The District Court's FTC v. Qualcomm Decision Rests on Impermissible Inferences and Should Be Reversed
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Last week the International Center for Law & Economics (ICLE) and twelve noted law and economics scholars filed an amicus brief in the Ninth Circuit in FTC v. Qualcomm*, in support of appellant (Qualcomm) and urging reversal of the district court's decision. The brief was authored by Geoffrey A. Manne, President & founder of ICLE, and Ben Sperry, Associate Director, Legal Research of ICLE. Jarod M. Bona and Aaron R. Gott of Bona Law PC collaborated in drafting the brief and they and their team provided invaluable pro bono legal assistance, for which we are enormously grateful. Signatories on the brief are listed at the end of this post.*

We've written about the case several times on Truth on the Market, as have a number of guest bloggers, in our ongoing blog series on the case here.

The ICLE *amicus* brief focuses on the ways that the district court exceeded the "error cost" guardrails erected by the Supreme Court to minimize the risk and cost of mistaken antitrust decisions, particularly those that wrongly condemn procompetitive behavior. As the brief notes at the outset:

> The district court's decision is disconnected from the underlying economics of the case. It improperly applied antitrust doctrine to the facts, and the result subverts the economic rationale guiding monopolization jurisprudence. The decision—if it stands—will undercut the competitive values antitrust law was designed to protect.

The antitrust error cost framework was most famously elaborated by Frank Easterbrook in his seminal article, *The Limits of Antitrust* (1984). It has since been squarely adopted by the Supreme Court—most significantly in *Brooke Group* (1986), *Trinko* (2003), and *linkLine*(2009).

In essence, the Court's monopolization case law implements the error cost framework by (among other things) obliging courts to operate under certain decision rules that limit the use of inferences about the consequences of a defendant's conduct except when the circumstances create what game theorists call a "separating equilibrium." A separating equilibrium is a

> solution to a game in which players of different types adopt different strategies and thereby allow an uninformed player to draw inferences about an informed player's type from that player's actions.
>
> *Baird, Gertner & Picker, Game Theory and the Law*

The key problem in antitrust is that while the consequence of complained-of conduct for *competition* (i.e., consumers) is often ambiguous, its deleterious effect on *competitors* is typically quite evident—whether it is actually *anticompetitive* or not. The question is whether (and when) it is appropriate to *infer* anticompetitive effect from *discernible* harm to competitors.

Except in the narrowly circumscribed (by *Trinko*) instance of a unilateral refusal to deal, anticompetitive harm under the rule of reason must be proven. It may not be inferred from harm to competitors, because such an inference is too likely to be mistaken—and "mistaken inferences are especially costly, because they chill the very conduct the antitrust laws are designed to protect." (*Brooke Group* (quoting yet another key Supreme Court antitrust error cost case, *Matsushita* (1986)).

Yet, as the brief discusses, in finding Qualcomm liable the district court did not demand or find proof of harm to competition. Instead, the court's opinion relies on impermissible inferences from ambiguous evidence to find that Qualcomm had (and violated) an antitrust duty to deal with rival chip makers and that its conduct resulted in anticompetitive foreclosure of competition.

We urge you to read the brief (it's pretty short—maybe the length of three blogs posts) to get the whole argument. Below we draw attention to a few points we make in the brief that are especially significant.

The district court bases its approach entirely on *Microsoft* — which it misinterprets in clear contravention of Supreme Court case law

The district court doesn't stay within the strictures of the Supreme Court's monopolization case law. In fact, although it obligingly recites some of the error cost language from *Trinko*, it quickly moves away from Supreme Court precedent and bases its approach entirely on its reading of the D.C. Circuit's *Microsoft* (2001) decision.

Unfortunately, the district court's reading of *Microsoft* is mistaken and impermissible under Supreme Court precedent. Indeed, *both* the Supreme Court and the D.C. Circuit make clear that a finding of illegal monopolization may not rest on an inference of anticompetitive harm.

The district court cites *Microsoft* for the proposition that

> Where a government agency seeks injunctive relief, the Court need only conclude that Qualcomm's conduct made a "significant contribution" to Qualcomm's maintenance of monopoly power. The plaintiff is not required to "present direct proof that a defendant's continued monopoly power is precisely attributable to its anticompetitive conduct."

It's true *Microsoft* held that, in government actions seeking injunctions, "courts [may] infer '***causation***' from the fact that a defendant has engaged in anticompetitive conduct that 'reasonably appears capable of making a significant contribution to maintaining monopoly power.'" (Emphasis added).

But Microsoft never suggested that ***anticompetitiveness*** itself may be inferred.

"Causation" and "anticompetitive effect" are not the same thing. Indeed, *Microsoft* addresses "anticompetitive conduct" and "causation" in separate sections of its decision. And whereas *Microsoft* allows that courts may infer "causation" in certain government actions, it makes no such allowance with respect to "anticompetitive effect." In fact, it explicitly rules it out:

> [T]he plaintiff… must demonstrate that the monopolist's conduct indeed has the requisite anticompetitive effect…; no less in a case brought by the Government, it must demonstrate that the monopolist's conduct harmed competition, not just a competitor."

The D.C. Circuit subsequently reinforced this clear conclusion of its holding in *Microsoft* in [*Rambus*]:

> Deceptive conduct—like any other kind—must have an anticompetitive effect in order to form the basis of a monopolization claim…. In *Microsoft*… [t]he focus of our antitrust scrutiny was properly placed on the resulting harms to competition.

Finding causation entails connecting evidentiary dots, while finding anticompetitive effect requires an economic assessment. Without such analysis it's impossible to distinguish procompetitive from anticompetitive conduct, and basing liability on such an inference effectively writes "anticompetitive" out of the law.

Thus, the district court is correct when it holds that it "need not conclude that Qualcomm's conduct is the sole reason for its rivals' exits or impaired status." But it is simply wrong to hold—in the same sentence—that it can thus "conclude that Qualcomm's practices harmed competition and consumers." The former claim is consistent with *Microsoft*; the latter is emphatically not.

Under *Trinko* and *Aspen Skiing* the district court's finding of an antitrust duty to deal is impermissible

Because finding that a company operates under a duty to deal essentially permits a court to infer anticompetitive harm without proof, such a finding "comes dangerously close to being a form of 'no-fault' monopolization," as Herbert Hovenkamp has written. It is also thus seriously disfavored by the Court's error cost jurisprudence.

In *Trinko* the Supreme Court interprets its holding in *Aspen Skiing* to identify essentially a single scenario from which it may plausibly be inferred that a monopolist's refusal to deal with rivals harms consumers: the existence of a prior, profitable course of dealing, and the termination and replacement of that arrangement with an alternative that not only harms rivals, but also is *less profitable* for the monopolist.

In an effort to satisfy this standard, the district court states that "because Qualcomm previously licensed its rivals, but voluntarily stopped licensing rivals even though doing so was profitable, Qualcomm terminated a voluntary and profitable course of dealing."

But it's not enough merely that the *prior* arrangement was profitable. Rather, *Trinko* and *Aspen Skiing* hold that when a monopolist ends a profitable relationship with a rival, anticompetitive exclusion may be inferred only when it also refuses to engage in an ongoing arrangement that, in the short run, is more profitable than no relationship at all. The key is the relative value to the monopolist of the current options on offer, not the value to the monopolist of the terminated arrangement. In a word, what the Court requires is that the defendant exhibit behavior that, but-for the expectation of future, anticompetitive returns, is irrational.

It should be noted, as John Lopatka (here) and Alan Meese (here) (both of whom joined the *amicus* brief) have written, that even the Supreme Court's approach is likely insufficient to permit a court to distinguish between procompetitive and anticompetitive conduct.

But what *is* certain is that the district court's approach *in no way* permits such an inference.

"Evasion of a competitive constraint" is not an antitrust-relevant refusal to deal

In order to infer anticompetitive effect, it's not enough that a firm may have a "duty" to deal, as that term is colloquially used, based on some obligation other than an *antitrust* duty, because it can in no way be inferred from the evasion of *that* obligation that conduct is anticompetitive.

The district court bases its determination that Qualcomm's conduct is anticompetitive on the fact that it enables the company to avoid patent exhaustion, FRAND commitments, and thus price competition in the chip market. But this conclusion is directly precluded by the Supreme Court's holding in *NYNEX*.

Indeed, in *Rambus*, the D.C. Circuit, citing *NYNEX*, rejected the FTC's contention that it may infer anticompetitive effect from defendant's evasion of a constraint on its monopoly power in an analogous SEP-licensing case: "But again, as in *NYNEX*, an otherwise lawful monopolist's end-run around price constraints, even when deceptive or fraudulent, does not alone present a harm to competition."

As Josh Wright has noted:

> [T]he objection to the "evasion" of any constraint approach is… that it opens the door to enforcement actions applied to business conduct that is not likely to harm competition and might be welfare increasing.

Thus *NYNEX* and *Rambus* (and *linkLine*) reinforce the Court's repeated holding that an inference of harm to competition is permissible only where conduct points clearly to anticompetitive effect—and, bad as they may be, evading obligations under other laws or violating norms of "business morality" do not suffice.

The district court's elaborate theory of harm rests fundamentally on the claim that Qualcomm injures rivals—and the record is devoid of evidence demonstrating actual harm to competition. Instead, the court infers it from what it labels "unreasonably high" royalty rates, enabled by Qualcomm's evasion of competition from rivals. In turn, the court finds that that evasion of competition can be the source of liability if what Qualcomm evaded was an antitrust duty to deal. And, in impermissibly circular fashion, the court finds that Qualcomm indeed evaded an antitrust duty to deal—because its conduct allowed it to sustain "unreasonably high" prices.

The Court's antitrust error cost jurisprudence—from *Brooke Group* to *NYNEX* to *Trinko* & *linkLine*—stands for the proposition that no such circular inferences are permitted.

The district court's foreclosure analysis also improperly relies on inferences in lieu of economic evidence

Because the district court doesn't perform a competitive effects analysis, it fails to demonstrate the requisite "substantial" foreclosure of competition required to sustain a claim of anticompetitive exclusion. Instead the court once again infers anticompetitive harm from harm to competitors.

The district court makes no effort to establish the *quantity* of competition foreclosed as required by the Supreme Court. Nor does the court demonstrate that the alleged foreclosure harms competition, as opposed to just rivals. Foreclosure per se is not impermissible and may be perfectly consistent with procompetitive conduct.

Again citing *Microsoft,* the district court asserts that a quantitative finding is not required. Yet, as the court's citation to *Microsoft* should have made clear, in its stead a court must find actual anticompetitive effect; it may not simply assert it. As *Microsoft* held:

> It is clear that in all cases the plaintiff must… prove the degree of foreclosure. This is a prudential requirement; exclusivity provisions in contracts may serve many useful purposes.

The court essentially infers substantiality from the fact that Qualcomm entered into exclusive deals with Apple (actually, volume discounts), from which the court concludes that Qualcomm foreclosed rivals' access to a key customer. But its inference that this led to substantial foreclosure is based on internal business statements—so-called "hot docs"—characterizing the importance of Apple as a customer. Yet, as Geoffrey Manne and Marc Williamson explain, such documentary evidence is unreliable as a guide to economic significance or legal effect:

> Business people will often characterize information from a business perspective, and these characterizations may seem to have economic implications. However, business actors are subject to numerous forces that influence the rhetoric they use and the conclusions they draw….
>
> There are perfectly good reasons to expect to see "bad" documents in business settings when there is no antitrust violation lurking behind them.

Assuming such language has the requisite economic or legal significance is unsupportable—especially when, as here, the requisite standard demands a particular *quantitative significance*.

Moreover, the court's "surcharge" theory of exclusionary harm rests on assumptions regarding the mechanism by which the alleged surcharge excludes rivals and harms consumers. But the court incorrectly asserts that only one mechanism operates—and it makes no effort to quantify it.

The court cites "basic economics" via Mankiw's *Principles of Microeconomics* text for its conclusion:

> The surcharge affects demand for rivals' chips because as a matter of basic economics, regardless of whether a surcharge is imposed on OEMs or directly on Qualcomm's rivals, "the price paid by buyers rises, and the price received by sellers falls." Thus, the surcharge "places a wedge between the price that buyers pay and the price that sellers receive," and demand for such transactions decreases. Rivals see lower sales volumes and lower margins, and consumers see

less advanced features as competition decreases.

But even assuming the court is correct that Qualcomm's conduct entails such a surcharge, basic economics does *not* hold that decreased demand for rivals' chips is the only possible outcome.

In actuality, an increase in the cost of an input for OEMs can have *three* possible effects:

1. **OEMs can pass all or some of the cost increase on to consumers in the form of higher phone prices**. Assuming some elasticity of demand, this would mean fewer phone sales and thus less demand by OEMs for chips, as the court asserts. But the extent of that effect would depend on consumers' demand elasticity and the magnitude of the cost increase as a percentage of the phone price. If demand is highly inelastic at this price (i.e., relatively insensitive to the relevant price change), it may have a tiny effect on the number of phones sold and thus the number of chips purchased—approaching zero as price insensitivity increases.
2. **OEMs can absorb the cost increase and realize lower profits but continue to sell the same number of phones and purchase the same number of chips**. This would not directly affect demand for chips or their prices.
3. **OEMs can respond to a price increase by purchasing fewer chips from rivals and more chips from Qualcomm**. While this would affect rivals' chip sales, it would not necessarily affect consumer prices, the total number of phones sold, or OEMs' margins—that result would depend on whether Qualcomm's chips cost more or less than its rivals'. If the latter, it would even increase OEMs' margins and/or lower consumer prices and increase output.

Alternatively, of course, the effect could be some combination of these.

Whether any of these outcomes would substantially exclude rivals is inherently uncertain to begin with. But demonstrating a reduction in rivals' chip sales is a necessary but not sufficient condition for proving anticompetitive foreclosure. The FTC didn't even demonstrate that *rivals* were substantially harmed, let alone that there was any effect on *consumers*—nor did the district court make such findings.

Doing so would entail consideration of whether decreased demand for rivals' chips flows from reduced consumer demand or OEMs' switching to Qualcomm for supply, how consumer demand elasticity affects rivals' chip sales, and whether Qualcomm's chips were actually less or more expensive than rivals'. Yet the court determined none of these.

Conclusion

Contrary to established Supreme Court precedent, the district court's decision relies on mere inferences to establish anticompetitive effect. The decision, if it stands, would render a wide range of potentially procompetitive conduct presumptively illegal and thus harm consumer welfare. It should be reversed by the Ninth Circuit.

Joining ICLE on the brief are:

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