PASSING ON THE MONOPOLY OVERCHARGE: A RESPONSE TO LANDES AND POSNER

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and

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In a recent issue of this Review, we presented a comprehensive analysis of passing on and a method for assigning causes of action to indirect purchasers in cases involving monopoly overcharges.[1] Immediately before publication (literally with galley proofs in hand), we received from the mailroom an article by Professors Landes and Posner on the same topic.[2] Given the direct relevance of their article and that our respective analyses reached opposite policy conclusions, we made several references to Landes and Posner in footnotes to our article. In the preceding pages they have replied to those comments.[3] In responding to their Reply, we seek to emphasize the basic differences which distinguish our approach from theirs, differences which lead to opposite conclusions.

Although there are important technical differences between our approach to the passing-on issue and that of Landes and Posner, the fundamental disagreement between us relates to the nature of economic theory and the use of that theory in legal and policy analysis. This disagreement is signified by the Landes and Posner criticism of our analytical "inconsistency." "Harris and Sullivan," they say, "are free if they like to reject the premises of economic theory; but then we question the appropriateness of their employing those premises to argue earlier in their article that most of a monopoly overcharge will be passed on." [4]

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[1] Harris & Sullivan, *Passing On the Monopoly Overcharge: A Comprehensive Policy Analysis*, 128 U. PA. L. REV. 269 (1979) [hereinafter cited as Harris & Sullivan].

[2] Landes & Posner, *Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws? An Economic Analysis of* Illinois Brick, 46 U. CHI. L. REV. 602 (1979) [hereinafter cited as Landes & Posner Article].

[3] Landes & Posner, *The Economics of Passing On: A Reply to Harris and Sullivan*, 128 U. PA. L. REV. 1274 (1980) [hereinafter cited as Landes & Posner Reply].

[4] *Id.* 1279.

We reject Landes and Posner's belief that economic theory is a doctrine, comprehensive and complete, which must be accepted or rejected in all-or-nothing fashion. We also reject their implicit premise that there is but one "right" brand of economic theory. Economic thought has an eclectic history, and it continues to develop along several lines. There have always been, and continue to be, alternative styles of economics. Among the modern choices, the self-designated "Chicago school" style of Landes and Posner is but one.

In our view, economic theories offer valuable insights into issues of central importance to antitrust policy formulation and adjudication. Economic theories do not, however, ask all of the salient questions, much less answer them. Economics provides intellectually rich abstractions of economic realities, but they remain abstractions nonetheless. Far more is needed to understand the behavioral complexities of a modern economy. In recognition of the power of economic theory, we employed it in the first part of our article; in recognition of the limits of economic theory, we supplemented it by reference to empirical observations of managerial behavior and organizational performance.

Nowhere is this fundamental disagreement regarding the appropriate uses of economic theory more apparent than in the first section of the Landes-Posner Reply, to which we respond at some length in our next section. Thereafter, we comment briefly upon several of our other differences with Landes and Posner regarding the issue of passing on.

I. Price Setting By Direct Purchasers

A central concern of our analysis was compensatory justice. We argued that, based upon economic theory and empirical evidence regarding commercial pricing practices, direct purchasers would, in the great majority of cases, pass on most, all, or even more than one hundred percent of a monopoly overcharge by raising prices to their customers (that is, the indirect, or downstream, purchasers of the antitrust violators). We further showed that direct purchasers that had won an antitrust suit and recovered damages under the rule of *Illinois Brick Co. v. Illinois*[5] would not, ordinarily, "pass back" that damage award to downstream purchasers, even if the monopoly overcharge had been passed on. Expanding upon this showing, we reviewed sixty-five government price-fixing

[5] 431 U.S. 720 (1977).

cases either won by the government or disposed of on a *nolo contendere* plea during the period from 1963 to 1974 (which we assumed were not atypical) and concluded that in a majority of those cases there was a high rate of passing on.[6]

Landes and Posner do not directly take issue with these showings. Instead, they claim that compensatory justice is achieved in a rather ingenious way: while direct purchasers may pass on the monopoly overcharge, they will also pass on the *prospective Illinois Brick* damage award. They claim that if direct purchasers increase prices by the amount of the overcharge, they will also reduce prices by an amount equal to the present discounted value of the expected damage award.[7] In other words, what the direct purchaser passes on with one hand, it passes back with the other!

In responding to their argument, we noted that Landes and Posner had "confused marginal costs and fixed costs," [8] an observation to which they take exception. Before considering the treatment of marginal costs, let us consider two critical precedent events: discovery of the violation and response to the violation by the direct purchaser.

Before managers can decide what to do with gains of anticipated litigation against specific suppliers, they first must discover the violation. Often, direct purchasers do not even suspect they are paying an overcharge; presumably, cartelists attempt to keep their conspiracy secret in order to avoid prosecution. Indeed, in a different context, Landes and Posner acknowledge that "the violation . . . [may be] concealed by the violators" and that this "is almost always the case with regard to price fixing, the principal offense to which the rule of *Illinois Brick* is applicable." [9] If managers lack information regarding the infraction, on what basis would they calculate the expected gains from future litigation?

At some point, of course, direct purchasers may learn of an antitrust violation and corresponding overcharges. But at that point, why would they behave, as Landes and Posner suggest, by passing on the expected gains from litigation through price reductions to their customers? Why would they not take immediate legal action against the violators? In assessing the deterrent effects of alternative assignments of the cause of action, Landes and Posner argue vigorously for assignment to direct purchasers on the grounds

[6] *See* Harris & Sullivan, *supra* note 1, at 321-38.

[7] Landes & Posner Article, *supra* note 2, at 605-08.

[8] Harris & Sullivan, *supra* note 1, at 298-99 n.67.

[9] Landes & Posner Reply, *supra* note 3, at 1276.

that they have better information and greater incentive to sue. If they have information and incentive, why wait to bring suit?

It was on these grounds that we argued that prospective gains must be seen as "windfalls." We think that it is highly unlikely that managers would view those gains as a stream of benefits closely related to the volume of production or sales. As Landes and Posner note, "the actual effect [of price-fixing conspiracies] on price is not considered systematically" [10] by courts in government prosecutions. Even in private damage actions, price effects can only be approximated. If courts, after the event, cannot relate damage awards precisely to actual price effects, why expect that managers will treat *anticipated* damage awards with such precision?

There is one other possible scenario which may be implicit in the Landes-Posner argument regarding price setting by direct purchasers in anticipation of gains from litigation. Suppose that, though managers of the firm do not know of any specific antitrust violation, they are aware of the *Illinois Brick* rule, and therefore realize that there are prospective gains from as yet unknown and unspecified litigation. By what mechanism might managers translate that knowledge into pricing decisions? Because Chicago theories ignore these behavioral issues, Landes and Posner offer no clues about the actual bureaucratic processes by which these price reductions would occur. Yet we can easily infer what kind of conduct would be required, based upon general knowledge of organizational behavior. When we do so it becomes clear that the Chicago theorists, by ignoring the behavioral issues, have reached an exceedingly dubious result.

If the managers of a direct purchaser were following the Landes-Posner scenario, they might view the purchase of inputs as consisting of two separate components: (1) the tangible product as specified in the invoice; and (2) the possible antitrust cause of action which under *Illinois Brick* accrues immediately upon payment of an overcharge to the direct purchaser. The price of the tangible product would of course be a positive cost which should be accounted for in the pricing decision, but the value of the cause of action would be counted as a negative cost. In order to make the proper "marginal cost" pricing decision, the direct purchaser would have to capitalize the present value of a cause of action for an unknown overcharge associated with each unit of each different input. To do so, it would have to gather information and make judgments about such factors as the likelihood of an over-

[10] *Id.* 1277 n.9.

charge on each of the inputs in the production process, the likely magnitude and duration of any such overcharge, the likely cost of the overcharge litigation, the risk that the litigation might fail, and even the possibility that Congress might act legislatively to change the *Illinois Brick* rule.

Information of that sort would be fragmentary supposition, and judgments based on it appallingly speculative. The inquiry, moreover, would be expensive. Data would have to be collected, legal opinions sought, meetings among managers convened, information and speculation evaluated and analyzed. Managers do not engage in such time-consuming or costly searches for a will-o'-the wisp; they attempt to manage only what seems manageable. Yet nowhere do Landes and Posner mention these information costs, much less their implication for their argument. Failure to account for information or transaction costs—or treating them as trivial—is one of the distinguishing characteristics of the Chicago-school tradition. In some cases (abstract modeling, for example), the assumptions that information is perfect and that transactions are costless allows for simplicity and elegance. In ascribing behavior to real-world managers, however, those assumptions can blind one to the truth.

The final irony of the Landes-Posner position is that, in the event direct purchasers actually engaged in the sort of behavior envisaged, managers would thereby produce records of the activity. The existence of such business records is of dual significance. First, if firms behave as Landes and Posner suppose (with respect not only to antitrust but also to all other forms of litigation which has potential damage awards), the empirical studies of industrial pricing behavior would uncover such practices. In our survey of that literature, we found no such evidence.[11] Second, however, if any particular firm did follow the Landes-Posner scenario and actually did pass on the value of the prospective damage award, that firm would have records available which would prove that it had done so. Thus, under our proposed reversal of *Illinois Brick,* that firm, being able to prove that it had passed on, would be entitled to recover the full amount of the overcharges it had paid.

All of this highlights another aspect of our disagreement with Landes and Posner, their reliance upon "marginal cost pricing" not merely as a theoretical construct but as a description of reality.

We reviewed, in some detail, the best available evidence regarding commercial pricing practices as they relate to the issue of

[11] *See* Harris & Sullivan Article, *supra* note 1, at 299-309.

passing on. Suffice it to say that there is little evidence that managers "marginal cost price." We also noted certain conditions, though, under which heuristic pricing practices (for example, cost-plus or markup pricing) are equivalent to marginal-cost pricing. Those conditions, it turns out, seldom apply, especially in the case of multiproduct firms (like retail stores—very often one of the links between monopoly overcharges and final consumers). Landes and Posner neither challenged that evidence nor presented evidence to support their position. Instead, marginal-cost pricing is merely assumed, without recourse to empirical verification.

In sum, we remain convinced that, at least on the grounds of compensatory justice, *Illinois Brick* should be reversed.

II. Elasticities and the Rate of Passing On.

In the theoretical part of our article,[12] we noted that when the elasticity of supply is infinite, the rate of passing on will be one hundred percent, irrespective of the elasticity of demand. We also showed that, over the long run, the elasticity of supply is, in most industries, infinite or nearly so. Landes and Posner reply that "[t]his argument fails to provide a ground for overruling *Illinois Brick* for several reasons," [13] to which we respond here in turn.

In their first three of these arguments, Landes and Posner suggest that our purpose was to imply that since all overcharges are passed on in the long run, it is not "necessary in each individual case to determine how much of the overcharge was passed on." [14] They read us, apparently, as trying to justify a per se rule which assumes total passing on in all cases.

We have been misunderstood. We do not seek to avoid particularized analysis in individual cases. It is the *Illinois Brick* rule championed by Landes and Posner which rejects case-by-case analysis in favor of a per se approach. Under *Illinois Brick* all cases involving monopoly overcharges are treated as if no passing on has occurred. The primary goal of our analysis was not to decide all cases—we have no such confidence in the predictive power of economic theory. Rather, we were attempting to show that the *Illinois Brick* rule produces the wrong result in most cases.

As Landes and Posner acknowledge, we also set forth, in addition to the economic theory of passing on, "a methodology for determining the amount passed on in individual cases." [15] That

[12] *Id.* 275-99.

[13] Landes & Posner Reply, *supra* note 3, at 1276.

[14] *Id.* These three arguments are contained in sections 2(a) through 2(c).

[15] Harris & Sullivan, *supra* note 1, at 315-21.

methodology, which is not criticized in their reply, is adequate to enable courts to make particularized judgments about the extent of passing on which will be much closer to the precise truth than the per se rule of *Illinois Brick* allows.

Landes and Posner also express concern that, even if in the long run all of the monopoly overcharges are passed on, "if price fixing occurs at irregular intervals . . . there is no presumption that direct purchasers fully adjust to the overcharge each time it occurs and thereby pass it on." [16] Again, it is factors of this kind which are taken into account in our proposed case-by-case methodology. The outcome may lack precision, but reasonable judgments based upon modest information can approximate the precise truth as closely as it is ever possible to do in any complex litigation.

In their section 2(d), Landes and Posner attempt to cast doubt upon our characterization of the long-run supply curve in most industries. They point out that, if the long-run supply curve is highly elastic, a rise in price due to cartel action would induce entry, so that the "cartel would be ineffective." [17] Unfortunately, they have mixed up the levels in the chain of distribution. It is the elasticity of supply of the direct-purchaser industry that determines the rate of passing on; we assume that the cartel action occurs at the level *above* the direct purchasers—that is, the sellers to the direct purchasers.

Finally, in section 2(e), Landes and Posner claim that "at most all Harris and Sullivan have shown . . . is that the entire overcharge is passed on to indirect purchasers" [18] and, thus, that the *Illinois Brick* rule defeats compensatory justice in every case. We are quite prepared to admit that compensatory justice is not the only objective of antitrust policy, but we think it symptomatic of the Chicago school of economics to dismiss equity issues so cavalierly. Antitrust policy has historically been, and ought to continue to be, concerned deeply with issues of economic equity and procedural fairness.[19] Of course efficiency matters, but it is not all that matters.

III. Information and Incentive to Sue

In addition to compensatory justice, the second salient concern of passing-on policy is deterrence. All else being equal, we should choose that assignment of a cause of action that will provide

[16] Landes & Posner Reply, *supra* note 3, at 1277.

[17] *Id.* 1278.

[18] *Id.*

[19] *See* Sullivan, Book Review, 75 Colum. L. Rev. 1214 (1975) (Handler, Blake, Pitofsky & Goldschmidt, Trade Regulation, Cases & Materials).

the greatest probability of discovery and prosecution of monopoly overcharge violations, thereby deterring potential violators. Landes and Posner claim that, on the ground of deterrence, the *Illinois Brick* rule is superior to our proposed alternative.

In reaching that judgment, Landes and Posner rely heavily upon their claim that "[t]he information costs of identifying and suing an antitrust violator, an important component of enforcement costs, are lower for the direct than the indirect purchaser." [20] They say that we "accept [their] point that the direct purchaser has lower information costs of identifying and prosecuting the antitrust violator than a remote purchaser." [21] That quote from Landes and Posner does not fairly represent our position. Although we do acknowledge that "direct purchasers . . . are closer to the violation and thus *may* be in better position to be aware of it," [22] we continue, however, by noting that "there are limits to the significance of propinquity." [23]

For deterrence the significant question is not which purchaser has the lowest information cost but, given the balance of costs and incentives, which purchaser is most likely to investigate, discover the violation, and sue. The fewer purchasers at any given level in the chain, the larger the share of each purchaser at that level of the total damages allocable to that level. The direct-purchaser level will often, but not always, have fewer firms than will lower levels. There will also be those situations in which indirect purchasers are fewer in number, or have better informational resources. Here, deterrence argues for granting the cause of action to indirect purchasers. One could cite no better example than the *Illinois Brick* case itself: the indirect purchasers there were public agencies represented by a single agent (the Illinois attorney general). By comparing competitive-bid data, the state was in an excellent position to detect and prosecute violators. Whether the direct purchasers (the hundreds of building contractors who purchased masonry products from the masonry manufacturers) knew of the violation, we do not know. We do know that they did not take legal action.

Granting the informational advantage to direct purchasers, and supported by what Landes and Posner call "erroneous rea-

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[20] Landes & Posner Reply, *supra* note 3, at 1274.

[21] *Id.* 1278.

[22] Harris & Sullivan, *supra* note 1, at 352 (emphasis added).

[23] *Id.* 352-53.

son," [24] we still challenged the incentives of direct purchasers to sue. Experience teaches that, whatever their informational advantages, direct purchasers often fail to sue to recover overcharges imposed by cartelists and monopolists. Landes and Posner, referring to their article, point out that when this occurs, the "supplier must pay something to bind the direct purchaser to him and this payment is, functionally, a form of antitrust damages." [25] That is exactly our point: if the direct purchaser passes on the monopoly charge but retains the "compensation" of the monopolist, the compensatory injustice to the indirect purchaser is multiplied, and deterrence is vitiated. We cannot accept the argument that the sharing of illegally gotten proceeds with direct purchasers justifies the rule of *Illinois Brick.*

We did not suggest, as Landes and Posner think we did, that the direct purchaser's incentive to sue would not be reduced by the possibility of a passing-on defense.[26] We acknowledged such an effect, but said:

> It is the *net* effect of *Illinois Brick* that is important, however, and there is reason to believe that legislative reversal would have a relatively small deterrent effect on suits by direct purchasers and a much larger and more significant effect in encouraging suits on behalf of down-chain purchasers.[27]

Additionally, Landes and Posner say that we described as fantasy their "suggest[ion] that the incentives of a state attorney general to sue might be different from those of a private firm." [28] We did not find that suggestion in the Landes and Posner article; if we did, we would have taken no issue with it. What Landes and Posner did say in their article, and what we did call a fantasy, was their quite different statement that a tendency may exist "for state attorneys general to bring headline-grabbing, scapegoat-seeking [*parens patriae*] suits against politically unpopular corporations, with little regard for the intrinsic antitrust merit of the suit and with little effort to press the suit to a successful conclusion." [29] Suffice it to say that we are aware of no theoretical or empirical

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[24] Landes & Posner Reply, *supra* note 3, at 1278.

[25] *Id.*

[26] *Id.* 1279.

[27] Harris & Sullivan, *supra* note 1, at 350 (emphasis in original).

[28] Landes & Posner Reply, *supra* note 3, at 1279.

[29] Landes & Posner Article, *supra* note 2, at 613.

basis for fearing such a tendency. We must regard with skepticism an analysis which confidently assumes, on the one hand, that an individual making decisions for a private entity will tend to act rationally, knowledgeably, and in the interest of that entity, and, on the other hand, that an individual making decisions for a public entity will tend to act impulsively, without adequate information, and in his own self-interest.

Finally, Landes and Posner take exception to our statements regarding the disincentives of direct purchasers, particularly our reference to their misunderstanding of managerial mentality.[30] It may well be a standard assumption of Chicago economic theory that the loss of a windfall gain is equated to an out-of-pocket cost, but that does not make it so in the minds of managers. Our position is based upon a sense of the organizational factors and cultural norms that constrain pure "profit-maximizing" behavior, behavioral influences which Chicago theory ignores.

Rational decisionmaking within corporations is bounded; people do not gather information about everything that might conceivably be relevant. If a firm is able to pass on a price increase from a particular supplier, that price increase is not likely to be high on the firm's agenda of "possible antitrust claims to be investigated when we have time." As antitrust practitioners well appreciate, antitrust actions, like other lawsuits, are often initiated by people who have a sense of having been hurt and a sense of grievance.

Moreover, even if a firm learns that a monopoly overcharge has occurred, there remains in the corporate community a real—though not absolute—inhibition against undertaking the role of bounty hunter. Indeed, it was not too many years ago that many corporations hesitated, out of a sense of propriety, to bring private antitrust actions even to redress real injuries (like monopoly overcharges not passed on).

Again, our disagreement with Landes and Posner is fundamental. We do not deny that managers are economically rational, but we insist they are boundedly so. The neoclassical "theory of the firm" is really not a behavioral theory at all; few economists think that economic theory describes how firms actually behave—certainly there is little or no empirical substantiation to support such a position. Economic theory is a set of *assumptions* about firms, assumptions which economists make for the sake of simplicity and analytical rigor.

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[30] Landes & Posner Reply, *supra* note 3, at 1279.

It is our opinion that the Landes and Posner approach to passing on epitomizes a generic failure of the Chicago school, a failure to recognize and abide by the logical and empirical limits of economic theory. Landes and Posner exihibit a classic case of reification, of confusing models with realities. We think it makes for bad economics; it makes for even worse antitrust policy.

The alternative is not, as Landes and Posner imply, to reject the use of economic analysis entirely, but to moderate its use and, when limitations of economic theory are encountered (and because noneconomic factors also matter), to supplement the analysis as seems appropriate. That is exactly what we tried to do in our article; if that is the charge against us, we demur.