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Pigeonholes in Antitrust

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Pigeonholes in antitrust

BY GEORGE A. HAY*

This conference is intended to celebrate the increased importance of economics in the decision-making process of the Antitrust Division and the role played by the Economic Policy Office in that development. I am delighted to join in that celebration. However, to inject a note of serenity into the proceedings, it is useful to be reminded that of the approximately 1,000 antitrust cases filed each year in federal courts, the Antitrust Division typically accounts for substantially less than 10% of the total. While I would not claim that the Department's impact is accurately measured by such a calculation, the statistic reminds us that there is a rather large chunk of antitrust activity over which the Department has little direct influence by its selection of which cases to file.

This is not to say that private cases are immune from the influence of economists. Judges writing opinions in those cases are likely to have considerable exposure to economic ideas through the live testimony of expert witnesses or through the economics literature cited by counsel for each side. Indeed, on special occasions, the judge may even have the benefit of an amicus brief from the Department itself, in which an economically sensible solution will be urged.

There have been some notable victories in the efforts by economists to influence the courts, as anyone familiar with the recent case law on predatory pricing can attest. However, I think

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HeinOnline -- 29 Antitrust Bull. 133 1984

as an overall matter economists have been much less successful in this effort than they have been in influencing the case selection process by the Antitrust Division (and the FTC).

One could argue that the disparity merely reflects the strong economics orientation of the present heads of the two federal antitrust agencies. But while there is no doubt that William Baxter and James Miller may have been more aggressive in pushing an economically oriented approach than any of their recent predecessors, the trend dates at least to Donald Turner's tenure as Assistant Attorney General.

One might also argue that a prosecutor is freer to attempt innovations (of any kind) than the courts, which may feel more tightly constrained to follow precedent. But whether or not that is true, I don't think it is the entire explanation.

My theme this afternoon is that there is another factor at work that goes a long way to explain the more limited influence economists have had on the courts. That factor is the courts' long-standing and deep-seated reluctance to involve themselves in any kind of in-depth analytical inquiry and their preference for deciding antitrust cases by reference to a few reasonably simple rules of thumb, so that the extent of their involvement is to determine which pigeonhole the challenged activity belongs in.

The per se rule for horizontal and vertical price-fixing is the most familiar example of the courts' use of rules of thumb, requiring a court merely to determine whether or not there is an agreement to fix or stabilize prices. Determination of the legality of horizontal mergers by adding up market shares is another, requiring the court merely to determine which of several market definitions is most appropriate (is it apples or fresh fruit?) and to compare market shares to an appropriate benchmark.

As any teacher of antitrust law will tell you, the courts' reluctance to place themselves in the role of economic analyst dates to the very earliest cartel cases following the passage of the Sherman Act. In *United States v. Trans-Missouri Freight Asso-*

HeinOnline -- 29 Antitrust Bull. 134 1984

ciation,[1] decided in 1897, the Supreme Court was confronted with defense arguments that the prices agreed to were reasonable, no more than necessary to prevent cutthroat competition from driving most of the railroads to bankruptcy. The Court expressed some skepticism about the entire argument, but a primary factor in the decision not to address the argument squarely was its reluctance to adopt a standard that would have required subsequent antitrust courts to evaluate whether a rate was reasonable.

The following year, Judge Taft, then an appellate judge, adopted essentially the same attitude in *United States v. Addyston Pipe & Steel Co.*[2] when confronted with the argument that the defendants controlled an insufficient share of the industry to raise rates above a reasonable level. To attempt to judge the reasonableness of such a restraint would have been setting sail "on a sea of doubt."

With minor deviations between 1911 and 1933, the courts have continued to express their reluctance to undertake any kind of full-scale inquiry in cases involving an agreement not to compete, opting for a blanket rule despite recognition that such a rule may occasionally penalize neutral or procompetitive conduct. A footnote in *Goldfarb* and a sentence or two in *Professional Engineers* may have raised expectations that the attitude was changing, but the recent *Maricopa* case bears witness to the view that the aversion to substantive analysis continues.[3]

So too in the merger area. One year after initially suggesting in *Brown Shoe*[4] that a full examination of the market in question,

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1 United States v. Trans-Missouri Freight Association, 166 U.S. 290 (1897).

2 United States v. Addyston Pipe & Steel Co., 171 U.S. 614 (1899).

3 State of Arizona v. Maricopa County Medical Society, 102 S. Ct. 2466 (1982); Goldfarb v. Virginia State Bar Association, 421 U.S. 773 (1975); National Society of Professional Engineers v. United States, 98 S. Ct. 1355 (1978).

4 Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

HeinOnline -- 29 Antitrust Bull. 135 1984

including its "structure, history and probable future," would be necessary to judge the probable anticompetitive effect of a merger, the Court seemingly adopting the advice of Derek Bok in a famous law review article,[5] indicated that the plaintiff in a merger case could make out a prima facie case solely by introducing evidence of a concentrated market and large market shares for the merging firms.[6]

While the treatment of price agreements and mergers provides the clearest illustration of the courts' preference for simple rules of thumb, there are numerous other illustrations, some of which I will mention this afternoon. The significance of this preference is *not* that courts are immune from the influence of economists and incapable of altering long-held positions in favor of more economically sensible standards. However, the preference for simple rules and pigeonholes means that the courts will resist economic advice that can't itself be transformed into a new set of pigeonholes to replace the old. Reforms that require courts to do extensive analysis are likely not to be adopted.

Actually, the use of pigeonholes and rules of thumb by courts should not come as a great surprise to an economist, given how extensively we use them in our own work, even outside the antitrust field. Economists routinely ignore the "theory of the second best" and adopt a rule of thumb that where price moves closer to marginal cost, welfare is improved. Economists doing benefit-cost analysis routinely ignore the principle that one can't make interpersonal utility comparisons and adopt a rule of thumb that a bridge should be built if the arithmetic sum of benefits, expressed in terms of willingness to pay, exceeds the sum of costs. Closer to home, economists evaluating price-discrimination schemes often adopt a rule of thumb that if the discrimina-

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5 Derek C. Bok, "Section 7 of the Clayton Act and the Merging of Law and Economics," *Harvard Law Review*, Dec. 1960, at 226-355.

6 Some read into the *General Dynamics* opinion a reversal of the Court's position on the need for a complete economic inquiry. I do not share that view. United States v. General Dynamics Corporation, 415 U.S. 486 (1974).

HeinOnline -- 29 Antitrust Bull. 136 1984

tion increases output, welfare must be improved, a conclusion that is not necessarily correct.

Moreover, it is possible to argue that the use of pigeonholes by courts is economically rational and socially efficient behavior. The work by Posner and Landes on the economic analysis of civil procedure reminds us that the overall goal of the legal system, viewed from an economic perspective, is to minimize the overall costs of the system, defined as the sum of error costs plus administrative costs.[7] A full-scale economic inquiry, if done well, would be likely to reduce error costs (the costs of discouraging efficient firm behavior and encouraging anticompetitive behavior as the result of incorrect decisions), but would be enormously costly in terms of judicial input and other resources. In addition, while the lamentations of business about the uncertainty caused by the unpredictability of antitrust might actually reflect simply a preference for less antitrust, there appears to be at least some sentiment for brightline rules even where those rules might in some cases turn out to prohibit behavior that might ultimately be deemed innocuous after a more detailed analysis.

But whether or not the use of pigeonholes by courts in antitrust cases is on balance efficient, it is widespread and, in my view, unlikely to disappear in the foreseeable future. Economists seeking to influence the courts are well advised to adapt to this phenomenon rather than attempt to override it.

Perhaps the best illustration of this phenomenon at work is the recent "revolution" in the law on predatory pricing. For almost the entire history of the Sherman Act, the inquiry in monopolization cases boiled down to two questions: Does the defendant possess monopoly power? Did it engage in exclusionary conduct? The process was complicated by the minor detail that no satisfactory definition of exclusionary conduct had been adopted, so that enormous effort was invested in providing enough evidence on behavior and intent that the court could

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[7] *See, e.g.,* Richard R. Posner, *Economic Analysis of Law* (2d ed. 1977); some of the joint articles by Landes and Posner are cited therein.

HeinOnline -- 29 Antitrust Bull. 137 1984

answer "yes" to the question of whether it had occurred. The persistent criticism by economists that the ambiguity in the standard was likely to discourage socially desirable behavior seemed to have little impact, since no satisfactory alternative set of pigeonholes gained favor. The main proposals to end the confusion and lengthy trials involved elimination of the conduct requirement altogether.

Against this background, the success of the Areeda-Turner proposals in reorienting the courts in section 2 cases is well known.[8] In my view, what made it possible for the courts to use the economic advice was that the advice came in the form of pigeonholes. This is not to say that the evidence needed to determine the appropriate pigeonhole would necessarily be minimal. However, after listening to the evidence, the court could choose one of two or three discrete pigeonholes which would effectively determine the outcome.

Of course, there has been ample academic criticism of the Areeda-Turner approach and courts have avoided literal adherence to their proposed rules. Therefore, I would not claim that it is the final resting place. Were I to predict the eventual resolution, I would guess that a somewhat broader yet still structured inquiry like that proposed by Joskow and Klevorick[9] will win out over a simple average variable cost test. I am reasonably confident that the end result will have the kind of pigeonhole characteristics common to both.

By way of contrast, I will speculate that the 1982 Merger Guidelines will not have as much influence on the courts as many (including myself) originally predicted. Not that I am especially critical of the Guidelines—as a statement of the appropriate economic methodology for merger analysis, it is a brilliant

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8 *See* George A. Hay, "A Confused Lawyer's Guide to the Predatory Pricing Literature," in FTC, *Strategy, Predation, and Antitrust Analysis* (Sept. 1981).

9 P. Joskow and A. Klevorick, "A Framework for Analyzing Predatory Pricing Policy," *Yale Law Journal,* Dec. 1979, at 213-70.

HeinOnline -- 29 Antitrust Bull. 138 1984

document, despite reservations I or others may have on individual details. Moreover, the guidelines do not have as their stated purpose the conversion of judicial decision making, but are offered merely to serve as an explanation of how the Antitrust Division will analyze mergers so as to assist counsel in determining which mergers are likely to be challenged and how evidence might be efficiently organized so as to persuade the Division in close cases.

Some of the changes contained in the guidelines may influence the courts. If conversion to the metric system had gone as smoothly and rapidly as conversion to the use of the Herfindahl Index, EPA ratings for automobiles would already be expressed in kilometers per liter. Also, the substantive relaxation of the critical market share standards and the safe harbor for relatively unconcentrated industries have all the characteristics that courts find attractive. Finally, the imprimatur of the Antitrust Division on the proposition that protection against supercompetitive pricing is the sole focus of antimerger policy may dissuade courts from using section 7 to advance other policy goals.

However, to an economist, the most important substantive changes in the guidelines are in the sections on defining the relevant market and measuring market shares (market definition from the supply side). Unfortunately, while the proposed 5% simulation gives the appearance of offering a straightforward rule of thumb, it has the disadvantage of requiring that specific numbers be chosen from a continuum of values rather than offering a series of discrete choices, only one of which may be selected. Hence, rather than deciding that the market instead of being limited to the state of Wisconsin should be expanded to include a three-state area, the court must now decide how much from the remaining two states will wind up in Wisconsin under the 5% experiment.

In at least two circumstances the guidelines can survive this disadvantage. Where the market shares are so close to the critical level that any additional product added to the universe will push them into the protected range, no specific value need be selected.

HeinOnline -- 29 Antitrust Bull. 139 1984

At the other extreme, where the elasticity of imports or the cross-elasticity of supply is extremely high, the court can follow the Landes-Posner rule and include all capacity for purposes of measurement. In less polar cases, however, I fear that courts will find that the guidelines require too much analysis and will continue to calculate market shares based on actual sales, perhaps subject to an Elzinga-Hogarty type of test,[10] which does have the all-or-nothing quality that permits pigeonhole analysis.

The 70-year body of case law on vertical restraints is one of the best illustrations of the courts' reliance on pigeonholes. Interestingly, the courts have not been immune to change. However, the process by which we have reached the present state of the law more closely resembles a comedy of errors than a Kuhn-like scientific revolution, as each of a series of tests has collapsed of its own weight.

From the first cases three themes, seemingly translatable into discrete pigeonholes, governed the status of vertical restraints imposed by a manufacturer. The first theme—that of restraint on alienation—was used to rule against any restraint the manufacturer tried to impose on a purchaser of its product. The second theme—that a manufacturer could choose with whom he would deal (the so-called Colgate doctrine)—limited the restraint on alienation doctrine to situations where an agreement (however defined) could be demonstrated. The third theme—that a manufacturer could direct its own employees—was used to insulate a vertically integrated firm from antitrust scrutiny in this area, leading to the curious result that an integrated manufacturer could fix retail prices while the identical restraint would be unlawful if imposed by a nonintegrated firm.

Unfortunately, consignment arrangements, which operated as a hybrid of vertical integration and restraint on alienation, posed serious problems for those pigeonholes, since it became clear that

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[10] Kenneth G. Elzinga and Thomas F. Hogarty, "The Problem of Geographic Market Delineation in Antimerger Suits," 18 *Antitrust Bulletin* 45-81 (1973).

HeinOnline -- 29 Antitrust Bull. 140 1984

a nonintegrated manufacturer could escape the doctrine of restraint on alienation by setting up a quasi-employment contract with its distributors. Failure to do so converted the identical restraint from immune to per se unlawful. In addition, extensive litigation over the question of whether the Colgate principle was satisfied has made it clear that once the concept of agreement is extended beyond formal contractual arrangements, there is no principled basis for establishing whether the restraint is unilaterally imposed. Faced with the awkwardness in such critical yet meaningless distinctions, and armed with a persistent stream of literature suggesting that vertical restraints could be economically efficient, the Court in *GTE Sylvania*[11] tried to reduce the size of the problem by imposing a new set of pigeonholes on top of the old, such that vertical price restraints would continue to be per se unlawful (with the consignment and Colgate issues left not fully resolved), but non-price restraints would be judged under a rule of reason.

While economists view the *Sylvania* decision as an improvement, there are enough problems with the revised standards that the Court has already been forced to reconsider its position. First, economists cited with approval in the *Sylvania* opinion continue to insist that the price/non-price distinction makes no theoretical sense. Moreover, independent of whether the distinction between price and non-price restraints is justified as a matter of theory, courts have realized to their discomfort that there are serious practical problems in deciding which way a restraint should be labeled, since even the typical non-price restraint is designed to insulate the dealers from intrabrand price competition to a certain extent, and is likely therefore to affect prices. Second, assuming that the restraint is labeled as non-price, courts are given little guidance as to what is meant by the rule of reason in this context and how it is to be applied. Finally, the Colgate and consignment issues remain unresolved.

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11 Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

The need for further revision of the standards creates an opportunity for economists to exert an influence.[12] It is interesting to speculate how one might structure economic advice to the courts so as to provide a new but better set of pigeonholes. It is clear that some economists would prefer a very simple rule. Manufacturer-imposed restraints would be per se lawful, be they price or non-price restraints. Only restraints which were reluctantly imposed by the manufacturer acting as the "cat's-paw" of the dealers would be unlawful. The sole exception would be where manufacturer-imposed restraints facilitated a manufacturers' cartel.

I have difficulty understanding how courts would make the "cat's-paw" distinction, unless the manufacturer testified credibly that he would be delighted to see the restraint invalidated. As a general matter, the restraint would benefit both the manufacturer and its dealer, and it would seem pointless to try to apportion the benefits to see who got the larger share. I am inclined to think that the distinction was never intended to be taken seriously, so that as a practical matter, all restraints would be treated as manufacturer imposed. On the horizontal cartel exception, while I am fascinated by the prospect that a facilitating practices approach could be used to invalidate parallel vertical restraints by several manufacturers, experience with the facilitating practices approach leads me to doubt that it would have many practical applications in the vertical context.[13]

Putting aside these practical reservations, the overall strategy would have the advantage of eliminating the need for economically meaningless yet historically important distinctions. The Colgate doctrine could be retired and consignment arrangements would raise no special issues. Finally, there would be no need for

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12 The Antitrust Division participated as amicus curiae in the recent *Monsanto* case (yet to be decided) and is apparently in the process of drafting guidelines on vertical restraints. Monsanto Co. v. Spray-rite Service Corp., 46 A.T.T.R. 603 (1984).

13 George A. Hay, "Oligopoly, Shared Monopoly and Antitrust Law," 67 *Cornell Law Review* 439-81 (Mar. 1982).

HeinOnline -- 29 Antitrust Bull. 142 1984

the Court to give further instruction on what was meant by a rule of reason analysis in the vertical context, since none would be needed.

If the courts are unwilling to adopt the strategy in its entirety, they will face some serious difficulties in deriving new standards that will limit the judge to application of simple rules. If a distinction is to be maintained between price and non-price restraints, the only plausible rule I can envisage is that a manufacturer could not require a dealer to charge certain prices nor dismiss a dealer *solely* because of his failure to adhere to suggested prices. While the dealer who was free-riding on the efforts of other dealers would often have lower costs and lower prices as a result, the manufacturer would be obliged to focus on whether the dealer was living up to his service and other dealership obligations and could not use failure of the dealer to charge the suggested price as the basis of an inference that the dealer failed to honor those obligations.

With regard to the Colgate doctrine, to the extent that price or non-price restraints will be found unlawful in some circumstances, it is difficult to see how the exception can be maintained for manufacturers' suggested retail terms followed by termination of noncomplying dealers. While I may not agree with the FTC decision in *Russell Stover,*[14] I concur with Commissioner Pertschuk's view that the Colgate distinction is unworkable.

Finally, with respect to a rule of reason analysis of vertical restraints, I continue to be mystified as to what the court is supposed to look for. If the standard economic theory of vertical restraints is accepted at face value, they are designed to permit a manufacturer to market its product more effectively. If so, consumer welfare should be improved regardless of whether the manufacturer is a monopolist or a small fry. I will venture to guess, however, that the courts will be sufficiently nervous about unleashing monopolists to do something that may turn out, in

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14 The Commission's decision was subsequently reversed. Russell Stover Candies, Inc. v. F.T.C., No. 82-2036, CA8 (Sept. 29, 1983).

HeinOnline -- 29 Antitrust Bull. 143 1984

some yet to be developed model, to be demonstratedly anticompetitive, that they will adopt a test that makes the legitimacy of vertical restraints depend primarily on the manufacturer's market share, with a share of 20% or more generating at least a greater burden on the manufacturer to show the need for the restraint, perhaps by demonstrating the seriousness of the free-rider problem.

While economists have frequently criticized individual tie-in cases, they have been unsuccessful in offering a workable standard that is superior to that currently in use. The dilemma arises because, where a tie-in is used to effect a price-discrimination scheme, the welfare results are ambiguous.

Moreover, a rule that makes legality depend on whether output is increased, while it may approximate the standard that is theoretically correct, is not likely to be useful as a rule of thumb. Since the profitability of discrimination to the discriminator is not at all dependent on whether output increases, there is likely to be little corporate documentation about the firm's perception of what will happen to output. Legality, then, would depend on a variable that the firm has no business interest in knowing and perhaps no special expertise in predicting—rather an unhappy state of affairs for those attempting to avoid antitrust problems. Moreover, it is not that much easier for the judge to determine, after the fact, whether output was larger than it would have been without the tie.

Interestingly, a rule that would essentially immunize vertical restraints for firms with small market shares and create a rebuttable presumption of illegality for larger firms bears some resemblance to the current rules governing tying arrangements. *Fortner* held that such arrangements are unlawful if imposed by a firm with market power, defined as the power to charge a noncompetitive price or exact other terms and conditions that could not be exacted in a competitive market.[15]

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15 Fortner Enterprises, Inc. v. U.S. Steel Corp., 395 U.S. 495 (1969).

HeinOnline -- 29 Antitrust Bull. 144 1984

Unfortunately, while the language might be interpreted to require a monopoly share of the market in a section 2 sense, it seems to have been interpreted so as to reach firms with some degree of product differentiation even where overall market shares are quite low and where barriers to entry are such that no long-term monopoly power is likely to exist. If that aspect of the rule were modified so as to require genuine monopoly power, the change would probably result in a net economic gain, but the rule would still not very closely approximate the theoretically correct standard.

There are numerous other illustrations of situations where the court's need for simple rules frustrates the economist's interest in a perfect outcome. However, the purpose of my paper is not to exhaust the possibilities but to stimulate discussion. To that end, let me close by restating my theme. Economists in the Antitrust Division operate in a luxurious intellectual environment. They are free to call things as they see them on individual cases with no particular need to distinguish past cases or to lay down general (yet simple) rules to govern future cases. Within that environment, they have scored impressive successes and are to be congratulated for them.

Outside the prosecutor's office, however, the game is played somewhat differently. Courts will neither take on the role of economic analyst themselves nor rely completely on the expert who simply asserts that, in his expert judgment, the behavior is or is not anticompetitive. Courts are prepared to adapt their standards to conform to economists' ideas about efficiency, but only where those ideas can be used to generate a limited set of pigeonholes or some simple rules. There may be circumstances where this is impossible without doing great violence to the underlying economic principles. But the stakes are sufficiently high that it would be wrong to admit defeat until greater effort is made.

HeinOnline -- 29 Antitrust Bull. 145 1984