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MATSUSHITA: MYTH V. ANALYSIS IN THE ECONOMICS OF PREDATION

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I. INTRODUCTION

Antitrust can be a dry subject. The structural analysis that is usually required may be of great importance, but the general public and even the legal profession fail to find it as stirring as economists think they should. The thrill of calculating a Herfindahl-Hirschman Index or even of correctly measuring barriers to entry is not known to those with ordinary tastes.

By contrast, the analysis of conduct, of the dirty tricks played by would-be monopolists or conspirators, has a fascination that appeals even to the palate uneducated by exposure to serious economics. Moreover, a focus on conduct leads to a search for "smoking gun" documents—a search that lawyers revel in and that can produce results that juries can understand (or think they do) far better than arguments over market definition and similar subjects. In addition, such a focus fits nicely with the Populist strain of the antitrust tradition, with its mistrust of large and powerful firms as in some way deliberately evil.

Behind all this there is the natural human appreciation for a good story, preferably with heroes and villains. The best such stories are the simplest—morality plays with the forces of good and evil locked in combat (and the jury invited to root for the good guys or, in the context of this discussion, the home team). But perhaps the most apt metaphor of all is that of the fairy tale, with the monopolist as the giant, for example, menacing his tiny competitors. Antitrust stories are surrounded by such myths and legends, popularly believed, but often without much sound basis in fact or economic analysis.

One of the most persistent of antitrust fairy tales is that of predation, with the predator in the role of the wicked witch. Predation can and sometimes does occur, but far less often than is alleged. Further, the economic analysis of predation is considerably more sophisticated than the simple legends.

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The *Matsushita* case, in which I had some involvement,[1] was a particularly good example of the fairy tale of predation. The principal myths that usually surround the kernel of possible truth were all present (together with a few more especially designed for the particular case). Further, this tale had the added excitement of potentially allowing a jury to rescue the American victims from a scheming set of foreign villains. Fortunately, the District Court and, later, the majority of the Supreme Court recognized the fairy tale for what it was and refused to allow it to be told to a jury.

As all this suggests, Professor Elzinga and I are in substantial agreement on the analysis of *Matsushita*.[2] My presentation will therefore not differ so much in substance as in detail and occasionally in emphasis. I shall concentrate on listing the myths about predation illustrated by plaintiffs' case.

II. THE MYTHS OF PREDATION

Myth Number One: *All That Is Required to Prove Predation Is to Show Pricing Below Cost.* This is the most wide-spread and important myth of all. Predation involves an act that is not profit-maximizing without counting the supra-normal profits that follow the destruction of competition. But it is also an act that *is* profitable when those profits are counted. Since (as we all know and as is illustrated below) the question of whether prices are below cost is not a simple one, any test for predation must be in two parts. It is not enough to argue that the act or price involved was not profitable by itself. One must also show that the act or price was reasonably expected to bring the supra-normal profits that would make it profitable. If not, then someone—possibly the defendant in its business decisions, but more likely the plaintiff's attorneys and experts in their analysis—has made a mistake.

The latter part of this test alone can often be dispositive. In the first place, predation is not a victimless crime. By its nature, predation must drive out or suppress competition. Where this is not a reasonable out-

1. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986). The original case was Zenith Radio Corp. v. Matsushita Electric Industrial Co., 513 F. Supp. 1100 (E.D. Pa. 1981) in which the district court decided for the defendants on a motion for summary judgment. That decision was reversed by the Court of Appeals for the Third Circuit in *In re* Japanese Electronic Products Antitrust Litigation, 723 F.2d 238 (3d Cir. 1983), and the Third Circuit was in turn reversed by the Supreme Court. After the decision by the Third Circuit, I was retained by counsel for defendants as a consultant and a potential expert witness should the case be retried.

2. Elzinga, *The New International Economics Applied: Japanese Televisions and U.S. Consumers*, 64 CHI.-KENT L. REV. 941 (1988) (Professor Elzinga's article appears in this symposium issue).

come, predation cannot be at work.[3] In the *Matsushita* case, the large market shares of the American firms still remaining after decades of supposed predation imply that the Japanese alleged predators must either have had more than the usual dogged determination or been unusually stupid.

Second, one can reasonably ask whether the supra-normal profits to be made once predation has destroyed competitors can possibly justify the loss taken during the predation period. In *Matsushita*, the Supreme Court saw very clearly that this justification was most unlikely, and Professor Elzinga has provided a clear and convincing analysis showing that the game could not reasonably have been worth the candle.

One can go somewhat farther in this case, however, because Elzinga's conclusion that the Japanese firms' investment in predation was a definite loser holds for a monopoly predator as well as for the supposed cartel. The fact that the predation alleged in *Matsushita* was supposedly accomplished through a conspiracy further illustrates why it made no sense.

On plaintiffs' theory, each of the Japanese companies absorbed losses for a long period of time. For those losses to have been worthwhile, each company must have firmly believed that it would later be compensated by significant gains. To put it mildly, such assurance of payoffs would not have been easy to arrange even with explicit and constant communication among the companies.

Consider, first, expectations as to the post-predation period when the ill-gotten gains are to be shared. For a company to be convinced that its predatory sacrifices will be duly and proportionally rewarded, it must believe that the cartelized market will be rigorously divided. This is not impossible, but cartels have a way of falling apart, and a cartel would have to be very long-lived to reap the rewards justifying a long predatory period.

Second, each company in a predatory conspiracy has an incentive not to cooperate. If the American firms are to be driven out by taking losses, then it pays to let others take the losses, instead of taking them oneself.

There is, of course, an exception to all this. If taking the losses oneself also brings on the gains, then one will have an incentive to play one's assigned role. This would certainly be the case if brand loyalty persisted beyond the predation period and played an important part in customer

3. On this point, see Fisher, *On Predation and Victimless Crime*, 32 ANTITRUST BULL. 85 (1987).

decisions. In such a case, a firm that acquired a high market share during the predatory period would be assured of a high share when prices later rose.

Of course, in a situation of persistent brand loyalty, it is even less clear than usual how one is to interpret pricing "below cost." If customers who purchase now develop a preference for a particular company's product, then it may very well be profit-maximizing to offer low prices now in order to make profits later; this needs no anticompetitive intent or effect. For example, if quality and dependability are important to customers, then they may pay more for a brand with which they have had good experience or which has developed a wide reputation for quality than for one that is as yet untried. In this situation, the return from the sale of a product is not merely its price, but also the profits that can later be made when the product's reputation has been established. Taking the latter profits into account can make it profit-maximizing to compete by initially selling at a price that is below cost.

Put aside such problems, however, and suppose that below-cost selling is undertaken for predatory reasons and effect, and that brand loyalty ensures that a high market share gained during the predatory era will persist into the recoupment period. Such a story needs no conspiratorial embellishments. If such persistent brand loyalty existed, each separate firm would have an incentive towards predation, and there would be no need to conspire to get others to do so.

If, on the other hand, brand loyalty is of minor importance (as appears to be the case with television sets), then it is hard to see how the conspirators could be kept from cheating and assured of a fair division of the spoils. Moreover, it is also hard to see how supra-normal profits could be expected at all in such a case. Without really persistent (and irrational) brand loyalty, there appear to be no barriers to entry into the production and marketing of television sets in the United States, and predatory destruction of domestic competition would not last into the period of supra-normal pricing.

There is a bit more to it than this, however. If one shuts one's eyes very tightly and sprinkles a little fairy dust, one can manage to interpret part of plaintiffs' case as plausibly directed at these issues. I refer to the agreement on minimum prices ("check" prices) and to the "Five Company Rule."

Nobody likes to lose money unnecessarily, and predators are no exception to this rule. One can imagine a situation in which a particular Japanese company competes for a contract by offering low prices. The

customer (a Sears, perhaps) bargains by claiming that it has a lower offer from a different supplier (presumably another Japanese company), but does not reveal that supplier's identity. Since the object of the predatory exercise is to drive out the American firms and not to fight each other, an agreement on minimum prices, set below the costs of the American firms, might permit the Japanese companies to avoid pricing their product lower than necessary.

Similarly, one might imagine that a rule restricting each company to five American customers would have the effect of focusing the predation, by making each predator compete for a different set of customers, and would ensure that each predator took its share of losses. The problem here is that the "Five Company Rule" did not work this way in practice. Not only could and did each Japanese company make one of its customers an American subsidiary which could then sell to anyone, but the Rule restricted rather than mandated selling. As Elzinga remarks:

> From an economic perspective, the Five Company Rule runs contrary to the hypothesis of a low price export conspiracy. An organizer of a predatory cartel might have to say, "you must sell to these five" but not "you are *limited* to these five."[4]

Putting aside such doubts, there is the obvious question of how minimum prices and restricted customer allocations could have damaged the plaintiffs. Here, I think, the plaintiffs deserve a little more credit than they are usually given. To the extent that such devices were necessary for the operation of the predatory conspiracy, they contributed to the losses suffered by plaintiffs. This, I think, was the soundest of plaintiffs' arguments, or would have been had they articulated it well and consistently. (It did not, of course, sit well with the argument that plaintiffs were also damaged by a conspiracy to *violate* the minimum price agreement.)

In any case, even to reach this part of the plaintiffs' argument requires one to believe several impossible things before breakfast (as the White Queen says to Alice). In particular, one must believe that the predatory conduct complained of would make sense for a single, unified predator, and, as already discussed, it certainly didn't. Further, one must suppose a very complex and sophisticated use of the minimum price agreement and the Five Company Rule in an environment with low entry barriers. In fact, the obvious explanation of the minimum-price agreement and the Five Company Rule lies in the desire of the Japanese to avoid unnecessary friction in trade relations with the United States.

4. Elzinga, *supra* note 2, at 961.

Myth Number Two: *Deep Pockets, Warchests, and the Subsidization of Predation*. This myth is less important than the first, but, in different forms, probably just as widespread. In one form (the "warchest"), it is the myth that supra-normal profits in one market are used to subsidize predatory actions in another, and that this observation itself adds something to the analysis of predation. In *Matsushita*, the subsidizing profits involved were said to have been earned by an alleged high-price conspiracy in Japan. In its more general form (the "deep pocket"), the myth asserts that the possession of a large source of cash is an important aspect of the predatory enterprise.

Of the two versions, the "warchest" story is the more colorful and the easier to dispose of. If cash resources are to be devoted to the financing of a predatory campaign, what difference can it make where those resources come from? (I come later to questions of price discrimination and below-cost pricing.) The decision to invest funds in predation would be the same whether the funds had been earned in legitimate activities, laundered by the Mafia, or supplied as unrestricted donations by philanthropists.

The "deep pocket" version, however, has a bit more to it. Predatory campaigns do involve losses, and hence the investment of funds. This requires that the funds be available. If capital markets are imperfect, firms that have internal sources of funds (deep pockets) may be better able to make such investments—or any investments—than firms without such sources.

Note, incidentally, that this argument implies that plaintiffs did have an interest in proving a conspiracy in the Japanese home market. If the only source of funds for investment in predation came from that conspiracy, then predation abroad required conspiracy at home. This might have made plaintiffs' evidence on the home-market conspiracy more than a prejudicial irrelevance.

The problem, of course, is that it is hard to believe that such funds could not have been found elsewhere. If investment in predation was really profitable, surely large companies would find the funds for it from other sources. While it is indeed implausible that lenders would have provided funds for so risky a venture as the alleged predatory conspiracy in *Matsushita*, this is not because of any imperfections in the capital market. Rather, it is because the investment required was plainly going to be unprofitable.

To put it another way, not only is it hard to see why outside lenders

would put up the money for such an adventure, it is hard to see why anyone would. As Elzinga states:

> If enormous profits were, in fact, being made in the Japanese home market, this might have afforded the Japanese sellers the ability to finance a costly predatory campaign in the United States. It does not provide the motive.[5]

Myth Number Three: *Charging Different Prices in Different Markets Implies Below-Cost Pricing in the Low-Price Market.* This myth is closely related to the charge of dumping which was also an issue in the *Matsushita* case.

In *Matsushita*, the analytic core of the plaintiffs' claim on this point was as follows. The Japanese companies were alleged to charge higher prices in Japan than in the United States. Because a television set sold in the United States could have been sold in Japan for a higher price, selling it in the United States was thus a below-cost sale, taking opportunity costs into account.

I put aside the factual question of whether prices for comparable items were in fact higher in Japan than in the U.S. (defendants claimed they were not), and consider the analytic issues involved. Here, one must consider different assumptions about market structures, and I shall begin by taking the extreme form of the plaintiffs' claims about the Japanese home market.

Suppose then, for the moment, that a single firm had monopolized the Japanese home market and was shipping products into the United States at a lower price than the monopoly price in Japan. Does a proper treatment of opportunity costs imply that the United States price is below cost because a television set sold in the United States could have been sold at a higher price in Japan?

The answer to this question is in the negative. The return that such a monopolist gives up if it sells a television set in the United States rather than in Japan is not the price in Japan but the marginal revenue there. A profit-maximizing monopolist producing for two markets from a common set of plants will operate so as to equalize marginal revenue in the two markets. If one market is competitive and the other monopolized, it will operate so as to make price in the competitive market equal to marginal revenue in the monopolized one. Since marginal revenue is below price in the monopolized market, a lower price in the United States than in Japan is perfectly consistent with profit maximization, and thus does not imply below-cost pricing in the U.S.

5. Elzinga, *supra* note 2, at 963-64.

A similar analysis applies when an oligopoly rather than a monopoly is involved. If, as plaintiffs alleged, the Japanese market was cartelized and supra-normal profits were earned, then those profits were earned through a restriction of output. As with the monopolist, the opportunity cost incurred by selling output in the U.S. rather than in Japan was not the price in Japan but the full effects of expanding output in Japan on the cartel's supra-normal profits there. These effects made the marginal return from the sale of more output in Japan less than the Japanese sales price.[6]

Finally, suppose that the Japanese market were competitive. Here the story is a bit more complex, but not more favorable to plaintiffs (whose case as presented, of course, involved a heavy claim that the Japanese market was cartelized). In the first place, if the two markets were really separate, then there would be no reason to expect the two competitive prices to be the same.

This does not end the matter, however, because the two markets were not separate; the same facilities were used to produce television sets for both. In this circumstance, the competitive equilibrium of price equal to marginal cost should have produced the same price in each market, since marginal costs were (*arguendo*) the same.

The problem here is that one cannot conclude from this argument and the (alleged) fact of lower prices in the U.S. than in Japan that below-cost selling was taking place in the U.S. market. All that one can say is that it cannot be true that both markets were in competitive equilibrium. Since the appealing hypothesis (and the one urged by the plaintiffs) is the usual inference that the high-price market (Japan) was not competitive, it is hard to make much of this argument in an American antitrust action about predatory prices.

III. MORAL

Below-cost pricing is an oft-repeated fear. Especially when foreign competition is involved, competitors are likely to complain when market

6. Plaintiffs suggested that the restriction of output required for the high-price conspiracy in Japan left the Japanese companies with excess capacity, which in turn enabled them to sell at a low price in the United States. Assuming this was true, it is hard to see what it has to do with predation. Such an argument simply suggests that the marginal costs of producing goods for the U.S. market were sufficiently low as to make low prices profitable. While it may be true that the U.S. prices in such a case would be below the average variable cost of all output (domestic and export) taken together, they would not be below the average variable cost of the output at issue—the output produced for export. To make such an argument is to misunderstand the point of the Areeda-Turner average variable cost criterion. Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975).

prices are below their own costs, or even if prices are below what they would like them to be. While the story of predation is analytically sound, in the sense that it provides a consistent theory in which below-cost pricing takes place, the special nature of the story makes its applicability narrower than legend would suggest. Many economists find the predatory story hard (although not impossible) to believe. Fortunately, in *Matsushita*, where the story was truly incredible, the Supreme Court also refused to believe it.