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Abstract

During my tenure as Deputy Assistant Attorney General for International Enforcement in the Antitrust Division of the United States Department of Justice, in a speech I delivered in London, in May 2002, I identified the regulation of single-firm conduct as the area of greatest divergence between U.S. and European competition policy. In the United States, led by the insights of the so-called Chicago School of economics, the courts have moved progressively toward an approach to single-firm conduct that has substantially narrowed the range of potential antitrust intervention. In Europe, by contrast, the courts appear to continue to take a more regulatory approach to the conduct of allegedly dominant firms especially in such areas as above-cost price discounting and access to what are sometimes called “essential facilities.” I speculated (admittedly with little empirical support) that this difference in approach might be contributing to the slower rate of economic growth in Europe, and I called, therefore, for a transatlantic dialogue over the relative merits of our differing approaches.
4. SINGLE-FIRM CONDUCT:
THE SEARCH FOR THE HOLY GRAIL
OF ADMINISTRABLE
PROCOMPETITIVE STANDARDS

WILLIAM KOLASKY*

During my tenure as Deputy Assistant Attorney General for International Enforcement in the Antitrust Division of the United States Department of Justice, in a speech I delivered in London in May 2002, I identified the regulation of single-firm conduct as the area of greatest divergence between U.S. and European competition policy. In the United States, led by the insights of the so-called Chicago School of economics, the courts have moved progressively toward an approach to single-firm conduct that has substantially narrowed the range of potential antitrust intervention. In Europe, by contrast, the courts appear to continue to take a more regulatory approach to the conduct of allegedly dominant firms especially in such areas as above-cost price discounting and access to what are sometimes called “essential facilities.” I speculated (admittedly with little empirical support) that this difference in approach might be contributing to the slower rate of economic growth in Europe, and I called, therefore, for a transatlantic dialogue over the relative merits of our differing approaches.

I am delighted that my invitation has been enthusiastically accepted on both sides of the Atlantic. Over the three-and-a-half years since my speech, several conferences and academic papers have focused on our divergent approaches to single-firm conduct, critically evaluating both the reasons for, and the effects of, these differences. Under the leadership of former Commissioner Mario Monti, the European Commission Directorate General for Competition has initiated a far-ranging review of the European law and policy toward single-firm conduct, with the objective of developing guidelines for enforcement of Article 82 of the Treaty of Rome that will not merely clarify, but more importantly reform, European law in this area.

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The Commission’s initiative is certainly welcome. No one, however, should underestimate the difficulty of developing enforcement guidelines in so complex an area. Any set of guidelines runs the risk of being either so general as not to be useful or so specific as to stifle the very competition they are designed to protect. It is for this reason that I thought it would be useful to share with the European audience of this book some of our experience in the United States both with antitrust enforcement guidelines generally and with the search for administrable standards for single-firm conduct in particular. As I will show, our experience with enforcement guidelines has been decidedly mixed. A few (such as our current horizontal merger guidelines) have been extremely successful, but others (such as the competitor collaboration guidelines and the earlier vertical restraint guidelines) have been nearly complete failures. Our search for administrable standards for single-firm conduct has produced a similarly mixed record. One antitrust scholar has even gone so far as to proclaim our current standards for exclusionary conduct to be “not just vague but vacuous.”

While this characterization is, in my view, unduly harsh, it serves to illustrate that even after more than 100 years of antitrust enforcement, our standards for single-firm conduct are still evolving and are, by no means, perfect.

In the remainder of this paper, I will strive to do five things. First, I propose to outline a set of general principles that should govern any effort to develop standards for single-firm conduct. Second, I will briefly recount our experience in the United States with enforcement guidelines and will try to draw a few lessons from our mixed record of success. Third, I will discuss briefly some of the difficulties any enforcement guidelines governing single-firm conduct will need to address in defining “dominance.” Fourth, I will review the U.S. Supreme Court’s decision this past term in Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, which provides the latest guidance on the standards that courts in the United States apply in determining whether single-firm conduct by allegedly dominant firms is “unnecessarily exclusionary” and, therefore, unlawful. Fifth, and finally, I will try to distil from Trinko and other recent cases a proposed standard for exclusionary conduct that the European Commission might consider in writing its new enforcement guidelines. This is obviously an ambitious undertaking for a relatively short paper and should, therefore, be viewed very much as a work in progress. I do not purport to offer definitive answers to any of these difficult questions, but only to offer suggestions to stimulate further discussion and debate.

I should, before moving to the substance of this paper, say a word about the important role Peter Plompen has played in stimulating this important debate. Through his long

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involvement with the International Chamber of Commerce Competition Committee and the OECD Business and Industry Advisory Committee, Peter has been one of the leaders in urging competition authorities throughout the world to apply our competition laws to promote competition, rather than to stifle it.

1. THE NEED FOR ADMINISTRABLE STANDARDS THAT WILL NOT STIFLE COMPETITION

As I have observed elsewhere, competition authorities must be very cautious in regulating the conduct of individual firms. This is because the very notion of free market competition necessarily assumes that individual firms will be allowed to compete freely, without undue government regulation. Efforts to regulate the conduct of individual firms, whether through competition laws or otherwise, therefore, run the risk of destroying competition in the name of protecting it.

For this reason, in both the United States and Europe, the competition laws regulate single-firm conduct only when the firm possesses a substantial degree of market power—what is called monopoly in the United States and dominance in Europe. It is equally important, however, that we recognize that even dominant firms should be allowed to compete aggressively, as long as they do so on the merits—that is, on the basis of superior efficiency in a manner that advances total welfare. We should never use our antitrust and competition laws to protect less efficient rivals from competition itself.

It is particularly important, therefore, in developing administrable standards for enforcing our section two and your Article 82 that we focus on the effects those standards will have on ex ante incentives to compete and to invest and innovate. As the U.S. Supreme Court reminded us in *Trinko*, fact-finding in antitrust cases is extremely costly to business, and the fear of incurring those costs can itself deter investment and aggressive competition. One of the most serious of these costs is the risk of what economists call false positives—that is, that competition on the merits will be misconstrued as an abuse of dominance. One of the surest ways to stifle competition and investment is to adopt rules that will expose companies to the ex post risk that conduct that promotes consumer welfare will mistakenly be found to violate the antitrust laws.

Finally, while there is no question but that decision-making in competition cases must be guided by economics, we must not lose sight of the critical differences between law

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and economics. In developing an analytical framework for enforcing our antitrust laws, especially those governing single-firm conduct, we must always remember the need for that framework to provide administrable standards that can be consistently applied by decision-makers who, because they are human, will always be fallible. As Justice Stephen Breyer has wisely observed, law, unlike economics, is an administrative system.\(^5\) Therefore, while economics can help inform antitrust enforcement, we sometimes must adopt standards for business conduct that do not necessarily leave room for every economic permutation to be taken into account in each individual case. Our analytical framework must make use of presumptions and, in some cases, even per se rules, in order to avoid imposing undue costs.

2. THE U.S. EXPERIENCE WITH GUIDELINES:
   A CAUTIONARY TALE

Over the past 40 years, the U.S. antitrust agencies have promulgated formal antitrust enforcement guidelines in six areas (mergers, vertical restraints, international enforcement, intellectual property, competitor collaborations, and health care). Most of these have now gone through multiple iterations. Our merger guidelines, for example, were first promulgated in 1968, and have gone through two major revisions (in 1982 and 1992), with each of those major revisions being followed by minor adjustments a few years later (in 1984 and 1997).

Some of these guidelines, most notably the merger guidelines, have been enormous successes. Others, such as the vertical restraint and competitor collaboration guidelines, have been abject failures. In examining the reasons for these successes and failures, I believe that five key lessons can be drawn from our experience.

The first is that guidelines are least likely to succeed in areas where the law is still unsettled and where there is still a serious political debate over the proper direction of competition policy. This was plainly the case with the vertical restraint guidelines which the Justice Department promulgated in 1984, at a time when there was still wide disagreement between the Republican Reagan Administration and the Democratic Congress over the fundamental objectives of our antitrust laws. The Reagan Administration believed fervently that antitrust enforcement should protect competition, not competitors; the Congressional Democrats believed just as strongly that antitrust enforcement should not only protect small local businesses, but should also protect their freedom to run their businesses as they saw fit. In the face of this largely political

\(^5\) See Case Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 232 (1st Cir. 1983).
debate over the fundamental purposes of the antitrust laws, the vertical restraint guidelines had little chance of success.

The second is that the most successful guidelines are those that provide a coherent and administrable analytical framework for making enforcement decisions that can also be used by businesses to predict whether their conduct is likely to be challenged. Here the merger guidelines are plainly the gold standard. Those guidelines provide a straightforward five-step framework for evaluating horizontal mergers. For each step, the guidelines identify the key questions that need to be examined and, equally importantly, provide objective measures for answering those questions. Thus, for example, the guidelines ask with respect to market definition: Would a hypothetical monopolist making this product be able profitably to impose a small but significant and non-transitory price increase, defined as a 5-10% increase lasting one year or longer? Similarly, with respect to entry, the guidelines ask: Were the merged firm to raise prices 5-10%, would new entrants be likely to enter the market with sufficient scale within two years to drive prices back to pre-merger levels? These are questions businessmen and women can understand and that are susceptible to proof (or at least educated guesses) one way or the other.

The third lesson is that the best guidelines are those that are soundly based both in economic science and in enforcement experience. Again, the merger guidelines are the gold standard. The 1982 revision to the merger guidelines was based on nearly 14 years of experience reviewing mergers under the previous 1968 guidelines, as well as a large body of litigated cases. It was also based on input from both lawyers and economists at the Antitrust Division who were not only familiar with the latest economic and legal scholarship, but who had practical experience applying that scholarship to day-to-day enforcement decisions. And, finally, it was based on input from the organized bar, which submitted its own recommendations for revised guidelines to the Division.

The fourth lesson is that the more wide-ranging and ambitious the subject matter, the less likely the guidelines are to be successful. The horizontal merger guidelines tackle a single, relatively narrow area of antitrust enforcement. By contrast, the competitor collaboration guidelines try to address an area of business conduct that is almost infinite in its variety. It should not be surprising, therefore, that the competitor collaboration guidelines are viewed as so diffuse and unfocused that they have been called by one former antitrust enforcer “the water is wet” guidelines.

The fifth and final lesson is that successful guidelines build on past successes. The highly successful 1992 revision to the horizontal merger guidelines kept the analytical framework of the 1982 guidelines largely intact, but improved it, based on ten years
of scholarship and experience. By contrast, the failed competitor collaboration guidelines largely ignored the analytical framework of the merger guidelines even in dealing with issues (such as market definition and market power) on which the two sets of guidelines obviously overlapped.

3. WHAT IS DOMINANCE?

With this prelude, we can now turn to some of the issues the European Commission will need to address in developing guidelines for the enforcement of Article 82. The first is the threshold issue of how to decide whether a firm has a “dominant position.”

U.S. law and European law appear to have adopted very similar legal standards for defining “dominance” (in European parlance) or “monopoly” (in U.S. parlance). In Europe, “dominance” is defined as “a position of economic strength” that gives “the power to behave to an appreciable extent independently of competitors, customers and ultimately of consumers.” In the U.S., “monopoly” is defined as the “power to control price or exclude competition.”

An economist would object that neither definition makes any sense as a matter of basic price theory. No firm can behave wholly independently of actual or potential rivals and customers, much less control price or exclude competition. All firms, even monopolists, are constrained by conditions of supply and demand which limit the prices they can charge and still earn a profit. The problem, of course, is that no one has been able to offer an alternative definition that is any better. We certainly cannot simply equate monopoly power or dominance with market power—that is, the ability to charge prices that are above marginal cost. In differentiated goods markets, all firms have some degree of market power, and in markets in which investment and innovation are important, prices must be above short-term marginal cost in order for a firm to earn a return of its investment.

It probably makes sense, therefore, to accept the inexactitude of the current legal definitions of dominance and monopoly and to focus our attention instead on how to identify a dominant position in practice. The traditional way to proceed under both U.S. and European law has been to first define the relevant market in which the alleged monopolist competes and then to measure the firm’s share of that market. Under U.S. law, we generally say that a share of 90 percent almost always indicates monopoly power while a share of less than 75 percent is rarely sufficient. By contrast, under

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European law, as I understand it, a share as low as 50 percent may in some circumstances be sufficient to raise a presumption of a dominant position. More recently, it has come to be recognized that competition enforcers must also examine the ease of entry and expansion by other firms because if entry and expansion are easy, even a very large share will not give rise to durable monopoly power.

The problem that arises, especially in markets driven by innovation, is that it is increasingly common for companies to capture very large shares of particular markets for some period of time, but for that position to give them little, if any, real power to control price or to exclude competition. Even in the case of Microsoft with its alleged Windows monopoly, anyone who has studied the record of that case will recognize that Microsoft has never viewed itself as having a sufficiently durable monopoly that it can relax and stop improving its operating system but rather must constantly keep innovating in order to maintain its market position. While Richard Schmalensee may have become the butt of some editorial cartoonists for his testimony that Microsoft does not have monopoly power, his position was hardly laughable.

I do not have a definitive answer to offer as to how enforcers should best go about determining whether a firm has a dominant position in a meaningful economic market. All I can do is to emphasize the importance that the analysis be a dynamic one that looks, not just at the current state of the market, but more importantly at the forces that may reshape the market in the future. Firms, like the incumbent wire line telecommunications carriers in the United States, who are rapidly losing share to emerging technologies such as wireless and Voice-Over-Internet-Protocol (VOIP), for example, plainly no longer have the monopoly power regulators have historically attributed to them, even if their share of traditional wire line traffic remains above 90 percent in some areas.

4. WHAT IS AN ABUSE?

Once they determine that a firm is dominant, the next, even more difficult question facing enforcers is to decide whether that firm is abusing its dominant position. Though the language of Article 82 and some early decisions applying it could be read to suggest that it is an abuse for a firm to exploit its dominant position by, for example, charging supra-competitive prices, the European Commission appears to have largely followed an enforcement policy that focuses principally on whether the conduct in question is exclusionary—that is, whether the conduct is likely to reinforce the firm's dominant position by making it more difficult for rivals to compete. In taking this approach, the Commission has brought European abuse-of-dominance law closer to the U.S. model, under which a monopolist has always been allowed to reap the fruits
of its monopoly position so long as it does not maintain its monopoly position by unlawful means.

The difficulty, of course, lies in identifying which means are unlawful. This is a question with which the U.S. courts have struggled for over one hundred years and with which they continue to struggle. One thing that has become evident is that no single, overarching general formulation of what constitutes exclusionary conduct is likely to be fully satisfactory. Because ours is a common law system, our standards for judging exclusionary conduct have emerged gradually over time as the courts have applied economic principles to the facts of the cases that have come before them. In some areas, such as predatory pricing, our courts have been able to develop relatively clear rules for what constitutes unlawful exclusionary conduct. But in others, such as bundled discounts, the task of developing coherent rules, or even a dependable analytical framework, is just beginning.

The best recent example of how our common law system works in defining what constitutes exclusionary conduct by a dominant firm is the Supreme Court’s decision this past term in *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko*.<sup>8</sup> *Trinko,* as it is generally known, involved the difficult issue of to what extent the antitrust laws should require a dominant firm to share its facilities with rivals. This was an issue on which the Supreme Court had last spoken nearly 20 years before in *Aspen Skiing Co. v. Aspen Highlands Corp.*<sup>9</sup> In that case, the Court had held that the Aspen Skiing Company, which owned three of the four skiable mountains in the Aspen area, had violated the antitrust laws by refusing to continue to cooperate with its rival, Aspen Highlands, in offering a four-mountain pass which allowed skiers to ski all four mountains on a single ticket. In the interim, the lower courts had developed what they called an “essential facilities” doctrine which appeared to require that a monopolist who owned a facility that could not be duplicated and was therefore essential to competition was required to share that facility with its rivals unless it had a good business reason for not doing so. The seductive appeal of this “essential facilities doctrine” has been so great in Europe that Commissioner Mario Monti once described it as one of America’s most successful exports.

*Trinko* gave the Court its first opportunity in nearly 20 years to revisit this issue and to consider whether the essential facilities doctrine was consistent with the fundamental objectives of antitrust law. While the Court declined either to endorse or reject the essential facilities doctrine as such, the Court’s decision leaves little scope for using the antitrust laws to require dominant firms to share their facilities with rivals.

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<sup>8</sup> 124 S.Ct. 872 (2004).
The significance of the *Trinko* decision in terms of defining antitrust duties to deal is particularly great because the case was before the Court on a motion to dismiss, so that it presented a pure question of law unclouded by any factual disputes. The plaintiff, *Trinko*, was a law firm that alleged it had been prevented from using its preferred telecommunications carrier, AT&T, for local service because Verizon, the incumbent local exchange carrier in New York, had failed to live up to its obligations under the Telecommunications Act of 1999 to share its facilities with its rivals. This alleged failure had led to an enforcement action by the Federal Communications Commission, which was resolved by a consent decree in which Verizon agreed to pay substantial penalties for its failure to comply with its obligations under the Act. *Trinko* alleged that this failure also constituted exclusionary conduct in violation of section two of the Sherman Act because, by not sharing its facilities with rivals as required by the Telecommunications Act, Verizon was thereby unlawfully maintaining its monopoly over local telephone service.

The Court begins its decision by reviewing the basic axioms of U.S. antitrust law with respect to single-firm conduct. Thus, the Court reminds us that “[t]he 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.”10 This is because, the Court goes on to explain, “[t]he 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.”11 The Court goes on to observe that one way in which firms may lawfully acquire monopoly power is “by establishing an infrastructure that renders them uniquely suited to serve their customers.”12 “Compelling such firms to share the source of their advantage,” the Court says, “is in some tension with the underlying purpose of the antitrust laws, since it may lessen the incentive for the monopolist, the rival, or both, to invest in those economically beneficial facilities.”13 In addition, the Court continues, enforced sharing would present two additional difficulties. First, it would “require[] 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.”14 Second, by “compelling negotiation between competitors,” enforced sharing “may facilitate the supreme evil of antitrust: collusion.”15 For these reasons, the Court concludes, the antitrust laws have long recognized the “right of a trader or manufacturer engaged in an entirely private

10 See Case *Trinko*, cited above, at note 8, at 879.
12 *Ibidem.*
13 *Ibidem.*
14 *Ibidem.*
15 *Ibidem.*
business, freely to exercise his own independent discretion as to parties with whom he will deal."\(^{16}\)

With this prelude, the Court turns to its prior decision in *Aspen Skiing*, one of the few cases in which a refusal by a single firm to cooperate with a rival was held to constitute exclusionary conduct for purposes of section two. The Court seeks immediately to cabin that decision, describing it as being “at or near the outer boundary of § 2 liability.”\(^{17}\) The Court goes on to identify two key features of the conduct in *Aspen Skiing* that supported liability in that case and that serve to limit its applicability. First, *Aspen Skiing* involved “[t]he unilateral termination of a voluntary (and thus presumably profitable) course of dealing;” this “suggested a willingness to forsake short-term profits to achieve an anticompetitive end.”\(^{18}\) Second, in *Aspen Skiing*, the defendant had refused to provide rivals a product (lift tickets) that it sold at retail even though the rival was willing to pay the full retail price. This, the Court observed, “revealed a distinctly anticompetitive bent” because it “suggest[ed] a calculation that its future monopoly retail price would be higher.”\(^{19}\) Neither of these key features was present in *Trinko*, leading the Court to conclude that there was no basis for using *Aspen Skiing* as a precedent for imposing liability on Verizon.

The Court closes its opinion in *Trinko* with a fascinating essay on the dangers of an overly expansive reading of section two and of the limited competence of courts in regulating single-firm conduct. The Court begins this essay by noting that because of the duties imposed by the Telecommunications Act of 1996, which were designed affirmatively to promote competition, the benefits of antitrust intervention are likely to be slight. Against the “slight benefits of antitrust intervention,” the Court says, it “must weigh a realistic assessment of its costs.”\(^{20}\) These costs are twofold. First, because both the “means of illicit exclusion” and “the means of legitimate competition” are “myriad,” mistaken inferences, especially false condemnations, “are especially costly because they may chill the very conduct the antitrust laws are designed to protect.”\(^{21}\) “The cost of false positives,” the Court concludes, “counsels against an undue expansion of § 2 liability.”\(^{22}\) Second, “even if the problem of false positives did not exist,” it is important to recognize that some potentially anticompetitive conduct may simply be “beyond the practical ability of a judicial tribunal to control.”\(^{23}\) One such

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16 Ibidem.
17 See Case Trinko, cited above, at note 8.
18 Ibidem, at 880 (emphasis in original).
19 Ibidem.
20 Ibidem, at 882.
21 See Case Trinko, cited above, at note 8.
22 Ibidem.
23 Ibidem, at 883.
type of conduct the Court mentions is an above-cost predatory pricing scheme, but another is access to essential facilities, since compulsory sharing of such facilities would ordinarily require close, continuing supervision by antitrust enforcers, something they are ill-suited to provide. For these reasons, the Court ends, especially where a regulatory statute already imposes sharing obligations designed to promote competition administered by a dedicated regulatory agency, there is no reason to impose additional or redundant duties under the antitrust laws.

The significance the Trinko decision is likely to have for the future shape of section two law is well illustrated by one of the first court of appeals decisions applying that decision, MetroNet Services Corp. v. Qwest Corp.\textsuperscript{24} MetroNet is a case in which a reseller of Centrex services in the Seattle-Tacoma metropolitan area sued the incumbent local exchange carrier, Qwest, alleging that Qwest had violated section two by changing the terms of a quantity discount it offered to require that a customer purchase 21 lines at a single location to qualify for the discount, thereby eliminating the arbitrage opportunity that had previously existed for reseller to buy at a discount and resell to customers who otherwise would not qualify. Prior to Trinko, the U.S. Court of Appeals for the Ninth Circuit had relied on the essential facilities doctrine to hold that Qwest’s conduct could be found to violate section two. Following Trinko, the Supreme Court vacated the Ninth Circuit decision and remanded for reconsideration in light of Trinko. On remand, the Ninth Circuit reversed itself and affirmed a grant of summary judgment in favour of Qwest dismissing the case on the basis of the Court’s reasoning in Trinko. An important part of the Court’s reasoning was that Qwest had always been willing to sell to MetroNet at the prevailing retail price and that preventing a dominant firm from changing the terms of a discount to prevent arbitrage might chill competition by making the firm less willing to discount at all.

5. WHAT IS COMPETITION? A PROPOSED STANDARD FOR EXCLUSIONARY CONDUCT

In the United States, we like to say that the purpose of the antitrust laws is to protect competition, not competitors. Some European enforcers have at times suggested that this is a non sequitur – that one cannot protect competition without protecting competitors because without competitors there would be no competition.\textsuperscript{25} I have

\textsuperscript{24} 383 F.3d 1124 (9th Cir. 2004).
addressed this seeming paradox at length elsewhere and will not repeat that discussion here.\textsuperscript{26}

The central point, to paraphrase President Bill Clinton, is that it depends on what we mean by competition. An economist would define competition, not in terms of any set number of competitors, but as a process – the process by which market forces operate freely to assure that society’s scarce resources are employed in the most efficient manner to maximize total economic welfare. Applying this definition, some markets may, in fact, be more competitive with fewer competitors. And using the antitrust laws to protect competitors from the rigors of competition through government regulation is a certain way to stifle competition.

Using this definition of competition allows us to identify what I believe are the two key questions we should ask whenever we are trying to separate the pro-competitive sheep from the anticompetitive goats, as Justice Breyer has put it.\textsuperscript{27} The first question is whether the conduct in question is likely to exclude an equally efficient rival from the market. The second is whether the alleged monopolist’s conduct involves a sacrifice of short-term profits in a manner that either reduces output or drives prices below cost and that would not be rational unless the monopolist expects the conduct to exclude rivals and to recoup its losses by charging higher prices and/or maintaining its monopoly position for a longer period of time. The answers to these two questions may not resolve every case, but they should serve to help structure the inquiry in a manner that is likely to reduce the risk of error, and especially of false positives.

\textsuperscript{26} See WILLIAM KOLASKY, cited above, at note 5, p. 29.

\textsuperscript{27} See Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 232 (1st Cir. 1983).