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CLEANING HANDS IN PREDATION CASES

A MODEST PROPOSAL TO IMPROVE PREDATORY-PRICING SUITS

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EXECUTIVE SUMMARY

Reasonable people may disagree on the threat to competition posed by below-cost, or so-called “predatory,” pricing. However, there is widespread agreement that the U.S. legal regime, which allows firms to sue their competitors for predatory pricing, provides such firms incentives to allege predatory pricing even when their price-cutting rivals are engaged in energetic and healthy competition. When firms win predatory-pricing suits against vigorously competitive rivals, they gain protection from competition. These successful plaintiffs can thus charge higher profits and earn monopoly profits.

One way to eliminate such abuse of the antitrust laws would be to eliminate altogether predatory pricing as a basis for lawsuits. Regardless of the merits or demerits of such a change, another more modest reform is possible that will go a long way toward eradicating the most abusive of such lawsuits. *Rivals* of price-cutting firms should be denied standing to sue for predation. The only private parties permitted to sue for predation should be firms that supply, and firms that buy from, price cutters.

Every firm wants to be a monopolist in its own market, but also wants to buy from and sell to firms that are *not* monopolies. Consequently, while firms may have incentives to wrongfully accuse their rivals of predatory price cutting, no firm has an incentive to wrongfully accuse its customers or suppliers of predation. By eliminating rivals’ standing to sue for predatory pricing, much of the potential for private abuse is stripped from antitrust law without, at the same time, shutting the courthouse doors to firms with genuine interests in maintaining competition.

All that Congress needs to do is amend sections 4 and 16 of the Clayton Act to specify that rivals of price cutters have no standing to file suits alleging predatory behavior. Rather than being used as a tool for monopolization, antitrust law will then better serve to foster competition.

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INTRODUCTION

Reasonable people disagree on the threat to competition posed by below-cost pricing. Some believe that cutting prices below cost is likely enough to create monopoly that the law must remain vigilant against such schemes; others believe that below-cost pricing is so unlikely to result in monopoly that the economy would be better served if courts refused to hear any allegations of “predatory pricing.” Many other reasonable people are in between these two poles, fretting to greater or lesser degrees over the threat posed to competitive markets by firms that cut prices below cost. However, there is universal agreement on one point: in a legal regime (such as ours) that allows firms to sue their competitors for predatory pricing, such competitors have incentives to allege predatory pricing even when price cutters are engaged in nothing more dastardly than energetic and healthy competition.

Firms have two good reasons for accusing price-cutting rivals of predatory pricing even when these firms know that the price cutting will not lead to monopoly. First, court orders commanding price-cutting firms to raise their prices protect the rivals of price cutters from competition. Such court orders have much the same effect on markets as do tariffs and other import restrictions. Producers’ profits increase because these firms no longer have to compete as vigorously for consumers’ dollars, while consumers suffer from the higher prices, lower output, and lower quality created by the trade restriction.¹

The great similarity between competitive and predatory prices opens the door to abusive lawsuits filed by firms against their price-cutting rivals.

¹According to two respected antitrust scholars, “[c]ases filed by competitors may be particularly harmful, as firms may sue to . . . restrain aggressive pricing, or merely to burden their rivals with litigation costs.” Edward A. Snyder and Thomas E. Kauper, “Misuse of the Antitrust Laws: The Competitor Plaintiff,” *Michigan Law Review*, vol. 90 (1991), p. 551.

The second reason rivals of price-cutting firms are prone to mischaracterize healthy and vigorous price cutting as predatory below-cost pricing is the great similarity of predatory prices with competitive ones. Measuring the costs of price cutters in order to ascertain below-cost pricing is notoriously difficult. Moreover, legitimate price cutting can include not only the lower prices made possible by lower costs, but also below-cost prices that enhance competition.²

It is both unnecessary and counterproductive to allow private firms to sue to prevent price cutting.

The great similarity between competitive and predatory prices opens the door to abusive lawsuits filed by firms against their price-cutting rivals. Those who fear that below-cost pricing can pave a clear path to monopoly see such abusive lawsuits as the unavoidable (if regrettable) price to be paid for the enhanced protection against monopolization provided by “private attorneys general”³ — that is, private firms with incentives to sue price cutters whose below-cost prices portend monopoly. The conventional view has been that, because the budgets of antitrust enforcement agencies are limited, empowering “private attorneys general” to be on the lookout for predatory pricing benefits the economy despite the occasional abusive lawsuit filed by firms against innocent price-cutting rivals.

In contrast, those who believe that below-cost pricing is almost never a rational route toward monopoly see such abusive lawsuits as an unnecessary and harmful legal impairment of competitive processes. If the incidence of genuinely successful predatory pricing is very small, it is both unnecessary and counterproductive to allow private firms to sue to prevent price cutting.

Under current antitrust law, legislatures and courts side with those who worry that below-cost pricing is a large enough threat to competitive markets to justify giving private firms standing to sue price cutters for monopolization. Courts then are left with the task of filtering legitimate allegations of predation from illegitimate ones. If courts fail to do this

²An example of the latter is a new entrant with an unfamiliar brand name that sells its initial product offerings below cost today as a means of becoming an established competitor tomorrow. Loss-leader marketing provides another example of below-cost pricing that can promote competition.

³The term “private attorneys general” refers to the alleged wish of Congress that, in addition to enforcement by government agencies, private parties will help enforce the antitrust statutes. According to the U.S. Supreme Court, private antitrust suits “provide a significant supplement to the limited resources available to the Department of Justice.” *Reiter v. Sonotone Corp.*, 442 U.S. 330, 344 (1979). See also Stephen J. Horvath III, “Standing of the Terminated Employee Under Section 4 of the Clayton Act,” *William & Mary Law Review*, vol. 25 (1983), p. 342:

An important policy consideration underlying section 4 is the need to provide an effective means for private enforcement of the antitrust laws. As “private attorneys general,” plaintiffs can enforce the laws, deter future anticompetitive conduct, and recover compensation for their injuries. Because the predatory nature of antitrust violations allows violators to reap profits through price fixing or overpricing, the most effective method of enforcing the law is to allow the injured party to sue the violator directly.

effectively, too many firms that should challenge rivals by slashing prices will instead challenge rivals by filing lawsuits. But courts are institutionally incapable of making more than rough guesses in measuring the relationship of a particular firm's price to its costs, and of determining whether particular below-cost prices are justified. After all, courts are manned by judges and not by industry and finance experts with proven skill and personal stakes in accurately assessing industrial and commercial prospects.⁴ Rules of standing — i.e., rules specifying who can sue — combine with forensic rules for defining and measuring plaintiffs' damages to make court decisions more reliable. In antitrust, standing and damages rules (if structured sensibly) help filter out cases in which plaintiffs' claims are likely illegitimate.⁵ Therefore, sound rules of standing are essential in ensuring that only plausible claims make it to trial. They result in more accurate — though still quite imperfect — case outcomes.

We argue here that antitrust law would be improved further by changing the rules of standing to deny *rivals* of price cutters standing to sue for predation. To this end, we propose that standing rules should permit only customers or suppliers of price cutters to sue for predation.⁶ More specifically, under our proposal, only the customers and suppliers of a firm — not its rivals — will be able to ask a court for an injunction commanding that firm to stop pricing below cost. No one will have standing to seek monetary damages for alleged predation until after the below-cost pricing has ended. At that point, only customers and suppliers will have standing to seek monetary compensation for damages caused by any monopoly prices that result.

⁴On the institutional limitations of courts in antitrust matters, see Frank H. Easterbrook, "The Limits of Antitrust," *Texas Law Review*, vol. 63 (1984), pp. 1-47; Frank H. Easterbrook, "Ignorance and Antitrust," in Thomas M. Jorde and David J. Teece, eds., *Antitrust, Innovation, and Competitiveness* (New York: Oxford University Press, 1992), pp. 119-36. In the latter essay, Judge Easterbrook says that:

[i]f judges had the data, we would not trust them to make good decisions. The business world relies on financial incentives to encourage managers to make the best use of knowledge and to weed out those who, despite their best efforts, cannot do as well as others. Judges do not profit from making astute business decisions and are not let go for making bad ones...

To the extent judges make economic decisions in antitrust cases, they are making predictions about tomorrow's effects of today's practices. This is problematic under the best of circumstances. Economists start from existing practices and try to explain why they exist and survive. Even when all agree about the effects so far, they disagree about impending effects under changed conditions. Experts will take diametrically opposed positions. (Ibid. pp. 120-21).

⁵Much of the definitive scholarship on antitrust standing rules has been done by William Page. See, e.g., William H. Page, "Antitrust Damages and Economic Efficiency: An Approach to Antitrust Injury," *University of Chicago Law Review*, vol. 47 (1980), pp. 467-504; William H. Page, "The Scope of Liability for Antitrust Violations," *Stanford Law Review*, vol. 37 (1985), pp. 1445-1512.

⁶Our discussion is limited to private enforcement of antitrust statutes. We are not proposing here that government's standing to sue for predatory pricing be changed.

Standing rules should permit only customers or suppliers of price cutters to sue for predation.

Customers and suppliers have no incentives to file suits alleging predatory pricing unless they genuinely believe that such below-cost pricing will likely beget monopoly.

The common belief that below-cost pricing is an obvious, sure-fire, and often-used means of monopolizing markets has no support in theory or history.

If adopted, our proposal would all but end attempts by firms to misuse prohibitions against predatory pricing as a shield from competition. Moreover, we show that as long as standing is enjoyed by customers and suppliers of predatory pricers, genuine predatory activity will not escape policing by “private attorneys general.” We demonstrate that customers and suppliers have incentives, when necessary, to sue to prevent predatory pricing, but they have no incentives to file suits alleging predatory pricing unless they genuinely believe that such below-cost pricing will likely beget monopoly. Because customers have every interest in purchasing goods and services at competitive prices, and because suppliers have every interest in keeping their *customers* competitive, any private party suing to stop predatory pricing under our proposal will likely intend to protect competition. Consequently, the very fact that a customer or supplier sues to stop predatory pricing conveys a great deal of reliable information to a court — information not conveyed when rivals file predatory-pricing suits.

To justify our proposal, we first explain the theoretical implausibility of most predatory-pricing allegations and then document the history of abuse of predatory-pricing laws by rivals of price-cutting firms.

PREDATORY PRICING: THEORY AND HISTORY

Predatory Pricing: An Unlikely Means of Achieving Monopoly

Life is full of things that seem “obvious” but that turn out upon investigation to be completely, or largely, imaginary. To the untutored observer, it appears obvious that the earth is flat and motionless and that the sun revolves around it. Of course, investigation proves these beliefs to be false. The belief in predatory pricing is similar to the “obviousness” of a flat, stationary earth around which the sun orbits. While the theoretical possibility of successful predatory pricing cannot be dismissed, the common belief that below-cost pricing is an *obvious*, sure-fire, and often-used means of monopolizing markets has no support in theory or history.

In fact, below-cost pricing is generally a poor way for an aspiring monopolist to achieve its goal. The first hurdle that a predatory pricer must clear is the inevitable losses the price war inflicts on the predator — losses necessarily larger than those suffered by the prey. To force its rivals to price below cost, the predator must itself price below cost. But to take sales away from rivals, the predator must *expand* sales at below-cost prices while each rival reduces sales to a level that minimizes its losses. Only a predator with access to price-war funding unavailable to any of its rivals has even a prayer of monopolizing its market by charging prices below cost.

Access to such funding by predators, however, is improbable. Even if the owners of the predatory firm are all incredibly wealthy, using their

funds to see their firm through a price war is not free. These owners have the option of investing in a wide variety of financial instruments and business opportunities worldwide. Only if the expected rate of return from monopolizing the predator's industry is higher than the rate expected from any other available use for such funds will owners of a predatory firm fund its price-war efforts. That is, the expected rate of return from funding a price war must be higher than likely returns available from any stock-market investments, bond investments, venture-capital investments, commodity investments, and real-estate investments. But if the return from investing in a price war to monopolize an industry is so very high, it must also be true that the industry in question is very lucrative. In that case, rivals of the predator will have great incentive to borrow monies to fund their efforts to *thwart* the predation. Firms in high-return industries will not fold up their tents at the first whiff of a price war. For the same reason that owners of predatory-pricing firms in such situations are willing to use their monies to fund the predation, banks and other institutions with monies to lend will look favorably upon lending to rivals of the firms that price below cost in such high-return industries.⁷

Even if the predator succeeds in driving all incumbent rivals into bankruptcy, however, the predator is by no means guaranteed the easy and prosperous life of a monopolist. Bankruptcy protects debtors from creditors; it does not actually destroy all the physical and human capital previously deployed by the bankrupt firms. This capital is available for purchase by other entrepreneurs — who will likely use it to compete in the newly monopolized, high-return industry. Of course, the predator can ensure that the assets formerly owned by rivals do not find their way back into the industry if the predator itself purchases these assets from the bankruptcy trustees. Such purchases, though, add extra expenses to those already incurred by the predator during the price war.

Even if bankruptcy actually destroys all capital previously used by the predator's rivals, new entrants can use newly created capital and eventually enter the monopolized market. They might do so quickly enough to ensure that the predator does not charge monopoly prices for a sufficient period of time to recoup the losses it incurred during the price war. In short, even predators who successfully rid their industries of existing rivals must expect new rivals in the future. These new rivals may arrive on the scene so quickly that the below-cost pricing turns out to have been a losing investment.

⁷Robert Bork explains this point nicely:

If the potential victim would find resistance to predation a profitable use for his liquid assets, a lender should find it equally profitable to lend the required capital. In fact, in any case in which the predator must use a technique that inflicts proportionally equal or greater losses upon himself, the victim would merely have to show the predator his new line of credit to dissuade the predator from attacking.

See Robert H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, 1978), pp. 147-48.

If the return from investing in a price war to monopolize an industry is so very high, rivals of the predator will have great incentive to borrow monies to fund their efforts to thwart the predation.

Even predators who successfully rid their industries of existing rivals must expect new rivals in the future.

Predatory Pricing: Largely Absent from the Historical Record

The above points are not idle speculation. They are amply supported by the historical record, which contains virtually no evidence of actual predatory pricing but brims with instances of rent-seeking firms in pursuit of cover from competition.

Still the most influential of all articles written on predatory pricing is John McGee's detailed study of Standard Oil's alleged use of predatory pricing to monopolize the oil-refining industry. McGee exhaustively examined the record of the 1911 Supreme Court decision against Standard Oil.⁸ His conclusion was startling because it contradicted the widely held belief that Standard Oil was a predatory pricer *par excellence*.⁹ McGee found *no* evidence that Standard Oil priced predatorially. The empirical record convinced McGee that "Standard did not use predatory discrimination to drive out competing refiners, nor did its pricing practice have that effect.... I am convinced that Standard did not systematically, if ever, use local price cutting in retailing, or anywhere else, to reduce competition."¹⁰

The historical record contains virtually no evidence of actual predatory pricing but brims with instances of rent-seeking firms in pursuit of cover from competition.

In one of the most widely respected studies of a number of predatory-pricing cases, Roland Koller gave further credence to McGee's suggestion that predatory pricing is much more imaginary than real. Koller examined 26 cases in which courts found that defendants priced predatorially. In only one of these cases was it plausible to suppose that the defendant hoped to gain monopoly power by using below-cost prices to drive rivals from the industry.¹¹

Kenneth Elzinga reached a similar conclusion in a study of the explosives industry — an industry supposedly once permeated with predatory pricing. According to Elzinga, of the 14 alleged victims of predatory pricing by the so-called "gunpowder trust," only "possibly two... were in fact subjected to the practice." The evidence of predatory pricing for even those two examples is ambiguous.¹²

More recent studies of predatory-pricing allegations confirm the findings of McGee, Koller, and Elzinga that predatory pricing is rarely,

⁸See *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911).

⁹The myth that Standard Oil ruthlessly used predatory pricing against rivals was made popular by muckraker Ida Tarbell's *The History of the Standard Oil Company* (New York: McClure, 1904).

¹⁰John McGee, "Predatory Price Cutting: The Standard Oil (N.J.) Case," *Journal of Law and Economics*, vol. 1 (1958), p. 168.

¹¹Roland H. Koller, "The Myth of Predatory Pricing: An Empirical Study," reprinted in Yale Brozen, ed., *The Competitive Economy* (Morristown, NJ: General Learning Press, 1975), pp. 418-28.

¹²Kenneth G. Elzinga, "Predatory Pricing: The Case of the Gunpowder Trust," *Journal of Law and Economics*, vol. 13 (1970), p. 236.

if ever, used. Kenneth Elzinga and David Mills examined three separate instances of alleged predation to determine the minimum amount of time-as-a-monopolist each of the firms in question would require in order to recoup the losses suffered during the predatory price war.¹³ Their conclusion was that only one of the three defendants had even the remotest hope of remaining a monopolist for a time sufficient to recoup losses. Therefore, it was unlikely that two of the three firms in the Elzinga-Mills sample were actually engaged in below-cost pricing for purposes of running rivals from the industry. The more general conclusion suggested by the Elzinga-Mills study is that recoupment of predatory-pricing losses is generally so unlikely that firms will only rarely price predatorially.

Finally, Edward Snyder and Thomas Kauper, in an examination of not only predatory-pricing cases but all manner of cases in which plaintiffs allege exclusionary behavior by defendants, found that “a majority of the claims alleging anticompetitive exclusion do *not* appear to . . . be intended to deter or undo harm to consumers.”¹⁴ As then-professor (now federal judge) Frank Easterbrook wrote, “[t]he available evidence . . . indicates that predation occurs infrequently, if at all. Studies of many industries find little evidence of profitable predatory practices in the United States or abroad.”¹⁵ More recently, William Baumol reported that “[t]here seems to be general consensus among informed observers that genuine cases of predation are very rare birds.”¹⁶

If predatory pricing is so very rare, why are firms routinely accused of it? The reason is that rivals of price cutters abuse antitrust law. By filing legal challenges to the lower prices of rivals, the plaintiffs in predatory-pricing suits seek legal assistance in forcing their rivals to stop competing vigorously. In short, a distressingly large number of predatory-pricing suits represent an abuse of the courts and of antitrust law.

Of course, pointing out that predatory-pricing suits are often anticompetitive does not, by itself, prove that such suits should never be entertained. Some may argue that the benefits of private lawsuits against predation — namely, dissuading firms from ever attempting to monopolize through below-cost pricing — outweigh the costs generated by abuse of such suits. As antitrust law is currently structured, there is a tradeoff between effective policing against predation and the risk of abusive predation suits. The more easily rivals can sue for predation, the more likely it is that predation will be prevented — but also that abusive suits will be filed and

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A distressingly large number of predatory-pricing suits represent an abuse of the courts and of antitrust law.

¹³Kenneth G. Elzinga and David E. Mills, “Testing for Predation: Is Recoupment Possible?” *Antitrust Bulletin*, vol.34 (1989), pp. 869-93.

¹⁴Snyder and Kauper, p. 553.

¹⁵Frank H. Easterbrook, “Predatory Strategies and Counterstrategies,” *University of Chicago Law Review*, vol. 48 (1981), p. 313.

¹⁶William J. Baumol, “Predation and the Logic of the Average Variable Cost Test,” *Journal of Law and Economics*, vol. 39 (1996), p. 51.

competition curtailed. Fortunately, this tradeoff is unnecessary. It is possible to substantially reduce the risk of abuse without decreasing the likelihood of effective private policing against genuine predation.

Key to understanding why the law's current tradeoff is unnecessary is the recognition that rivals are not the most reliable agents to police against predatory pricing. Instead, we show in the next section that firms have powerful incentives to prevent the success of predatory schemes launched by their suppliers or buyers. Moreover, firms have *no* incentives to file predation suits against suppliers or buyers unless they genuinely believe that the price-cutting tactics of those suppliers or buyers pose a real threat to competition. We now briefly examine the economic stakes that firms have in their suppliers as well as in their buyers.

CUSTOMERS' AND SUPPLIERS' INTERESTS IN PRESERVING COMPETITION

It is possible to substantially reduce the risk of abuse without decreasing the likelihood of effective private policing against genuine predation.

Unlike competitive firms, monopolists earn high profits by reducing outputs and raising prices above competitive levels. Thus, it is easy to see why customers prefer to purchase from competitive suppliers than from monopolists. Whether buyers are consumers purchasing groceries or firms purchasing inputs for use in production, each buyer clearly wants its suppliers to be competitive so that supplies are more abundant and prices are lower. Likewise, each supplier prefers to sell to competitive rather than monopolized customers. Because competitors produce more than monopolists, demand for suppliers' outputs will be higher if their buyers are competitive.

For example, suppose Congress declares that only McDonald's can legally sell hamburgers. Clearly, hamburger buyers will suffer. Fewer hamburgers will be produced, and those that are produced will fetch monopolistically high prices. But suppliers of inputs used in the production of hamburgers will suffer, too. Ranchers, bun bakers, condiment producers, etc., all will be harmed by the McDonald's hamburger monopoly. Because fewer hamburgers are produced once McDonald's becomes a monopolist, the demand for inputs used to make and market hamburgers is lower than it was when the hamburger trade was competitive. Only McDonald's benefits from its monopoly.

The lesson is that, for every firm aspiring to obtain an illegal monopoly through predatory pricing, there are other firms — suppliers and buyers — who have interests in ensuring that monopolization efforts fail. (For convenience, from this point forward we refer to suppliers upstream from an aspiring monopolist, along with buyers downstream from the aspiring monopolist, as “vertically related firms” — or “VRFs.”) VRFs often have incentives to use purely private means to thwart attempted monopolization. For example, a manufacturer might refuse to supply a retailer

suspected of being on the verge of monopolizing the retail market.¹⁷ However, these purely private efforts will not always materialize. In some instances, these efforts, perversely, will be prohibited by antitrust law.¹⁸ In other instances, they will founder on free-rider problems because the stake of each VRF in a threatened market may be too small to warrant a decision to incur the expense of acting alone to prevent the monopolization. But whether or not antitrust law or free-rider problems prevent VRFs from taking private steps to thwart monopolization, the interest of VRFs in maintaining competition among upstream and downstream firms is beyond dispute. It follows that VRFs, unlike rivals of price cutters, will sue to prevent predation only when they believe monopoly is a genuine threat.

OUR PROPOSAL IN DETAIL: ALLOW ONLY VRFs TO SUE FOR PREDATION

To recap our basic proposal, rivals of alleged predators never should have standing to sue for predation. Denying standing to rivals avoids anticompetitive suits by firms seeking protection from competition. The only private parties with such standing are VRFs — i.e., immediate suppliers or immediate customers of price-cutting firms.¹⁹ While the price cutting is still in progress, VRFs may ask the court only for an injunction ordering an end to the below-cost pricing. If the court denies the injunction, or if no VRF requests an injunction during the price-cutting period, VRFs still will be able to sue the price-cutter-turned-monopolist for damages equal to the amount of any monopoly overcharges that occur later.

¹⁷Donald J. Boudreaux and Andrew N. Kleit, “How the Market Self-Polices Against Predation,” Competitive Enterprise Institute *Antitrust Reform Project Occasional Paper*, June 1996.

¹⁸For example, suppose an electronics retailer sells Sony audio equipment at prices well below cost and, as a result, is on the verge of monopolizing the retail electronics trade. To prevent this monopolization, Sony might insist that the retailer contractually agree not to sell Sony products below certain prices. Unfortunately, such minimum resale price maintenance contracts are illegal under American antitrust law.

¹⁹In *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977) the Supreme Court ruled that only direct purchasers from monopolists generally have standing to sue for monopoly overcharges. For example, if an aluminum producer unlawfully monopolizes aluminum production, only firms that purchase directly from the aluminum monopolist may sue. Suppose Acme Corp. buys aluminum directly from the unlawful monopolist. Acme Corp. uses this aluminum to build aluminum storage bins for sale to retail customers. Acme Corp. has standing to sue for monopoly overcharges; purchasers of aluminum bins manufactured by Acme Corp. have no standing to sue. Acme Corp.’s customers are denied standing even if the prices they paid for aluminum bins is higher than it would have been without the illegal aluminum monopoly.

The *Illinois Brick* case creates a sound administrative rule. Because direct purchasers typically have ample incentives to sue for monopoly overcharges, and because apportioning the damages to direct and indirect purchasers would be an administrative nightmare, the rule gives legal standing only to direct purchasers. However, the *Illinois Brick* rule does not necessarily apply to state antitrust laws. See *California v. ARC America Corp.*, 490 U.S. 93 (1989).

Denying standing to rivals avoids anticompetitive suits by firms seeking protection from competition.

Under our proposal, not all predatory pricing will be — or should be — prevented.

A VRF will seek to enjoin predatory pricing whenever it believes that the predation will probably enable the price cutter to monopolize the market. Of course, VRFs gain some benefits during the predation period: customers of price cutters pay lower prices, and suppliers sell larger quantities. VRFs will thus weigh the value of the predation-period benefits against the expected costs of monopoly prices to be charged later if the predatory pricer succeeds. To recognize the current-period benefits of predation for VRFs is to recognize that not all predatory pricing will be — or should be — prevented.

Suppose that Revco Drugs knows that one of its pharmaceutical suppliers is pricing below cost in an effort to monopolize some part of the pharmaceutical trade. Revco — a VRF to that supplier — must then estimate the likelihood of the predator's success. If Revco concludes either that the predator's current rivals will not be bankrupted (or disciplined) by the predatorially low prices, or if Revco believes that the "successful" predator will not be able to charge monopoly prices for long before new competitors emerge to force prices down to competitive levels, then Revco will not attempt to prevent the predation. It will take advantage of today's low prices, confident that it will not have to pay (or pay for too long) any monopolistically high prices in the future. In such a case, the hapless predator will have bestowed an unintended gift upon Revco and other downstream buyers. Such gift giving is unlikely to be widespread among profit-seeking firms.

Consider also the perennial accusations by Boeing and other U.S. makers of commercial aircraft that Europe's Airbus consortium charges predatorially low prices for its commercial airliners. If Airbus were really a threat to monopolize aircraft manufacturing, the very sophisticated purchasers of airliners — namely, airlines such as American, Delta, and United — could be relied upon to take both private and legal steps to prevent an Airbus monopoly. There is no need to allow Boeing and other rivals of Airbus to seek legal redress for Airbus' prices.

VRFs (vertically related firms) have every incentive to uncover genuine predation and no incentive to level false accusations of predation.

VRFs have not only *incentives* to correctly assess the likely consequences of the pricing policies of their suppliers and customers, they also have some *ability* to do so. Customers of a price cutter will often know the trend of prices charged in the past. If prices suddenly fall below the trend line, customers may be alerted to the possibility of predation.²⁰ In addition, rivals of the price cutter will alert buyers to the predation campaign. Although these

²⁰This result is most plausible when the trend line of prices has been predictable. The more erratic the trend line, the lower the information content of sudden changes in price will be. But predation is most likely in industries with predictable price trends. The rational firm will engage in predation only if it expects to recoup in the future the losses it incurs today. Unpredictability of prices makes recoupment less certain, and will lead a firm considering predation to discount more highly its expected future monopoly gains. Put somewhat differently, an industry with a history of erratic prices is an industry likely subject to rapid technological, organizational, or demand changes. Predation in such an industry is riskier than in stable industries because of the higher probability that a sudden change in technology, industry organization, or demand will undermine the successful predator's monopoly.

rivals may have as much incentive to mislead VRFs as they have to mislead courts, VRFs — unlike judges and juries — have private wealth at stake in properly assessing the validity of the rivals’ accusations of predation. VRFs will seek to enjoin predatory behavior whenever they genuinely sense a risk of monopolization. They will not seek to enjoin price cutting that, in their estimation, portends no monopoly.

Note that the legal regime we propose for treatment of predatory pricing is quite similar to current legal rules for the treatment of horizontal price fixing (customers of price fixers have standing to sue for damages caused by monopoly overcharges). Even though the typical price fixer has at least several customers, no one to our knowledge argues that enforcement against horizontal price fixing by its “victims” is not sufficiently robust.

VRFs, of course, will err. They may sue suppliers or customers for predation when, in fact, no predation is underway. VRFs also may overlook genuine instances of predation. In the current legal regime, however, such errors are also made by even those rivals of price cutters who sue to prevent what they honestly believe to be predation. It is irrelevant that decisions by VRFs to sue will sometimes, or perhaps often, be misguided. What *is* relevant is that VRFs have every incentive to uncover genuine predation and no incentive to level false accusations of predation. Rivals of price cutters, unlike VRFs, have incentives to sue price cutters for predation regardless of the merits of the accusation.

VRF Standing to Sue for Damages

Suppose that a price cutter is either not sued by a VRF while the below-cost pricing is in progress, or that the court refused the VRF’s request for an injunction. Let’s also assume the unlikely event in which this price cutter then actually achieves a monopoly. Its rivals are either out of business or cowed into charging higher prices.²¹ The predator now raises prices. Even under our “modest” proposal to reform standing rules, customers and suppliers of the monopolist would retain their long-established standing to sue for monetary damages attributable to monopoly pricing.

Rivals of the successful predator should be denied standing also because their losses are not the kinds of losses that a pro-consumer antitrust law is meant to avoid. In *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*,²² a unanimous Supreme Court ruled that antitrust plaintiffs can recover only for

Customers and suppliers of the monopolist would retain their long-established standing to sue for monetary damages attributable to monopoly pricing.

²¹We note in passing our deep skepticism regarding allegations by firms that price-cutting rivals are attempting to discipline them into charging monopolistically high prices. Because each firm in the industry benefits when they all charge such prices, and because each firm must recognize the value that such discipline plays in helping to maintain the supracompetitive price structure, only firms that genuinely believe that below-cost pricing by a rival is meant as a disciplining maneuver will not complain to authorities.

²²429 U.S. 477 (1977).

If monetary damages (to customers and suppliers from monopoly overcharges) are optimally calculated, damage suits alone would be sufficient to prevent inefficient monopolization.

antitrust injuries. The Court defined such injuries as “the type the antitrust laws were designed to prevent and flows from that which makes the defendants’ acts unlawful.”²³ Because antitrust statutes are understood today to promote competition that maximizes consumer well-being, injuries suffered by rivals in a price war are not the kinds of injuries “the antitrust laws were designed to prevent.” As the Court has said time and again, “It is competition, not competitors, which the [Sherman] Act protects.”²⁴ Although predatory pricing might conceivably succeed in eventually leading to monopoly overcharges, it is those overcharges (suffered by customers) and not the losses borne by rivals that are meant to be prevented by a pro-competitive antitrust regime. As Frank Easterbrook correctly observes, “[t]he law of predation . . . has developed entirely through competitors’ suits, even though the competitors do not suffer the harm (the monopoly overcharges and ensuing deadweight loss) with which the antitrust laws are concerned.”²⁵ William Landes underscores this point: “If antitrust laws are meant to increase consumer welfare, then losses only to consumers, not to competitors, are relevant.”²⁶

The antitrust rules that determine injury and standing should be crafted by courts to promote the consumer-welfare goals of the law.²⁷ Ultimately, that task requires practical consideration of how best to prevent monopoly without simultaneously thwarting entrepreneurial efforts to better serve consumers. All practical considerations point to denial of standing for rivals. First, VRFs have incentives to seek injunctions when the risks of monopolization are high. Second, customers suffering monopoly overcharges have strong incentives to sue monopolists for overcharges. Third, firms have powerful incentives to accuse their price-cutting rivals of predation whether or not predation is really going on.

If monetary damages are optimally calculated, damage suits alone would be sufficient to prevent inefficient monopolization. Optimal monetary damages for an antitrust violation equal the value of the net antitrust harm to persons other than the offender,²⁸ and antitrust harm accordingly is limited to the “overcharge to consumers and deadweight loss minus net benefits during the period of below-cost pricing.”²⁹ Because consumers lose more from monopoly than monopolists gain, would-be monopolists that know that they will be liable to pay all consumer losses will never find it worthwhile to invest in a monopolization attempt.³⁰

²³ Ibid., p. 488.

²⁴ *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962).

²⁵ Easterbrook, “Predatory Strategies,” pp. 325-26.

²⁶ William M. Landes, “Optimal Sanctions for Antitrust Violations,” *University of Chicago Law Review*, vol. 50 (1983), p. 671.

²⁷ See Page, *supra* note 5.

²⁸ Landes, p. 656.

²⁹ Ibid., p. 671.

³⁰ As monopolists raise prices above costs, consumers cut back on the quantities that they demand from monopolists. Consequently, monopoly prices not only transfer money from consumers to monopolists on all output that is sold, but they also inflict losses on consumers in the form of foregone output. No one, not even the monopolist, receives what consumers lose by this foregone output. See, e.g., Robert B. Ekelund, Jr. and Richard Ault, *Intermediate Microeconomics: Price Theory and Applications* (Lexington, MA: D.C. Heath & Co., 1995), pp. 361-63.

If courts could consistently and accurately calculate such damages, the best legal rule for dealing with predatory pricing would be to permit only suits for damages *after* monopolies are achieved. There would be no need to permit anyone to sue seeking equitable or monetary relief from price cutters while the price-cutting is in progress. A firm considering a predatory-pricing campaign to achieve monopoly would know that, if its campaign succeeds, the predator will have to pay in damages *more* than it will earn in monopoly profits.³¹ Rational firms therefore would never engage in predation.

However, we cannot count on courts to calculate theoretically optimal damages with sufficient consistency to justify relying solely upon after-the-fact damages suits. This shortcoming on the part of courts may justify lawsuits to seek injunctions during the price-cutting period — but only when the plaintiffs are VRFs. An aspiring monopolist that faces the threat of both an injunction (during the price-cutting period) and monetary damages (following that period) will be less confident that it can benefit from the possibility that a court will underestimate the damages caused by its monopoly. Moreover, because VRFs have incentives to avoid false allegations of predation, the social costs of permitting them to seek injunctive relief are low.

POTENTIAL OBJECTIONS TO EXCLUSIVE VRF STANDING

Are Suits by VRFs Practical?

The likelihood that a customer or supplier with a large stake in an industry under siege by a predator will take steps to thwart the predation is clear. But what if no VRF has a substantial stake in buying from, or selling to, the predator and its rivals? If individual stakes are small, will any VRFs take legal action to block predatory pricing that poses a genuine threat of monopoly? Although such free-rider problems are possible, they are not inevitable. Lawsuits seeking injunctions are generally less involved and less costly than suits seeking damages.³² Therefore, a VRF will not require very large stakes in order to seek injunctive relief against a supplier or customer suspected of predatory pricing.

Moreover, the problem posed by small stakes can be overcome largely by awarding attorneys' fees to VRFs that successfully petition to

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³¹Ibid.

³²An extensive empirical investigation by economists Kenneth Elzinga and William Wood found that "cases seeking injunctive relief were shorter than others on average." Kenneth G. Elzinga and William C. Wood, "The Costs of the Legal System in Private Antitrust Enforcement," in Lawrence J. White, ed., *Private Antitrust Litigation* (Cambridge, MA: MIT Press, 1988), p. 120.

enjoin predation. A VRF that suspects a supplier or customer of predation already has some financial stake in preventing the predator's success. Even when that VRF's stake in the potentially monopolized industry is small, it will likely seek an injunction when it both genuinely believes that the predation will lead to lasting monopoly and feels confident that it can recover all or most of the legal costs it might incur in stopping such predatory behavior.

"Only Rivals of Predators Suffer Losses During Predation"

Predatory pricing is most likely to be successful and, hence, most likely to be attempted when the predator's production function and costs differ from those of its rivals.

Because VRFs suffer no antitrust injury and indeed are actually benefitted during the period of predation, it might be argued that VRFs can have no standing to sue until after the predation has succeeded, when it might be *too late* to restore competition. Rivals, in contrast, *do* suffer harm during the predatory period and accordingly would be the only firms that can properly get standing to sue before the predation has succeeded in creating monopoly.

This argument has two flaws. First, it overlooks section 16 of the Clayton Act, which gives plaintiffs standing to seek injunctive relief by pleading "*threatened* loss or damage" attributable to an antitrust violation [emphasis added].³³ (Section 16 also allows successful plaintiffs to recover court costs and reasonable attorneys fees.³⁴) Because this section does not require that VRFs first must suffer antitrust injury before courts can hear their pleas for injunctions, the only legislative changes needed to implement our proposal are a congressional amendment to section 4 of the Clayton Act to deny firms standing to seek damages from allegedly predatory *rivals*, and another amendment to section 16 to deny firms standing to seek injunctive relief from rivals' price cutting.³⁵

The second flaw in the argument above can be found in its presumption that, because only rivals of price cutters and no one else (except the alleged predator) suffers losses during the predatory period, those losses must be the kind that the antitrust laws were meant to prevent. But it is not necessarily true that every antitrust violation generates *antitrust-relevant*

³³"Any person, firm, corporation, or association shall be entitled to sue for and have injunctive relief, in any court of the United States having jurisdiction over the parties, against threatened loss or damage by a violation of the antitrust laws . . . 15 U.S.C. sec. 26 (1994); see also Ernest Gellhorn and William E. Kovacic, *Antitrust Law and Economics in a Nutshell*, 4th ed. (St. Paul: West Publishing Co., 1994), p. 464.

³⁴"In any action under this section in which the plaintiff substantially prevails, the court shall award the cost of suit, including a reasonable attorney's fee, to such plaintiff." 15 U.S.C. sec. 26.

³⁵Congressional action may not be necessary. The Supreme Court itself could build on the Brunswick decision and rule that rivals of alleged predators have no standing to sue because such rivals suffer no damages relevant to antitrust law. However, amending the Clayton Act to expressly deny standing for rivals in predation suits would ensure more securely that courts will keep their doors shut to rivals that sue price cutters.

losses during the short run. Indeed, predatory pricing seldom, if ever, generates such losses during the predation period.³⁶ Antitrust law is today widely regarded as a means to protect *consumers* from monopoly prices, not as a means to protect firms from losses attributable to price cutting.

“Rivals are Better Informed than VRFs about Possible Predation”

Yet another objection to our proposal might be that rivals of predatory pricers are uniquely well-situated to detect predatory pricing. Consequently, the risk that rivals have incentives to falsely allege predatory pricing is worth bearing because of the special knowledge that rivals possess for detecting predatory pricing. This argument rests on the assumption that each firm in an industry produces and sells at roughly equal costs (in other words, every firm in an industry has a “production function” equivalent to the production function of all other firms in the industry).

If this equivalence of production functions and costs of all firms in each industry were true, then rivals of price cutters would indeed be especially well-situated to determine whether the price-cutter’s low prices are below cost and whether such below-cost prices pose a genuine threat to competition. But predatory pricing is most likely to be successful and, hence, most likely to be attempted when the predator’s production function and costs *differ* from those of its rivals. After all, if every firm in an industry produces with identical efficiency at each level of output, no firm would enjoy much of a chance of bankrupting rivals.

Consequently, whenever price cutting threatens the economic existence of rivals, it is likely to be done by firms operating with significantly different cost structures than those of their rivals. Firms that hurl predatory-pricing charges at rivals are likely to be especially poorly informed about the costs of their price-cutting rivals. Consider the mom-and-pop grocery stores that complained so bitterly in the 1920s and 1930s about the allegedly predatory competition posed by supermarkets such as A&P.³⁷ Precisely *because* supermarkets operated so differently from mom-and-pops, they were able to underprice them without pricing below costs. Any inferences that mom-and-pops drew from their own business experiences to that of their rivals (supermarkets) misled them to conclude wrongly that supermarket prices simply *had* to be below supermarket costs. Mom-and-pops each knew one thing directly from their own experience — that they could not sell groceries profitably at prices as low as those charged by supermarkets. Their

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³⁶For an example of how predatory pricing could inflict immediate harm upon VRFs, suppose that Airbus really were on the verge of monopolizing the manufacture of commercial airliners. Financial markets might anticipate such monopolization even while the price war is still raging. This anticipation might be revealed in lower stock prices for the airlines that are expected to have to pay monopoly prices for aircraft in the future.

³⁷See Thomas W. Ross, “Winners and Losers Under the Robinson-Patman Act,” *Journal of Law and Economics*, vol. 26 (1984), pp. 243-71.

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mistake was to assume that another thing was true — that the retail experience of supermarket operations was similar.

The above observation suggests a more general point about market competition, made by the great economist Joseph Schumpeter many years ago. When comparing competition as depicted in the blackboard models of economists with competition that occurs in real-world markets, he noted that:

. . . in capitalist reality as distinguished from its textbook picture, it is not [price] competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control, for instance) — competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and outputs of the existing firms but at their very foundations and their very lives. This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful lever that in the long run expands output and brings down prices is in any case made of other stuff.³⁸

Schumpeter called this dynamic, all-important, and pervasive form of capitalist competition “the process of creative destruction.”³⁹

Entrepreneurs who successfully challenge existing modes of doing business with newer and more efficient ones increase consumer well-being. However, these entrepreneurs simultaneously and necessarily lower the value of all assets specific to the older, soon-to-be-displaced modes. Entrepreneurs “creatively destroy” existing modes of production, business organization, distribution, and marketing by devising better and revolutionarily different modes of production, organization, distribution, and marketing. They bring to the market radical new ideas, most of which had previously been unimagined. Owners or managers of established modes of business are unlikely to have the same entrepreneurial vision as that which guides the entrepreneurs whose new modes of industrial or commercial enterprise challenge established ones. Because each specific bit of entrepreneurial

³⁸Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper, 1942), pp. 84-85.

³⁹*Ibid.*, p. 81. The Federal Trade Commission has only this year grown to realize what Schumpeter understood 54 years earlier. In a May 1996 Staff Report, the FTC recognizes that “in many markets, the basis for competition today includes not only the price at which a product is sold but the ingenuity, variety, and speed of development of new goods and services. This innovation contributes powerfully to our economy and our future well-being, generally more so than do cost savings gleaned in existing ways of doing business.” FTC Staff, “Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace,” *Antitrust & Trade Regulation Reporter*, (Special Supplement) June 6, 1996, p. 5. The only error in the FTC’s otherwise apt description of the competitive process is its supposition that technological and organizational competition is somehow unique to the late 20th century. Such competition has always been important in capitalist economies. See, e.g., Joel Mokyr, *The Lever of Riches* (New York: Oxford University Press, 1990).

innovation is a deviation from accepted norms, most existing firms, when challenged by new entrepreneurial rivals, will possess no basis for ascertaining correctly whether the prices charged by entrepreneurial firms are below the latter firms' costs. Thus, because rivals of price-cutting firms are not especially knowledgeable about the costs and plans of these price cutters, reliance upon rivals to fulfill the role of "private attorneys general" is fraught with risk. The danger is either that rivals will be innocently unaware of new efficiencies possessed by price-cutting firms or that rivals will intentionally abuse laws against predatory pricing to squelch healthy competition.

CONCLUSION

Giving legal standing to sue for predation exclusively to immediate customers and immediate suppliers of price cutters will avoid rent-seeking abuses of antitrust law by private parties without sacrificing any of the vigor provided by enforcement by "private attorneys general." Such a legal rule will not only align the incentives of private plaintiffs with the interests of consumers, it will make much more reliable use of information spread throughout markets. Under current law, rivals have incentives to distort that information in ways that even the most discerning judge and jury have great difficulty unraveling. VRFs, on the other hand, possess unambiguous incentives to "get it right." Their interests lead them to determine as accurately as possible whether or not the low prices of a supplier or customer will generate monopoly. Only when VRFs determine that a long-lasting monopoly is a genuine threat will they bring suit as private parties.

Our proposal is modest. It requires only that Congress modify section 4 of the Clayton Act to deny firms standing to seek damages from allegedly predatory *rivals*, and amend section 16 of the Clayton Act to deny injunctive relief to rivals of price-cutting firms. State legislatures easily can make similar adjustments to their antitrust statutes. The only losers from such changes will be those parties who abuse the antitrust laws for private gain at the expense of consumers.

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