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Page 168

Analysis & Perspective

Daubert Sounds the Death Knell for Antitrust's Merger Presumption After Baby Foods

By Charles D. Weller

In *FTC v. Heinz*--the *Baby Foods* case--the Federal Trade Commission was able to invoke the concentration merger presumption of *U.S. v. Philadelphia National Bank (PNB)*. Without the *PNB* presumption, the FTC would have lost, says lawyer Charles D. Weller. That makes it important for defendants in antitrust merger cases to exclude the *PNB* presumption methodology.

There are "at least five legal challenges based on six U.S. Supreme Court decisions to attack the *PNB* presumption," Weller writes. He gives advice to lawyers on how to use the *Daubert* Quartet and *Khan-California Dental* to exclude--on relevancy, reliability, and "fit" grounds--the *PNB* presumption. And in doing so, Weller says, the litigant will build a record for U.S. Supreme Court review.

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This article is based on "An Evolution of Merger-JV Analysis: The Productivity Paradigm as a Positive Antitrust Policy for Competitiveness and Prosperity" in American Bar Association, Perspectives of The Task Force on Fundamental Theory (Nov. 2001), and "The Litigator's Guide to the Daubert Quartet," 1 BNA Expert Evidence Report 62 (Sept. 10, 2001).

In *Baby Foods*,¹ the Federal Trade Commission snatched victory from the jaws of defeat after losing at trial by convincing the U.S. Court of Appeals for the D.C. Circuit that the *Philadelphia National Bank (PNB)*² concentration theory merger presumption meant that big concentration numbers meant the merging defendants had a bigger burden of proof, which the defendants did not meet. Take away the *PNB* presumption, however, and the FTC would have lost (as they did a year before in *California Dental* when they had to prove their case without a presumption).³

This paper is a litigator's guide on how to win *Baby Foods*-like cases in the future by using the *Daubert* Quartet and *Khan-California Dental*⁴ to deny the FTC and other plaintiff's use of *PNB*, and to build a record for the first Supreme Court merger case since *General Dynamics*⁵ to overrule *PNB* (the Supreme Court in recent cases like *California Dental* and *Khan* has indicated a strong interest in revisiting antitrust presumptions from yesteryear).

The paper also suggests that antitrust agencies in the U.S. and around the world should drop concentration theory, first, because the new litigation realities in the United States outlined below make it likely they will lose if they use *PNB* and second, because there is now a long-needed dynamic economic theory, applicable to antitrust, that has just been published by Harvard Business School professor and Ph.D economist Michael Porter just in time to go beyond "dangerously incomplete" static microeconomics.

PNB Litigator's Toolkit. Serendipitously, for both litigator's interested in challenging *PNB* and antitrust agencies interested in reviewing merger and other antitrust policies dependent on concentration theory and *PNB*, the ABA's Antitrust Section published in November a book entitled *Perspectives on Fundamental Antitrust Theory* ("*ABA Theory*") that contains all the basic legal, factual, economics, policy and even cross examination materials needed.⁷ The book serves as a *PNB* Litigator's Toolkit.

Michael Porter's Dynamic Economics and Antitrust. Winning in court by depriving plaintiff's of the *PNB* presumption and concentration theory is the focus of this article. A litigator's fundamental task, of course, is to win, and winning does not require coming up with a replacement for concentration theory. However, it is helpful to note that *ABA Theory* also contains Michael Porter's article, "Competition and Antitrust: Towards a Productivity-Based Approach to Evaluating Mergers and Joint Ventures" ("*Porter Paper*").⁸ The article both supports overruling concentration theory and *PNB*, and provides a dynamic economic model that takes antitrust and economics to the next level beyond static microeconomics.

Porter's Paper documents how the "theoretical and empirical literature on competition has moved beyond seller concentration, price-cost margins, and other ideas central to current enforcement," and why "far more is at stake in protecting competition than short-term consumer welfare," which for antitrust means that we "should not be debating the size of the company, the market definition, nor what the 'correct' HHI [Herfindahl Index] should be," but instead, we "should be debating the merger or joint venture's impact on productivity growth and on the health of competition, using tools that capture the reality faced by firms [Five Forces and Diamond analysis]." (See Fig. 1).⁹

The 'Baby Foods' Case. *FTC v. Heinz* involved the FTC's challenge to the merger of Heinz and Beechnut, the No. 2 and No. 3 baby food companies in the United States--a merger that would give them 32 percent of the \$1 billion U.S. market for jarred baby foods.

A merger resulting in a company with only 32 percent of the market would not normally be of antitrust concern. Under concentration theory, however, the merger looked bad because the longtime industry leader, Gerber, had 65 percent of the market. As a result, the concentration numbers were high and the merger looked awful: It was a 3-to-2 merger, the two companies that remained after the merger would have 97 percent of the market, and the HHI would increase a whopping 510 points.

The trial court dutifully followed the *PNB* presumption and the surface rigor of concentration theory in finding the merger presumptively unlawful. However, the trial court then went further and found the defendants' rebuttal evidence overcame the presumption and the FTC's proof of an anticompetitive merger failed. Thus the FTC lost at the trial level.

On appeal, however, the D.C. Court of Appeals applied a "big numbers-bigger burden" interpretation of the *PNB* presumption. The "high market concentration levels present in this case require, in rebuttal," the Court of Appeals reasoned, "proof of extraordinary efficiencies," and then ruled the defendants' failed to meet their burden to prove "extraordinary efficiencies." Thus the court granted the FTC an injunction.

Without the *PNB* presumption and the big-numbers-impose-a-bigger-burden interpretation, it seems certain the FTC would have lost. Hence the question here: What can be done as a litigation matter to deny the FTC and any other plaintiff use of the *PNB* presumption?

Five Alternative Grounds for Attacking *PNB*. There are at least five legal challenges based on six Supreme Court decisions to attack the *PNB* presumption. If any one of the five is successful, the plaintiff can not use *PNB*.

Factually, the five legal challenges are also supported by extensive material discrediting the concentration theory on which *PNB* is based, which, for example, is summarized in *ABA Theory*, at 2:

As long ago as 1971 Professor McGee's survey of the literature concluded that "there is no clear relationship between concentration and "competitiveness..." Professors Scherer and Ross stated in 1990: "[R]ecent work has demonstrated that most, if not all, of the correlation between profitability and concentration found by Bain and his descendants (at least for the United States) was almost surely spurious. . . ." In 1984, Judges Posner and Easterbrook stated in the Supplement to their textbook: "These new studies call into question the position-which underlies much of antitrust law... that increasing concentration creates a significant risk of cartels (or cartel-like oligopolistic interdependence)." In 1999 economists Barry Harris and David Smith concluded: "Overall, the economics literature does not provide the basis for a merger enforcement policy based principally on concentration levels. Nobel Laureate George Stigler once commented: "the typical antitrust case is an almost impudent exercise in economic gerrymandering."

The five alternative grounds for attacking *PNB* are:

1. *Daubert Unreliable*: Expert evidence on the *PNB* factual predicates is unreliable and thus must be excluded.
2. *Daubert Irrelevant*: Economic expert evidence on the *PNB* factual predicates is irrelevant and thus must be excluded.
3. *Daubert Fit*: Economic expert evidence on the *PNB* factual predicates does not "fit" the real-world facts of the case and thus must be excluded.
4. *Khan Overruling*: Modern empirical and theoretical evidence requires overruling the *PNB* presumption, like *Khan* unanimously overruled maximum vertical price-fixing.

5. *California Dental Inapplicability*: The *PNB* presumption cannot be applied because the facts are distinguishable from those in *PNB* and its progeny, like the Supreme Court held the presumption involved in *California Dental* could not be applied to the facts there.

Significantly, for tactical or other reasons irrelevant here, none of the five challenges to *PNB* were used in *Baby Foods*. Thus *Baby Foods* provides no precedent complicating the five alternatives and the economic literature supporting them outlined next.

1. Not *Daubert* Reliable

The first three grounds for attacking use of the *PNB* presumption are based on the *Daubert* Quartet. *Concord Boat*¹⁰ illustrates the goal and procedurally what happens. *Daubert* objections to the admission of plaintiffs' economic expert were made before trial, at trial, after trial and on appeal. All of the objections failed until the appeal, when the expert was excluded on *Daubert* grounds and plaintiffs lost the case and their \$140 million judgment for failing to prove key elements.

Specifically, the goal here is to exclude plaintiff's expert testimony on the factual predicates necessary for plaintiff to invoke *PNB*. The factual predicates a plaintiff has the burden to prove in order to be entitled to the *PNB* presumption are:¹¹

- an "undue percentage share" of, and
- a "significant increase" in concentration in
- the "relevant market."

Version of *Daubert* to Use: *Kumho-Joiner v. Four Factors*

As a litigation matter, attacking the *PNB* presumption on the three *Daubert* grounds also requires careful attention to the version of *Daubert* that is used. As detailed in my Sept. 10 BNA article "The Litigator's Guide," *supra*, there are two basic versions of *Daubert*, First, the commonly used Four Factors test taken from dicta in *Daubert* in 1993. Second, the more demanding *Daubert* analysis adopted as holding in *Kumho* and *Joiner* by eight members of the Court, where they upheld the exclusion of all the experts involved. It is suggested that the *Kumho-Joiner* version of *Daubert* be used in preparing for and building a record to exclude plaintiff's expert evidence on the factual predicates required to invoke the *PNB* presumption.

a. *No Reliable Expertise on "Undue Percentage" and "Significant Increase."* The following economic literature shows there is no economic or other expert that will be able to testify "reliably" under *Daubert* on either the "undue percentage share" of or "significant increase" in concentration required to invoke the *PNB* presumption:

Harris and Smith. Harris and Smith in 1999 published an extensive review of both the theoretical and empirical economics literature on concentration.¹² They found that "[m]uch of the empirical

literature suffers from fundamental problems (e.g. the failure to define antitrust markets) that cause their results to be unreliable."¹³ 📖

Even when the empirical literature identifies statistical relationships between higher prices and concentration, these relationships

--vary from study to study

--vary from industry to industry

--often indicate only a small price impact associated with increased concentration.

Further, they find that "[t]he empirical economic literature provides no basis for the existence of a unique critical concentration level or for a specific critical HHI level of 1800."¹⁴ 📖

Judge Posner on Concentration. Judge Posner has explained that in the 1960's in the days of *Vons Grocery*¹⁵ 📖 he "accepted the oligopoly theory of economists Joe Bain and Edward Chamberlin," but today he does not because subsequent "empirical studies" have undermined concentration theory.¹⁶ 📖

Posner and Easterbrook. Judges Easterbrook and Posner similarly have stated that "new studies call into question the position which underlies much of antitrust law that increasing concentration creates a significant risk of cartels (or cartellike oligopolistic interdependence)."¹⁷ 📖

Scherer and Ross. Professors Scherer and Ross in their text ten years ago similarly report, bluntly, that later analysis of Joe Bain's work at the foundation of the *PNB* presumption was "almost surely spurious".¹⁸ 📖

[R]ecent work has demonstrated that most, if not all, of the correlation between profitability and concentration found by Bain and his descendants (at least for the United States) was almost surely spurious -- the result of aggregating a positive relationship between sellers' market shares and profitability to the industry level.

* * *

One cannot help recalling the Princeton physics professor who concluded a research report by noting, "The experiments indicate that the negative mesons are absorbed only one billionth as rapidly as calculated by the theoretical physicists. This would be a major error even for an economist."

Pautler Study. In 1983, Paul Pautler of the Federal Trade Commission concluded:¹⁹ 📖

The empirical evidence is too inexact to allow us to determine the correct market-share standards that should trigger enforcement concerns and our theories give us little if any guidance in choosing specific market share or concentration levels that are likely to lead to poor economic performance.

Porter and Sakakibara. Michael Porter and Mariko Sakakibara in an article reprinted in *ABA Theory* empirically and theoretically show that concentration theory and HHIs are unreliable and even erroneous measures of competition.²⁰ 📄

Measures of market structure, such as the number of firms, the four-firm industry concentration ratio, and the Herfindahl Index only indirectly measure market conduct.

* * *

High industry concentration is positively associated with market share fluctuations, contrary to the predictions of the literature on the influence of concentration.

b. *No Reliable Economic Expert on the "Relevant Market."* The economic literature also suggests there is no reliable economic theory or empirical analysis on the "relevant market" issue.

George Stigler: "[T]he determination of markets has remained an undeveloped area of economic research at either the theoretical or empirical level."²¹ 📄

Franklin Fisher: "Market definition is an artificial construction created by antitrust litigation. For any other purpose of economic analysis, the ... question ... is a meaningless one.... Such activity, however, has historically been of overwhelming importance in antitrust cases."²² 📄

Michael Porter. An industry's boundary is "often imprecise" and thus unreliable because.²³ 📄

- "distinctions between an industry's product and substitutes, incumbents and potential entrants, and incumbents and suppliers or buyers are often arbitrary";
- boundaries are "frequently in flux";
- product lines are "rarely static";
- "[f]irms can create new product varieties that perform new functions, combine functions in new ways, or split off particular functions into separate products";
- "new buyers can become part of an industry, existing buyers can drop out, or buyers may alter their purchasing behavior"; and
- the "current array of products and buyers" does not necessarily reflect "the products and buyers that an industry could potentially encompass."

2. Irrelevant Under *Daubert*: Price and Profitability Not Lessening Competition.

Assuming *arguendo* the economic literature provided a reliable basis for economic testimony on the factual predicates for the *PNB* presumption, which it apparently does not, there is another *Daubert* reason for excluding it: irrelevance. The theoretical and empirical economic literature on concentration analyzes the static microeconomic correlation between concentration and

profitability or price increases, not between concentration and lessening of competition, the legally relevant issue.

Analytically, Harris and Smith's article tells the joke about the drunk looking for his house keys under a street light, even though he knows the keys are elsewhere. Why look for the keys under the street light when he knows they are elsewhere? There isn't any light where the keys are, the drunk explains, but there is light under the street light. Harris and Smith conclude that using "concentration and market shares" to determine a "merger's impact on competition," is "much like the search for house keys under the streetlight."

More generally, the economic literature on concentration suffers from the drunk-under-the-street-light irrelevance flaw. That is, it is looking at price and profitability because those are the issues static microeconomics analyzes, but they are not the relevant legal issue, lessening of competition. The fundamental limitation of static consumer welfare and other microeconomic theory is that they are limited to allocative efficiency, and profitability and price increases are its tools. There is an extensive literature on these various economic theories, summarized in Porter's Paper, as well as in Harris and Smith's article, Tad Lipsky's and other papers, all in *ABA Theory*. Under the dynamic economic theory in Prof. Porter's Paper, the "*new standard for antitrust should be productivity growth*, rather than price/cost margins or profitability, because "the role of competition is to increase a nation's standard of living and long-term consumer welfare via rising productivity growth."²⁴ (See Fig. 1).

In static microeconomic theory, the two issues are assumed to be the same, lessening competition and price or profit increases, but as the Supreme Court made clear in *California Dental*, "assumption alone will not do."²⁵ Without the Supreme Court equating profitability or price increases to the Clayton Act's legal standard of substantially lessening competition, the economic analysis using concentration theory of other issues cannot be assumed to be the same, and therefore are irrelevant.

The assumptions in the various static microeconomic theories also make them vulnerable to a *Daubert* "fit" challenge, a third *Daubert* requirement for the admissibility of expert testimony, covered next.

3. The Economic Theories Do Not "Fit" Under Daubert.

Assuming *arguendo* plaintiff's economic experts on *PNB*'s predicates are not excluded on *Daubert* reliability and relevance grounds, they also can be attacked on *Daubert* "fit" grounds. Indeed, two prominent economic witnesses were excluded from testifying in major antitrust cases on *Daubert* "fit" grounds, Professor Hall of Stanford in *Concord Boat*²⁶ and MIT economist Franklin Fisher in *American Booksellers*, where the court held: "The Fisher model contains entirely too many assumptions and simplifications that are not supported by real-world evidence."²⁷ Similarly, the U.S. Supreme Court in *Illinois Brick* pointed out that "'in the real economic world rather than an economist's hypothetical model,' the latter's drastic simplifications generally must be abandoned."²⁸ Accordingly, the assumptions underlying the economic theory being applied by plaintiff's expert with the *PNB* presumption should be explored under *Daubert*'s "fit" requirement.

Analytically, the *Daubert* "fit" requirement can be understood by considering plane geometry and the earth. Plane geometry, as is well known from high school geometry, is highly rigorous. Nonetheless, plane geometry cannot be used to understand the earth (except for small distances where the earth is flat). It does not "fit" the earth. The assumptions in the various economic theories underlying concentration theory similarly do not "fit" the case at hand.

Harris and Smith. The Harris and Smith article helpfully explains that, in economics, "the theoretical models are quite sensitive to each model's assumptions."²⁹ For example, the Cournot Model, the "principal model" that "predicts a relationship between the HHI and greater-than-competitive pricing" is based on "assumptions" that "are generally unrealistic and do not accurately describe the behavior of most firms."

Franklin Fisher. MIT economist Franklin Fisher states that "fascination with equilibrium is, I believe, a central failing of modern economic theory," with the theory being "so powerful and so aesthetically appealing that we have lost sight of the fact that we typically have no satisfactorily rigorous theory of how, or even if equilibrium is attained," a limitation that "pervades all of economics," including Industrial organization economics.³⁰

Peter Drucker. Peter Drucker points out that "economics makes three assumptions that are no longer tenable:"³¹

One is that the national economy is a unit of activity in which monetary and tax policy determines the behavior of both individuals and businesses. Secondly is the scarcity axiom. The third one is that if you sell something you alienate it, you have lost it. None of these is valid anymore.

Michael Porter. "Standard economic models of firms and product markets have captured little of the complexity and dynamism of actual competition," and use "[t]heories or models that require restrictive assumptions [that] are untenable."³²

4. The PNB Presumption Should Be Overruled Under Khan

Alternatively, this same empirical and theoretical literature can be used to overrule PNB under *Khan* and its predecessors. The evidence and information held sufficient to overrule the maximum price-fixing presumption in *Khan* seems to be less robust by comparison to the literature that supports overruling *PNB*.

5. The PNB Presumption Is Inapplicable Under California Dental

Similarly, there is no set of facts today like the facts involved when the concentration presumption was applied in *PNB* and its progeny. Thus, like *California Dental*, the presumption does not apply.

Conclusion.

There are at least five legal grounds firmly rooted in Supreme Court precedent and amply supported by the facts for litigators representing defendants to prevent plaintiffs from using the *PNB* presumption, and thereby winning future cases tried like *Baby Foods*. In addition, these five litigation strategies can set the stage for the first Supreme Court merger case since *General Dynamics* to overrule another anachronism of antitrust law, *PNB*, and potentially persuade antitrust agencies to drop concentration theory as a litigation matter, and as a policy matter, also move to a dynamic economic theory the public deserves and the times require.

¹ *Federal Trade Commission v. Heinz*, 116 F. Supp. 2d 190 (D.D.C. 2000), rev'd 246 F.3d 708 (D.C. Cir. 2001).

² *U.S. v. Philadelphia Natl. Bank.*, 374 U.S. 321 (1963).

³ *Calif. Dental Assn v. FTC*, 143 L. Ed 2d 935 (1999) (no presumptive "quick look" theory of liability could be used) (the FTC lost on their Rule of Reason theory on remand to Ninth Circuit) 224 F.3d 942 (2000) (the case ended when the FTC decided not to seek review in February 2000).

⁴ See generally Weller, *BNA, supra. Daubert v. Merrell Pharmaceuticals Inc.*, 509 U.S. 579 (1993); *General Electric Co. v. Joiner*, 522 U.S. 136 (1997); *Kumho Tire Co. v. Carmichael*, 143 L. Ed. 2d 238 (1999); *Weisgram v. Marley Co.*, 145 L. Ed. 2d 958 (2000) are the *Daubert* Quartet. The two presumption cases are *State Oil v. Khan*, 139 L. Ed 2d 199 (1997) and *California Dental*.

⁵ *U.S. v. General Dynamics Corp.*, 415 U.S. 486 (1974).

⁶ M. Porter, H. Takeuchi & M. Sakakibara, *Can Japan Compete?* xv (2000). See generally Weller, *ABA Theory, supra*, at 215, and "Harmonizing Antitrust Worldwide by Evolving to Michael Porter's Dynamic Productivity Growth Analysis," *Antitrust Bulletin* (forthcoming 2002).

⁷ Available for no charge in pdf format at www.abanet.org/antitrust under "Recent Task Force Reports").

⁸ *ABA Theory*, at 125. The application of Porter's dynamic economics to five U.S. cities is the subject of a major national conference in Washington, D.C. on December 13, 2001, with analyzes and other details available at www.compete.org and www.isc.hbs.edu.

⁹ *Id.* in *ABA Theory* at 129, 130, 175

¹⁰ *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000) (cert. denied Nov. 2000).

¹¹ *Philadelphia National Bank, supra*, 374 U.S. at 363.

¹² Harris & Smith, "The Merger Guidelines v. Economics: A Survey of Economic Studies," *Antitrust Report* 23 (Sept. 1999), reprinted in *ABA Theory* at 9.

¹³ Harris & Smith, *supra*, at 25.

¹⁴ *Id.* at 43.

¹⁵ *U.S. v. Vons Grocery Co.*, 384 U.S. 270 (1966).

¹⁶ "From Von's to Schwinn to the Chicago School: Interview with Judge Richard Posner, Seventh Circuit Court of Appeals," *Antitrust* 4, 5 (Spring 1992).

¹⁷ R. Posner & F. Easterbrook, *Antitrust Cases, Economic Notes and Other Materials* 41-43 (2d ed. Supp. 1984).

¹⁸ F. Scherer & D. Ross, *Industrial Market Structure and Economic Performance* 411 (3d ed. 1990).

¹⁹ Pautler, "A Review of the Economic Basis for Broad-Based Horizontal Merger Policy," 28 *Antitrust Bulletin* 571, 650 (1983).

²⁰ "Competing at Home to Win Abroad: Evidence from Japanese Industry, 83 *Rev. of Economics & Statistics* 310 (2001); reprinted in *ABA Theory*, at 181 .

²¹ G. Stigler, *The Economist as Preacher* 51 (1985).

²² F. Fisher, *Industrial Organization, Economics and the Law* (1991), p. 37.

²³ M. Porter, *Competitive Advantage* 175, 233-34.

²⁴ Porter Paper in *ABA Theory*, at 144; see also Weller, *supra*, in *ABA Theory* at 268-79; Weller, "Antitrust Economics as Science After *Daubert*," 42 *Antitrust Bulletin* 871 (1997).

²⁵ 143 L.Ed 2d at 954 n.12.

²⁶ *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000) (cert. denied Nov. 2000).


²⁷ *American Booksellers Assn, Inc. v. Barnes & Noble, Inc.*, 135 F. Supp. 2d 1031, 1041 (N.D. Cal. 2001).

²⁸ *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 741-42 (1977), quoting *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481, 493 (1968).

²⁹ Harris & Smith, *supra*.

³⁰ F. Fisher, *Industrial Organization, Economics and the Law* xiii (1991).

³¹ "Peter Drucker, The ArchGuru of Capitalism, Argues That We Need a New Economic Theory and New Management Model," *Wall St. J.* (1/1/00). "[I]nformation becomes more valuable the more people have it. What this means for economics is ... that it will force us radically to revise basic economic theory." P. Drucker, *Management Challenges for the 21st Century* 27-28 (1999).

³² "Michael Porter on Competition," 44 *Antitrust Bulletin* 841, 860 (2000). 

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