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Ovation Reconsidered: A Response to Commissioner Leary

posted by Josh Wright at 3:08 pm

I was very pleased to thumb through the newest version of Antitrust Magazine and see a TOTM post get some attention. Its always nice to be cited and have folks take the time to respond to your work — or in this case, blog post. Its even more tickling when the person doing the responding is a prominent and well respected figure such as former Federal Trade Commissioner Leary. Commissioner Leary revisits the FTC's enforcement action in Ovation and takes on the criticism of that enforcement action in this post. You can see Commissioner Leary's article here (I believe ABA registration and password required). I'm grateful for the response and am going to take the opportunity to argue that, despite the Commissioner's criticisms, the troublesome implications that I pointed out in the earlier post associated with the enforcement approach in Ovation remain (see also guest blogger Mary Coleman's related concerns).

A brief recap is in order.

The Concurring Statement offered the following description of the facts of the transaction and potential antitrust theory:

> Merck was a very large ($25 billion in sales in 2007) and sophisticated company. If it profitably could have sold Indocin at a monopoly price it arguably would have done so. However, there is evidence that Merck had a large product portfolio that included a number of pharmaceutical products that were more profitable than Indocin. It is arguable that if it sold at a monopoly price a product used to treat premature babies, that could damage its reputation and its sales of those more profitable products….
>
> There is reason to believe that the sale of Indocin to Ovation had the effect of eliminating the reputational constraints on Merck that had existed prior to the sale. There is evidence that Ovation lacked Merck's large product portfolio and thus arguably was not concerned, as Merck had been, that the sale of Indocin at a monopoly price would damage its reputation and sales of more profitable products. More specifically, there is evidence that after the transaction, Ovation began charging

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roughly 1300 percent more than the price at which Merck sold the same product. Put differently, there is reason to believe that Merck's sale of Indocin to Ovation had the effect of enabling Ovation to exercise monopoly power in its pricing of Indocin, which Merck could not profitably do prior to the transaction. Moreover, there is also reason to believe that the transaction had the effect of substituting Ovation, a firm that had an incentive to protect its ability to engage in monopoly pricing, for Merck, which lacked the same incentive. It is arguable that Merck had no incentive to acquire NeoProfen, but Ovation had an incentive to do so in order to maintain its monopoly pricing in the PDA market. That, in my judgment, would be a violation of Section 7.

The anticompetitive theory is simple: Merck was a multi-product monopolist who was constrained in its pricing of Indocin because it was concerned at a reduction in demand for its other products because consumers would be upset if it priced this life-saving drug at "too high" a level. Under the theory, Merck is setting a profit-maximizing price and figures out that Indocin's profit-maximizing price would be higher because it is unconstrained by these reputational considerations. I asked:

> Assuming it is correct that the decision to lower the price is to do with these reputational demand concerns, why does it become a violation if they assign something that they were entitled to do under the antitrust laws to a third party?

My criticism was equally simple. I argued that:

> The implicit answer is that the antitrust laws condemn evasion of pricing constraints. This answer is getting more and more familiar at the current Commission. Let's follow the pattern. First, Rambus is based on the concept that evasion of patent disclosure rules in the standard setting context violation Section 2 and Section 5. Second, N-Data is based on the concept that evasion of a contractual pricing constraint in the form of a RAND commitment is a violation of at least section 5 even when the monopoly power is lawfully acquired. Third, Ovation now adds to the list the evasion of reputational constraints on pricing as the genesis of actionable antitrust conduct.

I went on to cite a myriad of examples that would satisfy the FTC "evasion of constraint" theory as described but were problematic because they were not likely to involve the exercise of monopoly power or produce harm that the antitrust laws were designed to prevent and might even be welfare

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> Why not a monopolist whose pricing is constrained by current demand. That is, the profit-maximizing monopoly price is $20 but the monopolist would REALLY like to charge $25. It is only the fact that current demand is not high enough to support that price that prevents the monopolist from charging it. So, our monopolist comes up with a plan (lets call it a scheme, it sounds worse) to evade the pricing constraint created by current demand by advertising its product to consumers and touting its virtues. Or perhaps its going to invest in the quality of the product. In either event, the purpose of the advertising is to shift the demand to the right and result in higher prices. No matter that output increases, it doesn't matter because the monopolist is evading a pricing constraint and presumably has violated Section 2. Evading reputational constraints on demand for X is not analytically any different evasion of the constraints imposed on demand by consumer preferences.
>
> But its much worse than that. There is virtually no limit to this evasion theory. Let's run through some examples. What if Merck evaluated its product line and decided that it would be be better off by dropping some of its product portfolio so that it could increase the price of Indocin? Merck's decision to drop products from its portfolio, or even the design of those product offerings, are surely an evasion of pricing constraints and a violation of Section 2 if it has monopoly power — and perhaps even if it doesn't under Section 5. So much for competition as a discovery process. Or what if Merck decided to create a subsidiary to sell Indocin under a different brand name and trade dress to mitigate the reputational costs it would bear from charging a higher price? Or fired the CEO who decided that charging the monopoly price in the first instance would be a bad idea in favor of a new manager who reached a different conclusion and wanted to increase the price? This evasion theory fairly quickly evaporates to the notion that the antitrust law governs prices that are determined to be unreasonable and not the competitive process.

Former Commissioner Leary takes me to task for apparently misunderstanding a very basic point. Citing my concern that the Ovation theory has virtually no limits and the various examples of evading pricing constraints that I discuss, he points out that the fact that just because the firm could achieve the same result another way does not mean that it is not

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reviewable under Section 7. That is, as he writes, "mergers are different" and "the mere fact that companies could have achieved the results by different means without antitrust enforcement does not necessarily mean that the merger is legal." Next, Commissioner Leary goes on in the article to question my conclusion that Rosch's analysis in Ovation reflects "his increasingly apparent view that economics and economists should play a minimal role in the shaping of antitrust enforcement decisions."

I'll simply refer readers to this post for evidence supporting my conclusions about Commissioner Rosch's views on economics and antitrust and add the observation that talking vaguely about incentives is not the same thing as doing economics or "expanded application of economics."

But what about Leary's central disagreement? Did I miss the basic point that the mere fact that a merger that violates Section 7 is not legal simply because the firms could form a cartel instead? I don't think so. And will explain why after the break.

The point of the examples I gave was not to demonstrate that the parties could have raised price a different way and therefore the merger could not be illegal. The post makes clear, at least I had thought, that the point of these examples was to show the folly of an approach that allowed "evasion of a pricing constraint" to be a sufficient condition for antitrust liability. The threat of that approach is that it might assign liability based on conduct that is not welfare reducing nor the province of the antitrust laws, i.e. a merger that changes the post-merger firm's incentives to price because it acquires market power. Indeed, the approach might well condemn conduct that is welfare increasing. Consider the examples again:

> What if Merck evaluated its product line and decided that it would be be better off by dropping some of its product portfolio so that it could increase the price of Indocin? Merck's decision to drop products from its portfolio, or even the design of those product offerings, are surely an evasion of pricing constraints and a violation of Section 2 if it has monopoly power — and perhaps even if it doesn't under Section 5. So much for competition as a discovery process. Or what if Merck decided to create a subsidiary to sell Indocin under a different brand name and trade dress to mitigate the reputational costs it would bear from charging a higher price? Or fired the CEO who decided that charging the monopoly price in the first instance would be a bad idea in favor of a new manager who reached a different conclusion and wanted to increase the price? This evasion theory fairly quickly evaporates to the notion that the antitrust law governs prices that

> are determined to be unreasonable and not the competitive process.

In each of these cases, the point is that substituting "evasion of a pricing constraint" for the more rigorous economic approach that focuses on whether the merger changes the firms ability to increase price as the result of *acquiring market power* opens the door for substantial havoc and prosecutorial discretion that doesn't have much to do with economics. For example, I wrote:

> Despite the fuzzy logic of the evasion of constraint theory, the FTC doesn't seem to be willing to apply it to quality investments or product advertising by monopolists. Isn't price discrimination by giving targeted rebates to marginal consumers and raising the prices to infra-marginal consumers merely an attempt to evade the constraint imposed by the fact that the firm cannot engage in perfect price discrimination? Doesn't it matter that the pricing constraint from the maverick firm is a constraint that arises out of the competitive process that is eliminated by the transaction? Sure it does. The maverick theory is sound economics and based on the concept that the acquisition of the maverick changes pricing incentives post-merger because of a change in the nature of competition before and after the merger. That is, acquisition of the maverick makes a reduction in competition more likely post-merger.
>
> That's not true in Indocin/Merck with the evasion of a reputational constraint on prices. The transaction has not altered the nature of competition or the competitive process. Indocin was the sole product. The FTC itself alleges in its monopolization claim that the first transaction gave Indocin monopoly power which it maintained in the second transaction. The transfer may have altered the profit-maximizing price. But not through the required mechanism: it did not reduce competition. The analogy to the maverick theory is fatally flawed. And reliance on the general principle that evasion of pricing constraints through merger or other conduct is a sufficient condition for antitrust liability is misguided and unsound policy precisely because it is without limiting principles, unhinged from sound economic foudnations, and threatens to turn antitrust enforcement into more general regulation of prices and optimal allocation of resources, e.g. which firm should have Indocin?

The comparison with the maverick theory is important. So is the discussion of N-Data. The former is important because it

distinguishes between a theory that deals with an evasion of a constraint removed because of a change in the competitive process (perhaps even a substantial lessening of competition) and a theory of evading a constraint that is independent of the competitive process. The latter leaves the door open to substantial funny business. The latter is important because it suggests that the Commission is willing to view the evasion of constraint as a sufficient not merely necessary condition. Lastly, simply describing Merck's fear of raising its price as an economic constraint does not render Ovation consistent with the modern "economic approach" to antitrust anymore than my awkward and usually unsuccessful attempts to tell jokes during law school lectures converts my teaching style to a "comedic approach." In either event, the objection to the "evasion" of any constraint approach is not that it condemns behavior that could otherwise be achieved in other forms without antitrust scrutiny, but that it opens the door to enforcement actions applied to business conduct that is not likely to harm competition and might be welfare increasing.

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