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Accommodating the Law and Economics of Price Cutting: The Vice or Virtue of Low Prices

*Joel Jay Finer**

One is best punished for one's virtues.

F. NIETZSCHE, BEYOND GOOD AND EVIL, aphorism *132 (1886).*

I. INTRODUCTION

A. The Contradictory Nature of Federal Policy

On June 12, 1961, the Justice Department threatened the General Electric Company with divestiture proceedings unless it signed a consent decree committing it to refrain from selling at "unreasonably low prices . . . where the effect is, or where there is a reasonable probability that the effect will be, substantially to injure, suppress or stifle competition or tend to ereate a monopoly."[1] The Government's proposed decree placed the burden on the company to establish that its future prices were neither unreasonable nor reasonably likely to cause the prohibited effects.[2] Although General Electric refused to sign the decree, it counteroffered to refrain from "[f]ollowing any plan, program or course of action of selling . . . at unreasonably low prices *with the purpose or intent* of substantially suppressing or stifling competition or tending to create a monopoly."[3] The company's proposed decree also placed the burden of establishing a failure to comply with its terms upon the Government.[4]

Although the interpretation and application of the federal antitrust laws are replete with paradoxes, inconsistencies, and seemingly conflicting premises, few situations illustrate the contradictory nature of federal

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1. N.Y. Times, June 12, 1961, at 1, col. 4; *see also* N.Y. Times, June 7, 1961, at 1, col. 3.
2. N.Y. Times, June 12, 1961, at 1, col. 4.
3. *Id.* at 15, col. 1 (emphasis added).
4. *Id.; see also* N.Y. Times, Dec. 6, 1961, at 69, col. 2, 76, col. 6 (President of GE stated that he refused to sign the decree "because it would deny our customers the right to have the best values we can offer, and it would hinder our capacity to compete vigorously with domestic and foreign competitors.").

policy toward industrial structure and business behavior as dramatically as the Justice Department's rejection of General Electric's proposed decree. For example, one primary objective of the Sherman Act[5] is to prevent practices that tend to restrict output and raise prices,[6] and price-fixing agreements are illegal per se because it is unreasonable to believe that they have any beneficial results. Many industries exhibit a high degree of concentration that enables a few firms to operate through a structure of quasi-agreements and spontaneous coordination, from which comes an implicit understanding that they will enhance their individual profits by refraining from engaging in price competition.[7] A major current concern of antitrust administration and industrial economics is to find ways of rendering these "oligopolies" more competitive, yet the crux of the government's allegations against General Electric and its executives was that they participated in a scheme designed to *reduce* prices in an oligopolistic industry. In view of the widespread concern over inflexible, unnaturally high prices, the rationale of the Justice Department's attempts in similar situations to prohibit "unreasonably low" prices with neither a showing that the alleged violator had an intent to suppress competition nor an examination of the effect that the lowering of prices had on the competitive process warrants critical examination. This Article will first survey the development and present status of legal limitations upon low or lowered prices. Following sections will examine the applicable legal doctrines within a framework of economic analysis, and the final section will propose an approach to the law of price cutting that attempts to bring it in line with the broader objectives of antitrust policy.

B. A Survey of the Law

Section 2 of the Sherman Act,[8] Section 2(a) of the Clayton Act (the Robinson-Patman Amendment),[9] and Section 3 of the Robinson-Patman Act[10] comprise the arsenal of legal restrictions on low prices. These provisions have existed for many years, but the Supreme Court never has articulated comprehensive standards for determining the legality of price cutting, and lower judicial and administrative interpreta-

5. 15 U.S.C. §§ 1-7 (1970).

6. *See* H. THORELLI, FEDERAL ANTITRUST POLICY 227 (1954).

7. *See generally* W. FELLNER, COMPETITION AMONG THE FEW (1949).

8. Act of July 2, 1890, ch. 647, § 2, 26 Stat. 209 (codified at 15 U.S.C. § 2 (1970)).

9. Act of June 19, 1936, ch. 592, § 1, 49 Stat. 1526, *amending* Clayton Act § 2, 38 Stat. 730 (1914) (codified at 15 U.S.C. § 13(a) (1970)).

10. Act of June 19, 1936, Pub. L. No. 74-692, § 3, 49 Stat. 1528 (codified at 15 U.S.C. § 13(a) (1970)).

tions have left innumerable questions unanswered. Since the legality of low prices often hinges upon whether a seller has acted with a predatory intent to injure a competitor or whether its actions are likely to have a predatory effect, the current legal status of price cutting is best discussed from those standpoints.

1. *The Sherman Act.*—A finding of a violation of Section 2 of the Sherman Act, which prohibits "attempts to monopolize" and "monopolization" but does not refer directly to price cutting, occasionally has been supported by evidence that the defendant engaged in predatory price cutting. In two classic Sherman Act cases involving the giant oil and tobacco trusts, *Standard Oil Co. v. United States*[11] and *United States v. American Tobacco Co.*,[12] the Supreme Court accepted the Government's allegations that the defendants had obtained monopolistic power by using innumerable fraudulent, oppressive, and predatory business tactics, including cutting local prices below cost, for the purpose of driving competitors out of business or forcing them to join the defendant combination.[13] On the other hand, when a defendant company charged with possessing the power and intent to monopolize has established that it did not engage in secret or less-than-cost price cutting, the Court has given some weight to this evidence in finding no violation.[14] Findings of monopolization and attempts to monopolize, therefore, may require the presence of predatory intent, which can be established by evidence of local, less-than-cost pricing. In these and other instances, the courts apparently fear the possibility that a large dominant firm will be able to subsidize its price-cutting losses in a local market or industry with "outside" funds until local competition is eliminated.

2. *The Clayton Act.*—Section 2 of the original Clayton Act was actually designed to regulate local predatory price cutting by monopolists operating in regional or national markets.[15] It was specifically directed at discriminations in price among different purchasers of commodities when the price differentials were not justified by allowances for the quantity or quality of the goods sold, selling or transportation costs, or when the lower price was not set for the purpose of meeting competi-

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11. 221 U.S. 1 (1911).

12. 221 U.S. 106 (1911).

13. *Cf. id.* at 160-61 ("[Upon American Tobacco Co.'s failure to induce plug manufacturers to join the combination] ruinous competition, by lowering the price of plug below its cost ensued. As a result of this warfare . . . the American Tobacco Company sustained severe losses . . . .").

14. *See, e.g.*, United States v. International Harvester Co., 274 U.S. 693 (1927); United States v. United States Steel Corp., 251 U.S. 417 (1920).

15. *See* E. KINTNER, A ROBINSON-PATMAN PRIMER 6-7 (1970).

tion. The section, however, proscribed only discriminations whose effect "may be to substantially lessen competition or tend to create a monopoly in any line of commerce." Although the provision proved generally ineffective—because of the latitude afforded sellers by the provision relating to quantity differentials—and was subsequently amended by the Robinson-Patman Act,[16] *Porto Rican American Tobacco Co. v. American Tobacco Co.*,[17] an important case under the original section, throws some light on the factors that the courts often consider evidence of predation.

American Tobacco Company (ATC), which had been selling cigarettes in Puerto Rico for fifteen cents per pack, requested Porto Rican American Tobacco Company (PRATC) to exert influence to prevent the passage of tax legislation, the impact of which would fall largely upon ATC. The legislation, however, was passed, raising ATC's distribution costs by three cents per pack. ATC, apparently motivated by a desire to retaliate for PRATC's failure to stifle the tax bill, reduced its price to twelve cents per pack. ATC's price cuts compelled PRATC to lower its price to ten cents per pack, consequently transforming PRATC's annual profits of 200,000 to 250,000 dollars into losses of 150,000 to 180,000 dollars. In finding that ATC had predatory intent, the Second Circuit stressed that, although the cost of cigarettes to ATC was more than double PRATC's cost, ATC could withstand the losses precipitated by its price cut because its annual income was more than three and one-half times PRATC's entire capital, that ATC had guaranteed its Puerto Rican distributor 20,000 dollars in annual profits, and that ATC had accompanied its price cut with an advertising barrage.[18] The court, moreover, stated that price cutting was "foreign to any legitimate commercial competition" and observed that "[i]f this competition, resulting in such loss, continued, it is fair to assume that [PRATC] could not continue in business, and its elimination as a competitor was certain."[19]

3. *Section 2(a) of the Robinson-Patman Act.*—The Robinson-Patman Act, which replaced section 2 of the original Clayton Act with section 2(a), was enacted in response to widespread protests by independent wholesalers and retailers against the granting of discriminatory favors by suppliers to chain stores and mass distributors.[20] Although its

16. Act of June 19, 1936, Pub. L. No. 74-692, 49 Stat. 1526 (codified at 15 U.S.C. § 13 (1970)).

17. 30 F.2d 234 (2d Cir. 1929).

18. *Id.* at 236-37.

19. *Id.* at 237.

20. *See* E. KINTNER, *supra* note 15, at 9-14.

principal objective was to limit the freedom of suppliers to discriminate among purchasers who compete with one another—the secondary line of competition[21] —the Act also retained and expanded upon the language in the original Clayton Act relating to price competition among sellers themselves—the primary line of competition. Thus the Act prohibits sellers from discriminating in price "between different purchasers of commodities of like grade and quality" whenever the effect of the discrimination "may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition . . . ." A seller, however, may overcome a prima facie showing of violation by demonstrating that the challenged price differentials reflected "differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered," were "made in good faith to meet an equally low price of a competitor," or were "in response to changing conditions affecting the market for or marketability of the goods concerned."

(a) The Role of Predatory Intent.—Although the statute itself does not deal specifically with predatory intent, whenever such an intent has been shown the courts customarily have also found the competitive injury necessary for a violation of section 2(a). Moreover, despite the statutory focus on establishing the injurious effects of price cutting, the courts have apparently relaxed their standards for finding injury when they believe that predatory intent has been shown, and their current attitude borders on a per se approach.[22] For example, in *Utah Pie Co. v. Continental Baking Co.*,[23] Utah Pie charged the Pet Milk Company, Continental, and the Carnation Company with violations of section 2(a) in the Salt Lake City market for frozen pies. Utah Pie originally had entered the market after experiencing failures in the general baking business. Because its local plant enabled it to operate with substantially lower local distribution costs, Utah sold 67 percent of the frozen pies in Salt Lake City in 1958. Faced with elimination from the market, each of the defendants initiated price cuts, lowering its prices below those charged in other markets. Consequently, Utah's share declined in 1959 to 34.3 percent, although it recovered to 45.3 percent of the market by 1961, the last year covered by the suit. A jury found that defendants had violated section 2(a), but the Tenth Circuit reversed[24] —reasoning that

21. *Id.* at 15-16.
22. *Id.* at 112-14.
23. 386 U.S. 685 (1967).
24. Continental Baking Co. v. Utah Pie Co., 349 F.2d 122 (10th Cir. 1965).

since Utah consistently had increased its sales volume and showed profits for the years in question, there was no actual or potential injury to competition. The Supreme Court reversed, holding that the improvements in Utah's financial picture did not preclude the jury from finding a violation of section 2(a).

The controlling factor in the Court's analysis apparently was its inference of predatory intent on the part of the defendants;[25] otherwise, Utah's steadily improving business would have rebutted a finding of competitive injury. As to Pet, the Court apparently believed there was direct evidence of predatory intent. In 1959, Pet's management identified Utah as "an unfavorable factor" that "d[u]g holes in our operation" and operated as a constant "check" on its Salt Lake City operations.[26] Pet, moreover, had employed industrial spies in Utah's plant and suffered substantial losses in Salt Lake City.

There was, however, no conduct on the part of Continental or Carnation that could be viewed as direct evidence of predatory intent. The Court apparently inferred predatory intent from the two defendants' responses to Utah's dominant position in the market. In June 1961, Continental had cut its prices and offered its pies at $2.85 per dozen, a price less than its direct cost including allocations for overhead. Utah, which prior to Continental's price cuts had sold its two types of pies for $3.10 and $3.40, responded to Continental's action by lowering its prices to $2.75 per dozen. On these facts, the Court upheld the jury's finding of injury to competition, reasoning that "it could . . . have reasonably concluded that a competitor who is forced to reduce his price to a new all-time low in a market of declining prices will in time feel the financial pinch and will be a less effective competitive force."[27] In reaching its conclusion, the Court disregarded several countervailing factors. Continental, for example, had refused to match Utah's price of $2.75 per dozen, a circumstance not wholly consistent with a view that Continental had acted with predatory intent. Moreover, Utah retained

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25. E. KINTER, *supra* note 15, at 115.

26. 386 U.S. at 697. The subsequent economic analysis of this Article will show, however, that the factors used by the Court as evidence of predatory intent are consistent with legitimate competition, indicating no more than Pet's desire to win business from Utah. For an excellent analysis and criticism of the decision by an author who describes it as "the most anticompetitive decision of the decade" see Bowman, *Restraint of Trade by the Supreme Court: The Utah Pie Case*, 77 YALE L.J. 70 (1967). Professor Bowman asserts that the *Utah Pie* decision was based on the decline in Utah's market share, but the Court's opinion does not indicate that it felt this factor decisive or even important. For a more sympathetic view of the decision see Murray, *Injury to Competition Under the Robinson-Patman Act: Futility Revisited*, 29 U. PITT. L. REV. 623 (1968).

27. 386 U.S. at 699-700.

its share of the market during the year of Continental's price cuts at 45 percent and substantially increased its sales volume.

As to Carnation, the Court concluded that the jury reasonably could have found that in 1960-61 Carnation sold below costs. Again, however, the Court's conclusion apparently disregarded other factors. Carnation did not increase its share of the market during the period of the price cuts, while Utah—the purported victim—increased its share from 34.3 to 45.3 percent. Moreover, "during the two years subsequent to the price cut, Carnation's below-cost prices . . . were generally above Utah Pie's special, big-buyer, brand price and seldom below the price charged for the plaintiff's regular brand."[28]

(*b*) *Price Cutting Without Predatory Intent.*—Despite the significant role that predatory intent has played in price-cutting decisions, findings of section 2(a) violations have not invariably turned upon evidence of predatory intent. The courts, however, have made a more conscientious effort to find evidence of injury to competition when the defendant's conduct does not readily permit an inference of predatory intent that would trigger the virtual per se approach of *Utah Pie*. For example, when the absence of sales below cost has not permitted an inference of predatory intent, the courts have departed from *Utah Pie*'s implicit concern for preventing injury to competitors by expanding their inquiry to require instead a causal link between the seller's low prices and an injury to the competitive process.[29] These cases additionally have rejected the Federal Trade Commission's previously stated view that the proper test of requisite injury is to ascertain whether a seller's low prices divert trade from a competitor.[30] *Samuel H. Moss, Inc.*[31] best exemplifies the Commission's "diversion" philosophy. Moss, a small manufacturer of rubber stamps in New York City, competed with at least 70 other such manufacturers. The Commission concluded that Moss' sales of the same product at different prices to different customers violated section 2(a) by reasoning that the "practices of the respondent have the capacity and tendency to induce the purchase of respondent's rubber stamps by various users thereof and have tended to, and do, divert trade to the respondent from its competitors. The lower prices at which res-

28. E. KINTNER, *supra* note 15, at 118.

29. *Id.* at 125.

30. *See, e.g.*, Page Dairy Co., 50 F.T.C. 395 (1953), in which the FTC prohibited a regional dairy from charging lower prices in particular localities than it charged elsewhere, although the dairy's costs were lower than the costs of its local competitors and the lower price apparently increased its profits. The FTC found the requisite injury by reasoning that retailers' narrow profit margin on milk readily induced them to divert purchases in response to price changes.

31. 36 F.T.C. 640 (1943), *aff'd*, 148 F.2d 378 (2d Cir.), *cert. denied*, 326 U.S. 734 (1945).

pondent offered for sale and sold its rubber stamps . . . had a substantially injurious effect upon competition . . . ."[32]

Although the Second Circuit affirmed the *Moss* opinion,[33] more recent decisions have established that the effect of price cutting on competition, rather than the mere circumstance of trade diversion, is the relevant consideration. For example, in *H. J. Heinz Co. v. Beech-Nut Life Savers, Inc.*,[34] the federal district court undertook a comprehensive market analysis when Heinz sued Beech-Nut on the ground that Beech-Nut's price reductions in California violated section 2(a). In 1957, Beech-Nut sold approximately seven percent of the baby food in California, while Heinz sold sixteen percent and Gerber Products Company 77 percent. Each company sold baby food nationally, and both Heinz and Beech-Nut marketed other products nationally. During 1957, Beech-Nut initiated local price cuts that precipitated a price war. As a consequence, both Heinz and Beech-Nut suffered heavy losses. After the conflict, Gerber controlled 70 percent of the California market and Heinz and Beech-Nut held twenty and ten percent. Heinz thereafter sued Beech-Nut, alleging that Beeeh-Nut's California price reductions were illegal territorial price discriminations. Beech-Nut moved for summary judgment and argued that prior section 2(a) cases had involved powerful national sellers cutting prices against weaker local competitors. Heinz's assets and earned surplus, on the other hand, were 300 and 250 percent of those of Beech-Nut. Heinz had larger gross sales than Beech-Nut, and a larger percentage of the market. Moreover, argued Beech-Nut, Heinz's investment in California was so large that the possibility of its deciding to leave the market rather than meet its competitor's price reductions was minimal. Thus Beech-Nut concluded that when a price cut occurs in a market "where the competitors are of equal or substantially equal strength, there is no reason to suppose that normal competitive responses will not protect the competitive process."[35]

Implicitly recognizing the validity of Beech-Nut's claims, Heinz

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32. 36 F.T.C. at 648-49.

33. Samuel H. Moss, Inc. v. FTC, 148 F.2d 378 (2d Cir. 1945). In affirming the FTC, the Second Circuit went even further than the FTC with regard to placing restrictions on discriminatory price reductions. The court suggested that discrimination was unlawful if the lower price tended "to prevent competitors from taking business away from the merchant [price cutter] which they might have got, had the merchant not lowered his price below what he was charging elsewhere." *Id.* at 379. Thus, whereas the FTC had found injury in the acquisition of more customers by aggressive price cutting, the Second Circuit reasoned that injury resulted merely from retaining existing customers by defensive price cutting.

34. 181 F. Supp. 452 (S.D.N.Y. 1960).

35. 181 F. Supp. at 461. *See also* E. KINTNER, *supra* note 15, at 126-29.

sought to show that it was actually the weaker company. Thus Heinz argued that its assets were committed to expansion, while Beech-Nut had a 25,000,000-dollar "war chest." Beech-Nut, moreover, had higher profits. Heinz's food business, on the other hand, operated at a low profit margin, thus affording it no opportunity to subsidize its California losses with high profits from other lines.

The court denied Beech-Nut's motion. It found that there was a genuine dispute over Beech-Nut's intent, which was "relevant" but "not essential" to a finding of injury.[36] Noting that in the context of this particular market the elimination of one of the three major suppliers could possibly have an impact on competition, the court stated that Beech-Nut had mistakenly emphasized size rather than the qualitative factors that separate one competitor from another.[37]

In *Anheuser-Busch, Inc. v. FTC*,[38] the Seventh Circuit used a similar analysis when defendant established legitimate motives for its conduct, and predatory intent therefore could not be readily inferred. Anheuser-Busch, a nationally known brewer, had lowered its St. Louis prices in two steps, thereby eliminating the difference between its price and the price charged by local competitors. Concurrently with its price cuts, Anheuser increased its advertising expenses, reorganized its sales force, and changed its methods of delivery and solicitation. Prior to adopting these tactics, Anheuser's sales had declined nationwide because, rather than absorbing wage increases internally, it had increased the differential between its prices and those of its St. Louis competitors. Although it later raised its prices to restore the earlier price differential, Anheuser's changed policies increased its share of the St. Louis market from 12.5 to 17.5 percent. During the period that Anheuser maintained its price cuts, its competitors continued to charge their original prices, but also varied and intensified their competitive activities. Each competitor continued to earn profits.

The FTC invoked its diversion theory, holding that Anheuser's conduct violated section 2(a).[39] The Seventh Circuit, however, reversed. Noting the absence of evidence that Anheuser had used profits from other areas to subsidize losses in St. Louis or even that Anheuser had taken losses in St. Louis at all, the court found that Anheuser-Busch's reductions "were parts of an experimental program of sales promotion

36. 181 F. Supp. at 465-66.
37. *Id.* at 464.
38. 289 F.2d 835 (7th Cir. 1961), *on remand from* 363 U.S. 536 (1960), *rev'g* 265 F.2d 677 (1959).
39. 54 F.T.C. 277 (1957).

in the St. Louis market and . . . were temporary and made necessary by competitive conditions."[40] The court explained that the section was not concerned with "mere shifts of business between competitors"; rather, the section's concern was for "the vigor or health of the contest for business, regardless of which competitor wins or loses."[41] Pointing out that one local competitor's beer was so "badly named, poorly merchandised, bitter in tase, and 'wild'—that is with unstabilized air content"—that consumers "disliked" it, and that another local competitor was badly managed, the court was unable to find a causal connection between Anheuser's price cuts and an actual or potential impairment of the competitive process.[42]

4. *Section 3 of the Robinson-Patman Act.*—Section 3 of the Robinson-Patman Act is the remaining weapon in the arsenal of legal restrictions on low prices. The section imposes criminal penalties upon persons who "sell, or contract to sell, goods in any part of the United States at prices lower than those exacted [elsewhere]" or who "sell, or contract to sell, goods at unreasonably low prices," in either case "for the purpose of destroying competition or eliminating a competitor." Pricing with such a purpose may violate section 2(a) of the Robinson-Patman Act and section 2 of the Sherman Act as well, which probably accounts for the Government's rare attempts to impose criminal penalties under section 3.[43] Until 1958, many courts permitted private litigants to bring treble damage actions under the section,[44] but in *Nashville Milk Co. v. Carnation Co.*[45] the Supreme Court held that section 3 was not intended to provide a civil remedy, reasoning in part that "it is not idle conjecture that the possibility of abuse inherent in a private cause of action based upon this vague provision was among the factors which led Congress to leave the enforcement . . . solely in the hands of the public authorities . . . ."[46] Although defendants have repeatedly questioned the constitutionality of section 3 on the ground that it is overly vague and thus fails to provide fair warning of criminal conduct,[47] the

40. 289 F.2d at 839.

41. *Id.* at 840.

42. *Id.* at 837 n.4.

43. *See* P. AREEDA, ANTITRUST ANALYSIS 665 (1967).

44. *See, e.g.,* Dean Oil Co. v. American Oil Co., 147 F. Supp. 414 (D.N.J. 1956), *aff'd*, 254 F.2d 816 (3d Cir.), *cert. denied*, 358 U.S. 835 (1958); Hershel Cal. Fruit Prods. Co. v. Hunt Foods, 119 F. Supp. 603 (N.D. Cal. 1954), *appeal dismissed*, 221 F.2d 797 (9th Cir. 1955); Myers v. Shell Oil Co., 96 F. Supp. 670 (S.D. Cal. 1951); Spencer v. Sun Oil Co., 94 F. Supp. 408 (D. Conn. 1950).

45. 355 U.S. 373 (1958).

46. *Id.* at 378.

47. *See, e.g.,* Vance v. Safeway Stores, Inc., 137 F. Supp. 841 (D.N.M. 1956), *rev'd on other grounds*, 355 U.S. 389 (1958).

Supreme Court upheld the section in *United States v. National Dairy Products Corp.*,[48] in which the defendant was charged with less-than-cost sales made "without legitimate commercial objective and with specific intent to destroy competition . . . ."[49] The Court, moreover, has held in another context that "the requirement of a specific intent to do a prohibited act may avoid those consequences to the accused which may otherwise render a vague or indefinite statute invalid."[50] Thus proof of predatory intent beyond a reasonable doubt is an essential element of every section 3 case.[51]

II. STRUCTURAL PREREQUISITES FOR HARMFUL PRICE CUTTING

As the preceding section of this Article indicates, the legality of a particular price cut under existing law will hinge upon whether the seller acted with predatory intent or whether its price cut will damage the competitive process. In either instance the courts have adopted less-than-cost pricing and a relative ability to subsidize local price cuts with other funds as the talismans of illegality. Unless satisfactorily explained, either will trigger a virtual per se violation of the antitrust laws. The antitrust laws, however, condemn anticompetitive practices, not merely lowering prices below cost or using retained earnings to subsidize sales. In relying on these practices as critical determinants of antitrust liability, courts remain within the bounds of the statutory language and the congressional intent only to the extent that such practices in fact result in harm to competition. The remainder of this Article will attempt to show that the de facto presumption of anticompetitive effect applied under current law to below-cost pricing and "deep pocket" capability can result in blanket condemnation of entirely legitimate competitive behavior and should therefore be replaced by judicial standards that accurately reflect the specialized conditions which make particular price cuts harmful. This section of the Article describes the structural preconditions for harmful price cutting, and section III will describe the situa-

48. 372 U.S. 29 (1963).

49. *Id.* at 37. *See also* E. KINTNER, *supra* note 15, at 267-68.

50. Screws v. United States, 325 U.S. 91, 101 (1945). For an analysis of the arguments questioning the constitutionality of § 3 see ATTORNEY GENERAL'S NATIONAL COMM. TO STUDY THE ANTITRUST LAWS, REPORT 201 (1955).

51. *See also* Ben Hur Coal Co. v. Wells, 242 F.2d 481, 486 (10th Cir.), *cert. denied*, 354 U.S. 910 (1957), in which the court stated "that a pricing policy based on sound economics is inadmissible simply because it may result in the destruction of a competitor, for it is not within the scope or purpose of the antitrust laws to protect a business against loss in a competitive market. . . . If . . . the price reductions . . . were made to increase volume and decrease unit cost in order to retain its proportionate share of a diminishing market, the appellees were certainly within the law."

tions in which firms utilize less-than-cost pricing and externally subsidized local price cuts for competitively legitimate reasons. Since price cutting that damages the competitive process should, of course, be condemned, the final section of this Article will propose new criteria for evaluating the legality of price cuts.

A. An Overview of the Competitive Process

Although economists and policy makers often disagree over how best to promote the competitive process, there is a general consensus that its primary goal is to yield a high output of goods and services at prices reflecting the relative intensities of consumer demand for them. In order to implement that goal, economic theory initially presumes that each individual and business unit seeks to maximize something: individuals strive to maximize utility, which they derive from consuming goods and services; business units, to maximize the surplus of their total receipts over total costs.[52] Several consequences flow from this initial presumption. If competition worked perfectly, all the firms in an industry, each of which manufactured an identical product, would produce a minute share of the industry's output, and no single firm could influence the price of its product. Any increase in demand for the industry's product would immediately prompt the entry of new firms into the industry, thereby eliminating the opportunity for existing producers to acquire excess profits. A fall in demand, on the other hand, would cause the instantaneous exit of marginal, high-cost producers and restore profits to their normal level. Industry entry and exit would thus be cost free, with the entire industry remaining in a state of equilibrium. Moreover, each firm would limit its competitive activity to attempts to reduce its costs, and prices would settle at the average cost of the industry's representative firm. The virtue of such a perfectly competitive system is that price tends to fall and output to increase for the products demanded most. Resources would automatically flow from low demand industries to industries facing greater demand and therefore offering higher profits. The influx of new resources into the high demand industry would continue until the industry price was forced down to a level necessary to supply demand, a level that would also represent the average cost of the industry's representative firm.

Actual competition, however, functions quite differently from the

52. Although the frequent allegation that profit maximization is an unrealistic view of behavior motivation undoubtedly contains more than a few grains of truth, the assumption has proven to be a highly useful tool of prediction and analysis. Consequently, this Article employs the controversial orthodoxy.

theoretical model of perfect competition. Each firm has some control over the price that it charges for its product. The ability of a firm in a less than perfectly competitive industry to exercise control over its price stems from three factors. First, one firm's product is rarely identical to those of its competitors. Secondly, a firm can increase the demand for its product, and hence the price at which it can sell a given output, by stimulating consumer interest through advertising and sales techniques. Thirdly, most industries have barriers to entry that obstruct the efforts of new competitors to share in its profits. Thus, in the imperfectly competitive economy of the real world, consumers pay higher prices for fewer goods and services than they would pay if the competitive process were theoretically perfect.

Realizing the impracticability of achieving perfect competition, economists have suggested criteria for characterizing a workable, practically obtainable competition as the goal of antitrust policy,[53] through an economic model based upon the maximization of consumer welfare. According to this model, the consumer's welfare is enhanced if actual or potential rivals can reduce the power of a seller to raise its price and lower its output. When the presence of actual and potential competitors means that a firm cannot increase its profits by raising prices above the prevailing industry level, each firm will continually seek to achieve that objective—and incidentally maximize consumer welfare—by increasing its managerial and technological efficiency, by improving the quality of its product and services, and generally by offering the consumer a more attractive package at lower prices than rival firms. In order for the model to function effectively, barriers to entry and exit must be relatively low, so that resources can flow to those industries offering high profits and from industries with low profit levels. Each firm, moreover, must independently determine its competitive policies and be unable to predict with certainty the speed, magnitude, and direction of its rivals' responses. Collusion or conscious parallelism among rival sellers would thwart the vigorous price competition needed to keep prices low and output high. The ultimate result of workable competition is that inefficient competitors cannot prevent a firm able to produce at a lower cost from making its best offer to the consumer. On the other hand, a firm

53. The following materials have been utilized in the section on competition and workable competition: J. CLARK, COMPETITION AS A DYNAMIC PROCESS (1961); J. DIRLAM & A. KAHN, FAIR COMPETITION: THE LAW AND ECONOMICS OF ANTITRUST POLICY (1954); C. EDWARDS, MAINTAINING COMPETITION (1949); C. KAYSEN & D. TURNER, ANTITRUST POLICY (1959); J. MILLER, UNFAIR COMPETITION (1941); C. WILCOX, PUBLIC POLICIES TOWARD BUSINESS (1960); ATTORNEY GENERAL'S NATIONAL COMM. TO STUDY THE ANTITRUST LAWS, REPORT (1955); Clark, *Toward a Concept of Workable Competition*, 30 AM. ECON. REV. 241 (1940).

offering an inferior package is not protected from suffering reduced profits, losses, or complete economic elimination as a result of its inefficiency, and bankruptcy serves to weed out the incompetents, reduce the excess capitalization of overexpanded industries, and realign resource allocation. The discussion that follows is an attempt to define the relationship of price cutting to the goal of workable competition—to determine the circumstances under which price cutting furthers or frustrates the procompetitive objectives of antitrust policy. In addition to providing guides for judicial interpretation, the discussion is intended to point out the limitations of economic theory as a policy-making tool.

B. The Structural Prerequisites of Predatory Price Cutting

Low prices, the primary objective of workable competition, are undesirable when they induce firms to leave an industry and enable the surviving seller or sellers to charge a higher price and produce a lower output than before the price was cut. A frequently voiced complaint is that firms engage in price cutting to eliminate their competitors and thereby gain greater control over price. The success of such maneuvers, however, hinges upon the ability of the price cutter to recoup more than the costs of its predatory policy by subsequently raising its prices. Unless a predatory policy appears profitable, the managers of a firm would fail to gain anything from undertaking it.

1. *The Costs of Economic Warfare.*[54]—Assume that a price cutter, firm *A*, has one competitor, firm *B*, in the relevant market. The costs to *A* of eliminating *B* will be determined by the comparative efficiencies of the two firms and *B*'s opportunity costs, which are the potential earnings that *B*'s resources could earn when employed in their most productive alternative use. Thus, assuming that firms act rationally to maximize profits, if *B*'s potential earnings elsewhere, reduced by the costs of leaving the industry and entering another, exceed its earnings from present operations, it will transfer its resources to the more profitable alternative employment. In practical terms, firm *B* will decide to manufacture a different product, transfer itself to another market, or junk its resources.

If *A* is more efficient than *B*,[55] *B* eventually may decide to leave

54. The primary materials employed in this section are: J. DIRLAM & A. KAHN, note 53 *supra*; F. MACHLUP, THE ECONOMICS OF SELLERS' COMPETITION (1952); J. MILLER, note 53 *supra*; Weintraub, *Price-Cutting and Economic Warfare*, 8 SO. ECON. J. 309 (1941-42).

55. *A* is more efficient than *B* if *A*'s lowest average unit cost and variable cost per unit are less than *B*'s. Average unit cost is the sum of fixed and variable costs per unit at one particular output. Fixed cost, or overhead, includes rent, depreciation, and maintenance, plus other recurring charges. Variable costs are all other costs per unit of output—for example, raw materials, wages, and fuel. *See* P. SAMUELSON, ECONOMICS 453-58 (7th ed. 1967).

the industry or market without any impetus from *A*. If *B*'s resources are flexible, even a small difference in efficiency may convince its managers to leave the industry or market.[56] On the other hand, if *B*'s resources are specialized or immobile, the costs to *B* of leaving the industry may convince it to remain and compete with *A*, despite even a substantial disparity in efficiency. *A*, therefore, would be forced to engage in price cuts to eliminate *B* as a competitor.

If *A* decides to eliminate *B*, *A*'s superior efficiency does not necessarily mean that it can continue to maximize its profits, or even make any profits at all, during the time it takes to convince *B* to leave. If *B*'s resources are somewhat specialized or immobile, its reaction to *A*'s low prices would likely be as follows: *B* will cut its own prices and continue producing as long as its price generates net revenues in excess of its total variable costs. Since its fixed costs will be incurred regardless of whether it ceases production, *B* has nothing to gain by shutting down. *B* will shut down only when *A* supplies a large enough portion of the market at a price so low that *B* cannot supply any remaining portion at a price above its variable costs. If the price necessary to convince *B* to shut down is not less than the price *A* would charge in the absence of a design to eliminate *B*, then *B*'s elimination entails no cost to *A*, since *A* foregoes no profits. If the necessary price is above *A*'s average cost but below the price that would otherwise maximize its profits, *A*'s predatory policy entails a real cost measured by its foregone profits. If the necessary price is below *A*'s average cost but above its variable costs, *A* will lose money on its total investment—but as long as *A* operates more efficiently than *B*, *A* can successfully continue its predatory campaign without relying on outside financial resources, and the costs to *A* will still be measured by foregone profits. If the necessary price is below *A*'s variable cost, however, *A* will be able to continue its campaign only if it possesses or has access to outside financial resources. When *A* is endowed with considerable financial resources and is willing to utilize its deep pocket to eliminate *B*, the comparative efficiencies of the firms may not be determinative: *A* might be capable of eliminating *B* even if the latter firm possessed superior efficiency. Although the cost to *A* of eliminating *B* would still depend on the firms' efficiencies, *A*'s actual ability to

56. Economic analysis can do little more than recognize that at some point *B* may leave the industry: the factors entering into the decision of *B*'s managers cannot be quantified. *B*'s managers will, of course, be strongly influenced by their psychological makeup—optimism, pessimism, dogmatism, caution, timidity, etc. When it is recalled that the relevant decision is made by *A*'s managers, who must estimate the characteristics of *B*'s managers before deciding to undertake a price cut, the problem becomes even more difficult.

eliminate *B* in this case would hinge solely upon the extent to which *A*'s access to liquid assets exceeds *B*'s.

If *B* responds to *A*'s price cut by setting a price that generates revenues above its total variable cost but less than its average cost, *B* will continue producing until it cannot meet its fixed costs with current assets and is, therefore, insolvent. At that point, reorganization or bankruptcy proceedings will ensue. *B*'s creditors may be compelled to write off part of their claims, or new owners may obtain the firm's plant and equipment at current value. In either case, *B* can acquire a new lease on life; a substantial portion of its capital costs will be written off, and *B*'s new managers may be able to employ the firm's devalued resources profitably at a market price considerably lower than previously required. Moreover, even if *A* remains able to sell at a price too low for *B* to profit by reopening its plant, *A* will not necessarily have accomplished its purpose. As long as *B* continues to overhang the market, *A* will be unable to recoup its losses or foregone profits. If *B*'s productive resources are extremely specialized or immobile, they will be a potential threat to *A*'s ambition until they become worn out, obsolete, or are sold as scrap. Furthermore, as the number of competitors and the size of the market increase, the cost to *A* of becoming the sole survivor and the financial power needed by *A* to absorb that cost will increase correspondingly.

2. *Subsequent Recoupment of Losses or Foregone Profits in the Absence of Barriers to Entry.*[57]—A price-cutting firm will profit from a predatory campaign only if it subsequently can recoup more than its battlefield costs by raising prices to a monopoly level. The ability of the predatory firm to raise its prices depends on the extent to which new firms may be deterred from entering the industry or market. An efficient firm that attains a dominant market position in an industry with low barriers to entry can retain that dominance only by remaining more efficient than potential competitors and periodically demonstrating its superior efficiency. In the previous example, *A* convinced *B* to leave the industry because *A* supplied a large portion of the market at a price that made it impossible for *B* to supply the remaining share at a price above its variable costs. A new firm would not enter the industry or market unless it expected at least to recover its average costs; therefore, as long as *A*'s average and variable units costs remain below those of potential entrants, entry into *A*'s industry or market would be unprofitable.

57. The material in this section derives from: Leeman, *The Limitations of Local Price-Cutting as a Barrier to Entry*, 64 J. POL. ECON. 329 (1956); McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J. LAW & ECON. 137 (1958).

If potential entrants have access to the machinery, equipment, tools, and skills needed to compete with *A*, and those resources are sufficiently divisible to permit additions to the productive capacity of the industry or market at a modest initial investment, any attempt by *A* to set a high price would draw a swarm of new competitors. *A*'s costs may be unknown, but prospective entrants are likely to compare their expected costs with *A*'s price, which they will treat as "proving" demand at that level, and will thus enter when *A*'s price suggests that profits can be made. In order to demonstrate a power of effective price competition, *A* would have to prove its capacity by continued periods of regular low prices. Moreover, prolonged periods of high prices might lead *A* to become lax in keeping uneconomical operations at a minimum, and it could fail to keep up to date on new and more efficient production, sales, and managerial techniques.[58] Thus an efficient firm facing the threat of potential entrants is likely to keep its prices low in order to retain its cost advantages and convince potential entrants of its superior efficiency.

It is sometimes argued that, even in the absence of barriers to entry, mere threats of a price war by a financially powerful firm will convince potential entrants of equal or greater efficiency not to enter the industry or market.[59] Although it has a surface attractiveness, the contention appears somewhat blemished upon close scrutiny. In order for *A*'s threat to be credible, *A* must reinforce it by sporadic price wars. Unless *A* believes that its current liquid income from other sources is sufficient to subsidize its losses,[60] the expectation of price wars will require it to hold liquid assets in reserve. *A* consequently must forego any earnings other than low interest on the funds in its "war chest." Each time it employs the war chest, *A* additionally foregoes all future earnings on the funds expended. Moreover, if *A* sells five times the volume of an equally efficient potential entrant, *A* must be prepared to absorb five times the losses. If the potential entrant is more efficient than *A*, the latter's losses would be correspondingly greater. *A* also may be required to defend a larger geographical area than a particular potential competitor might wish to enter, and thus *A* would require an even greater supply of liquid assets. Finally, if *A* has existing regional, national, or foreign competition possessing equal or greater liquid wealth, a high price or high profits in the local market could induce them to compete.

58. Labor unions, furthermore, often attribute a firm's increased profits to alleged increases in labor productivity. Thus derives their ability to demand and often receive a considerable share of a firm's monopoly profits.

59. *See, e.g.*, Leeman, *supra* note 57, at 330.

60. *See* pages 277-78 *supra*.

A firm contemplating a predatory policy that will entail short-run losses must weigh the certain costs of its policy against the speculative possibility of recouping its losses. The gamble involves considerably more risk than the managers of successful corporations are accustomed to assuming. Corporate managers, who personally have more to lose from an unsuccessful venture than they could gain from a successful project of equal magnitude, are far more likely to be risk-averters than risk-seekers. Their inherent conservatism thus will lead them to reject a policy that offers equal probabilities of substantial gain or loss and to demand a clearly discernible margin of safety before undertaking a predatory policy.

3. *Subsequent Recoupment of Costs When Barriers to Entry Exist.*[61]—Natural or artificial barriers to new competition arguably provide the safety margin necessary to convince corporate managers that a predatory policy should be undertaken.[62] The capital required to construct and equip an efficient plant can pose a significant barrier to the potential competitors of a predatory firm. The minimum cost of establishing a reasonably efficient operation varies considerably among industries,[63] and the highly specialized nature of many plants often requires large sums of money. Although attempts to estimate the significance of capital requirements as a barrier to entry necessarily rest upon speculative judgments,[64] it seems unlikely that amounts over 5,000,000 dollars can be raised without access to organized capital markets. Absolute cost barriers are not, however, a factor militating solely in favor of predation. Although it could furnish a shield for high prices after a successful predatory campaign, the existence of an entry barrier typically implies an exit barrier of equal magnitude. Thus the cost of eliminating a firm that has invested large sums in its capital plant will usually be extremely high.[65] A firm contemplating predation in an industry with

61. The material in this section derives largely from the following sources: J. BAIN, BARRIERS TO NEW COMPETITION (1956); Bain, *A Note on Pricing in Monopoly and Oligopoly*, in R. HEFLEBOWER & G. STOCKING, READINGS IN INDUSTRIAL ORGANIZATION AND PUBLIC POLICY (1956); F. MACHLUP, note 54 *supra*; Modigliani, *New Developments on the Oligopoly Front*, 66 J. POL. ECON. 215 (1958).

62. The "safety-margin" thesis is suggested in W. FELLNER, *supra* note 7, at 152-54.

63. The cost a few years ago of a reasonably efficient plant in some industries was as follows: a shoe manufacturing plant—$500,000 to $2,000,000; a metal container plant—$5,000,000 to $20,000,000; a rayon plant—$50,000,000 to $135,000,000; and an integrated steel plant—$265,000,000 to $665,000,000. *See* J. BAIN, *supra* note 61, at 158-59.

64. *See* J. BAIN, INDUSTRIAL ORGANIZATION 282-84 (2d ed. 1968).

65. Product differentiation may also work as a barrier to entry, but to the extent that it is a cost barrier, it probably also entails equivalent barriers to exit. A firm that has spent large sums establishing a consumer following will be difficult to drive out unless it can transfer and retain the

significant cost barriers must, therefore, incorporate the likelihood of tenacious resistance into its initial decision to undertake a price cut. Given the speculative nature of predatory warfare, the inherent conservatism of corporate managers, and the genuine virtues of legitimate price competition, reason strongly counsels in favor of viewing price cutting in an industry with high absolute cost barriers to entry as nonpredatory.

In addition to absolute cost barriers, economies of scale also could provide the shield to protect a price-cutting firm. Economies of scale occur when increasing size permits greater specialization in the use of the factors or agencies of production—plants, machinery, equipment, and tools. If the smallest scale at which a firm can achieve the reasonable efficiency[66] necessary for profitable competition is one that produces a significant portion of the industry or market output, the knowledge that its additional production would depress prices and thus lower profits might deter a potential entrant from competition. Moreover, that the existing firm's current price exceeds the potential entrant's long run average cost would not guarantee entry, because the most important price to a potential competitor is the one likely to result from its addition to industry output.[67]

Little empirical evidence exists with regard to the relationship between absolute cost barriers and economies of scale, but a priori reasoning suggests that there is a strong correlation between the two. Although it is, of course, true that the plant size required to satisfy a significant proportion of total market demand is a function of market size, achieving economies of scale typically requires substantial capital outlays for

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benefits of its consumer loyalty in another product or geograpbical market. However, consumer loyalty that is transferable between 2 markets is an additional inducement to enter tbe relevant market. Indeed, it is sometimes argued tbat tbe ability to differentiate a product is an effective means of overcoming barriers to entry. Twedt, *How To Plan New Products, Improve Old Ones and Create Better Advertising*, in PRODUCT MANAGEMENT: SELECTED READINGS 84, 85 (1970); Smith, *Product Differentiation and Market Segmentation as Alternative Marketing Strategies*, 21 J. MARKETING 3 (1956). If a predatory firm has succeeded in establishing such a bigh degree of consumer loyalty that its product is considered "unique," then it should be deemed to control an artificial entry barrier, and should be subject to the legal controls limiting other artificial barriers. *See* note 68-70 *infra* and accompanying text.

66. A firm with "reasonable" efficiency has unit costs tbat are not significantly higher than the lowest attainable unit cost for the industry.

67. Although economies of scale do permit a surviving firm to exercise some control over price, its power is often less than a genuine monopolist's because the possibility of entry will still influence its price. Acting rationally, the firm will set a limit price tbat is as bigh as it can charge without inducing entry. The minimum efficient output, market demand, the added costs of producing at less than optimum scale, and the reaction of price to increases in supply will determine the limit price. It will be high when the output of an efficient entrant would effect a significant drop in price, the costs of producing at less than optimum scale are high, or slack demand permits small increases in supply to cause large decreases in price.

specialized plants, machinery, equipment, tools, and processes. Thus the existence of economies of scale often implies the concomitant existence of high exit barriers, and the considerations previously discussed in relation to absolute cost barriers again militate in favor of construing ambiguous price cuts as nonpredatory. On the other hand, when absolute cost barriers are insubstantial, the unlikely presence of economies of scale nevertheless may provide the margin of safety that will prompt a firm to embark upon a predatory campaign.

Although absolute cost barriers and economies of scale are the most significant barriers to entry in our economy, firms sometimes exclusively possess resources that are essential to production or distribution. Thus, a firm may have patents that protect essential technical processes, control the local supply of a complementary means of production (for example, a fuel), own all the available sites for additional plants, control the channels of distribution through vertical integration or exclusive dealing arrangements, or enjoy a governmental privilege (for example, a license, franchise, or tax exemption). Although these "artificial" barriers initially might appear to offer shelter for successful predators, adequate legal devices for overcoming them may already exist. Exclusive dealing arrangements and mergers that significantly restrict the supply of important resources violate the Clayton Act.[68] Patents, in the rare cases in which they are a significant barrier, are subject to compulsory licensing.[69] Refusal to sell an essential resource to a potential competitor probably violates section 2 of the Sherman Act,[70] and distributing a scarce resource to a subsidiary at cost while extracting a profit from others possibly violates section 2(a) of the Robinson-Patman Act.

A predatory policy thus appears to hold a reasonable probability of success only in the uncommon situations when economies of scale are not accompanied by absolute cost barriers to entry, when barriers to entry markedly exceed industry exit barriers, or when a single firm has exclusive control of resources essential to potential competitors that

68. Clayton Act §§ 3, 7, 15 U.S.C. §§ 14, 18 (1970).

69. *Cf.* Besser Mfg. Co. v. United States, 343 U.S. 444 (1952); United States v. National Lead Co., 333 U.S. 319 (1947); United States v. United Shoe Mach. Corp., 110 F. Supp. 295, 354 (D. Mass. 1953), *aff'd*, 347 U.S. 521 (1954).

70. 15 U.S.C. § 2 (1970). "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding fifty thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court."

cannot be released by other antitrust remedies. Genuinely predatory price cutting is undoubtedly an evil, but a policy that fails to recognize its high improbability and treats predation as anything but a rarity will too often produce results that substantially impair the health of the competitive process.

C. Nonpredatory Price Cutting in Pursuit of Efficiency

Before examining the structural conditions that arguably make nonpredatory price cutting harmful, it would be worthwhile to consider briefly the effect of a policy that forbids discriminatory price cutting without regard for predatory intent or the possible acquisition of a power to control price. The essence of competition is a struggle between firms to attract business by offering consumers the best product for the lowest price. Forbidding a seller to divert trade from a less efficient competitor promotes inefficient operations, protects unnecessarily high prices, and prevents an efficient allocation of resources. Secret, selective, local price cutting is often the mechanism that weakens and eventually crumbles the artifically high price floors of oligopolistic industries. Prohibiting such anti-oligopolistic price cutting, however, buttresses artifically parallel price patterns and thwarts antitrust policy, which in other contexts unequivocally condemns price fixing arrangements.[71] Moreover, that a competitor's pursuit of efficiency may force an inefficient seller from business is surely an inadequate justification for mechanically condemning low prices. The profit incentive is seldom enough to ensure efficiency; the threat of loss and possible bankruptcy are also needed. Unless competition "hurts," incompetent firms utilizing the least efficient techniques and therefore offering the least attractive terms would pollute the streams of the competitive system. Prohibiting discriminatory pricing without requiring predatory intent or a power to control price is no more rational than boarding up hospitals because unsterilized instruments may spread disease.

There is, of course, the possibility in an industry with barriers to entry that a firm lowering its price in pursuit of efficiency will eliminate its competitors and thereby obtain substantial power over prices.[72] A

71. *See, e.g.*, United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940).

72. Materials employed in writing the following analysis include: J. CLARK, note 53 *supra*; J. DIRLAM & A. KAHN, note 53 *supra*; C. EDWARDS, note 53 *supra*; J. MILLER, note 53 *supra*; C. WILCOX, note 53 *supra*; Ferrall, *Quantity Discounts and Competition: Economic Rationality of Robinson-Patman*, 3 J. LAW & ECON. 146 (1960); Reynolds, *Cutthroat Competition*, 30 AM. ECON. REV. 736 (1940); Comment, *Sales Below Cost Prohibitions: Private Price Fixing Under State Law*, 57 YALE L.J. 391 (1948). Of course, the above authors do not necessarily agree with any or all of this analysis.

single firm can eliminate its competitors while pursuing efficiency only if it can profitably supply a large portion of the market at a price below the average cost of its competitors.[73] If substantial exit barriers exist, the firm must additionally sell at a price below its competitors' variable costs.[74] In order for either of those possibilities to exist, the industry must possess substantial excess capacity—a condition that often accompanies economies of scale. The need to cope with unpredictable upsurges in demand requires a firm to maintain some excess capacity. Additional excess capacity, however, reflects an ability to charge more than a perfectly competitive price and thus operate above the firm's lowest cost output. Further excess capacity indicates a significant misallocation of resources, implying either that the number of firms is too large to permit each to operate at its lowest cost output without depressing the price below the industry's representative average cost or that the industry's firms collusively or independently have coordinated their activities to restrict output and raise price. If one firm can eliminate its competitors without taking losses or foregoing profits, at least the former and perhaps also the latter possibility is indicated. In either event, the elimination of one or more competitors will rid the market of substantial idle resources, and it is quite possible that the surviving firm's price will not exceed the market price prevailing prior to the price cut, since that price had to be high enough to permit an inefficient, unnecessary competitor to survive.

Considering the problem within the framework of a policy that favors the promotion of free enterprise, the wasted resources of excess capacity are a greater evil than the possibility that a higher price would result if the excess were eliminated. Other industries probably could better utilize the resources released by an efficiency-seeking price cut, and the price in an industry to which the resources are transferred could well be reduced sufficiently to offset any price rise in the first industry. Moreover, efficiently operating firms from other markets probably could add moderate supplies if the price increase in the first industry were significant. Thus, low prices set in pursuit of efficiency should be permitted regardless of their effect,[75] and the benefits of genuine price

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73. *See* pages 276-78 *supra*.

74. *See* pages 277-78 *supra*.

75. Those who contend that the Robinson-Patman Act protects "competitors" at the expense of "competition" have misconstrued the intent of Congress. The civil provisions do not employ the word "competitor," but forbid injuries to "competition." The Act protects individual sellers from the impact of competition in pursuit of efficiency only when the defendant has obtained its efficiency by unfair or oppressive tactics. For example, the chairman of the House committee that reported the bill stated, when discussing the "cost" defense, that "the bill assures to the mass

competition demand that ambiguous price cuts should be construed in favor of the price cutter.

III. THE SELLER'S PRICE-COST RELATIONSHIPS AS EVIDENCE OF PREDATORY INTENT[76]

When a seller charges less than its average cost in one market or for one product and its price for other products or in other markets exceeds its average cost, the courts typically will presume the existence of predatory intent.[77] Prices above average costs, however, are not neccssarily evidence of an absence of predatory intent. A firm can successfully implement a predatory scheme by selling above its average cost if the structural prcconditions for predation are present and the firm's superior efficiency enables it to eliminatė a competitor without taking actual losses.[78] Less than average cost pricing, on the other hand, is no more an accurate barometer of predatory intent than above average cost pricing is an indicator of nonpredatory conduct. For example, a first principle of economic theory is that a firm maximizes its profits by equating the variable cost of producing and selling additional units with the increment to its total revenue resulting from the sale of those units.[79] In other words, it is advantageous for a firm to produce at any price that yields revenues above its additional variable costs and to continue producing until it can no longer add more to its revenue than it adds to

distributor as to everyone else, full protection in the use and rewards of efficient methods in production and distribution in return for depriving him of the right to crush his *efficient* smaller competitors with the power and resources of mere size." 80 CONG. REC. 9417 (1936) (emphasis added). Wben legislative history refers to the primary line of competition it reverts to war chest and subsidization language. *See* 80 CONG. REC. 9416 (1936). The history of § 2 of the original Clayton Act also indicates a congressional purpose to codify the cases under § 2 of the Sherman Act that prohibited local price cutting designed to destroy competitors and acquire a monopoly by powerful regional or national corporations. H.R. REP. No. 627, 63d Cong., 2d Sess. 8 (1914). *See also* S. REP. No. 698, 63d Cong., 2d Sess. 2-4 (1914).

76. The material in this section was derived from the following sources: J. CLARK, STUDIES IN THE ECONOMICS OF OVERHEAD COST (1923); J. MILLER, note 53 *supra*; E. SELIGMAN & R. LOVE, PRICE CUTTING AND PRICE MAINTENANCE (1932); Burns, *The Anti-Trust Laws and the Regulation of Price Competition*, 4 LAW & CONTEMP. PROB. 301 (1937); Clark, *Statutory Restrictions on Sales Below Cost*, 11 VAND. L. REV. 105 (1957); Ferrall, *supra* note 72; Hamilton, *Cost as a Standard for Price*, 4 LAW & CONTEMP. PROB. 321 (1937); McNair, *Marketing Functions and Costs and the Robinson-Patman Act*, 4 LAW & CONTEMP. PROB. 334 (1937); Rowe, *Price Discrimination, Competition, and Confusion: Another Look at Robinson-Patman*, 60 YALE L.J. 929 (1951); *A Symposium on the Robinson-Patman Act*, 49 NW. U.L. REV. 196 (1954); Comment, *supra* note 72.

77. *See* part I *supra*.

78. *See* page 277 *supra*.

79. In economic jargon, it is said that a firm will increase its output to the point at which its marginal costs equal its marginal revenues.

its costs. Thus the price of an additional sale or series of sales does not have to equal or exceed average cost—the sum of fixed and variable costs divided by output—in order to be profitable. As long as a sale makes a net contribution to fixed unit cost that would not otherwise be made, it is profitable. Producers consequently set their prices with reference only to their variable costs and their estimates of the demand for their product.

Industries characterized by substantial excess capacity often spawn less-than-cost pricing because firms will attempt to utilize their productive excess by selling below average cost on particular orders or in particular markets. A price reduction in all markets, however, is frequently self-defeating, since the revenue lost on all sales is not offset by a corresponding reduction in unit costs when total demand at the uniformly low price pushes production beyond the minimum-cost output or when the uniform price cut evokes immediate retaliation by national competitors. A policy that requires price to exceed average cost thus prevents a firm from utilizing its idle capacity, deprives society of a net addition to the volume of available goods, compels those who can afford the higher price to pay for unproductive plants and equipment, and helps to stabilize the artificially high prices that often prevail in industries with excess capacity.

Rather than lowering their prices in a particular market or on individual orders, firms with excess capacity often reduce their general price below average cost when they experiment with the demand for their products at varying prices. A firm with excess capacity has a fair idea of its variable costs at increasing outputs. It knows that its costs will either fall or in some circumstances remain constant as output increases. Indeed, a firm has no excess capacity when costs exceed revenues at increased outputs. Profits, however, are equal to the difference between average cost and price multiplied by the number of units sold. Two determinants of the profit equation—the fixed cost component of the average unit cost and the number of units sold—are determined by demand, a factor largely beyond the knowledge or control of the seller. A seller usually is aware of only one demand for its product—the demand at its current price. Although a seller's advertising influences demand, the demand for its product at other prices can be determined with certainty only by changing its price. If a seller with excess capacity suspects that relative demand for its product increases at lower prices, a price cut will cause a larger percentage increase in the number of units sold than the percentage decrease in price. Since variable cost will fall or remain constant as output increases, and fixed cost will be spread among a higher number of units, the seller's total profits will consequently increase. The fact that a particular price decrease causes losses may signify merely an erroneous estimate of demand by the seller. Thus the fallacy of a policy that prohibits less than average cost pricing is its dual failure to recognize that costs are frequently not the determinant of price and that price, which determines sales, volume of production, and utilization of plant capacity, is often the determinant of cost.

Finally, a firm sometimes will take deliberate losses or lower profits in the short run because it believes that it will increase its profits thereby in the long run. Thus, a firm offering a new product, version, model, or style of an old product may take short-run losses deliberately or even sell at a price below variable cost in the hope that consumers will develop a taste for or acquire complements to its product.[80] If its gamble proves successful, the firm will be able subsequently to raise its price and recoup its losses. Moreover, a recession in demand that a seller considers temporary may induce it to sell below average or variable cost in order to maintain customer contacts, protect goodwill, or hold its working force together. Of course, a general or marked recession in demand would force all sellers to reduce their prices, thus making the nonpredatory nature of a price cut obvious.

IV. A Recommended Approach Toward Price Cutting

Section I of this Article suggested that the courts have used several criteria to definc harmful price cutting, including below-cost pricing and the relative ability to subsidize local price cuts with other funds. Section II, however, suggested that price cutting will be unprofitable for a firm contemplating predation unless certain structural preconditions exist within the industry or market. It concluded that predation holds a reasonable probability of success only when economies of scale are not accompanied by absolute cost barriers to entry, when barriers to entry substantially exceed industry exit barriers, or when a single firm has exclusive control of essential resources that cannot be released by other antitrust remedies. Moreover, it argued that the benefits of genuine price competition demand that ambiguous price cuts should be construed in favor of the price cutter. Section III revealed that less-than-cost pricing and subsidization are inappropriate criteria for indicating

80. Coffee and tea are rival, competing products, or *substitutes*. Tea and lemon, however, are complementary commodities, or *complements*. Tea and salt are between the 2 extremes, and are *independent* commodities. An increase in the price of coffee will increase the demand for tea, and therefore lemon. The demand for salt, however, will be unaffected. *See* P. SAMUELSON, *supra* note 55, at 416-17.

the potential harmfulness of a price reduction. This section offers new criteria for accommodating the law and economics of price cutting. It proceeds on the theory that a prima facie violation of an antitrust prohibition must include two prerequisites: first, the relevant industry or market must exhibit the structural and qualitative preconditions that allow a price reduction to possess harmful potential; secondly, the defendant must reduce its price without a reasonable probability of enhancing its profits except by the subsequent acquisition of a power to control price gained by the elimination of vulnerable competitors. The second element of the equation, which determines whether the defendant acted with predatory intent, becomes relevant only after the first element is established.

Implementing the suggestions proposed herein will require the exercise of considerable judgment and discretion. Rigid per se rules are inappropriate tools for the complex task of identifying predatory price cutting because the mechnical application of an automatic rule would too often deny the presence of economic ambiguities and produce decisions with anticompetitive ramifications. The proposals nevertheless offer criteria that can be applied without undue reliance on prediction, speculation, and economic theorizing. Although their application by a court or jury will require no more discretion than is called for by the evaluation of a merger challenged under section 7 of the Clayton Act,[81] the repercussions of possible error would warrant undertaking even additional decisional difficulties, since a merger often has neutral effects on the competitive process[82] while nonpredatory price cutting is typically a positive sign of vigorous competition.

A. Structural Prerequisites to a Finding of Predation

Prior analysis suggested that predatory conduct cannot be profitable unless certain structural preconditions exist within an industry or market. Assuming that the managers of a firm are rational, predation is unlikely unless the following conditions exist: first, the price level represented by defendant's price reduction must endanger the continued presence of at least one competitor in the industry or market if maintained over the long run; secondly, the price-cutting firm must be substantially more efficient or more powerful than its vulnerable competi-

81. 15 U.S.C. § 18 (1970). Section 7 prohibits mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly," which is the same standard of injury employed by § 2(a) of the Robinson-Patman Act.

82. Price competition drives out excess capacity, but mergers other than spin-offs retain it.

tors at the new price; and thirdly, eliminating its vulnerable competitors must significantly enhance the price-cutting firm's ability to control price.

1. *Identifying Vulnerable Competitors.*—The first element of a prima facie case should be to identify those competitors unable to survive in the long run at a market price as low as that charged by the defendant. Of course, it is impossible for the defendant's low price to cause the exit of competitors from the industry or market when that price exceeds the average costs of the defendant's competitors. Thus the plaintiff should identify those competitors whose average costs of present output are above the defendant's price at the time the complaint issues.[83]

2. *Comparison of Relative Efficiencies and Market Power.*—Once vulnerable competitors are identified, the second element of a prima facie case should be to establish which of those competitors are at a significant cost or financial disadvantage to the defendant. Cost advantage is relevant because a firm might utilize its superior efficiency for predatory purposes without simultaneous subsidization. Since a highly efficient firm can set its price above either its average cost or the point necessary to require subsidization and nevertheless act predatorily,[84] vulnerable firms that have significantly higher costs than the defendant are potential victims of a predatory price cut even if they are as financially potent as the defendant.

Relative financial strengths are, of course, significant when determining whether the defendant has the ability to subsidize any losses incurred while eliminating a vulnerable competitor. A good rule of thumb for comparing the relative financial strengths of a defendant and its competitors is to divide the liquid assets of each party by its relevant market share. Thus, if a defendant has a three-fourths share of the market and a particular competitor has one fourth, the defendant has a greater "war chest" only when its liquid assets exceed the competitor's by more than a multiple of three. Unless there is a considerable difference between the parties' adjusted financial strengths, the weaker firm will probably be able to secure cash resources from investors optimistic about its prospects for survival and long-run earning potential. Thus one should not presume that a firm is willing to go the limit and sacrifice

83. The average costs of competitors at their pre-price-cut outputs should serve as a rough, long-run guide for identifying vulnerable competitors at the defendant's price. If the plaintiff were the only competitor of the defendant, it would only need to establish its own financial inferiority or higher costs.

84. *See* page 277 *supra*.

all its liquid assets to destroy a competitor when a slight financial advantage and short-run losses are the only evidence against the defendant.

3. *Ability To Control Price.*—The third element of a prima facie case should be to establish that the elimination of the defendant's vulnerable competitors and the subsequent redistribution of market shares among the remaining firms will substantially increase concentration in the relevant market and thus potentially enhance the defendant's power over price.[85] Unless there are barriers to entry, the defendant's power over price will not be significantly enhanced by eliminating its competitors. Economies of scale, absolute cost barriers, or artificial barriers resulting from exclusive control of essential resources, are thus necessary for the defendant to acquire power over price after the elimination of competitors; otherwise, a price rise would immediately attract new competitors.[86] Since absolute cost barriers become significant at approximately 5,000,000 dollars, that figure is tentatively suggested as the minimum cost barrier for establishing a prima facie case. Similarly, a plant capable of producing at least ten percent of the output in the relevant market is tentatively suggested as the minimal optimal size for establishing a prima facie case based upon economies of scale. The output generated by a smaller plant would be unlikely to depress the market price sufficiently to deter entry.

Unless it has exclusive control of essential resources, the defendant could rebut a presumption that it will gain the power to control price by establishing that the market is "wide" enough to reduce its potential power. For example, substitutes—products that perform essentially the same function as the defendant's—will limit the defendant's subsequent power to control price. If the defendant's and a competitor's products are fairly close substitutes, an increase in the defendant's price will cause a significant loss of business in favor of the competitor's product. Potential competitors furnish another limitation on the ability of a defendant to acquire power over price. Firms that presently compete with the defendant in other markets and that have low-cost access to the relevant market would find it profitable to enter whenever the defendant tries to increase price significantly. Similarly, firms with existing plants capable of producing the defendant's product without costly retooling would also find it profitable to enter the industry whenever the defendant tries to raise its price significantly. The addition of firms producing substi-

85. The concentration test used should be similar, although not necessarily identical, to the tests employed in Clayton Act § 7 merger cases. *See* Department of Justice Merger Guidelines, B.N.A. ANTITRUST TRADE & REGULATION REP. No. 360, X-1 to X-6 (June 4, 1968).

86. *See* pages 280-82 *supra*.

tutes, selling the same product in other geographic markets, or possessing flexible productive facilities therefore may broaden the market enough to reduce concentration below the point at which the defendant would acquire a power over price. If not, the final element of establishing a prima facie case is the problem of determining the defendant's predatory intent.

B. Establishing Predatory Intent

Price cuts often are ambiguous bases from which to infer the seller's intent. For example, barriers to exit increase the cost of eliminating a competitor and, all other things being equal, reduce the likelihood that a firm will embark upon a predatory course of conduct.[87] Similarly, the presence of excess capacity or economies of scale within an industry make it likely that price reductions are attempts to lower costs by increasing output.[88] Since predation is seldom the only, or even the most likely, motivational inference that can be drawn from the fact of price cutting, there should be a general presumption that price reductions are nonpredatory, and a prima facie case should include proof that the defendant set its price with the expectation of increasing profits after eliminating its competitors.

Below-cost pricing, moreover, is an inaccurate barometer of intent. A firm may price at less than cost in order to utilize idle capacity[89] or from a miscalculation of the demand for its product at a lower price.[90] Instead, proof of predatory intent should hinge upon all the following factors: whether the price set by the defendant was below its variable costs; whether previous sales experience of the defendant or its competitors indicated the low price would be profitable; whether observable changes in the composition, income, or tastes of consumers in the market for the product or its complements had occurred since the defendant's price was last changed; whether the defendant had recently experienced declining sales or some other impetus to reduce its prices; whether the decrease in the defendant's profits was unreasonably large under the circumstances; whether the defendant's previous cost experience at higher outputs indicated that it was near full (lowest cost) capacity so that any decrease in price would increase costs; whether the defendant sustained its self-imposed losses or lower profits for an unrea-

87. *See* pages 280-82 *supra.*
88. *See* pages 283-85 *supra.*
89. *See* pages 285-86 *supra.*
90. *See* page 286 *supra.*

sonably long period; and whether the defendant's price cut was promotional, resulting from an attempt to introduce a new product, or a new version or model of an older product.

If the above factors do not clearly establish that the defendant intended to destroy competitors, the court should adopt a "wait and see" policy. If the defendant thereafter continues to take self-imposed losses or reduced profits beyond the point at which a prudent business manager would realize that there was no reasonable possibility of increasing profits at that price, and vulnerable competitors are unable to increase their efficiency and make profits at the defendant's lower price, a finding of predatory intent should follow. Similarly, the profitability of a promotional price cut that had as its objective a long run increase in demand may eventually become so speculative that the imminent danger of having the defendant acquire a power to control price from its financial or cost advantage will clearly outweigh the uncertain benefits to be gained from prolonging the price cut. In any case, the wait and see policy requires a balancing of all the above factors in order to determine the existence of a substantial probability[91] that profits will increase only by eliminating competitors.

V. Conclusion

The policies advocated by this Article obviously derive from a deep skepticism regarding the allegedly harmful effects of price cutting. This skepticism is the product of an economic analysis that suggests few circumstances in which price cutting would be harmful. In most cases beneficial alternative explanations are far more probable. Indeed, the alternative explanations for price cutting are positively essential to the effective functioning of the competitive process. Few innocent firms would ever be found guilty of harmful price cutting according to the analysis proposed in this Article; yet few firms that do possess the power and intent to inflict substantial harm upon the competitive process would escape detection. The business of a legal system is to make the postulates of a society work. As long as competition remains the funda-

91. A violation of § 2(a) of the Robinson-Patman Act occurs only when the "effect" of a price discrimination may "substantially" lessen competition or injure, destroy, or prevent competition with the discriminator. The section should not be interpreted to warrant a finding of a violation when only a "reasonable probability" of predatory intent exists because a reasonable probability of predatory intent also implies a reasonable probability of nonpredatory intent. Prohibiting price cutting under such circumstances would itself create a reasonable probability of substantially lessening competition because workable competition requires the opportunity for intensive price rivalry.

mental objective of the federal antitrust laws, conduct that so clearly reflects the competitive essence must be considered innocent until affirmatively proved guilty.[92]

92. Other materials employed in writing this Article include: R. BOWIE, GOVERNMENT REGULATION OF BUSINESS (1955); A. NEALE, THE ANTI-TRUST LAWS OF THE UNITED STATES OF AMERICA (1960); M. LINDAHL & W. CARTER, CORPORATE CONCENTRATION AND PUBLIC POLICY (1959); Mason, *Monopoly in Law and Economics*, 57 YALE L.J. 34 (1937); Comment, *Civil Actions Under Section Three of the Robinson-Patman Act*, 55 MICH. L. REV. 845 (1957).