INNOVATION AND U.S. ANTITRUST LAW

BY GEORGE L. PRIEST[1]

1 George L. Priest is the Edward J. Phelps Professor of Law and Economics at Yale Law School.

CPI ANTITRUST CHRONICLE September 2023

CPI Antitrust Chronicle September 2023
www.competitionpolicyinternational.com

INNOVATION AND U.S. ANTITRUST LAW

By George L. Priest

This paper addresses the value of innovation as an ambition of U.S. antitrust law. It argues that innovation ought to be a principal goal of the antitrust laws, but has not been. The paper shows, however, the malleability of the U.S. antitrust laws that may allow innovation to be a principal value in the years ahead.

The central ambition of all societies is to create a dynamic economic system that promotes economic growth to the benefit of the citizenry. Stimulating innovation is a principal objective toward this end. Indeed, innovation is the central mechanism for economic growth. Joined by the gains from the redistribution of internal resources to higher valued uses — the principal accomplishment of market economies — innovation in the use of resources increases the worth of the economy, sometimes in a particular sphere, exponentially.

Antitrust law can be an important element of this general ambition by prohibiting the possession of economic power where, by restraining trade, it might diminish innovation or constrain economic growth as well as by dissolving harmful economic power where it has been achieved. The potential importance of antitrust law toward these ends is not inconsiderable. Indeed, the values enshrined in the antitrust laws of equalizing incumbent economic power in order to allow pure innovation to best succeed are transcendent and parallel to the equally transcendent principle of one person-one vote in the realm of political activity which seeks to equalize the possession of political power across the citizenry, including where the expression of political views has important effects on the economy. Again, given the ambition of creating a dynamic economic society, stimulating innovation should be a principal objective of the antitrust laws.

Antitrust law in the U.S., however, has not consistently promoted innovation. The provisions of the Sherman Act — prohibiting combinations that restrain trade and monopolization — and, later, the Clayton Act — prohibiting unfair trade practices — seek only to prohibit practices that might increase economic power or to dissolve it when it has been achieved. There is no reference in these statutes, except perhaps by negative implication, to promoting innovation.

Early cases under the Sherman Act followed this mold. *Trans-Missouri Freight* (1897) and *Addyston Pipe* (1889) sought merely to prohibit cartels, where the only innovation implicated was profit-maximization through joint agreements, worthy of being prohibited.

The early monopolization cases were similar but somewhat more complicated. In *Standard Oil* (1911) the defendants made a strong argument about innovation which the Supreme Court described as "a powerful analysis of the facts . . ." Standard Oil argued

> that the origin and development of the vast business which the defendants control was but the result of lawful competitive methods, guided by economic genius of the highest order, sustained by courage, by a keen insight into commercial situations, resulting in the acquisition of great wealth, but at the same time serving to stimulate and increase production, to widely extend the distribution of the products of petroleum at a cost largely below that which would have otherwise prevailed, thus proving to be at one and the same time a benefaction to the general public as well as of enormous advantage to individuals.

Nonetheless, the Court found against the defendants, ordering the break-up of the Standard Oil monopoly. Subsequent research has shown that the innovation behind the creation of the Standard Oil refining monopoly consisted of Rockefeller and his associates' recognition that forming a monopoly of oil refineries — first, in Cleveland; later extended to Pittsburgh and beyond — would create the power to monopsonize the railroads on which the refiners relied for carrying shipments from the oil territories to eastern ports for export.[2] The Supreme Court missed this point entirely, rejecting the record of the innovation it had praised on grounds of other Standard Oil practices, such as predatory pricing, of minimal economic effect.

The Supreme Court had the opportunity to address innovation in *U.S. Steel* (1920) where J.P. Morgan and Andrew Carnegie had brokered a deal to create a holding company controlling 180 formerly independent steel manufacturers that together possessed 80 to 90 percent of U.S. steel production. In retrospect, the formation of U.S. Steel was obviously anti-competitive, but the Supreme Court refused to condemn it, not on grounds of innovation, though Morgan and Carnegie received as commissions, respectively, $62 million and $225 million for their efforts in its creation, suggesting their high creativity, but because the Court concluded that the firm had not engaged in bad practices.

These early cases show a Supreme Court not exactly indifferent to innovation, but not particularly solicitous of it either. Of course, these early combination and monopolization cases, surely guided by the prohibitory provisions of the Sherman and Clayton Acts, each involved mergers or combinations where the business innovation was centrally anti-competitive: capturing the benefits from the control of large market shares which might sometimes lead to a reduction in prices and an expansion of output (as was claimed in Standard Oil), but more typically harming the economy.

Later cases show the difficulty courts have had in integrating the promotion of innovation as an objective of the antitrust laws. In Alcoa (1945), which is still a controlling precedent, the Justice Department brought suit against the major manufacturer of aluminum and aluminum products in the U.S. on monopolization grounds. Alcoa's monopoly over U.S. supply was initially based on patents, but had been eroded over time

2 See G.L. Priest, Rethinking the Economic Basis of the Standard Oil Refining Monopoly: Dominance Against Competing Cartels, 85 So.Cal.Law Rev. 499 (2012).

by foreign competition and competition from recycled aluminum products. The court, in a somewhat confusing passage, concludes that Alcoa's monopoly may have been achieved without anti-competitive intent, though does not exactly attribute innovation as the central determinant:

> persons may unwittingly find themselves in possession of a monopoly, automatically, so to say: that is, without having intended to put an end to existing competition, or to prevent competition from arising when none had existed; they may become monopolists by force of accident. Since the Act makes "monopolizing" a crime, as well as a civil wrong, it would be not only unfair, but presumably contrary to the intent of Congress, to include such instances. A market may, for example, be so limited that it is impossible to produce at all and meet the cost of production except by a plant large enough to supply the whole demand. Or there may be changes in taste or cost which drive out all but one purveyor. A single producer may be the survivor out of a group of active competitors, merely by virtue of his superior skill, foresight and industry. In such cases a strong argument can be made that, although the result may expose the public to the evils of monopoly, the Act does not mean to condemn the resultant of those very forces which it is its prime object to foster. . . The successful competitor, having been urged to compete, must not be turned upon when he wins.

Applying this "principle" that monopolies achieved inadvertently by luck or natural monopolies are exempt, the court then turned the objective of rewarding innovation on its head, concluding that Alcoa's continued efforts to expand supply and create demand — the essence of innovation in any industry — violated the antitrust laws:

> It was not inevitable that it [Alcoa] should always anticipate increases in the demand for ingot and be prepared to supply them. Nothing compelled it to keep doubling and redoubling its capacity before others entered the field. It insists that it never excluded competitors; but we can think of no more effective exclusion than progressively to embrace each new opportunity as it opened, and to face each newcomer with new capacity already geared into a great organization, having the advantage of experience, trade connections and the elite of personnel. Only in case we interpret "exclusion" as limited to maneuvers not honestly industrial, but actuated by a desire to prevent competition, can such a course, indefatigably pursued, be deemed not "exclusionary." So to limit it would in our judgment emasculate the Act; would permit just such consolidations as it was designed to prevent.

Separately from the antitrust laws, the Patent Act, with Constitutional basis, provides for a time-limited — currently 20-year — monopoly, justified by the ambition to stimulate innovation. The standards for a patent grant are that the proposed invention be "non-obvious" and reduced to practical use, which is not exactly the same as innovative, but perhaps all a public agency can administer.

The approach of the antitrust laws, however, has been to restrict the execution of the patent grant, finding many practices to constitute patent abuse and otherwise limiting the extent to which patent holders or licensees can profit from the innovation, such as by prohibiting the use of tying arrangements and other forms of patent restrictions. In terms of economics, these restrictions on the licensing of patents have the effect of reducing the strength of the basic patent term, thus reducing the statutory incentives for innovation.

In more recent years, since the mid-1970s, the Supreme Court has overturned many of the restrictions it had imposed on industrial practices, but the effects on promoting innovation have been uneven at best. Perhaps the greatest example in the modern age of using antitrust law to promote innovation was administrative — court approved, but not court initiated — in the settlement between the Justice Department and American Telephone and Telegraph Company ("AT&T") breaking the company up.

At the time, AT&T possessed a national monopoly over telephony, both local and long distance, regulated by the FCC. Various other companies — such as MCI — had tried to enter distinct markets, which AT&T resisted on grounds of natural monopoly. The Justice Department sued the company in 1974 and settled the case in 1982. The settlement, crafted by William Baxter, a Stanford law professor, though a Chicago School acolyte, divested the parent company of its local land-line monopolies, though all lines at the time were land-line — creating the Baby Bells, divested the company of its manufacturing subsidiary, Western Electric, which had insisted on a monopoly of telephone manufacture, and opened up competition for interstate service.

The settlement had a huge effect on innovation, which was suddenly allowed in telephony. Innovations such as Fax machines and modern cellphones developed in the wake of the break-up of the monopoly.

More recently, in 2004 in *Verizon v. Trinko*, Justice Scalia for the Supreme Court, delivered the strongest endorsement of promoting innovation through the antitrust laws, though the peculiar context of the litigation raises questions as to how significant Scalia's language will be for the future. The 1996 Telecommunications Act required regional incumbent local exchange carriers — the former Baby Bells, with control over regional telephone land lines — to share their networks with outside competitors, monitored by the FCC. Trinko, a New York City law firm, complained that its local carrier, Verizon, had discriminated against outside carriers. Earlier, in 1999, the FCC had investigated similar claims against Verizon and had levied fines and liability payments totaling $13 million.

The Supreme Court affirmed the dismissal of Trinko's claim. In stirring language, endorsing the promotion of innovation as an important value in antitrust jurisprudence, Justice Scalia addressed the significance of Verizon's practices taking account of its seeming monopoly over regional landline telephony:

> The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices — at least for a short period — is what attracts "business acumen" in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive conduct.
>
> Firms may acquire monopoly power by establishing an infrastructure that renders them uniquely suited to serve their customers. Compelling such firms to share the source of their advantage is in some tension with the underlying purpose of antitrust law, since it may lessen the incentive for the monopolist, the rival, or both to invest in those economically beneficial facilities. Enforced sharing also requires antitrust courts to act as central planners, identifying the proper price, quantity, and other terms of dealing — a role for which they are ill-suited.

This passage might provide grounds for transforming the basic goal of antitrust law to the promotion of innovation. But there are reasons to question its importance. The Supreme Court has not cited the passage since 2004. Secondly, the context of the *Trinko* litigation suggests that the case, more generally, may be regarded as a "primary jurisdiction" case, where the principal agency with jurisdiction over Verizon's practices was the FCC, despite the savings language of the 1996 Telecommunications Act which empowered antitrust jurisdiction. As mentioned, the FCC had penalized Verizon in the past for similar practices. Thus, Scalia's passage is pure dictum.

The principal question is how can the antitrust laws serve to promote innovation to increase the wealth of the economy? The provisions of the Sherman and Clayton Acts are not self-defining — " restraint of trade"; "unfair trade practices." Since the mid-1970s, they have been reinterpreted to embrace the values of greater output and lower prices under what is called the "consumer welfare" standard — following Robert Bork's advocacy. There has been much controversy over the Supreme Court's adoption of the "consumer welfare" standard and over its meaning. Much of this controversy relates to whether the dominant standard for interpretation of the antitrust laws should be so narrowly defined, as opposed to considering other values beyond lower prices and greater output.

The important point, however, is that the provisions of the Sherman and Clayton Acts are sufficiently open-ended to allow multiple interpretations. If the objective of a country is to develop a strong and vibrant economy, its basic policy, as well as the policy of its competition laws, ought to be to promote innovation.