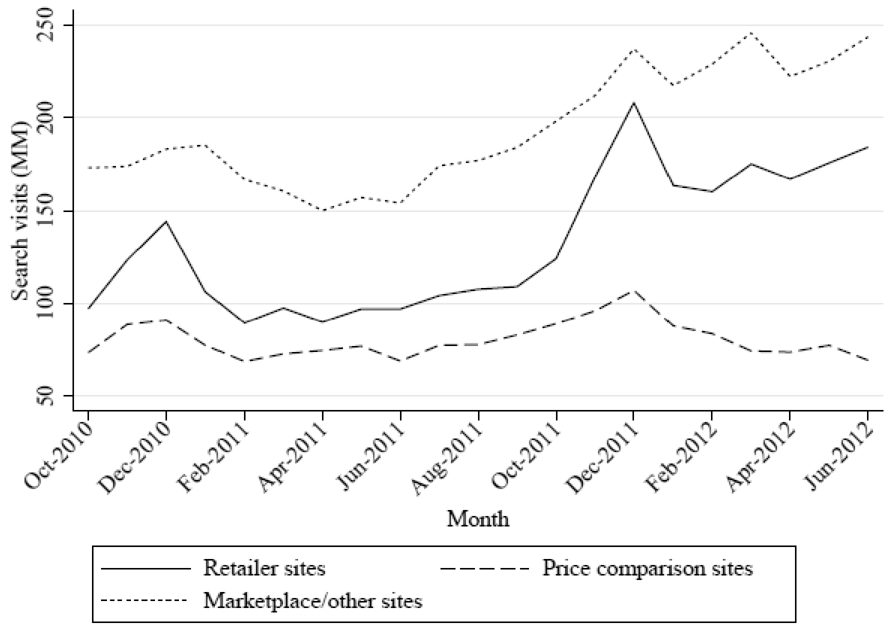
41 According to comScore's qSearch documentation, a search visit is a session in which a user conducted one or more searches. If searches are conducted at different points during the day, with more than thirty minutes of search inactivity at the site, they will count as multiple search visits. *See* COMSCORE, *supra* note 36.

Figure 2. Evolution of Search Visits at Retailer Sites, Price Comparison Sites, and Marketplace/Other Sites: Unbalanced Panel



One potential worry found in Figure 2 is that the data are comprised of the unbalanced panel of product search sites included in the qSearch data. In particular, qSearch includes properties only if the number of searches exceeds a certain threshold. As a consequence, platforms enter and exit the qSearch sample during the sample period. Figure 3 displays results based on a balanced panel; it is based solely on product search sites that remained in the qSearch database for the duration of the sample period. As shown in the figure, the patterns are similar to those in Figure 2. Holding the set of product search platforms constant, retailer sites, marketplace/other sites displayed significant growth over the past two years, while search visits at price comparison sites remained flat and actually declined substantially during the first six months of 2012.

Figure 3. Evolution of Search Visits at Retailer Sites, Price Comparison Sites, and Marketplace/Other Sites: Balanced Panel



The marketplace/other sites category in Figures 2 and 3 does not include searches on Craigslist because the qSearch data do not permit us to disentangle product searches from non-product searches—e.g., searches for jobs, personals, housing, and other services. Nonetheless, as illustrated in Figure 4, search activity on Craigslist closely mirrors that of the marketplace/other sites category, indicating that the overall trends displayed in Figures 2 and 3 are not the result of excluding Craigslist from the analysis.

Figure 4. Evolution of Search Visits, With Craigslist

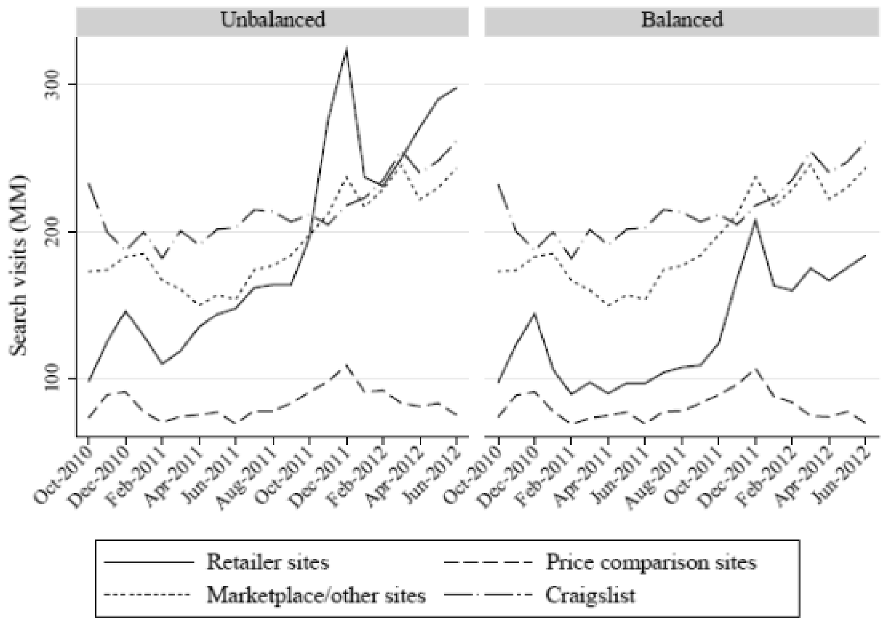


Table 1 provides summary statistics for the total number of product searches conducted on retailer sites, price comparison sites, marketplace/other sites, and Craigslist. In June 2012, consumers using browsers conducted 877 million searches at marketplace/other sites and an additional 737 million searches on Craigslist. Retailer sites amassed 634 million searches, while price comparison sites mustered only 134 million searches.

Table 1 also shows how searches at these platforms vary across heavy searchers, medium searchers, and light searchers.[42] The bulk of all searches in each category are conducted by so-called heavy searchers—the top 20% most active searchers in terms of the number of searches performed each month. Heavy searchers account for 71% of all product searches at marketplace/other sites, but account for only 57% of all product searches at retailer sites. In contrast, Table 1 also shows that price comparison sites and retailer sites are very similar in terms of their mix of heavy, medium, and light searchers.

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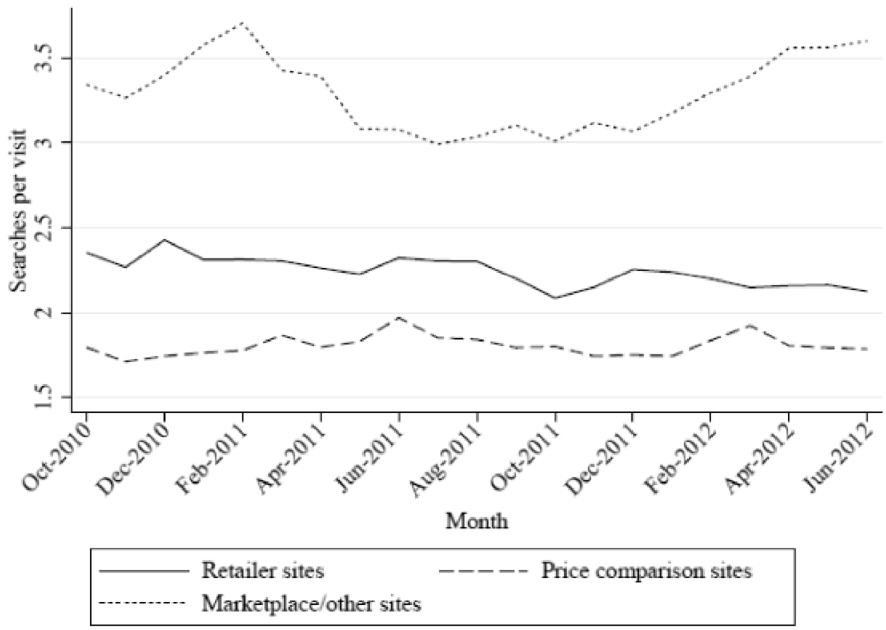
[42] These categorizations are based on comScore's classification of searchers; comScore defines the heavy searchers as the top 20% most active searchers in terms of the number of searches during a month. The light searchers are defined as the 50% least active searchers. *See id.*

Table 1. Product Searches by User Type, June 2012

	Searches (MM)	Percentage of product searches by user type		
		heavy searcher	medium searcher	light searcher
Retailer sites	634	57	31	11
Price comparison sites	134	60	29	11
Marketplace/other sites	877	71	24	5
Craigslist	737	70	24	6

The total number of searches summarized in Table 1 for June 2012 is the product of search visits—displayed earlier in Figure 3—and the number of searches per visit during that month—displayed in Figure 5. Notice in Figure 5 that, for each category, searches per visit remained relatively constant during the sample period. This implies that trends in total searches for the three categories are similar to those shown for search visits in Figure 2. Figure 5 also demonstrates that a typical search visit at marketplace/other sites results in more searches—slightly more than 3 searches—than at retailer sites—less than 2.5 searches—or price comparison sites (about 1.75 searches).

Figure 5. Evolution of Searches per Visit at Retailer Sites, Price Comparison Sites, and Marketplace/Other Sites



CONCLUDING REMARKS

Product search is dynamic, with evolving technological approaches and considerable turnover in both the importance of different platforms and the identity of key players. Price comparison sites were once the dominant platform for conducting product search. Today, the number of searches conducted on retailer sites and marketplace/other sites dwarf searches at comparison sites. In the beginning, eBay was a marketplace for buyers and sellers of used products, but today, about 70% of the products listed there are new. Amazon was once an online retailer that specialized in selling books and music from its own inventory; today it sells not only a wide array of general merchandize, but it serves as a marketplace where shoppers can search across a growing number of independent sellers. Additional evidence of this evolution is the fact that comScore recently started including product searches at Walmart.com in its qSearch database.

The overall trend—a trend that is continuing into the second decade of the millennium—is that retailer and marketplace/other sites are becoming the "go to" place for conducting product searches. Additionally, shoppers search more intensely at retailer sites and marketplace/other sites, resulting in significantly more overall searches at these sites than at price comparison sites. We note that our data and analysis are based on product search activity taking place in the U.S. It is therefore difficult to say whether the shift toward retail and marketplace sites is a global phenomenon, or is only local to the U.S. One development that suggests this trend might be a global phenomenon is the fact that several of the major sites in our data operate foreign subsidiaries that have evolved in ways similar to their U.S. counterparts. For example, Amazon.co.uk in the United Kingdom and Amazon.de in Germany now sell a wide variety of different products from their own inventories as well as from other sellers. In addition, eBay.de transitioned from auctions of used goods to a marketplace where consumers can purchase new items at a posted price.

We conclude with some caveats that highlight a few of the challenges in measuring online product search. First, product search platforms are differentiated, and each has advantages and disadvantages. Some sites rely more heavily on textual searches, while others supplement textual search with opportunities for shoppers to use pull-down menus, navigate directories, or take advantage of product recommendations. In addition to typing product queries into traditional search boxes, consumers use directories, menus, and different filtering and sorting tools to search for products. Most of these non-textual searches are not observed, as they often involve consumer clicking behavior. This may bias measurement in favor of platforms that heavily rely on textual searches relative to platforms that are designed to allow consumers to engage in non-textual searches.

Second, because platforms are differentiated, care must be taken in comparing the total number of searches on one platform with the total number on another. For example, it might take a shopper only one search on platform A to obtain relevant results; on platform B it might take four searches. In this case, for a given number of search visits, platform B would have four times as many searches as platform A. We have attempted to overcome this problem by focusing on search visits rather than total searches. To the extent that higher quality search platforms generate more search visits, one would expect higher quality sites to have more search visits than lower quality sites, even if the overall number of searches is lower on high-quality sites. In any case, our data indicate that the trends in search behavior at price comparison sites, retailer sites, and marketplace/other sites are similar regardless of whether one uses search visits or total searches to measure product searches.

Additionally, owing to the differentiated nature of the product information returned by searches at various platforms, a given number of searches might ultimately result in better purchase decisions on one platform than on another. Platforms differ with regard to the amount of time shoppers must invest in evaluating results pages, including seller reputations, shipping charges, payment options, return policies, and distinct product descriptions that contain other potentially important information about a product, such as whether it is new or used. Measures of searches on different platforms—be they numbers of searches or market shares—typically do not take these and other "search quality" issues into account.

Another difficulty in measuring product search is accounting for the universe of *potential* product searches. For instance, comScore's qSearch only tracks searches conducted using traditional, non-mobile web browsers. Increasingly, however, consumers are using other systems, e.g., iTunes, and applications, e.g., Amazon's Price Check and Sam's Club applications, to conduct product searches. The challenge with these systems is that they tend to be closed and in some cases mobile, making it more difficult to accurately measure product search activity on the universe of available platforms. While the absence of reliable data on mobile search activity led us to focus exclusively on non-mobile product search, to the extent that those conducting mobile searches use retailer or marketplace applications, such as Amazon Price Check, while in their local store—or search in a manner similar to those using desktops—the results would be similar. Nonetheless, this remains an open empirical question that would be interesting to examine when reliable data are available.

Finally, it is extremely difficult to disentangle product search from other types of search. We have attempted to overcome this difficulty by focusing exclusively on sites tracked by qSearch that specialize in helping consumers conduct product searches. In so doing, we have excluded searches on the many small retailer sites that are not tracked by qSearch, as well as searches on newspaper and other sites that are potentially related to product search. Our rationale for excluding these latter sites is that most of the searches on these sites are unlikely related to product search. In future research we hope to use other data to more closely explore these issues, including the nature of product search conducted on web search engines.

Appendix A1. Sample of Product Search Sites

Price Comparison Sites	***Retailer Sites***	***Marketplace/other sites***
abebooks.com	amazon.com	bensbargains.net
aol shopping	americangirl.com	cnet reviews
ask shopping search	barnesandnoble.com	consumersearch.com
become.com	buy.com	coupons.com
beso.com	cb2.com	dealam.com
bing shopping	circuitcity.com	dealio.com
bizrate.com	compusa.com	deals2buy.com
bookfinder.com	crateandbarrel.com	dealsofamerica.com
bottomdollar.com	dell.com	dealspl.us
buycheapr.com	disney shopping	digcoupons.com
calibex.com	gamespot.com	ebates.com
cnet shopper.com	globalcomputer.com	ebay.com
compare.com	jcpenney.com	epinions.com
dealnews.com	kmart.com	fatwallet.com
dealtime.com	kobobooks.com	goodguide.com
etsy.com	landofnod.com	groupon.com
google shopping/product search	microsoftstore.com	half.com
lowpriceshopper.com	newegg.com	overstock auctions
lycos shopping	officedepot.com	passionforsavings.com
mysimon.com	overstock.com	shopathome.com
nextag.com	samsclub.com	slickdeals.net
ohdeal.com	sears.com	toptenreviews.com
preciomania.com	shopping.hp.com	trustedreviews.com
pricedumper.com	staples.com	wize.com
pricegrabber.com	target.com	woot.com
pricewatch.com	techdepot.com	yahoo! deals
pronto.com	tgw.com	
shoplocal.com	the apple store	
shopping.com us	tigerdirect.com	
shoptrue.com	walmart.com	
shopzilla.com	zappos.com	
smarter.com		
techbargains.com		
thefind.com		
toyssale.com		
yahoo! u.s. shopping		

SHOULD GOOGLE BE REGULATED AS A PUBLIC UTILITY?

*Mark A. Jamison**

JEL CODES: K21, K23, L12, L13, L42, L51

I examine the validity of the arguments for regulating Google search and find that they are insufficient and regulation would likely be counter-productive. Google search does not fit the traditional frameworks for justifying regulatory control—namely, the public utility concept, common carrier concept, and essential facilities doctrine. In short, Google's search is not monopolistic in nature, does not preclude rivals from competing against it, does not rely on grant of a franchise as does a utility, and does not take control of rivals' content or service. Furthermore, regulation advocates fail to give adequate weight to the changes that continuously occur in the search business, the ways rivals benefit from Google's investments, the negative impacts of forcing Google to reveal its search algorithms, and regulation's stifling effect on innovation.

INTRODUCTION

The success of Google search, which reportedly provides about 65% of general[1] internet searches in the U.S.,[2] has resulted in a number of calls for regulation from industry observers and rivals, and has prompted investigations by antitrust regulators in the U.S. and in Europe.[3] The advocates of government intervention evoke traditional arguments supporting economic

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[1] There are several forms of search, including many specialized forms of search and general Web search. I adopt the term "general search" to denote the latter form of search, which is offered by Google, Yahoo!, Bing, and others.

[2] Brian Womack, *Microsoft Nears No. 2 Spot in U.S. Internet Search Market as Yahoo Slips*, BLOOMBERG (Dec. 15, 2011, 6:53 PM), http://www.bloomberg.com/news/2011-12-15/microsoft-nears-no-2-spot-in-search-market-as-yahoo-slips-1-.html.

[3] Rasmussen finds that the public generally did not share this sentiment at the time of the Rasmussen survey. Seventy-seven percent of adults believed there was no need for the government to regulate the way that search engines select their search results. Only 11% believed such regulation was necessary. The most frequent Internet users were the least likely to favor regulation. *See Most Say No to Government Regulation of Search Engines*, RASMUSSEN REPORTS (Jan. 9, 2011), http://www.rasmussenreports.com/public_content/lifestyle/general_lifestyle/january_2011/most_say_no_to_government_regulation_of_search_engines.

regulation. Some hold that Google search is like a public utility because Google has a monopoly, and general search is important.[4] A second argument asserts that Google is a common carrier and should be regulated as such.[5] Others simply state that Google has market power in general search and, therefore, should be subjected to the essential facilities doctrine.[6] Regardless of the justification used, the advocates all reach the same conclusion—that governments should impose restrictions on Google designed to benefit its rivals.

In this paper I examine the regulation proponents' claims and conclude that they are incorrect. I further conclude that regulation would be counterproductive. In a nutshell, regulation of Google search is inappropriate because Google search is not a monopoly[7] and does not qualify as either a public utility or a common carrier. Furthermore, search technologies and markets are constantly changing, which would make regulation costly both in terms of the administrative costs and in terms of the delays in innovation that regulation would cause. Also, economic regulation of Google search could decrease investment by Google, which would likely harm customers and rivals. It could also result in at least partial public disclosure of Google's search algorithms, which would allow other businesses to behave strategically to improve their search rankings without benefitting consumers. I arrive at these conclusions by examining whether the public utility

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4 Nathan Newman, *Will ITA Takeover Conditions Move Google Towards Becoming Public Utility?*, HUFFINGTON POST (Apr. 8, 2011, 2:17 PM), http://www.huffingtonpost.com/nathan-newman/will-ita-takeover-conditi_b_846754.html; John M. Simpson, *You Can Read 'CQ Researcher' In-depth Report on Google's Dominance*, CONSUMER WATCHDOG (Nov. 23, 2011), http://www.consumerwatchdog.org/node/12509; *see also Is Google too powerful?*, BBC NEWS (Feb. 21, 2003, 11:43 AM), http://news.bbc.co.uk/2/hi/2786761.stm.

5 Newman, *supra* note 4.

6 Eric K. Clemons & Nehal Madhani, *Regulation of Digital Businesses with Natural Monopolies or Third Party Payment Business Models: Antitrust Lessons from the Analysis of Google*, 27 J. MGMT. INFO. SYS. 43, 49, 75 (2010); *see* Benjamin Edelman, *Hard-coding Bias in Google 'Algorithmic' Search Results*, BENEDELMAN.ORG (Nov. 15, 2010), http://www.benedelman.org/hardcoding; Benjamin G. Edelman, *Google's Dominance—And What To Do About It*, AM. CONST. SOC'Y (Oct. 3, 2011), http://www.acslaw.org/acsblog/google%E2%80%99s-dominance-%E2%80%93-and-what-to-do-about-it [hereinafter Edelman, *Google's Dominance*]; Benjamin Edelman, *Remedies for Search Bias*, BENEDELMAN.ORG (Feb. 22, 2011), http://www.benedelman.org/news/022211-1.html.

7 As I explain later in this paper, the term monopoly in the public utilities context means the firm serves 100% of its market, the firm's monopoly service has no close substitutes, and the monopoly status endures over time. I also use and define the term natural monopoly, which refers to the economic efficiency of the monopoly arrangement. I distinguish between monopoly and monopolistic as follows. I use the term monopoly in the traditional economic sense and use the term monopolistic to refer to a firm that either serves 100% of its market or faces competition only from rivals that are seriously disadvantaged by lack of access to a factor of production, namely an essential facility that rivals need in order to be anything more than small, fledgling providers. This distinction is important because the literature on utilities and the literature on essential facilities both use the term monopoly, but sometimes use different definitions. I adopt the utilities definition of monopoly for this paper and use the term monopolistic when discussing the essential nature of a firm that possesses an essential facility.

concept, common carrier concept, or essential facilities doctrine, or any combination of the three, appropriately apply to Google search. I also examine the validity of a new argument for regulation created by the advocates, namely that economic regulation should be adopted if it would benefit competition.

The remainder of this article is organized in the following way. Section I describes the history of Internet search and how search engines work. Section II describes the foundations for the traditional rationales for regulation and assesses whether search fits these categories. Section III examines other rationales offered for regulating Google.

I. SEARCH

A search engine is a computer program that searches documents and other Web content based on a user query and returns a list of relevant results to the search user.[8] When a user enters a query, the search engine software accepts the query and checks for possible input errors, gathers and ranks a list of relevant pages from the engine's index or catalogue, checks to see if other databases such as news search are relevant to the query, gathers relevant advertisements, and returns the results to the user.[9] The index or catalogue is built mechanically by Internet spiders, manually by humans, or both.[10] Spiders search the Web—following links, requesting pages, reading pages for content, and indexing the information found into the catalogue. Search results from the catalogue are often called organic search.[11]

Although many of the underlying software technologies that make up a search engine predate the Internet, they came together for the Web in 1993, about two years after the introduction of the Web.[12] Of the four search engines launched in 1993, the most well-known was Excite.[13] Early search engines, such as Yahoo! Directory, launched in 1994, were often manually constructed directories that were costly and difficult to scale up.[14] Meta search engines, which draw results from multiple search engines, emerged to leverage the diversity of individual engines.[15]

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8 Aaron Wall, *History of Search Engines: From 1945 to Google Today,* SEARCH ENGINE HISTORY, http://www.searchenginehistory.com (last visited Jan. 24, 2013).

9 *Id.*

10 Danny Sullivan, *How Search Engines Work* (Oct. 14, 2002), http://www.uniroma2.it/didattica/prog_web/deposito/search_engine.pdf; Wall, *supra* note 8.

11 Wall, *supra* note 8.

12 *Id.*

13 *Id.*

14 *Id.*

15 *Id.*

The usefulness of search results to a user is determined largely by whether the content the user seeks is listed high in the search results.[16] There are a variety of methods for determining the relevancy of content to a query, and search engines vary in the methods they use and in how they combine the methods.[17] The location/frequency method looks for keywords in page titles and text, generally assuming that if the keyword is in the title, then the page is more relevant than if the keyword appears only in the paragraphs of the document.[18] Also, the more frequently a word appears on a page, the more relevant the page is considered to be to the query; however, a page may be considered to be spamming if a keyword appears to occur too often.[19] Search engines can track how often a site is selected based on keywords, and those pages that receive more click-throughs receive higher rankings.[20] In 1998, Google was launched with a unique relevancy technology called PageRank, which measured a Web page's importance according to the number of links to it from other Web pages, and the number of links linking to those Web sites in turn—similar in concept to how citations are used to measure the relative importance of academic publications.[21] Google's growth in popularity since then implies that users found the results of this ranking process valuable relative to other approaches.[22] Initially, Google provided its service to other search engines, such as Yahoo!, but these search engine providers chose to rely on their own engine algorithms and discontinued their use of Google's service.[23] In response, Google launched its own search service and soon grew into the most popular site for general search.[24]

Providers of general search are often multiproduct firms. Some providers, such as Microsoft, launched general search engines after success in other sectors like PC software.[25] Other general search providers have expanded beyond the traditional Web results into specialized results and more readily accessible answers.[26] These specialized search services, sometimes

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16 Danny Sullivan, *How Search Engines Rank Web Pages*, WORLDWIDE REVENUE SOLUTIONS, INC., http://www.wrsol.com/resources/WrsSEOTip2.pdf (last visited Jan. 7, 2012).

17 *Id.* at 1-2; Wall, *supra* note 8; *see also Google History*, GOOGLE, http://www.google.com/about/corporate/company/history.html (last visited Jan. 7, 2012).

18 Sullivan, *supra* note 16.

19 *Id.*

20 Thorsten Joachims, *Optimizing Search Engines Using Clickthrough Data*, PROC. OF THE EIGHTH ACM SIGKDD INTL. CONF. ON KNOWLEDGE DISCOVERY AND DATA MINING (2002); Sullivan, *supra* note 16.

21 Danny Sullivan, *What is Google PageRank? A Guide for Searchers & Webmasters*, SEARCH ENGINE LAND (Apr. 26, 2007, 1:18 AM), http://searchengineland.com/what-is-google-pagerank-a-guide-for-searchers-webmasters-11068.

22 Wall, *supra* note 8.

23 *Id.*

24 *Id.*

25 *Id.*

26 *Id.*

called vertical search, include video platforms, such as YouTube, book search, such as Yahoo!'s and Microsoft's Open Content Alliance, flight search, news search, and shopping search.[27] For example, the query "Internet competition" in Bing yielded several tabs on its first page, including a "Videos" tab. An identical query into Google search also yielded several tabs on its first page, including a "Books" tab that listed books on Internet competition and a "Videos" tab.[28]

Search is generally free to users and search providers receive revenue primarily by selling advertising.[29] For example, the query "pizza" in Google via Internet Explorer yielded three ads at the top of the first page.[30] An early model for advertising was to charge commercial sites for being included in the search catalogue.[31] The next innovation was pay-per-click, which is still in use and was pioneered by GoTo. In this model, an advertiser pays only if a user clicks on the advertiser's ad, which is often keyword-targeted.[32] The price per click is based on the keyword that the advertiser selects and can be set by the search provider or, as in the cases of Google's AdWords and Yahoo!'s Advertising Solutions, established through an auction process.[33] The pay-per-click model decreases risk for advertisers relative to paying simply for ad placement. It also facilitates targeted advertising because advertising platforms like Google's and Microsoft's factor the click-through rate into the click price, offering lower per-click prices to advertisers that are selected more often, and because search providers have an incentive to display ads that have higher click-through rates more frequently.[34] Another advertising model is content-targeted advertising, which places ads in Web sites based on the content of the sites. The advertiser pays an ad placement service, such as Google's AdSense, and owners of Web pages are compensated when viewers click through an ad.[35]

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27 *Id.*

28 Queries made Feb. 7, 2012 by the author. A PDF of the first page of each of the search results is available from the author.

29 Grant Crowell, *How Search Engines Make Money*, SEARCH ENGINE WATCH (Dec. 15, 2003), http://searchenginewatch.com/article/2066421/How-Search-Engines-Make-Money.

30 Query made January 2, 2012, by the author. A PDF of the first page of the search results is available from the author. Interestingly, the top two results from the organic search were the same as the top two ad results.

31 Wall, *supra* note 8.

32 *Id.*

33 Benjamin Edelman, Michael Ostrovsky & Michael Schwarz, *Internet Advertising and the Generalized Second-Price Auction: Selling Billions of Dollars Worth of Keywords*, 97 AM. ECON. REV. 242, 242 (2007); Wall, *supra* note 8.

34 *Advertise Your Business on Google*, GOOGLE ADWORDS, http://www.google.com/ads/adwords2 (last visited Jan. 7, 2012); Wall, *supra* note 8.

35 *What's AdSense*, GOOGLE ADSENSE, https://www.google.com/adsense/www/en_US/tour/index.html (last visited Jan. 7, 2012); Wall, *supra* note 8.

Today's three largest general search providers are Google, Yahoo!, and Microsoft.[36] Other general search engines include the meta search engine Dogpile, which compiles searches of Google, Bing, and Yahoo!; AltaVista, which uses Yahoo!'s search technology; Go.Com, which is Disney's family-friendly search engine; and Lycos.[37] Newer general search engines include DuckDuckGo, which emphasizes privacy and new search algorithms, and Blekko, which emphasizes new search algorithms and less spam.[38]

As is seemingly true of everything in the Internet, search is constantly evolving, which provides competitive pressures for general search providers.[39] The constant development of improved technologies that add value for customers and lower costs intensifies competition within general search. Also, new substitutes are emerging for general search.[40] Customers use Amazon for finding information about books, movies, and other products.[41] Other retailing sites offer ways for customers to share information and links to places of interest. Applications (apps) such as OpenTable bypass search altogether.[42] Social networks such as Facebook, LinkedIn, and Twitter offer features for finding information, getting recommendations, and reviewing products and services.[43] Some industry observers believe that Apple's new Siri service is the next generation for search.[44] Numerous mobile apps, such as barcode readers, travel apps, product and place reviews, and markets help customers find specific information in the right context. More specialized search services, including eBay, Kayak, Orbitz, Epicurious, Monster, Wikipedia, Yelp, UrbanSpoon, MapQuest, and Wolfram Alpha, are also targeting specific customer needs.[45]

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36 Press Release, Five Star Equities, Yahoo! and AOL Lag Behind Google for Market Share in the Internet Search Engine Industry (May 8, 2012), *available at* http://www.marketwire.com/press-release/yahoo-aol-lag-behind-google-market-share-internet-search-engine-industry-nasdaq-yhoo-1654074.htm.

37 THE SEARCH ENGINE LIST, http://www.thesearchenginelist.com (last visited Jan. 7, 2012).

38 *blekko's mission*, BLEKKO, http://blekko.com/about (last visited Nov. 9, 2012); *DuckDuckGo Privacy*, DUCKDUCKGO, https://duckduckgo.com/privacy.html (last visited May 27, 2012).

39 Farhad Manjoo, *The Great Tech Wars of 2012*, FAST COMPANY, Nov. 2011, at 106.

40 Danny Sullivan, *Digital Marketing Guide: Search*, ADVERTISING AGE (Feb. 22, 2010), http://adage.com/article/digital/digital-marketing-guide-search/142197/.

41 AMAZON, http://www.amazon.com (last visited Dec 19, 2012).

42 OPENTABLE, http://www.opentable.com/home.aspx (last visited Dec. 19, 2012).

43 *Id.*

44 Lizette Chapman, *Siri Investor Morgenthaler on the Next Generation of Voice Investments*, WALL ST. J. BLOGS (Oct. 19, 2011, 5:22 PM), http://blogs.wsj.com/venturecapital/2011/10/19/siri-investor-morgenthaler-on-the-next-generation-of-voice-investments/.

45 THE SEARCH ENGINE LIST, *supra* note 37.

II. FOUNDATIONS FOR ECONOMIC REGULATION

In this section, I examine traditional foundations for economic regulation, namely the public utility concept, common carrier concept, and essential facilities doctrine. I find that Google's general search service does not qualify for regulation under these traditional frameworks.

A. *Public Utilities*

While the economic regulation of business has a long history, the regulation of public utilities evolved largely over the last 150 years and mostly in the U.S. Industries qualify as public utilities if they tend to be natural monopolies, receive a public franchise or a certificate of public convenience and necessity, and are affected with the public interest; that is to say, utilities that have special legal obligations, and their performance has an extraordinary impact on social and economic functioning.[46]

As public utilities, electricity, gas, and water companies meet all of the aforementioned criteria,[47] but as I explain in more detail below, Google search meets none of them. Google search is not a natural monopoly as evidenced by the commercially viable general search services that compete with Google. Even if there were no rivals, the monopoly status would be fleeting because Internet-based markets are constantly evolving so that today's innovative service is tomorrow's relic.[48] While Google search is clearly popular, it is not essential to our social and economic functions in the way that electricity and water are. Nor does Google operate with a public franchise: entrepreneurs built the company without government sanction, and if the company does not keep up with changing technologies and markets, the company loses business to substitutes, and the loss has little impact on consumers or the economy.

46 *See generally* MARTIN G. GLAESER, OUTLINES OF PUBLIC UTILITY ECONOMICS (1927); CHARLES F. PHILLIPS, JR., THE REGULATION OF PUBLIC UTILITIES (1993).

47 An exception might be telecommunications. The telecommunications sector was once considered a natural monopoly and was protected from competition. The sector's monopoly status has changed; however, apparently because of tradition, some jurisdictions continue to impose utility-style regulation. Some elements of the sector are still monopolistic and the firms are considered to be common carriers, at least for traditional telephone services.

48 Today's Internet winners are often tomorrow's also-rans. For example, in 1998 *Fortune* ran an article with the title, "How Yahoo! Won the Search Wars." Randall E. Stross, *How Yahoo! Won the Search Wars*, FORTUNE, Mar. 2, 1998. According to the article, "Yahoo! has won the search engine wars and is poised for much bigger things." *Id.*

1. Natural Monopoly

For the purposes of identifying a utility, the firm is considered to be a natural monopoly[49] if it "cannot be operated with efficiency and economy unless it enjoys a monopoly of its market."[50] The utility is thought to serve 100% of its market,[51] but customers may have options at the margin, such as self-supply of electricity generation or streams and wells in the case of water. There can be no close substitutes for the natural monopoly's product or service,[52] and there must be barriers to entry so that the natural monopoly's status persists over time.[53]

The most common approach to determining whether a firm is a natural monopoly is to examine the market from a production technology perspective.[54] In this view, a monopoly is a natural monopoly if its production costs are subadditive, meaning that a single firm is the least cost arrangement for serving the entire market demand.[55]

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49 Some authors, such as Simpson, use the term "monopoly" or "monopolist" to characterize Google even though the firm serves less than 100% of its market. *See* Simpson, *supra* note 4. Others such as Clemons and Madhani use the term "monopoly power," which presumably admits that Google serves less than 100% of its market but retains the characterization. *See* Clemons & Madhani, *supra* note 6. Such uses of the terms "monopoly" or "monopoly power" may be normal in some contexts, but in the context of public utilities, the norm has been for "monopoly" to mean a firm that serves 100% of its market demand, not merely a firm that has a large market share.

50 *See generally* JAMES C. BONBRIGHT, ALBERT L. DANIELSEN & DAVID R. KAMERSCHEN, PRINCIPLES OF PUBLIC UTILITY RATES (1988).

51 *See generally* WILLIAM W. SHARKEY, THE THEORY OF NATURAL MONOPOLY (1982). A firm may be considered to be monopolizing a market if it serves less than 100% of its market but is taking steps to become the only active seller in the market. *See* KIP W. VICUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON, JR., ECONOMICS OF REGULATIONS AND ANTITRUST (3d ed. 2000). As such, monopolization is a term denoting the process of moving towards becoming a monopoly.

52 Barry C. Harris & Joseph J. Simons, *Focusing Market Definition: How Much Substitution Is Necessary?*, 12 RES. L. & ECON. 207 (1989). *See generally* Gregory J. Werden, *Demand Elasticities in Antitrust Analysis*, 66 ANTITRUST L.J. 363 (1997).

53 Market power, which is the ability to receive revenue in excess of economic costs without the threat of entry, may exist even if a firm is not a monopoly. The presence of market power without monopoly is not an element of the definition of utility. *See generally* HERBERT HOVENKAMP & PHILLIP E. AREEDA, FUNDAMENTALS OF ANTITRUST LAW § 5.01 (4th ed. 2011).

54 SHARKEY, *supra* note 51. There is at least one other approach, namely to define a firm as a natural monopoly if a single firm represents the only market structure that can receive non-negative profits. *See* JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION (1988). This approach does not lend itself to empirical testing because it lacks specific properties of costs, demand, and other factors that lead to such an outcome. Falling into this view, however, would be the notion of destructive competition, which is the idea that an industry with high fixed costs and homogenous products will tend to experience price wars that drive firms out of business until only one is left. *See generally* Herbert Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, 68 TEX. L. REV. 105 (1989).

55 SHARKEY, *supra* note 51.

2. Public Franchise and Affected with the Public Interest

The concepts of public franchise[56] and "affected with the public interest" are interrelated for utilities.[57] Governments give utilities special privileges, such as the power of eminent domain, and impose special obligations, such as affirmative obligations to serve a particular territory, to charge non-compensatory rates in certain circumstances, and to ensure service is not withdrawn without government permission.[58] For example, state utility regulators specify the service territories of electric utilities in the U.S. and grant the firms certificates of convenience and necessity.[59] In some jurisdictions, this arrangement takes the form of contracts between the service provider and the government.[60] In other jurisdictions, this arrangement is formulated by licenses or governed by statutes. The privileges are viewed as necessary for several reasons. First, the privileges are deemed necessary because the utility uses public resources, such as rights of way. In addition, the utility sometimes needs the privileges to secure needed private resources, such as access to private property. Moreover, the utility provides services that are commonly understood to be essential to the operation of a modern society. Finally the utility is a government-sanctioned monopoly whose boundaries must be defined, who should not be allowed to restrict supply in order to raise prices, and whose obligations are used as an instrument of government to convey economic favors on particular groups, such as low-income households or certain industries.[61]

B. *Applying the Public Utility Concept to Google Search*

Google search does not fit the definition of a public utility because it is not a monopoly and does not appear to be a natural monopoly. It has not received a public franchise, and it is not affected with the public interest. I focus on the monopoly issue here because Google has not received a public franchise for Internet search, and I will address the public interest issue in Section III.

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56 Public franchises are also granted to cable television providers even though they are not classified as public utilities.

57 The U.S. Supreme Court defined utilities as its own category of firms affected with the public interest. *See* Chas. Wolff Packing Co. v. Court of Indus. Relations, 262 U.S. 522, 535 (1923).

58 Barbara A. Cherry, *The Political Realities of Telecommunications Policies in the U.S.: How the Legacy of Public Utility Regulation Constrains Adoption of New Regulatory Models*, 2003 MICH. ST. L. REV. 757, 770 (2003).

59 BONBRIGHT ET AL., *supra* note 50.

60 TONCI BAKOVIC, BERNARD WILLIAM TENENBAUM & FIONA WOOLF, REGULATION BY CONTRACT: A NEW WAY TO PRIVATIZE ELECTRICITY DISTRIBUTION? (2003).

61 BONBRIGHT ET AL., *supra* note 50.

1. Google Search Not a Natural Monopoly

Evidence that Google search is not a monopoly comes from the number of search rivals, both general and specialized searches, some of which I listed in Section I.[62] Indeed, emerging general search providers such as DuckDuckGo are receiving funding from venture capitalists, implying that at least some investment experts believe that Google's market position is vulnerable.[63]

Despite this evidence, proponents of regulation argue that Google search is a monopoly,[64] or perhaps even a natural monopoly.[65] These arguments are flawed. Fairsearch argues that other search engines cannot compete with Google because of Google's economies of scale.[66] But this simplistic approach is inadequate, not only because it is devoid of any real data or conclusive evidence, but also because it is based on a faulty theory that the presence of scale economies is a sufficient condition for natural monopoly. Economists demonstrated long ago that this theory is insufficient for multiproduct firms.[67] Furthermore, a proper economic test for whether Google search is a natural monopoly would consider the multilateral rivalry

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62 Womack, *supra* note 2. According to Womack, in November 2011 Google search's market share in general search slipped from 65.6% to 65.4%, Yahoo!'s market share slipped from 15.2% to 15.1%, and Microsoft's market share grew from 14.8% to 15%.

63 Gabriel Weinberg, *DuckDuckGo is growing – welcome USV et al.!*, GABRIEL WEINBERG'S BLOG (October 13, 2011, 10:15 AM), http://www.gabrielweinberg.com/blog/2011/10/duckduckgo-is-growing.html. Weinberg is the founder of DuckDuckGo, a start-up web search engine that aims to compete with Google. *See* Jose Vilches, *Interview with DuckDuckGo founder Gabriel Weinberg*, TECHSPOT.COM (August 21, 2010), http://www.techspot.com/article/559-gabriel-weinberg-interview/.

64 *Can Search Discrimination by a Monopolist Violate U.S. Antritrust Laws?*, FAIRSEARCH (July 12, 2011), http://www.fairsearch.org/wp-content/uploads/2011/07/Can-Search-Discrimination-by-a-Monopolist-Violate-U.S.-Antitrust-Laws1.pdf [hereinafter *Search Discrimination*]; Eric K. Clemons, *Time to Wake Up and Smell the Antitrust*, THE BLOG (Sept. 21, 2010, 9:27 AM), http://www.huffingtonpost.com/eric-k-clemons/post_888_b_732887.html.

65 M.G. Siegler, *Google and the Monopoly Paradox*, TECHCRUNCH.COM, (Jan.12, 2012), http://techcrunch.com/2012/01/12/more-more-more.

66 *Search Discrimination*, *supra* note 64. Some supporters of regulation also argue that Google search is a monopoly because its size creates economies for advertisers that Google's rivals cannot match. *See id.*; David Hatch, *Google's Dominance: Is the Online-Search Giant too Powerful?*, CQ RESEARCHER, Nov. 11, 2011, at 955, 955-68. This view is based on assumptions of economies of scale for Google and economies of purchasing scale for advertisers. I refer to economies of production scale and purchasing scale together as economies of market scale, implying that a single firm is the least-cost arrangement when both producer and purchaser costs are considered, assuming there are no joint economies with other products. The presence of economies of scale is insufficient and not even necessary to cause natural monopoly in multiproduct firms. *See* William J. Baumol, *On the Proper Cost Tests for Natural Monopoly in a Multiproduct Industry*, 67 AM. ECON. REV. 809, 809 (1977); MARK A. JAMISON, INDUSTRY STRUCTURE AND PRICING: THE NEW RIVALRY IN INFRASTRUCTURE 91-93 (1999).

67 *See* Baumol, *supra* note 66. As I demonstrate in Section I, many providers of general search, including the leading providers, are multiproduct firms.

that Google faces and the economics of joint production of all of the services that could be produced with search.[68]

Even if scale economies were sufficient for making a firm a natural monopoly, the standard explicitly assumes static technologies and markets.[69] Neither condition is present for search technologies. The definition and the technologies of search are moving targets. For example, Apple is not considered a direct rival in general search, but its Siri product could be the next generation of search.[70] Services such as Yelp and UrbanSpoon for restaurants, MapQuest for locations, and Facebook and LinkedIn for company and personal information are growing in popularity as alternatives to general search.[71]

Clemons adopts an overly simplified method for identifying whether a firm is a natural monopoly, or at least has monopoly power, to observe whether the firm has unusually high temporal profits.[72] However, the appearance of high temporal profits is insufficient for such a finding since the profit measure omits relevant costs and, if used by itself, ignores the possibility of the firm having unique qualities. By definition, the amount of temporal profit a firm receives is directly related to the value of its products and its technical efficiency.[73] Stated simply, higher value and lower costs deliver financial rewards to the firm and economic efficiency to society as a whole.[74] Important costs are missing from the calculation of temporal profits, namely the financial outlays, risks, and other opportunity costs incurred in creating the innovative products, including the numerous failures that occurred along the way. These costs are not necessarily included in the

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68 See JAMISON, *supra* note 66. Jamison also says that multilateral rivalry exists when a firm faces competition from rivals that are diverse in their mixes of markets. *Id.* Substitutes for Google search include other general search services, specialized search, and some social networks. Companies that compete with Google also compete in markets where Google is absent. These companies include Microsoft, which competes in operating system markets where Google is not present, and Apple, which competes in electronic device markets where Google is not present. This is multilateral rivalry.

69 SHARKEY, *supra* note 51.

70 Dan Kaplan, *Siri, Quora, and the Future of Search,* TECHCRUNCH.COM (Oct. 16, 2011), http://techcrunch.com/2011/10/16/siriquora-and-the-future-of-search.

71 *See Internet Search & Navigation Services*, HOOVERS, http://www.hoovers.com/industry-facts.internet-search-navigation-services.1458.html (last visited Jan. 13, 2013) (subscription required); LEXISNEXIS ACADEMIC, http://www.lexisnexis.com.mutex.gmu.edu/hottopics/lnacademic/ (last visited Jan. 13, 2013) (subscription required); *see also* Kristi Hines, *40 Advanced and Alternative Search Engines*, KISSMETRICS, http://blog.kissmetrics.com/alternative-search-engines/ (last visited May 27, 2012).

72 Clemons, *supra* note 64. Following what appears to be the definition for profit used by Clemons, I define temporal profit as earned revenue less production costs and other investment costs for a firm for a specific period of time.

73 Technical efficiency is the measure of the firm's ability to minimize costs for a given output level at a specified quality. *See* DONALD RUTHERFORD, ROUTLEDGE DICTIONARY OF ECONOMICS 556 (2d ed. 2002).

74 Abbott B. Lipsky, Jr. & Gregory Sidak, *Essential Facilities*, 51 STAN. L. REV. 1187, 1225 (1999).

measures of current profits, unless the costs are quite recent, but are very real to businesses, entrepreneurs, and investors: they must believe such costs can be recovered and future profits received in order to be willing to take risks and invest in innovations.[75]

C. *Common Carriers*

A common carrier is a firm that offers transport service to the public.[76] For example, railroads and trucking companies are common carriers because they transport other people's goods. Common carriers have special obligations in part because customers give over control of their goods to a carrier and are dependent on the carrier to faithfully perform its service without harming the customers' property. For example, a telecommunications company carries others' electronic messages, sometimes across the globe, and customers depend upon the companies to ensure that the messages do not change while in transit. Some hold that common carriers do not have to be monopolies,[77] but the foundations for common carrier obligations include a presumption of monopoly.[78] Common carrier obligations are effected through economic regulation due to a belief that enforcement through contract law would be inefficient.[79] Although some common carriers, such as telecommunications, have also been traditionally classified as public utilities, this is not generally the case, as railroads, buses, and trucks are common carriers but not utilities.[80]

The regulation of common carriers is based on the English common law concept of "public callings" and, in general, requires carriers to charge reasonable prices, serve without discrimination, and provide honest and

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75 Temporal profits serve a valuable function in the marketplace in that they attract competition. For example, industry observers claimed in 1998 that Yahoo! owned general Internet search. *See* Stross, *supra* note 48. But Google's founders discovered uniquely valuable search algorithms, and the company became the industry leader. Today general search providers such as DuckDuckGo and Blekko assert that they have developed algorithms that are superior to those of Google. Whether these companies are correct and should succeed in the marketplace should be determined by customers, not by regulations that seek to hinder Google.

76 James B. Speta, *A Common Carrier Approach to Internet Interconnection*, 54 FED. COMM. L.J. 225, 252 (2002).

77 Barbara A. Cherry, *Back to the Future: How Transportation Deregulatory Policies Foreshadow Evolution of Communications Policies*, 24 THE INFO. SOC'Y 273 (2008).

78 *Public Callings-When is a Business a Public Calling-Regulation to Which They May Be Subjected*, 8 IND. L.J. 270, 272 (1933).

79 Barbara A. Cherry, *Utilizing "Essentiality of Access" Analysis to Mitigate Risky, Costly and Untimely Government Interventions in Converging Telecommunications Technologies and Markets*, 11 COMMLAW CONSPECTUS 251 (2003).

80 *Id.*

skillful service.[81] The concept of public callings developed to address perceived situations of economic coercion, exploitation, and misuse of bargaining power that resulted from shortages of tradesmen, giving each available tradesman monopoly status in his trade, many centuries ago.[82] The resulting regulation subjected certain businesses to the just price doctrine, which required that prices reflect the service's value for the community in general; namely, prices based on unique circumstances of specific buyers or sellers were not allowed.[83] These principles became embedded in U.S. law regarding common carriers because of market power abuses by railroad companies in the 1800s and because the railroad companies were granted special privileges by the government.[84]

D. *Applying the Common Carrier Concept to Google Search*

Google search does not fit the definition of common carrier since Google is not transporting someone else's property on that person's behalf, and also because Google's rivals do not give over control of their services to Google. As described in Section I, general search provides users with addresses of documents, ads, and specialized results such as video that are scored as highly relevant to the search query. Network providers, such as AT&T and Verizon, are classified as common carriers because they provide transmission services to retail telephone customers.[85] Also, if Google search were considered a common carrier service, then so would all search—including specialized search—because the categorization would apply to all firms performing the service, regardless of individual market position.

Furthermore, Google search is not a public calling. While the public callings concept has evolved over time, its roots are in the context of situations where unusual circumstances leading to supply limitations gave certain tradesmen extraordinary power over customers and the ability to engage in what was considered extreme discrimination.[86] While Google may have a large market share in general search in the U.S. by virtue of the majority of customers preferring Google's service to those of Google's rivals, I am unaware of any evidence that Google is restricting the supply of search results or search-based ads any more than what is demanded by the physical

81 Barbara A. Cherry, *Maintaining Critical Rules to Enable Sustainable Communications Infrastructures*, 24 GA. ST. U. L. REV. 947, 962 (2007); Speta, *supra* note 76, at 252.

82 John W. Baldwin, *The Medieval Theories of the Just Price: Romanists, Canonists, and Theologians in the Twelfth and Thirteenth Centuries*, TRANSACTIONS OF THE AM. PHIL. SOC'Y, June 1959, at 1.

83 *Id.*; Cherry, *supra* note 81.

84 Cherry, *supra* note 81.

85 Speta, *supra* note 76, at 252.

86 Baldwin, *supra* note 82; Cherry, *supra* note 81.

or cognitive limitations of page space and the number of search queries that users submit.

E. *Essential Facilities Doctrine*

The essential facilities doctrine developed in a U.S. legal case between MCI and AT&T,[87] but its foundations are in cases involving, for example, railroads, electricity distribution, and airlines.[88] The MCI case resulted from MCI's attempt to compete with AT&T in long distance calls before AT&T divested its ownership of local telephone lines. AT&T, with several years of a government-protected monopoly, had ownership control of assets that rivals needed to be able to compete and could not duplicate.[89] MCI could provide long-haul transmission as a specialized common carrier but needed local telephone lines to compete with AT&T generally. AT&T resisted providing access to its local lines until the resulting case, when the court affirmed that AT&T had to allow MCI access.[90]

The doctrine is basically a refusal-to-deal issue[91] and holds that a monopolistic firm's refusal to grant rivals access to a facility that the rivals need to compete against the monopolistic firm can give rise to a legal antitrust liability. There is a four-part test to determine whether the doctrine applies:

1. Is the vertically integrated[92] operator a monopolistic firm in control of the essential facility?

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87 MCI Commc'ns Corp. v. Am. Tel. & Tel. Co., 708 F.2d 1081 (7th Cir. 1983).

88 Lipsky & Sidak, *supra* note 74. Other instances where courts have evoked the essential facilities doctrine include a case where a professional football team was denied access to the only suitable football stadium in the city, Hecht v. Pro-Football, Inc., 570 F.2d 982 (D.C. Cir. 1977), *cert. denied*, 436 U.S. 956 (1978), and a case of denied access to a monopoly electricity utility's distribution grid, Otter Tail Power Co. v. United States, 331 F. Supp. 54, 61 (D. Minn. 1971), *modified*, 410 U.S. 366 (1973) (citing the "bottleneck" theory). Lipsky and Sidak describe other cases involving the doctrine. Lipsky & Sidak, *supra* note 74.

89 Jerry A. Hausman & Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 YALE L.J. 417, 417 (1999).

90 Spencer Weber Waller, *The New Law of Monopolization: An Examination of* MCI Communications Corp. v. American Telephone & Telegraph Co., 32 DEPAUL L. REV. 595, 596 (1983).

91 Cherry, *supra* note 81.

92 Vertical integration means the firm is engaged in more than one stage of production in sequence, for example, a farmer who produces corn and converts some portion of the crop to ethanol. If the farmer also sells corn to other ethanol manufacturers, the farmer would be considered to be selling the input, corn, to a downstream rival, the other ethanol manufacturer. *See* DONALD RUTHERFORD, ROUTLEDGE DICTIONARY OF ECONOMICS 591 (2d ed. 2002); *Idea: Vertical Integration*, THE ECONOMIST (March 30, 2009), http://www.economist.com/node/13396061.

2. Is the rival unable practically or reasonably to duplicate the essential facility?

3. Does the vertically integrated operator deny use of the facility to the rival?

4. Is it feasible for the vertically integrated operator to provide access to the rival?[93]

The existence of monopolistic control of a physical asset is fundamental to the doctrine.[94] As Hausman and Sidak explain,

> Inherent in the concept of an "essential facility" is the premise that the owner of that facility possesses monopoly power. The first two elements of the doctrine incorporate that recognition in a variety of ways. First, some degree of uniqueness and market control is inherent in the term "essential." Second, the inquiry regarding the impracticability of duplication ensures that the doctrine will apply only to facilities for which no feasible alternative exists or that cannot be reasonably reproduced. Finally, the term "facility" itself connotes an integrated physical structure or large capital asset with the degree of cost advantage or unique character that usually confers monopoly power and market control by virtue of its superiority.[95]

Lipsky and Sidak explain that the degree of monopolistic control must be significant, although not necessarily absolute:

> There will, of course, be instances in which the facility in question will be somewhat better than the alternatives, but not so much better as to preclude totally the continued survival of excluded parties. The present case law recognizes this distinction, and permits application of the doctrine where the competitive disadvantage is severe, rather than fatal.[96]

There are several restrictions on the application of the essential facilities doctrine. A recent Supreme Court case, *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko*,[97] while declining to explicitly endorse or reject the essential facilities doctrine, found that whether regulatory oversight by an agency could force access is a significant question.[98] Lipsky and Sidak identify other restrictions:

- The monopolistic firm must control the relevant market. For example, in *Drinkwine v. Federated Publications, Inc.*,[99] a publisher of a

93 Lipsky & Sidak, *supra* note 74, at 1190-91.

94 *Id.* at 1211.

95 Hausman & Sidak, *supra* note 89, at 467.

96 Lipsky & Sidak, *supra* note 74, at 1212.

97 Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, 540 U.S. 398 (2004).

98 *Id.* at 410; *see also* Roger D. Blair & Christine A. Piette, *The Interface of Antitrust and Regulation:* Trinko, 50 ANTITRUST BULL. 665, 676 n.3 (2005).

99 Drinkwine v. Federated Publ'ns, Inc., 780 F.2d 735, 738 (9th Cir. 1985).

weekly advertising tabloid sought distribution from a local newspaper, a request that the newspaper declined. The court found that while the newspaper was indeed a monopoly in its community, the relevant market was distribution and other methods were available, such as direct mail.

- Control of an essential facility does not convey market power if the market for the end product is competitive.

- It is problematic to apply the doctrine to intellectual property for the following reasons: (1) The significant probability of disclosure of intellectual property would destroy the property's value; and (2) mandatory sharing and compulsory dealings are inconsistent with the exclusivity that is necessary for incentives to create intellectual property.[100]

F. *Applying the Essential Facilities Doctrine to Google Search*

Google search does not fit the definition of an essential facility because inclusion in Google search is not an input sold to rivals or other enterprises, Google does not exclude rivals from being included in search results, and Google search is not monopolistic. Furthermore, even if Google search is or contains an essential facility, remedies could decrease customer value or force Google to divulge intellectual property.

1. Inclusion in Google Search is Not Sold and Google Does Not Exclude Rivals

In its early days, Yahoo! charged commercial Web sites for being included in its database.[101] Google and other general search providers finance their search operations by selling advertising, even to rivals.[102] This business model gives Google an economic incentive to provide valuable search results to consumers because advertising revenue is positively correlated with the number of search queries. This incentive applies even in instances where the search results would rank rivals' sites as more relevant to the search parameters than a Google site.

Furthermore, Google does not exclude rivals from its search results. Google's critics appear to concede this point, although Edelman asserts that Google restricts the supply of advertising for hotels by offering its own

100 Lipsky & Sidak, *supra* note 74, at 1219.
101 Wall, *supra* note 8.
102 Crowell, *supra* note 29.

hotel booking service, Google Hotel Finder.[103] However, he offers no evidence that Google's introduction of its own booking service resulted in a decrease in the supply of hotel advertising and does not explain how Google's provisioning of Google Hotel Finder may have restricted supply. He simply says, "Google raises price above marginal cost, restricts supply, and takes its pound of flesh from advertisers who have little alternative."[104] Indeed, Edelman contradicts his own claim[105] that Google restricts the supply of ads by asserting that Google has generally increased its number of ads displayed: "And Google now shows as many fourteen (sic) ads on a page; users with mid-sized screens often must scroll to see the second algorithmic result."[106]

2. Google Search Is Not Monopolistic

Above I demonstrated that Google's search is not a monopoly. Here I focus on whether Google search is monopolistic in the sense required for the essential facilities doctrine. This would mean that Google's vertical rivals would suffer a severe competitive disadvantage if Google were to deny them access to Google search. Examining whether this is true is necessarily a hypothetical exercise because I know of no evidence that Google denies rivals access to Google search.

Google would not impose a severe competitive disadvantage on its vertical rivals by denying them access to Google search because the rivals have economical alternatives for attracting users to their Web sites. This is evidenced by the willingness of vertical rivals to compete with Google, the lack of control that general search engines have over customers' Web site choices, and customers' willingness to choose general search engines other than Google.

3. Vertical Rivals' Willingness to Compete with Google

Edelman asserts that Internet entrepreneurs and investors are unwilling to launch new, vertical services that would compete with Google Maps and YouTube, for example, because Google's search algorithms foreclose competition.[107] Actual experience demonstrates the falseness of this assertion. Regarding whether firms would be willing to compete with YouTube, rivals

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103 Benjamin G. Edelman, *Finding and Preventing Biased Results*, ACS BLOG (Oct. 6, 2011), http://www.acslaw.org/acsblog/finding-and-preventing-biased-results.

104 *Id.*

105 *Id.*

106 Edelman, *Google's Dominance*, *supra* note 6.

107 Edelman, *supra* note 103.

Blip, Flikr, Dailymotion, and Vimeo have existed alongside YouTube since its inception.[108] A Twitter-linked video service, Yfrog, was launched in 2009, at least two years after Google's purchase of YouTube.[109] Competitors to Google Maps include Bing maps (Microsoft), OVI maps (Nokia), and an open source alternative, Open Street Map.[110] Also, as Kayak described in its Form S-1 filed with the U.S. Securities and Exchange Commission, during the first nine months of 2010, 72% of Kayak's volume was generated by people going directly to its Web site, and only 8% came from general search engines.[111] Furthermore, as explained above, DuckDuckGo is finding venture capital, contrary to Edelman's claim.[112] To its credit, Blekko is resisting the temptation to try to hamstring rivals with regulation, explaining instead that it would prefer to compete with Google and others without government intervention.[113]

4. Alternatives to Google Search

The presence and prominence of economical alternatives to Google search demonstrate that, while it is advantageous for a firm to be listed in Google search results, exclusion by Google would not be fatal, or even severely harmful.

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108 YouTube was founded in February 2005. *About YouTube*, YOUTUBE, http://www.youtube.com/t/about_youtube (last visited May 27, 2012). Blip was founded in 2005. *About*, BLIP, http://blip.tv/about (last visited May 27, 2012). Flickr was founded in 2004. Stewart Butterfield & Caterina Fake, *How We Did It: Stewart Butterfield and Caterina Fake, Co-founders,* INC.COM (Dec. 1, 2006), http://www.inc.com/magazine/20061201/hidi-butterfield-fake.html. *See also* Doreen Carvajal, *Taking on the Godzilla of Video-Sharing Sites*, N.Y. TIMES (Mar. 21, 2008), http://www.nytimes.com/2008/03/21/business/worldbusiness/21iht-motion24.html ("Daily Motion's founders lay claim to bragging rights by starting one month earlier than YouTube, on March 15, 2005 . . . ."). Vimeo was founded in 2004. *About*, VIMEO, http://vimeo.com/about (last visited Nov. 7, 2012).

109 Robin Wauters, *ImageShack Launches Mediocre TwitPic Alternative*, WASH. POST (Feb. 18, 2009, 10:31 PM), http://www.washingtonpost.com/wp-dyn/content/article/2009/02/19/AR2009021900369.html.

110 Adam DuVander, *23 Google Maps Alternatives*, PROGRAMMABLEWEB (Mar. 1, 2012), http://blog.programmableweb.com/2012/03/01/23-alternatives-to-google-maps/.

111 *See* Kayak Software Corporation, Registration Statement (Form S-1) 3 (Nov. 17, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1312928/000119312510262521/ds1.htm.

112 Carl Franzen, *DuckDuckGo Aims To Beat Google With New Search Features*, TPM (Mar. 30, 2012, 3:38 PM), http://idealab.talkingpointsmemo.com/2012/03/duckduckgo-taking-on-google-with-new-search-features.php.

113 Blekko's co-founder and CEO, Rich Skrenta, blogged, "[W]e don't need federal intervention to level the playing field with Google. Innovation and competition are far more powerful instruments to battle companies that have grown powerful and influential." Rich Skrenta, *Blekko's Not Afraid of Google, Why is Washington?*, SKRENTABLOG (Sep. 20, 2011, 10:36 AM), http://www.skrenta.com/2011/09/blekkos_not_afraid_of_google_w.html.

Although Google provides 60% to 70% of the general searches in the U.S., data shows that users are not tied to Google.[114] According to research by Performics:

1. 66% of users who prefer Google use a different search engine either frequently or occasionally;

2. 89% of users try a different search engine if they cannot find what they are searching for with their preferred engine;

3. new users are more likely to use Yahoo! than are more advanced users.[115]

A 2009 incident illustrates how readily and easily consumers switch to alternative sources of general search if Google fails to perform according to their expectations. For about an hour on the morning of January 31, 2009, a human error at Google caused each and every Google search result to contain the message "This site may harm your computer."[116] Even though the problem was short-lived, customers quickly moved to other search engines; during the one-hour time period that Google had the error, the number of Yahoo! searches doubled compared to the normal load.[117] Once Google fixed the problem, customers quickly switched back to Google, indicating how quickly general search users recognize problems and adapt their behavior so that they are using the general search engine that provides them with the greatest value.[118]

One use of general search is navigational queries. This decreases the influence that a search engine can have on directing results. Searching for known sites means that people use search to link to a site instead of typing in the URL. For example, Experian Hitwise identified the ten most-searched terms for 2011 as "facebook," "youtube," "facebook login," "craigslist," "facebook.com," "yahoo," "ebay," "www.facebook.com," "mapquest," and "yahoo.com."[119] Users were searching for "facebook," for example in lieu of typing "www.facebook.com" in the browser address

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114 Womack, *supra* note 2.

115 PERFORMICS, 2010 SEARCH ENGINE RESULTS PAGE INSIGHTS STUDY (2010).

116 Marissa Mayer, *"This Site May Harm Your Computer" on Every Search Result?!?!*, GOOGLE BLOG (Jan. 31, 2009, 10:29 AM), http://googleblog.blogspot.com/2009/01/this-site-may-harm-your-computer-on.html.

117 Jessica E. Vascellaro, *Fresh Evidence That Search Is Still Competitive? Not So Fast,* WSJ BLOGS (Mar. 17, 2009, 4:29 PM), http://blogs.wsj.com/digits/2009/03/17/fresh-evidence-that-search-is-still-competitive-not-so-fast/.

118 *Id.*

119 Joseph Paris, *People Still Use Search to Find the Most Popular Websites*, THE VERGE (Dec. 25, 2011, 6:02 AM), http://www.theverge.com/2011/12/25/2657912/people-search-popular-websites.

bar.[120] Thus, for the most popular searches, typing the URL into the browser address bar is a suitable substitute for search.

5. Search User Independence

Although search is important, it does not determine customer behavior; customers exercise discretion in making their choices. Even as early as 2005, before the recent rise of Facebook and smart phone apps as alternatives to general search, customers demonstrated their independence of search engine results. Qiu, Liu, and Cho find that search engines influenced only 13.6% of users' Web traffic at the time of the study.[121] According to early Pew Research results from about that time, only 44% of searchers regularly used just one search engine and two-thirds said they could stop using search engines without disrupting their lives very much.[122]

According to Pew, about 92% of adult Internet users use search engines, and studies often find that users generally select the first, second, or third items listed in search results.[123] But such findings do not mean that a search engine easily skews outcomes. Skewed results diminish the value to users, who are quite willing to change search engines. Indeed, the preponderance of first through third items being selected may mean that the search engines are working well. Also, according to the Performics study: (1) users pay attention to the descriptions of the search results listed (88% say they are more likely to select a search item if the item contains the exact words or phrases included in the query); (2) 89% of users modify their query if a search does not provide the desired item(s); and (3) 79% of users look beyond the first page of search results if it does not contain what they are looking for.[124]

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120 *Id.*

121 Feng Qiu, Zhenyu Lin & Junghoo Cho, Analysis of User Web Traffic with a Focus on Search Activities 1 (2005) (unpublished manuscript) (on file with University of California Los Angeles).

122 DEBORAH FALLOWS, PEW INTERNET & AMERICAN LIFE PROJECT, SEARCH ENGINE USERS i-ii (2005), *available at* http://www.pewinternet.org/~/media//Files/Reports/2005/PIP_Searchengine_users.pdf.pdf.

123 KRISTEN PURCELL, PEW INTERNET & AMERICAN LIFE PROJECT, SEARCH AND EMAIL STILL TOP THE LIST OF MOST POPULAR ONLINE ACTIVITIES 2 (2011), *available at* http://pewinternet.org/~/media//Files/Reports/2011/PIP_Search-and-Email.pdf.

124 Press Release, Performics, Search Engine Usage Study: 92 Percent of Searchers Click on Sponsored Results (Sept. 28, 2010), *available at* http://www.performics.com/news-room/press-releases/Search-Engine-Usage-Study-92-Percent/1422.

6. Advertiser Independence

Likewise, academic studies cast doubt on whether search advertising is an essential facility. Studies by Ratliff and Rubinfeld and by Goldfarb and Tucker find that offline advertising constrains prices for online advertising, implying that advertisers have effective alternatives to online advertising in general.[125] They further conclude that search-based advertising and non-search-based advertising compete with each other, meaning that search engine providers have no market power relative to other online advertising providers. These study results conflict with the statement by the Federal Trade Commission in approving Google's acquisition of DoubleClick,[126] so Ratliff and Rubinfeld[127] explain where the FTC erred in its analysis. Consistent with the findings of Ratliff and Rubinfeld and of Goldfarb and Tucker, the Performics study finds that organic search results could serve to limit the amount that advertisers are willing to bid to appear in search advertising because users favor organic search results over ads: 79% always or frequently select items in the organic search, while 80% only occasionally, rarely, or never select ads.[128] There is also evidence that other forms of online advertising serve as substitutes for search advertising: eConsultancy finds that the greatest growth in online advertising is with Facebook, not with search engines; that 35% of online advertisers have recently moved budget from search advertising to advertising on Facebook;[129] and that 23% of online advertisers have moved budget from search to display ads.[130]

7. Ease of Duplication

Another problem with applying the essential facilities doctrine to Google search and search advertising is that the doctrine is designed for resources that are difficult to duplicate, such as physical facilities, but Google's products are based in software and intellectual property.[131] As is demonstrated by Google's success in overtaking the once-dominant Yahoo!

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125 Avi Goldfarb & Catherine Tucker, *Advertising Bans and the Substitutability of Online and Offline Advertising*, 48 J. MARKETING RES. 207 (2011); Avi Goldfarb & Catherine Tucker, *Search Engine Advertising: Substitution When Pricing Ads to Context*, 57 MGMT. SCI. 458 (2011); James D. Ratliff & Daniel L. Rubinfeld, *Online Advertising: Defining Relevant Markets*, 6 J. COMPETITION L. & ECON. 15 (2010).

126 FED. TRADE COMM'N, STATEMENT OF FEDERAL TRADE COMMISSION CONCERNING GOOGLE/DOUBLECLICK 3, 7 (2007), *available at* http://www.ftc.gov/os/caselist/0710170/071220statement.pdf.

127 Ratliff & Rubinfeld, *supra* note 125, at 15.

128 2010 SEARCH ENGINE RESULTS PAGE INSIGHTS STUDY, *supra* note 115.

129 ECONSULTANCY, ONLINE ADVERTISERS SURVEY REPORT 17 (2011).

130 *Id.*

131 *See* Lipsky & Sidak, *supra* note 74, at 1219.

in general search, and by the constant launching of new general search engines and new substitutes for search, the Internet's openness makes it relatively easy for new services and companies to innovate and overtake the old guard. This ease of duplication and replacement contradicts a basic premise of the essential facilities doctrine, namely that the resource cannot be economically obtained by any other means. The fact that the resource is intellectual property[132] only expands the mismatch between the doctrine and search because of the industry's dynamic nature and because applying the doctrine would necessarily divulge Google's trade secrets.

As my description of the history of search in Section I demonstrates, search technologies are always changing. Indeed, according to Google, its research and development efforts in 2010 included the following:

- 13,311 tests of potential algorithm changes to determine how they impacted the precision of search results;

- 8,157 experiments where users compared pages of search results side-by-side to assess user value;

- 2,800 click evaluations to see how a small sample—typically less than 1% of Google's users—responded to a change.[133]

These efforts resulted in more than 516 improvements in 2010—more than one per day. Yahoo! is also investing in the human experience in search, having hired a team of well-known scientists from leading universities to work with Yahoo!'s team of cognitive psychologists, sociologists, economists, and ethnographers.[134] Google's and Yahoo!'s efforts in innovation imply many things. One is that user value is constantly increasing in the current environment. This challenges the notion that search engine providers are exerting market power: the providers may be influential, but the market is clearly a moving target, making it difficult to exploit market power in any traditional sense.

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[132] Daniel Fisher, *Should Regulators Treat Google Like Standard & Poor's?*, FORBES (Sept. 29, 2011, 7:46 AM), http://www.forbes.com/sites/danielfisher/2011/09/29/should-regulators-treat-google-like-standard-poors/.

[133] *Facts About Google and Competition*, GOOGLE, http://www.google.com/competition/howgooglesearchworks.html (last visited Jan. 6, 2012).

[134] Mike Swift, *Yahoo! Looks to Improve Search Experience,* YAHOO! LABS, http://labs.yahoo.com/news/166 (last visited Jan. 6, 2012).

8. Negative Impacts of Regulation

These investments in innovation also indicate the value of invention to the providers. Companies are investing significant amounts of money to advance their technologies, presumably in anticipation of profiting from these investments. Regulation would likely decrease the rate of innovation in ways that would diminish customer value and the competitiveness of the sector:

1. Regulation might result in innovative search engine providers divulging their intellectual property directly to rivals. Any potential transfer of such information to a rival decreases the innovator's expected profit, which in turn diminishes the incentive to innovate.

2. Regulation would necessitate search engine providers divulging their intellectual property at least to government officials, with the likely outcome of information leaking to rivals.

3. Even if government officials were able to protect intellectual property, the probability of leaks would exist, which would diminish the expected profits from innovation, which in turn would decrease the incentive to invest.

4. Information would likely become available to Web site owners, who could use it to manipulate search engine results in their favor. This would diminish the value of search results to users. In order to protect the value of search results, search engine providers would need to make additional investments in mechanisms to thwart the manipulation, which would increase the cost of innovation.

5. Search engine providers would need to submit technology changes to regulators for their approval. Review times would necessarily delay invention and such additional costs would discourage change, similar to the case of regulatory rules for information services by telecommunications firms.[135] This would be unworkable in the general search industry, where innovations are introduced at a rate of more than one per day.[136]

6. Regulation would also likely lock at least the dominant search engines to outdated models of Internet search and freeze their evolu-

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135 *See generally* James E. Prieger, *Regulation, Innovation, and the Introduction of New Telecommunications Services*, 84 REV. ECON. & STAT. 704 (2002).

136 *Facts About Google and Competition*, *supra* note 133.

tion, even while rivals move forward. This would diminish the influence of Google, while also making Google less valuable to consumers.[137]

7. Regulation would lock in industry and product boundaries that will be outdated even as the rules are being put in place, further delaying innovation.[138]

III. OTHER RATIONALES FOR REGULATING GOOGLE

Perhaps implicitly admitting that Google search does not fit the traditional frameworks for economic regulation, some authors, industry observers, and rivals have sought to invent a new framework. Edelman invokes a vague public interest criteria by arguing that "search and search advertising are the foundation of online commerce," which he uses to support his advocacy for regulating Google search.[139] Proponents of regulation also argue that regulation would be good for competition.[140] I discuss these issues in this section.

A. *Public Interest Criteria*

While not explicitly using the phrase "affected with the public interest," Edelman appears to invoke this concept in arguing that Google "search and search advertising are the foundation of online commerce" in support of his notion that Google search should be regulated.[141] The precise meaning of a firm being affected with the public interest has evolved over time.[142] In an 1876 case involving Illinois grain elevators, the U.S. Supreme Court identified such firms as including those that exercise "a sort of public office" and stand at the "gateway of commerce." As the Court explained, the Illinois grain elevators were uniquely situated between the river harbor and the railroad tracks. It was virtually impossible to move either the har-

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137 *See* Daniel A. Crane, *Search Neutrality as an Antitrust Principle* 7 (U. Mich. L. Sch., Working Paper No. 256, 2011).

138 Mark A. Jamison & James Sichter, *Business Separation in Telecommunications: Lessons from the U.S. Experience*, REV. NETWORK ECON., 2010, at 2-3.

139 Edelman, *Google's Dominance*, *supra* note 6.

140 Edelman, *supra* note 103; Fisher, *supra* note 132; Hatch, *supra* note 66, at 955-968; *Search Discrimination*, *supra* note 64, at 5.

141 Edelman, *Google's Dominance*, *supra* note 6.

142 *See* GLAESER, *supra* note 46, at 733; *see also* Cherry, *supra* note 58, at 764-767 (describing the history of a firm being affected with the public interest).

bor or the rails, so the elevators were "virtual monopolies" for storing and transferring grain coming from "seven or eight great States of the West."[143]

In 1923, the Court refined its definition of affected with the public interest, dividing such firms into three categories:

> (1) Those which are carried on under the authority of a public grant of privileges which either expressly or impliedly imposes the affirmative duty of rendering a public service demanded by any member of the public. Such are the railroads, other common carriers and public utilities. (2) Certain occupations, regarded as exceptional, the public interest attaching to which, recognized from earliest times, has survived the period of arbitrary laws by Parliament or colonial legislatures for regulating all trades and callings. Such are those of the keepers of inns, cabs, and gristmills. (3) Businesses which, though not public at their inception, may be fairly said to have risen to be such and have become subject in consequence to some government regulation. They have come to hold such a peculiar relation to the public that this is superimposed upon them. In the language of the cases the owner, by devoting his business to the public use, in effect grants the public an interest in that use and subjects himself to public regulation to the extent of that interest although the property continues to belong to its private owner and to be entitled to protection accordingly.[144]

Glaeser explains that the third category is meant for the firms at the gateway of commerce, such as the Illinois grain elevators. He further points out the importance of the word "peculiar," noting that all businesses affect the public welfare, and the only sensible way to understand the third category is to consider that these firms have an unusually close relationship to the public.[145]

Google search does not fit any of these categories of firms affected with the public interest. I have already explained that Google search is neither a utility nor a public calling. But Edelman appears to argue that Google search is the foundation of online commerce and so sits at the gateway of commerce,[146] an argument made more explicitly by Simpson.[147] If these arguments were correct, Google search would fit the third category—businesses which, though not public at their inception, may be fairly said to have risen to be such and have become subject in consequence to some government regulation. I examine whether Google search is a gateway to commerce in the same sense as the Illinois grain elevators.

Compared to the Illinois grain elevators, Google search does not possess such a privileged position. Certainly, Google succeeds in making itself valuable, but the value comes from Google's research and development into customers' search preferences, not, as with the grain elevators, from an accident of geography. Indeed, many firms engaged in online commerce pay for certain URL names, which implies that specific Web addresses have

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143 Munn v. Illinois, 94 U.S. 113, 130, 132 (1876).

144 Chas. Wolff Packing Co. v. Court of Indus. Relations, 262 U.S. 522, 535 (1923) (citations omitted).

145 GLAESER, *supra* note 46, at 162-63.

146 Edelman, *Google's Dominance*, *supra* note 6.

147 Simpson, *supra* note 4.

value, perhaps so that customers can easily remember the addresses and enter them directly. Furthermore, Google search has numerous rivals, as evidenced from their activity before the U.S. Congress and with antitrust agencies. Also, as explained in Section II, search itself is not in a privileged position because online service providers use many methods to attract customers.

B. *Benefit to Competition Argument*

Regulation supporters argue that regulating Google would benefit competition,[148] although they never explain what this means. It is unlikely that regulation advocates, such as Yelp and Microsoft, support the idea that more firms should enter their markets, so I interpret the phrase to mean that consumers benefit from the competitive interactions among firms. Such interactions can benefit consumers through aligning prices more closely with costs, increasing the amount of service being made available, and stimulating more innovations that improve consumer value.

As my analyses in Section II showed, general search engines lack market power. My analyses in Sections I and II also demonstrate that search is a highly innovative industry and that some innovations are sufficiently significant to result in new industry leaders. I know of no evidence that this industry lacks innovation due to its current market structure. However, some theoretical models suggest a firm with a large market share can sometimes leverage that market share to advantage itself as a market grows in other markets. Cremer, Rey, and Tirole draw this conclusion in the case of the Internet backbone,[149] and Carlton and Waldman do so in the case of software.[150] The essence of these findings is that complementarities, such as network effects, help a firm with a larger market share in one market to gain market share in other markets. Cremer et al. and Carlton and Waldman's findings lack an analysis of how opportunities for future markets impact investments in today's markets.[151] Jamison demonstrates that the opportunity to leverage complementarities across markets stimulates investment in existing markets.[152] Applied to the case of general search, the

148 *See* Edelman, *supra* note 103; Fisher, *supra* note 132; Hatch, *supra* note 66, at 961; *Search Discrimination*, *supra* note 64, at 4.

149 Jacques Crémer et al., *Connectivity in the Commercial Internet,* 48 J. INDUS. ECON. 433, 435 (2000).

150 Dennis W. Carlton & Michael Waldman, *The Strategic Use of Trying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. ECON. 194, 209-10 (2002).

151 *Id.*, at 194-220; Crémer et al., s*upra* note 149, at 433-36.

152 Mark A. Jamison, Restructuring in Network Industries: Competition and Mergers in Telecommunications (2001) (unpublished Ph.D. dissertation, University of Florida) (on file with University of Florida Library).

opportunities for future generations of search-like products probably help motivate Microsoft's, Yahoo!'s, and Google's investments in search.

Implicit in the regulation advocates' arguments that regulation would benefit competition is a belief that benefitting rivals is the same as improving competition. Competition improves if new interactions among firms decrease market power, make innovation more profitable, or both. This is different from helping rivals. The oversight advocated by the supporters of regulation appears to be intended primarily to help rivals by hindering Google. Hobbling one competitor from providing competitive pressure on others is unlikely to result in lower prices, more innovation, or any other outcomes that benefit customers. Indeed, the constraints on Google would more likely provide its rivals with an umbrella under which they could exist without much threat from what would otherwise be the most effective firm in the market.

An unstated premise in the advocates' argument for regulation is that Google's rivals, who believe that Google discriminates against them in search, would benefit from the same search value that Google creates today. As explained above, a firm such as Google benefits from synergies across its search services, and these synergies incent increased search investment. If regulation were to decrease Google's incentives to invest in search, search would be less valuable, which could decrease the customer traffic that rivals receive from Google search. These results are sensitive to underlying assumptions about whether Google discriminates against rivals, the costs and benefits of such discrimination, and the costs and benefits of investment in Google search. However, the analysis is clear that a conclusion about the benefits rivals might receive from the regulation of Google depends on market and production characteristics that are currently unknown.

CONCLUSION

In this article, I addressed the case for regulating Google search and find that the arguments are not compelling. The justifications are based on beliefs that Google search is a monopoly or at least a natural monopoly experiencing transitory competition, is affected with the public interest in the way that an electric utility is, performs a quasi-governmental function, provides transport services to rivals, and controls a facility that downstream rivals must obtain to compete with Google. None of these are true.

Also, fundamental to the regulation advocates' conclusions is the notion that Google discriminates against rivals. I have not inspected Google's algorithms to determine whether or how Google removes some documents from its search as I know some search rivals do,[153] favors Google-related sites relative to non-related sites in Google search results, or engages in other activities like some of the advocates of regulation claim. Certainly, incentives exist for Google to behave that way, but there are also offsetting incentives. For example, if discrimination diminishes the value of Google search and drives users to alternatives to Google search, the discrimination could be unprofitable. Furthermore, some discrimination can benefit customers if the discrimination leverages complementarities across products or markets. However, my interest here is not in whether the incentives exist or Google acts on them. I leave that for other research. Rather, my focus is on whether the arguments for regulation are substantial enough to justify economic oversight of Google even if such discrimination exists. I find that they are not.

153 Bing banned sites regarding Black Friday. *See* Danny Sullivan, *Banned Holiday Deal Sites Return to Bing*, SEARCH ENGINE LAND (Dec. 12, 2011, 6:22 PM), http://searchengineland.com/banned-holiday-deal-sites-return-to-bing-104479.

LEEGIN'S EFFECT ON PRICES: AN EMPIRICAL ANALYSIS

*Nathaniel J. Harris**

INTRODUCTION

Whenever the Supreme Court overrules nearly 100 years of precedent, the opinion will face significant debate, especially when the Court's decision potentially harms consumers. In *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, the Supreme Court held that minimum resale price maintenance (RPM)—manufacturers setting minimum resale prices for "downstream" buyers[1]—would be governed by the rule of reason.[2] This decision overruled a ninety-six-year-old opinion that declared RPM per se illegal.[3] Immediately following *Leegin*, many scholars and commentators criticized the Court, opining that switching to a rule of reason would increase consumer prices.[4] Many state legislators and Congress members have accepted this critique, and are considering rejecting *Leegin* by codifying a per se standard for RPM.[5]

Despite constant cries that consumer prices would increase, no empirical work has been conducted to determine if *Leegin* has actually affected prices. In this article, I construct empirical models in an attempt to determine if *Leegin* increased consumer prices. Then, I determine how dispositive these models are to the broader policy question of whether per se illegality should be codified. I find some evidence that *Leegin* increased pric-

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1 Thomas A. Lambert, *Dr. Miles Is Dead. Now What?: Structuring A Rule of Reason for Evaluating Minimum Resale Price Maintenance*, 50 WM. & MARY L. REV. 1937, 1940 (2009).

2 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 885 (2007).

3 Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 408 (1911).

4 Brief for the State of Kansas as Amicus Curiae at 3, O'Brien v. Leegin Creative Leather Prods., Inc., 2010 WL 3621913 (Kan. 2010) (No. 08-101000-S); Robert Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1487, 1494 (1983); Alan M. Barr, *State Challenges to Vertical Price Fixing In the Post-*Leegin *World*, ANTITRUST SOURCE, Dec. 2009, at 2. As of now, one state—Maryland—has codified per se illegality. Quentin R. Wittrock & Jeremy L. Johnson, *Can Franchisors Control Franchisee Prices?*, 28 FRANCHISE L.J. 199, 205 (2009).

5 *See infra* Section I.C.

es, but conclude that a per se standard for RPM should not be codified because increased prices do not necessarily harm consumers.

I discuss the background of RPM in Section I. This includes a discussion of the seminal Supreme Court case on RPM—*Dr. Miles Medical Company v. John D. Park & Sons Company* (1911)—and how RPM was treated prior to *Leegin*. Section I will also explain how *Leegin* changed the legal landscape at the federal and state levels. Section II summarizes the praise the Supreme Court received for the *Leegin* decision. In Section III, I examine the argument that *Leegin* was incorrectly decided because the decision will, among other things, increase consumer prices. This section will also discuss how frequently critics argue that *Leegin* increases prices. In Section IV, I use two difference in differences models and the consumer price index to empirically test the claim that *Leegin* has increased consumer prices. I include the results and implications of the study and conclude with what follows from the evidence of a price increase.

I. BACKGROUND OF MINIMUM PRICE RESALE AGREEMENTS

A. Dr. Miles *and Per Se Illegality*

The Sherman Act is more constitutional in nature than most federal statutes[6] and based on a common law structure.[7] Consequently, antitrust law is defined by the courts as they apply contemporary economics to the Sherman Act.[8] This is what occurs in the arena of vertical price agreements.

Vertical resale price maintenance (RPM) agreements are agreements between manufacturers and resellers, where the manufacturers set minimum retail prices for their goods.[9] For example, a shoe manufacturer will dictate to each of its retailers the minimum price they must charge for each pair of shoes.[10] It is not immediately intuitive why a manufacturer would want to establish minimum retail prices because retailer markup appears to be divorced from a manufacturer's revenue.[11] However, dictating minimum

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6 Appalachian Coals v. United States, 288 U.S. 344, 359-60 (1933) ("As a charter of freedom, the act has a generality and adaptability comparable to that found to be desirable in constitutional provisions.").

7 Frank H. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135, 136 (1984) ("Antitrust is a form of common law. The Sherman Act of 1890 told the courts to make up a law on the subject of restraint of trade. Congress no more prescribed the content of this law than it prescribes the content of the law of collective bargaining.").

8 Richard A. Posner, *Legal Formalism, Legal Realism, and the Interpretation of Statutes and the Constitution*, 37 CASE W. RES. L. REV. 179, 212 (1987).

9 Easterbrook, *supra* note 7, at 140.

10 Lambert, *supra* note 1, at 1944.

11 *Id.*

prices that retailers must charge benefits the manufacturers in three key ways.[12] First, RPM diminishes the free rider problem caused by discount retailers—making it profitable for retailers to engage in point of service sales and advertising campaigns.[13] Second, RPM can drive out non-dominant brands.[14] Third, RPM makes it easier to operate "a manufacturer-level cartel" because cheating is more transparent.[15] Additional benefits of RPM are discussed in Sections II and IV.B.[16]

Although manufacturers benefit from RPM, any agreement that sets a required minimum price may initially raise price.[17] Increased prices are harmful if they are the result of decreased quantity *and* the higher prices are not offset by procompetitive benefits.[18] In 1911, the Supreme Court addressed the problem of RPM in *Dr. Miles Medical Company v. John D. Park & Sons Company*.[19]

Dr. Miles Medical Company (Dr. Miles) was a pharmaceutical company that sold drugs to both wholesalers and retailers.[20] Dr. Miles entered into a series of vertical price agreements with its retailers in order to maintain a constant resale price.[21] Dr. Miles sued John D. Park & Sons Company, a retailer, alleging that they had engaged in "cutrate" pricing on Dr. Miles's drugs and caused several of Dr. Miles's other retailers to lose money.[22] The Court held that "combinations between dealers, having for their sole purpose the destruction of competition and the fixing of prices, are injurious to the public interest and void."[23] The Court's holding applied

12 *Id.*

13 *Id.* at 1952; Lester G. Tesler, *Why Should Manufacturers Want Fair Trade?*, 33 J.L. & ECON. 409, 410 (1990); *see infra* Section II.

14 Kenneth G. Elzinga & David E. Mills, *The Economics of Resale Price Maintenance*, *in* 3 ISSUES IN COMPETITION LAW AND POL'Y 1841, 1847 (Wayne D. Collins ed., 2008); Lambert, *supra* note 1, at 1949.

15 Lambert, *supra* note 1, at 1947.

16 Retailers will be willing to enter RPM agreements mainly because it can increase retailer profits and allow consumers to benefit from superior service. Paul Dobson & Michael Waterson, *Retailer Power: Recent Developments and Policy Implications*, 14 ECON. POL'Y 135, 147 (1999). Under RPM, free riding will be limited and retailers can capture more of the positive externalities that are created by retailer advertising and in-store marketing because they have "perfect insurance" of price without fears that discount retailers will undercut their efforts. Patrick Rey & Jean Tirole, *The Logic of Vertical Restraints*, 76 AM. ECON. REV. 921, 928 (1986).

17 Robert L. Hubbard, *Protecting Consumers Post-*Leegin, ANTITRUST, Fall 2007, at 42.

18 *See* Joel M. Mitnick, John J. Lavelle, William V. Reiss & Owen H. Smith, *A Commentary on Current State Enforcement Policy for RPM on Life Support from* Leegin*aire's Disease: Can the States Resuscitate* Dr. Miles*?*, ANTITRUST, Summer 2008, at 63, 65.

19 220 U.S. 373 (1911).

20 *Id.* at 374.

21 *Id.*

22 *Id.* at 375.

23 *Id.*

regardless of the benefits to the contracting parties.[24] The Court reasoned that the "public interest is the first consideration."[25] Although the Court did not expressly declare that RPM was "per se illegal," *Dr. Miles* stood for per se illegality since it was decided.[26] During the next ninety-six years, the federal and state courts applying federal law unequivocally followed this precedent.[27]

Most states have their own antitrust statutes that generally mimic the Sherman Act.[28] Antitrust laws in all but one state followed *Dr. Miles*'s per se ban on RPM; Illinois's state courts rejected the per se standard for RPM.[29] State antitrust laws adopted *Dr. Miles* in three different ways.[30]

First, many states codified *Dr. Miles* to place a ban on RPM regardless of procompetitive effects.[31] For example, the California antitrust statute says that all trusts are unlawful and defines a trust as:

> [A] combination of capital, skill or acts by two or more persons . . . [t]o make or enter into or execute or carry out any contracts, obligations or agreements of any kind or description, by which [parties] . . . [b]ind themselves not to sell, dispose of or transport any article or any commodity or any article of trade, use, merchandise, commerce or consumption below a common standard figure, or fixed value.[32]

This California statute is similar to the statutes in fifteen[33] other states that codified *Dr. Miles* prior to *Leegin*.[34]

Second, in the District of Columbia and five states, it is "permissive" to follow *Dr. Miles*.[35] In these states, either by statute or precedent, it is optional for state courts, interpreting state antitrust law, to follow the federal courts' interpretation of similar federal antitrust laws. For example, in Arizona, a statute states that "courts *may* use as a guide interpretations giv-

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24 *Id.* at 375, 385.

25 *Dr. Miles*, 220 U.S. at 406.

26 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 881 (2007) (explaining that *Dr. Miles* established the rule of per se illegality); Robert H. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 75 YALE L.J. 373, 399 (1966) (explaining that "vertical restraints suppressing competition among firms at a second level of the industry are illegal").

27 Richard A. Duncan & Alison K. Guernsey, *Waiting for the Other Shoe to Drop: Will State Courts Follow* Leegin*?*, 27 FRANCHISE L.J. 173, 178 (2008).

28 *See e.g.* ALASKA STAT. § 45.50.562 (2009).

29 Gilbert's Ethan Allen Gallery v. Ethan Allen, Inc., 620 N.E.2d 1349, 1350, 1354 (Ill. App. Ct. 1993) (explaining that RPM is not per se illegal under Illinois state antitrust law).

30 Michael A. Lindsay, *An Update on State RPM Laws Since* Leegin, ANTITRUST SOURCE, Dec. 2010, at 1.

31 *Id.*

32 *Id.* at ii; CAL. BUS. & PROF. CODE § 16720(e)(1) (West 2011).

33 *See* Lindsay, *supra* note 30, at i-xv. *See also* Duncan & Guernsey, *supra* note 27, at 174.

34 Lindsay, *supra* note 30, at 1.

35 Duncan & Guernsey, *supra* note 27, at 176.

en by the federal courts to comparable federal antitrust statutes."[36] The Supreme Court of Hawaii declared that a federal ruling will not be "blindly" accepted but rather will serve as a guide when interpreting state statutes.[37]

Lastly, through statute or case law, some states mandate that state antitrust laws will follow federal law and federal court precedent.[38] The Colorado legislature and others have declared that when interpreting the state antitrust statutes, "the courts *shall* use as a guide interpretations given by the federal courts to comparable federal antitrust laws."[39] The same result was obtained when the Supreme Court of Alaska held that "federal cases construing § 1 of the Sherman Act *will* be used as a guide."[40] Regardless of the fashion, all courts interpreting both federal and state law, except Illinois law,[41] followed *Dr. Miles* until 2007, when the Supreme Court decided *Leegin*.[42]

B. Leegin *and the Rule of Reason—Ending 100 Years of Precedent*

Per se illegality for RPM was criticized by some of the greatest antitrust scholars, including Richard Bork[43] and Frank Easterbrook.[44] Furthermore, in the forty years prior to *Leegin*, the Court overruled the per se standard and adopted the rule of reason for several other business practices—showing the Court's skepticism for the per se standard.[45] Thus, the

36 ARIZ. REV. STAT. ANN. § 44-1412 (2009) (emphasis added).

37 Island Tobacco Co. v. R.J. Reynolds Tobacco Co., 627 P.2d 260, 262, 268 (Haw. 1981).

38 Lindsay, *supra* note 30, at 1; *see, e.g.*, IDAHO CODE ANN. § 48-102(3) (West 2000) (providing the statute "shall be construed in harmony with federal judicial interpretations of comparable federal antitrust statutes").

39 COLO. REV. STAT. § 6-4-119 (West 2002) (emphasis added).

40 Alakayak v. B.C. Packers, Ltd., 48 P.3d 432, 448 (Alaska 2002) (emphasis added).

41 Gilbert's Ethan Allen Gallery v. Ethan Allen, Inc., 642 N.E.2d 470, 474 (Ill. 1994) (holding that "a rule of reason analysis should have been performed in determining whether the RPM was a violation of [the monopolization section] of the Illinois Act"). This holding occurred thirteen years prior to *Leegin*; Illinois's state law adhered to this holding since that time. Lindsay, *supra* note 30, at iv.

42 Duncan & Guernsey, *supra* note 27, at 178.

43 Bork, *supra* note 26.

44 Easterbrook, *supra* note 7, at 140-41.

45 Cont'l T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 58 (1977) (holding that the per se illegal standard for geographic restrictions on a franchise should be overruled and the rule of reason should be adopted); State Oil Co. v. Khan, 522 U.S. 3, 22 (1997) (holding that vertical maximum price fixing should be evaluated under the rule of reason instead of the per se rule); Alan J. Meese, *Market Failure and Non-Standard Contracting: How the Ghost of Perfect Competition Still Haunts Antitrust*, 1 J. COMPETITION L. & ECON. 21, 21 (2005).

stage was set for a change when the Supreme Court granted certiorari in *Leegin Creative Leather Products, Inc. v. PSKS, Inc*.[46]

Leegin Creative Leather Products, Inc. (Leegin) manufactured a line of leather apparel that was only sold by small retailers.[47] After some time, Leegin refused to distribute its products to retailers that sold Leegin's products below a suggested price.[48] One store operated by PSKS had been one of Leegin's preferred retailers.[49] Eventually it started cutting prices, and Leegin refused to sell its products to PSKS.[50] PSKS filed suit claiming that Leegin violated § 1 of the Sherman Act by illegally setting minimum retail prices.[51] The Court overruled *Dr. Miles*, holding that RPM should not be per se illegal, but rather governed by a rule of reason.[52]

The Court gave closely entwined legal and economic rationales for why per se illegality is an incorrect standard for RPM.[53] The court explained that per se illegality should be preserved for circumstances when conduct nearly always causes anticompetitive effects—an economically determined concept.[54] RPM, however, can result in many procompetitive effects—making it a candidate for the rule of reason instead of per se illegality.[55] These effects include increasing demand, ending the free rider problem, and promoting interbrand competition for existing firms and new entrants alike.[56] The Court held that because RPM is not something that always or almost always has net anticompetitive effects, the rule of reason is the correct standard for RPM.[57]

C. Leegin*'s Effect on the States and the Country as a Whole*

The structure of antitrust law in the United States has made *Leegin*'s effect more complicated.[58] Federal antitrust policy is governed primarily by the Sherman and Clayton Acts and their associated case law. States also

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46 Ronald A. Cass, *When Price 'Fixing' Makes Sense*, WALL ST. J., Mar. 24, 2007, at A10; Tony Mauro, *Antitrust Case On Price-fixing May Face Review*, NAT'L L.J., Sep. 4, 2006.

47 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 882 (2007).

48 *Id.* at 883.

49 *Id.*

50 *Id.* at 884.

51 *Id.*

52 *Id*. at 900.

53 *Leegin*, 551 U.S. at 889.

54 *Id.* at 886, 894.

55 *Id.* at 894.

56 *Id.* at 890-92.

57 *Leegin*, 551 U.S. at 899.

58 *See* Duncan & Guernsey, *supra* note 27, at 173-74 (exploring state antitrust laws and offering predictions on which state laws are likely to continue prohibiting RPM).

have their own varying antitrust laws.[59] Several states have statutes or precedents declaring that state antitrust laws will be construed according to federal court precedents interpreting similar federal statutes.[60] These states *should* follow *Leegin*. Other state laws make following federal courts permissive, and not mandatory; these states *may* follow *Leegin*.[61] A third category of states have codified bans on RPM, and it is *unlikely* that they will follow *Leegin* in their state antitrust laws.[62] There are a few additional states where legislation and court opinions conflict on how they apply federal antitrust precedent and it is uncertain whether they will follow *Leegin*.[63] Therefore, *Leegin*'s effect varies greatly from state to state since each state may or may not have its own antitrust laws that conflict with the Sherman Act and its associated federal case law.[64] By way of illustration, suppose State A codified *Dr. Miles* and State B follows *Leegin*. Firms using RPM nationwide are per se liable in State A but governed by the rule of reason in State B for the exact same conduct.

Consumer rights groups criticize *Leegin* because it will increase prices, and seek to reverse *Leegin*'s effect by codifying the per se standard at the state level.[65] These groups have been successful in Maryland, where the state legislature codified a per se standard for RPM.[66] These efforts to reject *Leegin* have not gone unchecked, legal societies[67] and practitioners[68] have encouraged lawmakers to embrace *Leegin*.

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59 *See id.* at 174 (providing three general categories into which states' antitrust laws can be grouped); *see supra* Section I.A. (providing examples of different state antitrust laws).

60 *See supra* Section I.A. (giving as examples Colorado and Alaska as two states whose legislatures have mandated that the antitrust laws will follow federal law and federal court precedent); Duncan & Guernsey, *supra* note 27, at 174.

61 *See supra* Section I.A. (giving as examples the District of Columbia and Hawaii as two of the five states whose legislatures have said the antitrust laws may follow *Leegin*, but are not required to); Duncan & Guernsey, *supra* note 27, at 174.

62 *See supra* Section I.A.; Duncan & Guernsey, *supra* note 27, at 174.

63 *See supra* Section I.A.; Duncan & Guernsey, *supra* note 27, at 174.

64 Duncan & Guernsey, *supra* note 27, at 173.

65 Joseph Pereira, *State Law Targets 'Minimum Pricing'*, WALL ST. J. (Apr. 28, 2009), http://online.wsj.com/article/SB124087840110661643.html. The president of the Maryland Consumer Rights Coalition declared, "The Supreme Court has basically abandoned the consumer, and now the states and the federal government are finding they have to step into the breach." *Id.*

66 MD. CODE ANN., COM. LAW § 11-204(a)(2) (West 2009); Elizabeth M. Bailey & Gregory K. Leonard, *Minimum Resale Price Maintenance: Some Empirical Evidence from Maryland*, 10 B.E. J. ECON. ANALYSIS & POL'Y, 2010, at art. 17, *available at* http://www.nera.com/extImage/PUB_Minimum_Resale_Price_0110.pdf.; Joseph Pereira, *State Law Targets 'Minimum Pricing'*, WALL ST. J. (Apr. 28, 2009), http://online.wsj.com/article/SB124087840110661643.html.

67 Letter from James A. Wilson, Chair, ABA Section of Antitrust Law, to Henry C. Johnson, Chairman, Subcomm. on Courts and Competition Policy, Comm. on the Judiciary, U.S. House of Representatives (May 5, 2009), *available at* http://www.americanbar.org/content/dam/aba/migrated/poladv/letters/antitrust/2009may6_leegincaseh_l.authcheckdam.pdf. In this letter, the Chair of the ABA Section of Antitrust Law urged both states and

States are not the only political bodies that have received pressure to reject *Leegin*; Congress received pressure to modify the Sherman Act to reject *Leegin*'s holding.[69] A bill was submitted by Senator Herb Kohl and supported by then-Senators Hillary Clinton and Joe Biden[70] with the express purpose "[t]o restore the rule that agreements between manufacturers and retailers, distributors, or wholesalers to set the price below which the manufacturer's product or service cannot be sold violates the Sherman Act."[71] A similar bill was also proposed in the House.[72]

II. PRAISE FOR *LEEGIN*

Many economists and legal scholars embraced *Leegin*.[73] They agreed with the Court that RPM has procompetitive effects[74] and is therefore, not a candidate for per se illegality.[75]

RPM causes numerous procompetitive effects. Firstly, RPM can solve the free rider problem that exists when firms try to establish point of service sales.[76] When RPM is per se illegal, a retailer may go to great lengths and accrue costs to advertise a product without reaping the benefit of increased sales.[77] A retailer would accrue costs through store displays and radio, television, and internet advertising.[78] Furthermore, retailers expend resources

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Congress to embrace L*eegin*. *Id.* The letter declared that "the ABA supports the position that under the federal antitrust laws—and analogous state and territorial antitrust law—agreements between a buyer and seller setting the price at which the buyer may resell a product or service purchased from the seller should not be illegal per se." *Id.*

68 *Bye Bye Bargains? Retail Price Fixing, The* Leegin *Decision and its Impact On Consumer Prices: Hearing on H.R. 3190 Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary,* 111th Cong. 35 (2009) (statement of Thomas G. Hungar, Partner, Gibson, Dunn & Crutcher, LLP, Washington, D.C.).

69 *Id*. at 9 (statement of Pamela Jones Harbour, Commissioner, FTC, Washington, D.C.); Julie M. Olszewski, Note, *Overruling Nearly a Century-Old Precedent: Why* Leegin *Got it Right*, 94 IOWA L. REV. 375, 388 (2008).

70 Olszewski, *supra* note 69, at 388.

71 S. REP. NO. 111-227, at 1 (2010).

72 H.R. REP. NO. 111-676, at 2 (2010).

73 *See, e.g., Bye Bye Bargains? Retail Price Fixing, The* Leegin *Decision and its Impact On Consumer Prices: Hearing on H.R. 3190 Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary,* 111th Cong. 35 (2009) (statement of Thomas G. Hungar, Partner, Gibson, Dunn & Crutcher, LLP, Washington, D.C.); Olszewski, *supra* note 69, at 375.

74 Lambert, *supra* note 1, at 1950-60.

75 ROBERT H. BORK, THE ANTITRUST PARODOX: A POLICY AT WAR WITH ITSELF 282, 288 (1993 ed.); George R. Ackert, *An Argument for Exempting Prestige Goods from the Per Se Ban on Resale Price Maintenance*, 73 TEX. L. REV. 1185, 1186 (1995); Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 22-26 (1981).

76 Lambert, *supra* note 1, at 1952.

77 *Id.*

78 *Id.*

training salesman and creating point of service sales.[79] However, these expenditures will be unfruitful without RPM because discount retailers that do not invest in promoting a product can undercut the price of retailers that do incur promotion costs.[80] Consumers will decide to purchase a product based on the efforts made by the retailer that spends money to advertise and educate the consumers,[81] and then go to discount retailers to make the actual purchase at a lower price.[82] However, when RPM is allowed, discount retailers—the previous free riders—will be bound to price at the same minimum level as everyone else and will be unable to undercut the other retailers.[83]

Secondly, RPM agreements may facilitate entry.[84] When there is an RPM agreement, retailers that have been selling a particular product are no longer concerned that they will be undercut by another retailer.[85] With this protection, retailers are more willing to market new brands and incur new costs because they do not fear losing profits on existing products.[86]

In addition, RPM will make it profitable for firms to market products with unpredictable demand.[87] Without RPM, a retailer will keep a minimal stock of items that are not consistently sold.[88] If they fully stock these items, they will have to sell them at a lower margin for fear that other retailers will undercut them and leave them with excess supply.[89] To hedge against this problem, retailers maintain a low supply for items with an unpredictable demand.[90] Consequently, when consumers actually want a product, there is a shortage of supply and consumers are forced to pay higher prices.[91] However, under RPM, margins are maintained and it is profita-

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79 *Id.*; *see*, *e.g.*, Howard P. Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND J. ECON. 346, 348 (1984) (an example of how resource expenditures can shift the demand for a product outward but this expenditure will be for naught in the absence of a way to charge higher prices to offset the increased costs).

80 Lambert, *supra* note 1, at 1952; Marvel & McCafferty, *supra* note 79.

81 *See id.*

82 Lambert, *supra* note 1, at 1952.

83 *Id.*

84 Olszewski, *supra* note 69, at 384.

85 Lambert, *supra* note 1, at 1958.

86 *Id.*

87 *Id.* at 1959.

88 *Id.*; David A. Butz, *Vertical Price Controls with Uncertain Demand*, 40 J.L. & ECON. 433, 457 (1997) ("[M]anufacturers would shun risky ventures whenever [a ban on RPM] renders them less profitable than more certain alternatives.").

89 *Id.*

90 *Id.*; *Bye Bye Bargains? Retail Price Fixing, The* Leegin *Decision and its Impact On Consumer Prices: Hearing on H.R. 3190 Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary,* 111th Cong. 55 (2009) (statement of Thomas G. Hungar, Partner, Gibson, Dunn & Crutcher, LLP, Washington, D.C.).

91 *Bye Bye Bargains? Retail Price Fixing, The* Leegin *Decision and its Impact On Consumer Prices: Hearing on H.R. 3190 Before the Subcomm. on Courts and Competition Policy of the H. Comm.*

ble to market new products with unpredictable demand.[92] Consumers then have more choices and pay lower prices for these products.[93]

Given these possible procompetitive effects, RPM is not a candidate for per se illegality.[94] Rather, the rule of reason should be used here[95] to assess RPM's benefits.[96]

III. ARGUMENTS THAT *LEEGIN* INCREASES PRICES AND ATTEMPTS TO ANNUL *LEEGIN*

A. *Claim that* Leegin *Will Increase Price*

Most arguments condemning *Leegin* simply claim that allowing RPM will increase prices.[97] These arguments assert that RPM agreements will cause prices to increase; a manufacturer will not create an agreement mandating a minimum cost for consumers that is below the cost already being charged.[98] Consequently, this conflicts with the goal of antitrust law, which is to protect consumers.[99] Since prices will go up when RPM is allowed,

on the Judiciary, 111th Cong. 47 (2009) (statement of Thomas G. Hungar, Partner, Gibson, Dunn & Crutcher, LLP, Washington, D.C.).

92 *Id.*; *see* Raymond Deneckere, Howard P. Marvel & James Peck, *Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition*, 87 AM. ECON. REV. 619, 622 (1997) (explaining that Nintendo was able to successfully replace Atari because Nintendo used RPM).

93 *Id.*; *see* Deneckere, Marvel & Peck, *supra* note 92, at 622.

94 Olszewski, *supra* note 69, at 386.

95 *Bye Bye Bargains? Retail Price Fixing, The Leegin Decision and its Impact On Consumer Prices: Hearing on H.R. 3190 Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary,* 111th Cong. 55 (2009) (statement of Thomas G. Hungar, Partner, Gibson, Dunn & Crutcher, LLP, Washington, DC).

96 State Oil v. Khan, 522 U.S. 3, 22 (1997) (holding that vertical maximum price fixing should be analyzed under the rule of reason because only this rule can effectively determine if there are anticompetitive effects); Cont'l T.V., Inc. v. GTE Sylvania, 433 U.S. 36, 58-59 (1977) (holding that nonprice vertical restraints should be governed by the rule of reason because there are likely procompetitive effects); Standard Oil Co. of N.J. v. United States, 221 U.S. 1, 60 (1911) (establishing that the rule of reason should be used to determine whether a horizontal restraint unreasonably restrains trade because there are economic reasons to support procompetitive justifications).

97 Gabriel A. Feldman, *The Misuse of the Less Restrictive Alternative Inquiry in Rule of Reason Analysis*, 58 AM. U. L. REV. 561, 564 (2009); Letter from Pamela Jones Harbour, Fed. Trade Comm'r, to the Supreme Court of the United States 9 (Feb. 26, 2007), *available at* http://www.ftc.gov/speeches/harbour/070226verticalminimumpricefixing.pdf [hereinafter Letter from Pamela Jones Harbour to Supreme Court].

98 Mark D. Bauer, *Whither* Dr. Miles*?*, 20 LOY. CONSUMER L. REV. 1, 13-14 (2007); Benjamin Klein, *Competitive Resale Price Maintenance in the Absence of Free Riding*, 76 ANTITRUST L.J. 431, 433 (2009).

99 John B. Kirkwood & Robert H. Lande, *The Fundamental Goal of Antitrust: Protecting Consumers, Not Increasing Efficiency*, 84 NOTRE DAME L. REV. 191, 191 (2008).

RPM nearly always cause anticompetitive effects and for that reason, per se illegality is the appropriate rule, not the rule of reason.[100]

Others offer more complicated arguments to criticize *Leegin*.[101] First, RPM should remain per se illegal because there is no evidence that the extra profits earned by retailers will actually be transferred to consumers; rather, RPM is a "consumer-funded" bribe to retailers.[102] RPM also prevents consumers who do not want point of service sales from realizing their preferences.[103] Furthermore, free riding in this circumstance is not necessarily bad, but rather shows that a retailer transfers wealth to their consumers instead of retaining it for themselves.[104] Alternatively, RPM is contrary to the goals of antitrust law because RPM causes wealth to be transferred from consumers to retailers and manufacturers.[105] All of these problems will result in higher prices.[106]

B. *Attempts to Annul* Leegin *and Frequency of the "Increase Price" Argument*

The predominant criticisms of *Leegin*, especially the claim that RPM will increase prices, have not been limited to scholarly debate alone. Thirty-eight state attorneys general joined and wrote a letter to Congress urging the repeal of *Leegin* claiming that the repeal was justified because RPM would increase prices.[107] Senator Herb Kohl also claimed that *Leegin* would increase prices when he proposed a bill to the Senate that would codify per se illegality.[108] Representative John Conyers proposed a similar bill in the House of Representatives.[109] The bill was proposed because *Leegin* was "expect[ed] . . . to result in increased prices charged to consumers."[110]

The president of the Maryland Consumer Rights Coalition, while promoting Maryland's law that codified per se illegality for RPM, declared, "[t]he Supreme Court has basically abandoned the consumer, and now the

100 Pamela Jones Harbour, *A Tale of Two Marks*, 20 LOY. CONSUMER L. REV. 32, 45 (2007).

101 Robert Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1487, 1489 (1983); *see also* Letter from Pamela Jones Harbour to Supreme Court, *supra* note 97, at 2.

102 Letter from Pamela Jones Harbour to Supreme Court, *supra* note 97, at 7.

103 *Id.*

104 *Id.* at 9.

105 *Id.* at 7.

106 *Id.* at 9.

107 Barr, *supra* note 4, at 2.

108 Press Release, Senator Herb Kohl, Kohl Examines the Legality of Manufacturers Barring Discount Prices (May 19, 2009), *available at* http://votesmart.org/public-statement/426103/kohl-examines-the-legality-of-manufactureers-barring-discount-prices.

109 H.R. REP. NO. 111-676, at 1 (2010).

110 *Id.* at 2.

states and the federal government are finding they have to step into the breach."[111] This "[h]igher [p]rices" argument has also been used in other states that are attempting to follow Maryland's lead and codify *Dr. Miles*.[112]

Federal Trade Commission Commissioner Pamela Jones Harbour opposed the rule of reason because of increased prices. She sent a letter[113] to the Supreme Court while *Leegin* was under consideration and also testified before the Senate Subcommittee on Antitrust, Competition Policy and Consumer Rights claiming that overruling *Dr. Miles* would raise prices.[114]

Although the Senate and House bills have not been passed at the time of this writing, *Leegin* remains unpopular and important to Congress[115] and others.[116] On November 3, 2011, the Senate Judiciary Committee reviewed a bill—an unamended version of the bill that had previously failed—that would codify per se illegality.[117] The Committee voted to resubmit the bill for approval, something that has not occurred.[118] There was also a Facebook group created to oppose *Leegin*.[119] This Facebook group claimed that the slow recovery from the 2008 recession can be partly blamed on *Leegin* and provides sample letters for constituents to send to their congressional representatives.[120] Despite the frequent claims that *Leegin* has increased prices without sufficient procompetitive effects, an empirical study has not been done to determine if prices have actually increased.[121]

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111 Pereira, note 65.

112 Ashley Doty, Leegin v. PSKS*: New Standard, New Challenges*, 23 BERKELEY TECH. L.J. 655, 659-60 (2008).

113 Letter from Pamela Jones Harbour to Supreme Court, *supra* note 97, at 9.

114 *See id.* at 9 (arguing that if *Dr. Miles* were reversed and RPM became more prevalent, there would be higher prices).

115 *Senate Judiciary Passes Bill to Prevent Manufacturer Price-Fixing*, WASH. INTERNET DAILY, Nov. 4, 2011.

116 Marjorie Sterne, *The Elimination of Price Fixing is Essential to Economic Recovery*, FACEBOOK, http://www.facebook.com/group.php?gid=49786972716&v=wall (last visited Sept. 26, 2011). Since the time of last visiting, this Facebook page cannot be found.

117 *Senate Judiciary Passes Bill to Prevent Manufacturer Price-Fixing*, WASH. INTERNET DAILY, Nov. 4, 2011.

118 Discount Pricing Consumer Protection Act, S. 75, 112th Cong. (2011) ("Reported without amendment" on Nov. 3, 2011).

119 Sterne, *supra* note 116.

120 *Id.*

121 There was an empirical study done when Maryland passed a law codifying per se illegality for minimum RPM. A difference in differences model was used to determine if there was an increase in video game prices before and after the law was put into effect. Bailey & Leonard, *supra* note 66.

IV. EMPIRICALLY TESTING *LEEGIN*'S EFFECT ON CONSUMER PRICE

A. *Methodology*

Leegin's effect on prices will be considered in three different phases. First, a time series graph and simple means comparison will indicate how the Consumer Price Index (CPI) has changed during the last ten years because of *Leegin*. Second, a difference in differences (DID) model[122] will be used to discuss how CPI has changed for products likely subject to RPM compared to products that are *not* subject to RPM. Third, a DID model will be used to estimate how CPI has changed in areas that have applied *Leegin* compared to areas that have *not* applied *Leegin*.

1. Data Collection

There has been very little empirical work done to describe the effects of *Leegin* because price data is not readily available. However, CPI is closely related to price.[123] "CPI is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."[124] Given the close similarities between price and CPI,[125] CPI will be used to determine how *Leegin* affects price. This is a central concern to the *Leegin* debate.[126]

Leegin had varying effects in different states. Some state antitrust laws are identical to the federal laws and require that courts follow federal precedent.[127] Other states have codified the per se illegality standard, which means *Leegin* would have no effect in these states because the firms using RPM will still be liable under state laws.[128] Consequently, some states will follow a per se rule for RPM and some states will use the rule of reason.[129]

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122 Joshua D. Angrist & Alan B. Kruger, *Empirical Strategies in Labor Economics*, *in* 3A HANDBOOK OF LABOR ECONOMICS VOLUME 1277, 1298 (Orley C. Ashenfelter & David C. Card eds., 1999).

123 *Consumer Price Index Addendum to Frequently Asked Questions,* BUREAU OF LABOR STATISTICS, http://www.bls.gov/cpi/cpiadd.htm (last modified Mar. 2, 2011).

124 *Frequently Asked Questions: What is Consumer Price Index (CPI)?*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/dolfaq/bls_ques28.htm (last visited Jan. 16, 2013).

125 *Id.*

126 *See supra* Section III.

127 *Supra* Section I.A.

128 Since a firm can still be sued under state law, *Leegin* will have no effect and firms will refrain from using RPM even though *Leegin* lifted the per se ban under federal law. *See infra* Section I.A.; Duncan & Guernsey, *supra* note 27, at 173.

129 *Id.* at 178.

These differences create a DID framework with the *Leegin* decision as the treatment.[130]

The Bureau of Labor Statistics produces the CPI in both monthly and annual increments.[131] For this project, annual CPI will be used to prevent the cyclical problems that arise from monthly price data.[132] The dataset will include the CPI for a ten year period from 2001 to 2010.

The CPI is not produced on a statewide basis but rather by metropolitan statistical areas (MSAs).[133] These MSAs do not necessarily follow state lines and frequently span multiple states.[134] For example, the Washington D.C. MSA includes parts of Maryland, Virginia, West Virginia, and all of the District of Columbia.[135] This is problematic because Maryland switched to the rule of reason with *Leegin* and then reverted back to per se illegality in 2009.[136] Virginia, however, follows federal precedent and adopted *Leegin*'s rule of reason.[137] Consequently, the Washington D.C. MSA has conflicting laws within its borders. In order to segregate the MSAs that either exclusively followed *Leegin* or exclusively retained a per se rule, I determined each state's treatment of RPM.

After reviewing all of the state statutes and precedents, I found that thirty states followed *Leegin* and fifteen remained per se illegal.[138] Since the MSAs do not follow state lines, the total number of MSAs that exclusively followed *Leegin* or exclusively remained per se illegal was reduced.[139] There were thirteen MSAs that followed *Leegin* and switched to a

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130 Mariana Bertrand, Esther Duflo & Sendhill Mullainathan, *How Much Should We Trust Difference-In-Differences Estimates?*, 119 Q. J. ECON. 249, 249 (2004).

131 *Consumer Price Index*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/cpi/data.htm (last visited Jan. 16, 2013).

132 Mark Bils, *The Cyclical Behavior of Marginal Cost and Price*, 77 AM. ECON. REV. 838, 838 (1987). Furthermore, the time graph for monthly CPI is highly cyclical with spikes during the third and fourth business quarters.

133 *Consumer Price Index*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/cpi/data.htm (last visited Jan. 16, 2013).

134 *Id.*

135 *Id.*

136 Lindsay, *supra* note 30, at vi.

137 *Id.* at xiv.

138 *See id.*; Duncan & Guernsey, *supra* note 27 (explaining how the different states treat *Leegin* and that how some states treat *Leegin* is indeterminate). The remaining states were indeterminate. *Id.*

139 A similar process has been used by an expert witness in *Realcomp II, Ltd. v. F.T.C.*, 635 F.3d 815, 832 (6th Cir. 2011) where the expert witness, Dr. Williams, had sifted through MSAs and selected a control group that could be used to analyze real-estate listings.

rule of reason in June 2007.[140] Five MSAs retained the per se standard after *Leegin* was decided.[141]

There are significant demographic differences between these two groups as well as within the groups themselves. In order to account for these differences, these models will incorporate several control variables including: population by MSA, per capita income by MSA, Gross Domestic Product (GDP) by MSA, and the net inflow of the earnings of inter-area commuters.[142] CPI for apparel will be used to determine *Leegin*'s potential effects because it is an industry where RPM is prevalent and because the pricing scheme under dispute in *Leegin* was for a product classified as apparel.[143]

A DID comparing states that follow *Leegin* with those that do not, though likely the best way to conduct this analysis, is not the only analysis I conduct. In phase one, I present and discuss a time series graph and a means comparison. In phase two, I compare the CPI on apparel for MSAs that that followed *Leegin* (Treatment Group) to the national CPI on lettuce using a DID model.[144] CPI on lettuce is used because lettuce is not a product generally subject to RPM.[145] In phase three, I conduct what I anticipate to be the optimal way, given the data constraints, to measure the effects of *Leegin*—a DID comparing CPI for apparel for the Treatment Group to CPI for apparel for MSAs that did not follow *Leegin*.

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140 The thirteen MSAs that followed *Leegin* and adopted a rule of reason for RPM are: Anchorage, Denver-Boulder-Greeley, Miami-Fort Lauderdale, Tampa-St. Petersburg-Clearwater, Honolulu, Chicago-Gary-Kenosha, Detroit-Ann Arbor-Flint, Minneapolis-St. Paul, St. Louis, Pittsburgh, Dallas-Fort Worth, Houston-Galveston-Brazoria, and Milwaukee-Racine.

141 The five MSAs where RPM remained per se illegal are: New York-Northern NJ-Long Island, Los Angeles-Riverside-Orange County, San Francisco-Oakland-San Jose, San Diego, and Cleveland-Akron.

142 *See* Stéphane Bonhomme & Ulrich Sauder, *Recovering Distributions in Difference-in-Differences Models: A Comparison of Selective and Comprehensive Schooling*, 93 REV. ECON. & STAT. 479, 480 (2011) (giving an example of how to control for differences in control groups and treatment groups by including additional variables).

143 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007). There are goods that may be more specifically prone to RPM, such as footwear and electronics. However, CPI by MSA is not available for such narrow classes of goods. Apparel itself is still notoriously subject to RPM. Marvel & McCafferty, *supra* note 79 ("RPM has been common in . . . apparel markets."); Bailey & Leonard, *supra* note 66, at 1 (explaining that video games are a common product that is subject to RPM); Benjamin Klein, *Competitive Resale Price Maintenance in the Absence of Free-Riding*, Hearings on Resale Price Maintenance, FTC, at 3-4 (Feb. 17, 2009), http://www.ftc.gov/opp/workshops/rpm/docs/bklein0217.pdf (explaining that athletic shoes, women's shoes, and leather products are commonly subject to RPM); Howard P. Marvel & Stephen McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J. L. & ECON 363, 363 (1985) ("It has been employed for complex products such as audio equipment and items as simple as toothpaste."); Robert Pitofsky, *Why 'Dr. Miles' Was Right*, REGULATION, January/February 1984, at 29 (RPM has appeared in "boxed candy, pet foods, jeans, vitamins, hair shampoo, knit shirts, [and] men's underwear.").

144 *Infra* Section IV.A.3.

145 Klein, *supra* note 143, at 3-4.

2. Average CPI Over Time and Means Comparison on MSAs that Followed *Leegin* and Adopted a Rule of Reason

Prior to discussing the DID model itself, a time series graph of average CPI for apparel in the MSAs that followed *Leegin* (Treatment Group) gives some insight into what happened before and after *Leegin* was decided. Figure 1 gives the average annual CPI for the Treatment Group from 2001 to 2010. The vertical line represents when *Leegin* began causing an effect. *Leegin* itself was decided midyear, June 28, 2007.[146] However, *Leegin*'s effects on the market began when certiorari was granted on December 7, 2006,[147] because it was anticipated that *Dr. Miles* would be overturned. This anticipation was warranted for two reasons. First, *Dr. Miles* was ninety-six years old and this was the first time the Supreme Court had ruled on minimum RPM since *Dr. Miles*.[148] The Supreme Court would not have granted certiorari if it did not plan on overruling the per se standard. Second, antitrust law had steadily transitioned from a per se standard to a rule of reason for many kinds of business conduct;[149] minimum RPM was the next per se standard on the list. Manufactures and commentators believed that *Dr. Miles*'s days were limited[150] and the market likely began to react when the Court granted certiorari. Admittedly, it is unlikely that any firm began using minimum RPM before *Leegin* was decided. However, price and non-price effects likely began before June 2007 and measuring the effects beginning when *Leegin* was decided would miss some of the effects of the decision that began when certiorari was granted. Thus, to be inclusive enough to capture all the effects of the decision, I measure the effects of the decision from the beginning of 2007, and not just from the time *Leegin* was decided.[151]

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146 *Leegin*, 551 U.S. at 877.

147 Jess Bravin & Mark H. Anderson, *Politics & Economics: Justices to Weigh Immunity Claims By Underwriters --- Plaintiffs Say Arrangements Wall Street Dealmakers Don't Merit Antitrust Shield*, WALL ST. J., Dec. 8, 2006, at A6.

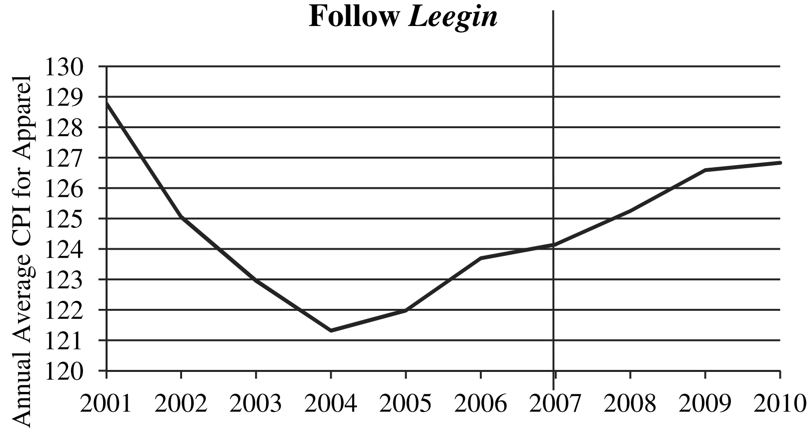
148 *Id.*

149 State Oil v. Khan, 522 U.S. 3, 22 (1997) (holding that vertical maximum price fixing should be analyzed under the rule of reason because only this rule can effectively determine if there are anticompetitive effects); Cont'l T.V., Inc. v. GTE Sylvania, 433 U.S. 36, 38, 59 (1977) (holding that non-price vertical restraints should be governed by the rule of reason because there are likely procompetitive effects); Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911) (establishing that the rule of reason should be used to determine if a horizontal restraint unreasonably restrains trade because there are economic reasons why there could be procompetitive justifications).

150 Peter M. Boyle & Sean M. Green, *Will Another Per Se Rule Fall?*, NAT'L L.J. (Mar. 19, 2007), http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=900005476158.

151 With the decision to use annual data, the alternative choice would be to begin measuring the effects of *Leegin* starting with 2008. Measuring the effects beginning at the time certiorari was granted is preferable to six months after the decision was decided because measuring from January 2008 would cause the analysis to miss six, and likely twelve months of effects.

Figure 1. Average Annual CPI for MSAs that Follow *Leegin*



As seen in Figure 1, CPI was already trending upward for apparel prior to 2007. The slope has actually been positive since 2004. The rate of change from 2007 to 2009 was greater than the rate of change just prior to 2007. This observed change is necessary but not sufficient to say that CPI increased because of *Leegin*—there are other factors that may have caused the upward trend that must be considered in order to make dispositive statements about *Leegin*'s effect on consumer prices. This is why a DID model is useful in this circumstance. It will account for overall market trends and shocks during this period.[152]

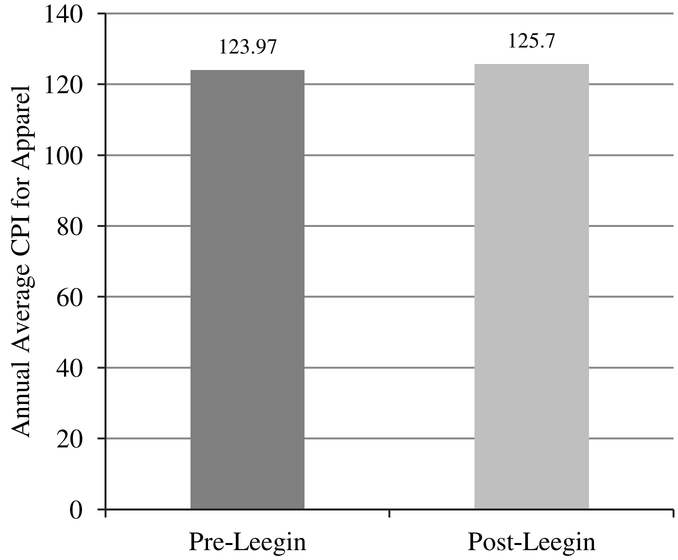
Before proceeding to a DID, a separate means comparison explores the differences in CPI for apparel—a product generally susceptible to RPM[153] both before and after *Leegin* was decided.[154] This comparison only includes the MSAs that followed *Leegin*—the Treatment Group. Figure 2 graphs the means.

152 Bertrand, Duflo & Mullainathan, *supra* note 130.

153 Marvel & McCafferty, *supra* note 79; Bailey & Leonard, *supra* note 66, at 1; Klein, *supra* note 143; Marvel & McCafferty, *supra* note 143; Pitofsky, *supra* note 143.

154 Comparing the means prior to doing regression analysis is a practice used in Michael R. Baye & Joshua D. Wright, *Is Antitrust Too Complicated for Generalist Judges? The Impact of Economic Complexity and Judicial Training on Appeals*, 54 J. L. & ECON. 1, 14 (2011). Though more complicated than the method used here, a similar methodology and analytical structure to Baye and Wright is used in this means comparison.

Figure 2. Average CPI for Apparel



The average CPI post-*Leegin* is nearly two units higher. However, a t-test shows that this difference is not statistically significant at any level.[155] Thus, a suggested conclusion cannot be drawn from this means comparison. As with the time graph, this means comparison implies that a DID is a more appropriate mode of analysis under these circumstances.

3. Difference in Differences Model #1: Products Subject to RPM with Products Not Subject to RPM as the Control

Although Figure 1 and Figure 2 yield useful information about the effects of *Leegin* on price, other effects within the market need to be controlled for because those effects may have caused changes in the CPI around the time *Leegin* was decided.[156] Consequently, comparing the CPI for apparel in these regions to the CPI of another product that is not subject to RPM will give additional insight into *Leegin*'s effect on prices. Lettuce is not subject to RPM and its CPI will be compared to the CPI for apparel in this model.[157]

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155 The probability, based on mean values, that the two samples were taken from the same distribution.

156 Bertrand, Duflo & Mullainathan, *supra* note 130.

157 Klein, *supra* note 143, at 3-4; *Consumer Price Index*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/cpi/data.htm (last visited Jan. 16, 2013).

This comparison is best done with a difference in differences (DID) model.[158] This statistical method measures the difference in the means of CPI for apparel and CPI for lettuce, thus controlling for any market trends that may have caused shocks in the CPI for apparel at the same time as when *Leegin* was decided.[159]

This method is beneficial because it naturally compares CPI for apparel to another product subject to market forces, and because a number of demographic and market variables can be included to control for additional effects.[160] This model will show how much the difference between CPI for apparel and CPI for lettuce changed after *Leegin* was decided, and whether this change is statistically significant. The model is characterized as:

$$Y = \text{CONSTANT} + \text{APPAREL}*dB + \text{CONTROL}*\text{DEM} + \text{LEEGIN}*d2 + \text{LEEGIN}*\text{APPAREL}*d2*dB + \gamma_s + \gamma_{t} + \varepsilon$$

In the model, Y is annual CPI; dB is the dummy variable that specifies whether the CPI is for lettuce or apparel; DEM is a vector of demographic variables (MSA population, income, and GDP); d2 is the variable for either before or after *Leegin* was decided; d2*dB is the interaction variable, or mixed dummy variable, for CPI for apparel after *Leegin* was decided; γ_s is a fixed effect for type of good; and γ_t is a fixed effect for time. LEEGIN*APPAREL, the coefficient for d2*dB, is the coefficient that is critically important to the question asked and will show how CPI changed for goods where RPM is prevalent when *Leegin* was decided. Table 1 reports the coefficients of the model, the z-statistics, and critical significance levels. It includes the resulting changes as more control variables are included.

158 Susan Athey & Guido W. Imbens, *Identification and Inference in Nonlinear Difference-in-Differences Models*, 74 ECONOMETRICA 431 (2006) (explaining in detail some of the characteristics and details of a difference in difference models); Jason Shafrin, *Difference in Difference Estimation*, HEALTHCARE ECONOMIST, http://healthcare-economist.com/2006/02/11/difference-in-difference-estimation/ (last visited Sept. 19, 2011) (giving a basic explanation of difference in difference models).

159 Bertrand, Duflo & Mullainathan, *supra* note 130.

160 Bruce D. Meyer, *Natural and Quasi-Experiments in Economics*, 13 J. BUS. & ECON. STAT. 151, 156 (1995) ("The incorporation of the influences of other variables . . . provides a simple way to adjust for observable differences between the observations in different groups."). The demographic variables are MSA population, income, and GDP.

Table 1. *Leegin*'s Effect on CPI for Apparel with CPI for Lettuce as the Control

VARIABLES	(1)	(2)	(3)	(4)	(5)
LEEGIN*PERSE	1.417	-36.21***	-8.453	-8.855	-12.87*
	(0.819)	(-7.127)	(-1.473)	(-1.572)	(-1.824)
GDP			1.01e-05***	1.03e-05***	7.96e-06***
			(7.045)	(7.365)	(2.737)
INCOME				0.00130**	0.00136**
				(2.345)	(2.446)
MSA POPULATION					1.33e-07
					(0.926)
Year FE	No	Yes	Yes	Yes	Yes
MSA FE	Yes	Yes	Yes	Yes	Yes
Observations	140	140	140	140	140
Number of MSAs	14	14	14	14	14

Note: Robust z-statistics are in parentheses.
* Significant at 10%
** Significant at 5%
*** Significant at 1%

The LEEGIN*APPAREL coefficient is the most important for this model. It shows that the difference between CPI for lettuce and CPI for apparel decreased[161] when *Leegin* was decided. This is statistically significant at the ninetieth percentile when all the control variables are included, which means there is a ninety percent probability that the correlation between CPI and *Leegin* is not the result of random occurrence.[162] It must be noted that the average CPI for lettuce was higher than the average CPI for apparel for the entire time period. This directionally indicates that CPI for apparel actually increased after *Leegin* was decided. One may also posit from this evidence that because CPI increased with *Leegin*, so did prices. However, the findings from this model alone are not dispositive.

A DID model is strongest when the control and treatment groups are identical but for the single factor that is being tested.[163] Here, lettuce and apparel are quite different products and are in different markets altogether,

161 LEEGIN*APPAREL is negative in Table 2 but LEEGIN*MSA is positive in Table 3. Yet, both tables show that CPI is higher because of *Leegin*. This is possible because in the first model (Table 2), CPI for the control group was higher than CPI for the Treatment Group for the entire time series. A DID model measures the change in the differences in the control group and Treatment Group. Since the Treatment Group is lower than the control group, a change in the difference will be negative if CPI increased for the Treatment Group. In the second model (Table 3), CPI for the Treatment Group is higher than CPI for the control group for the entire time series, so an increase in CPI will cause LEEGIN*MSA to be positive.

162 *What Does it Mean for a Result to Be "Statistically Significant"?*, STATS.ORG, http://stats.org/in_depth/faq/statistical_significance.htm (last visited Jan. 14, 2013).

163 Bertrand, Duflo & Mullainathan, *supra* note 130, at 251 (explaining that DID is "valid only under the very restrictive assumption that changes in the outcome variable over time would have been exactly the same in both treatment and control groups in the absence of the intervention").

thus weakening the ability of the model to exactly control for external market forces. Furthermore, CPI for lettuce is a national CPI and CPI for apparel is by MSA. These differences weaken the descriptive value of this model. However, I construct a superior DID in the next section where the control and Treatment Group are much more similar and better control for outside shocks that may have caused an increase in CPI after *Leegin*.

4. Difference in Differences Model #2: MSAs Following *Leegin* with MSAs Not Following *Leegin* as the Control

In the second DID model, I take the thirteen MSAs that followed *Leegin* and compare them to the other MSAs that did not apply *Leegin*. This model is superior to the previous model because the control group—MSAs that have not applied *Leegin*—is much more similar to the Treatment Group.[164] Both the Treatment Group and the control group are based on MSAs during the same time periods, and based on CPI for the same products.[165]

The model yields a variable that shows how CPI differs in an MSA applying a per se rule to an MSA applying a rule of reason after *Leegin* was decided. This essentially shows how much CPI has changed because of *Leegin* and whether the observed change is statistically significant. Table 2 reports the coefficients of the model, the z-statistics, and which coefficients are significant at critical levels.[166] It includes the resulting changes as more control variables are included.

164 *Id.*

165 *Id.*

166 This second DID model will be characterized as:

$$Y = CONSTANT + MSA*dB + CONTROL*DEM + LEEGIN*d2 + LEEGIN*MSA*d2*dB + \gamma_s + \gamma_t + \varepsilon$$

where Y is annual CPI, dB is the dummy variable that specifies if it is an MSA that follows *Leegin* or retained the per se standard, DEM is a vector of demographic variables (MSA population, income, net inflow of the earnings of inter-area commuters, and GDP), d2 is the variable for before or after *Leegin* was decided, d2*dB is a mixed dummy variable for MSAs that followed *Leegin* after *Leegin* was decided, γ_s is a fixed effect for MSA, γ_t is a fixed effect for time, and ε is the error term. δ_1, the coefficient for d2*dB, is the coefficient that is critically important to the question asked and will show what CPI does depending on whether it is an MSA that followed *Leegin* after the rule of reason was adopted in *Leegin*. The demographic variables are Income, Population, GDP, and Residence Net Inflow, or net inflow of the earnings of inter-area commuters.

Table 2. *Leegin*'s Effect On CPI for Apparel with MSA's Not Following *Leegin* as the Control

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
LEEGIN*MSA	1.791*	2.961	2.523	2.940	2.983	2.579
	(1.749)	(1.598)	(1.287)	(1.532)	(1.485)	(1.290)
GDP			-6.92e-06	-2.23e-05*	-2.18e-05	-4.96e-05**
			(-0.672)	(-1.937)	(-1.352)	(-2.342)
INCOME				0.00116***	0.00118***	0.00144***
				(2.930)	(2.884)	(3.387)
POPULATION					-9.55e-08	-1.98e-07
					(-0.0740)	(-0.154)
RESIDENTINFLOW						-1.56e-06**
						(-1.995)
Year FE	No	Yes	Yes	Yes	Yes	Yes
MSA FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	180	180	180	180	180	180
Number of MSAs	18	18	18	18	18	18

Note: Robust z-statistics are in parentheses.
* Significant at 10%
** Significant at 5%
*** Significant at 1%

I find that the LEEGIN*MSA coefficient is 2.579 and is statistically significant at the eightieth percentile. This means that average CPI was 2.579 points higher than average CPI in areas that adopted *Leegin* as compared to areas that did not adopt *Leegin*. Even though econometricians usually require the ninetieth or ninety-fifth percentile for an outcome to be labeled as statistically significant, the eightieth percentile in this output means that there is an eighty percent chance that the correlation between the *Leegin* decision and increased CPI is not a result of random occurrence. Thus, even though not statistically significant in formal econometric analysis terms, this model supports a causal relationship between *Leegin* and increased CPI. While this model is not dispositive, because of the close similarities between the treatment and control groups and the significance to the eightieth percentile, the results provide stronger evidence that *Leegin* did in fact have an impact on CPI and consequently on the prices that consumers pay.

However, there are still some caveats as to the strength of this model. First, this model only included five MSAs in the control group and only thirteen in the Treatment Group. This is far from a complete panel and slightly weakens the descriptive strength of the DID model.[167] Second,

[167] *See* BADI H. BALTAGI, ECONOMETRIC ANALYSIS OF PANEL DATA 165 (3d ed. 2005) (highlighting the fact that "econometric problems [are] associated with . . . incomplete panels" and providing some remedies).

three of the five control MSAs were from the state of California. The demographic controls likely accounted for this problem but it is not ideal.[168] Third, *Leegin* is recent enough that there were only four annual observation points after the opinion was decided. Finally, CPI is not the same as price, and conclusions about consumer price can only be inferentially drawn.

Regardless of these caveats, this model and the previous model provide evidence that prices have increased because of *Leegin*. The question remains though: How determinative are these models to the broader policy question of whether per se illegality should be codified?

B. *Dispositive Nature of These Models to the Broader Policy Question*

As discussed in Section III.A., many have argued that *Leegin* should be overruled because it has increased prices.[169] These models provide at least some evidence that there was a price increase. However, the question remains: Is a price increase sufficient justification for Congress to legislatively overrule *Leegin*. Admittedly, there are several theoretical limitations that prevent these models from dispositively showing that *Leegin* should be overruled.[170]

1. The Goal of Antitrust Law is to Promote Consumer Welfare

A consumer price increase is not sufficient to establish anticompetitive effects. The goal of antitrust law is to promote consumer welfare and conduct that decreases welfare is classified as anticompetitive.[171] An increase in price may mean a decrease in consumer welfare, but it may also mean an increase in consumer welfare. If a price increase is the result of decreased quantity, there is a net loss of consumer welfare.[172] The price may alterna-

168 *See* Angrist & Kruger, *supra* note 122, at 1299 (giving an example of how choosing geographic locations can cause problems in a model).

169 *See* Pamela Jones Harbour, Fed. Trade Comm'r, Testimony Before the Subcommittee on Antitrust, Competition Policy and Consumer Rights Senate Judiciary Committee at 6 (July 31, 2007), http://www.ftc.gov/speeches/harbour/070731test.pdf ("But that is no reason to subject all American consumer to higher prices, which is virtually certain to be the outcome of *Leegin*—unless Congress intervenes.").

170 Lambert, *supra* note 1, at 1950-60.

171 *See id.* (describing that state retail price maintenance laws should focus on general welfare effects); Avishalom Tor & William J. Rinner, *Behavioral Antitrust: A New Approach to the Rule of Reason After* Leegin, 11 U. ILL. L. REV. 805, 815 (2011) (describing how retail price maintenance may be justified as increasing consumer welfare).

172 *See* HENRY N. BUTLER & CHRISTOPHER R. DRAHOZAL, ECONOMIC ANALYSIS FOR LAWYERS 415-18 (2d ed. 2006) (giving an example of deadweight loss when quantity is decreased, allowing monopolists to charge a price above the competitive level).

tively increase because there is an increase in demand.[173] An increase in demand increases the quantity purchased at the market clearing equilibrium and increases welfare—a procompetitive result.[174] Therefore, a price increase may be anticompetitive or procompetitive depending on if it was caused by an increase or decrease in quantity sold. Consequently, changes in quantity are necessary to determine if *Leegin* has actually harmed consumers.[175]

Further research should be done to determine if *Leegin* affected the total quantity sold. A DID model based on total sales before and after *Leegin* was decided would be extremely informative.

2. A Price Increase Does Not Necessarily Rebut *Leegin*'s Procompetitive Effects

In *Leegin*, the Supreme Court decided to adopt a rule of reason for RPM because of RPM's procompetitive justifications.[176] These justifications included increased demand and ending the free rider problem.[177] As discussed previously, an increase in demand will be accompanied by a price increase.[178] Consequently, showing a price increase does not discredit this procompetitive justification.

The free rider problem in this context dissuades retailers from expending resources to promote products because other retailers that do not expend the same resources can charge less and yet maintain the same margin.[179] Retailers will not advertise because of this problem.[180] Advertising is a wealth transfer to consumers because added "information benefits consumers by providing information for decision-making of products and ser-

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173 *See* Tor & Rinner, *supra* note 171, at 813 (describing how higher prices due to retail price maintenance can lead to increased demand).

174 *Id.*

175 *See Leading Case: Federal Statutes and Regulations—Sherman Act—Minimum Resale Price Maintenance*, 121 HARV. L. REV. 425, 430 (2007) (explaining that state decision makers deciding what to do with *Leegin* should not look at price effects only but rather should look at welfare) [hereinafter *Minimum Resale Price Maintenance*]. Welfare is directly tied to the quantity of a good or service that is consumed. *Glossary of Statistical Terms—Consumer Welfare Definition*, OECD (Jan. 3, 2002), http://stats.oecd.org/glossary/detail.asp?ID=3177.

176 Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 890-92 (2007); Brief for Economists as Amici Curiae in Support of Petitioner, Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (No. 06-480), at 4-10.

177 *Leegin*, 551 U.S. at 890-92.

178 *See supra* Section IV.B.1.

179 Lambert, *supra* note 1, at 1952-55.

180 *Id.* at 1953 ("If such free riding is extensive, the high-service dealer will find that it cannot profitably continue to offer costly point of sale services and will cease to do so.").

vice."[181] Point of service sales is also a wealth transfer because consumers gain more from purchasing a product. When a consumer can gain additional wealth by purchasing a product, there will be an increase in consumer demand because a rational purchaser is a wealth maximizer.[182] Since there is an increase in demand, prices will increase as *Leegin* prevents free riding.

Since both of the procompetitive justifications made by the Supreme Court—demand will increase and free riding will end—will likely increase price, evidence of a price increase alone does not discredit *Leegin*'s holding.

3. *Leegin* Adopted a Rule of Reason for RPM, Not a Per Se Legal Standard

Firm behavior that results in increased prices should be carefully reviewed because increased prices may harm consumers.[183] However, procompetitive justifications must be taken into account.[184] Critics of *Leegin* seem to think that the Supreme Court's holding that there are procompetitive justifications for RPM necessarily entails that all RPMs are now legal.[185] However, *Leegin* did not declare that RPMs were per se legal, as has been advocated for by at least one scholar.[186] Under the rule of reason, each time a manufacturer uses RPM, the conduct is still subject to judicial review where the court will weigh evidence of both procompetitive and anticompetitive effects and subsequently determine if that particular RPM promotes consumer welfare.

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181 Hee "Andy" Lee & Carolyn U. Lambert, *The Influence of Technology-Enabled Customer Relationship Management on Customers' Attitude Toward Service Quality and Loyalty*, 11 J. FOODSERVICE BUS. RES. 363, 366 (2008).

182 Richard A. Posner, *Wealth Maximization Revisited*, 2 NOTRE DAME J.L. ETHICS & PUB. POL'Y 85, 86 (1985) (explaining that a rational consumer, when faced with a choice, will choose more wealth over less wealth).

183 *See* Kenneth L. Elzinga, *The Goals of Antitrust: Other than Competition and Efficiency, What Else Counts?*, 125 U. PA. L. REV. 1191, 1194 (1977) (explaining that efficiency is a goal of antitrust law and that "prices will be made lower in [an efficient] market so that for any given income . . . a larger basket of goods and services can be purchased."). Increasing prices is the opposite of the goal of decreasing prices and is a sign that there is consumer harm. Consequently, preventing increased prices is a goal of antitrust law.

184 *E.g.*, Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of Univ. of Okla., 468 U.S. 85, 86 (1984) (explaining that procompetitive justification should be taken into account).

185 *See* Letter from Pamela Jones Harbour to Supreme Court, *supra* note 97, at 1 (predicting that under *Leegin* "vertical minimum price fixing will become beyond effective challenge under the federal antitrust laws").

186 Posner, *supra* note 75, at 6.

Leegin is new enough that it is uncertain how the courts will apply the rule of reason.[187] There has yet to be any definitive interpretation about what the prima facie burden will be under the rule of reason for RPM and what constitutes cognizable rebuttal evidence.[188] If future adjudication indicates that showing a price increase meets the prima facie burden, then plaintiffs will have a much easier case and will be the likely victors in most RPM cases. Consequently, the fears that *Leegin* has abandoned the consumer would be unwarranted since a price increase is enough to shift the burden. However, if the courts begin to interpret *Leegin* as a per se legal standard, then the fear that consumers will be harmed is more justifiable. Only time will tell what "rule of reason" means for RPM under the *Leegin* decision.[189]

CONCLUSION

Leegin overruled *Dr. Miles* and ninety-six years of precedent when it declared RPM was not per se illegal but rather subject to rule of reason analysis. As can be expected when a century of precedent is overruled, there has been significant debate surrounding the Supreme Court's decision. Many scholars, consumer protection agencies, and practitioners have condemned *Leegin* because it will allegedly increase consumer prices and harm welfare. As a result, these groups are encouraging both states and Congress to pass laws that would codify *Dr. Miles*.

I constructed two DID models to determine if these concerns are legitimate and if *Leegin* has, on the whole, actually increased prices. I find that there is some evidence that CPI has increased because of *Leegin*. This evidence inferentially implies that prices have also increased because of *Leegin*.

However, a simple showing of price increases does not dispositively mean that *Leegin* should be overruled by Congress or state legislatures. Price increase alone could have just as feasibly resulted from an increase in demand, or the harms of the increase could be offset by procompetitive effects. A showing of increased price with an accompanying decrease in output is necessary to reject *Leegin*. As for now, though, a showing of increased price is but one step towards determining if *Leegin* is actually harmful to consumers. As a result, it is imperative that further work be done before states or Congress legislatively overrule *Leegin*.

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187 *See* Lambert, *supra* note 1, at 1939 (describing the Court's requirement that lower courts develop a "structured" rule of reason in RPM cases and describing different approaches that courts could use).

188 *See id.* at 1981-82 (describing a potential interpretation provided by one influential treatise).

189 *See id.* at 1941 ("[I]n the post-*Leegin* era, in the face of a proliferation of RPM arrangements, courts must develop means of distinguishing pro-from anticompetitive RPM agreements.").

CY PRES COMME POSSIBLE TO ANYTHING IS POSSIBLE: HOW *CY PRES* CREATES IMPROPER INCENTIVES IN CLASS ACTION SETTLEMENTS

Jennifer Johnston[*]

INTRODUCTION

The *cy pres* doctrine is a rule of construction originally utilized in trust law to save a testamentary charitable gift that would otherwise fail due to the original gift being impossible or impracticable to fulfill.[1] The evolution of *cy pres*, also known as fluid recovery,[2] allows courts to invoke the doctrine when distributing leftover damage or settlement funds in class actions.[3] In such cases, the courts interpret the doctrine to permit distribution of funds to the "next best" use when claiming class members or absent class members cannot be compensated individually.[4]

Cy pres distributions of unclaimed funds in class actions are controversial because they leave the courts with broad discretionary powers to decide where to direct the funds to indirectly benefit the class.[5] Often, this involves the court awarding money to charities or organizations that are, at best, loosely related to the class members' injury.[6] The system for distribution of funds knows few boundaries and is generally unpredictable.[7] As a

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[1] *In re* Airline Ticket Comm'n Antitrust Litig., 268 F.3d 619, 625 (8th Cir. 2001).

[2] Although fluid recovery and *cy pres* mean separate things they have come to be used interchangeably. *Cy pres* generally refers to charitable *cy pres*, which is the focus of this comment. Fluid recovery usually refers to a court ordering a future price reduction of the sales of the defendant's product for future consumers who are similarly situated to the class members. Kevin M. Forde, *What Can a Court Do with Leftover Class Action Funds? Almost Anything!*, JUDGES' J., Summer 1996, at 19; *see also* Martin H. Reddish, *Cy Pres Relief and the Pathologies of the Modern Class Action: A Normative and Empirical Analysis*, 62 FLA. L. REV. 617, 625 (2010).

[3] Democratic Cent. Comm. of D.C. v. Wash. Metro. Area Transit Comm'n, 84 F.3d 451, 455 (D.C. Cir. 1996).

[4] *Id*.

[5] *See Airline Ticket Comm'n*, 268 F.3d at 625 (noting that use of the doctrine in class actions has been especially controversial in the appellate courts).

[6] *See* Reddish, *supra* note 2, at 635 (noting it is clear in *cy pres* cases that courts make no effort to ensure the award will indirectly benefit the injured class members).

[7] Goutam U. Jois, *The Cy Pres Problem and the Role of Damages in Tort Law*, 16 VA. J. SOC. POL'Y & L. 258, 259 (2008).

result, uninjured third parties can acquire generous awards intended for purportedly injured class members.[8]

In the 1801 English case of *Brudenell v. Elwes*, Chief Justice Lord Kenyon stated, "The doctrine of *cy pres* goes to the utmost verge of the law, even in the construction of wills; and we must take care that it does not run wild."[9] Lord Kenyon worried about the abuses that could result from a doctrine that granted chancellors such great discretion over directing funds.[10] Although Lord Kenyon could never have envisioned how the doctrine would come to be used in the class action context, his fear that its discretionary nature would allow the doctrine to "run wild" has been realized. In fact, a 2007 article in the *New York Times* echoes Lord Kenyon's concern about *cy pres* but in the class action context.[11] The article notes that *cy pres* awards are "an invitation to wild corruption of the judicial process."[12]

Courts have held that the choice of fund distribution options should be guided by the objectives of the underlying statute under which the original suit was brought, and the interests of the absent class members.[13] Under this line of reasoning, some appellate courts have struck down distributions that are not tied to the benefit of the class members.[14] However, a great number of courts have disregarded this principle and approved distributions that are almost entirely unrelated to the class members' injury or the underlying issue at the heart of the lawsuit.[15] Courts that approve such vaguely related distributions do a great disservice to the absent class members, while at the same time furthering the interests of the plaintiffs' attorneys,

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8 JOHN H. BEISNER, JESSICA D. MILLER & JORDAN M. SCHWARTZ, INST. FOR LEGAL REFORM, *CY PRES*: A NOT SO CHARITABLE CONTRIBUTION TO CLASS ACTION PRACTICE 1 (2010), *available at* http://www.instituteforlegal reform.com/sites/default/files/cypres_0.pdf.

9 *See* AMY MORRIS HESS, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES: A TREATISE COVERING THE LAW RELATING TO TRUSTS AND ALLIED SUBJECTS AFFECTING TRUST CREATION AND ADMINISTRATION § 431 (2000) (quoting Brudenell v. Elwes, 102 Eng. Rep. 171, 174 (1801)).

10 Brudenell v. Elwes, 102 Eng. Rep. 171, 174 (1801).

11 Adam Liptak, *Doling Out Other People's Money*, N.Y. TIMES (Nov. 26, 2007), http://www.nytimes.com/2007/11/26/washington/26bar.html.

12 *Id.*; *see also* S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 416 (S.D.N.Y. 2009) ("Absent specific legislation, courts are left with unfettered discretion to direct the distribution of what can be large sums of money.").

13 Six Mexican Workers v. Ariz. Citrus Growers, 904 F.2d 1301, 1304 (9th Cir. 1990).

14 *See, e.g.*, *Six Mexican Workers*, 904 F.2d at 1304 (setting aside the district court's distribution because it did not serve the goals of the statute or protect interests of absent class members); Wilson v. Southwest Airlines, Inc., 880 F.2d 807, 809 (5th Cir. 1989) (setting aside *cy pres* distribution because the court failed to balance all interests); *In re* Folding Carton Antitrust Litig., 774 F.2d 1252, 1254 (7th Cir. 1985) (setting aside district court's *cy pres* distribution based on abuse of discretion).

15 *See, e.g.*, *In re* Compact Disc Minimum Advertised Price Antitrust Litig., No. MDL 1361, 2005 WL 1923446 (D.Me. Aug. 9, 2005) (approving a settlement where a *cy pres* distribution was made to a community arts center); Jones v. Nat'l Distillers, 56 F. Supp. 2d 355 (S.D.N.Y. 1999) (allowing distribution to a legal aid society despite a "thin" tie to purpose of litigation fund).

judges, the third party who receives the distribution, and—at times—even the defendants. Utilizing *cy pres* in this way can create ethical dilemmas and conflicts of interests for judges and attorneys, and creates a new "*cy pres* industry" in which charities send lobbyists to advocate for their cause to judges who have the authority to approve such a distribution.[16]

This comment argues that the use of *cy pres* in class actions effectively changes the incentives of parties involved in the proceeding, resulting in vast ethical implications. The best solution to this "*cy pres* problem" is one that maximizes the absent class members' interests while minimizing the interests of judges, plaintiffs' attorneys, and charities. Part II offers a brief background of the use of *cy pres*, from the origins of the doctrine to its use today in United States trust law, along with the evolution of the doctrine's use in class actions. Part III of this comment evaluates how the fairly recent introduction of *cy pres* into the adversarial judicial proceeding, especially in the class action context, has changed the traditional incentives of the parties involved in the proceedings and created ethical dilemmas. Finally, Part IV examines possible solutions to the *cy pres* problem and argues that statutory changes, particularly adding provisions analogous to the Class Action Fairness Act for federal class actions, are necessary to alter incentive structures to minimize abuses of the system and conflicts of interest.

I. BACKGROUND

A. *Origins of* Cy Pres *in Trust Law*

Cy Pres is a concept deeply entrenched in trust law.[17] The full name for the doctrine, "*cy pres comme possible*," is Norman French for "as near as possible."[18] The Restatement of Trusts notes the doctrine should be used when the specific charitable purpose for which property was placed in a trust no longer becomes a viable option either because it is unlawful, impossible, or impracticable to carry out the original purpose. In such cases, the court will direct the property to a charitable purpose that "reasonably approximates the designated purpose."[19] The testator's intent is accordingly executed "as nearly" as possible.[20]

At English common law, two powers of *cy pres* existed.[21] First, a chancellor of the court could exercise the judicial power of *cy pres*. The chancellor examined the intent of the original property in the trust, and then

16 *See, e.g.*, Jois, *supra* note 7, at 259-60.
17 Reddish, *supra* note 2, at 625.
18 HESS & BOGERT, *supra* note 9, § 431.
19 RESTATEMENT (THIRD) OF TRUSTS § 67 (2003).
20 *Id.* § 67 cmt. a.
21 EDITH L. FISCH, THE CY PRES DOCTRINE IN THE UNITED STATES § 1.00 (1950).

attempted to direct the funds to the next best use that most closely resembled the original intent.[22] Second, the king, acting as *parens patriae*, exercised the prerogative power of *cy pres*.[23] Under this power, the king had broad discretion to direct the funds to a purpose that was loosely connected to the original testator's intent.[24] Eventually, the chancellor became the king's proxy for this type of distribution.[25] This was a major development because it gave the judiciary the ability to exercise discretion as broad as the king's in directing the funds.

Most courts in the United States were originally hostile to the idea of *cy pres* in trust law and rejected both the judicial and prerogative forms of *cy pres* in several notable court decisions.[26] This hostility stemmed from the fear of giving too much power to the judiciary over such decisions, specifically the view that a chancellor would be able to use the *cy pres* doctrine to further his social or religious views at the expense of the testator's original intent.[27] Furthermore, many judges associated the doctrine with a monarchical government where the king could direct the funds to virtually any use he saw fit.[28] However, the doctrine has been accepted by most states over time, at least in the judicial form, with later decisions and legislation reversing the previous repudiations of the doctrine.[29] Today, forty-six states and the District of Columbia have codified judicial *cy pres* for use in trust law.[30]

Although each state enacted different statutes, most states generally set forth three requirements before *cy pres* can be utilized: (1) the testator must have a charitable intent in setting up the trust, (2) the gift must establish a valid charitable trust, and (3) the intended purpose of the gift must be impossible or impracticable to complete.[31] The first element, charitable intent, requires judicial discretion in determining the intent of the testator. However, this is subject to two restrictions: (1) if the gift is not charitable in nature, the doctrine of *cy pres* cannot be invoked,[32] and (2) the *cy pres* doctrine is not applicable to private trusts in trust law.[33] This second restriction means that if the gift was intended to go to a private party, but it became impossible or impracticable to fulfill the request (e.g., the recipient passed

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22 *Id*.

23 *Id.* § 2.03, at 56-57.

24 *Id*.

25 *Id*.

26 HESS & BOGERT, *supra* note 9, § 433.

27 *Id*.

28 *Id*.

29 *Id*.; Reddish, *supra* note 2, at 627.

30 Reddish, *supra* note 2, at 625 (*see infra* note 59 for a list of state statutes).

31 *Id*.; *see, e.g.*, UNIFORM TRUST CODE § 413 (2005); VA. CODE ANN. § 55-544.13 (West 2009). Many states have adopted the U.T.C. provisions which set out similar requirements.

32 Reddish, *supra* note 2, at 625.

33 RESTATEMENT (THIRD) OF TRUSTS § 67 cmt. a (2003).

away), then the gift could not be redirected to a charitable use.[34] Several states, such as Pennsylvania and Connecticut, have done away with the charitable intent requirement based on its subjective nature.[35]

B. *Introduction of Charitable* Cy Pres *into Class Actions*

After the amendment of Rule 23 of the Federal Rules of Civil Procedure in 1966, the role of class actions in the legal system greatly expanded.[36] One key revision was that in non-mandatory class actions, absent class members were automatically included in the class unless they affirmatively opted out of the action.[37] This adjustment intensified the problem of leftover funds following a class-wide settlement or a class-wide award.[38] In cases where a class-wide award is made or a class-wide settlement fund is created, individual class members must be compensated out of the established damage fund.[39] One court noted that often "the destiny of the disgorgement and penalties seems to have been an afterthought to the settlement."[40] Often, if some class members do not come forward to claim their awards or the process of searching for class members is too economically burdensome, funds that class members are technically entitled to will remain in the damage fund.[41] The sum remaining in these residual funds can be substantial.[42] In fact, it is often millions of dollars.[43] For example, in *West Virginia v. Pfizer*,[44] a $32 million fund remained undistributed from a $100 million settlement.[45] The question then becomes to whom the money should be distributed.

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34 *See id*. ("If at the time of the trust's creation its intended purpose is of no value to the community, or is otherwise not charitable by its nature, the trust is not enforceable as a charitable trust.").

35 Reddish, *supra* note 2, at 629; *see, e.g.*, 20 PA. CONS. STAT. ANN. § 7740.3 (West 2006) (see 2011 electronic update, "Modifies the doctrine of cy pres by presuming that the settlor had a general charitable intent when a particular charitable purpose becomes impossible or impracticable to achieve. Traditional doctrine did not supply that presumption, leaving it to the courts to determine whether the settlor had a general charitable intent.").

36 Reddish, *supra* note 2, at 630.

37 *Id.*; Fed. R. Civ. P. 23(c)(3)(B).

38 Reddish, *supra* note 2, at 630; *see also In re* Folding Carton Antitrust Litig., 557 F. Supp. 1091, 1104 (N.D. Ill. 1983), *aff'd* 744 F.2d 1252 (7th Cir. 1984).

39 Reddish, *supra* note 2, at 631.

40 S.E.C. v. Bear Stearns & Co. Inc, 626 F. Supp. 2d 402, 405 (S.D.N.Y. 2009) [hereinafter "S.E.C. v. Bear Stearns"].

41 *Id.*; *see also* Forde, *supra* note 2, at 19.

42 Jois, *supra* note 7, at 266.

43 *See, e.g.*, *id.* (citing *New Civil Litigation and Dispute Resolution Program Granted $ 2.9 Million*, VANDERBILT NEWS SERVICE, Oct. 31, 2005).

44 314 F. Supp. 710 (S.D.N.Y. 1970).

45 Forde, *supra* note 2, at 19 (citing West Virginia v. Chas. Pfizer & Co., 314 F. Supp. 710 (S.D.N.Y. 1970)).

Generally, the origins of *cy pres* in the class action context are attributed largely to a student comment published in 1972.[46] Prior to the use of charitable *cy pres*, the residual funds often reverted back to the defendant or escheat to the state—commonly known as a form of fluid recovery.[47] The use of *cy pres* stems from the court's broad discretionary powers in "shaping equitable decrees."[48] The 1972 comment argued that leftover funds in the class action process could be directed to the "next best" use by the court, using a new version of the *cy pres* doctrine.[49] The comment noted that funds could be distributed to the remaining class members who originally came forward with claims, escheat to the state, or the money could be distributed through the market.[50] It also noted that in order to best analogize the *cy pres* doctrine in the trust law context, the funds should go to the "nearest possible" or "next best" use which would benefit the class members.[51] The comment proposed a form of *cy pres* in the class action context that would be most similar to the one used in trust law.[52] Over a decade after the comment was published, additional scholarship argued that residual funds in class actions should be donated to charity or nonprofit organizations, even if the organization's purpose was only remotely related to the class member's injury.[53]

When the doctrine was initially introduced into the class action process, it was generally used under two conditions.[54] First, the funds had to be impossible or impracticable to distribute.[55] This problem can arise after the initial distribution has been made but some class members do not come forward to claim their share or cannot be located by the court.[56] *Cy pres* has also been used when it is economically infeasible to distribute money to all

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46 Reddish, *supra* note 2, at 631 (citing Stewart R. Shepherd, Comment, *Damage Distribution in Class Actions: The Cy Pres Remedy*, 39 U. CHI. L. REV. 448, 448 (1972)).

47 Many state statutes authorize leftover funds to escheat to the state after going unclaimed for a number of years. Similarly, there is a federal statute that applies to class actions in federal court. *See, e.g.,* 28 U.S.C.A. § 2041 (West 2006).

48 Van Gemert v. Boeing Co., 739 F.2d 730, 737 (2d Cir. 1984) ("The critical determining factor . . . is that trial courts are given broad discretionary powers in shaping equitable decrees. Equitable remedies are a special blend of what is necessary, what is fair, and what is workable.").

49 Stewart R. Shepherd, Comment, *Damage Distribution in Class Actions: The Cy Pres Remedy*, 39 U. CHI. L. REV. 448, 448 (1972).

50 *Id*.

51 *Id*.

52 Reddish, *supra* note 2, at 633.

53 *Id*. at 633-34 (noting that two more student comments were published in 1987 with this argument); *see also* Kerry Barnett, Note: *Equitable Trusts: An Effective Remedy in Consumer Class Actions*, 96 YALE L.J. 1591, 1595 (1987).

54 Reddish, *supra* note 2, at 633.

55 *Id*.

56 Six Mexican Workers v. Ariz. Citrus Growers, 904 F.2d 1301, 1307 (9th Cir. 1990).

of the class members.[57] Second, when residual funds remained, the court could invoke the doctrine by assigning the funds to the "next best" use to indirectly benefit the class members.[58] Used in this context, it was most analogous to the use of the doctrine in charitable trust law.[59] The rationale behind the use of *cy pres* in class actions is that it prevents the defendant from walking away from the litigation without paying the full cost of damages because of difficulty in distributing the funds to each class member individually.[60]

The first case to use a form of *cy pres* in an adversarial judicial proceeding was *Miller v. Steinbach* in 1974.[61] There, the court approved a settlement agreement in a stockholders' derivative suit where the size of the fund and the vast number of plaintiffs made it impracticable to distribute the funds.[62] Instead, according to the court, the parties agreed to apply "a variant of the *cy pres* doctrine at common law."[63] The court noted that while there was no precedent for using the *cy pres* doctrine in this context, there was also no legal prohibition against it.[64] Interestingly enough, the court acknowledged that approving the settlement would only benefit the plaintiffs' counsel and "perhaps several [of the companies] employees" but would "certainly not benefit those on whose behalf the action was brought."[65] However, the court also reasoned that no alternative was realistically possible at that point.[66]

Although some courts have stated the use of *cy pres* in class actions was intended to reflect the doctrine in trust law,[67] the "as near as possible"

57 *In re* Pharm. Indus. Average Wholesale Price Litig., 588 F.3d 24, 34 (1st Cir. 2009) (citing Molski v. Gleich, 318 F.3d 937, 954-55 (9th Cir. 2009) (rejecting a settlement because it was feasible to compensate class members individually)).

58 *See Six Mexican Workers*, 904 F.2d at 1307.

59 *See generally* Shepherd, *supra* note 49, at 448.

60 *See* Mirfasihi v. Fleet Mortg. Corp., 356 F.3d 781, 784 (7th Cir. 2004) ("In the class action context the reason for appealing to cy pres is to prevent the defendant from walking away from the litigation scot-free because of the infeasibility of distributing the proceeds of the settlement (or the judgment, in the rare case in which a class action goes to trial) to the class members.").

61 Beisner, *supra* note 8.

62 The court noted that if the funds were distributed to the claiming parties it would only be around $0.12 per share. Miller v. Steinback, No. 66 Civ. 356, 1974 WL 350, *1 (S.D.N.Y. 1974).

63 Martin H. Reddish, *Cy Pres Relief and the Pathologies of the Modern Class Action: A Normative and Empirical Analysis*, 62 FLA. L. REV. 617, 625 (2010) (citing Miller v. Steinbach, No. 66 Civ. 356, 1974 WL 350, at *2 (S.D.N.Y. Jan. 3, 1974) (noting that while there was no precedent for such an agreement, there was also no precedent that would prohibit it)).

64 *Miller*, 1974 WL at *2.

65 *Id.*

66 *Id.*

67 *See, e.g.*, Six Mexican Workers v. Ariz. Citrus Growers, 904 F.2d 1301, 1307 (9th Cir. 1990).

approach to indirectly compensating the victims is rarely used.[68] This is evident from the *Miller* case.[69] In addition, some courts have equated the use of residual funds for the general welfare instead of the "next best" use.[70] Currently, the use of *cy pres* in class actions is far from a neutral method in which to distribute unclaimed property or redirect the funds to the "next best" use. While it troubled the court in *Miller* to approve a *cy pres* distribution,[71] many courts readily approve such distributions today without any mention of the potential consequences or inequities to absent class members.[72]

A fairly recent example of a court approving a *cy pres* distribution to an organization completely unrelated to the injury the plaintiffs suffered is *In re Compact Disc Advertised Price Antitrust Litigation*.[73] The case involved an antitrust action regarding the prices of compact discs.[74] The *cy pres* award was given to the National Guild of the Community School of Arts.[75] Although it can be argued that the School of Arts was in some way connected to absent class members since the litigation involved music, it was not related to the class members' injury: overpaying for a compact disc.[76]

In addition to directing money to unrelated organizations, use of the doctrine in class actions has other controversial aspects. In its modern form, the doctrine permits the distribution of funds to uninterested parties before there are even any residual funds left over.[77] *Cy pres* awards are now determined ex ante in about 25 percent of class actions that involve such distributions.[78] *Cy pres* is also sometimes used as a mechanism by the parties, with the approval of the court, as a way of overcoming class man-

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68 *See* Reddish, *supra* note 2, at 634 (noting that the current form of *cy pres* in class actions involves the donation of a portion of the settlement or award fund to charitable uses which are loosely connected to the substance of the case).

69 *Miller*, 1974 WL at *2.

70 Charles N.W. Keckler, *Cy Pres and Its Predators*, *in* THE PURSUIT OF JUSTICE: LAW AND ECONOMICS OF LEGAL INSTITUTIONS 217 (2010).

71 *See Miller*, 1974 WL 350, at *2 (discussing the problems associated with distributing the funds in a way that would not benefit the class members).

72 *See, e.g.*, *In re* San Juan Dupont Plaza Hotel Fire Litig., 687 F. Supp. 2d 1 (D. P.R. 2010). In this mass-tort litigation case, over $100,000 of remaining funds were distributed to the Animal Legal Defense Fund based on a letter submitted by the organization. The court did not address whether the distribution to the organization benefitted, or was in any way related to the injuries of, the absent class members.

73 *In re* Compact Disc Minimum Advertised Price Antitrust Litig., No. MDL 1361, 2005 WL 1923446 (D.Me. Aug. 9, 2005).

74 *Id*.

75 *Id*.

76 Reddish, *supra* note 2, at 634 (citing *In re* Compact Disc Minimum Advertised Price Antitrust Litig., No. MDL 1361, 2005 WL 1923446 (D.Me. Aug. 9, 2005)).

77 *Id*. at 657.

78 *Id*.

ageability issues.[79] The *cy pres* award thus becomes an essential part of some class actions by assuring the court that the distribution of a class settlement or award will be sufficiently large to make the entire class proceeding worthwhile and manageable.[80] Without the use of *cy pres* in certain class actions, the payout to the class members would be too minimal to certify the class.[81]

II. *CY PRES* AND CHANGING INCENTIVE STRUCTURES

Charitable *cy pres* distributions effectively add third parties to adversarial proceedings, in the form of charities and nonprofit organizations. Compared to the traditional incentives in the adjudicatory process, introducing another party into a traditionally bilateral proceeding generates significant changes in incentives structures.[82] Judges are often given great discretion in approving a settlement.[83] Typically, the judge is also given wide latitude to decide where to direct the *cy pres* award, thus giving the judge incentives to consider his own interests and those of a third party organization he views as worthy to receive the funds.[84] Incentives that stem from the judge's discretion can create conflicts of interest, which in turn can create an appearance of impropriety on the part of the judge.[85]

Other times, the plaintiffs' attorney or the defendant is left to decide where to direct the funds, pending approval from the opposing side and the judge.[86] Since the plaintiffs' attorney's fee is often based on a percentage of the entire award, including the *cy pres* award, counsel for the class has a financial incentive to seek such an award.[87] *Cy pres* has also created a "*cy pres* industry" where charities, nonprofits, and even law schools lobby the judiciary to direct funds to their organizations.[88] In evaluating how *cy pres* has changed the incentives of parties involved, it is necessary to look at

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79 *See, e.g., In re* Hotel Tel. Charges, 500 F.2d 86, 89-90 (9th Cir. 1984); *see also* Windham v. Am. Brands, 565 F.2d 59, 72 (4th Cir. 1977).

80 Reddish, *supra* note 2, at 621.

81 *Id.*; *see also* Miller v. Steinback, No. 66 Civ. 356, 1974 WL 350, at *2 (S.D.N.Y. 1974) (recognizing that the class may not have been manageable).

82 Reddish, *supra* note 2, at 641.

83 Besiner et al., *supra* note 8, at 1.

84 *Id.*

85 *Id.* at 13. *See infra* pp. 283-84 for an example of judicial impropriety.

86 In rare cases, a fund administrator may be appointed to direct the funds. *See* Reddish, *supra* note 2, at 641.

87 WILLIAM B. RUBENSTEIN, ALBA CONTE & HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 14.5 (4th ed. 2011).

88 S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 409 (S.D.N.Y. 2009) (noting that representatives from organizations appeared at hearings and requested that a portion of remaining funds be set aside for their organization).

models of incentive structures for each party in a traditional adjudicatory class action proceeding and how these parties should ideally behave.

A. *Judges*

Judicial decision making has been the object of a vast body of social science and legal literature.[89] In one model of judicial decision making, the elements influencing decisions include the judge's own ideology, preferences, or values.[90] Other scholars argue that judges will behave in an altruistic fashion.[91] Judge Richard Posner offers a general structure for conceptualizing judicial decision making that takes into account multiple theories and a mix of factors.[92]

Judge Posner contends that the motivations constructing a "judicial utility function" include income, reputation, prestige, and popularity.[93] Although the model does not include a judge's desire to maximize or promote the public interest as part of the "ordinary judge's" utility function, Judge Posner also posits that public interest considerations undoubtedly affect judicial preferences.[94] Federal judges generally have life tenure and will not be removed unless there is an outright ethical violation.[95] Their monetary incentives, or "carrots and sticks," are notably lacking.[96] As their source of monetary income is fairly stable, other motivations weigh more heavily on their utility function.

Although Judge Posner's analysis applies to appellate judges, the analysis is usefully applied to any federal or state judges since, as stated above, they are generally insulated from significant economic incentives.[97] He notes that some judges, concerned primarily with policy:

> [S]tart by making the legislative judgment, . . . what rule or standard or principle enunciated in their judicial opinion—would have the best consequences. Only then do they consider

89 *See generally* Jack Knight, *Are Empiricists Asking the Right Questions About Judicial Decisionmaking?*, 58 DUKE L.J. 1531, 1534-1538 (2009) (describing trends in literature evaluating judicial decision making).

90 *Id*. at 1534.

91 Lynn A. Stout, *Judges as Altruistic Hierarchs*, 43 WM. & MARY L. REV. 1605, 1606 (2002).

92 Knight, *supra* note 89; *But see* Craig Green, *What Does Richard Posner Know About How Judges Think?*, 98 CAL. L. REV. 625 (2010) (critiquing Judge Posner's approach).

93 Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, SUP. CT. ECON. REV., 1993, at 15. The model for this utility function is $U = U(tj, tl, I, R, O)$ where tj is the number of hours per day that the judge devotes to judging, tl is the time he devotes to leisure, I is pecuniary income, R is reputation, and O represents other sources of utility such as popularity, prestige, and avoiding reversal. *Id*. at 31.

94 *Id.* at 14.

95 *Id*.

96 Stout, *supra* note 91, at 1606.

97 Posner, *supra* note 93, at 1.

> whether that outcome is blocked by the orthodox materials of legal decision-making, or more precisely, whether the benefits of that outcome are offset by the costs that it would impose in impairing legalist values . . . .[98]

Analyzing judicial decision making under Judge Posner's model provides insight into judicial behavior that may change when *cy pres* is brought into the decision of whether to approve a settlement. The broad discretion judges are given in approving *cy pres* awards will likely result in changed incentives. One court stated that district courts generally "enjoy considerable range in approving or disapproving a class settlement, given the generality of the standard and the need to balance benefits and costs."[99] If the judge is given discretion to direct the distribution to whatever charity she wishes, this may change her income function. If the judge awards the distribution to her favorite charity or organization, this likely increases her utility similar to an increase in income. Discretion over where to direct the money is thus an additional monetary incentive, or "carrot," that may push the judge to approve a settlement with a *cy pres* award.

Alternatively, in some cases the parties decide ex ante where to distribute the funds, thus keeping the final decision from the judge. However, the presiding judge still has ultimate authority to approve the *cy pres* award, which may provide incentives similar to those where she has discretion over where to direct the money. If she approves the settlement with the *cy pres* award, she may be praised as the "benevolent judge," which could very likely increase her prestige and popularity with both plaintiffs' attorneys and outside organizations.[100] Many scholars believe judges want to be popular with attorneys.[101] In fact, in Judge Posner's model, being praised for benevolence positively impacts a judge's prestige and popularity functions.[102]

There are several ways the use of *cy pres* in class action settlements can place judges in ethically compromising situations.[103] First, as noted above, the judge may have discretion over where to direct the *cy pres* distributions.[104] Since an impartial or unbiased judge should never award a *cy*

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98 Knight, *supra* note 89, at 1541 (quoting RICHARD A. POSNER, HOW JUDGES THINK 1, 84 (2008)).

99 Nat'l Ass'n of Chain Drug Stores v. New England Carpenter Benefits Fund, 582 F.3d 30, 45 (1st Cir. 2009).

100 *See* Jim Mustian & Chuck Williams, *Judge Doug Pullen's 'Gifts': Records Reveal Judge Directed Millions to Mercer and Morehouse, Gained Recognition,* LEDGER-ENQUIRER (Aug. 21, 2011), http://www.ledger-enquirer.com/2011/08/21/1701279/pullens-gifts-records-reveal-judge.html (noting that a judge in Georgia was praised for directing various *cy pres* awards to certain organizations).

101 Mustian & Williams, *supra* note 100; Posner, *supra* note 93, at 15.

102 Posner, *supra* note 93, at 15.

103 Beisner et al., *supra* note 8.

104 Sam Yospe, Note, *Cy Pres Distributions in Class Action Settlements*, 2009 COLUM. BUS. L. REV. 1014, 1020 (2009).

pres distribution or approve a settlement with a distribution based on his own preferences for a charity or organization, approval of an award can easily appear improper in certain situations.[105] One federal judge noted that *cy pres* distributions create an "appearance of impropriety" if the money goes to a judge's favorite charity.[106]

Awards directed by a small Georgia circuit court present a prime example of the ethical dilemmas that can arise.[107] One Chattahoochee Circuit judge awarded over $33.8 million to charities, nonprofits, and universities in the last several years, all though *cy pres*.[108] He is now being investigated by the State's Judicial Qualifications Commission for possibly benefitting from directing the awards to certain organizations.[109] For instance, multiple awards were directed towards Mercer School of Law, where the judge attended law school and taught part-time.[110]

Other troubling situations involve settlements that include *cy pres* awards that benefit either the defendant or the plaintiffs' attorneys, as opposed to the actual plaintiffs.[111] Further, approval of a *cy pres* award to a charity or organization that is not "worthy" is also questionable.[112] The Seventh Circuit, in rejecting the use of *cy pres* to set up a foundation in an antitrust class action that would be used to conduct research for antitrust issues, stated that the establishment of the proposed foundation would be "carrying the coals to Newcastle," or absolutely pointless.[113] The court noted that approving a settlement where the majority of the money would go to setting up a foundation to research a topic that has already been extensively researched by the legal community would be an abuse of discretion.[114]

Introducing *cy pres* into the adjudicatory process transforms supposedly impartial decision makers into grant supervisors.[115] This raises the question of whether the court should have the authority to decide where the money goes at all.[116] Taking this authority out of the hands of the judges

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105 *See* Beisner et al., *supra* note 8, at 13-14 (noting that allowing judges to choose how to spend other people's money is not a true judicial function and can lead to abuses).

106 S.E.C. v. Bear Sterns*,* 626 F. Supp. 2d 402 (S.D.N.Y. 2009). The judge also cites to the ALI Principles.

107 Mustian & Williams, *supra* note 100.

108 *Id*.

109 *Id*.

110 *Id*.

111 *See* Diamond Chem. Co., Inc. v. Akzo Nobel Chem. B.V., 517 F. Supp. 2d 212, 220 (2007) (approving a settlement with $5 million directed to plaintiff attorney's law school).

112 *See In re* Folding Carton Antitrust Litig., 744 F.2d 1252, 1254 (1984).

113 *Id*. at 1254.

114 *Id*. at 1255.

115 *See* Jois*, supra* note 7, at 259, 265 (citing Adam Liptak, *Doling Out Other People's Money*, N.Y. TIMES (Nov. 26, 2007), http://www.nytimes.com/2007/11/26/washington/26bar.html).

116 *See id*.

would immediately extinguish any such concerns and appearances of impropriety.

B. *Plaintiffs' Attorneys*

Agency theory can be useful for describing the lawyer's role as an agent of the client.[117] The agency relationship exists when the principal engages the agent to "perform some service on their behalf which involves delegating some decision making authority to the agent."[118] In such situations, the interests of the agent may diverge from those of the principal, leading to agency costs.[119] Traditional agency theorists offer two ways of reducing such costs: monitoring by the principal and bonding by the agent.[120] A third avenue for reducing agency costs, particularly in the attorney–client relationship, is aligning the incentives of the agent (lawyer) more closely with the principal (client).[121] Although there is a regulatory scheme in place in the judicial system to combat such problems in the general area of class actions,[122] such a system may not be useful for preventing additional problems that arise when *cy pres* is utilized.

The traditional role of the attorney is that of an independent professional advocating on behalf of her client, thus acting as an agent of the client and subject to the client's control in important matters.[123] However, class action attorneys do not fall into this traditional role, further complicating the traditional principal–agent relationship.[124] Instead, they function as "entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over important decisions in the lawsuit."[125] This leads to the possibility of the entrepreneurial attorney serving her own interests and not those of her client.[126] The attorneys are only subject to

117 Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendation for Reform*, 58 U. CHI. L. REV. 1, 12 (1991).

118 *Id*. (quoting Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976)).

119 *Id*.

120 *Id*. at 13 (citing Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976)).

121 *Id*.

122 Such safeguards include the use of representative plaintiffs and features to weed out bad representative class members. Attorneys are subject to legal ethics that purport to constrain their behavior. *Id*. at 3.

123 Macey & Miller, *supra* note 117, at 3.

124 *Id*.

125 *Id*.

126 *Id*.

constraints imposed on them by ethical codes, judicial oversight, and their "own sense of ethics and fiduciary responsibility."[127]

Plaintiffs' attorneys in class actions are generally not monitored with a watchful eye by their clients, who are often scattered across a state or even the entire country.[128] This renders monitoring—one of the typical solutions to agency costs—virtually useless in the class action context.[129] Although the interests of the class attorney may not always entirely coincide with the interests of the class members,[130] adding *cy pres* into the mix exacerbates this problem, since attorneys generally base their fees on the entire settlement or damage award, including the *cy pres* amount.[131] If the attorney is concerned primarily with her own interests, *cy pres* may be an attractive option to increase her fees at the expense of the absent class members. While in theory the class representatives should be monitoring the attorney, even if this were always possible, the attorney might then only look out for the interests of the "monitoring" clients.

Plaintiffs' attorneys' fees are calculated either as a percentage of the award or by the lodestar method.[132] The lodestar method calculates attorneys' fees by the amount of hours worked and how much effort the attorney put into the case.[133] Whether the fees are calculated by percentage or lodestar, on average they amount to about one-third of the award or settlement amount.[134] When calculating the fee based on percentage, the *cy pres* fund is almost always included.[135] Attorneys' fees will be tied directly—percentage based—or indirectly—lodestar—to the size of the class-wide award, including any *cy pres* distribution. Thus, the class attorney's financial interest will be isolated from her efforts to compensate individual class members.[136] This allows the attorney to ignore her responsibility to the class members, without sacrificing her fees. The focus becomes maximizing the total award, rather than the amount that goes directly to the class

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127 *Id*. at 8.

128 *Id*. at 3.

129 *See* Macey & Miller, *supra* note 117, at 3.

130 Theodore H. Frank, Cy Pres *Settlements*, CLASS ACTION WATCH, March 2008, at 1, *available at* http://www.fed-soc.org/doclib/20080404_FrankCAW7.1.pdf.

131 *See id*. at 22-23.

132 RUBENSTEIN ET AL., *supra* note 87.

133 Brooks Magratten, et al., *Calculating Attorney Fee Awards*, A.B.A. SEC. GEN. PRACTICE SOLO & SMALL FIRM DIV (Mar. 2010), https://www.americanbar.org/newsletter/publications/gp_solo_magazine_home/gp_solo_magazine_index/magratten_phillips_connolly_feldman_mamaysky.html.

134 *See* Reddish, *supra* note 2, at 639.

135 *Id.* (stating that the *cy pres* award is "always" included when calculating attorneys' fees).

136 *See* Alon Klement & Zvika Neeman, *Incentive Structures for Class Action Lawyers*, 20 J.L. ECON. & ORG. 102, 103 (2004), *available at* http://www.tau.ac.il/~zvika/JLEO2004.pdf (noting that when plaintiffs' attorneys are seeking their own private profit it often causes them "to behave in an opportunistic manner at the expense of the represented class").

members. Not only is such behavior unethical, it could also constitute a violation of the class members' due process rights.[137]

A recent example of how attorneys' fees can be tied to the *cy pres* award is found in a class action against Google.[138] The parties agreed to a settlement that the district court subsequently approved.[139] There, Google agreed to establish an $8.5 million common fund that included class administrator fees and expenses, class representative payments, attorneys' fees, and a *cy pres* award.[140] However, the settlement agreement also specified that the class counsel would seek up to 30 percent of the Common Fund, which included the *cy pres* distribution.[141]

The use of coupon settlements, another type of class action settlement, created analogous problems in the form of high attorneys' fees with little payout to the class members. Prior to the Class Action Fairness Act (CAFA), coupon settlements were a major problem because plaintiffs would receive almost no benefit from such a settlement.[142] A settlement in a Delaware state court case illustrates this problem.[143] There, a technology device manufacturer that produced a defective product agreed to a settlement that included the class members receiving coupons between $5 and $40 dollars on any future purchase of Iomega products.[144] The terms of the settlement also required Iomega to make a $1 million contribution of its products to schools.[145] The payout for the plaintiff's attorneys was $4.7 million.[146] The impropriety of this payout seems obvious. The class members of such settlements receive minimal—if any—benefit, and if they want to recover any value from the litigation, they are forced to deal with the defendant who wronged them.[147]

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137 For a more in depth discussion of possible due process violations, see generally Reddish, *supra* note 2, at 650.

138 *In re* Google Buzz User Privacy Litig., No. 5:10-CV-00672-JW, 2010 WL 6336647, at *5 (N.D. Cal. Sept. 3, 2010) (Verdict, Agreement and Settlement).

139 *Id*. at *2.

140 *Id*. at *5.

141 *Id*. at *8.

142 *See* S. REP. NO. 109-14, at 11-15 (2005) (explaining abuses of class actions through coupon settlements).

143 *Id*.; *see also* Rinaldi v. Iomega Corp., No. 98C-09-064-RRC, 41 U.C.C. Rep. Serv. 2d 1143, at *7-8 (Del. Super. Ct. Sept. 3, 1999); Gary Hinds, *Roy, Utah-Based Tech Company Settles Lawsuit with Rebate Offer*, STANDARD-EXAMINER, Apr. 14. 2001.

144 S. REP. NO. 109-14, at 11-15; *see also Rinaldi*, 41 U.C.C. Rep. Serv. 2d 1143, at *7.

145 S. REP. NO. 109-14, at 11-15; *see also Rinaldi*, 41 U.C.C. Rep. Serv. 2d 1143, at *7.

146 S. REP. NO. 109-14, at 11-15; *see also Rinaldi*, 41 U.C.C. Rep. Serv. 2d 1143, at *7.

147 *See* Susan B. Farmer, *More Lessons from the Laboratories:* Cy Pres *Distributions in* Parens Patriae *Antitrust Actions Brought by State Attorneys General*, 68 FORDHAM L. REV. 361, 394 (1999) (noting that this option is subject to criticism because class members must continue to buy from the defendant to recover their refund and an unintended effect of this is to give the antitrust violator an overall advantage in the marketplace because the artificially low prices increase its sales).

CAFA attempted to alleviate the coupon settlement problem in federal courts by requiring attorneys' fees in such settlement proceedings to be tied only to the actual value of the redeemed coupons.[148] CAFA does not require the same type of scrutiny in *cy pres* settlements.[149] This allows trial lawyers to base their fees on the entire settlement, including the *cy pres* fund.[150] While CAFA does restrict attorneys' fees when remaining coupons are donated to a charitable organization or government,[151] there is no mention of what should happen if actual funds and not coupons are donated to charity.

Since the implementation of CAFA, which placed stricter restrictions on various aspects of coupon settlements, many attorneys have shifted away from coupons and are pushing more readily for *cy pres*, in part because they will get larger fees.[152] This has turned *cy pres* into the new coupon settlement and may benefit class members even less than pre-CAFA coupon settlements since many class members are not receiving any benefit.[153]

Abuses by plaintiffs' attorneys in class actions can occur if the class action device is used improperly to increase litigation and settlement bargaining power for individual gain, with disregard for the claims of absent class members.[154] In addition, although *cy pres* was originally used in trust law to further the testator's intent—finding the next best use for the money that would satisfy his or her intent—the use of *cy pres* today in class actions often fulfills the plaintiffs' attorneys' intent by directing funds to the attorneys' favored charities[155] or by providing a basis for higher fee awards.[156]

One example of furthering the plaintiff attorney's intent and interests can be found in the case of *Diamond Chemical v. Akzo Nobel Chemicals.*[157] In this price-fixing case, the judge approved a $5.2 million settlement award to George Washington University Law School, the leading attorney's

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148 Class Action Fairness Act of 2005, 28 U.S.C. § 1712 (2006). The Act also expanded the jurisdiction the federal courts have to hear class action claims and resulted in most major class actions being heard in federal court. *See* Robert H. Klonoff & Mark Herrman, *The Class Action Fairness Act: An Ill-Conceived Approach to Class Settlements*, 80 TUL. L. REV. 1695, 1697 (2006).

149 *See generally* Class Action Fairness Act of 2005, 28 U.S.C. § 1712.

150 Frank, *supra* note 130.

151 S. REP. NO. 109-14, at 36 (2005) (noting attorneys' fees could not be based off remaining unclaimed coupons that are donated to charity or a government entity).

152 Frank, *supra* note 130 ("CAFA does not provide the same scrutiny to *cy pres* settlements [as it does to coupon settlements] and trial lawyers are shifting to that mechanism to accomplish the same task of maximizing return.").

153 *See* Reddish, *supra* note 2, at 626 (noting the number of *cy pres* awards in class action settlements sharply increased after 2001).

154 RUBENSTEIN ET AL., *supra* note 87, § 15:2.

155 *See, e.g.*, Diamond Chem., Inc. v. Akzo Nobel Chems., 517 F. Supp. 2d 212 (2007) (directing funds to the plaintiff attorney's alma mater).

156 *See, e.g.*, *In re* Google Buzz User Privacy Litig., 2010 WL 6336647 (N.D. Cal) (Verdict, Agreement and Settlement) (2010).

157 *Diamond Chem.*, 517 F. Supp. 2d 212 (2007).

alma mater.[158] The attorney was praised for his efforts and also added to the "L'Enfant Society" which is "the most prestigious of GW's gift societies" and membership in which is extended to individuals donating over $5 million.[159] This shows that prestige for the attorneys is an added incentive of securing a *cy pres* settlement to the charity or organization they prefer. Although in *Diamond Chemical* the attorneys' fees were only based on a percentage of the portion of the settlement that excluded the *cy pres* distribution,[160] in many cases attorneys' fees will be based on such a disbursement.

The American Law Institute's guidelines for aggregate litigation state, "A lawyer should advance the objectives of claimants or respondents. . . . [The] general duty on the part of lawyers [is] to pursue their interests when representing them."[161] When plaintiffs' attorneys agree to a *cy pres* award, they are agreeing to something that will not benefit the people they are supposed to represent.[162] The doctrine should only be utilized if class members cannot be found or it is economically infeasible to send each class member their portion of the settlement, but its availability disincentivizes attorneys to try to find class members. In addition, if attorneys agree to a *cy pres* award ex ante, too quickly, or at all, they are doing a major disservice to the absent class members and are not representing plaintiffs' interests properly.[163] While these actions may still serve deterrence goals, they do not directly benefit the class members, which should be a primary goal of litigation.[164]

Although not a class action, an analogous scenario in *S.E.C. v. Bear Stearns* illustrates what can happen when the court looks out for class members' interests.[165] In this antitrust case brought by the Securities and Exchange Commission, which subsequently settled, a fund administrator was appointed to give out the awards to investors who were harmed.[166] After the initial disbursements of the settlement funds, only 66 percent of the funds had been paid to the claiming investors.[167] At this point, some

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158 *See id.* at 212.

159 *George Washington University Leadership Donors, available at* http://development.gwu.edu/pdfs/2007donor_program.pdf (last visited Jan. 25, 2013).

160 *See* Diamond Chem. Co., Inc. v. Alzo Nobel Chems. B.V., 517 F. Supp. 2d 212 (2007) No. 02CV1018, 2003 WL 25625394 (Verdict, Agreement and Settlement).

161 AM. LAW INST., PRINCIPLES OF LAW FOR AGGREGATE LITIGATION § 3.07 (2009).

162 *See* Beisner et al., *supra* note 8, at 13 ("The bedrock of our system of civil justice is that a plaintiff who is injured can seek compensation for his or her injuries; using civil litigation to redistribute wealth to charities turns that fundamental goal on its head.").

163 *Id.*

164 *See* Barnett, *supra* note 53, at 1595 (noting that the goals for small claim consumer class actions are direct compensation, disgorgement, and deterrence and equity for absentee class members).

165 S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 409 (S.D.N.Y. 2009).

166 *Id.*

167 *Id.* at 408.

parties requested that the remaining funds go to charity.[168] Generally, in the analogous class action scenario, many courts would have approved such a request after the disbursement to class members, usually at the behest of the plaintiffs' attorney.[169]

Instead, the court in *Bear Stearns* directed the fund administrator to attempt to find the absent investors with an outreach program.[170] There was a 47 percent response rate and the majority of the claims were valid.[171] An additional 21 percent of the original disbursement funds was given out to the investors who made valid claims.[172] The court stated this was remarkable and underscored the importance of making more than one effort to solicit unresponsive claimants in any class action litigation.[173] In an analogous class action situation, where the plaintiffs' attorneys had advocated for directing the residual funds to charities instead of sending out the second notice, many absent class members who had valid claims would lose out on receiving their money.

C. *Charity/Not-for-Profit Organizations*

When a defendant's money is directed to a charity under *cy pres*, it introduces an artificially interested third party who was not harmed in any way by the defendant.[174] This turns a traditional bilateral adversary proceeding into something very different and rarely seen in any other judicial setting.[175] Nonprofits and charities have incentives to promote *cy pres* settlements and try to direct any residual funds to their organizations.[176] This has created a lobbying industry in which charities lobby the courts, rather than the legislature, which appears improper since a judge should be the impartial decision maker.[177]

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168 *Id*. at 409.

169 *Id*.

170 *Id.* at 410.

171 *Bear Stearns,* 626 F. Supp. 2d at 409 (additional distributions from Phase II totaled $92,956,548).

172 *Id.*

173 *See id*. at 409, 412 ("In many ways, this distribution process has been similar to that in class actions.").

174 *See* Reddish, *supra* note 2, at 622-623.

175 *Id*.

176 Charities such as Texas Access to Justice Foundation encourage individuals and attorneys to advocate for their cause to encourage courts to make *cy pres* awards to them. *See* Cy Pres*: Impact on Justice*, TEXAS ACCESS TO JUSTICE FOUND., http://www.teajf.org/donate/cy_pres.aspx (last visited Aug. 26, 2011).

177 This impropriety stems from the fact that the judiciary should be an impartial decision maker. The point of lobbying is to influence people's decisions; thus, lobbyists should not turn to judges, but to the legislature to advance their goals. *See* Frank, *supra* note 130.

In addition, in cases where the judge approves a settlement with a *cy pres* award that is then appealed, the charity on the receiving end of the award has an incentive to defend the award and submit amicus briefs to the higher court.[178] In a sense, the use of *cy pres* and the lobbying that goes with it transforms the judge into a "grant administrator."[179] The judiciary is ill-equipped to handle such a complication of the role of the judge in the proceeding.

For instance, in one case the court granted remaining funds to several charitable organizations.[180] The judge required annual reports to monitor the charities' handling of the money and established processes for continued funding.[181] This role as a grant administrator raises problems analogous to regulatory capture.[182] Scholars have argued that there are incentives to capture public institutions; thus, mixing *cy pres* into the judicial process brings with it the possibility of capture of the courts.[183] Ted Frank, a tort reform advocate, comments on this problem and states that one solution may be found in some states' existing law.[184] For instance, Illinois passed legislation requiring at least half of any *cy pres* award to go to a qualifying nonprofit charitable organization that has a principle purpose of providing access to justice for low-income residents.[185] He argues that it is much better that the legislative branch is lobbied over these issues than the judicial branch.[186] While this approach may solve the problem of lobbying the judiciary, it does not remedy situations where the award goes to a charity or organization that in no way benefits the absent class members.

In *S.E.C. v. Bear Stearns*, the judge stated that the court received regular mailings from various organizations soliciting donations of money from the residual funds that were not distributed.[187] He also noted that the $79 million in original residual funds "stimulated a cy pres feeding-frenzy."[188]

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178 Price v. Phillip Morris, No. 96326, 2005 WL 3434368, at *28 (Ill. Dec. 15, 2005) (Verdict, Agreement and Settlement); *see also* S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 409 (S.D.N.Y. 2009) (noting organizations appeared at hearings to request funds).

179 Jois*, supra* note 7, at 265.

180 Fears v. Wilhelmina Model Agency, Inc., 2005 U.S. Dist. LEXIS 7961, at 32 (S.D.N.Y. May 5, 2005).

181 Jois*, supra* note 7, at 265; *see also Fears*, 2005 U.S. Dist. LEXIS 7961, at 32.

182 Regulatory capture is the theory that regulatory agencies will be "captured" by certain entities they are appointed to monitor so the regulation favors those groups, not the public. *See* Jois*, supra* note 7, at 265 (citing George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971)).

183 *See id*. (citing Jon. D. Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics and Deep Capture*, 152 U. PA. L. REV. 129, 202-85 (2003)).

184 Frank, *supra* note 130.

185 *Id.*

186 *Id.*

187 S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 414 (S.D.N.Y. 2009).

188 *Id.*

While the court in *Bear Stearns* directed the fund administrator to find absent investors, the court in *Superior Beverage v. Owens* used a different tactic to decide where to direct the funds in that class action.[189] The parties settled with a *cy pres* fund that would be determined at some point after the settlement was arranged.[190] The court in the case advertised for suggestions from the public and awarded the funds to the "winning" projects after holding a hearing where representatives could advocate for their organizations' worthiness of receiving the funds.[191] Organizations were eager to lobby for their causes.[192] While the concept here may have been preferable to the judge or parties arbitrarily directing the funds, organizations still lobbied the court for an award, and ultimately the decision was left up to the judge.[193]

Perhaps there are fewer ethical implications on the part of the charities and organizations since many are worthy causes that deserve money. However, one problem arises when the money goes to an organization that initiates new litigation. In this respect, *cy pres* helps to promote the industry of non-economic litigation.[194] In many instances, *cy pres* distributions go to consumer-interest, litigation-related charities that may then use the distribution to finance new litigation of the same type. An example of this is in *In re Wells Fargo Securities Litigation*, where the court approved distributing funds to a clearinghouse run by a law school for publicizing securities litigation.[195]

The "*cy pres* feeding frenzy" that results from using the doctrine in class actions creates ethical implications. Charities should not be blamed for attempting to have money directed toward their worthy causes. However, the decisions must be taken out of the hands of judges and attorneys to counteract the increased use of lobbying.

III. SOLUTIONS TO THE *CY PRES* DILEMMA

If charitable *cy pres* is not used in the class action process to distribute unclaimed funds, courts have several other options. First, the money could

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189 *See* Superior Beverage Co., Inc. v. Owens-Illinois, Inc., 827 F. Supp. 477 (N.D. Ill. 1993).

190 KECKLER, *supra* note 70 (citing Superior Beverage Co., Inc. v. Owens-Illinois, Inc., 827 F. Supp. 477 (N.D.I.L. 1993)).

191 *See* Superior Beverage Co., Inc. v. Owens-Illinois, Inc., 827 F. Supp. 477 (N.D. Ill. 1993).

192 KECKLER, *supra* note 70.

193 *See Superior Beverage*, 827 F. Supp. at 477.

194 Jim Beck, *Cy Pres? No Way!*, DRUG & DEVICE LAW (Oct. 15, 2009, 8:00AM), http://druganddevicelaw.blogspot.com/2009/10/cy-pres-no-way.html.

195 *In re* Wells Fargo Sec. Litig., 991 F. Supp. 1193, 1198 (N.D. Cal. 1998).

escheat to the state or the treasury of the United States.[196] Second, the funds could go to the claiming plaintiffs, on a pro rata basis.[197] Third, the funds could revert back to the defendant.[198] Typically, prior to the use of *cy pres*, the courts used this third option.[199]

These other options are not necessarily less controversial.[200] Reversion of the funds back to the defendant certainly should not be used in litigated cases where a damage award—determined by a judge or jury—is left unclaimed. While reversion to the defendant may be a viable option in a mutually agreeable settlement setting, on its face it does not benefit absent class members. In addition, reversion to the defendant, even in the settlement context, will defeat the purposes of statutory deterrence goals, if the statute has such goals.[201] The two redeeming qualities of reversion to the defendant are that (1) it would likely eliminate class counsel's improper incentives because their fees would not be based on funds reverting to the defendant, and (2) it would take the decision of where to distribute the money out of the hands of the judge.

Once again, distributing the remaining funds on a pro rata basis to the claiming plaintiffs does not benefit absent class members, outside of the deterrence aspect of not allowing the funds to revert to the defendant. Some scholars and courts have argued against this approach, noting the claiming plaintiffs who receive the money on a pro rata basis will receive more than their properly apportioned amount.[202] Although this argument might not be as strong in the settlement context since the settlement award is not assessing actual damages, it still may result in a windfall to the claiming plaintiffs at the expense of the absent class members, thus improperly incentivizing plaintiffs to bring class actions.[203]

The best solution to the *cy pres* problem is one that restores the incentives of judges and plaintiffs' attorneys to those that arise in the traditional adversarial proceeding. The solution should maximize the absent class

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196 Reddish, *supra* note 2, at 619; *see also In re* Folding Carton Antitrust Litig., 744 F.2d 1252, 1258 (7th Cir. 1984) (holding that instead of invoking the *cy pres* doctrine, the money should escheat to the United States).

197 *See, e.g.*, *In re* Janney Montgomery Scott LLC Fin. Consultant Litig., No. 06-3202, 2009 WL 2137224 (E.D. Pa., July 16, 2009) (if unclaimed funds exceeded $50,000 the class members who filed valid claims would receive an additional pro rata distribution); *see also* Reddish, *supra* note 2, at 619.

198 Reddish, *supra* note 2, at 619; *see also* Jois, *supra* note 7, at 271 (citing telephone interview by Rachel Furman with Victoria Waciura, Vice President Bus. Dev., A.B. Data (Feb. 13, 2008)).

199 Beisner et al., *supra* note 8, at 13 (citing Kerry Barnett, Note: *Equitable Trusts: An Effective Remedy in Consumer Class Actions*, 96 YALE L.J. 1591, 1594 (1972)); *see also* Van Gemert v. Boeing Co., 739 F.2d 730 (2d Cit. 1984) (upholding reversion of unclaimed funds to the defendant).

200 *See generally* Reddish, *supra* note 2, at 619 (discussing the various problems with other uses of the undistributed funds).

201 *Id.*

202 *Id.*

203 *See id.*

members' interests while minimizing the improper incentives of judges, plaintiffs' attorneys, and charities.

A. *Class Actions in State Court*

Several states have implemented statutes that pre-determine what percentage of residual funds should go to a charity through *cy pres*.[204] The Washington state legislature enacted a statute requiring at least 25 percent of residual funds to be distributed to the Legal Foundation of Washington, which supports access to legal services for low-income individuals.[205] An Illinois statute states that a judge must distribute residual funds from a final judgment award to nonprofit organizations that meet certain criteria.[206] In the settlement context, the judge is allowed more discretion, and up to 50 percent of the residual funds can be distributed to nonprofits "that serve the public good."[207] Finally, a North Carolina statute requires that the distribution of any residual funds from a class action settlement be directed to a fund to subsidize legal services for the indigent population of the state.[208] The North Carolina statute is a step in the right direction, as it requires the entirety of the remaining fund to be distributed to a single organization and therefore takes the guesswork out of determining where the funds will go.[209] On the contrary, the Washington and Illinois statutes still leave the distribution of a substantial amount of the remaining funds to the judge's discretion.

The simple solution for class actions initiated in state courts should be for the money to escheat to the state in which the action was brought. Escheat is preferable to other solutions—even the North Carolina statute—since it produces the most benefits for the absent class members.[210] Escheat also fulfills deterrence goals by making the defendant internalize the full costs of the harm.[211] The only legitimate criticism against the funds escheating to the state is that it spreads the benefits to all state residents, rather than the absent class members who were harmed by the defendant's

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204 *See, e.g.*, 735 ILL. COMP. STAT. ANN. § 5/2-807(c) (Supp. 2008); N.C. GEN. STAT. § 1-267.10 (2005); *see also* Jois, *supra* note 7, at 267 (discussing the state statutes).

205 Jois, *supra* note 7, at 267; *see also* WAR SUPER CT. CIV. CR. 23(f).

206 735 ILL. COMP. STAT. ANN. § 5/2-807(c) (Supp. 2008).

207 Jois, *supra* note 7, at 267; *see also* 735 ILL. COMP. STAT. ANN. § 5/2-807(c) (Supp. 2008).

208 N.C. GEN. STAT. § 1-267.10 (2005).

209 N.C. GEN. STAT. § 1-267.10 (2005).

210 Jois, *supra* note 7, at 271.

211 This concept is similar to the debate regarding punitive damages going to the plaintiff versus escheat to the state. *Id.*; *see also* Barnett, *supra* note 53, at 1595 (noting that one of the goals of small claim consumer class actions is disgorgement and deterrence).

violation.[212] In theory, however, this criticism applies as much or more to other solutions.[213]

Typically, in state *parens patriae* actions, which are brought by state attorneys general on behalf of state residents, the residual funds have been used by the attorney general to fund a number of antitrust enforcement programs.[214] This type of distribution can similarly be used in class actions in state court. The funds should escheat to the state, and in certain cases may be earmarked for specific purposes that would benefit the class members, such as enforcing antitrust laws.[215]

Since CAFA was enacted, more class actions have been heard in federal court.[216] The majority of state class actions usually involve smaller aggregate damages and class members that reside in the forum state.[217] The administrative costs of identifying class members in federal class actions can be very high compared to the smaller aggregate claims generally found in state class actions. Alternatively, escheat to the state wastes virtually no money on administrative costs.[218] To save time and expense, the funds should revert to the state. More importantly, this solution would disincentivize certain parties, while benefitting the greatest number of absent class members.

B. *Class Actions in Federal Court*

If a class action is brought in federal court, there is greater difficulty in determining where to distribute the funds, given that the plaintiffs could be scattered throughout the country.[219] Allowing the funds to escheat to the United States Treasury is not as likely to benefit absent class members as escheating to the state in state class action.[220] Instead, fashioning a statutory remedy for the use of *cy pres* in federal courts would be helpful since the doctrine of *cy pres* is rooted in common law. Such a remedy should contain

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212 Farmer, *supra* note 147, at 394.

213 *See* discussion *infra* Part IV-Introduction.

214 Farmer, *supra* note 147, at 394.

215 Jois, *supra* note 7, at 271.

216 Klonoff & Herrman, *supra* note 148, at 1697 ("Under CAFA, most major class actions, including virtually all multistate class actions, will not be heard in federal court").

217 *See* S. REP. NO. 109-14, at 5 (2005) (noting interstate class actions "typically involve more people, more money, and more interstate commerce ramifications than any other type of lawsuit" and thus belong in federal court).

218 Barnett, *supra* note 53, at 1595.

219 *See* S. REP. NO. 109-14, at 4 (noting interstate class actions typically involve more people involved in interstate commerce).

220 Since the inception of CAFA, class actions brought in state court generally involve most of the plaintiffs residing in that state, where state-directed funds are more likely to benefit the absent class members. CAFA also helped deter class actions being brought in "favorable" state courts. *See generally* S. REP. NO. 109-14.

some provisions similar to the coupon settlement provisions in CAFA. First, it is important to examine Congress's intent when enacting CAFA to understand the prevalent abuses that Congress attempted to remedy. Second, by using CAFA as a model for how to combat certain *cy pres* abuses, a statutory solution to the *cy pres* problem can be fashioned.

1. Legislative Intent Behind CAFA

The primary purpose of enacting CAFA was to remedy abuses of the class action system by changing jurisdictional requirements and regulating the use of coupon settlements.[221] Congress was particularly worried about preventing abuses such as class counsel receiving disproportionate shares of settlements.[222] In the Senate Judiciary Committee Report accompanying the bill, the Committee noted that many courts were approving class action settlements in which most, if not all, monetary benefits went to class counsel instead of their clients.[223] The majority of these instances involved coupon settlements.[224]

One woman who was part of a class action settlement where the attorney payout was over $8.5 million stated she could not come to terms with that fact that "people who were supposed to be my lawyers, representing my interests took my money and got away with it."[225] Another example the Committee pointed to was a settlement that stemmed from an action against Nestle Water.[226] There, the plaintiffs alleged that Poland Spring water did not come from a water spring in Maine as advertised.[227] The case settled with coupons for free water bottles going to Poland Spring customers, $2.75 million going to charities, and $1.35 million going to the plaintiffs' attorneys for fees.[228]

CAFA contained a "Consumer Bill of Rights" which was enacted to protect class members.[229] While CAFA did not outwardly prohibit coupon settlements, it did subject them to greater scrutiny regarding whether the

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221 S. REP. NO. 109-14, at 21. For an example of a coupon settlement which contained problems the Committee was worried about, see Rinaldi v. Iomega Corp., No. 98C 09 064, 41 U.C.C. Rep. Serv. 2d 1143 (Del. Super. Ct. 1999).

222 S. REP. NO. 109-14, at 11.

223 *Id*. at 15.

224 *Id*.

225 *Id.* (citing *Class Action Lawsuits: Examining Victim Compensation and Attorneys' Fees: Hearings Before the Subcomm. on Administrative Oversight and the Courts of the Senate Comm. of the Judiciary*, 105th Cong. 14 (1997) (statement of Martha Preston)).

226 *Id.* at 17 (citing Ramsey v. Nestle Waters North American, Inc. d/b/a Poland Spring Water Co., No. 03 CHK 817 (Ill. Cir. Ct. Nov. 5, 2003)).

227 *Ramsey*, No. 03 CHK 817.

228 S. REP. NO. 109-14, at 17; *Ramsey*, No. 03 CHK 817.

229 S. REP. NO. 109-14, at 27-28.

coupons actually benefit the consumers.[230] Before a court can approve a coupon settlement, CAFA requires a fairness hearing.[231] In addition, CAFA regulates attorneys' fees in coupon settlements where either all or part of the remedy provided to the class members is in coupon form.[232] This restriction ensures that attorneys' fees are based on the value of the coupons that are actually redeemed by the class members.[233]

For instance, if a settlement agreement promises to issue $5 million in coupons, but only 20 percent of potential class members redeem the coupon, then the lawyers' contingency fee should be based on a recovery of $1 million actually redeemed and not $5 million promised.[234] This prohibition has caused a dramatic decrease in the number of coupon settlements.[235] Some scholars assert that class counsel may be inclined to turn to *cy pres* as a way to continue receiving high attorneys' fees because they can still base fees on the entire common fund, including the *cy pres* award.[236]

2. Statutory Solutions to the *Cy Pres* Problem in Federal Courts

Cy pres should be used only when absolutely necessary. A *cy pres* distribution would be "necessary" if every effort is made to find absent class members and residual funds are still leftover. For instance, if the settlement is large enough, each class member would receive a substantial amount—as in *S.E.C. v. Bear Stearns*, where over $79 million in residual funds remained[237]—and there is enough money to send out a second round of notices to find absent class members, then second phase notices should be used.[238] This approach would benefit the greatest number of class members, as evidenced in *Bear Stearns* when an additional 21 percent of the original distribution funds was distributed to people with valid claims.[239]

Once a second round is completed and residual funds still remain, *cy pres* can be utilized. A fund administrator who is a neutral third party, such

230 Donna L. Wilson, John W. McGuinness & Veronica D. Gray, *Settling Class Actions: Alternatives to Coupon Settlements After CAFA and Considerations for Corporate Defendants*, 16 ANDREWS CLASS ACTION LITIG. REP. 1 (2009).

231 S. REP. NO. 109-14, at 32.

232 *Id*. at 31.

233 *Id*.

234 *Id*.

235 *See id*. ("The Committee wishes to make clear that it does not intend to forbid all non-cash settlements. Such settlements may be appropriate where they provide real benefits to consumer class members.").

236 Frank, *supra* note 130.

237 Class members on average received $14,000 in settlement funds. *See* S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 412 (S.D.N.Y. 2009).

238 *Id*. at 411.

239 *Id*.

as the fund administrator in *Bear Stearns*, should be appointed to oversee the residual funds.[240] Plaintiffs' attorneys, defendants, and judges should have no say in where the funds are directed. The fund administrator may solicit bids from outside organizations through notice, similar to the process used in *Superior Beverage v. Owens*.[241] In determining where to direct the funds, the fund administrator must base the decision on what will be most beneficial to absent class members. This will help revert the doctrine back to the traditional form of the "next best" use. By taking the judge's discretion over the award out of the equation, charities will no longer need to lobby the judiciary.[242]

Finally, to disincentivize plaintiffs' attorneys from automatically pushing for a *cy pres* award, the common fund on which the attorney bases her fees should generally not include the *cy pres* award.[243] This would have an effect similar to CAFA's effect on coupon settlements.[244] Just as the CAFA provision on attorneys' fees helped to decrease the amount of coupon settlements, this provision would deter attorneys from agreeing to a *cy pres* award in order to increase their fees. This would also help deter or even eliminate class actions that would not be certified in the first place due to manageability issues if not for the *cy pres* award.

CONCLUSION

One appellate court, in rejecting a *cy pres* award because it distributed the class recovery to a third party, stated:

> Would it be too cynical to speculate that what may be going on here is that class counsel wanted a settlement that would give them a generous fee and [defendant] wanted a settlement that would extinguish 1.4 million claims against it at no cost to itself? The settlement that the district judge approved sold these 1.4 million claimants down the river.[245]

The agreement involved a settlement that would go entirely to a charity since the payout to the 1.4 million class members would be negligible. The

240 *See generally id.* (appointing a neutral third party as a fund administrator).

241 Superior Beverage Co., Inc. v. Owens-Illinois, Inc., 827 F. Supp. 477 (N.D. Ill. 1993) (the court solicited bids from outside organizations).

242 While reversion to the defendant or to the claiming class members has the same effect of eliminating judicial discretion over the funds, this solution still falls short because the "next best" use for benefitting the absent class members is not fulfilled by these solutions.

243 Since most class actions have absent class members that never come forward, attorneys' fees can perhaps still be based on the money these class members would have received. However, to deter attorneys from pushing for *cy pres* awards, rather than attempting to increase the amount of money class members receive, it should not be based on the entire fund if it is greater than a certain amount.

244 *See* Class Action Fairness Act of 2005, 28 U.S.C. § 1712 (2006).

245 Mirfasihi v. Fleet Mortg. Corp., 356 F.3d 781, 785 (7th Cir. 2004).

plaintiff's attorneys were awarded a very large sum based on a percentage of the settlement.[246]

The appellate court did an excellent job of summing up the problems that can arise when *cy pres* is used in class action settlements. The doctrine as it is used today is "an invitation to [the] wild corruption of the judicial process."[247] Many courts have disregarded the traditional principle of directing the funds to the "next best" use for the absent class members.[248] Instead, these courts have approved distributions that are almost entirely unrelated to the class members' injury or the underlying issue.[249] *Cy pres* changes incentives of the judge, possibly involving conflicts of interests and ethical dilemmas. It also changes the incentives of the class counsel and the charities or organizations that are at the receiving end of the award. Solutions to such problems include escheat to the state in state class actions and statutory provisions that control *cy pres* in federal class actions. Such simple solutions could make the difference in restoring each party's incentives to their proper place.

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246 *Id.*

247 Liptak, *supra* note 11; *see also* S.E.C. v. Bear Stearns, 626 F. Supp. 2d 402, 416 (S.D.N.Y. 2009) ("Absent specific legislation, courts are left with unfettered discretion to direct the distribution of what can be large sums of money.").

248 *See, e.g.*, *In re* Compact Disc Minimum Advertised Price Antitrust Litig., No. MDL 1361, 2005 WL 1923446 (D. Me. Aug. 9, 2005) (approving a settlement where a *cy pres* distribution was made to a community arts center); Jones v. Nat'l Distillers, 56 F. Supp. 2d 355 (S.D.N.Y. 1999) (allowing distribution to a legal aid society despite a "thin" tie to the purpose of the litigation).

249 *See, e.g.*, *In re Compact Disc*, No. MDL 1361, 2005 WL 1923446 (approving a settlement where a *cy pres* distribution was made to a community arts center); *Jones*, 56 F. Supp. 2d at 355 (allowing distribution to a legal aid society despite a "thin" tie to purpose of litigation fund).

KEEP YOUR EYE ON THE BRIBE: FOCUSING FCPA ENFORCEMENT

*Adam W. Park**

INTRODUCTION

After a municipal inspector confiscated his fruit cart, Mohamed Bouazizi set himself on fire.[1] Though those close to Bouazizi say that he acted for the sake of his own dignity,[2] his actions inspired hundreds of thousands of protesters to take the streets and demand an end to a dictator's reign and to protest a pervasive problem of corruption.[3] While the Tunisian movement and Bouazizi's protest inspired thousands in the United States to flood the streets of major cities in protest of wealth concentration in America,[4] the Department of Justice points to his act as a cry for help.[5] Assistant Attorney General Lanny Breuer recently reflected that the Foreign Corrupt Practices Act (FCPA)[6] has evolved over decades into an effective enforcement tool, but it is unclear that the history of the FCPA reveals that the statute intended to resolve problems of corruption overseas.[7] Although the Assistant Attorney General stated that the United States has gone too far in the fight against corruption to start going backwards, this history of the FCPA suggests that we have left something behind.

During the mid-1970s, information uncovered by the Watergate Special Prosecutor revealed a pattern of corporate conduct involving illegal

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1 *Assistant Attorney General Lanny A. Breuer Speaks at 26th National Conference on the Foreign Corrupt Practices Act*, U.S. DEP'T OF JUSTICE (Nov. 8, 2011), http://www.justice.gov/criminal/pr/speeches/2011/crm-speech-111108.html [hereinafter *Assistant Attorney General Lanny A. Breuer Speech*]; Rania Abouzeid, *Bouazizi: The Man Who Set Himself and Tunisia on Fire*, TIME (Jan. 21, 2011), http://www.time.com/time/magazine/article/0,9171,2044723,00.html.

2 Abouzeid, *supra* note 1.

3 *See Assistant Attorney General Lanny A. Breuer Speech*, *supra* note 1.

4 David Ariosto, *'Occupy' Protesters, Police Clash During 'Day of Action'*, CNN U.S. (Nov. 17, 2011), http://articles.cnn.com/2011-11-17/us/us_new-york-occupy_1_police-clash-riot-police-occupy-protesters?_s=PM:US; Bill Chappell, *Occupy Wall Street Timeline: From a Blog Post to a Movement*, NAT'L PUBLIC RADIO (Oct. 20, 2011), http://www.npr.org/2011/10/20/141530025/occupy-wall-street-from-a-blog-post-to-a-movement; *see About*, OCCUPY WALL STREET (Nov. 18, 2011), http://occupywallst.org/about/.

5 *See Assistant Attorney General Lanny A. Breuer Speech*, *supra* note 1.

6 Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78 (2006).

7 *Assistant Attorney General Lanny A. Breuer Speech*, *supra* note 1.

domestic political contributions.[8] Further investigation by the Securities and Exchange Commission (SEC) uncovered that the practice of making questionable or illegal payments by American corporations to foreign governments had persisted within the American business community.[9] More than 400 American corporations reported over $300 million in payments to foreign government officials to the SEC.[10] Legislators commented that these payments were bad business and were eroding the free market system by rewarding price-inefficient companies.[11] Other American government officials contended that direct prohibitions on corrupt foreign payments were needed to effectively deal with this problem.[12] Congress responded by passing the FCPA,[13] which, in addition to accounting provisions, included criminal penalties for American businesses issuing corrupt payments to foreign officials to secure business.[14]

Since its passage in 1977, however, the FCPA has come under frequent criticism.[15] Critical analyses conclude that American firms experience billions of dollars worth of lost business opportunities due to the risk of liability under the statute.[16] Though Congress has conceded amendments to loosen FCPA restrictions in order to level the playing field for American businesses, continued dedication to the fight against corruption has prevented lawmakers from completely appeasing the demands of American businesses.[17] Recent challenges to domestic corporations conducting business overseas led the U.S. Chamber Institute for Legal Reform to propose an amendment to the FCPA to decrease the burden imposed on corporations.[18] These proposed amendments limit corporate liability by (1) eliminating a parent company's liability for acts of a subsidiary, (2) increasing the *mens*

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8 MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., RL 300079, FOREIGN CORRUPT PRACTICES ACT (FCPA): CONGRESSIONAL INTEREST AND EXECUTIVE ENFORCEMENT 1 (1999); *Unlawful Corporate Payments Act of 1977: Hearing on H.R. 3815 and H.R. 1602 Before the Subcomm. on Consumer Protection & Finance of the H. Comm. on Interstate & Foreign Commerce*, 95th Cong. 212, 214 (1977) [hereinafter *Hearing on H.R. 3815*] (statement of the Hon. Harold M. Williams, Chairman, Securities and Exchange Commission).

9 SEITZINGER, *supra* note 8.

10 H.R. REP. 95-831, at 4 (1977).

11 H.R. REP. 95-640 at 4 (1977).

12 *See* SEITZINGER, *supra* note 8, at 3.

13 15 U.S.C. § 78 (2006).

14 SEITZINGER, *supra* note 8.

15 *Id.*

16 James Weber & Kathleen Getz, *Buy Bribes or Bye-Bye Bribes: The Future Status of Bribery in International Commerce*, 14 BUS. ETHICS Q. 699 (2004).

17 See Tor Krever, *Curbing Corruption? The Efficacy of the Foreign Corrupt Practices Act*, 33 N.C. J. INT'L & COM. REG. 83, 87 (2007) for a brief history of the FCPA, including amendments to the statute in 1988 and 1998.

18 *See* ANDREW WEISSMANN & ALIXANDRA SMITH, U.S. CHAMBER INST. FOR LEGAL REFORM, RESTORING BALANCE: PROPOSED AMENDMENT TO THE FOREIGN CORRUPT PRACTICES ACT 5 (2010), *available at* http://www.instituteforlegalreform.com/sites/default/files/restoringbalance_fcpa.pdf.

rea requirement for corporations,[19] and (3) limiting the scope of "foreign officials" covered under the current statute.[20] While a three-pronged approach to reducing the behavior covered under the statute would decrease the risk of corporate liability, such an approach may be better at reducing general compliance costs rather than providing focused relief to companies doing business with traditionally corrupt nations.

At the time of the FCPA's formation, Congress recognized that issues could arise from the disadvantage the statute imposed on American businesses.[21] Relying on the fact that corruption harms both our trade partners and competition, the government has persisted in its enforcement of the act, despite harmful effects on business.[22] These two interests, however, do not necessarily conflict with each other. This article proposes that to remedy the losses suffered by American businesses and to focus its energies on conduct most harmful to our trade partners, the Department of Justice (DOJ) should incorporate the economic lessons of other areas of Title 15 trade regulation to identify trade practices most harmful to competition and consumers.[23] Similar to antitrust law, which has evolved from a set of per se prohibitions to a complex body of economic analysis,[24] the DOJ should utilize economic reasoning to make assessments of transactions between American businesspeople and foreign officials. Just as antitrust jurisprudence departed from per se bans in favor of applying the rule of reason, FCPA allegations should be judged using a similar analysis.

Section I of this article presents the history of the FCPA and shows its legislative history indicates it was intended to regulate unfair trade practices, which harm the countries of officials receiving bribes and competition for such business. Section II explains the problems faced by corporations under current enforcement of the FCPA and further explains the solutions posed by the U.S. Chamber of Legal Reform. Section III argues that changes in the U.S.'s enforcement of antitrust laws may present a possible amendment to the FCPA. Finally, Section IV presents two changes to the DOJ's enforcement approach that would align with the purposes of the FCPA.

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19 Although the current FCPA limits an individual's liability to willful actions, it does not contain similar language for corporations, and therefore the omission extends the bounds of corporate liability beyond that of an individual.

20 *See* WEISSMANN & SMITH, *supra* note 18, at 5.

21 123 CONG. REC. 38,600 (1977).

22 *Id.*; Weber & Getz, *supra* note 16.

23 Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 9-12 (1984).

24 *Id.* at 9-10.

I. THE FOREIGN CORRUPT PRACTICES ACT OF 1977

The Watergate scandal and the SEC's voluntary disclosure program of the 1970s are typically viewed as the two events that inspired Congress to consider enacting anti-corruption legislation.[25] In addition to the break-in of the Watergate office complex in 1972, the investigation of the Nixon Administration revealed overseas "slush funds" that were used to illegally contribute to several political campaigns.[26] Subsequent investigations by the SEC revealed that undisclosed, illegal corporate payments were widespread.[27] In response, the SEC commenced a purportedly "vigorous enforcement program" under existing laws aimed at preventing the future concealment of illegal domestic and foreign payments.[28] In addition, the Commission instituted a four-year voluntary disclosure program, allowing SEC registrants to report questionable conduct to avoid costly litigation.[29] Over four years, the SEC received admissions from more than 500 corporations for questionable or illegal payments, which totaled over $300 million in corporate funds.[30]

In his testimony before a House subcommittee, Dr. Gordon Adams of the Council on Economic Priorities recited accounts of corrupt payments executed by several major American corporations.[31] Dr. Adams' testimony pointed out that nearly $200 million in commissions paid by Lockheed included commissions tied to contracts with the Japanese right wing.[32] Testimony by Lockheed's former chief operating officer revealed that one member of Japan's Liberal Democratic Party[33] received $7 million to act as Lockheed's secret agent to ensure that a major Japanese airline would purchase Lockheed jets.[34] Although the scandal did not have a clear impact on the party balance in the Japanese legislature, the prosecution of several Lib-

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25 Krever, *supra* note 17, at 87.

26 Courtney C. Thomas, Note, *The Foreign Corrupt Practices Act: A Decade of Rapid Expansion Explained, Defended and Justified*, 29 REV. LITG. 439, 442-43 (2010).

27 *Hearing on H.R. 3815*, *supra* note 8, at 214 (statement of the Hon. Harold M. Williams, Chairman, Securities and Exchange Commission).

28 *Id*.

29 *Id.*

30 Krever, *supra* note 17, at 87.

31 *Hearing on H.R. 3815*, *supra* note 8, at 28-30 (1977) (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities) (reporting bribery schemes of major American companies including Minnesota Mining and Manufacturing (now 3M), Gulf Oil (now Chevron), Northrop (now Northrop Grumman), Ashland Oil, and Lockheed (now Lockheed Martin)).

32 *Id*. at 26-28.

33 The Liberal Democratic Party held a long-standing majority in Japan's bicameral legislature, but feared voter backlash in the 1976 House of Representatives election because of frenzied media attention to the Lockheed bribery case. Michael Blaker, *Japan 1976: The Year of Lockheed*, 17 ASIAN SURVEY 81, 81 (1977).

34 *Id.* at 82.

eral Democratic Party leaders was the worst crisis in Japan's dominant political party's twenty-one year history.[35] Congressmen argued that these payments tarnished the image of American democracy abroad and brought friendly foreign governments under intense pressure from their own peoples, complicating American foreign policy.[36]

Some of the largest and most widely held public companies in America[37] also made these disclosures, including Exxon Mobil, Boeing, Northrop Grumman, Lockheed Martin, and Gulf Oil.[38] The practice of bribing foreign officials raised the concern that it corrupted the free market system, "under which the most efficient producers with the best products are supposed to prevail."[39] Virginia Senator William Proxmire stated that corporate bribery destroys the free market system, which should be based on price, quality, and service.[40] The Senator cited SEC findings that a substantial number of the foreign bribes disclosed were made to outcompete other American companies for the same business.[41] Additionally, overseas bribery was seen as derogatory to a corporation's image and thus harmful to trade and investment opportunities, thereby limiting a company's growth.[42]

Support for enacting a foreign bribery provision was not unanimous, and objectors pointed to the statute's threatened detriment on American businesses.[43] Criminalization through American laws was viewed as the most drastic approach to solving the problems caused by corporate bribery.[44] Corporate executives advocated for industry self-reform, arguing that corporations were already working towards reform through clarified company policy statements prohibiting such payments.[45] However, research commissioned by Congress indicated that many companies were dedicated to continuing corrupt practices.[46] When asked if he would fire a worker paying bribes abroad, one corporate chairman responded, "Hell, no! Why

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35 *Id.*

36 *E.g.*, 123 CONG. REC. 38, 599 (1977) (statement of Sen. William Proxmire).

37 *Hearing on H.R. 3815*, *supra* note 8, at 215 (statement of the Hon. Harold M. Williams, Chairman, Securities and Exchange Commission).

38 Krever, *supra* note 17, at 87.

39 *Hearing on H.R. 3815*, *supra* note 8, at 214 (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities).

40 123 CONG. REC. 38,599-60 (1977) (statement of Sen. William Proxmire).

41 *Hearing on H.R. 3815*, *supra* note 8, at 1-2.

42 *Id.* at 25-26 (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities).

43 *Id.* at 32-34, 59-66, 85-88 (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities) (Report on Questionable Foreign Payments by Corporations: The Problem and Approaches to a Solution, Ad Hoc Committee on Foreign Payments, for the Bar of the City of New York).

44 *See id.* at 32-33 (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities).

45 *Id.* at 33.

46 *Id.*

fire him for something he was paid to do?"[47] These corporations believed it was unrealistic to apply strict anti-bribery standards abroad, asserting that conforming to American ethical standards in foreign countries would lead to a competitive disadvantage with foreign multinationals.[48] Even the statute's most staunch supporters, such as Senator Proxmire, conceded the potential anticompetitive effects.[49] The Virginia Senator admitted that a nation's corporations could be disadvantaged in markets where another nation permits bribery, but he rebutted these concerns by emphasizing the statute's potential as leverage to negotiate a multilateral treaty prohibiting bribery.[50]

Rather than criminalize all conduct related to foreign payments deemed immoral or illegal, the Ad Hoc Committee on Foreign Payments for the Bar of the City of New York suggested that current antitrust regulations could address the bribery problem.[51] The committee believed that bribery constituted the necessary restraint of trade required for a violation of § 1 of the Sherman Act[52] when an American corporation utilized an intermediary or foreign subsidiary to collaborate on an illegal payment.[53] Additionally, provisions in the Clayton Act[54] and Federal Trade Commission Act[55] provide alternative outlets for prosecuting overseas bribery offenses.[56] These methods would provide not only Federal Trade Commission and DOJ enforcement, but would incentivize private suits seeking treble damages.[57] However, antitrust laws still were not tailored to fit the issues presented in a bribery suit and would not apply to bribes of tax or regulatory agencies, which would indirectly affect American commerce.[58]

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47 *Hearing on H.R. 3815*, *supra* note 8, at 33 (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities).

48 *See id.* at 34.

49 *See* 123 CONG. REC. 38, 600 (1977).

50 *Id*.

51 *Hearing on H.R. 3815*, *supra* note 8, at 59, 86 (Report on Questionable Foreign Payments by Corporations: The Problem and Approaches to a Solution, Ad Hoc Committee on Foreign Payments, for the Bar of the City of New York).

52 15 U.S.C. § 1 (2006).

53 *Hearing on H.R. 3815*, *supra* note 8, at 86 (Report on Questionable Foreign Payments by Corporations: The Problem and Approaches to a Solution, Ad Hoc Committee on Foreign Payments, for the Bar of the City of New York).

54 15 U.S.C. § 13(c) (2006).

55 15 U.S.C. § 45 (2006).

56 *Hearing on H.R. 3815*, *supra* note 8, at 86 (Report on Questionable Foreign Payments by Corporations: The Problem and Approaches to a Solution, Ad Hoc Committee on Foreign Payments, for the Bar of the City of New York).

57 *Id*.

58 *See id.* The Supreme Court would also later preclude the applicability of the Sherman Act to collaborations between a corporation and a foreign subsidiary. *See* Copperweld v. Independence Tube, 467 U.S. 752 (1984) (holding that a parent company is incapable of conspiring with its wholly owned subsidiary for the purposes of § 1 of the Sherman Act).

Despite objections, the House and Senate advanced resolutions,[59] and the FCPA was signed into law on December 19, 1977.[60] The law is divided into two provisions, each enforced by a different division of the government.[61] First, the statute required publicly held corporations to maintain accurate books and records, and to establish accounting controls to prevent firms from disguising corporate bribes.[62] The statutory accounting provisions addressed potential problems that overseas bribery would pose to stockholders and investors while mitigating the difficulties of enforcement.[63]

The second prong of the statute made it unlawful for any corporation issuing securities registered with the SEC or any "domestic concern"[64] to make any payment to a foreign official to obtain or retain business.[65] This provision carried penalties for violators including a maximum fine of $1 million for corporations, and a $10,000 fine and five-year maximum imprisonment for individuals.[66] Per the statute, the SEC and DOJ shared joint enforcement responsibility for the criminal bribery provisions.[67]

In 1987, an omnibus trade and competitiveness act was introduced in the Senate to modernize "very old trade laws," including the FCPA.[68] In enacting amendments to provide a clearer line between prohibited bribes and permissible facilitating payments, both houses insisted that their proposed amendments did not change the basic intent of the law.[69] In addition to consolidating enforcement of the anti-bribery provision with the DOJ, the amendments clarified the anti-bribery provision by establishing two clear affirmative defenses.[70] The first provided four examples of minor payments, which would fall under the statute's "grease payment" exception

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59 The bill was advanced through the House of Representatives as Unlawful Corporate Payments Act, H.R. 3815, 95th Cong. (1977) and through the Senate as the Foreign Corrupt Practices Act, S. 305, 95th Cong. (1977).

60 Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended at 15 U.S.C. § 78 (2006)).

61 *See id.*

62 *See* Presidential Statement on Signing the Foreign Corrupt Practices Act of 1977, 13 WEEKLY COMP. PRES. DOC. 1909 (Dec. 20, 1977).

63 *Hearing on H.R. 3815*, *supra* note 8, at 27 (statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities); H.R. REP. 95-831, at 19 (1977).

64 Domestic concern is defined as encompassing any individual who is a citizen, national, or resident of the United States, or any company, which has its principal place of business in the United States or is organized under the laws of the United States.

65 *See* Foreign Corrupt Practices Act, 91 Stat 1494, § 30 A (1977).

66 *See id.* §§. 103(c)(1)-(4), 104(b)(1)(A)-(B).

67 Krever, *supra* note 17, at 89.

68 H.R. 3, 100th Cong. (1987).

69 United States v. Kay, 359 F.3d 738, 750 (5th Cir. 2004).

70 United States Trade Enhancement Act of 1987, S. REP. No. 100-85, at 52-54 (1987).

from liability.[71] Second, the amendments exempted from liability any payment made in compliance with the written laws of a foreign country.[72] These clarifications of the statute's restrictions decreased the burden on businesses, but the 1988 amendments also increased penalties for violations.[73] A corporation's violation of the anti-bribery provisions increased to a $2 million maximum fine; individuals were subject to a $100,000 maximum fine and up to five years' imprisonment.[74]

Despite attempts to amend the FCPA to ease compliance burdens for American corporations, complaints resurfaced that the statute disadvantaged domestic companies in the global market.[75] Amendments introduced in 1998 sought to align the FCPA with the Organization for Economic Cooperation and Development (OECD)[76] Anti-Bribery Convention (the Convention) with the hope that other countries would quickly follow the U.S.[77] The Convention, adopted by the U.S. in 1997,[78] established a procedure for self and mutual evaluation of anti-bribery provisions among ratifying countries.[79] These amendments—leveling the playing field in international trade—sought to address concerns that American corporations lost upwards of $30 billion per year because of unfair competition in foreign countries where bribes were paid.[80]

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71 *Id.* at 59 (providing that the types of payments permissible under the FCPA are (1) any facilitating or expediting payment to expedite or to secure the performance of a routine governmental action, (2) any nominal payment, gift or offer, or promise which constitutes a courtesy, a token of regard or esteem, or in return for hospitality, (3) any reasonable and bona fide expenditures associated with selling or purchasing goods or with the demonstration of products, and (4) any reasonable bona fide expenditures associated with the performance of a contract).

72 *Id.* (adopting an amendment stating that "[i]t shall be an affirmative defense to any violation of this Act that a payment, gift, offer or promise of anything of value to a foreign official is lawful under the law and regulations of the foreign official's country").

73 H.R. REP. NO. 100-576, at 923-924 (1988).

74 *Id*. at 924.

75 *See* Presidential Statement on Signing the International Anti-Bribery and Fair Competition Act of 1998, 34 WEEKLY COMP. PRES. DOC. 2290 (Nov. 10, 1998) [hereinafter Signing Statement on International Anti-Bribery] (acknowledging an estimated $30 billion per year lost by American companies competing for international contracts).

76 The OECD was initially established to run the U.S. financed Marshall Plan after the Second World War, and it created a forum for countries to compare policy experiences in efforts to answer common problems. *See History*, ORG. FOR ECON. CO-OPERATION AND DEV., http://www.oecd.org/about/history (last visited Jan. 14, 2013).

77 *The International Anti-Bribery and Fair Competition Act of 1998: Hearing on H.R. 4353 Before the Subcomm. on Finance & Hazardous Materials of H. Comm. on Commerce*, 105th Cong. 8-11 (1998) [hereinafter *Hearing on H.R. 4353*] (statement of Andrew J. Pincus, General Counsel, Department of Commerce).

78 Signing Statement on International Anti-Bribery, *supra* note 75.

79 Kathryn Nickerson, *International Enforcement of the OECD Antibribery Convention*, 12.3 FED. ETHICS. REP. 1-3 (2005).

80 144 CONG. REC. H10, 302-02, H10, 305-06, 11-15 (daily ed. Oct. 9, 1998) (statement of The Clerk); Signing Statement on International Anti-Bribery, *supra* note 75. *But see Hearing on H.R. 4353*,

To ensure the United States' ability to take the lead in implementing the provisions of the Convention, Congress enacted five amendments to clarify the FCPA's prohibitions and emphasize the law's aim at payments made to secure an improper business advantage.[81] First, the amendments supplemented the prohibited conduct by including payments made to secure "any improper advantage."[82] Second, coverage of individuals was expanded to include "any person," thus extending coverage to all foreign persons committing violations while on American soil.[83] Third, the amendments expanded the definition of foreign officials under the statute to include officers of international organizations.[84] Fourth, jurisdiction was expanded to cover acts of American citizens or corporations in furtherance of unlawful payments that take place outside of the U.S.[85] Finally, the amendments applied penalties to all employees and agents of American businesses in order to eliminate the disparity between U.S. nationals and non-U.S. nationals employed by American companies.[86]

In its modern form, the FCPA anti-bribery provision makes it unlawful for any issuer, domestic concern, or any person while in U.S. territory to give anything of value to any foreign official for the purpose of influencing a decision, doing anything illegal, or securing any improper advantage.[87] Affirmative defenses in the statute permit payments that are lawful under the written laws and regulations of the foreign official's country and for reasonable and bona fide expenditures.[88] The statute defines "foreign official" as any officer or employee of a foreign government or any department, agency, or instrumentality thereof; or of a public international organi-

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supra note 77, at 5 (1998) (testimony of the Honorable Edward J. Markey, Representative, Mass.) (stating that "these changes actually strengthen the statute by extending its coverage to cover foreign persons and corporations, bribes paid to officials of international organizations, and clarifying that the law's prohibitions should be construed to cover any payments made to secure any 'improper advantage'").

81 144 CONG. REC. H10,302-02, H10,305-06, 11-15 (daily ed. Oct. 9, 1998) (statement of The Clerk).

82 *Hearing on H.R. 4353*, *supra* note 77, at 8-11 (statement of Andrew J. Pincus, General Counsel, Department of Commerce).

83 *Id.*

84 *Id.*

85 *Id*.

86 *Id*.

87 15 U.S.C. § 78dd-1(A) (2006) (addressing conduct by issuers with the SEC); *Id*. § 78dd-2 (addressing conduct by domestic concerns); *Id*. § 78dd-3 (addressing conduct by any person not defined as an issuer or domestic concern taking place while in a territory of the United States).

88 *Id*. § 78dd-1(c)(1)-(2) (exempting expenses "such as travel and lodging expenses"). As recent scholarship has pointed out, what exactly qualifies as a reasonable bona fide expenditure is not established by the statute. *See* Kyle P. Sheahen, *I'm Not Going to Disneyland: Illusory Affirmative Defenses Under the Foreign Corrupt Practices Act*, 28 WIS. INT'L L.J. 464, 485-488 (2010). Until new guidelines are provided by the DOJ, firms must appeal to the DOJ's opinion procedure to request a statement of the Justice Department's enforcement intentions.

zation.[89] The penalties for violations are a maximum of $2 million for corporations, and $10,000 and five years' imprisonment for individuals.[90] Jurisdiction extends to unlawful conduct occurring entirely outside the U.S.[91]

II. CURRENT ENFORCEMENT TRENDS AND PROBLEMS FACING AMERICAN BUSINESSES

In its first two decades, the FCPA had a limited impact on the incidence of bribery.[92] However, FCPA activity has increased dramatically over the past seven years. Open investigations increased from merely three in 2002 to eighty-four at the close of 2007.[93] In December 2008, the DOJ brought allegations against Siemens A.G. alleging that Siemens A.G. and its subsidiaries, in addition to violating the records and accounting provisions of the FCPA, engaged in corrupt payments on a global scale, doling out millions of dollars in kickbacks and commissions to obtain contracts with foreign countries.[94] The $450 million criminal fine paid by Siemens A.G. under the plea agreement with the DOJ was more than ten times greater than the previous overall largest fine in any bribery proceeding.[95]

What was the inspiration for the sudden emergence of enforcement activity? Commentators suggest that the limited enforcement of the FCPA was due to the DOJ's focus on Cold War era foreign policy concerns.[96] Additionally, fear that enforcement would potentially offend or embarrass officials in allied countries resulted in caution when investigating alleged offenses.[97] Such concerns led the DOJ to require U.S. attorneys to obtain permission from Washington before pursuing charges under the FCPA.[98]

While several factors may have contributed to the DOJ's more aggressive enforcement of the FCPA,[99] statements by DOJ officials demonstrate an increased dedication to curtailing corruption's damaging effects in developing countries. In a 2006 speech before the American Bar Association

89 15 U.S.C. § 78dd-2(h)(2)(a) (2006).

90 *Id*. § 78dd-3(e)(1)-(3).

91 *Id*. § 78dd-2(i)(1)-(2).

92 Krever, *supra* note 17, at 93.

93 Thomas, *supra* note 26, at 449-50.

94 Press Release, U.S. Dep't of Justice, Siemens A.G. and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008), http://www.justice.gov/opa/pr/2008/December/08-crm-1105.html [hereinafter DOJ Press Release].

95 Thomas, *supra* note 26, at 450.

96 Krever, *supra* note 17, at 93.

97 *Id*.

98 Thomas, *supra* note 26, at 442-43.

99 *See id*. at 442-43 (suggesting that the expansive interpretation of threshold requirements for bribes contributed to the increase in enforcement action); *see* Krever, *supra* note 17, at 94.

National Institute on the FCPA, Assistant Attorney General Alice S. Fisher commented that corruption is the "linchpin of so many different global problems," including "stifl[ing] economic growth and sustainable development."[100] Matthew Friedrich expressed such sentiments while serving as the Assistant Attorney General for the DOJ Criminal Division. Upon announcing three guilty pleas to FCPA violations, Friedrich asserted that "corruption is not a victimless offense. . . . People do get hurt. And the people who are hurt the worst are often residents of the poorest countries on the face of the earth."[101]

Assistant Attorney General (AAG) Lanny Breuer also reflected upon increased awareness of the economic effects of corruption in a recent statement before the National Conference on the FCPA.[102] Referring to Mohamed Bouazizi's protest and the Arab Spring protests, AAG Breuer noted the DOJ's commitment to combat the systematic corruption enabling a developing country's public officials to abuse their power for personal gain.[103] Although this view of corruption is not an express statement of a DOJ initiative, the concurring views of successive DOJ officials illustrates the increased awareness of corruption's consequences, which may have contributed to the increase in enforcement activity.

Although the 1998 amendments were intended to address the disadvantage to American businesses,[104] the alarming monetary consequences of bribery offenses, in addition to the reputational harm faced by corporations subject to FCPA investigations, have inspired a renewed drive for further amendments.[105] In an article for the U.S. Chamber Institute for Legal Reform, Andrew Weissmann presented the problem the FCPA imposes on American businesses engaged in operations overseas.[106] Weissmann argued that the risk of engaging in business overseas involves not only the potential for massive monetary penalties should a FCPA violation ensue, but also the costs of legal fees, forensic accounting, and other investigative costs even

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100 Alice S. Fisher, Ass't Att'y Gen., U. S. Dep't of Justice, Prepared Remarks at the National Institute on the Foreign Corrupt Practices Act at the American Bar Association (Oct. 16, 2006) *available at* http://www.justice.gov/criminal/fraud/pr/speech/2006/10-16-06AAGFCPASpeech.pdf.

101 Matthew Friedrich, Acting Ass't Att'y Gen., U.S. DOJ, Remarks at the Press Conference Announcing Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations (Dec. 15, 2008) (transcript available at http://www.justice.gov/opa/pr/2008/December/08-opa-1112.html).

102 *Assistant Attorney General Lanny A. Breuer Speech*, *supra* note 1.

103 *Id.*

104 H.R. REP. NO. 105-802, at 9 (1998).

105 *See* Joel M. Cohen, Michael P. Holland, Adam P. Wolf, *Under the FCPA, Who is a Foreign Official Anyway?*, 63 BUS. LAW. 1243, 1248 (2008); *see also* WEISSMANN & SMITH, *supra* note 18, at 5 (explaining the high cost of FCPA litigation and the even higher fines resulting therefrom).

106 WEISSMANN & SMITH, *supra* note 18, at 5.

before trial.[107] Several empirical studies suggest that the FCPA has resulted in a substantial loss of business or export opportunities to foreign competitors. A 2000 study by the U.S. Department of Commerce valued alleged foreign bribery in 180 commercial contracts over three years at about $80 billion.[108] A 1995 study that analyzed the economic effects of the FCPA found that American firms were dissuaded from conducting business with countries receiving higher ratings on *Business International*'s corruption level index.[109] Critics of the FCPA claim that it costs up to $1 billion annually in lost export trade.[110] Though similar studies estimate different costs experienced by American exports, these studies reflect the loss of business opportunities due to borders established by the FCPA, not the cost of compliance.[111] By imposing the risk of bet-your-company litigation on companies dealing in countries where bribery is a pervasive practice, the FCPA encourages corporations to forego the potential benefits of trade.[112]

In addition to the burdens imposed on businesses, commentators suggest that the affirmative defenses to the statute do not provide meaningful protection.[113] Although payments that comply with a foreign country's law are exempted under the FCPA's local law defense, courts have interpreted this provision as inapplicable if a person could not be prosecuted in the foreign country due to a technicality.[114] Although the promotional expenses defense exempts contributions such as travel and lodging expenses, these payments would already fall short of "corrupt" conduct.[115]

Still, FCPA supporters insist that American companies have not suffered as much as critics suggest.[116] A study by Mary Jane Sheffet reports that American shares of export trade in Asia and Africa have grown over the past decade.[117] Growth came in industries particularly affected by corrupt practices rather than in markets less exposed to corruption: aircraft, construction equipment, oil and gas field machinery, telecommunications

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107 *Id.* (citing Melissa Klein Aguilar, *How to Size Up, & Manage, FCPA Investigations*, COMPLIANCE WEEK, Aug. 17, 2010).

108 Weber & Getz, *supra* note 16, at 699.

109 Ajani Harris, The Impact of the Foreign Corrupt Practices Act on American Business from 1977-2010 at 51 (April 25, 2011) (B.A. thesis, Claremont University), *available at* http://scholarship.claremont.edu/cmc_theses/129.

110 SEITZINGER, *supra* note 8, at 2.

111 Weber & Getz, *supra* note 16, at 699.

112 Jonathan P. Doh, Peter Rodriguez, Klaus Uhlenbruck, Jamie Collins, Lorraine Eden & Stanislav Shkshnia, *Coping with Corruption in Foreign Markets*, 17 ACAD. MGMT. EXEC. 114, 120 (2003) (suggesting that corporations faced with markets characterized by corruption may want to avoid the market entirely and avoid the costs of corruption or the disadvantage to competitors engaging in the practice).

113 Sheahen, *supra* note 88, at 489.

114 *Id.* at 473.

115 *Id.* at 478.

116 Krever, *supra* note 17, at 90-91.

117 *Id.*

equipment, and medical equipment.[118] Results of a General Accounting Office survey of 250 of the top 1,000 American corporations demonstrated that about 30% of the respondents claimed the FCPA caused a decrease in business.[119] Additionally, some corporate executives have applauded the FCPA for insulating their companies from pressures by foreign officials for bribes.[120]

While the growth in American export trade demonstrates that American businesses have increased productivity—whether in spite of, or as a result of, the FCPA—this fact does not directly confront the losses in export trade due to the FCPA.[121] Additionally, studies have shown that foreign bribery remains widespread amongst American corporations and the countries with which these corporations do business.[122] This suggests that despite the costs born by American corporations, the desired effect has not been conferred. Though General Accounting Office surveys demonstrate a widespread opinion that the FCPA has not had a dramatic effect on American business, these surveys predate the recent expansion of FCPA enforcement.[123]

Signatories of the FCPA in 1977 recognized the potential for detrimental effects to American businesses given the prohibition on foreign bribe payments.[124] For this reason, opponents of enacting an anti-bribery provision believed the most desirable solution would be one based on multilateral or bilateral treaties, with unilateral activity limited to heightened disclosure standards.[125] Because of the difficulties in determining whether a corporation sought to gain some business advantage through corrupt payments or was the reluctant victim of extortion by a foreign official, classifying conduct could rest on subtle distinctions.[126] Despite these concerns, citizens in countries plagued by corruption must rely on trade partners willing to police their own businesses.[127] Bribery may not only interfere with

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118 *Id.*

119 Daniel Pines, Comment, *Amending the Foreign Corrupt Practices Act to Include a Private Right of Action*, 82 CAL. L. REV. 185, 208 (1994).

120 Krever, *supra* note 17, at 93.

121 WEISSMANN & SMITH, *supra* note 18, at 5-6.

122 Krever, *supra* note 17, at 93; *See generally* Doh, et al., *supra* note 112, at 114-29 (supporting the persistence of bribery in developing nations); Jon S. T. Quah, *Corruption in Asian Countries: Can it be Minimized?*, 59 PUB. ADMIN. REV. 483-94 (1999) (concluding that bribery is a strongly established practice in many prominent Asian countries who show undedicated resolve to prevent the practice).

123 Pines, *supra* note 119, at 208-09.

124 123 CONG. REC. 38599, 38599-600 (1977) (statement of Sen. William Proxmire).

125 *Hearing on H.R. 3815*, *supra* note 51, at 63-64.

126 *Id.* at 64-66.

127 *See* Keith Blackburn & Gonzalo F. Forgues-Puccio, *Distribution and Development in a Model of Misgovernace*, CENTRE FOR GROWTH & BUS. CYCLE RESEARCH 1-8, *available at* http://www.econstor.eu/bitstream/10419/19808/1/Furgues_Puccio.pdf (2004) (implementing a dynamic general equilibrium model to predict a positive relationship between corruption and inequality); *But see* Carolyn Dobson & Antonio Rodriguez Andres, *Is Corruption Really Bad for Inequality? Evidence from*

development objectives but may also cause the country's poor to suffer the most.[128]

III. LEARNING FROM HISTORY

As the framing of both the FCPA and the Sherman Act suggested, the statutes intended to regulate trade practices viewed as harmful to free and fair trade.[129] As the FCPA's framers insisted that bribery in foreign countries short-circuited competition based on product quality, service, and price, Senator Sherman's statements on the Sherman Act demonstrated a similar dedication to protecting free markets.[130] Though the FCPA established a comprehensive ban on corrupt payments to foreign officials, the width of the prohibition was not absolute.[131] Just as the framers of the FCPA did not intend for the statute to affect all payments made to foreign officials,[132] Senator Sherman similarly ensured that the Sherman Act would not apply to business arrangements that benefit production.[133] As a bill, the Sherman Act was guaranteed not to affect combinations likely to increase productivity where there is free and fair competition.[134]

Prominent theorists have long debated the true goal of antitrust laws.[135] Through the evolution in economic thought, American antitrust laws have undergone a period of enlightened reasoning, embodied in the change of the Supreme Court's analysis of anticompetitive conduct.[136] Since the an-

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Latin America, 47 J. DEV. STUD. 959 (2011) (concluding that corruption generally and inequality within a society have an inverse relationship because of the increased reliance on the informal sector for labor).

128 "Corruption can cause both a wastage and a misallocation of resources that work against efficiency and equality. In doing so, it can sabotage the prospects for growth and widen the gap between the rich and the poor." Blackburn & Forgues-Puccio, *supra* note 127, at 20.

129 H.R. REP. NO. 95-640, at 7 (1977).

130 *Hearing on H.R. 3815*, *supra* note 39, at 28-30.

131 H.R. REP. NO. 95-640, at 7 (1977).

132 *Id.*

133 Michael A. Carrier, *The Rule of Reason: Bridging the Disconnect*, 1999 B.Y.U. L. REV. 1265, 1316 (1999).

134 *Id.*

135 *Compare* ROBERT H. BORK, THE ANTITRUST PARADOX 50 (1993) ("Antitrust policy cannot be made rational until we are able to give a firm answer to one question: What is the point of the law—what are its goals? Everything else follows from the answer we give. . . . Only when the issue of goals has been settled is it possible to frame a coherent body of substantive rules."), *with* Frank H. Easterbrook, *Workable Antitrust Policy*, 84 MICH. L. REV. 1696 (1986) (presenting a critique of the Chicago School approach to antitrust law from an efficiency prospective to argue that the legislative history of the Sherman Act evinces a concern for low prices and consumers' welfare).

136 *Compare* United States v. Trenton Potteries Co., 273 U.S. 392 (1927) (holding that no fixed prices are reasonable), *with* Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., 441 U.S. 1 (1979) (stating that as generally used in the antitrust field, "price fixing" is a shorthand way of describing business behavior to which the *per se* rule has been held applicable).

nouncement of *Broadcast Music*[137] and other decisions reflecting an analysis of conduct through modern economic principles, courts have seen fewer private and government initiated antitrust cases.[138] The resolution of these cases in recent lower court opinions reflects an affirmation that the ultimate purpose of antitrust law is to provide the benefits of competition to consumers.[139]

One of the main goals of antitrust law is to protect consumers in the relevant market from anticompetitive, exploitative behavior, unfairly transferring wealth to firms that abuse monopoly power.[140] Similarly, the history and commentary by those responsible for its enforcement point to the FCPA's goal of eliminating unfair trade practices, which unfairly transfers wealth from the general population to corrupt foreign officials.[141] Just as antitrust analysis has evolved to focus on the narrow goal of protecting consumers from anticompetitive behavior, decisions about whether corrupt practices should be pursued under the FCPA should focus on an enlightened understanding of how certain business behaviors harm competition and consumers. By adopting an approach more consistent with the ultimate goals of the FCPA—the prevention of unfair trade practices and harmful effects on trade partner countries—enforcement could be downsized and the cases brought would most effectively protect competition and combat wealth concentration.

IV. ADJUSTING THE DOJ'S APPROACH TO MEET ANTICOMPETITIVE CONCERNS

Proponents of strong FCPA enforcement point to the harmful effects of bribery on legitimate competition.[142] If American companies used bribes in order to compete rather than the traditional means of using superior products, lower prices, or favorable terms to win contracts with foreign countries, the eventual award would go to inefficient producers.[143] Howev-

137 Broadcast Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1 (1979).

138 *See* Ping Lin, Baldev Raj, Michael Sandfort & Daniel Slottje, *The U.S. Antitrust System and Recent Trends in Antitrust Enforcement*, 14 J. OF ECON. SURVS. 255, 261 (2000) (for statistics on private and government antitrust cases in the United States from 1942-1995).

139 John B. Kirkwood & Robert H. Lande, *The Fundamental Goal of Antitrust: Protecting Consumers, Not Increasing Efficiency*, 84 NOTRE DAME L. REV. 191, 192 (2008).

140 *Id.*; *see also* Steven C. Salop, *Question: What is the Real and Proper Antitrust Welfare Standard? Answer: the True Consumer Welfare Standard*, 22 LOY. CONSUMER L. REV. 336 (2010) (explaining why the true consumer welfare standard is the better standard for achieving the goals of antitrust legislation).

141 *See Assistant Attorney General Lanny A. Breuer Speech*, *supra* note 1, at 1-2.

142 *See Prepared Remarks of Alice S. Fisher*, *supra* note 100, at 1-2.

143 *See Hearings on 3815*, *supra* note 39, at 27 (Statement of Dr. Gordon Adams, Director of Military Research, Council on Economic Priorities).

er, in countries with an engrained system of bribery, prohibiting American companies from participating in the practice does not necessarily enhance competition.

Studies indicate that in nations where bribery is an established practice, the necessity of such payments is not only unlikely to dissipate but also does not differ across industries.[144] Firms with extensive public sector dealings face a higher probability of having to pay bribes due to the increased likelihood of bureaucratic control.[145] In a study by Transparency International,[146] nearly three quarters of the 178 countries surveyed in 2010 received an index score below five, indicating a serious corruption problem.[147] Although the majority of nations receiving highly corrupt index ratings are located in the Middle East and sub-Saharan African regions, major American trade partners such as Mexico[148] and China[149] also received scores indicating a pervasive corruption level.[150]

Taking these factors into account, American corporations that engage in commerce with nations with a deep-rooted system of bribery may have to decide to either pay bribes to compete with other corporations paying bribes or avoid the market entirely.[151] When all corporations participate equally in the market for bribes, no one corporation gains an unfair advantage over its competitors.[152] Allowing necessity to count as a justification would permit corrupt payments in situations where the payment does not create an unfair advantage over competitors.[153] In fact, some economists consider corrup-

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144 *See* Blaker, *supra* note 33, at 81-90; Jakob Svensson, *Who Must Pay Bribes and How Much? Evidence from a Cross Section of Firms*, 118 Q. J. ECON. 207, 216 (2003).

145 Svensson, *supra* note 144, at 216.

146 Transparency International is an international organization dedicated to the fight against corruption, and publishes an annual index of the perceived levels of public sector corruption around the globe. For more information, see *Our Organisation*, TRANSPARENCY INT'L, http://www.transparency.org/whoweare/organisation (last visited Jan. 21, 2013).

147 *Corruption Perceptions Index 2010*, TRANSPARENCY INT'L (Oct. 26, 2010), http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results (nations participating in the survey are given a score between ten and zero, with ten indicating that the country is very clean and zero indicating a nation that is highly corrupt).

148 Despite a 6.2% decrease in GDP in 2009, Mexico remains a strong trade partner with the United States possessing a GDP (purchasing power parity) of $1.603 trillion (2010 estimate). *See Mexico*, CIA WORLD FACTBOOK, *available at* https://www.cia.gov/library/publications/the-world-factbook/geos/mx.html (last updated Jan. 7, 2013).

149 Possessing a GDP (purchasing power parity) of $10.34 trillion (2010 estimate). *See China*, CIA WORLD FACTBOOK, *available at* https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html (last updated Jan. 2, 2013).

150 *Corruption Perceptions Index 2010*, *supra* note 147.

151 *See* Doh et al., *supra* note 112, at 119-20.

152 *But see* Blackburn & Forgues-Puccio, *supra* note 127, at 5 (noting the potential for the use of excessive rules and regulations as a means for extracting bribes to raise the cost of business activity and undermine efficiency).

153 *See* Doh et al., *supra* note 112, at 120.

tion to be an essential component to keeping the economy going in locales with excessive bureaucracy or market restrictions.[154]

Still, some commentators suggest that bribery may have a similar effect to an exclusive dealing contract or tying arrangements, which are traditionally subject to regulation under the Sherman Act.[155] In an article arguing for the applicability of antitrust laws to overseas bribery by foreign companies, Franklin Guvertz noted two decisions in which courts equated bribery to exclusive dealing in its effect on competition.[156] Recent scholarship points out, however, that the per se prohibitions on exclusive dealing and tying arrangements have all but disappeared.[157] Courts recognize the important business purposes of exclusive dealing, such as promotion of more effective distribution.[158] Because bribes may act as "speed money" to circumvent countries with extensive institutional hurdles, the result will also be a more efficient distribution of goods or services that can enhance growth.[159]

Where firms engage in conduct that appears to directly conflict with competition in countries known to have an established practice of corruption, prosecutors may face more difficult decisions. For example, the SEC entered into a Deferred Prosecution Agreement[160] with Tenaris S.A. regarding allegations that the steel pipe product producer violated the FCPA by bribing Uzbekistan government officials during a bidding process to supply

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154 Johann Graf Lambsdorff, *How Corruption in Government Affects Public Welfare – a Review of Theories*, CENT. FOR GLOBALIZATION AND EUROPEANIZATION OF THE ECON. Jan. 2001, at ("[S]ome economists consider corruption to be a means of aiding the economy, particularly in the case of cumbersome regulation, excessive bureaucracy, or market restrictions.") (citations omitted).

155 Franklin A. Geurtz, *Using the Antitrust Laws to Combat Overseas Bribery by Foreign Companies: A Step to Even the Odds in International Trade*, 27 VA. J. INT'L L. 211, 221 (1987) (citing City of Atlanta v. Ashland-Warren, Inc., 1982-1 Trade Cas. (CCH) p. 64, 527 (N.D. Ga. 1981) (ruling for the plaintiff and noting that the restraint of trade caused by the bribe was similar to that involved in reciprocal dealing or tying arrangements)).

156 *Id.* at 220 (citing Associated Radio Serv. Co. v. Page Airways, 624 F.2d 1342 (5th Cir. 1980) (concluding that the aggregate effect of the defendant's bribes created a sufficient impact in the relevant market to violate both sections 1 and 2 of the Sherman Act); City of Atlanta v. Ashland-Warren, Inc., 1982-1 Trade Cas. (CCH) p. 64, 527 (N.D. Ga. 1981) (ruling for the plaintiff and noting that the restraint of trade caused by the bribe was similar to that involved in reciprocal dealing or tying arrangements)).

157 Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L.J. 311, 312 (2002) (noting that lower court decisions have come to recognize that even the highest levels of percentage foreclosure may entail no consumer harm, but actually view the typical exclusive dealing arrangement to be entirely legal).

158 *Id.*

159 *See* Blackburn & Forgues-Puccio, *supra* note 127, at 5.

160 A deferred prosecution agreement is an agreement upon which a corporate defendant charged with misconduct takes responsibility for the wrongdoing, and prosecution is deferred to insure that the defendant complies with the terms of the agreement. U.S. SEC. & EXCH. COMM'N, ENFORCEMENT MANUAL 129 (2012), *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

pipelines for transporting oil and natural gas.[161] Transparency International recognizes Uzbekistan as having a pervasive problem of corruption given its 1.6 rating on the Transparency International ratings.[162] This score ranked Uzbekistan as the nation most susceptible to corruption in Eastern Europe and Central Asia, scoring 172 out of the 178 nations surveyed.[163] Though Tenaris was able to obtain bid information and use this information to win successive contracts,[164] it is possible that other firms operated similarly and simply lost to the most efficient producer.

Although the effect on competition does not seem dispositive on its own, the concern remains that bribery tends to injure the poor by sabotaging prospects for growth and widening the gap between the rich and the poor.[165] While many studies have sought to analyze the indirect effects of bribery on the growth and distribution of wealth in developing countries,[166] the obvious effects are apparent when viewing examples of such transactions.

In 2011 the DOJ convicted Lindsey Manufacturing Company and several individuals of conspiracy to violate the FCPA in connection with a bribery scheme involving officials of the Comisión Federal de Electricidad (CFE), a Mexican energy utility.[167] According to court documents, Lindsey Manufacturing officials paid an agent a 30% commission with the understanding that the commission would be used to pay bribes to two Mexican officials.[168] In order to cover the costs of these bribes, the prices of goods were increased by 30%, leading to charges to CFE of $5.9 million over the market price for goods and services.[169]

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161 Press Release, U.S. Sec. & Exch. Comm'n, Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011), *available at* http://www.sec.gov/news/press/2011/2011-112.htm [hereinafter SEC Press Release].

162 *Corruption Perceptions Index 2010*, *supra* note 147.

163 *See id*.

164 SEC Press Release *supra* note 161.

165 *See* DOJ Press Release*, supra* note 94 ("[P]eople who are hurt the worst [by corruption] are often the . . . poorest . . . ."); Blackburn & Forgues-Puccio, *supra* note 127, at 3 ("[T]here are good reasons for believing that corruption has important distributional effects that result in the poor becoming poorer and the rich becoming richer.").

166 *See, e.g.*, ERIC CHETWYND, FRANCES CHETWYND & BERTRAM SPECTOR, CORRUPTION AND POVERTY: A REVIEW OF RECENT LITERATURE (2003), *available at* http://www.eldis.org/vfile/upload/1/document/0708/doc14285.pdf; Blackbur & Forgues-Puccio, *supra* note 127.

167 United States v. Aguilar, 783 F. Supp. 2d 1108, 1109 (C.D. Cal. 2011). This conviction has since been dismissed. Order Granting Motion to Dismiss at 41, United States v. Aguilar, No. CR 10-01031(A)-AHM (C.D. Cal. Dec. 1, 2011).

168 First Superseding Indictment ¶ 3, United States v. Aguilar, 783 F. Supp. 2d 1108 (C.D. Cal. 2011).

169 Press Release, U.S. Dep't of Justice, California Company and Two Executives Indicted for their Alleged Participation in Scheme to Bribe Officials at State-owned Electrical Utility in Mexico (Oct. 21, 2010), http://www.justice.gov/opa/pr/2011/May/11-crm-596.html.

Although the court's refusal to grant Lindsey Manufacturing's motion to dismiss and subsequent conviction was based mainly on a theory of unfair competition,[170] the transaction illustrates how bribes operate as a wealth transfer to government officials. The net result was Lindsey Manufacturing benefitting from the transaction, their agent and the foreign officials benefiting from the 30% overcharge, and the CFE receiving products at a price 30% above value. When a transaction does not reflect the needs of the country receiving goods and services and above-value prices are being charged, it is apparent how corruption can cause both waste and misallocation of resources.[171]

By focusing on bribery transactions in which above-value prices are charged, agencies may withdraw pressure from firms reluctant to engage in foreign commerce, but continue to aggressively challenge firms engaging in transactions contrary to the FCPA's design. Rather than the leniency requested by some lobbyists,[172] a renewed focus and approach would efficiently direct enforcement agencies towards their stated goals.

CONCLUSION

Despite promises from the U.S. DOJ[173] and U.K. fraud enforcement officials[174] that new guidance would shed light on fraud enforcement policies, government agencies remain dedicated to pursuing bribery charges. In November of 2012, the DOJ and SEC released much–awaited guidance on FCPA compliance, claiming that the document marked an "unprecedented undertaking by DOJ and SEC to provide the public with detailed information about our FCPA enforcement approach and priorities."[175] Despite efforts by the Chamber and other organizations to lobby for change, the DOJ's resource guide shows no signs of concession regarding the proposed reforms.[176] Commentators concede that the guide convincingly argues that

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170 *Aguilar*, 783 F. Supp. 2d. at 1119-20.

171 Blackburn & Forgues-Puccio, *supra* note 127, at 20.

172 *See generally* WEISSMANN & SMITH, *supra* note 18.

173 *See, e.g.*, Samuel Rubenfeld, *Breuer Teases FCPA Guidance to Come in 2012*, WALL ST. J. BLOG (Nov. 8, 2011, 4:38 PM), http://blogs.wsj.com/corruption-currents/2011/11/08/breuer-teases-fcpa-guidance-to-come-in-2012/; *Assistant Attorney General Lanny A. Breuer Speech*, *supra* note 1.

174 *See* Barry Vitou & Richard Kovalevsky, *BREAKING: We'll See Your New FCPA Guidance and Raise You: SFO Plans Self Reporting Guidance to be Updated*, THEBRIBERYACT.COM (Nov. 13, 2011, 11:00 AM), http://thebriberyact.com/2011/11/13/breaking-well-see-your-new-fcpa-guidance-and-raise-you-sfo-plans-self-reporting-guidance-to-be-updated/.

175 *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, DOJ (Nov. 14, 2012), http://www.justice.gov/criminal/fraud/fcpa/guide.pdf.

176 Hon. Alberto R. Gonzales, *The Impact Of The New FCPA Guidance On Reform Efforts*, FCPA PROFESSOR (Dec. 3, 2012), http://www.fcpaprofessor.com/the-impact-of-the-new-fcpa-guidance-on-reform-efforts.

the DOJ enforces the FCPA in a straightforward and evenhanded manner.[177] However, attorneys advising clients on FCPA matters are keen to point out that the resource guide may not be as reliable a source as it appears.[178] Though companies may be able to more comfortably navigate the waters of international trade, some opportunities to do business overseas will remain too costly. It will take some time before data can reveal the DOJ resource guide's effect on American businesses competing for international contracts. Should American businesses continue to lose money to foreign companies competing over international contracts, it may be necessary to recalibrate the approach the DOJ takes towards FCPA enforcement.

177 *Id.*

178 *Top Five Takeaways From the New FCPA Guide*, CROWELL & MORING (Nov. 21, 2012), http://www.crowell.com/NewsEvents/AlertsNewsletters/White-Collar-Alert/Top-Five-Takeaways-From-the-New-FCPA-Guide.