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George A. Hay
Cornell Law School, george.hay@cornell.edu

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THE FTC AND PRICING: OF PREDATION AND SIGNALLING

GEORGE A. HAY

Professor of Law and Economics, Cornell Law School

This paper summarizes and comments on two recent FTC cases. The first case involved accusations of predatory pricing against Borden, the manufacturer of ReaLemon, the dominant brand of reconstituted lemon juice.[1] The second involved price-signalling and other so-called facilitating practices by the four makers of lead-based antiknock compounds.[2]

I. *BORDEN*

What qualifies the *Borden* case to be included in the "Recent Antitrust Developments" program is that earlier this year the FTC and Borden reached an agreement modifying and weakening the order that the FTC had originally issued in the case, an order that had already been upheld by the Sixth Circuit.[3] While Borden had petitioned for certiorari, it was

[1] Borden, Inc., [1979-83 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,995 (March 1, 1983).

[2] Ethyl Corp., [1979-83 Transfer Binder] TRADE REG. REP. (CCH) ¶ 22,003 (March 22, 1983).

[3] Borden, Inc. v. FTC, 674 F.2d 498 (6th Cir. 1982), *vacated and remanded*, 51 U.S.L.W. 3841 (No. 82-328) (U.S. May 23, 1983). Following agreement with Borden on the modification, the Commission requested the Solicitor General to advise the Supreme Court that the petition for a writ of certiorari should be granted, and the decision of the court of appeals be remanded to the Commission. Following remand, the Commission entered the negotiated order in settlement of the litigation.

The original order placed three substantive restrictions on Borden:

> (1) Granting price reductions, directly or indirectly, which result in different net prices among Borden's ReaLemon customers, whether or not such customers compete in the same geographic area, which differences in price are not attributable to differing costs of manufacture, sale or delivery, and the effect of which is to hinder, restrain or eliminate competition between respondent Borden and its competitors in the production, marketing and sale of processed lemon juice;
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> (2) Selling ReaLemon lemon juice below its cost or at unreasonably low prices, the effect of which is to hinder, restrain or to eliminate competition between respondent Borden and its competitors in the production, marketing and sale of processed lemon juice.
>
> (3) Granting promotional allowances or payments of any kind for customers' promotional services, the effect of which is to hinder, restrain or eliminate com-

HeinOnline -- 52 Antitrust L.J. 409 1983

not the FTC's fear of losing in the Supreme Court that caused them to negotiate a weaker settlement; it was a fear of winning. Three members of the present Commission disagreed so fundamentally with the original Commission decision (which was not modified in any substantive way by the court of appeals) that they were willing to defend that decision before the Supreme Court.

The Commission's turnabout can be attributed in part to a change in the membership of the Commission.[4] However, the case also illustrates the unsettled state of the law and the literature on predatory pricing which has existed since publication of Areeda and Turner's 1975 article.[5]

ReaLemon had long been the dominant producer of reconstituted lemon juice.[6] However, in 1969, Golden Crown, which previously had produced and sold reconstituted lemon juice only in the Chicago market, embarked on a plan to expand its sales beyond Chicago to the midwest and later to other markets in the northeast and southeast. Golden Crown's method of expansion was to sell its product to retailers at prices well below those of ReaLemon.

Borden responded to the challenge with substantial price cuts in those cities where Golden Crown was a threat. Borden's prices in those cities were less than its average total costs (ATC) of production and distri-

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> petition between respondent Borden and its competitors in the production, marketing and sale of processed lemon juice.

92 F.T.C. 669, 832-33 (1978).

The modified order eliminated the first and third restrictions and the second was changed simply to prohibit Borden from:

> Selling ReaLemon brand reconstituted lemon juice at a price or prices so that Respondent's net revenue during any fiscal quarter for any sales district is below Respondent's variable cost of the product sold in that quarter and sales district.

[1979-83 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,995, at 22,491.

[4] Commissioners Miller, Douglas and Clanton voted to accept the negotiated order, Commissioners Bailey and Pertschuk dissenting. Commissioners Pertschuk and Clanton are the only present members who were part of the original unanimous Commission, although Commissioner Clanton wrote a separate concurrence reflecting considerable disagreement with the Commission decision, written by then-Chairman Pertschuk. Therefore, while Commissioner Clanton has switched sides, his views about the case have not dramatically changed.

[5] Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975). The development of the literature is emphasized in Brodley & Hay, *Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards*, 66 CORNELL L. REV. 738 (1981). The development of the law is emphasized in Hurwitz & Kovacic, *Judicial Analysis of Predation: The Emerging Trends*, 35 VAND. L. REV. 63 (1982). Additional discussion can be found in the three articles on predatory pricing in 51 ANTITRUST L.J. 361-421 (1983).

[6] ReaLemon's market share ranged from 75-89% during the 1967-74 period. Defendants argued unsuccessfully that the market should include fresh lemons.

HeinOnline -- 52 Antitrust L.J. 410 1983

bution. However, it did not appear that prices were below Borden's average variable costs (AVC) using the standard economic definition of the term.[7] Hence Borden's pricing would not violate the Areeda-Turner standard.

The 1978 Commission refused to be bound by the Areeda-Turner standard. A three member coalition cited all the relevant Section 2 cases (*Alcoa, United Shoe Machinery, Grinnell*) for the proposition that a monopolist violates Section 2 whenever its dominant position is not economically inevitable but rather is deliberately maintained.[8] The problems with such an open-ended view of the behavioral requirements for a Section 2 violation are by now well known, and the Commission itself essentially rejected that view two years later.[9] Had that been the only basis for the opinion in *Borden,* it would hardly be surprising that the recent Commission would want to disavow it.

There was, however, a narrower basis for the original Commission's finding. This basis is suggested by the majority opinion, developed with considerable precision in the Pitofsky concurrence, and restated with approval by the court of appeals. If the vote by the 1983 Commission to turn its back on the original decision is newsworthy, it is because it appears to reject this narrower basis as well.

The evidence was that, in terms of production and distribution costs, ReaLemon held no advantage over Golden Crown. To the 1978 Commission, this meant that the two were "equally efficient." However, consumer identification with the ReaLemon name meant that ReaLemon could sell at a 30 percent price premium over Golden Crown. This meant that if Borden lowered prices to approximately its variable costs, Golden Crown could not maintain its market share without suffering substantial out-of-pocket costs since it would have to price well below its own variable costs. It was apparently Borden's view that the prospect of such losses would discourage Golden Crown (or others) from any future ideas of expansion, thereby insulating the bulk of Borden's monopoly profits from attack.

The situation where the dominant firm commands a price premium based on consumer identification was viewed by the 1978 Commission as an exception to Areeda and Turner's claim that an AVC test is adequate

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[7] Commissioner Clanton, using a definition contained in the Areeda-Turner article, *supra* note 5, found prices less than AVC. Borden, Inc., 92 F.T.C. 669, 814-16 (1978).

[8] As indicated in note 7 *supra,* Commissioner Clanton felt that Borden failed to satisfy the Areeda-Turner standard. Commissioner Pitofsky based his concurrence on the principles discussed immediately below.

[9] E.I. du Pont de Nemours & Co., 96 F.T.C. 653 (1980).

to protect an equally efficient entrant. If the preference for ReaLemon was attributable simply to Borden's past expenditures on advertising and other avenues of goodwill, it appeared that by setting prices below ATC yet above AVC, Borden could eliminate (or deter) an equally efficient entrant which did not have the benefit of a stock of goodwill based on past expenditures and therefore must incur higher variable costs just to stay even. The case seemed to be a good candidate for Posner's suggested rule that a dominant firm should not be allowed to price below ATC in order to exclude an equally efficient competitor.[10]

The 1983 Commission rejected the claim that, by any legitimate standard, Golden Crown could be labeled "equally efficient" as ReaLemon. More importantly, the Commission rejected a test for predation that would offer some protection for firms like Golden Crown by prohibiting a dominant firm from temporarily reducing prices below ATC to eliminate a rival because it "would require dominant firms to raise a price umbrella over competitors by maintaining minimum prices set with reference to their competitors' costs rather than their own."[11]

Despite the Commission's explicit disclaimer that its position on predatory pricing can be inferred from its actions in this case, its attitude toward such a test suggests a refusal to acknowledge any exception to the Areeda-Turner AVC test for prices between AVC and ATC.[12] Such a view would put the 1983 Commission in a more permissive posture toward dominant firm pricing that those courts which have considered the Areeda-Turner test in recent years. As the Commission notes in its Statement, "Most courts have used average variable costs as a factor

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[10] R. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 188 (1976).

[11] Borden, Inc., [1979-83 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,995, at 23,496-497 (March 1, 1983). There are other aspects of the 1978 opinion that the 1983 Commission disagrees with and criticizes in its statement announcing the modifications of the order. However, in my view, the Commission could have defended the original result without reliance on these aspects of the opinion. Nevertheless, it should be stressed that the Commission statement explicitly discourages any generalization from the handling of this particular case to what the Commission's overall views on predatory pricing might be. Commissioner Clanton, in a separate statement, says that the problem is not necessarily defending the original decision but defending the relief ordered in the case which, among other things, prohibited Borden from selling "below its cost or at unreasonably low prices, the effect of which is to hinder, restrain or eliminate competition. . . ." 92 F.T.C. at 833.

[12] The Commission's statement is explicit:

> The Commission has determined to settle the pending litigation that resulted from its decision and order of November 7, 1978 because its prior decision herein does not set forth a satisfactory, cost-based standard for predation under Section 2 of the Sherman Act and Section 5 of the Federal Trade Commission Act.

[1979-83 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,995, at 22,493.

Any exception to the Areeda-Turner test for prices between AVC and ATC must depart from a strict cost-based standard.

against which to test an alleged predator's pricing levels, but almost always have expressed a willingness to consider other factors."[13]

Given the Commission's disclaimer and given the fact that most predatory pricing cases are filed by private plaintiffs, the *Borden* settlement may not be of major significance for present or potential defendants in a monopolization case. Probably the most important effect of the settlement is that the Supreme Court has been deprived of a fairly good vehicle for defining its own views on the predatory pricing controversy.

Meanwhile, the academic community has continued the process of evaluating various proposed standards and designing new ones. In turn, the lower courts have had considerable opportunity to test the operational feasibility of the academicians' ideas and to add their own improvements. Whether this evolutionary process will soon come to rest on a particular rule or procedure is questionable.[14] But when and if the Court does elect to take up the issue, it will be the beneficiary of a much richer theoretical and empirical basis for decision-making than it would have had in the period immediately following the original 1975 Areeda-Turner article.

II. *ETHYL*

The FTC's *Ethyl* opinion is the high-water mark to date for the so-called "facilitating practices" theory.[15] The *Ethyl* case involved the four U.S. companies which produce "lead antiknock compounds," the product added to gasoline to reduce engine knocking. The complaint alleged that the four companies each followed certain practices which had the effect of reducing competition by "facilitating" uniform supracompetitive prices. Unlike a case brought under the Sherman Act, which may require the finding of an agreement, the theory of *Ethyl* was that although the practices were pursued independently by the four respondents, their

[13] *Id.* at 22,498.

[14] For a discussion of the prospects for a consensus among academics, counselors and courts, *see* Hay, *The Economics of Predatory Pricing*, 51 ANTITRUST L.J. 361 (1983).

[15] The theory was heavily publicized during John Shenefield's tenure as Assistant Attorney General for Antitrust. *See* DEPARTMENT OF JUSTICE, MEMORANDUM ON SHARED MONOPOLIES (May 26, 1978), *reprinted in* ANTITRUST & TRADE REG. REP. (BNA) No. 874 F-1 (July 27, 1978). The theory was often referred to as the "shared-monopoly" theory. This term generated considerable confusion because it had been used to apply to several quite distinct antitrust situations. For a fuller discussion of the concept and the underlying theory, *see* Hay, *Oligopoly, Shared Monopoly and Antitrust Law*, 67 CORNELL L. REV. 439 (1982). The theory was actually put forward by the Department in 1977 in the course of modifying an outstanding consent decree against General Electric and Westinghouse. *See* 42 Fed. Reg. 17,004 (1977). The Department engaged in a two-year search for a vehicle to test the theory but found no good candidate. In the interim, the FTC filed the *Ethyl* case under § 5 using the same basic theory.

HeinOnline -- 52 Antitrust L.J. 413 1983

parallel use significantly reduced competition and therefore violated the Federal Trade Commission Act.[16]

The complaint identified four specific practices—use of a pricing format that involved uniform delivered list prices, use of contracts providing for 30 days advance notice to customers of price changes, actually providing notice of price changes more than 30 days in advance to customers and to the press, and use of the "most-favored-nation" price clauses in sales contracts (guaranteeing that a price cut to any individual customer would be made available to all customers).

The theory of the case was that the use of uniform delivered list prices made it easy for the four firms to match one another's list prices to any customer since the same delivered price applied to every customer regardless of location. The advance notice to customers and advance announcements to the press of price changes made it easier for the four to equalize their list prices before price changes actually went into effect. This reduced any one firm's risk of initiating a price increase since the initiating firm could be assured prior to the effective date of the increase that each of its rivals was planning to increase list price by the same amount on the same day, with no period during which the initiating firm had list prices in effect that were higher than its rivals'. The most-favored-nation clause reduced the incentive to give selective discounts from list prices and therefore made it less likely that any firm would "cheat" on the oligopoly price.

In its opinion the Commission approved the theory in all major respects and enjoined the use of the facilitating practices.[17] The opinion contained three significant economic conclusions. First, the industry was performing noncompetitively in that prices were for the most part uniform and at a noncompetitive level. Second, while the industry was highly concentrated, that fact alone was not sufficient to explain the noncompetitive pricing. The identified practices contributed significantly to the poor performance and in their absence the industry would likely be far less successful in avoiding price competition. Third, the purported benefits

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[16] Had the Justice Department come up with a test case for the facilitating practices theory under the Sherman Act, they would have alleged that parallel use of the practices constitutes an agreement.

[17] Ethyl Corp., [1979-83 Transfer Binder] TRADE REG. REP. (CCH) ¶ 22,003, at 22,527 (March 22, 1983). The Commission was not persuaded that the press announcements had much of a facilitating impact given other ways that firms learned of one another's price increases. Respondents could continue to contract to give customers a given period of advance notice of price increases but could not give any more advance notice than provided for in the contract. Finally, the two smallest of the four respondents were not barred by the cease and desist order entered against the other two respondents.

HeinOnline -- 52 Antitrust L.J. 414 1983

to customers and to competition generally from use of the practices were outweighed by the competitive harm.

Based on these conclusions, the Commission found respondents liable and enjoined continued use of the practices. In so doing, the Commission explicitly endorsed the basic legal theory of the complaint, i.e., that under Section 5 there is no requirement to find an agreement. Parallel, although independent, use of certain practices is unlawful if they result in substantial harm to competition. While support for such a standard can be found in prior FTC cases, including *Cement Institute,*[18] *Triangle Conduit,*[19] and *Boise Cascade,*[20] *Ethyl* contains the clearest statement of the theory and is the most straightforward application to date.

The immediate practical consequences of the FTC decision are not likely to be significant. For one thing, the decision has been appealed by some of the respondents. Given the strong dissent by Chairman Miller and the likelihood that by fall there will be two other Commissioners who did not participate in the decision,[21] it is possible that the Commission will, in one way or another, repudiate the decision. Even if the decision withstands appeal, the absence of a private right of action under Section 5 means that further application of the theory is contingent on the support of Miller's Bureau of Competition Director.

Moreover, independent of ideological issues, the usefulness of an *Ethyl* precedent is constrained by the substantial evidentiary burden in facilitating practice cases as compared to a case where there is a formal agreement to fix prices. The plaintiffs must first show that the industry's prices or other aspects of performance are noncompetitive. This is avoided entirely in a per se case. Moreover, since performance is an aspect of liability, the plaintiff is not even entitled to the relaxed standards that are used in assessing damages. Next the plaintiff must show that the practices contributed significantly to the noncompetitive performance. Defendants will make the argument that, in a concentrated industry, noncompetitive pricing could occur even in the absence of facilitating practices. Once again, proof of the "but for" world is a liability, not damage, issue and is avoided entirely in a per se case. Finally, plaintiff must show that the benefits to competition from the challenged practices are outweighed by the harm, another issue which is circumvented in the

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[18] FTC v. Cement Institute, 333 U.S. 683 (1948).

[19] Triangle Conduit & Cable Co. v. FTC, 168 F.2d 175 (7th Cir. 1948), *aff'd by equally divided court sub nom.* Clayton Mark & Co. v. FTC, 336 U.S. 956 (1949).

[20] Boise Cascade Corp. v. FTC, 637 F.2d 573 (9th Cir. 1980).

[21] Commissioner Douglas did not participate in the decision. Commissioner Clanton is expected to have left the Commission by the fall of 1983.

HeinOnline -- 52 Antitrust L.J. 415 1983

case of a formal agreement. Given these evidentiary hurdles, it will be surprising if the FTC uncovers numerous facilitating practices cases even without any reluctance to employ the theory.

Even though *Ethyl* was a Section 5 case and the majority opinion took pains to distinguish the requirements for a Section 5 violation from those for a Sherman Act Section 1 violation, the most interesting possibility for *Ethyl* to have a significant impact is for the theory underlying the opinion to influence the standards in a Section 1 case. The legal doctrine of liability under Section 1 has always focused on the concept of "agreement." The clearest example is direct communication among supposed competitors in which they agree on the prices to be charged.

However, as economists have known since before the passage of the Sherman Act, formal agreement may not be necessary for firms to achieve a supracompetitive price, especially where the industry is highly concentrated. Plaintiffs and courts have reacted to this possibility by trying to extend the Sherman Act to cover "tacit" or "implicit" agreement. However, despite many efforts, there is still no consensus on the precise definition of tacit or implicit agreement. Part of the reason for this confusion is that liability in an antitrust context normally requires some form of culpable behavior. Yet, in the purest case of oligopoly pricing, firms are simply recognizing that, in a highly concentrated industry, price decisions by one firm will inevitably evoke reactions from others. As a result, it may be individually profit-maximizing to charge a supracompetitive price.[22]

The *Ethyl* opinion offers a way out of this apparent dilemma by rejecting the dichotomy in which supracompetitive prices result either from formal agreement on the one hand or from pure conscious parallelism on the other. In *Ethyl,* the supracompetitive prices are traced to certain specific practices and it is these practices which constitute the arguably culpable conduct. Implicit in *Ethyl,* therefore, is the notion that formal agreement is merely an illustration of the kind of specific acts that can lead to supracompetitive prices. However, there seems to be no special reason why other specific acts, such as the facilitating practices in *Ethyl,* cannot satisfy the "contract, combination or conspiracy" requirement of Section 1, with particular emphasis on the concept of combination.[23]

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[22] *See* Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal,* 75 HARV. L. REV. 655 (1962).

[23] Presumably "pure" conscious parallelism, in which firms achieve supracompetitive prices without the benefit of any specific facilitating practices, would not involve any culpable acts and would not therefore violate § 1.

Despite the logical appeal of this approach, plaintiffs face an uphill battle to wean courts off the emphasis on agreement or somehow to redefine the concept of agreement to fit the facilitating practices theory. Moreover, as indicated earlier, the severe evidentiary requirements in a facilitating practices case will make plaintiff's lawyers fully appreciate the advantages of the per se rule for formal agreements. For all these reasons, one should not expect to see a rash of facilitating practices cases either from the FTC or under the Sherman Act. The opinion has considerable appeal for economists and antitrust theorists. It is less significant for the litigator or the corporate planner.

MRS. HILLS: Thank you very much, George. The clarity of your remarks makes it very apparent why both sides in *Borden* chose to cite you. We appreciate your being here with us today.

Our second speaker is Ernest Gellhorn, Dean of the Case Western Reserve University Law School. Dean Gellhorn obtained his B.A. and LL.B. from the University of Michigan and then went into private practice. He has taught at Duke, Arizona State, Washington University and the University of Virginia. He was Dean at Washington and Arizona State, and he has been consultant to the Administrative Conference of the United States, and also to the Senate Committee on Government Operations. With that varied career, he is eminently qualified to bring us up to date on a whole host of things; but this morning it will be "The Merger Guidelines: A Year of Experience."

HeinOnline -- 52 Antitrust L.J. 417 1983