

Antitrust **LAW** ECONOMIC THEORY & COMMON LAW EVOLUTION



KEITH N. HYLTON

Antitrust Law
*Economic Theory and Common
Law Evolution*

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Preface

This book is, at least in part, the result of frustration. As a teacher of antitrust law, I found that the available textbooks did not offer the range of perspectives I try to give my students. I hope this frustration is reflected here. It has led me to push hard to create something that does not fit into one of the molds offered by the existing textbooks.

The available textbooks on antitrust approach the subject from one of two angles, law or economics. From the law angle, one finds either law casebooks or hornbooks. The law casebook, for those who have never seen one, is a compilation of excerpts from important court opinions, interspersed with discussions and questions contributed by the casebook authors. As a way of learning the important results of a court decision, the casebook is inefficient. One is forced to read through lengthy court opinions in the end to note one or perhaps as many as three important legal propositions. In addition, I have often found myself thinking, as I looked at a casebook, that the author is trying to push me in a certain direction without stating his opinions openly. I prefer to see opinions set out openly.

The format of this book avoids what I see as the drawbacks of the casebook. The case summaries state concisely the important legal propositions, and clearly separate them from the less important statements. Following each case, I discuss whether the decision can be defended on economic or legal grounds. My aim is not to brainwash students; it is to push them to question all aspects of the decision, from legal validity – that is, consistency with prior decisions and relevant statutory law – to policy considerations.

The other style of law textbook is the hornbook, in which the author summarizes the cases and provides some synthesis of the law. The benefit

of this approach is that it avoids the inefficiency of the casebook – forcing the student to read four hundred pages in order to extract forty legal propositions. The key drawback of the hornbook is that it can die quickly. The law and our understanding of it change over time. The legal propositions associated with a decision that we think are important today may not be tomorrow, while the less important statements may gain in prominence. The casebook, by setting out the decision in full, is capable of changing as views of the law change. The standard hornbook does not have this adaptability.

I hope that the format of this book avoids the early death problem. Bork's *Antitrust Paradox* did not die early because it presents a sustained theoretically consistent critique of antitrust doctrine. Theory plays an important role in making any discussion of the law worthy of reading after the law has changed. Theory provides a method of understanding or explaining the law, and an objective standard for criticizing it. These standards exist independently of the statement of the law. The reader of a theoretical hornbook such as Bork's picks up more than just the case law, and this is what makes the theoretical hornbook adaptable and capable of withstanding shifts in legal doctrine. I hope I have immunized this book in the same way.

What does this book contribute to the many textbooks already out there? First, I have tried to integrate law and economics at a reasonably high level. Some of the discussions of economic issues are pitched at the advanced-undergraduate economics level. The issues are simply too deep to try to cover as many and remain at a level that assumes absolutely no training whatsoever in economics. Thus, one important difference between this book and most antitrust textbooks, especially law texts, is that I devote a great deal of energy to discussing the relevant economics.

Of course, if one had the time, one could get all of this material out of some of the better antitrust casebooks. The footnotes of the recent Areeda editions (coauthored with Louis Kaplow) contain references to much of the relevant theoretical work in economics. But no one has the time to consult all of the references. I have tried to incorporate some of the recent teachings in a simple way, sparing the reader the task of hunting down journal articles. The reader who seeks a deeper treatment of the issues can read the articles cited in the footnotes of this text, or consult an advanced textbook such as Jean Tirole's *The Theory of Industrial Organization*, and from there embark on a broader search of the literature.

The other side of the coin in this integration process is the law. Unlike most textbooks that stress the economics of antitrust, I have presented the law in a detailed way. I summarize and provide economic analyses of the major and minor legal propositions of each decision. In some instances, I draw attention to minor parts of opinions that have interesting economic implications.

Second, this book attempts to present the material as simply and straightforwardly as possible. I have tried to avoid highfalutin economic and legal terminology. I have tried to explain economic concepts in simple terms with simple examples. As a result, even though the book deals with some advanced issues, the presentation should be easy to follow even if the reader has not had much training in either law or economics.

Third, unlike either the law textbook or the economics textbook, this book attempts to integrate discussion of some issues in common law theory. By common law theory, I mean the exploration of such issues as certainty of law, the relative merits of rules versus legal standards, the process of legal evolution, and the capacity of courts to apply reasonableness standards to business practices. These issues are general, appearing in many fields of law outside of antitrust. I have taken a position on many of these issues, and, of course, the reader is free to disagree. For the reader who disagrees, the useful part of the discussion will be the examples in which case law and economics are integrated in a discussion of legal theory. The case law provides a set of concrete examples that illustrate some long-standing controversies in common law theory. The discussion of economics provides some content to the notion of reasonableness when used as an alternative to that of positive legal validity.

For the student of legal evolution, the most general and frequently recurring problem in antitrust law is the tension between the economic conception of a reasonableness inquiry and the administrative concerns of courts and enforcement agencies. An economically defensible reasonableness inquiry would seek to determine whether a practice, challenged as a restraint of trade, generates economic benefits in excess of its social costs. A practice that enhances society's wealth would be permitted under this standard. However, such a standard, in the antitrust realm, would tend to put courts and enforcement agencies in a disadvantaged position relative to defendants. Courts and enforcement agencies often do not have enough information to rigorously assess the economic reasonableness of a challenged practice. Such an assessment

often requires information privately held by the defendant and his business associates.

Courts and enforcement agencies have responded to this imbalance by interpreting antitrust statutes in a manner that excuses the plaintiff in certain instances from having to demonstrate that the challenged practice is economically unreasonable. The Supreme Court started along this path in its first opinion interpreting Section 1 of the Sherman Act, *U.S. v. Trans-Missouri Freight Assn.*¹ and post-Sherman Act antitrust statutes have avoided any reference to reasonableness. The problem this has generated is that courts find it very hard to move away from reasonableness standards. Indeed, to do so is to abandon the most basic feature of common law adjudication: the equation of legal validity with some notion of reasonableness. The common law process has traditionally developed, generated new law, by extending settled propositions. The extension is justified by appealing to reasonableness, whether based on cost-benefit balancing or a survey of the parties' expectations. In other words, it has not been the practice of courts in the western world to say, "this is the law, and to hell with its justification." Because the common law process requires justification of legal standards, antitrust courts are continually pushed in the direction of providing an economic reasonableness justification for every decision.

The tension between economic reasonableness and administrative concerns seems to be the principal, or at least one of the principal, driving forces in the evolution of antitrust law as a field of federal common law. In several chapters of this book, I note that the law has moved from a reasonableness inquiry to a per-se standard and then back toward a reasonableness inquiry.² The forces pushing in either direction are continually acting on antitrust doctrine. Indeed, it is possible to state a very simple model of antitrust evolution. Public enforcement agencies and federal statutes put pressure on courts to adopt per-se standards. This pressure pushes the law in the direction of per-se rules until, in some cases, a "validity crisis" is reached – a point at which the court can no longer defend its decisions by appealing to economic reasonableness arguments. At that point, the court either retreats from the per-se standard (*Sylvania*, Chapter 13) or reinterprets the reasonableness argu-

¹ 166 U.S. 290 (1897).

² See Chapters 5 (Section 1), 9 (boycotts), 13 (vertical restraints), and 15 (horizontal mergers).

ments (*Addyston Pipe*, Chapter 5). As I point out in the text, this process is observed in several areas of antitrust law.

The tension between economic reasonableness and administrative concerns also has implications for the role of economic theory in antitrust analysis. Economic theory is obviously helpful, and probably necessary, in getting a sense of the meaning of economic reasonableness; and I do not believe there is any area of economic analysis that is too abstract to be useful in this enterprise. However, there may be limits on the extent to which antitrust doctrine should reflect or take into account all of the concerns of the economic theorist. As Judge (now Justice) Breyer put it in his *Barry Wright* opinion,

while technical economic discussion helps to inform the antitrust laws, those laws cannot precisely replicate the economists' . . . views. For, unlike economics, law is an administrative system, the effects of which depend upon the content of the rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counter-productive, undercutting the very economic ends they seek to serve.³

In view of this, the critic of antitrust doctrine must give some thought to the likelihood and cost of judicial error. Where the expected cost of error (the likelihood multiplied by the cost) is high, antitrust doctrine should stop short of requiring a full blown inquiry into all of the matters of concern to the economist. The controversial part, of course, is identifying those areas in which the expected cost of error is high enough to warrant this approach.

If the costs of error were the same, whether an erroneous finding of innocence (false acquittal) or an erroneous finding of guilt (false conviction), then we might be led by administrative concerns to adopt rules of per-se legality and per-se illegality with equal frequency. However, economic analysis permits us to state presumptions or hypotheses regarding the relative costs of false acquittals and convictions in antitrust litigation. If, with respect to a certain type of claim (e.g., predatory pricing), economic reasoning leads us to hypothesize that the expected costs of false convictions are greater than those of false acquittals, we should prefer to adopt per-se legality rules to govern these claims, and conversely. This is the primary sense in which I think economic theory

³ *Barry Wright v. ITT Grinnell Corp.*, 724 F.2d 227, 234 (1st Cir. 1983).

should inform antitrust doctrine, and I have tried in several parts of this book to use economic reasoning in this manner.

The mixture of perspectives may make this book unsuitable for any particular class. The criticism of court decisions may seem too harsh to make appropriate material for law students. I leave these questions to the reader. At the least, I hope that this will provide answers to, or a better method of answering, many questions not covered in the standard presentations of antitrust law.

As with any project that takes a lot of time, this one benefited from the input of many people. Mark Grady, whose office was across the hall from mine in my early teaching years at Northwestern, influenced my thinking on antitrust as well as other areas of legal scholarship. Readers who are familiar with Mark's work will notice that influence in some parts of this book. Indeed, this book follows Mark's course outline, which he gave me in my first year of teaching to help me get started. I also must thank Frank Fisher, who took the time to give me detailed, page-by-page comments on a very early draft. And there are friends and colleagues, like Roger Blair, who gave me useful advice on a chapter here or there, and I am sorry that I cannot list all of them here. Finally, I should thank my former students and research assistants, especially Deborah Loesel, Brian Kaiser, and Jessica Selb, who helped with the research and inspired me to see this project through.

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I

Economics

In this chapter, I will introduce economic concepts that I plan to use throughout the text, set out the basic economics of monopoly, and compare monopoly with its polar opposite, perfect competition. I also will discuss some relatively new topics, such as transaction-cost and information economics, and their relevance to antitrust policy.

I. DEFINITIONS

A. Monopoly

A monopolist is a single supplier of a good. However, this definition is too simple, because it includes firms that become dominant by being the lowest-cost competitor and those that obtain an exclusive franchise from the state. As far as antitrust policy is concerned, there is a big difference between these two cases. Because the simple, “single-supplier” definition is potentially misleading, one should focus on market conditions. The crucial feature of monopoly status is the *absence of competition* from other firms.

The common example of monopoly in our lives is local telephone service, provided in most places in the United States by a regulated, privately owned monopoly. However, even here competition from wireless and optical fiber companies has eroded the monopoly status of the local telephone companies. One of the purest monopolies in recent memory was Aeroflot, the airline of the former Soviet Union. Before the breakup of the Soviet Union, there were no competing airlines.

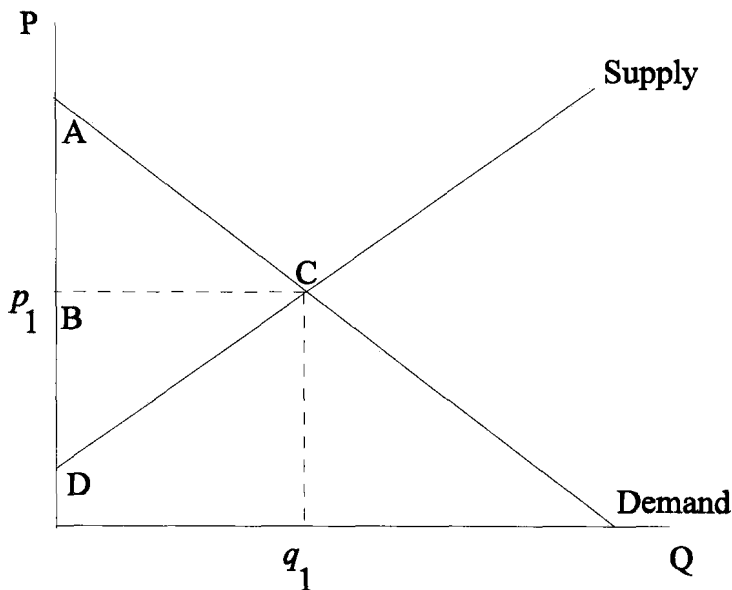


Figure 1.1

B. Market Price

A *market equilibrium*, where the quantity demanded by consumers equals the quantity supplied by producers, generates a market price, as shown in Figure 1.1. The downward sloping line is the demand curve and the upward sloping line is the supply curve. Think of the demand curve as a schedule of bids offered by consumers. Each point along the curve is a maximum price that at least one consumer is willing to pay. The horizontal axis measures the total quantity demanded at a given price, and since each consumer would accept the item at a lower price, quantity demanded increases as price falls. Similarly, one can think of the supply curve as a schedule of minimum asking prices stated by producers. Since each producer is willing to sell the good at a price at or above his asking price, the total quantity offered for sale at a given market price (measured by the horizontal axis) increases as price rises.¹

¹ More technically oriented treatments typically explain that each consumer has a schedule of bids for each quantity desired. Consumers offer less per unit for higher quantities because the utility gained per unit of consumption falls as consumption expands. The market demand curve is the "horizontal sum" of the individual demand schedules. The student trained in economics may prefer to think in these terms. I have attempted to simplify the presentation in the text.

In a market with many producers and consumers, none of them actively sets the equilibrium price. It is, in a passive sense, determined by the actions of the marginal consumer and marginal producer. The marginal consumer (point C in Figure 1.1) is just indifferent between buying the good and going without it, given the market price. Similarly, the marginal producer (also at C) is indifferent between selling at the market price and keeping his output. The inframarginal consumer (to the left of C along the demand curve in Figure 1.1) is willing to pay more for the good than is the marginal consumer, and the inframarginal producer (to the left of C along the supply curve) is willing to part with the good for a lower price than the marginal producer would accept. The price in an exchange between inframarginal actors is indeterminate – it is any level between the maximum the consumer is willing to pay and the minimum the producer is willing to accept.

To see the role played by marginal actors in the determination of equilibrium, suppose the price is initially set above the level that equalizes the amounts demanded and supplied. Suppliers would offer a quantity larger than consumers were willing to purchase, and as a result some sellers would be unable to find buyers. Among them would be inframarginal sellers, who would cut their asking prices in order to make a sale. This process would continue until the equilibrium price is reached.

C. Market's Contribution to Wealth

Because the marginal consumer determines price, all other consumers (inframarginal) gain by making trades in the market. *Consumers' surplus* measures the gain to consumers from taking advantage of the market: some consumers would still buy the good at a higher price, but they can purchase it at the cheaper market price. Similarly, because the marginal producer determines price, *producers' surplus* measures the gain to producers generated by market transactions.

The diagram in Figure 1.1 also illustrates the incremental wealth generated by the market, which is equal to the sum of consumers' surplus and producers' surplus. Consumers' surplus is the area ABC, and producers' surplus is the area DBC. The total surplus, or the market's contribution to wealth, is maximized when price is equal to the market equilibrium level p_1 and quantity is equal to the market equilibrium level q_1 . Because total surplus hits its maximum at the market equilibrium, I will refer to this as the *social optimum*.

Although this may seem an unusual way to measure incremental wealth,² this is the approach Adam Smith emphasized in arguing against the mercantilist policies followed by England and other European countries over the eighteenth century.³ The doctrine of mercantilism, still with us today in many quarters, held that a government should manage foreign trade in order to maximize gold reserves. To the mercantilists, this was how a country became wealthy. In practice, the doctrine necessitated a strategy of maximizing exports and minimizing imports. Adam Smith's argument, startlingly counterintuitive at the time and still misunderstood by the majority of governments today, was that the mercantilists' conception of wealth was invalid and that their policies were likely to reduce rather than increase wealth. A market's real contribution to wealth is the difference between the value of the benefits a good provides and the resource cost of its production. Smith argued that a policy of free trade in competitive markets maximizes this measure of incremental wealth. Of course, understanding Smith's argument requires some familiarity with the properties of competitive markets. I take up that topic next.

D. Defining Perfect Competition

A competitive equilibrium satisfies the assumptions of the model of perfect competition, which are as follows.

1. Atomism. The output of each seller and the consumption amount of each buyer is a small fraction of the total output of the market, so no buyer or seller can have more than a very small influence on market price or quantity. Alternatively, each buyer and seller takes market price as given.

We could speak generally of a spectrum with atomism on one end and monopoly on the other. Of course, the theoretical endpoints are hardly ever observed. Atomism, in its extreme version, requires an infinite number of infinitesimally small producers and consumers. Monopoly requires a single seller, but even where we do find a single seller of an item, often suppliers of close substitutes constrain the monopolist's price-setting decisions.

² It is important to note the difference between stocks and flows. Consumers' surplus is a flow while wealth is a stock. In view of this, I have referred to consumers' surplus as a component of incremental wealth.

³ *An Inquiry into the Nature and Causes of the Wealth of Nations* (Edwin Cannan, ed., New York: Modern Library 1994).

2. *Perfect Information.* Consumers can distinguish between different goods. They also know if one seller is offering a particular good at a lower price than another seller. Really, all we need is that information must get around reasonably fast. The assumption of perfect information simplifies the matter.

Obviously, the assumption is not an accurate description of the world.⁴ In the real world, we see firms advertising. We could make the model resemble the real world more closely by assuming that information is a commodity that must be supplied.

However, once we assume information must be supplied, the reason for making the simplifying assumption of perfect information starts to become clear. The market for information is peculiar. Information is a *public good*, in the sense that a decision to supply it to one person generally means that the good is also available to others. For example, the purchaser of a newspaper may read it and then give it to a friend. Because the information can be shared, the producer may not receive compensation for the benefits conferred upon a large number of consumers, and in this case the market may provide insufficient incentives to produce news. This is illustrated in Figure 1.2. The forward-shifted demand curve includes the benefits of newspapers to nonpaying readers. The social optimum is at (p_2, q_2) rather than the market equilibrium (p_1, q_1) .

This example suggests that relaxing the assumption of perfect information immediately introduces some element of market failure into the model. Consider the case of advertising to inform consumers of the existence of a better mousetrap. Suppose there are competing sellers of this new mousetrap. A seller who advertises the mousetrap cannot be sure that the benefit will accrue to himself alone, because he cannot limit the message only to consumers who will purchase from him. Since some of the benefits may go to other sellers, his incentive to pay for informative advertising is attenuated.

In the extreme case, failure of the assumption of perfect information can make a market virtually infeasible. The best example is the problem of *adverse selection* in the insurance market. Suppose there is a

⁴ A related and more fundamental criticism is that the assumption of perfect information ignores the central problem that needs to be explained: how privately held information is revealed and communicated among market participants, see F. A. Hayek, *Individualism and Economic Order* 77–106 (London: Routledge & Kegan Paul, 1949). Although Hayek's critique has important implications for antitrust policy, space will not permit me to cover it here.