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ARTICLES

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ABSTRACTS

ARTICLES

PREDATORY PRICING AND RECOUPMENT *Christopher R. Leslie* 1695

Predatory pricing is a two-step strategy for securing monopoly profits. During the first step—the predation stage—a firm charges a price below its costs in the hope of driving its competitors out of the market by forcing them to sell at a loss as well. If it succeeds, the firm can proceed to the second step—the recoupment stage. After it has the market to itself, the now-dominant firm charges a monopoly price in an effort to recoup the losses it sustained in the predation stage and to earn a steady stream of monopoly profits into the future.

Predatory pricing violates section 2 of the Sherman Act, which prohibits the use of anticompetitive conduct to acquire or maintain monopoly power. Predatory pricing is one form of anticompetitive conduct. Many judges and scholars, however, believe that predatory pricing does not occur because the two-step strategy combines significant up-front costs with a low probability of success. This skepticism has led courts to impose a recoupment element for section 2 predatory pricing claims. The recoupment element requires an antitrust plaintiff bringing a predatory pricing claim to prove that the defendant will be able to acquire monopoly power and to charge a monopoly price for long enough to make the whole scheme profitable. Antitrust liability becomes a function of the defendant's profitability.

This Article discusses the evolution of and rationale for the recoupment requirement. It shows how recoupment analysis by courts is often flawed, largely because judges incorrectly assume that market entry, which can prevent recoupment, is easy. This Article then illustrates the many ways in which recoupment can occur, including recoupment in other markets and recoupment through cartel or oligopoly pricing. Despite these various modes of recoupment, federal courts have sometimes structured the recoupment requirement in a way that is literally impossible to satisfy. This Article advocates more fine-tuned recoupment analysis.

After exploring the judicial misapplication of the recoupment requirement, this Article challenges the underlying premises of the element by showing how predatory pricing can hurt consumers and competition even if a firm engaged in predatory pricing is unable to eventually recoup its losses. Ultimately, the recoupment requirement does not distinguish between anticompetitive and benign (or beneficial) conduct. This Article concludes by explaining how eliminating the recoupment re-

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vestment by legal rules is possible because of the varied menu of legal rules firms can choose from when organizing and raising capital.

This Essay makes several contributions to the literature. By introducing legal diversification, it reveals a new understanding of how investors, issuers, and society can benefit from maintaining a variety of legal rules to govern investment in businesses. The corporate law scholarship has long advocated preserving a variety of rules under which firms can organize, but it has yet to consider how investors can take advantage of that variety to protect themselves before market competition has revealed the "best" rules. Legal diversification also complements recent literature emphasizing the importance of diversity in financial regulation by highlighting another reason diversity of legal rules is important to healthy capital markets. Legal diversification fills gaps in the literature that advocates regulatory diversity by offering an explanation for why that diversity is a valuable protection for investors and an indispensable mechanism for allowing firms to choose the most efficient legal rules to govern their organization and operation.

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ARTICLES

PREDATORY PRICING AND RECOUPMENT

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Predatory pricing is a two-step strategy for securing monopoly profits. During the first step—the predation stage—a firm charges a price below its costs in the hope of driving its competitors out of the market by forcing them to sell at a loss as well. If it succeeds, the firm can proceed to the second step—the recoupment stage. After it has the market to itself, the now-dominant firm charges a monopoly price in an effort to recoup the losses it sustained in the predation stage and to earn a steady stream of monopoly profits into the future.

Predatory pricing violates section 2 of the Sherman Act, which prohibits the use of anticompetitive conduct to acquire or maintain monopoly power. Predatory pricing is one form of anticompetitive conduct. Many judges and scholars, however, believe that predatory pricing does not occur because the two-step strategy combines significant up-front costs with a low probability of success. This skepticism has led courts to impose a recoupment element for section 2 predatory pricing claims. The recoupment element requires an antitrust plaintiff bringing a predatory pricing claim to prove that the defendant will be able to acquire monopoly power and to charge a monopoly price for long enough to make the whole scheme profitable. Antitrust liability becomes a function of the defendant's profitability.

This Article discusses the evolution of and rationale for the recoupment requirement. It shows how recoupment analysis by courts is often flawed, largely because judges incorrectly assume that market entry, which can prevent recoupment, is easy. This Article then illustrates the many ways in which recoupment can occur, including recoupment in other markets and recoupment through cartel or oligopoly pricing. Despite these various modes of recoupment, federal courts have sometimes structured the recoupment requirement in a way that is literally impossible to satisfy. This Article advocates more fine-tuned recoupment analysis.

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After exploring the judicial misapplication of the recoupment requirement, this Article challenges the underlying premises of the element by showing how predatory pricing can hurt consumers and competition even if a firm engaged in predatory pricing is unable to eventually recoup its losses. Ultimately, the recoupment requirement does not distinguish between anticompetitive and benign (or beneficial) conduct. This Article concludes by explaining how eliminating the recoupment requirement in predatory pricing litigation would better serve the purposes of antitrust law.

INTRODUCTION

Antitrust law condemns conduct and agreements that unreasonably restrain trade. The goal of antitrust law is to protect competition in the marketplace. Beginning with the Supreme Court's opinion breaking up Standard Oil over a century ago, antitrust law has been concerned with predatory pricing. In its most basic form, predatory pricing is a two-step strategy for securing monopoly profits. During the predation phase, the firm charges a price below its costs in the hopes that its competitors will be unwilling or unable to sustain the losses they would incur if they matched the below-cost price and will exit the market. After the rivals are vanquished, the post-predation phase begins. With the market to itself, the dominant firm charges a monopoly price with the goal of recouping the losses it sustained during the predation phase and then earning a steady stream of excess profits into the future.[1] If executed successfully, this two-stage process can secure the predatory firm more money than it would get by vying for customers in a competitive marketplace. While no federal statute explicitly condemns predatory pricing, pricing below cost implicates several antitrust causes of action. First and foremost, predatory pricing may violate section 2 of the Sherman Act, which prohibits mo-

1. Transamerica Computer Co. v. IBM, 698 F.2d 1377, 1384 (9th Cir. 1983) ("Predatory pricing occurs when a company that controls a substantial market share lowers its prices to drive out competition so that it can charge monopoly prices, and reap monopoly profits, at a later time.").

nopolization and attempted monopolization[2]—that is, a dominant firm's use of anticompetitive conduct to acquire or maintain monopoly power in a relevant market.[3] Predatory pricing qualifies as a form of anticompetitive conduct. Second, predatory pricing can implicate section 1 of the Sherman Act when it is pursued jointly through an agreement among competitors. Section 1 of the Sherman Act condemns agreements that unreasonably restrain trade and, in theory, predatory pricing conspiracies violate section 1.[4] Third, predatory pricing can also violate the Robinson-Patman Act. The Robinson-Patman Act condemns certain forms of price discrimination, such as when a firm charges a profitable price in one geographic market and a predatory price in another geographic market, using the profits from the first market to subsidize predation in the second.[5] Most predatory pricing litigation is brought under section 2 of the Sherman Act, which is the focus of this Article.

Predatory pricing has long been a controversial cause of action in antitrust. Many judges and scholars believe that successful predatory pricing simply does not occur because price predation is a high-risk strategy that entails significant up-front costs and a low likelihood of sustained profitability.[6] This skepticism has led courts to impose a recoupment element for section 2 predatory pricing claims. The recoupment element requires a predatory pricing plaintiff to prove that the defendant will be able to acquire monopoly power and charge a monopoly price long enough to make the whole scheme profitable.

Since its creation in the 1980s, the recoupment requirement has been little scrutinized, which is surprising given that this lone element

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2. 15 U.S.C. § 2 (2012) ("Every person who shall monopolize, or attempt to monopolize, . . . any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony . . . .").

3. E.g., United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1966) (defining monopolization). Section 2 also condemns attempted monopolization when a firm with a significant market share and a specific intent to monopolize engages in anticompetitive conduct with a dangerous probability of monopolizing a relevant market. Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447, 454 (1993) (articulating required elements of attempt to monopolize).

4. 15 U.S.C. § 1 ("Every contract, combination . . . , or conspiracy, in restraint of trade . . . is declared to be illegal.").

5. 15 U.S.C. § 13(a) ("It shall be unlawful for any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition . . . ."); United States v. Nat'l Dairy Prods. Corp., 372 U.S. 29, 33–34 (1963) ("The 1936 enactment of the Robinson-Patman Act was . . . aimed at a specific weapon of the monopolist—predatory pricing.").

6. See Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986) ("[T]here is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful."); Bathke v. Casey's Gen. Stores, Inc., 64 F.3d 340, 343 (8th Cir. 1995) ("[T]he Supreme Court has urged great caution and a skeptical eye when dealing with unfair [predatory] pricing claims.").

has effectively eliminated the viability of predatory pricing claims. After presenting the origins of the recoupment requirement, this Article explains why the recoupment element is both unnecessary and counterproductive. To appreciate why the recoupment requirement is superfluous, it is instructive to compare two scenarios: predatory pricing with recoupment and predatory pricing without recoupment. In Scenario 1, Firm *A* makes widgets and has two competitors. The average variable cost of making the product is $10 per unit. In an effort to eliminate its two competitors, Firm *A* reduces its price to $9 per unit. The two competitors remain in the market for two years before exiting the market entirely. During this time, Firm *A* sells two million units of product and racks up losses of approximately $2 million. After the competitors exit the market, Firm *A* begins charging a monopoly price, $11 per unit, and continues to sell one million units each year for three years until a new firm enters the market and bids the price back down to $10 per unit. Assume a discount rate of zero for simplicity, and the price predation seems like a profit-maximizing strategy. During the monopoly period, Firm *A* earns $3 million in monopoly profits. Firm *A* will have recouped its $2 million investment in predatory pricing in the first two years and received an additional $1 million in monopoly profits during the third year.

In Scenario 2, all of the facts remain the same with one exception: Firm *A* reduces its price to $8 per unit. This means that its losses during the predation period total $4 million. After its competitors exit the market, Firm *A* will again earn $3 million in monopoly profits until a new rival enters the market and restores the competitive price. Firm *A* will not recoup its investment in predation and will instead lose $1 million despite its monopoly position for two years.

In both scenarios, Firm *A* acquires monopoly power through predatory pricing. The competitors suffer the same antitrust injury and consumers in the post-predation period have paid the same monopoly overcharges. Yet because of the recoupment requirement, Firm *A* has only violated section 2 of the Sherman Act in Scenario 1, not Scenario 2. This makes little sense because in both scenarios, Firm *A* has engaged in predatory pricing and has imposed the same injuries on its competitors and consumers. The failure to profit from anticompetitive conduct should not immunize that conduct from liability.

Part I of this Article discusses the evolution of and rationale for this recoupment requirement. It explains how courts imposed the recoupment requirement in section 2 litigation through a misapplication of a section 1 case. Courts and commentators have justified the recoupment requirement as necessary to reduce the risk of an innocent firm being held liable for predatory pricing. Further, they argue that predatory pricing harms neither consumers nor competition unless the predator recoups its investment in below-cost pricing.

Part II examines the recoupment requirement in operation. It explains how federal courts are often too quick to conclude that a defendant could not recoup its investment in an alleged predatory pricing scheme. Part II examines the many ways that recoupment is possible—ways that federal judges often fail to appreciate. In some cases, courts have structured the recoupment requirement in a way that is literally impossible to satisfy. The recoupment requirement has made it exceedingly difficult for predatory pricing claims to survive summary judgment. If the recoupment requirement is to serve its intended function, judges need to recognize the many ways that below-cost pricing can be profitable.

Part III challenges the underlying premises of the recoupment requirement. It shows how predatory pricing can hurt consumers and competition even without recoupment. In particular, consumers who purchase during the post-predation period when prices are supracompetitive suffer antitrust injury regardless of the monopolist's profitability. Part III also examines the inefficiency inherent in price predation.

Part IV advocates eliminating the recoupment requirement for monopolization claims based on predatory pricing. The primary justification for the recoupment requirement is to reduce the risk of false positives. Part IV explains how other screens for false positives are better than the recoupment element. It then shows how the recoupment requirement can create false negatives in antitrust litigation and explores the costs of this form of judicial error. Finally, it explains why the profitability of anticompetitive conduct is generally irrelevant in antitrust jurisprudence.

I. THE RECOUPMENT REQUIREMENT IN PREDATORY PRICING JURISPRUDENCE

A. *The Evolution of the Recoupment Requirement*

The Supreme Court first recognized predatory pricing as an antitrust violation in *Standard Oil Co. v. United States*.[7] In the following decades, antitrust plaintiffs enjoyed a high success rate in predatory pricing cases.[8] Early courts did not require plaintiffs to prove that the defendant either recouped its investment in below-cost pricing or had a reasonable

7. E.g., Christopher R. Leslie, Revisiting the Revisionist History of *Standard Oil*, 85 S. Cal. L. Rev. 573, 573 (2012) [hereinafter Leslie, *Standard Oil*] (discussing Supreme Court's condemnation of Standard Oil's anticompetitive conduct, including predatory pricing).

8. See, e.g., Patrick Bolton, Joseph F. Brodley & Michael H. Riordan, Predatory Pricing: Strategic Theory and Legal Policy, 88 Geo. L.J. 2239, 2250 (2000) [hereinafter Bolton, Brodley & Riordan, Predatory Pricing] (noting, prior to Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993), "[p]laintiffs won most litigated cases"); James D. Hurwitz & William E. Kovacic, Judicial Analysis of Predation: The Emerging Trends, 35 Vand. L. Rev. 63, 140–45 (1982) (observing higher degree of plaintiff success in pre-*Brooke Group* era of predatory pricing cases).

probability of doing so.[9] Judicial and scholarly attention focused more on the appropriate measurement of cost for predatory pricing claims. In a famous article, Professors Phillip Areeda and Donald Turner proposed a legal test based on average variable cost (AVC) being used as a proxy for marginal cost.[10] Under this test, a price below AVC was presumed to be predatory while a price above AVC was presumed lawful. As courts adopted variations of the Areeda-Turner test, plaintiffs' success rates fell.[11]

The Supreme Court revisited the predatory pricing debate with its opinion in *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*[12] In *Matsushita*, American manufacturers of consumer electronics products brought a claim under section 1 of the Sherman Act, asserting that Japanese manufacturers of consumer electronics had conspired to charge predatorily low prices in the American market in order to drive American firms out of business.[13] According to the complaint, after the Japanese firms had the American market to themselves, they would operate as a cartel in America, as they were doing in Japan.[14] The Third Circuit held that plaintiffs had presented sufficient evidence to survive summary judgment.[15] The Supreme Court reversed in a 5-4 opinion.[16]

The *Matsushita* majority expressed skepticism about the rationality of predatory pricing conspiracies. The plaintiffs' theory assumed that the defendants had collectively agreed to sustain losses for several years, and the Court reasoned that for this "investment to be rational, the conspirators must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered."[17] The majority believed that recoupment was unlikely given that the predation would have to eliminate the American manufacturers from the market in order for the conspirators to be able to raise their prices, but this subsequent increase in price would encourage the eliminated manufacturers (or new

9. See Timothy J. Trujillo, Note, Predatory Pricing Standards Under Recent Supreme Court Decisions and Their Failure to Recognize Strategic Behavior as a Barrier to Entry, 19 J. Corp. L. 809, 813 (1994) (noting in earlier period "[b]elow cost pricing plus anticompetitive intent appeared to be all that was necessary" to stake a claim).

10. Phillip Areeda & Donald F. Turner, Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88 Harv. L. Rev. 697, 716–17 (1975) [hereinafter Areeda & Turner, Predatory Pricing].

11. Bolton, Brodley & Riordan, Predatory Pricing, supra note 8, at 2250–51, 2253.

12. 475 U.S. 574 (1986).

13. Id. at 577–78 (discussing plaintiffs' theory of case).

14. Id. at 584 (discussing respondents' allegations of planned future cartelization in United States).

15. Id. at 580.

16. Id. at 582.

17. Id. at 588–89.