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The Next Big Thing

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I. INTRODUCTION

Pop quiz: What do antitrust cases involving the leading PC operating system, a national association's rules about real estate listings, and a joint venture between a cable company and a movie studio have in common?

Hint: Not the statute involved. One was Sherman § 2, one was Sherman § 1 and one was Clayton § 7.

Answer: They were all about competition to be the "next big thing."

Quite a lot has been written on the importance of innovation to the U.S. economy, and how, if at all, antitrust enforcement can promote or protect innovation. The aim of this short article is slightly different. Enforcement actions are where the rubber meets the road, so in some sense they tell us more than speeches and policy documents.

In this article I look at how the U.S. Department of Justice ("DOJ") approached innovation in the *National Association of Realtors* and *Comcast/NBC Universal* cases. While it is difficult to draw conclusions from only a couple of data points, I outline the ways in which DOJ seems to have developed an internally consistent approach toward exclusionary conduct in the digital world. I do not see the same kind of consistency over at the Federal Trade Commission ("FTC"). Google is the great unknown as I write this. But based on the FTC's decision to close its investigation of the Universal/EMI merger, I am not overly optimistic about the prospects of a Google case. One conclusion that may be drawn is that DOJ benefitted institutionally from fully litigating the *Microsoft* case, while the FTC has paid a price for not fully testing an innovation theory in court. As it stands now, there seems to be something of a "digital divide" between the DOJ and FTC.

II. INNOVATION IN CONTEXT

There is a consensus that innovation brings large economic gains. Indeed, there seems to be a consensus that the gains from innovation may be much larger than those associated with price competition, the traditional focus of antitrust law.

And while collusion may be the "supreme evil" as far as price competition is concerned, exclusion may be the "supreme evil" when it comes to innovation. As Professor Jon Baker recently suggested, the economics of exclusion are similar to collusion. Despite this, claims of exclusionary conduct are still greeted somewhat skeptically while collusion is uniformly condemned. Baker argues that exclusion should be a core concern of antitrust.

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[1] Allen Grunes, Shareholder, Brownstein Hyatt Farber Schreck, LLP. The author was involved in some of the matters discussed in this article, both while at the Department of Justice and in his current position. However, the views expressed herein are the author's own and do not represent those of any other person or entity. I am particularly grateful to Chris Sagers, Henry Su and Maurice Stucke for their helpful comments and critiques of earlier drafts. Needless to say, they bear no responsibility for the final result.

There is a parallel debate (not surprisingly) about what role, if any, antitrust enforcement should play in promoting innovation. On the one side are people like Professors Josh Wright and Geoff Manne, who have argued that innovation creates special problems for antitrust enforcement, both because economists know less about the relationship between competition and innovation than they do about the relationship between competition and price, and because errors of too much enforcement may be especially costly in innovative industries.

On the other side of the fence are people like Professor Tim Wu, who advocates using enforcement policy to raise the costs of exclusionary conduct by an incumbent firm as a means to promote innovation by outsiders and force the incumbent to respond in kind. Since the antitrust agencies are in the business of enforcing the law and not optimizing innovation in some abstract sense, I interpret Wu to be suggesting that the agencies be more aggressive when an enforcement opportunity arises that centers on the impact of exclusion on innovation.

In the last four years, both the DOJ and FTC have gained additional experience with the sort of issues that antitrust in the digital age presents. And there is no doubt that the agencies of late have been paying more attention to harm to innovation as a potential competitive effect from mergers and other conduct. In the 1992 Horizontal Merger Guidelines, innovation got a footnote. The 2010 Merger Guidelines devote an entire section to it. At DOJ, former AAG Christine Varney and later Acting AAGs Sharis Pozen and Joe Wayland gave speeches about antitrust and innovation. At the FTC, Commissioner Tom Rosch gave a speech about antitrust and the high-tech sector and Commissioner Edith Ramirez gave a speech about competition policy in the intellectual property marketplace. Moreover, the DOJ now has a "Chief Counsel for Innovation" while the FTC has a "Chief Technologist" and also brought Professor Wu into the agency for a time to think about these issues.

Without getting into the theoretical debate, it would be useful to take a look back at how the agencies have treated innovation in practice and, in particular, digital innovation. So I want to talk about a few cases that explicitly involve innovation in the sense of competition to be the "next big thing," and antitrust enforcement as a means of keeping the path clear for the next big thing.

III. UNITED STATES V. NATIONAL ASSOCIATION OF REALTORS

In 2005, DOJ filed suit against the National Association of Realtors. The case involved a concerted effort by traditional "brick and mortar" real estate brokerage firms to limit competition coming from a new source: the internet.

A number of "tech-savvy" real estate brokers had figured out how to create "virtual" offices on the web, dispensing with most of the expense of maintaining physical offices, reducing the number of sales agents they needed, permitting customers to do much of what a sales agent traditionally did, and potentially offering a lower commission rate. DOJ alleged that the Association had adopted policies to obstruct competition from these innovative brokers.

The National Association of Realtors sets the rules for multiple listings services in the United States. According to the complaint, the traditional brokers responded to the new competition by causing the association to change the rules of the game. The rules had required a broker to display all of its listings and not to withhold any from a given multiple listing service. The complaint alleged that the Association, at the urging of some of the larger brokerage firms,

decided to allow unhappy members to "opt out" of making their listings available to the upstarts. The likely result, of course, was that a traditional firm would have been able to show a customer all or substantially all of the real estate listings in a particular area, but an online broker would not.

United States v. National Association of Realtors was hardly the first government antitrust action to focus on how conduct affects innovation. But it illustrates several important points about how innovation enters the equation as a practical matter in the digital economy:

1. DOJ made it clear that the case was about innovation. Indeed, in the section of the complaint on "competitive effects," the first of the effects listed is that, unless remedied, the conduct would diminish innovation.
2. The innovation came about because of the disruptive potential of the internet, and its ability to cut out some of the costs and intermediaries, and to put some of the savings into consumers' hands.
3. Like other cases involving efforts to limit innovation, the focus was on exclusionary conduct by the incumbents.
4. The case had to do with the early stages of competition from firms with new business models. Brokers with "virtual office websites" were something of a novelty, and there was no indication that they occupied more than a tiny fraction of the real estate brokerage business.
5. There was evidence that the incumbent firms recognized the threat posed by the innovative firms. The complaint quoted a number of the concerns voiced by "brick and mortar" firms that were found in the documents.

In sum, the case focused on keeping the path open for innovation from a source that had not yet proved itself, but had the potential to do so. Price competition got a bit of a shout out, but it was very much a subsidiary issue.

The *National Association of Realtors* case did not come out of the blue. It falls within the tradition of cases like *Associated Press* and *Allied Tube*, both of which involved exclusionary conduct by an association of competitors with some degree of market power. It also owes something to the FTC's *Toys "R" Us* case, which involved a dominant retailer and a ring of its suppliers together excluding upstart retailers, and *Liggett Group v. Brown & Williamson*, which involved a ring of incumbents excluding generic entry. What makes *National Association of Realtors* particularly into a case about innovation, however, is that the exclusionary conduct was aimed at disruptive internet companies in the early stages—"upstart start-ups," if you will.

IV. *UNITED STATES V. COMCAST AND NBC UNIVERSAL*

Fast forward to 2011 and DOJ's investigation of the joint venture between Comcast and NBC Universal. That transaction brought together Comcast, a large cable and internet provider, with NBC Universal, a large broadcast and content provider.

Of course, vertical mergers in media are nothing new. Beginning in the mid-1990s, the major television broadcasters combined with major studios—Disney with ABC, Viacom with

CBS, NBC with Universal. In 2000, fueled by the dot-com bubble, the leading internet service provider of the time AOL acquired content and cable conglomerate Time Warner.

What was new about the DOJ case against Comcast and NBC Universal was its focus on innovation—in this case, innovation by "online video distributors" ("OVDs"). These are firms such as Hulu, Netflix, Apple, and others that offer consumers ways to access professional, full-length content on demand over the internet. OVDs have a variety of business models, including ad-supported programming which is free to the user (Hulu), unlimited streaming for a monthly subscription fee (Netflix), and the purchase or rental of an individual show (Apple).

According to DOJ, these OVDs are relatively recent entrants into video distribution. While still small in terms of market share, they have grown in popularity, especially among younger viewers who want on-demand viewing and choice among devices. DOJ noted that dozens of companies are innovating and experimenting with online video distribution, with new developments occurring "almost daily."

DOJ found that "[t]oday, some consumers regard OVDs as acceptable substitutes for at least a portion of their traditional video programming distribution services" and either buy smaller content packages from traditional distributors or are "cutting the cable cord" altogether. DOJ added that while OVDs had a "de minimis" share of the overall market, growing demand would likely strengthen the competitive challenge they pose to traditional distributors.

The competitive effects discussed in DOJ's Competitive Impact Statement deserve to be quoted at some length because DOJ really stakes out the turf for mergers when innovation is a core concern:

> Antitrust law, including Section 7 of the Clayton Act, protects consumers from anticompetitive conduct, such as firms' acquisition of the ability to raise prices above levels that would prevail in a competitive market. It also ensures that firms do not acquire the ability to stifle innovation. . . .
>
> A merged firm can more readily harm competition when its rivals offer new products or technologies whose competitive potential is evolving. Nascent competitors may be relatively easy to quash. For example, denying an important input, such as a popular television show, to a nascent competitor with a small customer base is much less costly in terms of foregone revenues than denying that same show to a more established rival with a larger customer base. Even if a vertical merger only delays nascent competition, an increase in the duration of a firm's market power can result in significant competitive harm. The application and enforcement of antitrust law is appropriate in such situations because promoting innovation is one of its important goals. The crucial role of innovation has led at least one noted commentator [Professor Herbert Hovenkamp] to argue that restraints on innovation "very likely produce a far greater amount of economic harm than classical restraints on competition," and thus deserve special attention. By quashing or delaying the progress of rivals that attempt to introduce new products and technologies, the merged firm could slow the pace of innovation in the market and thus harm consumers.

That last paragraph is unusual in that it offers much more explanation than is typical of a case where the focus is on price.

The settlement with DOJ required the Comcast/NBC Universal joint venture to make available to OVDs the same package of broadcast and cable channels that it sells to traditional

video programming distributors. In addition, the joint venture was required to offer an OVD broadcast, cable, and film content that is similar to the content the online distributor receives from one of the joint venture's programming "peers." Comcast also agreed to relinquish its management rights in Hulu.

Significantly, the same five factors that were present in the *National Association of Realtors* case were also present in the *Comcast/NBC Universal* settlement:

1. DOJ made it abundantly clear that, from its standpoint, the case involved preserving the pathways of innovation. Writing in January 2012, then-Acting Assistant Attorney General Sharis Pozen highlighted the importance of this aspect of the case: "Finally and very importantly, the Division determined that, absent conditions, it is likely that the transaction would depress the level of innovation, including experimentation with new models of content delivery."
2. The innovation came about because of the disruptive potential of the internet. OVDs provide content online, as opposed to through more traditional routes into the home. The internet also makes possible the ability to access content out-of-home. And, according to DOJ, OVDs also may represent an unbundling option—similar to the role Apple's iTunes plays in the music industry.
3. DOJ's focus was on the threat of exclusionary conduct by incumbents.
4. The new form of competition was in the early stages. According to DOJ, online video distributors offered more limited viewing options than cable companies, satellite providers, and Verizon and AT&T, and had a "de minimis" share of the overall market. But they were "expanding rapidly and have the potential to provide increased and more innovative viewing options in the future."
5. DOJ alluded to recognition of the threat. It noted the parties' "own assessments—as reflected in numerous internal documents and their executives' testimony—of the importance of OVDs and their potential to alter dramatically the existing competitive landscape . . ."

In sum, it is fair to say that the *Comcast/NBC Universal* decree reflects precisely the same sort of thinking that went into the *National Association of Realtors* case.

V. THE RELEVANCE OF *UNITED STATES V. MICROSOFT*

Do these factors sound familiar? They should. They really come out of the D.C. Circuit's decision in *Microsoft*. I have to believe that this consistency probably owes much to the fact that *Microsoft* was fully litigated, and the theory had passed muster with Judge Douglas Ginsburg and the D.C. Circuit. Litigation, while rare at the agencies, provides a crucible for theories and approaches to be tested in the real world of trials and appeals. Litigation provides discipline and sets the metes and bounds for later enforcement actions. And, as such, it adds to consistency. *National Association of Realtors* and *Comcast/NBC Universal* are illustrations of precisely the sort of consistency that can emerge from the disciplining force of litigation.

The discipline of litigation helps in another respect. Not every internet start-up is an innovator worthy of antitrust protection. Not every act by an incumbent that can be interpreted

as in some sense exclusionary is worthy of condemnation. Indeed, a blanket rule to that effect would be both wrongheaded and more likely stifle innovation than protect it. But litigation creates rules that are reasonably clear, evidence-based, and forward-looking.

In *Microsoft*, the evidence was clear that Microsoft saw both Netscape and Java as a threat to its operating system monopoly, and took action (real action, not halfway measures) based on that perceived threat. The action was intended to prevent Netscape from getting the scale it needed to emerge as a full-fledged competitor, and to mislead developers into adopting Microsoft's competing (and incompatible) version of Java. There was objective evidence of both a threat and a response.

Similarly in the *National Association of Realtors* complaint, DOJ quoted statements by a number of larger brokers who saw the threat posed by internet firms in real terms, including threats to their bottom lines. And in the *Comcast/NBC Universal* complaint, DOJ went out of its way to allege that defendants recognized the new threat.[2]

This sort of evidence traditionally has been labeled "intent" evidence, but in fact goes beyond that. If there is more than a passing comment in an email or two, we may have confidence that there is a plausible threat from an innovator. One can call it intent evidence but it is really evidence of incipiency. In the merger context, it is evidence that a transaction is likely to cause anticompetitive harm because it is being proposed against the background of an acknowledged threat to incumbency. An acknowledgement that innovation is threatening an incumbent position provides the necessary linkage between the transaction and the perceived harm.

VI. MEANWHILE, OVER AT THE FEDERAL TRADE COMMISSION

The FTC has also been paying more attention to digital innovation of late. As I write this, the big unknown is, of course, what will happen in the FTC's Google investigation. As I've said elsewhere,[3] the *Microsoft* case provides a roadmap—perhaps *the* roadmap—for an FTC monopolization case. It is a roadmap that specifically takes innovation into account and identifies the type of exclusionary conduct that the FTC should be focusing on: conduct by Google directed at firms that have the potential to be the next big thing and that threaten Google's dominance in search and/or search advertising. Whether the FTC has such a case cannot be said at this point. By the time this article is published, we may know.

FTC has its own precedent to follow, most notably *Intel*. Of particular note was FTC's allegation that Intel feared competition from graphics processors, which had been a complementary product to Intel's chips. In response to the growing potential for graphics processors to substitute for many of the functions of Intel's chips, the FTC alleged that Intel took steps to reduce the interoperability of this new form of competition with Intel's own products.

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[2] DOJ was never put to its proof, of course, since the *Comcast/NBC Universal* matter was settled and not litigated. The allegations in the complaint are stated only in general and conclusory terms. Nevertheless, the important point is that DOJ felt it necessary to search for such evidence, and to allege, at least, that it was present.

[3] A. Grunes, *Is there a basis in antitrust law for requiring 'neutral' search results*?, ANTITRUST & COMPETITION POL'Y BLOG (May 21, 2012), *available at* http://lawprofessors.typepad.com/antitrustprof_blog/2012/05/is-there-a-basis-in-antitrust-law-for-requiring-neutral-search-results-comments-of-allen-grunes-.html.

Intel was settled, which is in some sense unfortunate, as it presented an opportunity to test a theory of innovation in court.

In real estate, the FTC successfully challenged the policies of Realcomp, an association of real estate brokers in southeastern Michigan that limited the online distribution of discount real estate broker listings. That case is very similar to DOJ's case against the *National Association of Realtors*. And in fact, in the FTC's 2009 decision, then Commissioner Bill Kovacic highlighted the importance of innovation in terms very similar to those we have been discussing:

> The changes sketched here illustrate how technological dynamism and organizational innovation can place enormous pressure on traditional business models and create possibilities for "the new commodity, the new technology, the new source of supply, the new type of organization" that can transform markets. Because technological and organizational dynamism are powerful stimulants for economic progress, an especially important application of antitrust law is to see that incumbent service providers do not use improper means to suppress innovation-driven competition that benefits consumers.

VII. AND A MISSED OPPORTUNITY: UNIVERSAL/EMI

The FTC may have missed an opportunity to advance the ball in its review of the Universal/EMI merger. Before the transaction, Universal was already the world's largest recorded music company. In 2008, Universal's then-CEO, Doug Morris, stated in a Billboard interview, "[w]e're running the most dominant company that there ever has been in the industry." EMI was the smallest of the four major record labels, but was not a failing firm.

The industry as a whole, of course, has been facing challenges for more than a decade. With the development of MP3 technology in the 1990s, the introduction of Napster in 1999, the launch of iTunes in 2003, and the ongoing proliferation of new digital music services, the business models under which recorded music companies operate have been substantially altered. But the industry was reaching an inflection point. In 2011, industry revenue increased for the first time since 2004 and sales of digital music in the United States surpassed physical sales for the first time ever.

The return to growth was largely due to consumer acceptance of innovative digital services such as iTunes, Rhapsody, Spotify, Amazon, and others. Opponents of the merger pointed out that this digital innovation has come about because, in the premerger competitive environment, each of the four major recorded music businesses (Universal, Sony, Warner, and EMI) had been able to effectively sponsor new services by being the first to sign contracts with important innovators, while none of the majors was large enough that it could hold up the launch of any new service. So the structure of the market on the content side was relevant to innovation on the tech side.

There was evidence in the public record that both Universal, and its parent Vivendi, were unhappy with the deals they had cut with digital firms, but lacked the ability to do anything about them. Well before the merger, Universal's former CEO had said: "if they don't want to use our product, fine. If they want to use our product, then we do not want to just be licensing." And a Vivendi executive, shortly after the merger was announced, was quoted as saying: "We hope that in the future we will be less dependent on a certain number of digital platforms which have damaged our position."

The concern among opponents was that the merger could create such a large player—a "supermajor"—that the competitive balance, which had enabled digital innovation even if one of the majors wanted to hold out, would be altered and tilted toward Universal. The story was clearly an innovation story.

The European Commission, in ordering divestitures and conditions, highlighted the importance of this concern. It found that the transaction, as originally structured, would have "negatively affected the possibilities for innovative providers to expand or launch new music offerings and would ultimately have reduced consumers' choice for digital music." The FTC was apparently not able to marshal such evidence, and closed its investigation without action. In this respect, the FTC appears to have missed an opportunity. Whether there was a case to be brought is an open question, but if an investigation focuses on price when it should be focusing on innovation, there is a next-to-no chance that the staff will find a case even if one is there.

VIII. CONCLUSION

In the 1990s, the antitrust agencies developed a novel but narrow view of an "innovation market," which the 1995 Intellectual Property Guidelines characterized as "research and development directed to particular new or improved goods or processes, and the close substitutes for that research and development." But, as Professor Maurice Stucke has pointed out, this assumed that the input—specialized research and development ("R&D") assets or characteristics of specific firms—was a good proxy for the output—socially beneficial innovation. These days, the agencies seem to be moving toward a broader concept of innovation, one that goes beyond the formalistic equation of R&D expenditures (and patents or patent portfolios, for that matter) with innovation.

The market provides a discovery mechanism that enables customers to experiment with new disruptive technologies. Incumbents, fearing this threat, may seek to squelch it. The agencies, rather than focusing solely on short-term price effects, are thinking more about this sort of "cheap" exclusion. At present, DOJ appears to be further along than FTC in incorporating this thinking into enforcement actions.