PRICE THEORY, COMPETITION, AND THE RULE OF REASON

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Everyone knows that antitrust law should protect and further "competition." But what exactly *is* competition? A grocer might "compete" by (falsely) claiming that her rival is selling poisoned beef or (falsely) claiming that her own beef is more nutritious. She might also price below her own costs or those of her rival, driving him out of business and taking over the market, at least for a time. A firm that makes film might "compete" against its rivals by inventing a better film or by redesigning a popular camera to use only its brand of film, expanding its own market share as a result.

While each of these practices is "competitive" in one sense, any rational society should distinguish among them. All would applaud the invention of a new film, but most would agree that slander and false advertising are not "competition" in any sense that society wishes to embrace. The distinction between these practices could rest on some abstract conception of (legitimate) "competition." Most, however, would adopt a more instrumental definition, distinguishing among various practices based upon their perceived social utility. Such an approach would treat as "competitive" any practice that, under the circumstances, would seem to further society's welfare when compared to the *status quo*.

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If "competition" however defined, is our *desideratum*, then it might seem that its antithesis, cooperation, is a bad thing. Not so fast. To be sure, Ford and General Motors should not "cooperate" when setting prices. But what if the same two firms merge, eliminating competition between them while at the same time realizing significant economies of scale that enhance the new firm's ability to compete in the larger marketplace? Similarly, two or more employers should not "cooperate" when setting the wages of their respective employees. However, what if a college sports league adopts a rule forbidding members to pay their "student-athletes" more than tuition plus room and board, claiming that the policy prevents "college" football from deteriorating into semi-pro football?[2] Finally, grocers should not divide territories among themselves. Nevertheless, what if dozens of small grocers pool their resources to form a joint venture that develops a private label brand and assigns each member a particular territory in which it will have the exclusive right — and thus powerful incentives — to promote and sell the brand?[3]

As each of these examples should show, socially useful "competition" often requires some cooperation, cooperation that reduces or even eliminates rivalry between the cooperating parties. Indeed, when we speak of "a firm" engaged in "unilateral" activities, we are almost always referring to what economists call a "nexus of contracts" between employees, managers and suppliers of capital, contracts that snuff out competition between the parties to them. (Partners at Skadden, Arps do not bid against each other for the labor of associates.) If society defines as "competitive" all marketplace activity that enhances its welfare, then many forms of cooperation, even those that

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[2]*See* NCAA v. Bd. of Regents of the University Of Oklahoma, 468 U.S. 85 (1984).

[3]*See* United States v. TOPCO, 405 U.S. 596 (1972).

eliminate "competition" between cooperating parties, are "competitive" in the sense that is relevant for antitrust purposes.

A society that seeks to encourage useful "competition" must construct an institutional framework that channels individual initiative in "competitive" directions.[4] Thus, society must prevent those "unilateral" acts, like slander, that reduce welfare. It must also enforce those contracts that implement useful cooperation. Finally, it must forbid those agreements that entail "undue" or "harmful" cooperation and thereby undermine society's welfare.[5]

Section 1 of the Sherman Act, which forbids contracts "in restraint of trade," polices the line between acceptable ("competitive") and unacceptable ("anticompetitive") cooperation.[6] Like "competition," the term "restraint of trade" does not define itself; all contracts, like all cooperation, restrain trade or competition in some sense. For nearly a century, then, courts have expressly held that the Sherman Act forbids only *unreasonable* restraints, usually purporting to judge "reasonableness" according to economic effect. In modern parlance, courts applying this "Rule of Reason" ask whether a contract "promotes" competition or, instead, "destroys" it, by creating or exercising market power.

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[4]*See* F.A. Hayek, *Free Enterprise And Competitive Order*, 110-114 *in* INDIVIDUALISM AND ECONOMIC ORDER (1948). *See also* Ronald H. Coase, *The Institutional Structure Of Production*, 82 Am. Econ. Rev. 713, 717-18 (1992) (background structure of legal entitlements can affect nature of economic activity and thus allocation of resources).

[5]*See* Hayek, *Free Enterprise And Competitive Order*, at 115 ("We cannot regard 'freedom of contract' as a real answer to our problems if we know that not all contracts ought to be made enforceable and in fact are bound to argue that contracts 'in restraint of trade' ought not be enforced.").

[6]Section 2, by contrast, polices unilateral acts. *See* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984) (explaining the respective domains of Sections 1 and 2 of the Sherman Act).

Some contracts are so plainly harmful that courts condemn them with little analysis, deeming them "unreasonable *per se*." Most contracts survive such condemnation, however, and undergo more careful scrutiny, under what courts (redundantly) call "the Rule of Reason." Courts, scholars and the enforcement agencies have articulated a three step test to govern analysis under *this* Rule of Reason. First, a plaintiff must establish a *prima facie* case by showing that the restraint produces tangible anticompetitive harm, a showing that usually consists of proof of "actual detrimental effects" such as increased price or reduced output. Second, the defendants must prove that their agreement produces "procompetitive" benefits that outweigh the harm implicit in plaintiff's *prima facie* case. Third, even if the defendants can make such a showing, the plaintiff can still prevail by proving that the defendants can achieve the same benefits by means of a "less restrictive alternative." This three part test, it is said, helps courts distinguish those contracts that "harm" or "destroy" competition, by creating or exercising market power, from those that promote it.

This article offers a critique of the modern Rule of Reason and the vision of "competition" on which it depends. As shown below, the present structure of Rule of Reason analysis as articulated by courts, the enforcement agencies and most leading scholars rests on an outmoded model of "competition" and is thus inherently biased against contractual integration that produces non-technological efficiencies. More precisely, the modern structure of Rule of Reason analysis rests upon a vision of competition derived from neoclassical price theory, the economic paradigm that dominated industrial organization for much of the twentieth century. According to this paradigm, "competition" consists of constant technological rivalry between autonomous firms, unconstrained by so-called "non-standard" contracts, that is, agreements that constrain the discretion of purchasers and competitors. This rivalry, it is said, results in an "equilibrium" of "competitive" prices, output, and other terms of trade, an equilibrium that maximizes social welfare. Within this paradigm, any contractual arrangement that produces output, prices or other terms of trade that depart from the "competitive" baseline is *prima facie* "anticompetitive" and properly subject to condemnation absent concrete proof of some justification that "outweighs" the harm.

Price theory's definition of "competition" drives each aspect of the modern Rule of Reason described above. For instance, decisions allowing plaintiffs to establish a *prima facie* case by proving "actual detrimental effects" rest upon a presumption that any departure from the prices or other terms of trade produced by technological rivalry reflects an "anticompetitive" exercise of market power. Similarly, the requirement that procompetitive benefits "offset" or "outweigh" anticompetitive effects by reducing prices or preventing their increase rests upon price theory's partial equilibrium trade-off model and its assumption that any benefits resulting from a contract or transaction coexist with anticompetitive effects reflected in a *prima facie* case. Given this assumption, courts naturally conclude that any benefits produced by such a contract coexist with anticompetitive harm, harm that courts must "balance" against benefits. Indeed, the same assumption, *i.e.*, that benefits necessarily coexist with anticompetitive harm, drives the requirement that, where possible, defendants achieve any procompetitive benefits through means less restrictive of "competition."

Each of the price-theoretic assumptions animating the current structure of Rule of Reason analysis is inconsistent with recent advances in economic theory, in particular, transaction cost economics (TCE). According to TCE, technological rivalry unconstrained by non-standard contracts can produce suboptimal results, as firms and consumers struggle to overcome various costs of transacting in an atomistic market. As a result, the transaction cost paradigm assumes that non-standard contracts are presumptively efforts to overcome these costs, thus better serving consumers and society at large. On the other hand, price-theoretic "competition" — technological rivalry unconstrained by non-standard contracts — will most often result in a market failure, that is, output, price and other terms of trade different from those desired by consumers and society at large. Properly understood, then, "competition" can take a contractual form and includes most such restraints, which need not involve or create market power but instead help firms and consumers better approximate the price, output and other terms of trade that a well-functioning market would produce.

Of course, TCE is not new to antitrust. In recent decades, the Supreme Court has often embraced TCE when determining whether or not a contract is unlawful "*per se*." Applying TCE, the Court has held that certain contracts once deemed unlawful *per se* may in fact attenuate or overcome market failure with the result that courts should evaluate such agreements under the more forgiving "Rule of Reason." Such decisions implicitly recognize that contracts producing price, output or other terms of trade different from the *status quo ante* can be beneficial, and there is no reason to confine this reasoning to decisions policing the boundaries of the *per se* rule.

TCE and its vision of "contractual competition" undermine each of the three main aspects of the Rule of Reason described above. To begin with, application of transaction cost reasoning refutes those decisions and enforcement policies holding that proof of "actual detrimental effects" suffices to establish a *prima facie* case. To be precise, where defendants avoid *per se* condemnation by arguing plausibly that a restraint overcomes market failure, proof that the agreement results in price, output, or other terms of trade that depart from those produced by price-theoretic "competition" should not give rise to a presumption that the restraint reflects any exercise of market power. Instead, such proof is at least equally consistent with a conclusion that the agreement is a form of contractual competition that overcomes market failure and thus *enhances* social welfare. Therefore, such proof should not give rise to a *prima facie* case under the Rule of Reason. By adopting a contrary approach, the Supreme Court, lower courts and the enforcement agencies have clung to an outmoded vision of competition inconsistent with the more modern vision it has often embraced in the *per se* context.

TCE also undermines the standards courts currently employ to evaluate justifications defendants offer for non-standard contractual integration that is *prima facie* "anticompetitive." Market failure often produces price, output, or quality that departs from the optimal level. Non-standard contracts can enhance social welfare precisely because they alter the terms of trade produced by an unrestrained market. Thus, proof that a non-standard contract produces benefits otherwise deemed cognizable under the Rule of Reason suggests that any increase in prices, for instance, reflects the procompetitive elimination of market failure. Such an increase need not reflect an exercise of market power, with the result that there are no "harms" to balance against benefits. As a result, proof that a contractual restraint produces procompetitive benefits by eliminating a market failure should rebut a *prima facie* case, regardless whether this proof tends to show that the agreement reduces prices.

At the same time, courts and enforcement agencies should abandon their consideration of so-called "less restrictive alternatives" when conducting Rule of Reason analysis. Consideration of such alternatives depends upon an assumption that procompetitive benefits necessarily coexist with anticompetitive effects once a plaintiff has established a *prima facie* case. Because such effects coexist, it is said, antitrust law should encourage defendants to adopt restraints that achieve the same benefits while harming "competition" less. Once a defendant shows that a restraint attenuates a market failure, however, any presumption of anticompetitive effects should collapse, undermining any assertion that harms and benefits coexist and that defendants should achieve benefits through a less "anticompetitive" method.

Part I of this article examines the normative and jurisprudential foundations of the Rule of Reason, showing that the rule requires courts to employ the best available economic theory to determine whether a challenged contract advances consumer welfare or instead harms consumers by creating or exercising market power. Part II reviews the standards that courts and the enforcement agencies apply when conducting analysis under the Rule of Reason, standards that leading scholars have also embraced. Part III outlines the competing models of competition that price theory and TCE have produced as well as the influence of these respective models on antitrust doctrine. Part IV argues that the current structure of Rule of Reason analysis reflects the outmoded price-theoretic vision of competition and is therefore unduly biased against those non-standard agreements that plausibly overcome market failure.

I. THE RULE OF REASON

A. Normative Foundations — Preventing Monopoly Or Its Consequences:

The language of the Sherman Act seems straightforward, banning, as it does, "restraints of trade or commerce among the several states."[6] The "plain language" of the statute would seem to call into question any contract with an interstate nexus.[7] All contracts, it seems,

[6] 15 U.S.C. § 1.

[7] PHILIP AREEDA, 7 ANTITRUST LAW ¶ 1501 (1986). *See also* NCAA v. Bd. Of Regents of the University of Oklahoma, 468 U.S. 85, 98 (1984) (noting that every contract "restrains trade" in some sense).

"restrain trade" that is, alter commerce from the course it would otherwise take. Nonetheless, as Justice Holmes told us, economic progress requires cooperation, and the power to *regulate* commerce does not include the power to "explode the economy into individual atoms."[8] From the very beginning, then, the Supreme Court engrafted upon the statute a "reasonable construction," thus avoiding assertions that the Act outlaws ordinary and useful contracts, which at the time found shelter in liberty of contract.[9] In so doing, the Court made it plain that agreements that actually promote commerce are outside the scope of the Act, even if such contracts "indirectly" restrain interstate trade or even (indirectly) increase "the cost of conducting an interstate business."[10] Thus,

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[8]*See* Northern Securities Co. v. United States, 193 U.S. 197, 411 (1903) (Holmes, J., dissenting) ("I am happy to know that only a minority of my brethren adopt an interpretation of the law that would make eternal the *bellum omnium contra omnes* and disintegrate society so far as it could into individual atoms. If this were [Congress'] intent I should regard calling such a law a regulation of commerce a mere pretense. It would be an attempt to reconstruct society."). *See also* Polk Bros., Inc. v. Forest City Enterprises, 776 F.2d 185, 188 (7th Cir. 1985) ("The war of all against all is not a good model for any economy. Antitrust law is designed to ensure an appropriate blend of cooperation and competition, not to require all economic actors to compete full tilt at every moment.").

[9]*See* United States v. Joint Traffic Ass'n, 171 U.S. 505, 568 (1898) ("The act of Congress must have a reasonable construction, or else there would scarcely be an agreement or contract among business men that could not be said to have, directly or remotely, some bearing upon interstate commerce, and possibly to restrain it."), *quoting* United States v. Hopkins, 171 U.S. 578, 600 (1898); *Joint Traffic*, 171 U.S. at 567-68 (Sherman Act does not outlaw "ordinary contracts and combinations" protected by liberty of contract); Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899) (liberty of contract does not protect the sort of direct restraints of interstate trade forbidden by the Sherman Act); *id.* at 235-38 (finding restraint in question "direct" because it raised prices above the level "competition" would produce). *See also* Alan J. Meese, *Liberty and Antitrust In The Formative Era*, 79 B.U. L. REV. 1 (1999) (state and federal formative era decisions construed Sherman Act to avoid interference with liberty of contract); MARTIN J. SKLAR, THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM 105-117 (1988) (Congress rejected proposals to ban all contracts limiting "free competition" because of constitutional concerns).

[10]*Joint Traffic Ass'n.*,171 U.S. at 568 ("the statute applies only to those contracts whose direct and immediate effect is a restraint upon interstate commerce . . . to treat the act as condemning all agreements under which, as a result, the cost of conducting an interstate business may be increased, would enlarge the application of the act far beyond the fair meaning of the language used."); Hopkins v. United States, 171 U.S. 578, 592-600 (1898) (same); Anderson v. United States, 171 U.S. 604, 615-19 (1898) (contract that affects interstate trade incidentally or indirectly not a violation of the Act). *See also* United States v. Trans-Missouri Freight, 166 U.S. 290 (1897); United States v. Addyston Pipe & Steel Co., 85 F. 271 (1898) (Taft, J.), *aff'd*

the Court said, the Act only banned contracts that restrained trade — and thus increased prices — *directly*, that is, without connection to any main, lawful purpose.[11] Such contracts were, of course, beyond the protection of liberty of contract.[12]

Since 1911, the approach taken in these early cases has found expression in the "Rule of Reason" announced in Standard Oil Co. v. United States.[13] There the Court confirmed that the Sherman Act, like the common law before it, served to promote the right to contract, not to smash it.[14] To be sure, commercial contracts would limit the freedom of action of the parties to them and

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175 U.S. 211 (1899) (Sherman Act does not proscribe partial restraints that are ancillary to a legitimate undertaking).

[11]*See Addyston Pipe*, 175 U.S. at 235-38 (finding naked horizontal price fixing a "direct" restraint of trade because it drove prices above a reasonable level); *Joint Traffic*, 171 U.S. at 566-68; *Hopkins*, 171 U.S. at 592-600; *Anderson*, 171 U.S. at 615-19 (agreement not a restraint of trade within the meaning of the Act where it did not "meddle with prices" and thus "lacked every ingredient of monopoly" but was instead designed to "regulate the transaction of business in which the parties to the business were engaged."). *See also* National Cotton Oil Co. v. Texas, 197 U.S. 115, 128-30 (1905) (liberty of contract does not prevent states from banning monopolistic combinations).

[12]*See* Meese, *Liberty and Antitrust*, 79 B.U. L. Rev. at 65-67 (formative era courts defined as "direct" those restraints that exercised market power without countervailing benefits and thus fell outside the protection of liberty of contract); BARRY CUSHMAN, RETHINKING THE NEW DEAL COURT, 142-149 (1998) (explaining that commerce clause jurisprudence of the period equated intrastate activities that affected interstate commerce "directly" with businesses "affected with a public interest" and thus subject to price regulation under then-prevailing applications of "substantive due process"). *See generally* Munn v. Illinois, 94 U.S. 113 (1877).

[13]221 U.S. 1 (1911). *See also* United States v. American Tobacco Co., 221 U.S. 106 (1911) (reaffirming and elaborating *Standard Oil*'s Rule of Reason).

[14]*See Standard Oil*, 221 U.S. at 60 (the Sherman Act "evidenced the intent not to restrain the right to make and enforce contracts which did not unduly restrain interstate or foreign commerce, but to protect that commerce from being restrained by methods, whether old or new, which would constitute an interference, that is, an undue restraint."); *American Tobacco Co.*, 221 U.S. at 180 (*Standard Oil* court exercised "the duty to interpret which inevitably arose from the general character of the term restraint of trade [which] required that the terms restraint of trade should be given a meaning which would not destroy the individual right to contract and render difficult and not impossible any movement of trade in the channels of interstate commerce."). Scholars who have considered the question uniformly agree that the *Standard Oil* Court construed the Sherman Act in light of liberty of contract. *See, e.g.*, RUDOLPH PERITZ, COMPETITION POLICY IN AMERICA, 56-58 (1996) ("The *Standard Oil* opinion's Rule of Reason can be understood as

thus in some sense restrain competition and trade.[15] Nonetheless, it was the right to contract, and not regulatory intervention, that would empower firms and individuals to participate in the marketplace, preserving meaningful competition and thwarting monopoly over the long run.[16] As

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closing *Lochner's* circle of individual liberty[.]"); SKLAR, CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, at 146-48; Edward Corwin, *The Antitrust Acts And The Constitution,* 18 Va. L. Rev. 355, 368-70 (1932). It should be noted, however, that some of these same scholars have argued that *Standard Oil* constituted a departure from decisions such as *Joint Traffic* and *Trans-Missouri Freight. See, e.g*, PERITZ, COMPETITION POLICY, at 50-58; Corwin, *Antitrust Acts And The Constitution*, 18 Va. L. Rev. at 368-70. *See also* David Millon, *The Sherman Act And The Balance of Power*, 61 S. CAL. L. REV. 1219, 1288 n. 314 (1988) (arguing that *Standard Oil's* Rule of Reason was a departure from earlier, more "literal" caselaw); *Standard Oil*, 221 U.S. at 83-106 (Harlan, J., concurring and dissenting) (arguing strenuously that "Rule of Reason" announced by *Standard Oil* was inconsistent with previous case law). I have argued elsewhere that, in fact, the approach taken by *Standard Oil* is entirely consistent with prior caselaw, which also construed the Sherman Act in light of liberty of contract. *See* Meese, *Liberty and Antitrust*, 79 B.U. L. Rev. at 43-67 (early decisions construed Sherman Act in light of liberty of contract). *See also* Cline v. Frink Dairy Co., 274 U.S. 445, 460-61 (1927) (Taft, C.J.) (*Standard Oil* simply reaffirmed principles announced in *Joint Traffic* and *Addyston Pipe*); WILLIAM HOWARD TAFT, THE ANTITRUST ACT AND THE SUPREME COURT, 89-95 (1914) (same); Robert H. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing And Market Division*, 74 YALE L. J. 775, 802-805 (1965) (same); WILLIAM LETWIN, LAW AND ECONOMIC POLICY IN AMERICA: THE EVOLUTION OF THE SHERMAN LAW, 265 (1956) (*semble*).

[15]*See Standard Oil*, 221 U.S. at 63 (all contracts literally "restrain trade" to some extent); *see also* Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918) (Brandeis, J.) ("But the legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.").

[16]*See Standard Oil*, 221 U.S. at 62 ("the omission of any direct prohibition against monopoly in the concrete . . . indicates a consciousness that the freedom of the individual right to contract when not unduly or improperly exercised was the most efficient means for the prevention of monopoly."); *American Tobacco*, 221 U.S. at 180 (failure to construe Sherman Act in light of liberty of contract would "render difficult if not impossible any movement of trade in the channels of interstate commerce."); *id.* at 181 ("giving the statute a reasonable constriction, the words 'restraint of trade' did not embrace all those normal and usual contracts essential to individual freedom, and the right to make which was necessary in order that the course of trade might be free"); *Joint Traffic*, 171 U.S. at 566-68 (Sherman Act does not ban "ordinary contracts and combinations"); Whitwell v. Continental Tobacco Co., 125 F. 454, 460-61 (8th Cir. 1903) (Sanborn, J.) ("There is nothing in the [Sherman Act] which deprived any of the competitors of these rights [of contract]. If there had been, the law itself would have destroyed competition more effectually than any contracts or combinations of persons or of corporations could possibly have stifled it. The exercise of these undoubted rights is essential to the very existence of free competition, and so long as their exercise by any person or corporation in no way deprives competitors of the same rights, or restricts them in the use of these rights, it is difficult to perceive how their exercise can constitute any restriction upon competition or any restraint

a result, the Court said, the Sherman Act did not disturb "normal," "usual" or "ordinary" contracts that "furthered" or "developed" trade but instead struck only at those "unusual" contracts that restrained competition "*unduly*."[17] This distinction between "usual" and "unusual" contracts, the Court said, was equivalent to that between "direct" and "indirect" restraints it had announced in prior decisions.[18]

Whether a particular restraint on competition was "undue," the Court said, would depend upon an analysis of the character of the agreement or the surrounding circumstance of the

upon interstate trade."). *See also* National Society Of Professional Engineers v. United States*,* 435 U.S. 679, 688 (1978) ("[I]t is that body of law [*i.e.*, contract law] that establishes the enforceability of commercial agreements and enables competitive markets – indeed a competitive economy – to function effectively."); *National Cotton Oil*, 197 U.S. at 128 ("some combination of capital, skill or acts is necessary to any business development, and . . . the result must inevitably be a cessation of competition"); *Addyston Pipe*, 85 F. at 282 (noting that, at common law, "restrictions in the articles of partnership upon the business activities of the members . . . *were to be encouraged.*") (emphasis added).

[17]*See Standard Oil*, 221 U.S. at 57 (American common law forbade only those restraints that "unduly diminished competition"); *id.* at 58 (American common and statutory law forbade only those restraints "unreasonably restrictive of competition conditions"); *id.* at 62 (statute's "purpose was to prevent undue restraints of every kind or nature"); *id.* at 75-76 (finding that defendants' methods of expansion were not "normal" or "usual" and thus constituted undue restraints of trade); *American Tobacco*, 221 U.S. at 179 ("the words 'restraint of trade' at common law and in the law of this country at the time of the adoption of the anti-trust act only embraced acts or contracts or agreements or combination, which operated to the prejudice of the public interests by unduly restricting competition, or unduly obstructing the course of trade"); *id.* (*Standard Oil* held that "statute did not forbid or restrain the power to make normal and usual contracts to further trade by resorting to all normal methods, whether by, agreement or otherwise, to accomplish such purpose."); *Northern Securities*, 193 U.S. at 361 (Brewer, J. concurring) ("Congress did not intend to reach and destroy those minor contracts in partial restraint of trade which the long course of decisions at common law had affirmed were reasonable and ought to be upheld. . . . the general language of the Act is also limited by the power which each individual has to manage his own property and determine the place and manner of its investment. Freedom of action in this respect is among the inalienable rights of every citizen."). *See also Joint Traffic*, 171 U.S. at 566-68 (Sherman Act banned only "direct restraints" and not all contracts "under which, as a result, the cost of conducting an interstate commercial business may be increased"); *Standard Oil*, 221 U.S. at 66 ("Rule of Reason" and "direct or indirect" test articulated in *Joint Traffic* "come to one and the same thing").

[18]*See Standard Oil*, 221 U.S. at 66 (application of the Rule of Reason produces same results as distinction between "direct" and "indirect" restraints); *American Tobacco Co.*, 221 U.S. at 178-79 (*Standard Oil* announced Rule of Reason "without departing from any previous decision of the court"); *see also Cline*, 274 U.S. at 460-61 (same); TAFT, THE ANTITRUST ACTS, at 89-95 (same).

case.[19] Such an analysis did not involve implementation of any abstract, technical conception of "competition." Unlike modern economists, who view "competition" as a technical term of art, functionally linked to the efficient allocation of resources, the *Standard Oil* Court, like classical economists, equated competition with rivalry, the struggle between several firms to realize economic opportunities.[20] Defined in this way and thus drained of any economic content, "competition" was not an unalloyed good, as it is for modern economists. When tempered by an appropriate amount

[19]*See Standard Oil*, 221 U.S. at 58 (Sherman Act struck at "all contracts or acts which were unreasonably restrictive of competitive conditions, either from the nature or character of the contract or act or where the surrounding circumstances were such as to justify the conclusion that they had not been entered into or performed with the legitimate purpose of forwarding personal interest and developing trade, but on the contrary . . . with the intent to do wrong to the general public and to limit the right of individuals.").

[20]*See* FRANK M. MACHOVEC, PERFECT COMPETITION AND THE TRANSFORMATION OF ECONOMICS, 96-138 (1995) (examining classical conception of competition)*;* Paul McNulty, *Economic Theory And The Meaning Of Competition*, 82 Q. J. ECON. 639, 647 (1968) (arguing that the classical concept of competition "was a behavioral one, the essence of which was the effort of the individual seller to undersell, or the individual buyer to outbid, his rivals in the marketplace"); George Stigler, *Perfect Competition, Historically Contemplated*, 65 J. POL. ECON. 1-2 (1957) (finding that Adam Smith equated "competition" with "rivalry in a race – a race to get limited supplies or a race to be rid of excess supplies"). *See also* HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937, 270 (1991) ("Although classicists were concerned to preserve 'competition,' they did not understand the term as we understand it today. Competition was not a theory about cost-price relationships, as it came to be in Neoclassical economics . . . .Rather, competition was a belief about the role of individual self-determination in directing the allocation of resources, and about the limits of state power to give privileges to one person or class at the expense of others."). Two years before passage of the Sherman Act, a leading political economist defined competition in the following manner:

> "[Competition is] the operation of individual self-interest, among the buyers and sellers of any article in any market. It implies that each man is acting for himself solely, by himself solely, in exchange, to get the most he can from others, and to give the least he must himself."

See FRANCIS A. WALKER, POLITICAL ECONOMY, 91-92 (3d ed. 1888), *quoted* in HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 274.

of cooperation embodied in an "ordinary" or "normal" restraint, such rivalry could enhance economic welfare by assuring consumers high quality products at the lowest possible price.[21]

Instead of banning all restraints on "competition," then, the Sherman Act required antitrust courts to employ the sort of "reason" that they had long employed when implementing the common law of trade restraints.[22] The application of such reason would enable judges to enforce the "public policy embodied in the statute," by determining whether a challenged restraint limited marketplace rivalry ("competition") so much that it produced or threatened to produce monopoly or

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[21]*See Standard Oil*, 221 U.S. at 58 (common law did not void those contracts that had a "legitimate purpose of reasonably forwarding personal interest and developing trade"); *Joint Traffic*, 171 U.S. at 575 ("it is plain that commerce can and does take place on a large scale and in numerous forms without competition"). *See also* McNulty, *Meaning of Competition*, 82 Q. J. Econ. at 643-45 (classical economists argued that "competition" would result in "natural" price, *i.e.*, the lowest price necessary to induce production of the product in question). Some scholars would take issue with the assertion that Congress designed the Sherman Act to maximize consumer welfare, if such welfare is equated with total social wealth and thus involved application of a Kaldor-Hicksian efficiency benchmark. According to these scholars, classical economists did not understand that the exercise of market power would distort the allocation of resources and thus reduce total social welfare. *See* Louis Kaplow, *Antitrust, Law and Economics, and the Courts*, Law and Contemporary Problems, Autumn, 1987, at 181, 207-208 & note 140. Thus, it is said, Congress must have had purely distributional goals in mind when it passed the Sherman Act, with the result that any arrangement that increases prices, directly or indirectly, offends the Act. *See* Robert H. Lande*, The Rise and Coming Fall Of Efficiency As The Ruler Of Antitrust*, 33 Antitrust Bull. 429 (1988); Kaplow, *Antitrust And The Courts*, at 207-208; Robert Lande, *Wealth Transfers As The Original And Primary Concern Of Antitrust: The Efficiency Interpretation Challenged*, 34 Hastings L. J. 65 (1982). However, at least some classical economists apparently understood that the possession and exercise of market power would distort the allocation of resources and reduce total social welfare. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, 682-83 (Modern Library Edition 1994) (arguing that mercantile monopolies "derange more or less the natural distribution of the stock of the society" and that "every derangement of the natural distribution of stock is necessarily hurtful to the society in which it takes place"). *See also* E.G. West, *The Burdens Of Monopoly: Classical Versus Neoclassical*, 44 S. Econ. J. 829 (1979) (arguing that Adam Smith understood allocative inefficiency as one burden of monopoly).

At any rate, the conclusions of this article do not depend upon any equation of "consumer welfare" with efficiency defined in a Kaldor-Hicksian sense. Even if the Sherman Act forbids all contracts that 1) exercise market power and 2) result in higher consumer prices, the present structure of Rule of Reason analysis is overinclusive in the sense that it identifies as "anticompetitive" numerous contracts that do not, in fact, create or exercise market power. *See* nn. ___, *infra* and accompanying text.

[22]*See Standard Oil*, 221 U.S. at 60.

its consequences.[23] There were, according to the Court, three such consequences: the ability to restrict output, raise prices, or reduce quality.[24] Modern economists, of course, would equate these consequences with the exercise of market power and the corresponding reduction in social welfare.[25] This treatment of the Sherman Act as a form of externality regulation was consistent with the then-

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[23]*See Standard Oil*, 221 U.S. at 60 ("the standard of reason which had been applied at the common law . . . was intended to be the measure used for determining whether in a given case a particular act had or had not brought about the wrong against which the statute provided."); *id.* at 62 (Court should apply rule of reason "to enforce the prohibitions of the Act and thus the public policy which its restrictions were obviously enacted to subserve."); *id*. at 58 (stating that the common law refused to enforce "all contracts or acts which were unreasonably restrictive of competitive conditions [and thus designed] to bring about the evils, such as enhancement of prices, which were considered against public policy"); *Addyston Pipe*, 85 F. at 282-83 (contract whose "sole object" is to "restrain competition" was unenforceable at common law and thus unlawful under the Sherman Act).

[24]*Standard Oil*, 221 U.S. at 64; *id.* at 61 (defining "restraint of trade" as "undue restraint of the course of trade" which bring about monopoly or "which produces the same result as monopoly"); *id.* at 57 (common law referred to contracts that "were thought to unduly diminish competition and hence to enhance prices — in other words, to monopolize" as "being in restraint of trade"); *id.* (prohibition on restraints of trade were aimed at "the acts of individuals producing or tending to produce the consequences of monopoly"); *id.* at 52 (listing "evils" of monopoly as: 1) the power to fix prices; 2) the power to limit output and 3) the danger of deterioration in the quality of the monopolized product); *id.* (characterizing "power arbitrarily to enhance price" as one "evil of monopoly"). *See also* ADAM SMITH, THE WEALTH OF NATIONS, at 69 ("The monopolists, by keeping the market constantly under-stocked, by never fully supplying the effectual demand, sell their commodities much above the natural price, and raise their emoluments, whether they consist in wages or profit, greatly above their natural rate."); THOMAS SOWELL, CLASSICAL ECONOMICS RECONSIDERED, 20-21 (1974) (classical economists equated "monopoly" with any restriction of supply).

[25]*See, e.g.*, HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY, 11-13 (1999) (describing deadweight loss caused by monopolist's exercise of market power); William Landes And Richard Posner, *Market Power In Antitrust Cases*, 94 Harv. L. Rev. 937 (1981) (defining market power as ability profitably to price above marginal cost); Guido Calabresi, *Transaction Costs, Resource Allocation, and Liability Rules: A Comment*, 11 J. L. & Econ. 67, 70 (1968) (antitrust regulation can be justified as regulation eliminating the externality of deadweight welfare losses caused by monopoly restrictions on output); KENNETH ELZINGA AND WILLIAM BREIT, THE ANTITRUST PENALTIES, 3 (1976) (same); SMITH, WEALTH OF NATIONS, at 69 (arguing that "[t]he price of monopoly is upon every occasion the highest which can be got. The natural price, or the price of free competition, on the contrary, is the lowest which can be taken, not upon every occasion indeed, but for any considerable time together. The one is upon every occasion the highest which can be squeezed out of the buyers, or which, it is supposed, they will consent to give. The other is the lowest which the sellers can commonly afford to take, and at the same time continue their business."). *See also* Bork, *The Rule of Reason*, 74 YALE L. J. at 802-805, 831-32 (*Standard Oil*'s Rule of Reason designed to further "the creation of wealth, or, to say the same thing, the maximization of the satisfaction of consumer wants").

dominant approach to political economy, an approach that the Court had read into the due process clauses of the Fifth and Fourteenth Amendments.[26]

This "Rule of Reason" did not empower courts to validate harmful agreements that judges might nevertheless deem "reasonable."[27] Nor did it empower judges to void "legitimate" or "normal" contracts that incidentally limited competition and might indirectly raise prices.[28] Instead, the rule required courts to ban all contracts that limited competition in a manner that would produce the consequences of monopoly and thus harm consumers and society.[29] Absent government

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[26] *See* HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 200-201 (arguing that the Supreme Court only sustained abridgements of contractual liberty that were designed to correct market failure); Meese, *Liberty And Antitrust In The Formative Era*, 79 B.U. L. Rev. at 15-34 (recounting classical economic paradigm and its embrace by courts practicing economic due process); *id*. at 88-91 (suggesting that formative era jurisprudence could be explained by concern for welfare losses caused by cartel output reductions); PERITZ, COMPETITION POLICY IN AMERICA, at 50-52 (arguing that *Standard Oil* reflected concern for liberty of contract recognized in *Lochner*); SKLAR, CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, at 108-117 (arguing that Congress narrowed initial drafts of the Sherman Act to accomodate concerns that statute might infringe liberty of contract). *See also National Cotton Oil*, 197 U.S. at 129 ("It is the power to control prices which makes the inducement of combinations and their profits. It is such power that makes it the concern of the law to prohibit or limit them.").

[27] *See Standard Oil*, 221 U.S. at 65 (Rule of Reason does not empower courts to exempt agreements that unduly restrict competition from the statute); *Joint Traffic*, 171 U.S. at 575-77 (rejecting defendants' invitation to consider policy arguments in favor of railroad cartel).

[28] *See Standard Oil*, 221 U.S. at 66 ("To treat as condemned by the act all agreements under which, as a result, the cost of conducting an interstate commercial business may be increased would enlarge the application of the act far beyond the fair meaning of the language used. There must be some direct and immediate effect upon interstate commerce in order to come within the act."), *quoting Hopkins*, 171 U.S. at 592; *Standard Oil*, 221 U.S. at 54 (listing "*undue* enhancement of price" as one evil of monopoly) (emphasis added); *American Tobacco*, 221 U.S. at 179 (Act does not forbid "the power to make normal and usual contracts to further trade by resorting to all normal methods whether by agreement or otherwise, to accomplish such purpose."); *Joint Traffic*, 171 U.S. at 566-68 (same); *see also Chicago Bd. of Trade*, 246 U.S. at 238 (mere fact that a contract restrains price competition does not condemn it under Rule of Reason).

[29] *See Standard Oil*, 221 U.S. at 52-62. *See also* Bork, *The Rule of Reason and the Per Se Concept*, 74 YALE L.J. at 802-804 (*Standard Oil* created "a rule of reason keyed to the avoidance of the consequences of monopoly and had placed upon the courts the duty of performing economic analysis to determine in which acts and agreement the evils of monopoly were present.").

imposition of monopoly, then, the Sherman Act, if properly enforced, would ensure the appropriate amount of competition and protect society from arrangements that produced or threatened to produce market power.[30]

B. Applying Principles —The Role of Evolving Economic Theory:

Although initially controversial,[31] modern courts and commentators agree that *Standard Oil* should be the starting point for any antitrust analysis.[32] Still, the embrace of this principle begs an important question: how should courts should go about distinguishing "ordinary," "normal," or usual restrictions, which "further" and "develop" trade from those that "unreasonably restrict competitive conditions" and thus produce the consequences of monopoly?[33] *Standard Oil*'s invocation of the common law in support of its Rule of Reason suggests one source of wisdom,

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[30] *See Standard Oil*, 221 U.S. at 62 ("The operation of the centrifugal and centripetal forces resulting from the right to freely contract was the means by which monopoly would be inevitably prevented if no extraneous or sovereign power imposed it and no right to make unlawful contracts having a monopolistic tendency were permitted. In other words that freedom to contract was the essence of freedom from undue restraint on the right to contract."); *Whitewell*, 125 F. at 400-401 (protection of right to contract was "essential to the very existence of free competition.").

[31] *See* LETWIN, LAW AND ECONOMIC POLICY IN AMERICA, at 265-70 (describing political and legislative reaction to *Standard Oil*); Albert H. Walker, *The Unreasonable Obiter Dicta Of Chief Justice White In The Standard Oil Case* (1911). As noted earlier, some contemporary and modern commentators have argued that *Standard Oil*'s invocation of the Rule of Reason was a wholesale repudiation of prior decisions under the Act. *See* n. ____, *supra*. I have shown elsewhere that this position rests on a misreading of pre-1911 decisions. *See* Meese, *Liberty and Antitrust*, 79 B. U. L. REV. at 43-67 (arguing that, like *Standard Oil*, early state and federal decisions construed antitrust statutes narrowly, to avoid claims that such statutes offended liberty of contract); *id.* at 59-67, 75-80 (early caselaw voided only those contracts that exercised or threatened to create market power). *See also* TAFT, THE ANTITRUST ACTS AND THE SUPREME COURT, at 89-95 (arguing that *Standard Oil* did not depart from prior caselaw).

[32] Business Electronics Corp. v. Sharp Electronics, 485 U.S. 723 (1988); Arizona v. Maricopa County Medical Society, 457 U.S. 332, 343 (1982); *National Society of Professional Engineers*, 435 U.S. at 687-92; Continental T.V. v. GTE Sylvania, 433 U.S. 36, 49 (1979); Klor's, Inc. v. Broadway Hale Stores, 359 U.S. 207 (1959); SULLIVAN AND GRIMES, LAW OF ANTITRUST 192-94 (praising *Standard Oil* as "an antitrust classic"); 7 AREEDA, ANTITRUST ¶¶ 1500-1501.

[33] *See Standard Oil*, 221 U.S. at 58 (distinguishing between these two sorts of contracts).

namely the vast body of precedents governing trade restraints that was in place when Congress passed the Sherman Act.[34] Congress, after all, anticipated that the courts would draw upon common law precedents and methodology when formulating antitrust doctrine.[35] Perhaps courts should ban those restraints that were void at common law, while at the same time validating those that common law courts would have enforced.[36]

From the very beginning, however, courts have rejected invitations to engraft the stock of common law precedents onto the Sherman Act.[37] As *Standard Oil* itself noted, the universe of trade restraints is in constant flux: human ingenuity produces restraints that the common law did not address.[38] More fundamentally, the *effects* of well-known restraints are themselves not static:

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[34]*See Standard Oil*, 221 U.S. at 60 (Congress intended the courts to apply "the standard of reason which had been applied at the common law and in this country in dealing with the subjects of the character embraced by the statute."). *See also* nn. ____, *supra* and accompanying text.

[35]*See, e.g.*, State Oil v. Khan, 522 U.S. at 20-21 ("Congress 'expected the courts to give shape to the statute's broad mandate by drawing on common-law tradition.'"), *quoting National Society Of Professional Engineers*, 435 U.S. at 688. *See also* SKLAR, CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, at 112-17 (detailing Congressional assumptions that Courts would treat the Sherman Act as a license to articulate a common law of trade restraints).

[36]*Cf. Klor's, Inc.*, 359 U.S. at 211 (suggesting that Sherman Act banned all contracts that were unenforceable at common law and any others that "new times and economic conditions would make unreasonable").

[37]*See Trans-Missouri Freight*, 166 U.S. at 327-28 (rejecting argument that the term "restraint of trade" is "to be given the same meaning that [it] received at common law"). Moreover, while then–Judge Taft purported to rely upon the common law to justify his decision in *Addyston Pipe*, the approach he announced in fact departed from the common law's willingness to enforce "reasonable" horizontal price fixing agreements. *See* HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 286-87. *See also* nn. ___, *infra* and accompanying text (describing Supreme Court's repudiation of common law decisions enforcing non-coercive price-fixing agreements).

[38]*See Standard Oil*, 221 U.S. at 59-60 (Congress drafted the Sherman Act to address "the many new forms of contracts and combinations which were being evolved from existing economic conditions"); *American Tobacco*, 221 U.S. at 180-81 (Rule of Reason empowers courts to condemn arrangements that frustrate the policy of the statute even if they were unknown to the common law).

economic conditions change, and such changes may themselves alter the effects of particular restraints. At the same time, human understanding evolves — or at least changes — over time; restraints that once appeared beneficial or benign to the most learned economists may now seem harmful.[39]

For these reasons, even the common law was not static, but instead treated identical restraints quite differently in different eras.[40] At one time, for instance, covenants ancillary to the sale of a business were unlawful "*per se.*"[41] Over time, however, conditions and economic understanding changed, and courts came to believe that such agreements were both more beneficial and less harmful than once imagined.[42] As a result, courts refused to enforce only "general" restraints of trade that barred the seller from pursuing his trade in the entire jurisdiction, enforcing those partial restraints that were reasonable.[43]

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[39] *See Standard Oil*, 221 U.S. at 57-58 (noting that, during the late 19th Century, American courts and legislatures adjusted common law restrictions in response to changed understandings of the economic effects of various agreements); *id.* at 55-56 ("development of more accurate economic conceptions and the changed conditions of society" caused repeal of overbroad English statutes and adjustment in English common law).

[40] *See, e.g.*, Gibbs v. Consolidated Gas Co., 130 U.S. 396, 409 (1889) (stating that the original rules governing restraints of trade were "made under a condition of things and a state of society, different from those which now prevail, [with the result that] the rule laid down is not regarded as inflexible, and has been considerably modified."); Skrainka v. Scharringhausen, 8 Mo. App. 522, 525 (1880) ("It is not that contracts in restraint of trade are any more legal or enforceable now than they were at any former period, but that courts look differently at the question as to what is a restraint of trade."); Diamond Match Co. v. Roeber, 13 N.E. 419, 421-22 (N.Y. 1887); Kellog v. Larkin, 3 Pin. 123, 139-41 (Wis. 1851). *See also Standard Oil*, 221 U.S. at 51-58 (describing common law's evolving treatment of trade restraints); *Addyston Pipe*, 85 F. at 280-82 (same).

[41] *See* Year Book, 2 Hen. V., Folio 5, pl. 26.

[42] *See* Mitchell; *Addyston Pipe*, 85 F. at 280-81 (describing evolving appreciation of benefits of various ancillary restraints); Diamond Match Co. v. Roeber, 13 N.E. 419, 420-23 (N.Y. 1887).

[43] *See* Mitchel v. Reynolds, 1 P. WMS. 181, 24 ENG. REP. 347 (1711). *See also*, *e.g.*, Union Strawboard Co. v. Bonfield, 61 N.E. 1038 (Ill. 1901) (invalidating general restraint without regard to reasonableness); Alger v. Thacher, 36 Mass. (19 Pick.) 51 (1837) (same).

Antitrust courts have always taken a similar approach, eschewing any reliance upon a static common law and instead embracing economic theory to assist them in distinguishing "undue" restraints from those that are "ordinary" or "normal."[44] Such an approach follows naturally from *Standard Oil*'s requirement that judges employ "reason" to determine whether a restraint hinders competitive rivalry between the parties to it in a manner that produces the economic consequences banned by the statute.[45] In so doing, courts have felt free to rely upon economic theories quite different from those extant in 1890, thus "updating" the Sherman Act to keep pace with changing perceptions about the "economic consequence" of particular agreements.[46] While the

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[44]*See Khan*, 522 U.S. at 15-22 (relying upon changed economic perceptions to overrule *per se* ban on maximum resale price maintenance); *Business Electronics*, 485 U.S. at 732 ("The Sherman Act adopted the term 'restraint of trade' along with its dynamic potential. It invokes the common law itself, and not merely the static content that the common law assigned that term in 1890."); *Klor's, Inc.* 359 U.S. at 211 (Sherman Act empowered courts to ban contracts which new times and economic conditions would make unreasonable"); Dr. Miles Med. Co. v. John D. Park & Sons, 220 U.S. 373, 406 ("with respect to contracts in restraint of trade, the earlier doctrine of the common law has been substantially modified in adaptation to modern conditions."); *Trans-Missouri Freight*, 166 U.S. at 327-29. *See also* HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 268 ("One of the great myths about American antitrust policy is that courts began to adopt an 'economic approach' to antitrust problems only in the 1970s. At most, this "revolution" in antitrust policy represented a change in economic models. Antitrust policy has been forged by economic ideology since its inception."); Michael S. Jacobs, *An Essay on the Normative Foundations of Antitrust Economics*, 74 N.C. L. Rev. 219, 226 (1995) ("In almost every era of antitrust history, policymakers have employed economic models to explain or modify the state of the law and the rationale for its enforcement.").

[45]Bork, *The Rule of Reason*, 74 YALE L. J. at 805 ("It should be stressed that White's test was phrased wholly in economic terms, giving no evidence of concern for possibly competing values. A corollary of this value choice is that the law should develop according to the progress of economic thought. The law is, therefore, neither made inflexible by controlling precedent nor required to change only through abrupt shifts of basic doctrine. Thus a court could alter the law without repudiating the theory underlying prior decisions by explaining that those decisions had misconceived the economic effect of particular agreements or practices. This characteristic is, of course, inherent in Peckham's and Taft's statements of the rule of reason, as it is in any law governed by economic analysis.").

[46]*See Business Electronics*, 485 U.S. at 731 ("The term 'restraint of trade' in the statute, like the term of common law, refers not to a particular list of agreements, but to a particular economic consequence, which was to be produced by quite different sorts of agreements in varying times and circumstances."); *see also Khan*, 522 U.S. at 15-22 (relying upon revised economic understanding to repudiate prior doctrine); *Continental T.V.*, 433 U.S. at 52-57 (same); *Klor's Inc*, 359 U.S. at 211 (Sherman Act empowered courts to

principle animating the Rule of Reason remains constant, applications change, as courts "translate" the principle in light of new information.[47]

II IMPLEMENTING *STANDARD OIL'S* RULE OF REASON

A. A Two Step Inquiry:

One could read *Standard Oil* and its Rule of Reason to require a case-by-case assessment of the reasonableness of each challenged restraint.[48] Indeed, some early caselaw seemed to indicate as much.[49] Yet, the decision itself suggested a contrary approach, stating that courts

ban contracts made unreasonable by "new times and economic conditions").

[47]*See* Lawrence Lessig, *Fidelity In Translation*, 71 TEX. L. REV. 1165, 1247-51 (1993) (describing such an approach to interpretation and application of the Sherman Act); *see also* Alan J. Meese, *Tying Meets The New Institutional Economics* 146 U. PENN. L. REV. 1, 91-93 (1997) (arguing that the Supreme Court should "translate" tying doctrine in light of recent changes in economic theory).

The evolving judicial treatment of horizontal price-fixing provides a quintessential example of this approach. When Congress passed the Sherman Act, common law courts generally enforced such agreements, at least those that set a "reasonable" price. *See* HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 288-93. Such an approach reflected the "political economy" of the day, which assumed that markets were invariably populated by numerous sellers and characterized by low barriers to entry. In such a world, horizontal price fixing could only produce prices above the "natural" level if cartelists took steps to thwart entry by others. *See* Meese, *Liberty and Antitrust*, 79 B.U. L. Rev. at 17-18. Indeed, some early decisions under the Sherman Act refused to void cartels that did not seek to limit the output of strangers to the agreement. *See* United States v. Nelson, 52 F. 646 (C.C. Minn. 1892). Nonetheless, the Supreme Court rejected this approach to price fixing, voiding such agreements regardless whether defendants interfered with the actions of others. *See Dr. Miles,* 220 U.S. at 404-409*; Addyston Pipe,* 175 U.S. at 238-45.

[48]*Standard Oil*, 221 U.S. at 60 (statute "intended that the standard of reason which had been applied at the common law and in this country in dealing with the subjects of the character embraced by the statute was intended to be the measure used for the purpose of determining whether, *in a given case*, a particular act had or had not brought about the wrong against which the statute provided.") (emphasis added). Indeed, the author of *Standard Oil*, Chief Justice White, argued as much (in dissent) fifteen years earlier. *See Trans-Missouri Freight Ass'n.,* 166 U.S. at 343-74 (White, J. dissenting) (arguing that courts should ban anly those price fixing agreements that set unreasonable prices).

[49]*See, e.g.*, Appalachian Coals v. United States, 288 U.S. 344 (1933); Chicago Board of Trade v. United States, 246 U.S. 231 (1918). Moreover, while scholars often cite Judge Taft's and Justice Peckham's *Addyston Pipe* decisions as examples of "*per se* rules" against unadorned horizontal price fixing, both decisions in fact ultimately rested upon a determination that the cartel under attack had charged "unreasonable" prices. *See Addyston Pipe*, 175 U.S. at 235-38 (rejecting assertion that cartel merely set reasonable prices); *id.* at 238 ("The facts thus set forth show conclusively that the effect of the combination

should determine the reasonableness *vel non* of a restraint by examining the "character and nature" of an agreement *or* the "surrounding circumstances."[50] Subsequent courts ultimately came around to this position, declaring certain categories of restraints unreasonable "*per se*," and thus subject to summary condemnation.[51]

Per se rules are no exception to the approach articulated in *Standard Oil*. To the contrary, such rules simply implement the overarching Rule of Reason, just as a requirement that motorists "stop, listen and look" before crossing any railroad tracks once implemented the more general requirement that tort victims act reasonably.[52] A conclusion that a particular class of restraint is unlawful "*per se*" rests upon a determination that a thoroughgoing examination of the "reasonableness" of such restraints will always or almost always result in a conclusion that they exercise or create market power and thus restrain "competition" (rivalry) "unduly."[53] In this way,

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was to enlarge prices beyond a sum which was reasonable."); *Addyston Pipe*, 85 F. at 291-93 (finding that defendants' cartel had produced unreasonable prices). *See also* Meese, *Liberty And Antitrust*, 79 B.U. L. Rev. at 59-67 (*Addyston Pipe* rested on finding that cartel prices were above the reasonable level).

[50]*Standard Oil*, 221 U.S. at 58; *American Tobacco*, 221 U.S. at 179. *See also* Bork, *The Rule of Reason and the Per Se Concept*, 74 YALE L. J. at 804 (*Standard Oil* opinion recognized that some arrangements could be unlawful *per se*).

[51]S*ee* FTC v. Superior Court Trial Lawyers Ass'n, 493 U.S. 411 (1990); Arizona v. Maricopa County Med. Soc'y, 457 U.S. 332 (1982); Northern Pacific R. Co. v. United States, 356 U.S. 1, 5 (1958). *See also* Klor's, Inc. v. Broadway Hale Stores, 359 U.S. 207, 211 (1959) (relying on *Standard Oil*'s reference to "nature and character" of certain agreements for proposition that some agreements are unreasonable *per se*).

[52]Baltimore & Ohio R.R. v. Goodman, 275 U.S. 66 (1927).

[53]State Oil v. Khan, 522 U.S. 3, 10 (1997) ("*Per se* treatment is appropriate 'once experience with a particular kind of restraint enables the Court to predict with confidence that the Rule of Reason will condemn it.'"), *quoting Maricopa County*, 457 U.S. at 344; *accord Superior Court Trial Lawyers Ass'n*, 493 U.S. at 433, n. 15. *See also Northern Pac. R. R.*, 356 U.S. at 5; *Standard Oil*, 221 U.S. at 58 (public policy condemned "all contracts or acts which were unreasonably restrictive of competitive conditions, either from the *nature or character of the contract or act*, or where the surrounding circumstances were such as to justify the conclusion that they had not been entered into or performed with the legitimate purpose of reasonably forwarding personal interest, and developing, trade.") (emphasis added).

per se rules replicate the result that full blown analysis would produce while at the same time avoiding the administrative costs of such an inquiry.[54]

As applied in the courts, then, *Standard Oil*'s Rule of Reason manifests itself in a two step analysis. The first step -- *per se* analysis -- requires characterization and then classification of a restraint. Here courts inquire into the nature of the agreement and decide whether it is unlawful per se or instead subject to further scrutiny. If the restraint survives this step, that is, if it is not unreasonable *per se*, courts proceed to the second step, namely, (more fact-intensive) analysis of the actual effects of the restraint. While courts refer to this second step as a "Rule of Reason" analysis, both steps of the process attempt to answer the question put by *Standard Oil*, *viz.*, is a restraint "unreasonably restrictive of competitive conditions."[55]

Because both steps involve the same ultimate inquiry, the methodology employed in the first step should help shape the approach taken in the second. After all, the creation of *per se* rules is as much a process of exclusion as of inclusion. Thus, the standards employed at the first step do more than define the class of restraints subject to immediate condemnation; they also implicitly determine the nature of those restraints that are "left over" and thus subject to more thorough scrutiny under the second step's Rule of Reason. Moreover, for three decades *per se* rules dominated

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[54]*See Khan*, 522 U.S. at 10; *Superior Court Trial Lawyers*, 493 U.S. at 434-35; *Maricopa County Medical Society*, 457 U.S. at 344.

[55]*See National Society of Professional Engineers*, 435 U.S. at 490, *quoting Standard Oil*, 221 U.S. at 58; Board of Regents of the University of Oklahoma v. NCAA, 468 U.S. 85, 104 (1984) ("whether the ultimate finding is the product of a presumption [implemented via the *per se* rule] or actual market analysis, the essential inquiry remains the same – whether or not the challenged restraint enhances competition."); *Chicago Bd. of Trade*, 246 U.S. at 238 ("The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition."). *Standard Oil*, 221 U.S. at 57 (American common and statutory law banned arrangements that "were thought to unduly diminish competition"). *See also Superior Court Trial Lawyers Ass'n*, 493 U.S. at 433-34.

antitrust doctrine, as courts continually expanded the list of agreement subject to automatic condemnation. Only recently have courts begun to contract the scope of *per se* rules, and they have done so in a manner that has important implications for the Rule of Reason in general. Thus, any attempt to comprehend and critique modern Rule of Reason analysis must therefore begin with an understanding of the process that leads to Rule of Reason treatment in the first place.

B. The First Step — Per Se Analysis:

The current caselaw, which I do not question, holds that a particular class of restraints is unreasonable "*per se*" if the restraints are "always or almost always anticompetitive" *and* always or almost always "lack redeeming virtues" that would, if present, "outweigh" or "justify" any anticompetitive effect.[56] Plaintiffs can readily satisfy the first prong of this test, given the manner in which the Court defines "anticompetitive" when conducting *per se* analysis.[57] Like *Standard Oil*, the Court has abjured any technical definition of "competition" and instead equated the term with "rivalry" for the purpose of *per se* analysis, with the result that any coordination of previously

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[56]*See* State Oil v. Khan, 522 U.S. 3, 10 (1997) ("Some types of restraints, however, have such predictable and pernicious anticompetitive effect, *and* such limited potential for procompetitive benefit, that they are deemed unlawful per se.") (emphasis added); Broadcast Music, Inc. v. Columbia Broadcasting Systems, 441 U.S. 1, 7-8, 19-20 (1979) (same); Catalano v. Target Stores, 446 U.S. 643, 646, 649-50 (1980) (same); Continental T.V. v. G.T.E. Sylvania, 433 U.S. 36, 49-50 (1977); United States v. Topco Associates, 405 U.S. 596, 607 (1972) (same); *Northern Pacific Railway*, 356 U.S. at 5 (same). *See also* Northwest Wholesale Stationers v. Pacific Stationery & Printing Co., 472 U.S. 284, 290 (1985) (stating that certain group boycotts are *per se* unlawful because they "are so likely to restrict competition without any offsetting efficiency gains that they should be condemned as *per se* violations").

It should be noted that the Court has used the term "anticompetitive" in a different sense on occasion to refer to an arrangement's overall effect on economic welfare. *See*, *e.g.*, *NCAA*, 468 U.S. at 103-104 ("Per se rules are invoked when surrounding circumstances make the likelihood of *anticompetitive* conduct so great as to render unjustified further examination of the challenged conduct.") (emphasis added). Such usage is comparatively rare, however.

[57]*See Chicago Bd. of Trade*, 246 U.S. at 238 (noting that all contracts limit individuals' freedom of action and thus restrain competition in some sense).

independent activity is "anticompetitive."[58] This definition of "anticompetitive" sweeps quite broadly, applying as it does to any number of garden variety arrangements. The formation of a partnership or a corporation, for instance, necessarily eliminates actual or potential rivalry between the parties to the new venture.[59] The same is true of a merger, joint venture, or covenant ancillary to the sale of a business.[60] If competition is equated with "rivalry," all of these restraints reduce "competition" when compared to the *status quo ante* and thus satisfy the first part of the two part test for *per se* illegality.

Of course, the economy would grind to a halt if the Sherman Act banned all agreements that are "anticompetitive" in this broad sense. Recognizing this, *Standard Oil* held that the Act forbids only "undue" restrictions of competition.[61] Thus, an initial conclusion that a restraint is "anticompetitive" is only the beginning of *per se* analysis. Courts recognize that many restraints

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[58] *See NCAA*, 468 U.S. at 98-100 (agreement on price and output required justification to avoid *per se* condemnation); *Maricopa County Med. Soc'y*, 457 U.S. at 342-54 (maximum price fixing arrangement "anticompetitive" and unlawful absent valid competitive justification); *Catalano*, 446 U.S. at 649-50 (agreement fixing credit terms between competitors unlawful *per se* given absence of any recognized redeeming virtue); *National Society of Professional Engineers*, 435 U.S. at 692-96 (ban on competitive bidding required competitive justification); *Sylvania*, 433 U.S. at 51-59 (treating reduction of intrabrand rivalry as sufficient to require inquiry into restraint's redeeming virtues); White Motor Co. v. United States, 372 U.S. 253, 261-64 (1963) (possibility that territorial restraint had redeeming virtues obviated application of *per se* rule).

[59] *See Maricopa County Medical Society*, 457 U.S. at 357 (partnership involves price fixing but is subject to Rule of Reason because of economic integration that produces efficiencies); *Broadcast Music, Inc.* 441 U.S. at 9 (stating that the existence of a partnership is not *per se* unlawful because of its redeeming virtues); *Addyston Pipe*, 85 F. at 280 (creation of partnership and associated restraints analyzed under the Rule of Reason even though the arrangement "might reduce competition").

[60] *See Broadcast Music, Inc.*, 441 U.S. at 23; *National Society of Professional Engineers*, 435 U.S. at 688-89 (covenants not to compete analyzed under the Rule of Reason even though they eliminate "potential competition").

[61] *See* nn. ____, *supra* and accompanying text; *Polk Bros.*, 776 F.2d at 188 ("Antitrust law is designed to assure an appropriate blend of cooperation and competition").

that eliminate or temper competition produce "procompetitive" efficiencies or "redeeming virtues" that can "outweigh" or "justify" any "anticompetitive" limitation on rivalry.[62] In other words, courts recognize that such restraints might be "normal" or "ordinary" with the result that a fact-intensive Rule of Reason analysis will not always or almost always condemn them.[63] Indeed, given the breadth with which the Court defines "anticompetitive," it is the second portion of this test that saves most restrictions on rivalry from automatic condemnation and thus determines whether a particular type of restraint is unreasonable *per se*.[64]

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[62]*See NCAA,* 468 U.S. at 102 (finding that various horizontal restrictions on rivalry between member schools could help create a distinctive product and thus be "procompetitive"); *Maricopa Medical Society,* 457 U.S. at 357 (noting that doctors that formed a clinic "would have the type of partnership in which a price-fixing agreement among the doctors would be perfectly proper."); *National Society of Professional Engineers*, 435 U.S. at 688-89 (stating that courts have historically sustained covenants ancillary to the sale of a business as reasonable because "[t]he long-run benefit of enhancing the marketability of the business itself — and thereby providing incentives to develop such an enterprise — outweighed the temporary and limited loss of competition."); *Broadcast Music Inc.*, 441 U.S. at 9 ("When two partners set the price of their goods or services they are literally 'price fixing,' but they are not in per se violation of the Sherman Act."); *id.* at 23 ("Not all arrangements that have an impact on price are *per se* violations of the Sherman Act or even unreasonable restraints. Mergers among competitors eliminate competition, including price competition, but they are not illegal *per se*, and many of them withstand attack under any existing antitrust standard."); *Sylvania*, 433 U.S. at 51-57 (refusing to apply *per se* rule to restraints that limited intrabrand rivalry because such restrictions could enhance interbrand rivalry); Appalachian Coals, Inc. v. United States, 288 U.S. 344, 360-61 (1933) ("The mere fact that the parties to an agreement eliminate competition between themselves is not enough to condemn it . . . . The familiar illustrations of partnerships, and enterprises fairly integrated in the interest of the promotion of commerce, at once occur."); *Addyston Pipe*, 85 F. at 280 ("When two men became partners in a business, although their union might reduce competition, this effect was only an incident to the main purpose of a union of their capital, enterprise, and energy to carry on a successful business, and one useful to the community. Restrictions in the articles of partnership upon the business activity of the members, with a view toward securing their entire effort in the common enterprise, were, of course, only ancillary to the main end of the union, and were to be encouraged.").

[63]*See Broadcast Music, Inc.*, 441 U.S. at 23-24. *Cf. Khan*, 522 U.S. at 10 (*per se* condemnation only appropriate when Rule of Reason analysis will always or almost always condemn a contract).

[64]*See* 7 AREEDA, ANTITRUST, ¶ 1509, p. 414 ("classifying conduct as falling within the *per se* category depends on the presence or absence of redeeming virtues.").

One may wonder at this point why *any* type of contract is ever unreasonable *per se*. After all, a determination whether a restriction is "undue" or not would seem to require a case-by-case exercise of judgment. Moreover, one can always attribute some "benefit" or "redeeming virtue" to a particular contract, no matter how harmful it might seem. Indeed, much regulation consists of coercive restrictions that mandate prices or output different from what a "free" market would produce.[65] Nonetheless, the Sherman Act does not recognize the same breadth of justifications for contractual restrictions on trade that the Constitution tolerates where legislative interference is concerned.[66] More precisely, proponents of a private restraint that restricts competition cannot avoid *per se* treatment by arguing that the reduction in competition produces non-economic benefits that somehow outweigh the agreement's economic effects.[67] While states can decide that enforcing a raisin cartel is wise public policy, grape growers cannot "justify" a cartel by arguing that society is better off if the cartelists receive a supra-competitive return on their investment.[68] Thus, a purported

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[65]*See* West Coast Hotel v. Parrish, 300 U.S. 379 (1937) (sustaining statute setting minimum wage against due process challenge); Nebbia v. New York, 291 U.S. 502 (1934) (sustaining state statute setting minimum resale price of milk); New State Ice Company v. Liebman, 285 U.S. 262, 280-311 (1935) (Brandeis, J. dissenting) (recounting various purported benefits of entry restrictions). *Cf.* Dr. Miles Med. Co. v. John D. Park & Sons, 220 U.S. 373 (1911) (minimum resale price maintenance an unreasonable restraint of trade).

[66]*Cf.* Williamson v. Lee Optical, 348 U.S. 483, 491 (1955) (sustaining Oklahoma statute prohibiting opticians from fitting or duplicating lenses without a prescription from an ophthalmologist).

[67]*See Superior Court Trial Lawyers Ass'n,* 493 U.S. at 424; *National Society of Professional Engineers*, 435 U.S. at 692 (purpose of analysis under Section 1 of the Sherman Act is "not to decide whether a policy favoring competition is in the public interest or in the interest of the members of an industry."); *id* at 689-91, nn. 16-17. Indeed, even where Congress has itself exempted a particular industry or activity from the antitrust laws, courts read such "exceptions . . . narrowly, with beady eyes and green eye shades." Chicago Professional Sports Ltd. Partnership. v. N.B.A., 961 F.2d 667, 672 (7th Cir. 1992); Group Life & Health Ins. Co., v. Royal Drug Co., 440 U.S. 205, 231 (1979).

[68]*Compare* Parker v. Brown, 317 U.S. 341 (1943) (state-created raisin cartel that restrained interstate commerce is beyond the scope of the Sherman Act) *with National Society of Professional Engineers*, 435 U.S. at 689-90 (private parties cannot justify restraints on the ground that competition is itself unreasonable

virtue is only "redeeming" if it serves a "legitimate" purpose, that is, does not depend on the exercise of market power.[69] Put another way, a restraint is "procompetitive" if it affects productive activity in a manner that enhances the welfare of consumers.[70] Defendants cannot avoid *per se* condemnation of an "anticompetitive" restraint by arguing that rivalry is itself unreasonable.[71]

Ultimately, then, any determination of whether a restraint falls into the *per se* category or merits further analysis under the Rule of Reason requires an assessment of any justifications proffered by the proponents of a restraint. That is to say, once a plaintiff has shown that a restraint limits "competition," *i.e.*, rivalry between the parties, the tribunal must determine whether any justification proffered by the defendants is "cognizable," that is, constitutes the sort of "virtue" that

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in a particular industry). *See also Addyston Pipe*, 85 F. at 282-83.

[69] *See National Society of Professional Engineers*, 435 U.S. at 690-91, nn. 16-17 (concluding that *Standard Oil* limits courts to consideration of competitive impact of restraints); *see also NCAA*, 468 U.S. at 104 ("Under the Sherman Act the criterion to be used in judging the validity of a restraint on trade is its impact on competition."); *American Tobacco*, 221 U.S. at 179 (Sherman Act does not "restrain the power to make normal and usual contracts to further trade"); *Joint Traffic*, 171 U.S. at 568 (Act does not reach an agreement "for the purpose of promoting the legitimate business of an individual or corporation."); Bork, *The Rule of Reason and the Per Se Concept*, 74 YALE L. J. at 805 ("It should be emphasized that [*Standard Oil*'s Rule of Reason] was phrased wholly in economic terms, giving no evidence of concern for competing values."). *See also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 12-17 (1998) (explaining distinction between total social wealth and total social utility).

[70] *See* nn. ___, *supra* and accompanying text (*Standard Oil* rests on desire to thwart "consequences of monopoly" that harm consumers). *See also*, *e.g.*, *Khan*, 522 U.S. at 14-16 (treating as "procompetitive" propensity of contract to result in lower consumer prices); FTC v. Indiana Federation of Dentists, 476 U.S. 447, 460 (1986) (treating"the creation of efficiencies in the operation of a market or the provision of goods and services" as a "procompetitive virtue"); *NCAA*, 468 U.S. at 113-14 (equating "procompetitive efficiencies" with reduction in consumer prices).

[71] *See National Society of Professional Engineers*, 435 U.S. at 689-90. *See also Addyston Pipe*, 85 F. at 282-83 (*dicta*); United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 220-22 (1940); *Joint Traffic*, 171 U.S. at 575-77; *Standard Oil*, 221 U.S. at 65 (under the Rule of Reason, restraints of trade can "not be taken out of that category [of undue restraints] by indulging in general reasoning as to the expediency or non-expediency of having made the contracts, or the wisdom or want of wisdom of the statute which prohibited their being made."). *Cf. Socony-Vacuum Oil Co.*, 310 U.S. at 170-72 (describing state and federal regulation designed to combat evils of destructive competition).

the Sherman Act recognizes as "redeeming" or "legitimate." Such an analysis does not entail any assessment of the factual basis of the purported justification. Instead, the step consists of a sort of relevance inquiry, that is, a determination whether, if proved, the justification offered by the defendants would tend to enhance the welfare of consumers, thus rebutting any presumption that the restriction on competition is "undue."[72] The body of law distinguishing restraints that are unreasonable *per se* from those that are not consists in large part of a series of conclusions about whether various proffered justification are "cognizable" in this sense, determinations that depend in part on economic theory's best evaluation of the causes and consequences of such restraints.[73] Absent such a justification, it seems safe to assume that the defendants—who have spent resources negotiating and enforcing an agreement that eliminates rivalry without producing any cognizable benefits—believe they have or will soon have the market power necessary to injure consumers, *i.e.*, to produce monopoly or its consequences.[74] Thus, such restraints are always or almost always

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[72]*See* Thomas G. Krattenmaker, *Per Se Violations in Antitrust Law: Confusing Offenses With Defenses*, 77 Geo. L. J. 165, 172-73 (1988); *National Society of Professional Engineers*, 435 U.S. at 386 (describing district court's refusal to make findings regarding whether competition unregulated by the restraint would have resulted in inferior engineering services); *id.* at 693-96 (affirming district court's decision in this regard); *Topco*, 405 U.S. at 705 (noting that district court found defendants' market position as well as the benefits of the restraint "relevant" to its analysis); *id.* at 606-12 (reversing district court's decision to consider evidence that challenged restraint enhanced inter-brand competition).

[73]*See* Krattenmaker, *Per Se Violations In Antitrust Law,* 77 GEO. L. J. at 172-73; HOVENKAMP, FEDERAL ANTITRUST POLICY, at 254 ("the label 'illegal per se' entails that certain justifications or defenses will not be permitted"). *See also* nn. ___, *infra* and accompanying text (showing that changes in economic theory have resulted in changed judicial conclusions about whether certain justifications were cognizable).

[74]*See Superior Court Trial Lawyers*, 493 U.S. at 435, n. 18 ("'Very few firms that lack power to affect market prices will be sufficiently foolish to enter into conspiracies to fix prices. Thus, the fact of agreement defines the market.'") (*quoting* ROBERT BORK, THE ANTITRUST PARADOX, 269 (1978)); *Joint Traffic*, 171 U.S. at 569 (contending that price fixing agreement must "maintain [ ] rates above what competition might produce" because "if it did not do that, its existence would be rescinded or abandoned"); Summit Health, Ltd. v. Pinhas, 500 U.S. 322, 339 (1991) (Scalia, J. dissenting) (existence of naked horizontal price fixing agreement itself defines contours of the relevant market and suggests that the defendants possess market power); *Addyston Pipe*, 85 F. at 282-83 ("where the sole object of both parties in making the contract

"undue," with the result that *per se* condemnation is appropriate.[75] If, however, a defendant can proffer such a justification, the *per se* rule does not apply, and courts examine the restraint under the Rule of Reason.

C. *The Second Step — The Rule of Reason:*

Under current law at least, defendants are able to proffer cognizable benefits for most restraints.[76] Such proffers obviate application of the *per se* rule and mandate a full Rule of Reason analysis. While the Supreme Court has declined to specify the precise method of such an analysis, it has provided some general guidance, guidance supplemented by the Court's pronouncement in the *per se* context. According to the Court, tribunals conducting a Rule of Reason analysis must "weigh" all of the relevant facts and circumstances and thereby determine whether, in the Court's words, the restraint in question "destroys competition," and thus works consumer harm or instead merely "regulates," "promotes," or "furthers" competition, to the benefit of consumers.[77] Such

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as expressed therein is merely to restrain competition, and enhance and maintain prices, it would seem that there was nothing to justify or excuse it, then it would necessarily have a tendency toward monopoly, and therefore would be void."); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 256 ("a naked agreement is rational only on the premise that the participants have market power."); 7 AREEDA ANTITRUST, ¶ 1506 ("The defendants are in the best position to suggest the benefits that might flow from their activities. If they fail to suggest any, the court is entitled to assume there are none.").

[75] *See* nn. ____, *supra* and accompanying text (Sherman Act forbids as "undue restraints" those contracts that produce monopoly or its consequences).

[76] *See* nn. ___, *infra*.

[77] *See Business Electronics,* 485 U.S. at 723 ("Under [the Rule of Reason] the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition")*, quoting Sylvania*, 433 U.S. at 49; *National Society of Professional Engineers*, 435 U.S. at 691 ("the inquiry mandated by the Rule of Reason is whether the challenged agreement is one that promotes competition or one that suppresses competition."); *Chicago Bd. of Trade*, 246 U.S. at 238 ("The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.") (*quoted* in *Sylvania*, 433 U.S. at 49).

weighing, in turn, requires courts to determine whether the harmful effects of a restraint, if any, outweigh any redeeming virtues.[78]

The Court's injunction to "weigh" "all the circumstances of a case" begs several questions about what form such "weighing" should take. Someone must produce evidence of what those circumstances are, and courts must evaluate such evidence by assigning burdens of proof. After all, the plaintiff's *assertion* that a contract produced actual harm is just that, an assertion. At the same time, defendants' *proffer* of cognizable "procompetitive" benefits, while sufficient to avoid *per se* condemnation, is not *proof*. The nature of the adversary system therefore begs three related questions. First, what, if anything, must a plaintiff show to make out a *prima facie* case? Second, if a plaintiff does establish such a case, what must defendants proffer or even show to rebut it and avoid judgment? Third, if the defendants rebut a *prima facie* case and thus avoid judgment, how should courts go about "weighing" the facts and circumstances of a case? As shown below, the Supreme Court has provided a definitive answer to the second question, while strongly suggesting answers to the first and third. Taking their cues from the High Court, lower courts, leading scholars and the enforcement agencies have answered each of these questions for themselves, and the result has been a common Rule of Reason test with three main elements.

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[78] *See NCAA*, 468 U.S. at 113-15 (examining whether proffered procompetitive efficiencies offset restraint's anticompetitive consequences); *Sylvania*, 433 U.S. at 57, n. 27 (rejecting assertion that courts are incapable of "balancing intrabrand and interbrand competitive effects of vertical restrictions"); *see also*, *e.g.*, Law v. NCAA, 134 F.3d 1010, 1019 (10th Cir. 1998) (ultimately under the Rule of Reason "the harms and benefits must be weighed against each other in order to judge whether the challenged behavior is, on balance, reasonable.") (*citing* AREEDA, 7 ANTITRUST LAW at ¶ 1502, p. 372). Capital Imaging v. Mohawk Valley Medical Association, 996 F.2d 537, 543 (2d Cir. 1993) (under the Rule of Reason "the factfinder weighs the harms and benefits of the challenged behavior"); 7 AREEDA ANTITRUST ¶ 1500, p. 362-63 (Rule of Reason analysis calls for balancing); *id.* at ¶ 1502, p. 372 (same); *id.* at ¶ 1507 (same); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 257-58 (same).

1. *Prima Facie* Case

As noted above, proof that a contract limits rivalry between parties to it gives rise to a presumption that the arrangement restricts competition unduly and thus reflects an exercise of market power. Absent a plausible assertion that the restraint produces cognizable benefits, this presumption survives, and courts declare the arrangement unlawful *per se*.[79] One could imagine a similar approach under the Rule of Reason, under which proof of the restraint would itself cast upon defendants a burden of producing evidence that their arrangement produces cognizable benefits, the absence of which would establish the existence of harm.[80]

While the Supreme Court has not squarely addressed this question, lower courts have uniformly held that plaintiffs must make some threshold showing of what courts call "anticompetitive harm" over and above the mere existence of a contract that is "anticompetitive" as courts employ that term in *per se* analysis.[81] Such a showing establishes a *prima facie* case which,

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[79] *See* nn. ____, *supra* and accompanying text.

[80] *See* nn. ____, *supra* (discussing judicial assumption that absence of cognizable benefits suggests that restraint on rivalry harms consumers).

[81] *See* Carrier, *The Real Rule of Reason*, 1999 B.Y.U. L. REV. at 1268 (lower courts uniformly require proof of anticompetitive harm before requiring defendants to adduce evidence of benefits). Some have read *NCAA* to provide that the mere existence of an explicit restraint on price or output casts upon the defendant some burden of justification. *See NCAA,* 468 U.S. at 109 ("when there is an agreement not to compete in terms of price or output, 'no elaborate industry analysis is required to demonstrate the anticompetitive character of such an agreement.'"); *California Dental Association*, 526 U.S. at 770 (apparently reading *NCAA* in this manner) (*dicta*); Chicago Professional Sports Ltd. Partnership v. National Basketball Ass'n, 961 F.2d 667, 674 (7th Cir. 1992) (reading this passage to hold that any agreement on price or output required some justification). However, this passage followed the court's endorsement of the district court's findings that the restraint actually reduced output and raised prices, *see NCAA*, 468 U.S. at 104-108. Thus, some scholars have argued that the Court did not in fact mean to dispense with the requirement that plaintiffs prove some anticompetitive harm beyond the mere existence of the restraint to establish a *prima facie* case. *See* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 262; 7 AREEDA ANTITRUST LAW, ¶ 1511, pp. 433-434; *see also* Law v. NCAA, 134 F.3d 1010, 1020 (10th Cir. 1998). *See generally* Meese, *Farewell To The Quick Look*, 68 Antitrust L. J. 461, 463 (2000) (describing alternate readings of *NCAA*).

if not rebutted, entitles the plaintiff to judgment.[82] A requirement that plaintiffs make such a threshold showing reflects *Standard Oil*'s normative assumption that, without more, a mere restriction on parties' freedom of action does not constitute a cognizable antitrust harm.[83] A contrary approach, *i.e.*, a requirement that defendants adduce evidence of benefits in each and every Rule of Reason case, would reflect undue hostility toward private contracts, the very activity the Sherman Act is supposed to promote.[84] Economic logic also compels such a requirement. For, once the defendants have identified a valid procompetitive objective for the restraint, thus avoiding *per se* condemnation, mere proof that the arrangement restricts rivalry cannot give rise to a presumption of tangible anticompetitive *effect*, since such a restriction is at least equally consistent with a conclusion that the arrangement is a "normal" or "usual" method of furthering trade.[85] Absent some threshold showing of actual harm, then, courts properly leave assessment of such arrangements to the marketplace.[86]

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[82]*See* Capital Imaging v. Mohawk Valley Medical Ass'n, 996 F.2d 537, 543 (2d Cir. 1993); 7 AREEDA, ANTITRUST LAW ¶1502, at 371 (1986).

[83]*See* nn. ____, *supra* and accompanying text. *See also* Meese, *Liberty and Antitrust In The Formative Era*, 79 B. U. L. REV. at 34-80 (formative era state and federal courts repeatedly rejected claims that contractual restriction on freedom of action constituted a cognizable antitrust harm); Bork, *Rule of Reason* 74 YALE. L. J. at 804 (*Standard Oil*'s "test phrased in wholly economic terms").

[84]*See Standard Oil*, 221 U.S. at 61-62.

[85]*See* Matsushita Elec. Indus. Corp. v. Zenith Radio Corp., 475 U.S. 574, 587-95 (1986) (noting that evidence that is as consistent with procompetitive as with anticompetitive objectives cannot, without more, support an inference of anticompetitive conduct); Monsanto Co. v. Spray-Rite, 465 U.S. 752, 761-64 (1984) (same); First Nat'l Bank v. Cities Serv. Co., 391 U.S. 253, 279-80 (1968) (same). *See also* Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 466-67 (1992) ("[l]egal presumptions that rest on formalistic distinctions rather than actual market realities are generally disfavored in antitrust law.").

[86]*Capital Imaging*, 996 F.2d at 547 ("justifications are unnecessary where [plaintiff] has not carried its own initial burden of showing a restraint on competition."); Consultants & Designers, Inc. v. Butler Service Group, Inc., 720 F.2d 1553, 1560 (11th Cir. 1983). *See also* Carrier, *The Real Rule of Reason*, 1999 B.Y.U. L. REV. at 1308-14 (analysis of legislative history of the Sherman Act supports requirement of

a. *The Market Power Filter*

While all lower courts agree that a plaintiff must make some threshold showing that a contract produces tangible economic harm, there is disagreement about just what form such a showing must take. Led by the Seventh Circuit, a diminishing number of courts now hold that a plaintiff must first prove that the proponent of a restraint possesses market power of the sort necessary to harm competition and thus consumers in the manner that the plaintiff alleges.[87] Such a showing involves proof of market structure similar to that which plaintiffs must make when challenging mergers and must include proof of the boundaries of a relevant market, the defendants'

threshold proof of anticompetitive harm); *id.* at 1558 (this requirement is "beyond debate"). It should be noted that some scholars believe that the mere existence of some restraints should give rise to a burden of justification. *See, e.g.*, John J. Flynn, *The "Is" and "Ought" of Vertical Restraints After Monsanto Co. v. Spray-Rite Service Corp.*, 71 CORNELL L. REV. 1095, 1143-46 (1986). These scholars believe that contractual restraint of individual "freedom" is itself a cognizable antitrust harm, separate and apart from any effect such contracts might have on consumers. Thus, mere proof that a contract restrains a dealer's discretion, for instance, gives rise to a presumption of harm according to these scholars. *See* Alan J. Meese, *Price Theory And Vertical Restraints: A Misunderstood Relation*, 45 UCLA L. REV. 143, 176-83 (1997) (discussing so-called "Populist" approach to vertical restraints). Such an approach is of course inconsistent with *Standard Oil.*

[87]*See, e.g.*, L.A.P.D., Inc. v. General Electric Corporation, 132 F.3d 402, 405 (7th Cir. 1997) (Easterbrook, J.); Chicago Professional Sports Ltd. v. National Basketball Ass'n, 95 F.3d 593, 600 (7th Cir. 1996) (Easterbrook, J.); Rothery Storage v. Atlas Van Lines, Inc., 792 F.2d 210, 217-21 (Bork, J.); Ball Memorial Hospital, Inc. v. Mutual Hospital Insurance, 784 F.2d 1325, 1334-35 (7th Cir. 1986) (Easterbrook, J.); Polk Bros., Inc. v, Forest City Enterprises, 776 F.2d 185, 191 (7th Cir. 1985) (Easterbrook, J.); Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742, 745 (7th Cir. 1982) (Posner, J.).

position therein, and the presence of barriers to entry.[88] In these circuits, failure to establish market power undermines the plaintiff's *prima facie* case and requires dismissal of the claim.[89]

b. *The Supreme Court Demurs:*

Nonetheless, courts that make a showing of market power a necessary condition in proof of a Rule of Reason claim are swimming against the tide. Most notably, the Supreme Court has declined to apply the market power filter in each Rule of Reason case it has entertained while at the same time suggesting an alternate method of establishing "anticompetitive harm" of the sort necessary to give rise to a *prima facie* case. In reasoning that seems to apply beyond the individual cases in question, the Court has suggested that proof of "actual detrimental effects" should suffice to establish a *prima facie* case, regardless whether structural indicia suggest that the defendants possess market power.

Consider first NCAA v. Board of Regents.[90] There the Court evaluated an agreement among the NCAA's member schools limiting the price and output of televised college football games. The Court rejected the claim that the arrangement was unlawful *per se* merely because it

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[88] *See, e.g., Valley Liquors*, 678 F.2d at 745 (plaintiff must establish relevant product and geographic market to prove market power.); *Ball Memorial Hosp., Inc.*, 784 F.2d at 1335-36 (absence of barriers to entry defeats Rule of Reason claim regardless of defendants' market share); *Rothery Storage*, 792 F.2d at 217-21 (plaintiff's failure to establish the existence of any market in which the defendants played a significant role doomed Rule of Reason challenge); *id.* at 230 (noting that "[M]erger policy has always proceeded by drawing lines about allowable market shares . . . . We can think of no good reason not to apply the same inferences to [defendants'] ancillary restraint."). *See also* 1992 Department of Justice and Federal Trade Commission Joint Merger Guidelines, §§ 1-3; FTC V v. Tenet Health Care Corp., 186 F.3d 1045, 1051-54 (8th Cir. 1999) (failure to establish concentration in properly defined market undermines *prima facie* case); New York v. Kraft Gen. Foods, Inc., 926 F. Supp. 321, 361-63 (S.D. N.Y. 1995) (same).

[89] *See, e.g., Ball Memorial Hospital,* 784 F.2d at 1335 ("Firms without market power bear no burden of justification."); *Polk Bros.*, 776 F.2d at 191; *Rothery Storage*, 792 F.2d at 217-21.

[90] 468 U.S. 85 (1984).

purported to limit rivalry on price and output.[91] As the Court saw things, some limit on "competition" was necessary to create the relevant product — college football — in the first place.[92] For instance, reliance upon an unbridled market would lead member schools to compete for players by paying them salaries or waiving any requirement that they attend class, thus undermining an essential feature of the product in question — amateurism.[93]

Having declined to apply the *per se* rule, the Court turned to an application of the Rule of Reason. Relying upon the district court's findings of fact, the Court concluded that the NCAA's arrangement had resulted in output and prices for the Association's product — televised college football games — different from what a "free market" would have produced.[94] This, the Court said, was exactly the sort of effect that constituted a harm under *Standard Oil*'s articulation of the Rule of Reason and thus cast upon the defendants a burden of justification.[95]

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[91] *See* nn. ___, *supra* and accompanying text (courts deem such a limitation to be "anticompetitive" for purpose of the *per se* rule).

[92] *See NCAA*, 468 U.S. at 101-103.

[93] The Court noted, for instance, that some agreement not to pay players a salary was necessary to create amateur football. *See id.* at 102 ("In order to preserve the character and quality of the "product," athletes must not be paid, must be required to attend class, and the like. And the integrity of the "product" cannot be preserved except by mutual agreement.").

[94] *See NCAA*, 468 U.S. at 105 ("The District Court found that if member institutions were free to sell television rights, many more games would be shown on television, and that the NCAA's output restriction has the effect of raising the price the networks pay for television rights."); 106-107 ("The anticompetitive consequences of this arrangement of this arrangement are apparent. . . . Price is higher and output is lower than they would otherwise be, and both are unresponsive to consumer preference."); *id.* at 106, n. 30 (quoting district court finding that "Clearly the NCAA controls grossly distort the prices actually paid for an individual game from that to be expected in a free market.").

[95] *See NCAA*, 468 U.S. at 107-108 ("A restraint that has the effect of reducing the importance of consumer preference in setting price and output is not consistent with [consumer welfare]. Restrictions on price and output are the paradigmatic examples of restraints of trade that the Sherman Act was intended to prohibit."), *citing Standard Oil*, 221 U.S. at 52-60; *id.* at 113 ("the NCAA television plan on its face constitutes a restraint upon the operation of a free market, and the findings of the District Court establish that

Having found the existence of what it deemed anticompetitive harm, the Court then turned to defendants' argument that proof of market power was nonetheless necessary to establish a *prima facie* case under the Rule of Reason. The Court rejected this argument for two reasons: one "legal" and one "factual."[96] As an initial "legal" matter, the Court claimed that the restraint in question, while not unlawful *per se*, was nonetheless a "naked restraint on price and output, and thus presumptively harmful."[97] Invoking Professor Areeda and the views of the Solicitor General, the Court asserted that no detailed market analysis was needed under these circumstances to cast on the defendant a burden of justification.[98] Quoting language from the Solicitor General's brief, the Court suggested that an assessment of market power was only one method of ascertaining competitive effects in Rule of Reason litigation, a method that courts could discard whenever the plaintiff had demonstrated anticompetitive effects through other means.[99] This reasoning, of course, applied well

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it has operated to raise prices and reduce output. Under the Rule of Reason, these hallmarks of anticompetitive behavior place upon petitioner a heavy burden of establishing an affirmative defense which competitively justifies this apparent deviation from the operations of a free market.").

[96]*NCAA,* 468 U.S. at 109 ("we must reject this argument for two reasons: one legal, and one factual.").

[97]*See NCAA*, 408 U.S. at 109.

[98]*See NCAA*, 468 U.S. at 109 ("where there is an agreement not to compete in terms of price or output, 'no elaborate industry analysis is required to demonstrate the anticompetitive character of the agreement."), *quoting Professional Engineers*, 435 U.S. at 692, *citing* P. AREEDA*,* THE RULE OF REASON IN ANTITRUST ANALYSIS: GENERAL ISSUES 37-38 (1981).

[99]*NCAA*, 468 U.S. at 110, n.42. In particular, the Court quoted the Solicitor General's assertion that:

> "While the reasonableness of a particular alleged restraint often depends on the market power of the parties involved, because a judgment about market power is the means by which the effects of the conduct on the marketplace can be assessed, market power is only one test of 'reasonableness.' And where the anticompetitive effects of conduct can be ascertained through means short of extensive market analysis, and where no countervailing competitive virtues are evident, a lengthy analysis of market power is not necessary."

beyond the context of the restraint in question, to any analysis under the Rule of Reason. At any rate, the Court said, the district court had found as a factual matter that the defendants did have market power, because broadcasts of college football were a distinct product for which there were no reasonable substitutes.[100]

Just two years later, in F.T.C. v. Indiana Federation of Dentists, the Court again addressed the requirement for establishing a *prima facie* case under the Rule of Reason. There the Justices faced an agreement between dentists in certain Indiana localities not to provide X-rays to their patients' insurers.[101] While the Court declined to hold the agreement unlawful *per se*, the Justices rejected the Federation's assertion that proof of market power was necessary to establish a case under the Rule of Reason. In so doing, the Court emphasized that the Commission had found the presence of "actual, sustained adverse effects on competition."[102] In particular, the Commission had found that insurers were unable to secure compliance with their requests for X-rays from dentists that were parties to the restraint.[103] In areas not subject to such an agreement, by contrast, insurers had little difficulty obtaining compliance with their requests.[104] Given this finding that the agreement among the Federation's members had actually affected the terms of trade, the Court said, there was

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See NCAA, 468 U.S. at 110, n. 42, *quoting* Brief of the United States as Amicus Curiae, at 19-20 (footnote and citation omitted).

[100]*See NCAA*, 468 U.S. at 111-112.

[101]See 476 U.S. 447 (1986).

[102]*Indiana Federation of Dentists*, 476 U.S. at 461.

[103]*See Indiana Federation of Dentists*, 476 U.S. at 460-61.

[104]*Id.* at 456 (noting evidence that "outside of Indiana, in states where dentists had not collectively refused to submit x rays, insurance companies found little difficulty in obtaining compliance by dentists with their requests.").

no reason to go further. Quoting the leading treatise on Antitrust, authored by Professor Areeda, the Court claimed that proof of market power was simply "a 'surrogate for detrimental effects, and that proof of the latter was sufficient to establish a *prima facie* case.'"[105]

Of course, both *NCAA* and *Indiana Federation of Dentists* involved horizontal restraints, leaving open the possibility that the Court might apply the market power filter to vertical arrangements. Neither decision, however, purported to limit its endorsement of the "detrimental effects" test to the horizontal context; both quoted and relied on sources that contained no such limitation.[106] Moreover, each defined as "free" the market that had existed before the restraints, and each stated that market power was simply one vehicle for determining whether, in fact, the restraint produced results different from what a "free" market would otherwise have generated.[107]

At any rate, even in the vertical context, the Court has declined the opportunity to employ a market power filter, thus implying that proof of direct effects may suffice to establish a *prima facie* case. In Continental T.V. v. GTE Sylvania, for instance, the Court held that courts should analyze non-price vertical restraints under the Rule of Reason.[108] In so doing, however, it

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[105]*See Indiana Federation of Dentists*, 476 U.S. at 460-61, *quoting* AREEDA, 7 ANTITRUST LAW, ¶ 1511, p. 429.

[106]*See Indiana Federation of Dentists*, 476 U.S. at 460-61, *quoting* AREEDA, 7 ANTITRUST LAW, ¶ 1511, p. 429. *NCAA*, 468 U.S. at 110-111 (quoting Brief Amicus Curiae For The United States, at 19-20). It should be noted that Professor Areeda subsequently embraced a different test, albeit not a market power filter, for certain non-price vertical restraints. *See* 8 AREEDA, ANTITRUST LAW ¶¶ 1648-1649C (1989). *See* n. ___, *infra* (discussing Professor Areeda's approach to establishing a *prima facie* case for vertical territorial and customer limitations). *See also* Patterson, *Market Power In Rule Of Reason Cases*, 37 San Diego L. Rev. at 8-9 (suggesting that rationale of these decisions may apply with equal or greater force in the vertical context).

[107]*See* nn. ___, *supra* and accompanying text; *NCAA*, 468 U.S. at 113 (stating that "the NCAA television plan on its face constitutes a restraint upon the operation of a free market").

[108]*See* 433 U.S. 36, 38-39, 59 (1978).

indicated that reduction in "intrabrand competition" *i.e.*, competition in the sale of the manufacturer's own product, was an anti-competitive effect, and remanded the case to the lower courts for further analysis, even though the defendant's share of the relevant market was only 5%.[109] Moreover, in Jefferson Parish Hosp. Dist. No. 2 v. Hyde, the Court declined to declare a tying contract unlawful *per se* because the defendant's market share was insufficient to establish market power but nonetheless went on to analyze the arrangement under the Rule of Reason.[110] The Court concluded that the plaintiff had not carried its burden because it had not shown that the arrangement affected the price or quality of the tied product.[111]

c. *An Alternative Approach: The Actual Detrimental Effects Test*

Not surprisingly, most lower courts, the enforcement agencies and several leading scholars have rejected the market power screen proposed by the Seventh Circuit.[112] Echoing *Indiana*

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[109] *See id.* at 51-52. *See also* Continental T.V. v. G.T.E. Sylvania, 694 F.2d 1132 (9th Cir. 1982) (analyzing arrangement on remand without applying market power filter).

[110] *See* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 29-31 (1985).

[111] *See id.* at 30-31, n. 52 ("The record simply tells us little if anything about the effect of this arrangement on price or quality of anesthesiological services. As to price, the arrangement did not lead to an increase in the price charged to the patient. As to quality, the record indicates little more than that there have never been any complaints about the quality of [the defendant's] services, and no contention that his services are in any respect inferior to those of the plaintiff.").

[112] *See, e.g.* Re/Max International, Inc. v. Realty One, Inc., 173 F.3d 995, 1014-1015 (6th Cir. 1999) (proof of market power is not necessary to establish a *prima facie* case), *citing Indiana Federation of Dentists*; Law v. NCAA, 134 F.3d 1010, 1019-20 (10th Cir. 1998) (same); Levine v. Central Florida Med. Affiliates, inc., 72 F.3d 1538, 1551-52 (11th Cir. 1996) (same); K.M.B. Warehouse v. Walker Mfg. Co., 61 F.3d 123, 129 (2d Cir. 1995) (same) (*citing Indiana Federation of Dentists*); United States v. Brown University, 5 F.3d 658, 668 (3d Cir. 1993) (same) (*citing Indiana Federation of Dentists*); Flegel v. Christian Hospital, Northeast-Northwest, 4 F. 3d 682, 688 (8th Cir. 1993)(same), *citing Indiana Federation Of Dentists*); Department of Justice And Federal Trade Commission Guidelines For Collaborations Among Competitors, ¶ 3.3 (2000) ("Competitor Collaboration Guidelines"); PHILLIP E. AREEDA, 7 ANTITRUST LAW ¶ 1511 (1986); SULLIVAN AND GRIMES, LAW OF ANTITRUST, AT 210-12 (approving *NCAA*'s rejection of market power inquiry given proof of increased prices); HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE, 256 (1998). To be sure, Professor Areeda opined that

Federation of Dentists and Professor Areeda, these judges, officials and scholars all conclude that plaintiffs should be able to establish a *prima facie* case simply by showing that the restraint in question produces "actual detrimental effects," such as a reduction in output or quality or an increase in price.[113] Such proof, it is said, establishes a presumption of "anticompetitive harm," thus giving rise to a *prima facie* case.[114] These scholars, jurists and officials do not question the normative or

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"plaintiffs must ordinarily allege and prove the market that is allegedly restrained and that the defendants occupy a sufficient role in that market to restrain competition there." 7 AREEDA, ANTITRUST LAW, at ¶ 1507b, p. 397. He did not, however, suggest that proof of market power was a legal *requirement* but instead claimed that plaintiffs would have difficulty proving actual detrimental effects and thus would often be forced to turn to proof of market power as a surrogate for such effects. *See id.* at ¶ 1503, p. 376.

It should be noted that Professor Areeda did not confine his support for the "actual detrimental effects" test to those instances in which the defendants obviously possessed market power. For instance, he endorsed application of this test in *NCAA*, where the definition of the relevant market was hotly contested. *See* 7 AREEDA, ANTITRUST LAW, ¶ 1511 at 432-34. *Cf.* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 262 (conceding that resolution of the market power question in *NCAA* is "indeterminate"); Frank H. Easterbrook, *Ignorance and Antitrust*, 119, 124-26 *reprinted* in ANTITRUST, INNOVATION AND COMPETITIVENESS (Thomas M. Jorde & David J. Teece eds. 1992) (suggesting that televised college football does not constitute a relevant market).

[113] *See, e.g.*, *Re/Max International,* 173 F.3d at 1014-15 (proof that practice raised commissions paid by the plaintiff established *prima facie* case and shifted burden of production to the defendants); *Law*, 134 F.3d at 1020 (finding anticompetitive effect sufficient to establish *prima facie* case where challenged agreement produced salaries different from those that preceded restraint); *Levine*, 72 F.3d at 1551-52; *K.M.B. Warehouse*, 61 F.3d at 129 ("If a plaintiff can show an actual adverse effect on competition, such as reduced output, we do not require a further showing of market power"); *Brown University*, 5 F.3d at 668 ("The plaintiff may satisfy [its initial burden of proof under the Rule of Reason] by proving the existence of actual anticompetitive effects such as reduction in output, increase in price, or deterioration in the quality of goods and services."); *Flegel,* 4 F.3d at 688-89 (proof that restraint reduced quality would establish "actual detrimental effect" and thus give rise to a *prima facie* case); *Competitor Collaboration Guidelines*, § 3.3; HOVENKAMP, FEDERAL ANTITRUST POLICY, at 256, n. 25 ("Detrimental effects include observed decreases in output, an observed increase in price coordination, or exclusion from the market of firms that seem to be competitive entrants.").

[114] *See, e.g. Re/Max Intern.*, 173 F.3d at 1014-15 (plaintiff's showing that defendants' practices increased its real estate commissions established *prima facie* case); *Law*, 134 F.3d at 1020 (finding anticompetitive effect sufficient to establish *prima facie* case where challenged agreement produced salaries different from those that preceded restraint); Hairston v. Pacific 10 Conference, 101 F.3d 1315, 1319 (9th Cir. 1996) (proof that athletic conference excluded plaintiff from bowl competition sufficed to establish a *prima facie* case); J. F. Feeser, Inc. v. Serve-A-Portion, Inc., 909 F.2d 1524, 1542-43 (1990) (plaintiff established a *prima facie* case by showing that a supply contract raised the price of defendant's competitors). *Cf. Levine*, 72 F.3d at 1551-52 (finding that plaintiff did not make out a *prima facie* case where other factors

theoretical basis for the market power screen. None questions the premise that "consumer welfare" should be the sole objective of the antitrust laws, as *Standard Oil* held.[115] All also agree that, as a matter of economic theory, the possession of market power is a *sine qua non* of consumer harm.[116] Still, proponents of a "detrimental effects" route to a *prima facie* case argue that market definition is an uncertain and expensive process, subject to a high rate of error.[117] Thus, once a tribunal is convinced that anticompetitive effects are present, any further analysis of market structure would

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likely explained defendants' rising fees); *Tunis Bros. Co.*, 952 F.2d at 728 (plaintiffs did not make out a *prima facie* case where, *inter alia*, competing dealers prices, though higher, did not rise after the purported restraint).

[115]*See, e.g., Re/Max Intern., Inc.*, 173 F.3d at 1000 (purpose of antitrust is to ensure that efficient enterprises displace inefficient ones so that "consumers' economic interests are better served"); *Brown University,* 5 F.3d at 673-78 (holding that social and political concerns cannot justify restraint that increases consumer prices); *Competitor Collaboration Guidelines*, § 1.2 ("Overview of Analytical Framework") ("The central question [in Rule of Reason analysis] is whether the relevant agreement likely harms competition by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement."); *id.* at § 3.3 (same); AREEDA, 1 ANTITRUST ¶ 111 (1978) (arguing that courts should not give dispositive effect to non-economic values when interpreting and applying the Sherman Act).

It should be noted that two scholars who support the actual detrimental effects test also assert that courts should read non-economic values into the Sherman Act. *See* SULLIVAN AND GRIMES, THE LAW OF ANTITRUST, at 2-7 (arguing that the purpose of antitrust is the prevention of economic oppression). However, Professors Sullivan and Grimes do not rely on non-economic values to justify their support for the actual detrimental effects test.

[116]*See, e.g.*, *Re/Max Intern. Inc.*, 173 F.3d at 1015 (antitrust violation entails "use of market" power to exclude more efficient competitor); *Competitor Collaboration Guidelines*, § 3.31 (equating "anticompetitive harm" with exercise of market power); AREEDA, VII ANTITRUST, ¶ 1507, p. 400 ("the plaintiff cannot show a significant trade restraint without giving us some reason to believe that the defendants have some market power").

[117]*See* Patterson, *Market Power In Rule of Reason Cases*, 37 SAN DIEG. L. REV. at 2-3 ("The market power inquiry is generally acknowledged to be one of the most difficult and inconclusive in antitrust law, and market definition, which is often a prerequisite to the evaluation of market power, is similarly problematic."); Willard Tom & Chul Pak, *A Flexible Rule of Reason*, 68 ANTITRUST L. J. 391, 399 (2000); Stephen Calkins, *California Dental Association: Not The Quick Look, But Not The Full Monty*, 67 Antitrust L. J. 495, 521 (2000). *See also Competitor Collaboration Guidelines*, § 3.3 ("The Agencies focus on only those factors, and undertake only that factual inquiry, necessary to make a sound determination of the overall competitive effect of the relevant agreement.").

seem redundant. Why require the plaintiff to rely on an *inference* of anticompetitive effects (from market structure), when it can prove those effects directly?[118]

Lower courts that embrace the "actual detrimental effects" test do so without qualification. Nonetheless, some of these same courts have declined to apply this approach to certain vertical restraints. These courts assert that plaintiffs challenging some restraints must establish harm to "interbrand competition:" proof that a restraint reduces competition in the sales of a manufacturer's own product will not suffice.[119] These decisions do not, it should be noted, apply the market power filter but instead state that plaintiffs can prevail by showing "actual detrimental effects" in the market as a whole.[120] In other vertical contexts, however, several courts have embraced some version of the actual detrimental effects test.[121]

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[118]*See Re/Max Intern.,* 173 F.3d at 1014-15 (proof of actual detrimental effects suggests defendants' "use of market power to prevent a more-efficient competitor from establishing itself."); *Law*, 134 F.3d at 1019 (characterizing proof of market power as "indirect" proof of anticompetitive effects); *Brown University*, 5 F.3d at 668 (courts often rely upon market power because proof of actual detrimental effects "is often impossible to make").

[119]*See, e.g.*, Ezzo's Investors, Inc. v. Royal Beauty Supply, Inc., 243 F.3d 980 (6th Cir. 2001); *KMB Warehouse*, 61 F.3d at 127-128 (proof of harm to intrabrand competition not sufficient to establish prima facie case against vertical distribution restraint). *Cf. NCAA* (proof that restraint raised prices of defendants' product sufficed to establish *prima facie* case). One could argue that the singular focus of these decisions on the interbrand market is compelled by the Supreme Court's determination that interbrand competition is the "primary concern of antitrust law." *See Business Electronics Corp.*, 485 U.S. at 724, *quoting Sylvania*, 433 U.S. at 52, n. 19. However, neither *Business Electronics Corp.* nor *Sylvania* held that interbrand competition is the *only* concern of antitrust law. If it were, then a cartel of the manufacturer's own dealers would be of no antitrust concern. Thus, to the extent that intrabrand competition matters for antitrust purposes, proof that such competition is restrained and that such a restraint leads to "actual detrimental effects" would seem sufficient to establish a *prima facie* case under the best reading of decisions such as *NCAA*, *Indiana Federation of Dentists*, and *Sylvania*.

[120]*See, e.g.*, *K.M.B. Warehouse*, 61 F.3d at 127-28.

[121]*See, e.g.*, Town Sound and Custom Tops v. Chrysler Motors, 959 F.2d 468 (3d Cir. 1992) (rejecting market power filter when analyzing tying contract under the Rule of Reason); Grappone v. Subaru of New England, Inc., 858 F.2d 792 (1st Cir. 1988) (Breyer, J.) (conducting Rule of Reason analysis without regard to market power); Minnesota Association Of Nurse Anesthetists v. Unity Hospital, 208 F.3d 655, 661-

2. Rebutting The *Prima Facie* Case:

Proof that a restraint is *prima facie* "anticompetitive," however made out, does not itself give rise to liability. Instead, such proof merely casts upon defendants a burden of justification, that is, of adducing evidence that the restraint in fact produces cognizable "procompetitive" benefits that may "justify" or "offset" any anticompetitive effects.[122] Courts and individual judges occasionally assert that defendants bear the burden of *proving* that a restraint creates such benefits.[123] However, the vast majority of courts and scholars conclude that the defendants' burden at this point is merely a burden of *production*, that is, of adducing evidence from which a tribunal could conclude that the restraint produces cognizable benefits.[124]

Proof that a restraint produces significant cognizable benefits does not entitle the defendants to judgment, however. Instead, courts, enforcers, and leading scholars all conclude that

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62 (8th Cir. 2000) (suggesting that proof that exclusive dealing contract raised defendants' own prices would suffice to establish a *prima facie* case); J.F. Feeser, Inc. v. Serv-A-Portion, Inc., 909 F.2d 1524 (3d Cir. 1990) (proof that supply contract raised the prices paid by defendants' competitors sufficed to establish a *prima facie* case).

[122] *See NCAA*, 468 U.S. at 113-20 (where defendant failed to prove existence of procompetitive benefits, plaintiff prevailed); *Law*, 134 F.3d at 1022-24 (same); 7 AREEDA, ANTITRUST LAW, ¶ 1503, p. 376 (courts allow plaintiffs to rely upon proof of market power because proof of actual effects is difficult).

[123] *See NCAA,* 468 U.S. at 113 (defendants bear "a heavy burden of establishing an affirmative defense which competitively justifies [the restraint]"); *California Dental Ass'n*, 526 U.S. at 788 (Breyer, J. concurring in part dissenting in part) ("In the usual Sherman Act § 1 case, the defendant bears the burden of *establishing* a procompetitive justification.") (emphasis added).

[124] *See, e.g.*, *Capital Imaging Assocs.*, *P.C.*, 996 F.2d at 543 ("After the plaintiff satisfies its threshold burden of proof under the Rule of Reason, the burden shifts to the defendant to offer evidence of pro-competitive 'redeeming virtues' of their combination. Assuming defendant *comes forward* with such proof the burden shifts back to plaintiff . . .") (emphasis added); AREEDA, 7 ANTITRUST ¶ 1507b at 397 ("Once the plaintiff satisfies his burden of persuasion . . . he will prevail unless the defendants introduce evidence sufficient to allow the tribunal to find that their conduct promotes a legitimate objective."). It should be noted that Justice Breyer has cited each of these authorities in support of his assertion that defendants bear a burden of proof once the plaintiff has established a *prima facie* case. *See California Dental Ass'n*, 526 U.S. at 788 (Breyer J. dissenting). Both of the authorities, however, plainly refer to a burden of *production*.

the fact-finder must weigh any such benefits against the arrangement's anticompetitive harms, determining which effects predominate.[125] In so doing, judges, officials and scholars assume that any "redeeming virtues" necessarily coexist with the anticompetitive harm established by the plaintiff.[126] In *NCAA*, for instance, defendants claimed that the venture and the accompanying restraint produced marketing efficiencies and was thus procompetitive.[127] The Court rejected this argument, claiming that procompetitive efficiencies would necessarily manifest themselves as increased output and lower prices.[128] The district court, however, had found that the plan reduced output and increased prices, and the Court held that these findings established that anticompetitive

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[125]*See Law*, 134 F.3d at 1019 ("the harms and benefits must be weighed against each other in order to judge whether the challenged behavior is, on balance, reasonable.") (*citing* 7 AREEDA, ¶ 1502, at 372); Doctor's Hospital of Jefferson, Inc. v. Southeast Medical Alliance, 123 F.3d 301, 307 (5th Cir. 1997) ("the anticompetitive evils of a restrictive practice must be balanced against any procompetitive benefits or justifications within the confines of the relevant market."); *Hairston*, 101 F.3d at 1319 (court must determine "whether the restraint's harm to competition outweighs the restraint's procompetitive effect."); *Flegel*, 4 F.3d 688 (court "weighs 'the harms and benefits to determine if the behavior is reasonable on balance'"), *quoting Bhan*, 929 F.2d at 1413; *Capital Imaging*, 996 F.2d at 543 ("once defendant produces evidence of benefits, the factfinder must weigh the costs and benefits of a restraint"); *Competitor Collaboration Guidelines*, § 3.37 (Agencies' analysis involves "comparison of cognizable efficiencies and anticompetitive harms . . . in assessing the overall competitive effect of the agreement."); 7 AREEDA, ANTITRUST, at ¶ 1507b, p. 397 (absent showing that defendants could achieve benefits via less restrictive means, "the tribunal must somehow weigh and balance the harm against the benefit"); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 257-58 (same); SULLIVAN AND GRIMES, THE LAW OF ANTITRUST, at 211 (rule of reason applied to horizontal restraints requires court to determine "whether benefits are attained and, if so, whether they exceed the harms"); *id.* at 333-35 (same) (endorsing such an approach to vertical restraints).

[126]*See* nn. ___, *infra* and accompanying text.

[127]*See NCAA*, 468 U.S. at 113-14 (describing the NCAA's argument).

[128]*See NCAA*, 468 U.S. at 114 ("If the NCAA's television plan produced procompetitive efficiencies, the plan would increase output and reduce the price of televised games."). *See also id.* at 103 (characterizing *BMI* as holding that "a joint selling arrangement may be so efficient that it will increase sellers' aggregate output and thus be procompetitive.").

harm swamped any benefits and thus refuted the defendants' attempt at justification.[129] The Court rejected on similar grounds the defendants' claim that the restraint furthered "competitive balance" among the various members of the league.[130] Courts, enforcers, and leading scholars have taken the same approach where defendants claim that efficiencies justify an otherwise anticompetitive merger, assuming, as they do, that any efficiencies coexist with anticompetitive effects.[131]

Indeed, the Supreme Court has gone even further, suggesting that a purported justification is not even cognizable in the first place unless it tends to reduce prices to or below the level that obtained before the defendants adopted the challenged restraint. In National Society v. Professional Engineers, the Court evaluated a professional association's ban on competitive bidding by its members.[132] Defendants sought to justify the ban by asserting that competitive pressure to

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[129] *See NCAA*, 468 U.S. at 114. *See also National Society of Professional Engineers*, 435 U.S. at 693 (defendants claim that restraint enhanced quality of product by preventing competitive bidding rested on assumption that restraint led to higher prices and thus were not cognizable); *Competitor Collaboration Guidelines*, at § 3.37 ("Overall Competitive Effect") ("the Agencies assess the likelihood and magnitude of cognizable efficiencies and anticompetitive harms to determine the agreement's overall actual or likely effect on competition in the relevant market. To make the requisite determination, the Agencies consider whether cognizable efficiencies likely would be sufficient to offset the potential of the agreement to harm consumers in the relevant market, for example, by preventing price increases."); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 264 ("the only justifications that are acceptable are those tending to show that the challenged restraint really does tend to increase output, and thus decrease price.").

[130] *See NCAA*, 468 U.S. at 119-120 ("The hypothesis that legitimates the maintenance of competitive balance as a procompetitive justification under the Rule of Reason is that equal competition will maximize consumer demand for the product. The finding that consumption will materially increase if the controls are removed is a compelling demonstration that they do not in fact serve any such legitimate purpose.").

[131] *See, e.g.*, FTC v. University Health, 938 F.2d 1206 (11th Cir. 1991); FTC v. Cardinal Health, Inc., 12 F. Supp. 34, 61-63 (D.D.C. 1998); FTC v. Staples, Inc., 970 F.Supp. 1066, 1088-1090 (D.D.C. 1997); 1992 Federal Trade Commission and Department of Justice Joint Merger Guidelines, § 4.0; HOVENKAMP, FEDERAL ANTITRUST POLICY, at 503 (endorsing such an approach). *See generally*, Oliver Williamson, *Economies As An Antitrust Defense: The Welfare Tradeoffs*, 58 Amer. Econ. Rev. 18 (1968).

[132] 435 U.S. 679 (1978).

offer services at the lowest price would undermine the quality of services that members would ultimately provide.[133]

The Court rejected this argument, holding that the District Court properly refused to consider evidence supporting it. According to the Court, the very description of the argument confirmed that the defendants' agreement had an "anticompetitive purpose and effect."[134] For, the Court said, defendants' argument was premised on the assumption that the agreement would maintain or increase the price level.[135] Recognition of such a justification, then, would be inconsistent with the Sherman Act's "legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services."[136]

3. The Less Restrictive Alternative:

Indeed, the fact that a restraint results in lowers prices or increased output does not necessarily doom the plaintiff's case. Instead, lower courts, agencies and leading scholars all agree that the fact-finder should subject such proof to a "less restrictive alternative test."[137] Thus, even

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[133]*See id.* at 685-86 (discussing defendants' proferred justification and associated offer of proof). At bottom, the Association was simply asserting that unrestrained rivalry would produce what economists call a "lemons equilibrium." *See generally* George Akerloff, *the Market for 'Lemons': Qualitative Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

[134]*See National Society of Professional Engineers*, 435 U.S. at 693.

[135]*See id.* at 693-94.

[136]*Id.* at 695. *See also Superior Court Trial Lawyers*, 493 U.S. at 423-24 (rejecting argument that coercive imposition of higher legal fees was justified because increased fees would increase the quality of representation); 7 AREEDA, ANTITRUST, at ¶ 1504, p. 380-81 (endorsing this aspect of *Professional Engineers*); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 194 (defendants' justification in *Professional Engineers* necessarily rested on a desire to exercise market power).

[137]*See, e.g.*, *Law*, 134 F.3d at 1019 (once defendants prove that benefits are present, the plaintiff can prevail by showing that "those objectives can be achieved in a substantially less restrictive manner"); *Hairston*, 101 F.3d 1319 ("Under the rule of reason, the fact-finder examines the restraint at issue and determines whether the restraint's harm to competition outweighs the restraint's pro-competitive effects");

before they "balance" procompetitive benefits against anticompetitive harm, courts and agencies first allow a plaintiff to prove that a restraint or practice less restrictive of rivalry between the parties would produce the same benefits produced by the restraint.[138] Such proof entitles the plaintiff to judgment, regardless whether the benefits of the restraint outweigh its costs.[139] Indeed, some scholars have argued that plaintiffs should prevail even if the less restrictive alternative is slightly

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Brown University, 5 F.3d at 679; *Flegel*, 4 F.3d at 688 ([once the defendant adduces evidence of procompetitive effects] "The plaintiff, driven to this point, must then try to show that any legitimate objectives can be achieved in a substantially less restrictive manner."), *quoting Bhan*, 929 F.2d at 1413; *Capital Imaging Assoc., P.C.*, 996 F.2d at 543 ("Assuming defendant comes forward with such proof, the burden shifts back to plaintiff for it to demonstrate that any legitimate collaborative objectives could have been achieved by less restrictive alternatives.'); U.S. Healthcare, Inc. v. Healthsource, Inc., 986 F.2d 589, 594 (1st Cir. 1993) (rule of reason analysis requires "the most careful weighing of costs and benefits"); *Competitor Collaboration Guidelines*, § 3.36(b) ("Reasonable Necessity and Less Restrictive Alternatives") ("[I]f the participants could have achieved or could achieve similar efficiencies by practical, significantly less restrictive means, then the Agencies conclude that the relevant agreement is not reasonably necessary to their achievement."); AREEDA, 7 ANTITRUST, ¶ 1507b; *id.* at ¶ 1505b; HOVENKAMP, FEDERAL ANTITRUST POLICY, at 257 (endorsing such a test for evaluation of horizontal restraints ancillary to joint ventures); *id.* at 489 (endorsing such a test when evaluating vertical distribution restraints); ROSS, PRINCIPLES OF ANTITRUST LAW, at 157-58 (contending that an ancillary restraint should be unlawful if "broader than necessary to achieve its purpose"); SULLIVAN & GRIMES, THE LAW OF ANTITRUST, at 223 (endorsing such a test for analysis of horizontal restraints); *id.* at 335 (endorsing such an approach); Thomas A. Piraino, Jr., *Reconciling Competition And Cooperation: A New Antitrust Standard For Joint Ventures*, 35 W.&M. L. Rev. 871, 930 (1994) (endorsing application of less restrictive alternative test to restraints ancillary to legitimate joint ventures).

[138] *See, e.g.*, *Re/Max International, Inc.*, 173 F.3d at 1015 (rejecting proferred benefits as a matter of law where defendants could have achieved such benefits by less restrictive means); Chicago Professional Sports Ltd. Partnership v. National Basketball Ass'n, 961 F.2d 667, 675-76 (7th Cir. 1992) (Easterbrook, J.) (rejecting claim that reduction in free riding justified apparent output rejection where defendants could have charged purported free riders a fee for use of common resource); General Leaseways, Inc. v. National Truck Leasing Assoc., 744 F.2d 588, 592 (7th Cir. 1984) (voiding territorial allocation where defendants could have and did achieve legitimate objective by means of a less restrictive alternative); Mackey v. N.F.L., 543 F.2d 606, 621 (8th Cir. 1979) (voiding regulation of free agency where league could achieve legitimate objectives via less restrictive means). *See also NCAA*, 468 U.S. at 114 (finding that defendants attempt at justification failed where, among other things, "*NCAA* football could be marketed just as effectively without the television plan"), *citing* 546 F. Supp. at 1306-1308; *Law*, 134 F.3d at 1024, n. 16 (declining to consider less restrictive alternatives where defendant had not proved existence of cognizable benefits). *Cf.* County of Tuolumne v. Sonora Community Hospital, 236 F. 3d 1148, 1159 (9th Cir. 2001) (rejecting asserted less restrictive alternative as less effective and "significantly more costly" than restraint under challenge).

[139] *See* n. ____, *supra*.

less effective than the restraint under challege.[140] While the Supreme Court has not squarely endorsed such a test, it has premised one *per se* rule on the assertion that less restrictive alternatives are always available to advance any legitimate objective.[141] This approach is also identical to that taken by courts and the enforcement agencies in the merger context.[142]

The less restrictive alternative test may seem counterintuitive, given the Rule of Reason's singular focus on consumer welfare.[143] After all, application of such a test allows courts

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[140]*See* 11 HOVENKAMP, ANTITRUST LAW ¶ 1912i, p. 302 ("plaintiff is permitted to show that the same (or nearly the same) benefits could be achieved by a realistic, less restrictive alternative); 7 AREEDA, ANTITRUST LAW, ¶ 1505, p. 383 (after a plaintiff has established a prima facie case, a restraint "must not only promote the legitimate objective but must also do so significantly better than the available less restrictive alternative."); *id.* at ¶ 1507b (courts should ask whether "the objective could be achieved (nearly?) as well" by the less restrictive alternative."); SULLIVAN AND GRIMES, THE LAW OF ANTITRUST, at 223 (courts should ask whether less restrictive alternative proffered by the plaintiff is "nearly as effective"); Sullivan, *Viability Of Horizontal Restraints Law*, 75 Calif. L. Rev. at 851 (courts should ask whether legitimate objectives "can be substantially obtained" by less restrictive alternatives offered by the plaintiff). It should be noted that Professor Hovenkamp suggests a different approach in a subsequent discussion of the question. *See* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 257 (asking whether alternative will achieve "the same" efficiencies).

[141]*See, e.g.*, *Jefferson Parish*, 466 U.S. at 25-26, n. 42; Standard Oil Co. of California v. United States, 337 U.S. 293, 305-306 (1949) (tying agreements are *per se* unlawful because less restrictive alternatives are "protection enough" for any legitimate objectives); International Salt Co. v. United States, 332 U.S. 392, 397-98 (1947) (presence of less restrictive alternative undermines attempt to justify tying contract); International Business Machines v. United States, 298 U.S. 131, 138-140 (1936) (same). To be sure, the Court mentioned the presence of less restrictive alternatives in *NCAA* as one factor militating against the defendants' attempt to justify the restraint at issue. *See id.* at 119. Ultimately, however, the Court determined that any cognizable benefits produced by the restraint did not outweigh the restraint's anticompetitive effects, given the district court's findings that the restraint resulted in prices higher than they otherwise would have been. Thus, the Court did not have to determine whether the presence of a less restrictive alternative could render an otherwise beneficial restraint unlawful. *See* nn. ___, *supra*, and accompanying text.

[142]*See* FTC v. University Health, 938 F.2d 1206 (11th Cir. 1991); FTC v. Staples, 970 F. Supp. 1066, 1090 (D. D. C. 1997) (rejecting efficiency defense where defendants purportedly could have achieved such benefits via less restrictive means); *Joint Merger Guidelines* § 4.0. *See also* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 503-504 (endorsing application of less restrictive alternative test in the merger context).

[143]*See* nn. ____, *supra* and accompanying text (showing that *Standard Oil*'s Rule of Reason rests on solicitude for consumer welfare).

to void restraints that are beneficial "on balance" because they do not enhance consumer welfare "enough."[144] How is it that courts can void a contract that produces none of the evil consequences of monopoly that *Standard Oil* deemed the sole target of the Sherman Act?[145]

There is, however, some internal logic to the less restrictive alternative test, not to mention some support in the common law.[146] After all, the requirement only comes into play after the plaintiff has demonstrated that the restraint in question produces harmful effects, such as a reduction in output or increase in prices. If the Rule of Reason is designed to enhance consumer welfare, then it seems that antitrust doctrine should be concerned with such a departure from the allocation of resources previously produced by a competitive market, even if such a departure happens to coincide with the creation of cognizable benefits. Such a departure, it seems, produces an externality, an externality that reduces consumer welfare below what it could be.[147] Presumably the less restrictive alternative requirement, if properly enforced, will induce firms to achieve cognizable benefits without simultaneously creating or exercising market power, thus defeating a

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[144]*See* Alan J. Meese, *Tying Meets The New Institutional Economics*, 146 U. Penn. L. Rev. 1, 73 (1997) (showing that, as applied in the tying context, the less restrictive alternative test penalizes defendants "not for imposing net social harm, but instead for failing to benefit society sufficiently").

[145]*See* nn. ____, *supra* and accompanying text (showing that *Standard Oil*'s Rule of Reason voids only those contracts that lead to monopoly or the evils associated with it).

[146]*See Baltimore Gas*, 130 U.S. at 409 (if "the restraint upon one party is not greater than protection to the other party requires, the contract may be sustained."); *see also* ROSS, PRINCIPLES OF ANTITRUST LAW, at 158.

[147]*See* KENNETH G. ELZINGA & WILLIAM BREIT, THE ANTITRUST PENALTIES 3-4 (1976) (characterizing output reduction below competitive level as an externality); Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules — A Comment*, 11 J. L. & ECON. 67, 70 (1968) (same).

market failure and maximizing the welfare of consumers.[148] It therefore seems appropriate that courts ask whether "there [are] other and better ways . . . by which the collaborators can achieve their legitimate objectives with fewer harms to competition."[149]

III ANTITRUST'S TWO MODELS OF COMPETITION

As noted earlier, *Standard Oil's* Rule of Reason analysis should distinguish those restraints that unduly limit "competition" — which the Court equated with rivalry — from "normal" or "usual" contracts that limit rivalry but further or develop trade.[150] Application of the Rule of Reason, then, requires courts to employ economic theory to determine whether a contract produces the consequences of monopoly and thus offends the policy laid down by the Sherman Act.[151] For

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[148]*See* SULLIVAN AND GRIMES, THE LAW OF ANTITRUST, at 223; HOVENKAMP, ANTITRUST POLICY, at 259 (noting that a court that condemns an arrangement because of presence of a less restrictive alternative can limit its relief to a requirement that the parties achieve their objectives by less restrictive means). *See also* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 255-59 (assuming that procompetitive benefits coexist with anticompetitive effects once a plaintiff has established a *prima facie* case); 7 AREEDA, ANTITRUST at ¶ 1507b, p. 397-98 (same); Sullivan, *Viability of Horizontal Restraints Law*, 75 Calif. L. Rev. at 851 (same).

[149]*See* AREEDA, 7 ANTITRUST ¶ 1502, p. 371; *id.* at 384 (less restrictive alternative analysis asks whether defendants' "objective [can] be achieved as well without restraining competition so much"). *See also* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 258 (justifying less restrictive alternative test as search for "obviously less anticompetitive alternative"); SULLIVAN & GRIMES, THE LAW OF ANTITRUST, at 335 ('[If] strong evidence is offered for the promotional benefits of the distribution restraint, a court should examine whether less anticompetitive means . . . may be available to achieve the same marketing benefits. That the producer may prefer a particular distribution restraint is not enough to justify its use because the preference may be based on an anticompetitive gain from the restraint."); *id.* at 223 (applying similar reasoning in the horizontal context); Sullivan, *Viability of Horizontal Restraints Law*, 75 Calif. L. Rev. at 851 ("if [efficiencies] can be substantially obtained by means significantly less threatening to competition, the inquiry should also end.").

[150]*See* nn. ___, *supra* and accompanying text.

[151]*See Standard Oil*, 221 U.S. at 63-64 (Sherman Act empowers courts to implement the public policy evinced by the Act in light of reason). *See also Khan*, 522 U.S. at 21 (Court should revise precedents "when the theoretical underpinnings of those decisions are called into question."); *Continental T.V.*, 433 U.S. at 47-48 (relying in part on great weight of scholarly commentary as rationale for overruling prior decision). *But see Klor's, Inc.*, 359 U.S. at 211(stating that the Sherman Act bans those restraints that were invalid at common law and others that advances in economics show to be unreasonable). *See generally* Frank H.

instance, such theory can inform courts as to whether a contract is "always or almost always anticompetitive," "lacking in redeeming virtue," and thus subject to *per se* condemnation.[152] Such theory can also assist courts in determining how to structure Rule of Reason analysis of those contracts that may produce redeeming virtues and thus survive the *per se* inquiry.[153]

Courts do not generate economic theory themselves; nor can they locate this theory in legislative history or common law precedents. Instead, courts exercising "reason" must select from among those theories that economists and others generate, theories on which advocates rely when litigating Rule of Reason cases. Any attempt to understand antitrust doctrine as well as the results produced by Rule of Reason litigation must begin with an understanding of the economic theories of the time, as such theories inevitably inform judges' understanding of the restraints the Sherman Act requires them to evaluate.[154]

As shown below, economists have over the past few decades provided antitrust courts with two different economic paradigms capable of implementing *Standard Oil's* normative focus on consumer welfare: price theory and transaction cost economics. Each such paradigm embraces a normative conception of "competition" functionally related to the efficient allocation of resources.

Easterbrook, *Is There A Ratchet In Antitrust Law?*, 60 TEX. L. REV. 705 (1982) (arguing that changes in economic theory can justify expansion or contraction of antitrust prohibitions).

[152] *See* nn. ____, *supra* and accompanying text (*per se* analysis requires courts to determine whether an agreement is "always or almost always" anticompetitive and, if so, whether the agreements lacks procompetitive redeeming virtues).

[153] *See* nn. ___, *supra* and accompanying text (showing that courts decline to apply *per se* rule where defendants adduce plausible assertion that contract produces redeeming virtues).

[154] *See* HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 268; Jacobs, *Normative Foundations of Antitrust Economics*, 74 N.C. L. REV. at 226-27 ("In almost every era of antitrust history, policymakers have employed economic models to explain or modify the state of the law and the rationale for its enforcement.").

However, while these two paradigms begin with the same normative focus, each offers a radically different descriptive account of the causes and consequences of contractual integration, the main object of Rule of Reason analysis. As a result, each approach implies alternative and contradictory models of "competition" that courts can and do apply when conducting the sort of Rule of Reason analysis mandated by *Standard Oil*.

A predecessor to Transaction Cost Economics ("TCE"), price theory held a monopoly on antitrust economics for some time, driving both steps of *Standard Oil's* Rule of Reason as well as merger law. More recently, TCE has emerged as a stout competitor to price theory, and each paradigm currently has significant and contradictory influence over the scope and content of *per se* rules. In particular, the Supreme Court continues to embrace the price-theoretic model of competition in some contexts, relying on price theory to conclude that certain practices are necessarily "anticompetitive" and without redeeming virtue. At the same time, the Court has rejected price theory in other contexts, relying upon TCE to conclude that contracts once deemed "plainly" (and only) anticompetitive can in fact possess redeeming virtues and thus should receive further analysis under the Rule of Reason.

This part will elucidate the price-theoretic model of "competition" and its historical influence on antitrust policy and doctrine. This part will also introduce and explain price theory's competitor— transaction cost economics — as well as its concomitant model of "competition." Unlike price theory, which recognizes only technological competition, TCE suggests that much competition is essentially contractual, that is, takes the form of competing governance structures, each of which is ultimately a creature of contract. Finally, this part will examine the continuing influence of each of these contending models on the current scope of *per se* rules and thus, by implication, the influence of these paradigms on the category of restraints that survive *per se* analysis and thus warrant further analysis under the Rule of Reason. In so doing, this section will set the stage for Section IV's analysis and critique of price theory's continuing influence on the three main elements of Rule of Reason analysis identified earlier.

A. Contractual Integration And Applied Price Theory:

For decades courts did not really "choose" between competing economic theories. Instead, economists created and embraced a uniform economic paradigm which lawyers, enforcement officials, and legal scholars transmitted to the courts. This paradigm, called "price theory," dominated economists' treatment of industrial organization, the study of how firms are organized and conduct their activities.[155] Price theory rested upon several interrelated assumptions which, when taken together, made up a model that economists and others employed to interpret business behavior, including contracts, the focus of antitrust's Rule of Reason.[156] The assumptions animating this paradigm were straightforward. Firms were autonomous entities that interacted with others through an impersonal and chaotic spot market.[157] The boundary between a "firm" and "the

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[155] *See* R. H. Coase, *Industrial Organization: A Proposal for Research*, 61-64 in POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION (V. Fuchs, ed. 1972) (arguing that, as of 1972, Industrial Organization consisted simply of applied price theory). Indeed, after reviewing two of the period's leading industrial organization texts, Professor Coase concludes that "Essentially [both authors] consider the subject of industrial organization as applied price theory." *See id.* at 62; GEORGE STIGLER, THE ORGANIZATION OF INDUSTRY, 1 (1968) (portraying industrial organization as "price or resource allocation theory"); JOE S. BAIN, INDUSTRIAL ORGANIZATION, 25-27 (1968). *See also* RICHARD CAVES, AMERICAN INDUSTRY STRUCTURE, CONDUCT, PERFORMANCE, 14 (1967) ("The subject of 'industrial organization' applies the economist's models of price theory to the industries in the world around us."); Joe S. Bain, *Market Classifications In Modern Price Theory*, 56 Q. J. ECON. 560 (1942).

[156] *See* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM,7, 23-26 (1985) (describing "orthodox framework" of economics from 1940 to 1970s).

[157] *See* Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386, 388 (1937) (asserting that then-current economic theory described firms as "islands of conscious power in an ocean of unconscious co-

market," that is, the distinction between what a firm produced itself and what it purchased from others, was solely a function of the firm's own costs and those of potential suppliers of goods or services, including distribution. Firms had little or no control over these costs, which were instead determined by technology.[158]

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operation like lumps of butter coagulating in a pail of buttermilk") (*quoting* D.H. ROBERTSON, CONTROL OF INDUSTRY 85 (1923)).

[158]*See* Richard N. Langlois, *Transaction Cots, Production Costs, and the Passage of Time*, in COASEAN ECONOMICS: LAW AND ECONOMICS AND THE NEW INSTITUTIONAL ECONOMICS 1, 2-4 (Steven G. Medema ed., 1998) (describing technological focus of so-called "Pigouvian price theory"); Oliver Williamson, *Technology and Transaction Cost Economics*, 10 J. ECON. BEH. & ORG. 355, 356 (1988) (asserting that under, price-theoretic paradigm, "the 'natural' boundaries of the firm were thought to be defined by engineering considerations."); WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM, at 7-8 ("The prevailing orientation toward economic organization [under price theory] was that technological features of firm and market organization were determinative."); *id.* at 23-26, 86-89; George Stigler, *The Division of Labor is Limited By the Extent of the Market*, 59 J. POL. ECON. 185, 185 (1951) (stating that economic theory has "generally treated as a (technological?) datum the problem of what the firm does — what governs its range of activities or functions.").

Thus, contemporary descriptions of the benefits of vertical integration emphasized cost reductions of technological origin. *See, e.g.*, F.M. SCHERER, INDUSTRIAL STRUCTURE AND ECONOMIC PERFORMANCE, 70 (1970) ("The most obvious and pervasive motive for vertical integration is to reduce costs. A classic example is found in the steel industry: integration of diverse furnace with rolling mill operations eliminates the need for separate reheating steps."); WILLIAM G. SHEPARD, MARKET POWER & ECONOMIC WELFARE, 37 (1970) ("The cost advantages in a firm may be of two types: technical and pecuniary. Only technical economies represent a genuine improvement in social efficiences"); JOE S. BAIN, INDUSTRIAL ORGANIZATION 381 (1968) ("economies of integration generally involve a physical or technical integration of the processes in a single plant. A classic case is that of integrating iron-making and steel-making to effect a saving in fuel costs by eliminating a reheating of the iron before it is fed to a steel furnace."); JOEL DIRLAM AND ALFRED KAHN, FAIR COMPETITION: THE LAW AND ECONOMICS OF ANTITRUST POLICY, 23 (1954) ("[I]ntegration may also have strong economic justification and may make competition more effective. To take the most obvious kind of example, a petroleum refinery that operates both a simple distillation and a thermal cracking unit or a steel mill that operates side by side a blast furnace and Bessemer converter can make use of certain by products, like gases or heat, which would be wasted if the steps were performed disconnectedly. The possible improvements in efficiency are not confined to such engineering savings from integrated productive operations. A farm machinery manufacturer who can give his salesman a full product line to carry must make fuller use of the gasoline and time they use in distributing his products then if he had only one product to sell. And the economic advantages are not limited to efficiency: by integration a firm may uncover new supplies of raw materials, offer customers new products or alternative sources of old ones, and reduce costs and prices through bypassing or supplanting a monopolist."); Robert H. Bork, *Vertical Integration and the Sherman Act*, 22 U. CHI. L. REV. 157, 200 (1954) (describing the benefits of vertical integration as "bypassing a monopoly at one level, or . . . enabling the achievement of internal efficiencies).

Price theory's exclusive focus on technological efficiencies was not arbitrary or accidental, but instead reflected a number of overlapping assumptions about the nature of markets and their supporting institutions as well as the capacity of firms and individuals that participate in them. For instance, price theory assumed that purchasers had perfect information about the items they purchased, or that sellers could convey such information, and buyers could absorb it, without cost.[159] Moreover, price theory assumed that bargaining and enforcement costs were non-existent, with the result that trading partners could negotiate complete contracts governing every aspect of their relationship, contracts that courts would easily enforce.[160] The availability of such perfect contracting would, in turn, prevent opportunism.[161] Indeed, some price theorists assumed that firms and individuals would refrain from opportunism even in the absence of contractual restraints.[162]

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[159]*See* Langlois, *Transaction Costs, Production Costs, and the Passage of Time*, at 2 ("In this kingdom [the price-theoretic paradigm], knowledge remains explicitly and freely transmittable, and cognitive limits seldom if ever constrain."). This assumption was implicit in the assertion by many economists that purchasers should be "free" to choose whether to purchase a product that the seller wished to tie to the main product. *See* nn. ___, *infra* and accompanying text.

[160]*See* WILLIAMSON, ECONOMIC INSTITUTIONS, at 7 (explaining that price-theoretic paradigm assumed that judicial enforcement of well-specified contracts would prevent opportunism); Langlois, *Contract, Competition, And Efficiency*, 55 BROOKLYN L. REV. at 835 ("The traditional economic theory of the firm feeds off of . . . the 'classical' theory of contract. Briefly put, classical contracting involves homogenous goods traded among anonymous transactors with all the (possibly contingent) terms explicitly spelled out in advance."); Kenneth Arrow, THE ORGANIZATION OF ECONOMIC ACTIVITY: ISSUES PERTINENT TO THE CHOICE OF MARKET VERSUS NONMARKET ALLOCATION, *in* PUBLIC EXPENDITURES AND POLICY ANALYSIS, 59, 60 (1970) ("the existence of vertical integration may suggest that the costs of operating competitive markets are not zero, *as is usually assumed in our theoretical analysis*.") (emphasis added).

[161]*See* WILLIAMSON, ECONOMIC INSTITUTIONS, at 7. *See also id.* at 30 (defining opportunism as "self-interest seeking with guile").

[162]For instance, economists argued that, if exclusive dealing between parties produced mutual benefits, dealers would observe such exclusivity voluntarily, without contractual requirement to do so. *See* Derek C. Bok, *The Tampa Electric Case And The Problem of Exclusive Arrangements Under The Clayton Act*, 1961 S. CT. REV. 267, 307-308 ("If a strong and legitimate business need for exclusive selling actually does exist, it is strange that dealers will not follow this policy without being compelled to do so by contract, for the advantages that result should benefit them as well as the firms from which they buy. Perhaps an

Others assumed that firms could combat opportunism by adopting "less restrictive" provisions that did not limit rivalry.[163] In short, price theory assumed that market contracting — transacting — was costless.[164]

These assumptions and concomitant emphasis on technological origins of efficiency rendered economists hostile to vertical integration generally and also had important implications for economists' interpretation of the causes and consequences of contractual integration.[165] According

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occasional dealer will be too inept or short sighted to perceive his best interests, but such men could presumably be replaced for demonstrable inefficiency without resorting to the widespread use of restrictive contracts."); DIRLAM AND KAHN, THE LAW AND ECONOMICS OF ANTITRUST POLICY, at 181-87 ("It is difficult to see why many of the mutual benefits and socially beneficial consequences of exclusive dealing require coercion [*i.e.*, contractual requirement] for their achievement."). Others argued that purchasers were capable of deciding for themselves whether to purchase a product that a seller wished to "tie" to a main product. *See, e.g.*, James M. Ferguson, *Tying Arrangements and Reciprocity: An Economic Analysis*, 30 L. & CONTEMP. PROBS. 522, 558-64 (1965); Donald F. Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50, 66-67 (1958); Alfred E. Kahn, *A Legal and Economic Appraisal of the "New" Sherman and Clayton Acts*, 63 YALE L.J. 293, 324, n. 160 (1954); William B. Lockhart & Howard R. Sacks, *The Relevance of Economic Factors in Determining Whether Exclusive Arrangements Violate Section 3 of the Clayton Act*, 65 HARV. L. REV. 913, 946 (1952); Louis B. Schwartz, *Potential Impairment of Competition — The Impact of Standard Oil Co. of Calif. v. United States*, 98 U. PA. L. REV. 10, 27 (1949) ("The efficiency of uniting two products in use [should] be judged by the end user."). Others assumed that dealers would provide optimal level of advertising and promotional services absent any vertical restraints. *See, e.g.*, Comanor, *Vertical Territorial and Customer Restrictions*, 81 HARV. L. REV. at 1430 (recognizing free rider problem but asserting that "unrestricted market" would provide sufficient pre-sale promotional services by dealers).

[163] *See* Donald Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655, 699 (1962) (requirement that dealer use its best efforts within an area of "primary responsibility" will assure effective promotion by dealers); KAYSEN & TURNER, ANTITRUST POLICY, at 158 (automobile manufacturer could rely upon warranties and dealer good faith to ensure that dealers employed appropriate replacement parts).

[164] *See* Coase , *The Firm, The Market, and The Law*, at 6 (noting that "the concept of transaction costs" "is largely absent from current economic theory").

[165] *See* BAIN, INDUSTRIAL ORGANIZATION, at 381 ("The trained observer tends to form a considerable suspicion from casual observation that there is a good deal of vertical integration which, although not actually uneconomical, is also not justified on the basis of any cost savings. This is apparently true in particular of the integration of distributive facilities by manufacturing firms. *In most cases the rationale of the integration is evidently the increase of market power of the firms rather than a reduction in cost.*") (emphasis added); BLAIR, ECONOMIC CONCENTRATION, at 25-40.

to price theory, firms realized all relevant efficiencies within their boundaries, in the process of manufacturing the product in question.[166] Thus, once a product was sold, and title to it passed beyond the boundaries of the firm, a firm could do nothing to influence its quality or the satisfaction that the consumer received from it. As a result, price theory recognized only "standard contracts," that is, agreements of purchase and sale that simply mediated passage of title from firm to consumer (or dealer), perhaps with an accompanying warranty.[167] Price theorists did recognize that complete vertical integration could, in rare cases, produce technological efficiencies that were realized "within" a firm, before passage of title.[168] However, they saw no benevolent purposes for incomplete integration achieved by so-called "nonstandard" contracts, agreements that reached "beyond" the firm and controlled the discretion of purchasers after the passage of title or other transaction.[169] Professor Williamson has summarized this intellectual milieu as follows:

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[166]*See* Langlois, *Contract, Competition, And Efficiency*, 55 BROOKLYN L. REV. at 834 ("the economists' firm – at least until recently – was a black box, a production function that took in inputs and transformed them into outputs."); *id.* at 835 (describing traditional theory's failure to recognize benefits of non-standard contracting); Oliver Williamson, *Delimiting Antitrust*, 76 GEO. L.J. 271, 272 (1987) (describing the "prevailing practice [under price theory] of describing the firm as a production function whose natural boundaries were defined by technology. Economic inputs were thus transformed by the production technology into economic outputs. Organizational considerations [that might explain the boundaries of firms] were effectively suppressed."); WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM, at 371 (describing price-theoretic view that "true economies take a technological form, [and] hence are fully realized within firms. [Hence], according to the price-theoretic paradigm, there was nothing to be gained by introducing nonstandard terms into market-mediated exchange."); Coase, *The Firm, The Market, and The Law*, at 3 ("The firm to an economist . . . 'is effectively defined as a cost curve and a demand curve, and the theory [of the firm] is simply the logic of optimal pricing and input combination.'"), *quoting* MARTEN SLATER, FORWARD TO EDITH T. PENROSE, THE THEORY OF THE GROWTH OF THE FIRM, ix (2d ed. 1980).

[167]*See* WILLIAMSON, ECONOMIC INSTITUTIONS, at 23 (defining "classical market exchange – whereby a product is sold at a uniform price to all consumers without restriction").

[168]*See* n. ___, *supra* and accompanying text (describing price-theorists' belief that complete vertical integration could create technological efficiencies).

[169]*See* WILLIAMSON, ECONOMIC INSTITUTIONS, 23-25 (distinguishing between "classical market exchange" and "nonstandard contracting").

> "The allocation of economic activity as between firms and markets was taken as a datum; firms were characterized as production functions; markets served as signaling devices; contracting was accomplished through an auctioneer; and disputes were disregarded because of the presumed efficacy of court adjudication. The possibility that subtle economizing purposes are served by organizational variety does not arise within — indeed is effectively beyond the reach of — this orthodox framework. Correspondingly, the prevailing public policy attitude toward unfamiliar or nonstandard business practices during that interval was deep suspicion and even hostility."[170]

Because non-standard agreements had no apparent efficiency purposes, price theorists condemned such arrangements as "monopolistic" attempts to acquire or protect market power.[171]

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[170]WILLIAMSON, ECONOMIC INSTITUTIONS, at 7. Professor Coase offered a similar evaluation of the economic milieu associated with price theory:

> "If an economist finds something — a business practice of one sort or another — that he does not understand, he looks for a monopoly explanation. And as we are very ignorant in this field, the number of ununderstandable practices tends to be rather large, and the reliance on a monopoly explanation is frequent."

Coase, *Industrial Organization: A Proposal for Research*, at 67.

[171]For instance, the leading textbook on industrial organization concluded that tying contracts and exclusive dealing arrangements had a "general tendency to create and preserve more concentrated market structures than would otherwise exist, and to elevate barriers to the entry of new sellers to various markets." *See* BAIN, INDUSTRIAL ORGANIZATION, at 364; *id.* at 567 (asserting that the "exclusionary potential of tying contracts" is "obvious"). Other scholars took similar positions. One economist concluded that tying contracts produced no benefits that could not be achieved by other means and necessarily reflected exercises of market power. *See* Donald F. Turner, *The Validity of Tying Arrangements Under The Antitrust Laws*, 72 HARV. L. REV. 50 (1950); MILLER, UNFAIR COMPETITION 199 (1940) (same). Another opined that "it is almost self-evident that exclusive-dealing contracts, when imposed by large suppliers, will injure competition by preventing the smaller manufacturers from getting their goods to the market and by depriving distributors and dealers of their freedom to handle lines of competitive producers. There are few, if any, circumstances under which exclusive dealing imposed by large concerns can be envisaged as promoting competition." *See* BLAIR, ECONOMIC CONCENTRATION, at 368. Others concluded that contractual restraints on rivalry between dealers could produce no benefits, but would instead lead to excessive promotion that served only to enhance the manufacturer's market power. *See* William S. Comanor, *Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath*, 81 HARV. L. REV. 1419, 1436 (1968) (arguing that contractual integration cannot produce efficiencies).

B. Price Theory And The Meaning Of Competition:

Price theory's exclusive focus on technological efficiencies and concomitant hostility toward non-standard contractual restraints implied a particular, narrow definition of "competition." As explained earlier, *Standard Oil* equated "competition" with rivalry, without assigning any technical economic meaning to either term. Within the lexicon of *Standard Oil*, then, *all* contracts are "anticompetitive" in the sense that they restrain the freedom of action of parties to them.[172] The mere fact that a contract was "anticompetitive" in this sense, however, did not condemn the arrangement under the Rule of Reason.[173] In a similar way, the current approach to implementing the *per se* rule treats any restraint on rivalry as "anticompetitive," subject to a plausible assertion that the arrangement produces redeeming virtues.[174]

Price theory, by contrast, imbued the word "competition" with normative significance and elevated the term to a technical economic concept functionally related to the efficient allocation

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[172] *See* nn. ____, *supra* and accompanying text (describing *Standard Oil*'s definition of competition as "rivalry", without any economic content).

[173] *See* nn. ___, *supra* and accompanying text. As Justice Brandeis put it in *Chicago Bd of Trade,* a mere reduction in competition did not indicate that a restraint produced the consequences of monopoly:

> "The [government's] case was rested upon the bald proposition, that a rule or agreement by which men occupying positions of strength in any branch of trade, fixed prices at which they would buy or sell during an important part of the business day, is an illegal restraint of trade under the Anti-Trust Law. But *the legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition.* Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain is of their very essence."

See Chicago Bd. of Trade, 246 U.S. at 238 (emphasis added).

[174] *See* nn. ___, *supra* and accompanying text.

of resources.[175] Within this paradigm, a restraint is "competitive" if it affects the allocation of resources in a manner likely to enhance social welfare, or, in the lexicon of *Standard Oil*, "advances trade."[176] The assumptions of price theory described earlier produced a particular, narrow version of legitimate "competition," behavior that, when pursued by all market participants, maximized social welfare. In its most doctrinaire form, price-theoretic "competition" was entirely passive, consisting simply of responding to market demand by setting output where price equaled marginal cost.[177] Moreover, price-theoretic "competition" was more than a behavioral concept; it was also a "state of affairs."[178] If replicated in all industries, such "competition" produced a "general *competitive* equilibrium," and with it optimal prices, output and quality in all sectors.[179] Derived from the antiseptic model of perfect competition, this definition of "competition" excluded from its

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[175] *See* Paul McNulty, *Economic Theory and the Meaning of Competition*, 84 Q. J. ECON. 639, 640-50 (1968) (describing classical conception of competition and distinguishing it from modern definition).

[176] *See* nn. ___, *supra* and accompanying text (showing that *Standard Oil* approved contracts that advanced trade).

[177] *See* MACHOVEC, PERFECT COMPETITION AND THE TRANSFORMATION OF ECONOMICS, at 16 (under perfect competition model "the only acceptable behavior of firms is to mechanically reallocate capital in response to a new set of perfect information emissions – provide like manna from heaven, indiscriminately and simultaneously – to the roboticized helmsmen of each firm."); McNulty, *Economic Theory and the Meaning of Competition*, 84 Q. J. ECON. at 648-50; Coase, *The Firm, The Market, and The Law*, at 3 ("The firm to an economist . . . is 'effectively defined as a cost curve and a demand curve, and the theory [of the firm] is simply the logic of optimal pricing and input competition'"), *quoting* Market Slater, Forward to EDITH PENROSE, THE THEORY OF THE GROWTH OF THE FIRM, ix (2d ed. 1980). *See also* SHEPHERD, MARKET POWER & ECONOMIC WELFARE, at 25-27; CAVES, AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE at 38; STOCKING & WATKINS, MONOPOLY AND FREE ENTERPRISE, at 6-9.

[178] *See* McNulty, *Meaning of Competition*, 84 Q. J. Econ. at 643-45; HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 273-74 (distinguishing between classical notion of competition and modern notion, the latter of which views competition as a "state of affairs").

[179] *See* SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, at 12-19 (describing model of "general competitive equilibrium"); SHEPHERD, MARKET POWER & ECONOMIC WELFARE, at 25-29 (same). *See also* KAYSEN AND TURNER, ANTITRUST POLICY, at 12-13.

ambit all varieties of non-standard contracts, as well as practices — like advertising, product differentiation, and price cutting — that businesspeople would deem methods of doing battle with competitors.[180] According to the models employed by many economists, such practices were not "competitive" at all, but instead thwarted "competition" and created or preserved market power.[181] Commenting on the economist's vision of "competition" in 1948, Professor Hayek wrote:

> "The peculiar nature of the assumptions from which the theory of competitive equilibrium starts stands out very clearly if we ask which of the activities that are commonly designated by the verb 'to compete' would still be possible if those conditions were all satisfied. Perhaps it is worth recalling that, according to Dr. Johnson, competition is 'the action of endeavoring to gain what another endeavors to gain at the same time.' Now, how many of the devices adopted in ordinary life to that end would still be open to a seller in a market in which so-called 'perfect competition' prevails. I believe that the answer is exactly none. Advertising, undercutting, and improving ("differentiating") the goods or services produced are all, excluded by definition — 'perfect' competition means indeed the absence of all competitive activities."[182]

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[180] *See* Langlois, *Contract, Competition, And Efficiency*, 55 BROOKLYN L. REV. at 835 (linking classical theory of contract and related traditional theory of the firm to perfect competition model). *See also* McNulty, *Meaning of Competition*, 84 Q. J. Econ. at 649 ("Perfect competition, on the other hand, is an equilibrium situation in which price becomes a parameter from the standpoint of the individual firm and no market activity is possible . . . [t]hus, the single activity which best characterized the meaning of competition in classical economics – price cutting by an individual firm in order to get rid of excess supplies – becomes the one activity impossible under perfect competition.").

[181] *See* Joan Robinson, *The Impossibility of Competition*, 245 in MONOPOLY AND COMPETITION AND THEIR REGULATION (E. H. Chamberlin, Ed. 1954) (noting that "competition in practice is very imperfect"); *id*. at 245-46 ("in the broad sense in which business men understand it, [competition] largely consists in destroying competition in the narrow economist's sense by product differentiation, advertisement, and the creation of goodwill."). *See also* Friedrich Hayek, *Competition As Discovery Procedure*, *in* F. A. HAYEK, NEW STUDIES IN PHILOSOPHY, POLITICS, ECONOMICS, AND THE HISTORY OF IDEAS, 179 (1978) ("[economists] who seem to derive their conception of competition solely from modern textbooks, have not unnaturally concluded that competition does not exist.").

[182] *See* Hayek, *The Meaning Of Competition*, at 96.

> "This theory [of competitive equilibrium] throughout assumes the state of affairs already to exist which, according to the truer view of the older theory, the process of competition tends to bring

While Professor Hayek accurately described the views of many economists, there were others who possessed a more sophisticated view of the subject. Many industrial organization theorists who otherwise embraced the price-theoretic paradigm often recognized that the real world usually departed from that depicted by perfect competition models.[183] For instance, economists recognized the existence of negative and positive externalities that might cause markets to fail to achieve the optimum allocation of resources.[184] Moreover, economists recognized that firms often strove to improve their products or discover new (technological) methods of production, thus lowering costs.[185] These efforts often led firms to expand significantly, sometimes by merger, taking

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> about (or to approximate) and that, if the state of affairs assumed by the theory of perfect competition ever existed, it would not only deprive of their scope all the activities which the verb "to compete" describes but would make them virtually impossible"

Id. at 92. *See also*, Hayek, *Competition As Discovery Procedure*, at 179 ("It is difficult to defend economists against the charge that for some 40 to 50 years they have been discussing competition on assumptions that, *if* they were true of the real world, would make it wholly uninteresting and useless.") (emphasis is original); Coase, *The Firm, The Market, and The Law*, at 9-10 ("Monopoly and impediments to trade such as tariffs are easily handled by normal price theory, whereas the absence of transaction costs in the theory makes the effect of a reduction in them difficult to incorporate in the analysis."); McNulty, *Economic Theory And The Meaning Of Competition*, 84 QUARTERLY JOURNAL OF ECONOMICS at 641 ("As it is, it is one of the great paradoxes of economic science that every act of competition on the part of a businessman is evidence, in economic theory, of some degree of monopoly power, while the concept of monopoly and perfect competition have this important common feature: both are situations in which the possibility of any competitive behavior has been ruled out by definition.").

[183] *See* KAYSEN AND TURNER, ANTITRUST POLICY, at 8 ("The existence of significant economies of scale at both the plant and the firm level over some size range means that firms are not generally insignificant in relation to the market.").

[184] *See* SHEPHERD, MARKET POWER & ECONOMIC WELFARE, at 28; KAYSEN AND TURNER, ANTITRUST POLICY, at 13, n. 12.

[185] *See* SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, at 22 (describing existence of product differentiation as a potentially beneficial departure from perfect competition); MILLER, UNFAIR COMPETITION, at 8 ("Competition is a very complex phenomenon. It may take any one of several forms. It may become a rivalry in buying factors of production of better quality or in buying factors on more favorable terms. It may consist in an endeavor to organize and utilize factors more effectively in producing goods and services, this involving a rivalry in technological processes as well as in economy in the use and

advantage of (technological) economies of scale.[186] As a result, many industries were populated by only a few sellers, and economists recognized that some such departure from perfect competition was necessary to maximize social welfare.[187] Nonetheless, while economists recognized that markets might not always be populated by numerous sellers, they generally embraced the other assumptions of the perfect competition model, assumptions which suggested that efficiencies could only be realized within the firm.[188]

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organization of men and materials. It may take the form of rivalry in attracting customers. This in turn may be done in various ways: by price competition, by informative or competitive advertising, by differentiation of product or of many ancillary terms and conditions of sale, or finally by effective choice and control of the channels of distribution."). It should be noted that Professor Miller's fulsome definition of competition did not include non-standard contracts. *See id.* at 199-200 (tying contracts only useful where seller has a "strong monopoly position"); *id.* at 210 (exclusive dealing arrangements only useful where there is "some element of monopoly control").

[186] KAYSEN AND TURNER, ANTITRUST POLICY, at 128-29 ("From the standpoint of both buyers and sellers, mergers may promote efficiency. Where the appropriate scale of operations or degree of integration of the firm changes, mergers may provide the most economical method of reshaping the structures of existing firms to the new cost conditions.").

[187] *See, e.g.*, KAYSEN AND TURNER, ANTITRUST POLICY, at 5-8; STOCKING AND WATKINS, MONOPOLY AND FREE ENTERPRISE, at 53-61, 108; *id.* at 13 ("Pure competition can scarcely be realized in a machine age."); DIRLAM AND KAHN, FAIR COMPETITION, at 32 ("Product differentiation, for example, is often a means of competition that serves the public by providing minimum assurances of quality and by catering to a real consumer desire for product improvement or variation."); *id.* at 33 ("Rarely does the cause of effective competition demand an attack on an industry because of the fewness of the firms that make it up.").

[188] *See* F. A. Hayek, *The Meaning of Competition*, in INDIVIDUALISM AND ECONOMIC ORDER 94 (1948) (asserting that most assumptions of the perfect competition model "are equally assumed in the discussion of the various 'imperfect' or 'monopolistic' markets, which throughout assume certain unrealistic 'perfections.'"); Langlois, *Transaction Costs, Production Costs, and the Passage of Time*, at 2 (noting that Joan Robinson and Edward Chamberlin, who pioneered the theory of oligopoly, relied upon various assumptions of the perfect competition model). *See also* TURNER AND KAYSEN, ANTITRUST POLICY, at 7 ("the rigorous model of the perfectly competitive market is the appropriate starting point of any definition [of competition relevant to antitrust policy]."); *id.* at 8 ("though the model of [perfectly] competitive market structure is not usable as such in our definition of competition, other concepts of the model are."). While Professors Turner and Kaysen recognized that the perfect competition model could not provide the final definition of competition relevant to antitrust policy, they nonetheless assumed that any practice that a firm would not adopt in a perfectly competitive market reflected an exercise of market power. *Id.* at 8. *See also* n. ____, *infra*.

Price theory's model of competition was more than theoretical: it also influenced the policy prescriptions of scholars, particularly those interested in antitrust regulation.[189] In particular, this account of "competition" provided a benchmark against which economists and others evaluated the causes and consequences of non-standard contracts. The classic articulation of this approach can be found in a text authored by two Harvard scholars, one an economist, who premised their work on the assumption that any business practice that would not be adopted by a similar firm operating in a perfectly competitive market necessarily reflected the possession and exercise of market power.[190] If unchecked, such *anticompetitive* practices could entrench and enhance a firm's market power, protecting the oligopolistic structure of non-competitive industries.[191] Such reasoning applied with particular force to non-standard contracts, which limited rivalry, produced no cognizable benefits,

[189]*See* Coase, *Industrial Organization*, at 66-67 (describing particular influence that price theoretic approach to industrial organization had on antitrust policy).

[190]*See* KAYSEN AND TURNER, ANTITRUST POLICY, at 8 ("where firms can persistently behave over substantial periods of time in a manner which differs from the behavior that the competitive market would impose on competitive firms facing similar cost and demand conditions, they can be identified as possessing market power."); *id.* at 75 (same); STOCKING AND WATKINS, MONOPOLY AND FREE ENTERPRISE, at 108 ("The effectiveness of competition is apt to vary directly with the number of sellers up to the maximum consistent with the economies of scale."); BAIN, INDUSTRIAL ORGANIZATION, at 364 (concluding that concentrated "market structure . . . is to some extent created by conduct, although the conduct in question generally is feasible because of certain basic environmental and structural characteristics of industries that various sellers can exploit to their advantage") (emphasis added). Despite the qualification ("generally"), Professor Bain offered no account of how or why such contracts would arise absent an already concentrated market structure. Another Harvard Scholar assumed that any practice other than the "efficient organization of production" reflected the exercise of market power. *See* MILLER, UNFAIR COMPETITION, at 8 ("In a purely competitive market competition becomes simply a matter of efficiency in organization of production and the correct determination of the quantity to be produced. But such conditions are rare. It is doubtful whether there is any market in which neither the demand nor the supply is significantly affected by monopolistic or monopsonistic forces.).

[191]KAYSEN & TURNER, ANTITRUST POLICY, at 79-80, 89-91. *See also* BAIN, INDUSTRIAL ORGANIZATION, at 363-65 (concluding that various non-standard practices fortify pre-existing market power).

and thus exercised or created market power to the detriment of consumers.[192] Public policy should intervene in the market to eradicate such "anticompetitive" practices when feasible, and such intervention would eliminate market imperfections, render each industry as "competitive" as possible, and assure optimal prices, output and quality.[193] Many economists held similar views, and other antitrust scholars followed suit, evaluating and condemning various non-standard contracts as "anticompetitive" attempts to create, protect, or exercise market power.[194]

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[192]*See* KAYSEN AND TURNER, ANTITRUST POLICY, at 157-59 (arguing that tying contracts necessarily reflect an exercise of market power); *id.* at 156-57 (concerted refusals to deal are nearly always anticompetitive and thus should be unlawful *per se*). Other economists agreed. *See* BAIN, INDUSTRIAL ORGANIZATION, at 363-65 (defining tying and exclusive dealing contracts as "predatory" practices that thwart effective competition); MILLER, UNFAIR COMPETITION, at 199 ("A tying arrangement is a successful business practice only in the circumstance that the seller has a strong monopoly position in one or more products."); *id.* at 210 ("exclusive dealing arrangements . . . are useful only in markets where there are some elements of monopoly control in the manufacture of the product."). It should be noted that Professors Kaysen and Turner made no attempt to explain those tying contracts imposed in apparently competitive markets. Such arrangements, they said, "were random small transactions of no consequence." *See* KAYSEN AND TURNER, ANTITRUST POLICY, at 159.

[193]*See* KAYSEN AND TURNER, ANTITRUST POLICY, 12-13 (*citing* A. C. PIGOU, ECONOMICS OF WELFARE); *see also* BAIN, INDUSTRIAL ORGANIZATION, at 503 (public policy should encourage "workably competitive markets" and "reasonably good economic performance" by, *inter alia*, banning predatory and exclusionary conduct); *id.* at 506-508; *id.* at 14 ("workable (reasonably satisfactory) competition is revealed by, and is the result of whatever gives rise to, reasonably satisfactory or workable market performance — performance that enhances the aggregate economic welfare to a reasonable degree. Ideal performance is found in adaptations of enterprises to their markets which enhance to the maximum possible degree the attainment of overall economic objectives relating to employment, efficiency, income distribution, and so on. "Workable" performance generally refers to adaptations of enterprises to their markets which reasonably approximate the ideal, or do not embody gross and important discrepancies from it."); *id.* at 14-15 (describing as "ideal" economic performance that produces prices equal to cost, *i.e.*, perfect competition).

[194]*See* nn. ___, *supra* (collecting authorities agreeing with Kaysen and Turner). Other classic exemplars of this approach include: LAWRENCE SULLIVAN, ANTITRUST (1977); William Commanor, *White Motor And Its Aftermath*, 81 HARV. L. REV. 1419 (1967); EARL W. KINTNER, AN ANTITRUST PRIMER (1964); LOUIS SCHWARTZ, FREE ENTERPRISE AND ECONOMIC ORGANIZATION (1959); JOEL DIRLAM & ALFRED KAHN, FAIR COMPETITION (1954); GEORGE W. STOCKING AND MYRON W. WATKINS, MONOPOLY AND FREE ENTERPRISE (1951); JOHN PERRY MILLER, UNFAIR COMPETITION (1940). *See also* Jacobs, *The Normative Foundations Of Antitrust Economics*, 74 N. C. L. Rev. at 226-27 (contending that "Harvard School" of industrial organization dominated antitrust thought in the 1960s).

Indeed, even Professor Clark, praised by Professor Hayek for embracing an expansive definition of "competition," defined competition in a manner that seemed to exclude contractual limits on the discretion

C. Judicial Reliance on Price Theory:

For over three decades, courts implementing *Standard Oil*'s Rule of Reason embraced price theory with a vengeance, often at the behest of expert enforcement agencies.[195] As explained earlier, *Standard Oil* equated "competition" with rivalry, which normal contracts could "duly" restrict.[196] Ultimately, however, courts came to adopt price theory's more stylized definition of the term, which treated "competition" as that collection of business practices leading to the efficient allocation of resources and thus the maximization of social welfare. While this redefinition of "competition" retained *Standard Oil's* normative focus on consumer welfare, courts simultaneously embraced the various descriptive assumptions generated by price-theory's brand of industrial organization and the particular model of competition that these assumptions implied.[197] More precisely, courts during this era held that antitrust regulation was designed to interdict any and all limitations on "competition," which they defined as moment-to-moment technological rivalry

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of firms, *i.e.*, non-standard contracts.

> "Competition between business units in the production and sale of goods is the effort of such units, acting independently of of one another (without concerted action), each trying to make a profitable volume of sales in the face of the offers of identical sellers of identical or closely similar products."

See JOHN MAURICE CLARK, COMPETITION AS A DYNAMIC PROCESS, 13 (1961). *See also* Hayek, *The Meaning Of Competition*, at 92; J.M. Clark, *Toward A Concept Of Workable Competition*, 30 Amer. Econ. Rev. 241 (1940) (arguing that the perfect competition model did not provide a useful benchmark for judging the efficacy of competition in actual markets).

[195]The period in question began about 1940 and ended in 1977.

[196]*See* nn. ___,*supra* and accompanying text.

[197]*See* nn. ___,*supra* and accompanying text (describing various assumptions associated with price-theoretic industrial organization).

between completely autonomous firms unconstrained by non-standard contracts.[198] What followed was the so-called "inhospitality tradition" of antitrust, which manifested itself in the form of extreme hostility toward any contractual restraint on the "freedom" of individuals or firms to engage in head-to-head rivalry.[199] According to this approach, practices inexplicable under the price-theoretic model

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[198] A different Professor Clark, who embraced a broad view of the meaning of competition (approvingly) characterized antitrust's definition of "competition" as follows:

> "The concept of competition that has grown out of the antitrust laws is not confined to price competition, but accords a place to competition as affecting productive techiques and quality and design of products. As to productive techniques, it is especially concerned that access of producers to good and efficient techniques should be as wide as is consistent with the essential purpose of the patent system. This system is built around the principle of stimulating innovation in products and technical methods by offering inventors a temporary monopoly in the particular inventions each has made, on conditions that their specifications are publicly disclosed. . . . A balanced concept of competition – one in which the aspects of productive techniques, improved and differentiated products, and price all play a part."

See J.M. CLARK, COMPETITION AS A DYNAMIC PROCESS, 47 (1961). This, of course, is a purely technological conception.

[199] *See* WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM, at 19 (describing inhospitality tradition of antitrust); *id.* at 370-73 (describing influence of inhospitality tradition on antitrust treatment of non-standard contracts); Easterbrook, *Is There A Ratchet In Antitrust Law?*, 60 TEX. L. REV. at 715 ("[the] inhospitality tradition of antitrust . . . called for courts to strike down business practices that were not clearly procompetitive. In this tradition an inference of monopolization followed from the courts' inability to grasp how a practice might be consistent with substantial competition. The tradition took hold when many practices were genuine mysteries to economists, and monopolistic explanations were congenial. The same tradition emphasized competition in the spot market. Long-term contracts, even those arrived at by competitive processes, were deemed anticompetitive because they shut off day-to-day rivalry."). The phrase "inhospitality tradition" apparently was coined by Professor Donald Turner, an economist who headed the Antitrust Division of the Department of Justice in the 1960s. According to Professor Turner "I approach territorial and customer restrictions not hospitably in the common law tradition, but inhospitably in the tradition of antitrust law." Donald F. Turner, *Some Reflections on Antitrust*, 1966 N.Y. ST. B.A. ANTITRUST L. SYMP. 1, 1-2. *See also* Jacobs, *Antitrust Economics*, 74 N. C. L. REV. at 227-28 (describing so-called Harvard School of industrial organization and antitrust policy during this period); nn. ____, *infra* and accompanying text (collecting decisions contending that (price-theoretic) competition would maximize social welfare.

of "competition" were necessarily "anticompetitive" attempts to acquire or exercise market power and thus resulted in a "non-competitive" allocation of resources.[200]

This "inhospitality tradition" pervaded antitrust law in general and the Sherman Act in particular, especially at the *per se* stage of analysis. The result was a vast expansion of the scope of *per se* rules and concomitant contraction of the scope and importance of more thorough "Rule of Reason" analysis. Agreements limiting rivalry between joint venturers were unlawful *per se*, even if such arrangements were ancillary to an otherwise legitimate venture that enhanced rivalry with non-venturers and thus appeared to produce benefits for consumers.[201] According to the Supreme Court, such agreements amounted to a "destruction of competition in one sector of the economy," infringed the "freedom of individual members [of a venture] to compete," were "always or almost always anticompetitive," and produced no redeeming virtues.[202] Collective refusals to deal were similarly unlawful *per se*, regardless whether they produced or threatened to produce harm to consumers.[203] Such arrangements deprived their victims of the "freedom to buy . . . in an open

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[200]Easterbrook, *Is There A Ratchet In Antitrust Law*?, 60 Tex. L. Rev. at 715.

[201]*See* United States v. Topco, 405 U.S. 596 (1972) (declaring ancillary restraints allocating territories among joint venture partners unlawful *per se*, despite district court finding that participants possessed no market power and that venture enhanced competition); United States v. Sealy, Inc., 388 U.S. 350 (1967) (same). *See generally*, Meese, *Farewell To The Quick Look*, 68 ANTITRUST L. J. at 469-70, n. 30-31 (quoting extensively from district court findings in *Topco* that the restraints facilitated the success of the venture *vis a vis* larger, integrated chains, thus serving the interests of consumers).

[202]*See Topco*, 405 U.S. at 610; *id.* at 610-611; *id.* at 610 ("Implicit in such freedom is the notion that it cannot be foreclosed with respect to one sector of the economy because certain private citizens or groups believe that such foreclosure might promote greater competition in a more important sector of the economy."); *Sealy*, 388 U.S. at 355 (finding horizontal ancillary restraints unlawful because "their anticompetitive nature and effect are so apparent and so serious that the courts will not pause to assess them in light of the rule of reason").

[203]*See* Radiant Burners, Inc. v. Peoples Gas Light and Coke Company, 364 U.S. 365 (1961) (declaring gas companies' collective refusal to deal with customers of burner manufacturer unlawful *per se*); Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 209 (1959) (collective refusal by appliance

competitive market,"[204] "interfere[d] with the natural flow of commerce,"[205] and had "by [their] 'nature' and 'character,' a monopolistic tendency."[206] Horizontal price fixing that reduced prices was automatically unlawful, because it "crippled the freedom of traders to sell in accordance with their independent judgment."[207]

Courts did not reserve this hostility for agreements among rivals, but exhibited equal disdain for vertical arrangements. Here again, non-standard agreements that reduced some form of rivalry were deemed without redeeming virtue and thus "anticompetitive" attempts to obtain or exercise market power. While not unreasonable *per se*, vertical mergers between a manufacturer and distributor were unlawful under the Clayton Act if the distributor possessed a non-trivial share of the market, with the result that the transaction resulted in a "foreclosure of a share of the market otherwise open to competitors."[208] Exclusive dealing contracts that bound a non-trivial number of dealers were unlawful, regardless of their benefits, because they placed a "potential clog on

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manufacturers to deal with single retailer in San Francisco unlawful *per se* despite absence of any showing of public harm); Fashion Orignators Guild v. FTC, 312 U.S. 457 (1940).

[204] *Klor's, Inc.*, 359 U.S. at 213; *id.* at 211 (*Standard Oil*'s Rule of Reason voids contracts that "interfered with the 'nature flow' of an appreciable amount of interstate commerce") *quoting Standard Oil*, 221 U.S. at 57, 61.

[205] *Radiant Burners*, 364 U.S. at 660, *quoting Klor's, Inc.*, 359 U.S. at 213.

[206] *Klor's, Inc.*, 359 U.S. at 213, *quoting Standard Oil.*

[207] Kiefer-Stewart v. Joseph Seagram & Sons, 340 U.S. 211, 213 (1951).

[208] *See* Brown Shoe Co. v. United States, 370 U.S. 294, 327-334 (1962) (finding vertical merger unlawful where transaction would "foreclose" other manufacturers from 2-3% of the nation's shoe stores); A.G. Spaulding & Bros., Inc., 56 F.T.C. 1125, 1168-69 (1960) (declaring vertical merger unlawful without regard to share of market actually foreclosed); Kennecot Copper Corp. v. United States, 231 F. Supp. 95, 104-105 (S.D. N. Y. 1964) (finding that merger between copper producer and one of ten manufacturers of "paper insulated copper wire" lessened competition by foreclosing other manufacturers from selling copper to the purchased firm).

competition"[209] took "away freedom of purchasers to buy in an open market," and were thus "anticompetitive."[210] Arrangements whereby a manufacturer encouraged dealers to purchase and promote the products of a particular supplier were equally problematic, even though they were not *de jure* or *de facto* exclusionary. Such arrangements precluded dealers from making purchasing decisions "solely on the basis of competitive merit" because they ensured that "non-sponsored brands do not compete on even terms of price and quality competition."[211] Such arrangements "impaired competition"[212] and "adversely affected" the "operation of the competitive market."[213] They were not normal competitive practices, but instead involved the "utilization of economic power in one market to curtail competition in another,"[214] and the "use of economic power as a partial substitute

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[209]Standard Oil of California v. United States, 337 U.S. 293 (1949) (exclusive dealing contracts necessarily "substantially lessen[ed] competition" where manufacturer bound 6.7% of region's dealers); United States v. Richfield Oil Corp., 99 F. Supp. 280 (S.D. Cal. 1951), *aff'd.* 343 U.S. 922 (1952) (finding unlawful exclusive dealing contract that bound 3% of region's dealers).

[210]*See* F.T.C. v. Brown Shoe, 384 U.S. 316, 320, 321 (1966) (finding that such an agreement involving 1% of the nation's shoe retailers offends the "central policy of the Sherman Act" and thus constitutes an "unfair trade practice" in violation of Section 5 of the FTC Act). *See also* Dictograph Products v. FTC, 217 F.2d 821, 828 (2d Cir. 1954) ("It is the policy of the Congress that [the defendant's] merchandise must stand on its own feet in the open market . . . without the competitive advantage to be obtained by the use of prohibited exclusionary agreements.").

[211]*See* F.T.C. v. Texaco, 393 U.S. 223, 230 (1968).

[212]*See* Atlantic Refining Co. v. F.T.C., 381 U.S. 357, 370 (1965).

[213]*See Texaco*, 393 U.S. at 230. *See also In re Firestone Tire & Rubber Co., et al.*, 58 F.T.C. 371, 413 (1961) (banning supplier's agreement to pay distributor large commissions because, under such an arrangement, "the success of the one group is not due to the fact that its members are more able competitors, nor because they offer superior products and services, and the failure of the other group is not traceable solely to the possible inferiority of their products and services. The one outstanding fact is that [the defendant] has been successful . . . because of the sales commission system and not because of either their own competitive abilities or because of the competitive advantages of their products.").

[214]*See Atlantic Refining Co.*, 381 U.S. at 369; *id.* at 376 (finding "little point" for the arrangement "were it not for [defendants'] ability to exert power over their wholesalers and dealers"). *See also Texaco*, 393 U.S. at 228-29 (finding that, despite lack of facts showing actual coercion "Texaco's dominant economic

for competitive merit."[215] Even if such arrangements produced benefits, they constituted "unfair methods of competition" whenever they involved a not insubstantial amount of commerce.[216]

Other vertical arrangements suffered a similar fate, and for similar reasons. Thus, tying contracts "den[ied] competitors free access to the market . . . because of the [seller's] power or leverage" and thus curbed "competition on the merits with respect to the tied product."[217] Sellers could invariably achieve any benefits produced by such contracts through less restrictive means.[218] So, for instance, a seller that wished to protect the goodwill of the tying product by ensuring that purchasers used tied products of sufficient quality could provide information to consumers about the merits of the tied product or "even" adopt contractual specifications governing the quality of compliments the consumer could purchase.[219] Such less restrictive alternatives were consistent with

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power was used in a manner which tended to foreclose competition in the marketing of [tires, batteries and accessories]").

[215]*Texaco*, 393 U.S. at 230.

[216]*See Atlantic Refining*, 381 U.S. at 371 (conceding that such contracts "may well provide Atlantic with an economical method of assuring efficient product distribution among its dealers"); *id.* (finding "it unnecessary to embark upon a full-scale economic analysis of competitive effect . . . [because] the Commission found that a not insubstantial portion of commerce is affected."); *Texaco*, 393 U.S. at 230 ("The Commission is not required to show that a practice it condemns has totally eliminated competition in the relevant market. It is enough that the Commission found that the practice in question unfairly burdened a not insubstantial volume of commerce.").

[217]*See* Fortner Enterprises v. United States Steel Corp., 394 U.S. 495, 498 (1969) (*quoting* Northern Pacific R. Co. v. United States, 356 U.S. 1, 5-6 (1958)); United States v. Loew's, Inc. 371 U.S. 38, 44-46 (1963); *id.* at 48 (describing adverse effects of contracts in question on "free competition"). *See also* Meese, *Tying Meets the New Institutional Economics*, 146 U. PENN. L. REV. at 13-16 (describing traditional view that tying contracts are the result of "coercive forcing").

[218]*See Fortner Enterprises*, 394 U.S. at 503 ("tying arrangements generally serve no legitimate business purpose that cannot be achieved in some less restrictive way."); *Standard Oil*, 337 U.S. at 306 (same).

[219]*See* Times Picayune Co. v. United States, 345 U.S. 594, 605 (1953) (claiming that "any intrinsic superiority of the 'tied' product would convince freely choosing buyers to select it over others, anyway");

(price theoretic) "competition."[220] Firms that sought tying contracts, on the other hand, were exercising market power to "force" purchasers to take a tied product of lower quality, higher price, or both.[221] Thus, such agreements "serve[d] hardly any purpose beyond the suppression of competition."[222]

Standard Oil, 337 U.S. at 306; International Salt Co. v. United states, 332 U.S. 392, 397-98 (1948) (seller may not protect goodwill of tying product by resorting to "disguised restraints of free competition"); IBM v. United States, 298 U.S. 131, 138-39 (1936) (seller could protect goodwill by "proclaiming the virtues of its own cards or warning against the danger of using in its machines, cards which do not conform to the necessary specifications, or . . . make[ ] its leases conditional upon the use of cards which conform to them."); Siegel v. Chicken Delight, Inc. 448 F.2d 43, 51-52 (9th Cir. 1971) (same). *See* Meese, *Tying Meets the New Institutional Economics*, 146 U. PENN. L. REV. at 71-84 (describing traditional view that numerous less restrictive alternatives could achieve legitimate objectives of tying contracts).

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> "The economic merit in tying rivets to machines and an economic justification for such tying will not suffice to prevent the operation of the statute. The Clayton Act is intended *to preserve competitive conditions*. The *open market* not the court should be the forum for the presentation of claims as to the merits of tied articles. The lessees are quite capable of judging for themselves *in an atmosphere of competition* whether or not the rivets of one manufacturer will work in the machines of another."

Judson L. Thompson MFG. Co. v. F.T.C., 150 F.2d 952, 958 (1st Cir. 1945) (emphases added). *Cf.* nn. ____, *supra* and accompanying text (describing assumptions by price theorists that firms could costlessly convey information and that purchasers would readily absorb such information).

221 *See Fortner*, 394 U.S. at 498; Northern Pacific R. Co. v. United States, 356 U.S. 1, 5-6 (1958). *See also* KAYSEN & TURNER, ANTITRUST POLICY, 157 ("Tying implies some market power on the part of the seller practicing it.").

222 *See Fortner Enterprises*, 394 U.S. at 498 (*quoting* Northern Pacific R. Co. v. United States, 356 U.S. 1, 5-6 (1958)).

To be sure, courts purported to qualify the *per se* rule with a requirement that plaintiffs demonstrate the seller's economic power in the market for the tying product. *See Northern Pacific R. Co.*, 356 U.S. at 6-7. Still, courts found such power so readily as to render this requirement barely relevant. So, for instance, courts held that sellers had sufficient economic power whenever they possessed a product with "unique attributes" that was "attractive to consumers," *i.e.*, whenever the market in question was characterized by product differentiation. *See* United States v. Loew's, Inc., 371 U.S. 38, 45 (1963); *id.* at 46-48 (possession of a copyright creates presumption of economic power); *Chicken Delight*, 448 F.2d at 49-50. Indeed, as suggested in the text, courts even went so far as to find that the existence of such contracts itself implied the "power" to impose them. *See Fortner*, 394 U.S. at 504; *Loew's, Inc.*, 371 U.S. at 49 (fact of market foreclosure confirmed presumption that copyright conferred economic power); *Northern Pacific R. Co.*, 356 U.S. at 8 ("the very existence of this host of tying arrangements is itself compelling evidence of the defendant's great power"). *Cf. id.* at 6-7 (no "economic power" would be present if "one of a dozen food

Courts even went so far as to ban agreements limiting rivalry between a manufacturer's own dealers in the sale of its product. Resale price maintenance and exclusive territories were unlawful *per se*, as were restrictions on the identity of customers to whom dealers could resell.[223] Like franchising, such arrangements were "unusual," "inconsistent with the free-market principle embodied in the Sherman Act,"[224] and "so obviously destructive of competition that their mere existence [was] enough" to justify condemnation.[225] Exceptions were made only for agreements of consignment, under which the manufacturer retained title to its product and thus realized efficiencies "within" its own boundaries.[226] Indeed, courts even banned contractual arrangements that assured consumers *lower* prices, *i.e.*, maximum resale price maintenance. Such vertical price ceilings, the Court said, interfered with "the forces of a competitive market" crippled the ability of dealers "to compete," and produced no corresponding benefits.[227] Here again, the Court equated "competition" with technological rivalry, unconstrained by non-standard contracts, even if such "competition" produced prices *higher* than those set by the challenged contract.

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stores in a community were to refuse to sell flour unless the buyer also took sugar"). In short, any departure from perfect competition (including the very existence of tying contracts) was deemed evidence of economic power.

[223]*See* United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

[224]United States v. General Motors, 384 U.S. 127, 145-48 (1966).

[225]*Schwinn*, 388 U.S. at 379; *General Motors*, 384 U.S. at 146.

[226]*See Schwinn*, 388 U.S. at 379-82 (recognizing that restrictions governing consignment sales may be reasonable methods of competition with other manufacturers). *Cf.* Simpson v. Union Oil, 377 U.S. 13 (1964). *See* Comanor, *Vertical Restrictions on Territories and Customers*, 81 HARV. L. REV. at 1436 (contending that contractual integration cannot produce efficiencies). *See also* nn. ____, *infra* and accompanying text (describing endorsement of similar economic reasoning by the United States).

[227]*Albrecht*, 390 U.S. at 152-53.

The Court did not pursue this vision of competition unilaterally, but instead received help and encouragement from expert enforcement agencies, *viz*, the Department of Justice and the Federal Trade Commission. In administrative decisions and briefs filed with the Court, these agencies repeatedly embraced the assumptions of price theory and the concomitant account of "competition" that these assumptions implied.[228] If exclusive dealing produced cognizable benefits, the government said, dealers would choose such a course "voluntarily," that is, without any contractual requirement.[229] Thus, contracts requiring such exclusivity "suppressed competition."[230]

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[228] At least some enforcement officials were aware of their influence on generalist courts and resolved only to bring those cases that rested upon what they believed to be sound legal and economic propositions:

> "It is the duty of the Department of Justice, not to bring a case simply on the basis that it thinks it *can* win, but to bring only those cases that it thinks it *should* win. It is our duty to do the best we can in determining appropriate interpretations of the law, and in assisting the courts in creating a rational body of antitrust law by seeking to win cases only on the basis of legal propositions which the Government believes to be sound, on the basis of the best thought it can bring to bear. I believe that it is important that the Government accept this obligation with particular seriousness when it brings antitrust cases. Because antitrust problems are typically technical and complex, many courts, whether rightly or wrongly, tend to rely to a greater extent than usual upon the Government's presentation of its case. This tendency is reinforced by the fact that many issues of antitrust law are presented to the courts in cases involving the FTC—cases in which the courts tend to defer to the judgment of an administrative agency. Thus the Department of Justice must refrain from arguing cases upon dubious legal grounds, even though, by exercising this restraint, it loses cases that might otherwise be won."

See Donald Turner, *Address To The American Bar Association*, 10 ANTITRUST BULL. 685, 686 (1965) (emphasis in original). Thus, the enforcement agencies shared a significant portion of the responsibility for the dominance of price theory's model of competition during this period.

[229] In *FTC v. Brown Shoe Co.*, the Solicitor General, head of the Antitrust Division, and FTC urged the Court to void exclusive dealing contracts because:

> "[E]ven if it were supposed that complete line concentration was the most efficient approach, one would expect that retailers would be eager to achieve the attendant economies and would not have to be held to the line by contractual agreement. As the Commission concluded, '[w]hile line concentration itself may or may not be economically justifiable, there is no economic justification for making the adherence to this doctrine the subject of agreement between buyer and seller and enforcing the agreement to the latter's advantage' (citation omitted). Independent shoe dealers do not need restrictions on their freedom of

According to the Department of Justice, exclusive territories, location clauses and customer restrictions produced no benefits, because: 1) distribution efficiencies could only be realized within the boundaries of the firm[231] or, at any rate, 2) through less restrictive alternatives.[232] Thus, such arrangements had no purpose except to "restrict competition among parties who would otherwise compete" and overrode "the independent allocations [of sales effort] which would be made by individual firms in responses to the forces in a free market."[233] The Federal Trade Commission

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> choice in order to achieve efficiency."

Brief for the United States at 29-30, FTC v. Brown Shoe Co., 384 U.S. 316 (1966) (No. 118). *See also* n. ____, *supra* and accompanying text (describing identical assumption by price theorists).

[230]*See* Brief for the United States in Brown Shoe Co., at 30.

[231]In a brief coauthored by Donald Turner and Richard Posner, the United States argued:

> "[A] rule that treats manufacturers who assume the distribution function themselves more leniently than those who impose restraints on independent distributors merely reflects the fact that, although integration in distribution may sometimes benefit the economy by leading to cost savings, agreements to maintain resale prices or to impose territorial restrictions of unlimited duration or outlet limitations of the type involved here have never been shown to produce comparable economies."

Brief for the United States at 50, United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967) (No. 25).

[232]*See* Brief of the United States in White Motor Co. v. United States, 372 U.S. 253 (1963), at 25-26. *See also* Donald Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655, 699 (1962) (arguing that legitimate objectives of exclusive territories could be achieved through "less restrictive alternatives such as a clause assigning each dealer a territory of primary responsibility which he agrees to use his best efforts to develop."). The endorsement of so-called "best efforts" clauses is of course an example of the price-theoretic assumption that judicial interpretation and enforcement of contracts is costless. *See* nn. ___, *supra* and accompanying text (explaining that price theory adopted this assumption).

[233]*See Brief for the United States in White Motor Co.*, at 21, 25. *See also id.* at 24 ("The policy of the Sherman Act is that the proportion of time, money, and effort to be devoted to interbrand rather than intrabrand competition and to each of the inducements offered by sellers to buyers, is to be determined by the free decisions of individual sellers, not by agreements between a manufacturer and its purchasers."); *id.* at 22 ("The function of the agreement, thus described, is to restrain competition — the very thing the Sherman Act forbids — and thus the argument stands as its own condemnation. The policy of the Sherman Act does not prefer one form of competition to another. The Act is based on the philosophy that the most

agreed, stating that such arrangements prevented "competitive considerations . . . from playing their normal part in distributor and dealer relationships," and marked a "distortion of natural patterns of distribution."[234] Numerous antitrust scholars agreed with these assessments.[235]

Exclusive territories ancillary to the formation of a joint venture met similar disdain. Although such arrangements could perhaps encourage local advertising, such advertising was "from the standpoint of the policy of the antitrust laws . . . at best, a mixed blessing."[236] At any rate, there

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efficient distribution of trucks, as of any other product, will result from intra-brand competition between sellers of one brand.").

[234]*See In re Sandura*, 61 FTC 756, 815-16. *Id.* at 814 (referring to the "competitive distortions engendered by respondent's artificial distribution structure").

[235]For instance, responding to the argument that exclusive territories or location clauses were legitimate methods of assuring adequate dealer promotion, Professor Lawrence Sullivan opined:

> "The most comprehensive response to arguments like this is that [intrabrand] *competition* should be the device which determines what the public really needs or wants. Take the claim that display facilities are needed. If the public prefers expensive shopping amenities to lower prices, it will pay the higher prices to have greater amenities. . . .This is what should happen. . . .The contrary view assumes that the *manufacturer* knows better than *the market* how dealers ought to be deployed and what services and facilities they should offer in order to maximize output. But this argument, like the comparable one in favor or resale price maintenance, assumes that the manufacturer will always know what is best and that his administered judgment about the ideal deployment of outlets across the nation will be more efficient than the deployment achieved through the myriad individual decisions by dealers investing in the distribution process. This assumption undercuts the primary policy commitment which underlies the whole of antitrust, the conviction that market decisions are likely to be more sensitive, flexible and accurate gauges of the way resources should be deployed than any monolithic, administered decision."

LAWRENCE SULLIVAN, ANTITRUST, 414-16 (1977). Like price theorists, then, Professor Sullivan drew a distinction between "competition" and "the market," on the one hand, and non-standard contracts (the manufacturer's "monolithic, administered decision") on the other. The later simply did not constitute "competition." *See also id.* at 15-17 (lauding various price-theoretic industrial organization textbooks as proper basis for antitrust economics).

[236]*See* Brief For The United States in United States v. Seally, Inc., 388 U.S. 350 (1967) (No. 9), 19. *See also* Brief For The United States in United States v. Topco, 405 U.S. 596 (1972) (No. 70-82) 28 (arguing that brand names necessarily "insulate [a product] to some degree, from competition") (*citing* JOE BAIN, BARRIERS TO NEW COMPETITION, 114-15).

were less restrictive methods of achieving such promotion, and exclusive territories would result in a "severe diminution in the amount and vigor of competition in the industry."[237] Indeed, the United States went so far as to compare such restrictions (unfavorably) to governmental regulation of market entry, the latter of which was superior because administered by "disinterested" regulators.[238]

The Court's hostility toward any and all contracts that limited "competition" as it defined it may seem inconsistent with *Standard Oil*'s normative conclusion that the Sherman Act only bans "undue" restraints on "competition."[239] Any apparent inconsistency is entirely illusory, however, and close analysis reveals that the Court's embrace of price theory was entirely consistent with *Standard Oil's* consumer-driven approach. *Standard Oil* did not equate "competition" with any formal state of affairs or technological practices leading to that state and thus did not approve any restraints that are "anticompetitive" in a price-theoretic sense.[240] Instead, as noted earlier, that decision equated competition with rivalry, and recognized that some (but not all) restraints on such "competition" could enhance consumer welfare.[241]

For its part, the price-theoretic Court did not "explode the economy into individual atoms," but like *Standard Oil* instead validated or signaled approval of some restrictions on rivalry

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[237] *See* Brief For The United States in *Seally*, at 19; *see also* Brief in Reply For The United States in *Topco*, at 3 (such restrictions are unlawful *per se* because "the theory of the Sherman Act is that the free forces of the marketplace and not agreements among competitors, are to determine the allocation of business.").

[238] *See* Brief For The United States in *Topco*, at 26.

[239] *See* nn. ____, *supra* and accompanying text.

[240] *See* nn. ___, *supra* and accompanying text (explaining that *Standard Oil* equated "competition" with rivalry).

[241] *See* nn. ___, *supra* and accompanying text.

that appeared to produce technological efficiencies "within" firms.[242] For instance, while the Court banned outright limits on how and where a dealer could resell a product, it approved identical limits on dealers that took the form of consignment agreements.[243] Such contractual arrangements, which controlled dealers so long as title remained "within" the manufacturer, allowed firms some control over their distribution network and thus advanced price-theoretic competition.[244] Moreover, while the Court was generally hostile to horizontal and vertical mergers during this period, it repeatedly signaled its approval of transactions that eliminated rivalry between smaller firms if necessary to produce (technological) economies of scale and thereby create a more effective competitor.[245] Like consignment agreements, such transactions restrained "competition" in some sense, by eliminating rivalry that might otherwise take place. Nonetheless, the Court said, such restrictions advanced overall competition as understood by price theorists, and thus were not "undue" restrictions of competition of the sort condemned by *Standard Oil*.[246]

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[242] *Cf. Northern Securities*, 193 U.S. at 411 (Holmes, J. dissenting).

[243] *See Schwinn*, 388 U.S. at 377-82.

[244] *See Schwinn*, 388 U.S. at 379-81; *id.* at 382 (sustaining district court's finding that the "net effect" [of a consignment arrangement] is to preserve and not to damage competition in the bicycle market").

[245] *See Vons Grocery*, 384 U.S. at 277 (suggesting that a merger could be "defended on the ground that . . . the two had to merge to save themselves from destruction by some larger and more powerful competitor"); United States v. Philadelphia National Bank, 374 U.S. 321, 370-71 (1963) (same); *Brown Shoe Co.*, 370 U.S. at 319-20 (stating that merger between small firms could create a more effective competitor against dominant firms and thus result in a "stimulation to competition").

[246] *See* nn. _____, *supra* and accompanying text (*Standard Oil* forbids only undue limits on competition). *See also Philadelphia National Bank*, 374 U.S. at 367 ("The test of a competitive market is not only whether small competitors flourish but also whether consumers are well served.").

Even those decisions of this era that voided non-standard contracts often invoked *Standard Oil*, purporting at least to ban only those restraints that unreasonably restrained trade.[247] However, price theory's conclusion that non-standard contracts produced no cognizable benefits led the Court to conclude that such agreements were not normal, usual, or ordinary practices that advanced competition and trade, but were instead "unusual" methods that reflected the exercise of or attempt to acquire market power and thus threatened the "evil consequences" of monopoly.[248] Because such restraints were not consistent with a "competitive" market, they restrained trade unduly and were thus banned.[249] While the Court voided some restraints that the *Standard Oil* Court may have approved, it did not reject the decision's normative premise but instead applied that premise in light of new theory, just as *Standard Oil* suggested.[250]

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[247]*See, e.g.*, *Topco*, 405 U.S. at 606-607; *Schwinn*, 388 U.S. at 374 (citing *Standard Oil* for the proposition that the Court must determine "whether the restraint is 'reasonable' in the special sense in which § 1 of the Sherman Act must be read for purposes of this inquiry"); *Klor's, Inc.*, 359 U.S. at 211 (describing *Standard Oil* as "a landmark opinion" that "read § 1 to prohibit . . . undue restraints of trade"); *Northern Pacific R. Co.*, 356 U.S. at 5 ("the courts have construed [Section 1] as precluding only those contracts or combinations which 'unreasonably' restrain competition") (*citing Standard Oil*). It should be noted that many decisions that failed to cite *Standard Oil* relied upon *Northern Pac. R. Co.*'s articulation of the *per se* rule. *See, e.g.*, *General Motors*, 384 U.S. at 145-46.

[248]*See Schwinn*, 388 U.S. at 379 (enforcement of vertical restraints "would sanction franchising and confinement of distribution as the ordinary instead of the unusual method"); *Klor's, Inc.*, 359 U.S. at 213 (group boycot *per se* unlawful because it had a "monopolistic tendency"); *id.* at 211 (*Standard Oil* banned contracts with a "monopolistic tendency") *quoting Standard Oil*, 221 U.S. at 57.

[249]*See, e.g.*, *Klor's*, 359 U.S. at 213 (group boycott "interferes with the natural flow of interstate commerce"). *Cf. Standard Oil*, 221 U.S. at 61 (Sherman Act forbids contracts that produce an "undue restraint on the course of trade"); *id.* at 58 (American common law treated as illegal contracts that had the effect of restraining the "free flow of trade").

[250]*See* nn. ____, *supra* (showing that *Standard Oil's* Rule of Reason necessarily requires courts to apply evolving economic theory).

To be sure, the vision of "competition" embraced by the Court served social and political goals aside from the furtherance of economic efficiency.[251] In particular, decisions voiding non-standard contracts appeared to enhance the "freedom" of dealers and others bound by such agreements.[252] Still, as a rhetorical matter at least, the Court embraced its version of "competition" primarily because of its economic benefits.[253] In language that could have come from a textbook on industrial organization, the Court insisted that its version of competition between firms unrestrained by non-standard contracts would produce competitive markets and thus optimal ("competitive") prices, output and quality, maximizing the economic welfare of society and consumers.[254] Any furtherance of non-economic values was incidental to "competition's" tendency to enhance economic welfare.

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[251] *See* Meese, *Farewell To The Quick Look*, 68 ANTITRUST L. J. at 466-68 (describing influence of "Populist" social and political concerns on antitrust doctrine during this period). *See also*, *e.g.*, *TOPCO*, 405 U.S. at 610-11 (characterizing the Sherman Act as a "Magna Carta of Free Enterprise" that guarantees individual traders the "right" to be free of voluntary contractual restrictions on competition); *Brown Shoe Co.*, 370 U.S. at 344 (claiming that Congress meant Clayton Act to further decentralization of economic power even at the expense of higher prices).

[252] *See* Meese, *Price Theory And Vertical Restraints: A Misunderstood Relation*, 45 U.C.L.A. L. Rev. at 176-83 (describing so-called "populist" approach to vertical restraints that seeks to enhance the "freedom" of dealers and others from such contracts). *But see id.* at 184-95 (arguing that non-standard agreements actually enhance freedom).

[253] *See* Donald I. Baker & William Blumenthal, *Ideological Cycles and Unstable Antitrust Rules*, 31 ANTITRUST BULL. 323, 330 (1986) (arguing that during this period, "[t]he precise objective of antitrust policy was unimportant, for populist and economic approaches yielded consistent results"). Other scholars have been less charitable, asserting that the Court used economic theory as a fig leaf, to justify predetermined results. *See* Alan J. Meese, *Economic Theory, Trader Freedom, and Consumer Welfare: State Oil v. Khan and the Continuing Incoherence of Antitrust Doctrine*, 84 CORNELL L. REV. 763, 768 (1999); Thomas E. Kauper, *The Warren Court and the Antitrust Laws: Of Economics, Populism, and Cynicism*, 67 MICH. L. REV. 325, 330 (1968) (arguing that the Warren Court "used economic doctrine to support decisions arrived at upon other grounds"); Frederick M. Rowe, *The Decline of Antitrust and the Delusion of Models: The Faustian Pact of Law and Economics*, 72 GEO. L. J. 1511, 1524-27, (1984) (same).

[254] *See* nn. ____, *supra* and accompanying text (describing price theory's conclusion that "competitive" markets produce optimal allocation of resources, prices, output and quality).

> "The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the *unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress*, *while at the same time* providing an environment conducive to the preservation of our democratic political and social institutions."[255]

By defining "competition" so narrowly, to exclude non-standard contracts as "monopolistic," the Court was able to justify expansive interference in the economy, under the guise of correcting "market failure."[256] So long as the dominant economic paradigm defined "competition" to exclude such agreements, the Court could employ economic theory as a fig leaf, justifying a pursuit of social values by invoking efficiency concerns.[257]

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[255]*See Northern Pacific R. Co.*, 356 U.S. at 4 (emphases added). *See also Times-Picayune Co.*, 345 U.S. at 605 ("Tying arrangements, we may readily agree, flout the Sherman Act's policy that competition rule the marts of trade. Basic to the faith that a free economy best promotes the public weal is that goods must stand the cold test of competition; that the public, acting through the market's impersonal judgment, shall allocate the Nation's resources and thus direct the course its economic development will take."). The United States agreed:

> "The policy of the Sherman Act is that the most efficient use of resources and the most desirable distribution of economic power results from the separately made choices of buyers and sellers in a competitive marketplace."

Brief for the United States in White Motor Co., at 15.

[256]*See* MACHOVEC, PERFECT COMPETITION AND THE TRANSFORMATION OF ECONOMICS, at 194-200 (arguing that application of perfect competition competition model justified expanded antitrust intervention). *See also id*. at 52-95 (exploring link between perfect competition model and calls for central planning to achieve "perfect" result); Carl J. Dahlman, *The Problem of Externality*, 22 J. L. & Econ. 141 (1979) (arguing that many economists improperly assume that any departure from perfect competition justifies regulatory intervention). *See generally* Hayek, *Meaning Of Competition*, at 100 (arguing that the unrealistic definition of "competition" embraced by many economists creates a "standard of perfection as something desirable to be aimed at" and that in the real world this standard should be "wholly irrelevant").

[257]*See* Meese, *Economic Theory, Trader Freedom, and Consumer Welfare*, 84 CORN. L. REV. at 789-94 (arguing that changes in economic theory have made it more clear that protection of "trader freedom" entails an economic cost and thus caused the Supreme Court to pursue consumer welfare exclusively).

D. The Collapse Of Price Theory And A New Definition Of "Competition:"

Price theory did not maintain its monopoly on industrial organization and antitrust policy indefinitely. Just as rules of *per se* illegality had reached their greatest scope, a competitor emerged in the form of transaction cost economics. TCE embraced price theory's normative premise, seeking to determine whether practices are "competitive" in the sense of furthering economic welfare. In so doing, however, TCE challenged the root assumption of price theory's descriptive model of competition, namely, that technological factors gave rise to the existence of firms and determined the proper boundary between "the firm" and "the market." While technological considerations might explain why two stages of a production process should take place in close physical proximity, they could not explain why a single owner should coordinate both stages of the process.[258] In particular, proponents of TCE's new paradigm emphasized that reliance upon market contracting to perform a particular economic function involves a unique cost, namely, the cost of

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[258]Consider what Professor Bain called the "classic case" of technological benefits purportedly produced by vertical integration: the unification "of iron-making and steel-making to effect a saving in fuel costs by eliminating a reheating of the iron before it is fed into the steel furnace." *See* BAIN, INDUSTRIAL ORGANIZATION, at 381; DIRLAM AND KAHN, FAIR COMPETITION, at 23 (employing this same example); KAYSEN AND TURNER, ANTITRUST POLICY, at 120 (giving "integrated steel plant" as example of technical economies produced by vertical integration which "leads to an alteration of the structure of the plant *as well as the firm*.") (emphasis added). As Professor Williamson has pointed out, such considerations may well explain why two processes are located in close proximity. They do not, however, explain why both processes fall under common ownership. *See* Oliver Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 Amer. Econ. Rev. 112 (1971) (discussing traditional view that vertical integration produces economies through "technical complementarity in flow process operations'); *id*. at 116-117 (arguing that "flow process economies between otherwise separable stages of production [are] really a special case of the contractual incompleteness argument. . . . The advantages of integration thus are not that technological (flow process) economies are unavailable to nonintegrated firms, but that integration harmonizes interests (or reconciles differences, often by fiat) and permits an efficient (adaptive, sequential) decision process to be utilized.").

transacting, not incurred when a firm performs an activity itself.[259] The choice between "the firm" and "the market," then, depends at least in part upon the transaction costs of using the latter, costs that are unrelated to production technology.[260]

The antiseptic models of price theory — what Professor Coase called "blackboard economics" — had ignored these costs, assuming, for instance, that bargaining and information costs did not exist, and that market transactions consisted simply of costless standard contracts readily enforceable by the courts.[261] By contrast, practitioners of transaction cost economics emphasized that the "real world" often differed substantially from the state of the world assumed by price theory, thus suggesting that price theory's methodology for evaluating the cause and consequence of vertical integration was incomplete.[262] Most importantly, attention to the "real world" revealed transaction

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[259] *See* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA (n. s.) 386, 390 (1937) ("The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism.").

[260] Coase, *The Firm, The Market, And The Law*, at 7 ("The limit to the size of the firm is set where its costs of organizing a transaction become equal to the cost of carrying it out through the market."); Williamson, *Vertical Integration of Production*, 61 AMER. ECON. at *passim*; Coase, *Nature of the Firm*, 4 ECONOMICA at 390-91.

[261] *See* nn. ____, *supra*, and accompanying text.

[262] *See* Langlois, *The New Institutional Economics* at 13-14. Here again Professor Coase was prophetic. Speaking of economists' general approach to problems of regulating industry, he said:

> "Contemplation of an optimal system may suggest ways of improving the system, it may provide techniques of analysis that would otherwise have been missed, and, in certain special cases, it may go far to providing a solution. But in general its influence has been pernicious. It has directed economists' attention away from the main question, which is how alternative arrangements will actually work in practice. It has led economists to derive conclusions for economic policy from a study of an abstract model of a market situation. It is no accident that in the literature (and for that matter in Professor Caves's paper) we find a category "market failure" but no category "government failure." Until we realize that we are choosing between social arrangements which are all more or less failures, we are not likely to make much headway."

See Ronald H. Coase, *The Regulated Industries: Discussion*, 54 AMER. ECON. REV. 194, 195 (1964). *See* costs in abundance. Firms must identify trading partners and determine the price and quality of the product or service offered.[263] They must negotiate and memorialize agreements governing the transaction, attempting to anticipate and provide for each and every contingency that might occur over a long-term transaction, including the possibility that one or both parties might behave opportunistically, that is, take advantage of the other party so as to reallocate to itself a greater portion of the benefits of the relationship than the parties initially anticipated.[264] While parties could, theoretically provide for all contingencies by relying upon implicit or explicit requirements of "good faith," the costs of enforcing such provisions are very real, and courts are blunt instruments for interpreting and adjusting commercial relationships.[265]

This new transaction cost economics provided an entirely new lens through which to examine the causes and consequences of vertical integration. Even if potential trading partners possessed superior technology and thus lower production costs, reliance upon such partners *i.e.*, the market, to perform a particular function might be ill-advised, given the cost of transacting. Put more

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also Hayek, *The Meaning of Competition*, at 92 (arguing that the price-theoretic definition of competition "has little claim to be called 'competition' at all" and that "its conclusions are of little use as guides to policy.").

[263] *See* Carl Dahlman, *The Problem of Externality*, 22 J. L. & ECON. 141, 144-47 (1979) (defining transaction costs). *See also* Coase, *The Firm, The Market, and The Law*, at 6 ("In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on.") (*quoting* Coase, *The Problem of Social Cost*, 3 J. L. & ECON. at 15).

[264] WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM, at 47-52 (defining opportunism); *id.* at 32 (contending that, in the real world, parties must contend with possibility of opportunism when negotiating contracts); Williamson, *Vertical Integration of Production,* 61 AMER. ECON. REV. 115-17.

[265] WILLIAMSON, ECONOMIC INSTITUTIONS, at 32 ("Since the efficacy of court ordering is problematic, contract execution falls heavily on the institutions of private ordering."); *id.* at 68-84 (describing shortcomings of classical contract law as a vehicle for policing opportunism).

bluntly, price theory's "market" — a series of spot transactions governed by standard contracts — often failed to provide the cheapest way of coordinating the use of a given technology.[266] As a result, practitioners of transaction cost economics came to presume that complete vertical integration is an attempt to avoid or overcome such market failures, thus assuring the best possible allocation of resources in an imperfect world.[267] Integration that economists and courts once treated as attempts to "leverage" market power to gain strategic advantage over rivals were now seen by many as attempts to overcome market failure and enhance social welfare, without creating or relying upon market power.[268]

Transaction cost economics did more than explain many instances of complete vertical integration — it also offered insights into the rationale of partial integration accomplished solely by contract. Indeed, TCE suggested that "the firm" is simply a shorthand description of a particular set of contractual relationships, *i.e.*, "a nexus of contracts."[269] Adoption of this particular

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[266]*See* OLIVER WILLIAMSON, MARKETS AND HIERARCHIES, 8-10, 20-21 (1975).

[267]*See* WILLIAMSON, ECONOMIC INSTITUTIONS, at 103-130 (arguing that "vertical integration . . . is more consistent with transaction cost economizing than with the leading alternatives"); WILLIAMSON, MARKETS AND HIERARCHIES, at 20 (stating that "a presumption of market failure is warranted where it is observed that transactions are shifted out of a market and into a firm"); Williamson, *Delimiting Antitrust*, 76 GEO. L. J. 271, 273 ("The older story of the firm as production function gradually made way (or gave way) to a theory of the firm in which express allowance was made for transaction costs. Accordingly, the firm was thereafter described as a governance structure . . . technology was no longer determinative, and the boundaries of the firm (what to make, what to buy, how to trade, etc.) now needed to be derived."); Coase, *The Firm, The Market, and The Law*, at 5-7.

[268]*See* Coase, *Industrial Organization: Proposal for Research*, at 67-68 (asserting that non-standard contracts and other practices inexplicable under price theory are often necessary for "bringing about a competitive situation"); *cf.* Hayek, *Meaning of Competition*, at 96 (suggesting that many activities inconsistent with the perfect competition model are in fact methods of achieving a more "competitive" result).

[269]*See* Armen Alchian and Harold Demsetz, *Production*, *Information Costs, And Economic Organization*, 62 Amer. Econ. Rev. 777 (1972). *See also* Scott E. Masten, *A Legal Basis For The Firm*, 4 J. L. Econ. & Org. 181, 194-95 (1988) (observing that transactors could replicate by contract the various

set of contractual arrangements (complete vertical integration) can generate its own costs, and the "firm" and "the (spot) market" are not the only means of conducting economic activity.[270] There are an infinite variety of (non-standard) arrangements "in between," arrangements for which price theory had produced no benign explanation.[271] Relying upon a revised paradigm based upon transaction cost reasoning, economists and others offered new interpretations of old phenomena — non-standard contracts — the price-theoretic inhospitality tradition had condemned.[272] Tying contracts, for instance, were often beneficial methods of protecting the goodwill of a manufacturer or franchisor by ensuring that purchasers would choose complements of sufficient quality.[273] Vertical restraints

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rights and obligations that arise by default within a firm).

[270]*See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); WILLIAMSON, MARKETS AND HIERARCHIES, at 8-9.

[271]*See* Steven Cheung, *The Contractual Nature of the Firm*, 26 J. L. & ECON. 1, at 19 (1983) ("The polar cases are complicated by middlemen and subcontractors; agents contract among themselves; and any type of input may support a variety of contractual arrangements. We surmise that these very complications, which render 'the firm' ambiguous, have arisen from attempts to save transaction costs that were not avoidable in the polar cases."); Benjamin Klein, *Vertical Integration, Appropriable Rents, And The Competitive Contracting Process*, 21 J. L. & ECON. 297, 326 (1978) ("[The] primary distinction between transactions made within a firm and transactions made in the marketplace may be too simplistic. Many long term contractual relationships . . . blur the line between the market and the firm.").

[272]*See* Coase, *The Firm, The Market, and The Law*, at 6-7 ("The existence of transaction costs will lead those who wish to trade to engage in practices which bring about a reduction of transaction costs whenever the loss suffered in other ways from the adoption of those practices is less than the transaction cost saved. The people one deals with, *the type of contract entered*, the kind of service supplied, will all be affected.") (emphasis added). *See also* THOMAS KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTION, 114-17 (1970) (explaining that paradigm shifts cause reinterpretation of previously-observed phenomenon).

[273]*See* Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. L. & ECON. 345 (1985) (arguing that franchise tying contracts can protect goodwill of the franchise system); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J. L. & ECON. 223 (1978). *See also* Meese, *Tying Meets The New Institutional Economics*, 146 U. PENN. L. REV. at 61-94 (employing transaction-cost reasoning to show that tying contracts are often voluntary integration designed to obviate market failure).

on distributors such as exclusive territories or minimum resale price maintenance could encourage optimal promotional efforts by ensuring that dealers who invested in such promotion received remuneration for their efforts.[274] Maximum resale price maintenance can also enhance a manufacturer's goodwill, by preventing opportunistic price gouging by dealers that could undermine the manufacturer's reputation.[275]

Although initially couched as an explanation for vertical restraints, transaction cost economics suggested new explanations for horizontal agreements as well. The firm itself, of course, was simply a nexus of contracts between potential competitors.[276] Like vertical restraints, horizontal limits on rivalry by joint venture partners could combat market failure and make the venture a more effective competitor.[277] Price ceilings set by otherwise independent venture partners could protect consumers and the venture from opportunism.[278] Concerted refusals to deal could be salutary methods of self-help by venture partners enforcing beneficial forms of contractual integration.[279] Proponents of a transaction cost approach opined that such non-standard practices were

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[274] *See* Robert H. Bork, *The Rule of Reason and the* Per Se *Concept: Price Fixing and Market Division*, 75 YALE L. J. 373, 429-52 (1966); Lester G. Telser, *Why Should Manufacturers Want Fair Trade*, 3 J. L. & ECON. 86 (1960).

[275] *See* Meese, *Price Theory And Vertical Restraints*, 45 UCLA L. Rev. at 165-66. *See also* Frank H. Easterbrook, *Maximum Price Fixing*, 48 U. CHI. L. REV. 886, 893-95 (1981) (arguing that joint venturers can use maximum price fixing to establish collective reputation for low cost pricing).

[276] *See generally* Alchian and Demsetz, *Production, Information, And Economic Organization*, 62 Amer. Econ. Rev. at *passim.*

[277] *See* Bork, *Price Fixing and Market Division*, 75 YALE L. J. at 429-65.

[278] *See* Easterbrook, *Maximum Price Fixing*, 48 U. Chi. L. Rev. at 893-95.

[279] *See*, *e.g.*, HOVENKAMP, FEDERAL ANTITRUST POLICY, at 224-27 (describing possible procompetitive purposes of collective refusals to deal). *See also* RICHARD A. POSNER, ANTITRUST LAW, 207-211 (1976) (characterizing boycotts as self-help measures that can often serve beneficial purposes).

presumptively efficient attempts to avoid the market failures that would otherwise result from reliance on standard contracting in an atomistic market.[280]

Transaction cost economics did more than provide new explanations for a variety of practices. It also implied an entirely different model of "competition" relevant to application of *Standard Oil*'s Rule of Reason and its distinction between "ordinary" and "undue" restraints on competition or rivalry. Price theory, it will be recalled, equated "competition" with technological rivalry between autonomous firms, unconstrained by non-standard contracts.[281] Such rivalry took the form of quality improvements and price reductions and, when unconstrained, produced the best possible allocation of resources. While mergers or internal expansion could enhance such competition by generating technological efficiencies, contracts that limited rivalry between otherwise independent firms produced no cognizable benefits. Thus, such agreements were "anticompetitive" in a price-theoretic sense and thus "undue" restraints under *Standard Oil*, restraints that exercised market power and produced a departure from the optimal mix of price, quality, and output that a

[280]*See* WILLIAMSON, ECONOMIC INSTITUTIONS, at 28 (concluding that there is a "rebuttable presumption that nonstandard forms of contracting have efficiency purposes"). *See also* Coase, *The Firm The Market, and The Law*, at 26 (noting the ubiquity of transaction costs and resulting market failure in the real world).

To be sure, some proponents of this more hospitable approach to non-standard contracts purported to rest their arguments on "price theory." *See, e.g.*, Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PENN. L. REV. 925, 928 (1979) (arguing that hospitable, "Chicago" approach to antitrust rests upon rigorous application of price theory); BORK, ANTITRUST PARADOX, at 117-29 (arguing that "price-theory" should guide application of antitrust statutes); Robert H. Bork, *Resale Price Maintenance and Consumer Welfare*, 77 YALE L. J. 950, 952 (1968) (contending that arguments in favor of minimum rpm are "grounded in basic price theory"). *See also* Jacobs, *Normative Foundation of Antitrust Economics*, 74 N. C. L. REV. at 228-29 (arguing that Chicago School approach rested on applied price theory). However, close analysis shows that, despite this rhetorical embrace of price theory, these insights in fact rested upon a rejection of many assumptions of price theory in favor of Transaction Cost Economics. *See* Meese, *Price Theory And Vertical Restraints*, 45 UCLA L. Rev. at 166-170.

[281]*See* nn. ____, *supra* and accompanying text.

"competitive" market would produce.[282] Such agreements were "market failures" that government should correct via the antitrust laws.

According to the new paradigm, however, it was price-theoretic "competition" that would often lead to market failure and thus interfere with an efficient allocation of resources. Instead of producing the most favorable mixture of price, output, and quality, reliance upon technological rivalry and standard contracts to conduct economic activity often led to suboptimal results from the perspective of society and consumers.[283] Far from "destroying" useful competition and enhancing market power, then, complete vertical integration and various forms of non-standard contracting often promoted competition and consumer welfare by guiding the allocation of resources closer to the socially optimal result that a well-functioning market would actually produce.[284] An exclusive territory that induced dealers to provide appropriate services and information to consumers produced a better allocation of resources and more consumer satisfaction, while at the same time furthering rivalry between manufacturers.[285] Similarly, a franchisor's requirement that its franchisees purchase

[282] *See* nn. ____, *supra* and accompanying text.

[283] *See* nn. ____, *supra* and accompanying text.

[284] *See* Baxter, *The Viability of Vertical Restraints Doctrine*, 75 CALIF. L. REV. at 947-48 (arguing that vertical restraints are forms of partial integration that overcome market failures and associated distortions of the allocation of resources); Oliver Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PENN. L REV. 953, 988-89 (1979) ("allocative inefficiency is more apt to arise with respect to cost concerns, such as diseconomies of scale, failure to operate assets in a least cost way, and incurring of significant transaction costs. Organizaitonal changes that give rise to cost savings in any of the respects will, if not accompanied by offsetting price distortions, invariably give rise to social gains."); Coase, *Industrial Organization: A Proposal for Research*, at 68 (arguing that non-standard contracts and other practices are often "a necessary element in bringing about a competitive situation"). *Cf.* KAYSEN & TURNER, ANTITRUST POLICY, at 12-13 (arguing that courts should void anticompetitive arrangements, thus furthering "competition" in each industry and enhancing social welfare) *citing* PIGOU, THE ECONOMICS OF WELFARE.

[285] *See* Williamson, *Assessing Vertical Market Restrictions*, 127 U. PENN. L. REV. at *passim*; Robert H. Bork, *Resale Price Maintenance and Consumer Welfare*, 77 YALE L. J. 950 (1968); Bork, *Price Fixing*

inputs from it could encourage investments in quality that consumers were willing to pay for, avoiding the suboptimal "lemons equilibrium" that unconstrained rivalry might otherwise produce and furthering rivalry between franchise systems.[286] Finally, restrictions on the marketing discretion of joint venture partners could induce each venturer to engage in optimal promotion of the venture's product, enhancing competition with other ventures and assuring more consumer satisfaction than unconstrained "competition" would produce.[287]

To be sure, each such contract restrains "competition" in one sense. Yet, if courts insist, as they have, on defining "competition" as that process which best serves the interests if consumers, none of these arrangements is "anticompetitive"in a sense relevant to Rule of Reason analysis.[288] That rule does not treat competitive rivalry as an end in itself, but instead views rivalry and cooperation as complementary tools for maximizing social welfare.[289] The competition that takes place in the real world and between various groups ultimately depends upon the institution of private contracts, many of which, including "the firm" itself, are "non-standard."[290] Innovation includes the discovery of new organizational forms and the application of old forms to new

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And Market Division, 75 YALE L. J. at 472-75.

[286]*See* Klein & Saft, *Law and Economics of Franchise Tying Contracts*, 26 J. L. & ECON. at 349-54.

[287]*See* Bork, *Price Fixing and Market Division*, 75 YALE L. J. at 472-75.

[288]*See* nn. ___, *supra* and accompanying text (showing that courts embraced this technical model of competition during the inhospitality era); *see also* nn. ___, *supra* and accompanying text (*Standard Oil* equated competition with "rivalry").

[289]*See* nn. ____, *supra* and accompanying text. *See also* nn. ____, *supra* and accompanying text (arguing that courts embracing the price-theoretic paradigm did not void all restrictions on rivalry).

[290]*See National Society of Professional Engineers*, 435 U.S. at 688; *Sylvania*, 433 U.S. at 53, n. 21; *Chicago Bd. of Trade*, 246 U.S. at 238; *Standard Oil*, 221 U.S. at 62. *Cf.* Hayek, *Meaning Of Competition*, at 96 (arguing that various activities inexplicable under price theory's model of competition are in fact necessary to achieving a competitive result).

contexts.[291] Such contracts *prevent* or attenuate market failure, moving the market toward what economists would deem a more "competitive" result. Indeed, as Professor Coase pointed out, many markets deemed "perfectly competitive" are in fact the end result of complex contracts limiting rivalry between competitors.[292] Such *contractual* competition cannot product perfect results — no

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[291]*See* Williamson, *Antirust Lenses And Transaction Cost Economics*, in ANTITRUST, INNOVATION, AND COMPETITIVENESS, at 139-40 ("That the 'same technical facilities' produce with a 'great variety of costs' comes as no surprise if nontrivial cost consequences result when firms are organized and managed differently."); JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY, 84 (1943) (arguing that price competition is "a matter of comparative indifference" when compared to "the competition from a new commodity, the new technology, the new source of supply, [or] *the new type of organization*.") (emphasis added).

[292]Speaking in particular about commodity exchanges, Coase noted:

> "I refer to commodity exchanges and stock exchanges. These are normally organized by a group of traders (the members of the exchange) which owns (or rents) the physical facility within which transactions take place. All exchanges regulate in great detail the activities of those who trade in these markets (the times at which transactions can be made, what can be traded, the responsibilities of the parties, the terms of settlement, etc.), and they all provide machinery for the settlement of disputes and impose sanctions against those who infringe the rules of the exchange. *It is not without significance that these exchanges, often used by economists as examples of a perfect market and perfect competition, are markets in which transactions are highly regulated (and this quite apart from any government regulation that there may be). It suggests, I think correctly, that for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed.* Economists observing the regulations of the exchanges often assume that they represent an attempt to exercise monopoly power and aim to restrain competition. They ignore or, at any rate, fail to emphasize an alternative explanation for these regulations: that they exist in order to reduce transaction costs and therefore to increase the volume of trade."

See Coase, *The Firm, The Market, and The Law*, at 8-9 (emphasis added). *See also* Easterbrook, *Limits of Antitrust*, 63 TEX. L. REV. at 1 ("The goal of antitrust is to perfect the operation of competitive markets. What does this mean? A "competitive market" is not necessarily the one with the most rivalry moment-to-moment. The auction in which atomically small buyers and sellers continuously shout out bid and asked prices, the picture of 'perfect competition' found in economic texts, is a hypothetical construct. Every market entails substantial cooperation over some domain in order to facilitate competition elsewhere. . . . Markets themselves are organized. The Chicago Board of Trade, perhaps the closest of modern markets to the textbook ideal, has a sheaf of rules and cooperative arrangements that reduce the cost of competition."). *Compare Anderson*, 171 U.S. at 616 (sustaining rules ancillary to cattle exchange whose object was to "provide for the ready transaction of the business of the associates by obtaining a general headquarters for its conduct, and thus to ensure a quick and certain market for the sale or purchase of the article dealt in."); Hayek, *Meaning of Competition*, at 96 ("The whole *organization* of the market serves mainly the need of human institution ever can. Nonetheless, the result is superior to that which would obtain in a (real) world *without* non-standard contracting.[293] These contracts do not depend upon the creation or enhancement of market power and thus do not produce the evils against which antitrust law is directed. From the perspective of the Sherman Act and *Standard Oil*'s Rule of Reason, such limitations are not "undue," but instead serve to "promote" and "enhance" the sort of real world "competition" that would "develop trade" and advance society's welfare.[294] Given this recognition of contractual competition, proof that a non-standard contract limits rivalry in no way indicates that it is "anticompetitive."

E. TCE In The Supreme Court: A Partial Victory For The New Paradigm

The insights produced by transaction cost economics soon came to influence antitrust policy, leading the Supreme Court to contract the scope of certain *per se* rules. Most notably, these advances in theory caused the courts and enforcement agencies to abandon their hostility toward many vertical restraints. In Continental T.V. v. GTE Sylvania, for instance, the Court abandoned the *per se* rule against manufacturer restrictions on locations, territories and customers that dealers could serve.[295] The Court relied expressly upon transaction cost reasoning, emphasizing that a

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spreading the information on which the buyer is to act.") (emphasis added).

[293] *See* Hayek, *Meaning Of Competition*, at 100 ("The basis of comparison, on the grounds of which competition [in the real world] ought to be judged cannot be a situation which is different from the objective facts and which cannot be brought about by any known means. It ought to be the situation that would exist if competition were prevented from operating. Not the approach to an unachievable and meaningless ideal but the improvement upon the conditions that would exist without competition should be the test.'). Applying Professor Hayek's wisdom, then, many decisions during the price-theoretic era "prevented competition from operating."

[294] *See* Coase, *Industrial Organization: A Proposal for Research*, at 68.

[295] 433 U.S. 36 (1978).

"purely competitive situation" between dealers could produce a market failure, namely, inadequate promotional expenditures that could enhance the goodwill associated with a dealer's product.[296] Thus, while vertical restraints necessarily hindered intrabrand competition, they could in some cases enhance "interbrand" competition between manufacturers by preventing dealers from free riding on the promotional efforts of their colleagues.[297] While such restraints constrained the discretion of dealers, such a non-economic concern was beyond the scope of the Sherman Act.[298]

A decade later, the Court narrowed the definition of minimum resale price maintenance, excluding agreements between a dealer and manufacturer to terminate another dealer that was cutting prices.[299] Here again, the Court relied upon transaction cost reasoning, noting that reductions in dealer prices could go hand-in-hand with a reduction in promotional efforts, to the detriment of interbrand competition and consumers.[300] Another decade would pass before the Court

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[296]"Because of market imperfections such as the 'free rider' effect, these [promotional] services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the service than if none did." *Sylvania*, 433 U.S. at 55.

[297]*Sylvania*, 433 U.S. at 55-57. *See also* WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM, at 370-73 (describing transaction-cost basis of *Sylvania*).

[298]*Sylvania*, 433 U.S. at 53, n. 21 ("Competitive economies have social and political as well as economic advantages, but an antitrust policy divorced from market considerations would lack any objective benchmarks. As Justice Brandeis reminded us: 'Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence.'") (*quoting Chicago Bd. of Trade*, 246 U.S. at 238).

[299]*See* Business Electronics Corp. v. Sharp Electronics, 485 U.S. 717 (1988). *See also* Monsanto v. Spray-Rite Service Co., 465 U.S. 725 (1984) (a manufacturer's termination of one distributor after complaints from competing distributors cannot itself support finding of resale price maintenance).

[300]*See Business Electronics Corp.*, 485 U.S. at 727-28. To be sure, the Court did not carefully examine whether, in fact, the restraint at issue actually produced the benefits the defendants claimed for it. *See* Williamson, *Antitrust Lenses And Transaction Cost Economics*, at 156-57 (criticizing the Court for simply "parroting" defendants' free rider argument, even though the evidence was "conflicting"). It should be emphasized, though, that the reasonableness *vel non* of the restraint was not before the Court. Instead, the narrow question presented was whether the restraint *plausibly* produced procompetitive benefits and thus survived *per se* scrutiny. *See Business Electronics Corp.*, 485 U.S. at 728-30 (declining to apply a *per se* rule

abandoned the *per se* ban on maximum resale price maintenance, finding that such restraints could further interbrand competition by protecting consumers from opportunistic price gouging by a manufacturer's dealers.[301]

At the same time, the Court slowly contracted the scope of the *per se* rule against horizontal restraints on rivalry, recognizing in the process that such restraints can produce non-technological efficiencies.[302] In BMI v. CBS, for instance, the Court refused to apply the *per se* rule to a price agreement between thousands of composers, finding that the arrangement was necessary to the creation of a new product — a blanket license — and thus properly subject to analysis under the Rule of Reason.[303] In *NCAA*, discussed earlier, the Court further contracted the *per se* rule, holding that some cooperation between competitors — including cooperation on price — was necessary to create college football with the result that Rule of Reason treatment of *other* horizontal ancillary restraints was appropriate.[304] Like *Sylvania* and its progeny, each of these decisions relied on transaction cost reasoning. In *BMI*, for instance, the Court emphasized that individual bargains

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because "a quite plausible purpose of the restriction [is] to enable [the defendant] to provide better services under the sales franchise agreement.").

[301] *See* State Oil v. Khan, 522 U.S. 3 (1997); Alan J. Meese, *Economic Theory, Trader Freedom, and Consumer Welfare: State Oil v. Khan and the Continuing Incoherence of Consumer Welfare*, 84 CORNELL L. REV. 763, 777-81 (1999) (explaining how TCE undermined economic premises of *Albrecht*) . It should be noted that *Albrecht* also fell prey to developments within price theory, particularly the recognition that maximum rpm could eliminate the so-called "double mark-up" problem and thus expand output. *See, e.g.*, Roger D. Blair & John E. Lopatka, *The Albrecht Rule After Khan: Death Becomes Her*, 74 Notre Dame L. Rev. 123 (1998).

[302] *See Topco*, 405 U.S. at *passim* (declaring ancillary territorial restraints unlawful per se); *Seally*, 388 U.S. at *passim* (same).

[303] 441 U.S. 1, 19-25 (1979).

[304] *NCAA*, 468 U.S. at 101-102.

between composers and performers — price-theoretic "competition" — were rarely feasible, and that the blanket license under challenge was necessary to overcome these costs and thus increase the output of performances and compositions.[305] Moreover, in *NCAA*, the Court concluded that (price-theoretic) "competition" between schools to attract athletes would transform amateur football into professional football, undermining the league's effort to offer a distinctive product to consumers.[306] In each case, the Court recognized that unconstrained rivalry between horizontal competitors could produce a market failure, reducing the welfare of consumers and society.[307]

Each of these modern decisions rejected a price-theoretic account of "competition" in favor of one derived from transaction cost economics. In so doing, courts "translated" *Standard Oil's* normative premise in light of new understandings of the economic causes and consequences of certain restraints.[308] Restraints once deemed entirely "anticompetitive" and thus unlawful *per se*

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[305] *BMI*, 441 U.S. at 20-23. *See also NCAA*, 468 U.S. at 114 ("In *Broadcast Music*, the availability of a package product that no individual could offer enhanced the total volume of music that was sold."); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 210 ("The blanket license arrangement [at issue in *BMI*] saved untold millions in transaction costs.").

[306] *NCAA*, 468 U.S. at 101-102 ("Moreover, the NCAA seeks to market a particular brand of football — college football. The identification of this 'product' with an academic tradition differentiates college football from and makes it more popular than professional sports to which it might otherwise be comparable, such as, for example, minor league baseball. In order to preserve the character and quality of the 'product,' athletes must not be paid, must be required to attend class, and the like. And the integrity of the 'product' cannot be preserved except by mutual agreement; if an institution adopted such restrictions unilaterally, its effectiveness as a competitor on the playing field might soon be destroyed. Thus, the NCAA plays a vital role in enabling college football to preserve its character, and as a result enables a product to be marketed which might otherwise be unavailable. In performing this role, its actions widen consumer choice — not only the choices available to sports fans but also those available to athletes — and hence can be viewed as procompetitive.").

[307] *See* nn. ____, *supra* and accompanying text.

[308] *See* nn. ___, *supra* and accompanying text (showing that *Standard Oil* contemplates such translation).

now could produce cognizable benefits and were properly subject to a more discriminating analysis under the Rule of Reason.[309]

This reliance upon a new economic paradigm led some to proclaim the death of the inhospitality tradition.[310] The tradition is alive, if not entirely well, however. *Sylvania* itself drew a line between non-price vertical restraints and minimum resale price maintenace, suggesting that the latter would remain unlawful *per se*, as it has.[311] Such a distinction has no basis in transaction cost economics, which views both practices as methods of overcoming the market failure that unbridled rivalry would produce.[312] Nearly a decade after *Sylvania*, the Court reaffirmed the *per se* rule against tying contracts, failing to recognize the various benefits of these arrangements and reiterating the claim that such agreements necessarily thwart "competition on the merits" when obtained by sellers with market power.[313] In so doing, the Court reiterated its claim that

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[309]*See, e.g.*, *Khan*, 522 U.S. at 15-16; *Sylvania*, 433 U.S. at 54-59.

[310]*See, e.g.*, Richard Markovits, *The Limits to Simplifying Antitrust: A Reply To Professor Easterbrook*, 63 TEX. L. REV. 41, 51 (1984) ("The inhospitality tradition is dead, or at least dying."); Richard A. Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1, 5-12 (1978) (describing various precedents purportedly "endangered" by the *Sylvania* decision).

[311]*See Sylvania*, 433 U.S. at 51, n. 18. *See also Business Electronics Corp.*, 485 U.S. at 724-25 (adhering to *per se* rule against minimum rpm) (*dicta*); Monsanto v. Spray-Rite Service Co., 465 U.S. 752 (1984) (declining invitation of Amicus Curiae United States to reconsider *per se* ban on minimum rpm).

[312]*See* Williamson, *Assessing Vertical Market Restrictions*, 127 U. PENN. L. REV. at 954-60; William Baxter, *Vertical Practices -- Half Slave, Half Free*, 52 ANTITRUST L.J. 743 (1983).

[313]*See* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 12 (1985) (concluding that where seller possesses market power "forcing is present, [and] competition on the merits in the market for the tied item is restrained"); *accord* Eastman Kodak v. Image Technical Services, 504 U.S. 451 (1992). *See also* Meese, *Tying Meets the New Institutional Economics*, 146 U. PENN. L. REV. at 86-94 (arguing that developments in transaction cost economics require repudiation of *Jefferson Parish*). It should be noted that, despite its adherence to the *per se* rule, *Jefferson Parish* adopted a more rigorous definition of market power than that embraced by prior decisions. *See id.* at 26-29. *But compare Eastman Kodak*, 504 U.S. at 467-78 (existence of information gaps and specific-investments confers market power for *per se* purposes).

technological "competition" would maximize social wealth.[314] Finally, the Court has also reaffirmed the *per se* rule against maximum horizontal price fixing, reiterating its previous assertion that such conduct thwarts "the forces of the competitive market."[315]

Despite the revolution in economic theory worked by Transaction Cost Economics, the case law governing the scope of *per se* rules lacks a coherent account of "competition." Some doctrines still equate "competition" with technological rivalry, unconstrained by non-standard contracts. Arrangements inconsistent with such rivalry are therefore "anti-competitive." Other decisions embrace a more modern, contractual version, which recognizes that real world competition usually requires contracts and other practices inexplicable with price-theoretic models. The trend, if there is one, would seem to be away from price theory.

IV THE RULE OF REASON'S OUTMODED MODEL OF COMPETITION

By embracing TCE in some *per se* contexts, the Court has significantly expanded the number of contracts subject to full analysis under the Rule of Reason. Unlike *per se* analysis, which consists of purely hypothetical assertions about a restraint's costs and benefits, analysis under the

[314] *See Jefferson Parish*, 466 U.S. at 12 ("'Basic to the faith that a free economy best promotes the public weal is that goods must stand the cold test of competition; that the public, acting through the market's impersonal judgment, shall allocate the nation's resources and thus direct the course its economic development will take.'") (*quoting Times-Picayune Publishing Co.*, 345 U.S. at 605).

[315] *See* Arizona v. Maricopa County Medical Society, 457 U.S. 332, 346-47 (1982) (*quoting Albrecht*, 390 U.S. at 152). It should also be noted that the Court has retained the distinction between "competition on the merits" and presumptively anticompetitive non-standard contracts in the monopolization context. *See Eastman Kodak*, 504 U.S. at 483 (contracts by monopolists that foreclose "competition on the merits" for a significant portion of the marketplace are presumptively unlawful.); Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985). *See also* Alan J. Meese, *Don't Disintegrate Microsoft (Yet)*, 9 GEO. MAS. L. REV. 761, 786-90 (2001) (showing that Court's preference for "competition on the merits" in the monopolization context reflects the inhospitality approach to antitrust).

Rule of Reason calls for examination of a restraint's actual economic impact.[316] Under current law this analysis contains three main elements. First, the plaintiff must establish a *prima facie* case, by showing that a restraint produces "actual detrimental effects" or offering indirect evidence that the defendants possesses or may acquire market power. Second, if the plaintiff makes such a showing, defendants must respond by offering proof of real cognizable benefits that "outweigh' any harm identified by the plaintiff. Third, even if the defendant shows that the benefits of a practice outweigh its harms, a plaintiff can respond by showing that a less restrictive alternative will produce the same benefits.[317]

As shown below, the current structure of Rule of Reason analysis as applied to contractual integration reflects an outmoded model of "competition," a model that the Court has often rejected in the *per se* context. Although judicial embrace of transaction cost economics and a contractual version of competition has saved many forms of contractual integration from condemnation under the *per se* rule, the current structure of Rule of Reason analysis applied to these very same restraints rejects TCE in favor of a price-theoretic, technological account of "competition." More precisely, each element of the current Rule of Reason balancing test rests upon the sort of outmoded price-theoretic premises that gave rise to the inhospitality tradition and its broad *per se* rules.

Application of the TCE paradigm suggests that the current Rule of Reason test is flawed as applied to contractual integration in three distinct ways. First, proof of "actual detrimental effects" should not suffice to establish a *prima facie* case that contractual integration that plausibly

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[316] *See* nn. ____, *supra*.

[317] *See* nn. ____, *supra* and accompanying text (describing current law).

overcomes market failure is harmful. Second, if such proof does suffice and defendants show that such integration will overcome a market failure, courts should not "balance" such benefits against purported harms. Third, proof that a "less restrictive alternative" will produce benefits similar to those produced by the restraint in question should not entitle a plaintiff to judgment. While the current Rule of Reason test may well make sense when applied to restraints or mergers that create technological efficiencies that arise "within" a firm, application of that test to contractual integration that purportedly prevents market failure cannot be justified. Courts and the enforcement agencies should alter the structure of Rule of Reason analysis to account for recent advances in economic theory, just as they have done so often in the *per se* context.

A. The *Prima Facie* Case:

As explained earlier, current law allows plaintiffs to establish a *prima facie* case by showing that the contract under challenge produces higher prices or a reduction in output or quality when compared to the *status quo ante*.[318] While plaintiffs can also rely upon proof that the defendant possesses a significant share of a properly-defined market characterized by entry barriers, relatively few plaintiffs are able to make such a showing. Leading scholars and the enforcement agencies have endorsed the "actual detrimental effects" approach, although some lower courts, particularly the Seventh Circuit, have demurred.[319]

On its face, the actual detrimental effects test seems a straightforward application of *Standard Oil*. That decision, after all, held that the Sherman Act bans those contracts producing the

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[318] *See* nn. ____, *supra* and accompanying text. *See also*, *e.g.*, *Indiana Federation of Dentists*, 476 U.S. at 460-61; *NCAA*, 468 U.S. at 104-108.

[319] *See, e.g.*, *Chicago Professional Sports Ltd.*, 95 F.3d at 600-601; *see also Murrow Furniture Galleries*, 889 F.2d at 528.

"evils" or consequences of monopoly, *viz*. higher prices, lower output, or a deterioration in quality.[320] Proof that a restraint results in a change in price or output should therefore, it seems, cast upon the defendants some burden of justification.

Current law's definition of a *prima facie* case is a faithful application of *Standard Oil* *if* the price-theoretic approach to industrial organization provides a satisfactory model for interpreting the causes and consequences of economic activity in general and non-standard contracts in particular. As explained earlier, the price-theoretic model assumes that "competition" consists of constant technological rivalry between various firms, unconstrained by non-standard contracts.[321] This rivalry manifests itself in unilateral efforts to alter the cost and quality of a firm's products.[322] While mergers and other practices producing technological efficiencies can be "competitive" within this paradigm, non-standard contracts cannot produce cognizable benefits and are thus "monopolistic."

The "competition" imagined by price theory and endorsed during the inhospitality era results in a "competitive" result, that is, a "competitive" equilibrium in prices, output, and quality.[323] This equilibrium reflects an optimal allocation of resources and thus maximizes the welfare of society.[324] These results, in turn, form a sort of baseline, the departure from which is presumptively (and etymologically) "anticompetitive." By their nature, non-standard contracts produce no

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[320]*See* nn. ____, *supra* and accompanying text (explaining *Standard Oil's* normative premise).

[321]*See* nn. ____, *supra* and accompanying text.

[322]*See* nn. ____, *supra* and accompanying text.

[323]*See* nn. ____, *supra* and accompanying text.

[324]*See Northern Pac. R. Co.*, 356 U.S. at 4; *Times Picayune Co.*, 345 U.S. at 605. *See also* nn. ____, *supra* and accompanying text.

cognizable benefits and thus reflect an ("anticompetitive") attempt to exercise or obtain market power and thereby produce price, quality and output different from the competitive baseline. Such reasoning led courts at one time to condemn such non-standard contracts as unlawful *per se* or nearly so, with little or no analysis of their actual effects.[325]

As explained earlier, the Supreme Court has rejected the price-theoretic account of competition in certain *per se* contexts, mandating Rule of Reason scrutiny of many non-standard contracts as a result.[326] Moreover, a requirement that a plaintiff actually prove that a restraint produces tangible "anticompetitive" effects would seem to be an improvement over the hostility toward such restraints manifested by the inhospitality tradition. Nonetheless, reliance upon "actual detrimental effects" to establish a *prima facie* case rests upon a similar embrace of price-theoretic "competition" as a baseline for evaluating the *effect* of contractual integration. For instance, any presumption that a price increase caused by the adoption of a restraint reflects the exercise of market power necessarily depends upon an assumption that the prices set by the preexisting "unrestrained"

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[325] *See* nn. ____, *supra*.

[326] *See* nn. ___, *supra* and accompanying text.

market were "competitive" in some relevant sense.[327] Such an assumption, of course, flows naturally from application of the price-theoretic paradigm and its account of "competition."

Adoption of the revised economic paradigm produced by Transaction Cost Economics undermines price theory's model of "competition" and with it the account of "anticompetitive harm" that drives the definition of a *prima facie* case embraced by courts, enforcement agencies and numerous leading scholars. According to this new paradigm, there is no reason to presume that results produced by rivalry unconstrained by non-standard contracts are "competitive" in any relevant sense or otherwise appropriate benchmarks for measuring the effect of a restraint. To the contrary, TCE predicts that unrestrained rivalry between autonomous firms will often result in a market failure, that is, a departure from the optimal allocation of resources that a perfectly competitive market would produce.[328] Such a departure will necessarily manifest itself in prices, output, or quality different from what a well-functioning market would bring about.

As a result, where defendants avoid *per se* liability by plausibly asserting that a restraint combats a market failure, proof that contractual integration results in prices or other terms

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[327]The enforcement agencies have embraced this assumption explicitly, stating that the "central question" in Rule of Reason analysis is whether a restraint results in prices or output different from what an "unrestrained" market would produce. *See Competitor Collaboration Guidelines*, § 3.1 ("Rule of reason analysis focuses on the state of competition with, as compared to without, the relevant agreement. Under the rule of reason, the central question is whether the relevant agreement likely harms competition by increasing the ability or incentive profitably to raise prices above or reduce output, quality, service or innovation below what likely would prevail in the absence of the relevant agreement."). *See also NCAA*, 468 U.S. at 104-108 (proof that ancillary restraint reduced output and increased prices when compared to operation of a "free market" sufficed to establish a *prima facie* case); *id*. at 114-115 (proof that restraint produced prices higher than the "competitive" market undermined claim that arrangement was procompetitive); *National Society of Professional Engineers*, 435 U.S. at 693-95 (justification that assumed that restraint produced prices higher than unrestrained rivalry is not cognizable); 7 AREEDA, ANTITRUST, ¶ 1504, p. 380-81 (justification that rests upon assertion that "competitive" prices are too low cannot be cognizable); *id*. at ¶ 1511, pp. 432-33 (endorsing *NCAA's* approach to defining a *prima facie* case).

[328]*See* nn. ____, *supra* and accompanying text.

of trade different from those that existed before the agreement does not suggest the presence of or attempt to obtain market power. As noted earlier, transaction cost economics adopts a presumption that non-standard contracts have efficiency purposes, absent concrete proof to the contrary.[329] By embracing TCE in the *per se* context, the Supreme Court has adopted a similar presumption, which plaintiffs must rebut by establishing a *prima facie* case when challenging a restraint under the Rule of Reason.

Proof that an agreement results in prices or output different from the *status quo ante* in no way establishes that a restraint produces cognizable antitrust harm. Here it is important to keep in mind that: 1) the defendant has avoided *per se* treatment by adducing a plausible story that the restraint overcomes market failure, 2) the plaintiff has adduced no evidence regarding the structure of the relevant market, and 3) market failures are widespread.[330] As a result, proof that a restraint alters price or output when compared to the *status quo ante* is at least equally consistent with an alternative explanation, namely, that the agreement under scrutiny corrects a market failure and does

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[329]*See* nn. ___, *supra* and accompanying text. *See also* WILLIAMSON, ECONOMIC INSTITUTIONS, at 28 (concluding that there is "a rebuttable presumption that nonstandard forms of contracting have efficiency purposes").

[330]*See* Coase, *The Firm, The Market, And The Law*, at 26 (noting that transaction costs and thus market failures are ubiquitous in the real world).

One might argue that the very fact that a plaintiff has selected a particular case for litigation itself suggests that the defendants' conduct is more harmful than the average contract. Why, after all, would a plaintiff waste resources challenging an arrangement that a court will most likely deem reasonable? However, it should be noted that a plaintiff's chance of success will itself be a function of the structure of Rule of Reason analysis articulated by the courts. If a plaintiff could establish a *prima facie* case simply by showing that a restraint produced prices above the *status-quo ante*, then plaintiffs could more readily avoid summary judgment and thus use the threat of treble damage liability to negotiate a generous settlement. The prospect of such a settlement, and not the underlying economics of the challenged agreement, may drive much antitrust litigation, with the result that there is no reason to assume that challenged agreements are significantly more anticompetitive than those that are not, at least so long as courts adhere to the current approach to Rule of Reason litigation.

not involve the exercise or creation of market power.[331] Because such failures can result in prices that are below the optimum, or output that is above it, contracts that correct or attenuate market failure will often increase prices or reduce output when compared to the status quo ante.[332] As a result, proof that such a restraint alters price or other terms of trade is at least equally consistent with a procompetitive explanation, it cannot give rise to a *prima facie* case under settled antitrust doctrine.[333] Absent proof that market structure is conducive to the creation or exercise of market power, a plaintiff's attempt to establish a *prima facie* case should fail.

Consideration of three examples will illustrate this counter-intuitive point. First, assume that a manufacturer grants its dealers exclusive territories, departing from a prior policy that allowed dealers to sell where they pleased.[334] Assume further that a terminated dealer (or the government) challenges the policy under the Sherman Act. Under current law, the parties to the arrangement could avoid *per se* condemnation by claiming that the restraint will prevent dealers from

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[331]*See* Baxter, *Viability of Vertical Restraints Doctrine*, 75 CALIF. L. REV. at 948; Williamson, *Assessing Vertical Market Restrictions*, 127 U. PENN. L. REV. at 987-88 ("allocative inefficiency is more apt to arise with respect to cost concerns, such as diseconomies of scale, failure to operate assets in a least cost way, and the incurring of significant transaction costs. Organizational changes that give rise to cost savings in any of these respects will, if not accompanied by offsetting price distortions, invariably lead to social gains."); Coase, *Industrial Organization: A Proposal for Research*, at 68 (contending that nonstandard contracts and other practices are often attempts at "bringing about a competitive situation").

[332]*See* nn. ___, *supra* (explaining that price-theoretic "competition" can produce prices, output and quality that depart from the optimum).

[333]*See* Matsushita Elec. Industrial Corp. v, Zenith Radio Corp., 475 U.S. 574, 587-95 (1986) (holding that evidence that is equally consistent with pro and anticompetitive objectives cannot by itself support an inference of anticompetitive harm); Monsanto Corp. v. Spray-Rite Service Corp., 465 U.S 752, 761-64 (1984) (same); First National Bank v. Cities Serv. Co., 391 U.S. 253, 279-280 (same). *See also Eastman Kodak*, 504 U.S. at 466-67 (legal presumptions employed in antitrust litigation should rest on actual market realities and not implausible economic theories).

[334]*Cf. Sylvania*, 433 U.S. at 38-39 (describing *Sylvania*'s reform of its distribution system that included creation of location clauses).

free riding on each others' promotional efforts and thus counteract a market failure.[335] Moreover, the logic of decisions such as *NCAA* and *Indiana Federation of Dentists* suggests that proof that the restraint increases the retail price of the manufacturer's product should establish a *prima facie* case that the arrangement is "anticompetitive."[336] Should proof that the restraint produces prices above the pre-existing level establish a *prima facie* case?[337] Emphatically not. A market that is "competitive" in a price-theoretic sense may not produce sufficient dealer investment in promotional activity or other services. Such activity costs money, and a dealer will not invest money in

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[335] *See Business Electronics Corp.*, 485 U.S. at 725-29; Continental T.V. v. GTE Sylvania, 433 U.S. 36 (1978).

[336] *See NCAA.*, 468 U.S. at 104-108 (proof that restraint increased prices of defendants' products sufficed to establish a *prima facie* case); nn. ____, *supra* and accompanying text (showing that the Supreme Court has not limited the "actual detrimental effects" test to the horizontal context); *see also Jefferson Parish,* 466 U.S. at 29-31 (conducting Rule of Reason analysis despite absence of market power); *Sylvania*, 433 U.S. at 51-59 (suggesting that courts should analyze non-price vertical restraints by comparing impact on "intrabrand" and "interbrand" competition). *But see* nn. ____, *supra* and accompanying text (suggesting that some courts apparently require proof of market-wide "actual detrimental effects" where certain vertical restraints are concerned).

[337] *See Sylvania*, 433 U.S. at 51-52 (assuming that reduction in intrabrand competition is an antitrust harm). It should be noted that some scholars who would otherwise apply the "actual detrimental effects" approach conclude that a plaintiff should have to offer some evidence of market shares to establish a *prima facie* case when challenging a vertical distribution restraint. None of these scholars, however, would require plaintiffs to establish the sort of market structure ordinarily associated with a market power filter, and each offers a test that seems to ignore the presence or absence of barriers to entry. *See* SULLIVAN AND GRIMES, LAW OF ANTITRUST, at 327-32 (purporting to apply market power screen but defining market power as including a "successful brand" without regard to absence of barriers to entry); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 488-89 (proof that a manufacturer has a 40% share of a relevant market and that one half of its dealers are governed by a restraint should establish a *prima facie* case, apparently without regard to entry conditions); *id.* at 446 (asserting that entry by multiproduct retailers cannot be presumed "easy"); 8 AREEDA, ANTITRUST LAW, ¶ 1648d2B, at 530 (manufacturer's possession of 30% share of relevant market sufficient to establish *prima facie* case; no analysis of entry barriers indicated). *Cf. Jefferson Parish*, 466 U.S. at 26-29 (30% share of properly defined market does not establish market power, despite the existence of some customers with strong preferences for the defendant's product).

promotion unless it can capture the benefits of such expenditures.[338] Thus, reliance on unconstrained dealers to distribute a product may produce a market failure, that is, suboptimal dealer expenditure on promotional activities and nonoptimal consumer demand for the product in question.[339] This failure, in turn, will manifest itself in the form of lower prices and perhaps even increased output.[340]

An exclusive territory could correct this market failure, by conferring a sort of property right on dealers to sell in a particular area.[341] Armed with this right, dealers could invest in optimal levels of promotion, knowing that they could recapture the benefits of such investment.[342] Such investment would raise dealers' cost of operation and thus result in prices higher than those that obtained before the restraint, so long as consumers are willing to pay the premium that reflects this additional service. All beneficial vertical restraints are designed to increase price in exactly this manner.[343]

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[338] *See Sylvania*, 433 U.S. at 54-56; Williamson, *Assessing Vertical Market Restrictions*, 127 U. PENN. L. REV. at 958-60; 975-80; Bork, *Rule of Reason*, 75 YALE L. J. at 433-36; Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. L. & ECON. at 89-92.

[339] *See Sylvania*, 433 U.S. at 55 ("Because of market imperfections such as the so-called 'free rider' effect, the [promotional] services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did."); Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J. L. & ECON. at 89-92; Bork, *Rule of Reason*, 75 YALE L. J. at 429-38.

[340] *See* Posner, *Analysis of the Restricted Distribution, Horizontal Merger, and Potential Competition Decisions*, 75 COLUM. L. REV. at 284-85 (free riding results in lower dealer prices).

[341] *See* Meese, *Quick Look*, 68 Antitrust L. J. 487, n. 109 (analogizing exclusive territories to property rights); Bork, *Resale Price Maintenance and Consumer Welfare*, 77 Yale L. J. 950, 956 (1968) ("Contract law delegates to private persons the power to create property rights because of their superior knowledge of the efficiencies to be gained in particular situations. R.P.M. is best seen as an instance of this general principle.").

[342] Bork, *Rule of Reason*, 75 YALE L. J. at 433-36.

[343] *See* Frank H. Easterbrook, *Vertical Restraints and the Rule of Reason*, 53 ANTITRUST L. J. 135, 156 (1984) ("Every restricted dealing arrangement is designed to influence price. It must be. If territorial

Such a price increase would not reflect any exercise of market power and thus would not manifest the sort of "evil consequence" the Sherman Act condemns.[344] Economists, including those who adhere to price theory, define market power as the ability profitably to restrict output and price above the cost of production, and this is the sort of power *Standard Oil* had in mind.[345] If an exclusive territory raises prices by eliminating or attenuating market failure, such an increase would reflect increased dealer costs and thus not reflect any exercise of market power.[346] Despite its (indirect) impact on price, such a restraint would not be "undue," but would instead constitute a

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limits induce dealers to supply additional service and information, they do so only because they raise the price and call forth competition in the service dimension. . . . Every argument about restricted dealing implies that the restrictions influence price. There is no such thing as a free lunch; the manufacturer can't get the dealer to do more without increasing the dealer's margin."); Posner, *Analysis of the Restricted Distribution, Horizontal Merger, and Potential Competition Decisions*, 75 COLUM. L. REV. at 284; William F. Baxter, *Vertical Restraints Doctrine*, 75 CAL. L. REV. 933, 945-46 (1987):

> Higher retail prices are entirely consistent with the benign explanation of resale price maintenance. Imposition of [resale price maintenance] reflects a judgment on the part of the brand owner that her products will compete more successfully, both against other branded products and against generic rivals, if the retailer competes along parameters other than price. And the retailer's expenses of engaging in those other forms of rivalry are financed by setting a retail margin higher than would prevail if retail price competition were allowed or encouraged.

See also Telser, *Why Should Manufacturers Want Fair Trade*, 3 J. L. & Econ. at 91 (absent such restraints dealers "reduce their prices because they avoid the additional cost of the special services").

[344] *See* Posner, *Analysis of the Restricted Distribution, Horizontal Merger, and Potential Competition Decisions*, 75 COLUM. L. REV. at 284 (higher prices occasioned by vertical restrictions reflect additional cost of optimal service and not market power); *Standard Oil*, 221 U.S. at 66 (Sherman Act does not forbid contract that "indirectly" raises prices). *See also* nn. ____, *supra* and accompanying text.

[345] *See* William Landes and Richard Posner, *Market Power In Antitrust Cases*, 94 HARV. L. REV. 937 (1981); KAYSEN & TURNER, ANTITRUST POLICY, at 12-13 (treating economic efficiency as primary goal of antitrust and equating efficiency with marginal cost pricing). *See* nn. ____, *supra* and accompanying text.

[346] *See* Easterbrook, *Vertical Restraints and the Rule of Reason*, 53 ANTITRUST L. J. at 156.

"normal," "ordinary," or "usual" method of furthering trade.[347] Although a "non-standard" contract that reaches "beyond" the firm, such an arrangement would be economically indistinguishable from a manufacturer's (cost-increasing) decision to enter employment contracts with additional salespeople or advertising experts to promote the product "itself."[348] Even price theorists would treat such "intra-firm" activities as "competitive;" there is no reason to treat other contracts that produce the same results any differently.[349] Thus, proof that such a restraint produces increased prices may simply confirm that the arrangement is having its laudable, welfare-enhancing effect.[350] Because

[347] *See Standard Oil*, 221 U.S. at 66 ("To treat as condemned by the act all agreements under which, as a result, the cost of conducting an interstate commercial business may be increased would enlarge the application of the act far beyond the fair meaning of the language used. There must be some direct and immediate impact upon interstate commerce in order to come within the act.") (*quoting Hopkins*, 175 U.S. at 592); *Business Electronics*, 485 U.S. at 729-30 (agreement between dealer and manufacturer to terminate a second dealer was "ancillary" despite possible impact on price). *See also* Fowle v. Park, 131 U.S. 88, 97 (1889) (enforcing resale price maintenance and exclusive territories ancillary to sale of patent medicine); *Addyston Pipe*, 85 F. at 283 (citing *Fowle* as a case properly enforcing an ancillary restraint); nn. ____, *supra* and accompanying text (discussing distinction between direct and indirect restraints).

[348] *See* Bork, *Rule of Reason*, 75 YALE L. J. 438 ("since there is presently no antitrust objection to the most efficient utilization of local sales effort by ownership integrated firms, there seems no reason to discriminate against the achievement of the same objective by contract-integrated systems through the use of market division agreements"); Walsh v. Dwight, 58 N.Y.S. 91, 93 (App. Div. 1899) (resale price maintenance not an unlawful restraint of trade because manufacturer could have achieved same objective by relying upon its own employees to distribute the product in question).

[349] *See* nn. ____, *supra* and accompanying text (describing price-theoretic definition of "competition."). *See also*, *e.g.*, *Schwinn*, 388 U.S. at 381-82 (finding consignment agreement reasonable method of distributing manufacturer's goods).

[350] *See* Meese, *Farewell to the Quick Look*, 68 ANTITRUST L. J. at 495; Frank H. Easterbrook, *Ignorance And Antitrust* 119, 121, *reprinted* in ANTITRUST, INNOVATION AND COMPETITIVENESS (Thomas M. Jorde & David J. Teece, eds. 1992) ("[M]onopoly and efficiency explanations so often imply similar traits. Think of vertical restrictions within a dealership network. If these monopolize, the price rises and output falls. If the restraints cause dealers to supply efficient point-of-sale services delivered to consumers, again price rises, and quantity may fall (although consumers' surplus would rise because they value the higher quality."); Baxter, *Vertical Restraints Doctrine*, 75 CAL. L. REV. at 945-46.

such proof is equally consistent with the defendants' procompetitive account of the restraint, it cannot establish any presumptive entitlement to judgment.[351]

Ironically, the Supreme Court's approach to non-price vertical restraints in the *per se* context would seem to compel rejection of the "actual detrimental effects" test in this context. As already noted, the Court has embraced TCE's model of competition when addressing non-price vertical restraints, recognizing that restraints limiting intrabrand "competition" may be "reasonable" insofar as they prevent free riding.[352] The Court has also refused to apply the *per se* rule simply because a vertical practice results in prices higher than those that obtained before the restraint.[353] In so doing, the Court has explicitly recognized that vertical agreements may increase prices by

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[351]*See* Matsushita Elec. Indus. Corp. v. Zenith Radio Corp., 475 U.S. 574, 587-95 (1986) (holding that evidence that is as consistent with procompetitive as with anticompetitive account of a restraint cannot, without more, support an inference of anticompetitive conduct); Monsanto Co. v. Spray-Rite Services, Co., 465 U.S. 752, 761-64 (1984) (same); First Nat'l Bank v. Cities Services Co., 391 U.S. 253, 279-80 (1968) (same).

Of course, manufacturers that adopt vertical restraints in an attempt to overcome market failure hope that additional sales effort induced by the restraint will ultimately result in increased output, as consumers demand more of the product. Nonetheless, proof that such a restraint results in reduced output should not suffice to establish a *prima facie* case. Such proof may simply reflect a variety of phenomena unrelated to the exercise of market power. For instance, a manufacturer may lose sales because it has miscalculated consumers' response to additional promotion only to find consumers have choosen substitute products in response to the increased price of the manufacturer's product. It would be perverse to rest a *prima facie* case on evidence that the market had punished a firm's poor judgment. Moreover, much promotional activity will only enhance consumer demand over the longer run. For instance, automobile dealers may slowly enhance goodwill by advertising, participating in community activities, and providing excellent post-sale service. Such activities could actually reduce the dealer's sales in the short run, with the result that a plaintiff challenging an exclusive territory could show that output fell after a manufacturer granted the dealer such protection. Of course, this result would be perverse.

[352]*See Sylvania*, 433 U.S. at 54-57.

[353]*See Business Electronics Corp.*, 485 U.S. at 731. *See also* Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 762-64 (1984).

inducing dealer promotion *and* that such price increases are procompetitive.[354] Moreover, the court has explicitly held that product differentiation is procompetitive.[355] Application of an "actual detrimental effects" test, by contrast, necessarily rests upon a repudiation of TCE's more plausible conception of competition in favor of the outmoded model associated with price theory.

Consider as a second example a horizontal restraint, drawn from an actual case.[356] Assume that a number of local moving companies form a joint venture (Hercules) designed to create a national moving system. The venture engages in national advertising, takes calls on a "1-800" number from customers and settles customer complaints.[357] The venture also promulgates uniform standards governing various aspects of member services, trains member employees in how to meet those standards, and monitors compliance with those requirements.[358] The venture itself owns no trucks and employs no drivers but instead refers customers who contact it to individual members, who display the venture trademark on their trucks, the uniforms of their employees, and their own

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[354]*See Business Electronics Corp.*, 485 U.S. at 727-28 ("Any agreement between a manufacturer and a dealer who happens to have charged lower prices can be alleged to have been directed against the terminated dealer's 'price cutting.' In the vast majority of cases, it will be extremely difficult for the manufacturer to convince a jury that its motivation was to ensure adequate services, since price cutting and some measure of service cutting usually go hand in hand."); *id.* at 731 (noting that "price cutting is frequently made possible by 'free riding' on the services provided by other dealers"); *Monsanto Co.*, 465 U.S. at 762-63 ("The manufacturer often will want to ensure that its distributors earn sufficient profit to pay for programs such as hiring and training additional salesmen or demonstrating the technical features of the product, and will want to see that 'free-riders' do not interfere. . . . Thus, the manufacturer's strongly felt concern about resale prices does not necessarily mean that [a violation of the Sherman Act has occurred].").

[355]*See NCAA*, 468 U.S. at 101-102 (stating that contractual restrictions on horizontal rivalry were necessary to enable the NCAA to differentiate its product from minor league sports). *See also Sylvania*, 433 U.S. at 56 (asserting that "a large part of the promotional efforts resulting from vertical restrictions [will] convey socially desirable information about product availability, price, quality, and services").

[356]*See* Rothery Storage v. Atlas Van Lines, Inc., 792 F.2d 210 (D.C. Cir. 1986).

[357]*See Rothery Storage*, 792 F.2d at 211.

[358]*See Rothery Storage*, 792 F.2d at 211-212.

local advertising.[359] Finally, assume that the venture sets rates for moving services provided to those customers that contact the venture directly, leaving members free to set rates for customers generated by their own local sales effort.[360]

Two years after the venture's inception, Hercules revises its bylaws, to provide that the venture shall set rates governing any carriage of goods under the venture's trademark, without regard to the source of the customer in question.[361] The bylaws also provide that members are free to carry goods at other rates, so long as they generate and conduct such business under their own local trademarks.[362]

Assume now that the venture expels a member for carrying goods under its trademark at rates below what the venture has prescribed. The former member challenges the expulsion under the Sherman Act, claiming that the expulsion enforced unlawful price maintenance.[363] While the plaintiff asserts that the restraint is unlawful *per se*, the venture avoids summary condemnation by asserting that the agreement on price is ancillary to the formation of the venture and necessary to prevent some members from underselling others and thus expropriating an undue share of the

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[359]*See Rothery Storage*, 792 F.2d at 212 (describing such an allocation of responsibility).

[360]It should be noted that this assumption is a slight departure from the actual facts in *Rothery*. There the venture initially allowed members absolute price discretion with respect to all customers. *See id.* at 211-12.

[361]*See Rothery Storage*, 792 F.2d at 213 (describing such a policy change).

[362]*See Rothery Storage*, 792 F.2d at 213.

[363]*Rothery Storage*, 792 F.2d at 217-18 (describing plaintiff's assertion that similar conduct constitutes price maintenance). As a formal matter, the plaintiff could also allege that the expulsion constitutes a group boycott. *See Rothery Storage*, 792 F.2d at 215-16 (evaluating such an argument and finding that such boycotts are analyzed under the Rule of Reason).

opportunities created by the venture.[364] Although the Supreme Court declined to recognize such arguments during the inhospitality era, more recent legal developments suggest that the Court might treat such benefits as cognizable, thus obviating application of the *per se* rule.[365]

How then might the plaintiff go about establishing a *prima facie* case under the Rule of Reason? Under current law, the most obvious route would be to establish that prices for the carriage of goods by the venture rose, or that the venture's output fell, after the bylaw amendment.[366]

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[364] *See Rothery Storage*, 792 F.2d at 224-30 (agreement on price charged by members operating under venture's trademark analyzed under the Rule of Reason). *See also e.g.*, *NCAA,* 468 U.S. at 101-102 (noting that horizontal agreement not to pay athletes a salary could thwart market failure that unbridled competition would produce); *BMI,* 441 U.S. at 20-21 (joint price setting that accompanied creation and enforcement of blanket license analyzed under the Rule of Reason); *Chicago Bd. of Trade*, 246 U.S. at 238-40 (analyzing price restraint ancillary to the formation of a grain exchange under the Rule of Reason); *Chicago Bulls Professional Sports Ltd.*, 95 F.3d at 597-600 (agreement by N.B.A. franchises to limit output of televised games judged under the full Rule of Reason given plausible benefits and extent of contractual integration between the parties); SCFC ILC, Inc. v. Visa USA, Inc., 36 F.3d 958, 969-72 (10th Cir. 1994) (joint venture could exclude competitor to prevent latter from reaping undue portion of the fruits of the venture); Polk Bros. v. Forest City Enterprises, 776 F.2d 185 (1985) (finding that horizontal division of markets ancillary to creation of a shopping center could reduce free riding and was thus properly analyzed under the Rule of Reason).

[365] *See Topco*, 405 U.S. at 606-612 (finding that the presence or absence of such benefits was irrelevant to the *per se* inquiry). *But see Rothery Storage*, 792 F.2d at 223-230 (*Topco* does not survive rationale of *NCAA*, *Sylvania*, and *BMI*). *See also Chicago Bulls Professional Sports Ltd.*, 95 F.3d at 597-600 (output limitation ancillary to joint venture analyzed under the Rule of Reason); *Polk Bros.*, 776 F.2d at 188-90 (analyzing agreement restricting products each party could sell under the Rule of Reason).

Two scholars have suggested that *Topco* is still good law, even with respect to ancillary restraints, because the Supreme Court declined to modify the decision in Palmer v. BRG of Georgia, Inc., 498 U.S. 46 (1990) (*per curiam*). *See* SULLIVAN AND GRIMES, LAW OF ANTITRUST, 229-30. There was, however, no assertion in *Palmer* that the horizontal division of territories in question produced any cognizable benefits, let alone those of the sort involved in *Topco*. Thus, the Court's failure in *Palmer* to opine regarding an issue not before it should not be taken as a reaffirmation of this aspect of *Topco*.

[366] *See NCAA*, 468 U.S. at 104-108 (proof that an ancillary restraint increased price and reduced output of defendants' product sufficed to establish a *prima facie* case); Indiana Federation of Dentists, 476 U.S. at 460-61; *Re/Max International, Inc.*, 173 F.2d at 1014-15 (proof that practice raised commissions paid by the plaintiffs established *prima facie* case); *Law*, 134 F.3d at 1020 (finding that the plaintiff had established a *prima facie* case because the challenged practice "was successful in artificially lowering the price of coaching services" purchased by defendants); *Hairston*, 101 F.3d at 1319 (proof that restraint excluded member school from bowl competition sufficed to establish *prima facie* case); *J.F. Feeser, Inc.*, 909 F.2d at 1542-43 (proof that supply contract caused some firms to pay higher prices for the defendant's

Here again, though, such proof should not raise a presumption that the restraints produce anticompetitive harm.

To be sure, the arrangement eliminates horizontal rivalry with respect to price, but then so do restraints ancillary to the formation of a partnership.[367] In so far as the defendants have adduced a plausible claim that unrestrained rivalry results in a market failure, there is no reason to assume that the rivalry that pre-existed the restraint produced prices or output that were "competitive" in any meaningful sense. To the contrary, a policy allowing venture members to set whatever rates they wished for locally-generated customers could well produce a lemons equilibrium, that is, prices and quality below the social optimum, and output above it. After all, even customers generated by individual members would rely at least in part on the reputation associated with the venture's trademark. That reputation, in turn, would be a function of expenditures on national advertising, as

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products established *prima facie* case); *Competitor Collaboration Guidelines*, § 3.3; HOVENKAMP, FEDERAL ANTITRUST POLICY, at 256 & n. 25 ("observed decreases in output, an observed increase in price coordination or exclusion from the market of firms that seem to be competitive entrants" is sufficient to establish a *prima facie* case); *id.* at 262 (proof that restraint results in a reduction in output establishes a *prima facie* case); AREEDA, 7 ANTITRUST, ¶ 1511, pp. 432-33. *See also* nn. ____, *supra* and accompanying text.

Indeed, it should be noted that the enforcement agencies would apparently require even *less* of a plaintiff in this context. *See Competitor Collaboration Guidelines*, § 3.3 (stating that proof of explicit agreement on price or output itself requires some evidence of justification). Of course, the argument in the text, namely, that proof of actual detrimental effects should not suffice to establish a *prima facie* case, applies with even greater force against this position. *See generally* Meese, *Quick Look*, 68 Antitrust L. J. at 478-89 (arguing that mere proof of explicit agreement on price or output should not establish a *prima facie* case).

Finally, it should be noted that Professor Hovenkamp concludes that the restraint in *Topco* should survive Rule of Reason scrutiny because of the venture's low market share. *See* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 260. He does not explain why application of a market power screen is appropriate in this context, but inappropriate in a case like *NCAA*, where he approves application of an "actual detrimental effects" route to establish a *prima facie* case. *See id.* at 262-63.

[367] *See Addyston Pipe*, 85 F. at 230.

well as the quality of service provided by each member of the venture.[368] By announcing and charging cut-rate rates for "locally-generated" business, some members could deprive others of the prices necessary to cover the cost of maintaining high quality service.[369] Moreover, such price cutting could deprive the venture's membership of the resources necessary to cover the cost of sufficient national advertising, which price cutters who generate a significant portion of their business locally might deem less important than average members of the venture.[370]

Of course, tolerance of absolute pricing discretion could reduce prices and seemingly enhance output of the venture's services — the number of moves — in the short run, as price cutters attract business by free riding off the quality image associated with the venture trademark. Over the longer run, however, consumers "stung" by low quality may choose a different venture for their future moves.[371] By setting uniform rates, then, the venture can prevent this deterioration in quality,

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[368] *See* Paul Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J. L. & ECON. 223, 227-28 (1978) (reputation associated with franchise system depends upon collective efforts of franchisees).

[369] *See Rothery Storage*, 792 F.2d at 222-23; Rubin, *Structure of the Franchise Contract*, 21 J. L. & ECON. at 228 (describing propensity of franchisees to free ride on efforts of others absent effective monitoring).

[370] *Cf. Chicago Professional Sports, Ltd.*, 961 F.2d at 673 (describing disparate incentives faced by sporting teams that generate substantial revenue in national market through television contracts and those that generate most revenue locally, through gate receipts).

[371] *See* Klein and Saft, *Franchise Tying Contracts*, 28 J. L. & Econ. at 349-51 (describing so-called super highway problem, whereby consumers attribute poor quality of one franchise to other firms operating under the same trademark, ultimately reducing the demand for products sold under the franchise trademark). The Federal Trade Commission's opinion in *In re California Dental Association* also illustrates the shortcomings of an "actual detrimental effects" test. *See* 121 F.T.C. 190 (1996), *aff'd*, 128 F.3d 720 (9th Cir. 1997), *vacated on other grounds*, 526 U.S. 756 (1999). There the Commission relied on evidence that certain dentists used advertising to increase their sales to support its conclusion that the Association's rules against false advertising were presumptively anticompetitive. *See California Dental*, 121 F.T.C. at 310-311. Such evidence, however, was equally consistent with the Association's assertion that the advertising was inherently misleading and that regulation of members' advertising was therefore necessary to forestall a lemons equilibrium. *See California Dental Association*, 526 U.S. at 771-73 (finding that such self-regulation

protecting the reputation associated with the trademark and enhancing the overall demand for the venture's product over the longer run.[372] While such a restraint would increase price or reduce output compared to the *status quo ante*, such effects are entirely consistent with the defendants' account of the restraint's cognizable benefits.

In the same way, of course, the formation of a partnership by two previously independent lawyers would eliminate the pricing discretion that each lawyer previously enjoyed. Moreover, restraints on "moonlighting" could prevent one partner from luring customers away from the partnership with cut rates for shoddy work.[373] Thus, the formation of the partnership and

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of advertising could be procompetitive for this reason). After all, firms engage in false advertising to *increase* their sales, and proof that the Association's regulations reduced the advertising and output of some dentists may simply have indicated that the regulations were having their intended, beneficial effect. *See* Meese, *Quick Look*, 68 Antitrust L. J. at 495-96, n. 143.

[372]*See*, *e.g.*, Lester G. Telser, *Why Should Manufacturers Want Fair Trade*?, 3 J. Law & Econ. 86 (1960). Some scholars have argued that price maintenance cannot by itself induce venture members to invest in an appropriate amount of promotion. *See* Benjamin Klein and Kevin M. Murphy, *Vertical Restraints As Contract Enforcement Mechanisms*, 31 J. Law & Econ. 265 (1989). These scholars claim that dealers subject to price maintenance might simply "pocket" the difference between the price set by the manufacturer and the pre-existing price, without providing any additional promotional services. *Id*. As a result, these scholars conclude that price maintenance merely guarantees dealers economic rents, and that manufacturers still must monitor and police dealers' promotional efforts, terminating those who shirk by not providing sufficient promotional services. *See id.*

The author respectfully disagrees with this analysis of vertical restraints. So long as there is effective interbrand competition, dealers who fail to provide an effective level of promotion will suffer *vis a vis* dealers of competing products. In other words, while price maintenance does not itself guarantee that dealers will engage in promotional efforts, an agreement setting a floor on retail prices ensures that dealers who engage in such promotion will reap the rewards of their efforts. Dealers who face significant interbrand competition will have every incentive to engage in such promotion. Since the presence of "actual detrimental effects" does not negate the existence of interbrand competition, proof of such effects is equally consistent with defendants' assertion that such a restraint solves a market failure.

[373]*See Addyston Pipe*, 85 F. at 280 ("when two men became partners in a business, although their union might reduce competition, this effect was only incidental to the main purpose of a union of their capital, enterprise and energy to carry on a successful business, and one useful to the community. Restrictions in the articles of partnership upon the business activity of the members, with a view of securing their entire effort in the common enterprise, were of course only ancillary to the main end of the union, and were to be encouraged."); Matthews v. Associated Press of the State of New York, 136 N.Y. 333, 341 (1893)

associated restraints could increase prices, by enhancing the quality associated with the venture and thus differentiating its product. Under current law, a plaintiff challenging the initial formation of the partnership — a merger of once independent firms — would have to establish a relevant market and the existence of concentration within it before the defendant would bear any burden of production.[374] Proof of "actual detrimental effects" would not suffice. Moreover, once the merger took place, any pricing decisions would be beyond scrutiny under Section 1 of the Sherman Act.[375] There is simply no good reason to treat one variety of contractual cooperation — the formation and operation of a partnership — differently from another — the creation of a legitimate joint venture with ancillary restraints.[376] Proof that an ancillary restraint increases prices is entirely consistent with the venture's account of its benefits and thus cannot itself form the basis for a judgment against the defendants.[377] Similar logic applies to other horizontal restraints that plausibly counteract market failure.[378]

(Peckham, J.) ("A business partnership could provide that none of its members should attend to any business other than that of the partnership, and that each partner who came in must agree not to do any other business and must give up all such business as he had theretofore done. Such an agreement would not be in restraint of trade, although its direct effect might be to restrain to some extent the trade which had been done.").

[374]*See* 1992 Joint Merger Guidelines, § 1.0-2.0; FTC v. Tenet Health Care Corp., 186 F.3d 1045, 1051-54 (8th Cir. 1999); New York v. Kraft General Foods, Inc., 926 F. Supp. 321, 361-63 (S.D. N.Y. 1995).

[375]See Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984) (wholly-owned subsidiaries or divisions of the same firm are not capable of conspiring for Section 1 purposes). *See also Maricopa County Medical Society*, 457 U.S. at 357 (price setting by doctors in a partnership would be "perfectly proper").

[376]*See* nn. ___, *supra* and accompanying text (explaining that a "firm" is simply one variety of contractual integration); *Chicago Bulls Ltd. Partnership*, 95 F.3d at 597-98 (characterizing a business firm as contractual cooperation between otherwise independent actors).

[377]*See* nn. ____, *supra* and accompanying text.

[378]*See, e.g.*, *Polk Bros., Inc.*, 776 F.2d at 188-90 (analyzing ancillary horizontal agreement under Rule of Reason).

Here again, reliance upon "actual detrimental effects" to establish a *prima facie* case would seem inconsistent with the Supreme Court's pronouncements in the *per se* context. As explained earlier, the Court's jurisprudence on non-price vertical restraints assumes that such restraints can eliminate market failure and thus result in prices higher than those that existed before the restraint.[379] There is simply no reason in law or economics to confine this rationale to the vertical context; horizontal restraints can also combat market failure in a variety of ways.[380] Indeed, the line between "vertical" and "horizontal" restraints is not always clear. Franchising, for instance, is a vertical restraint to some and a horizontal restraint to others.[381] The effect of such arrangements are the same regardless of the label attached. More to the point, in *NCAA*, the Court expressly recognized that unbridled horizontal rivalry — there, the "competition" for student athletes — could

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[379] *See* nn. ____, *supra* and accompanying text.

[380] *See* Meese, *Quick Look*, 68 ANTITRUST L. J. at 479-81 (arguing that restraints characterized as "vertical" are often equally "horizontal"); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 205-211*;* Martin B. Louis, *Restraints Ancillary to Joint Ventures and Licensing Agreements: Do Seally and Topco Logically Survive Sylvania and Broadcast Music?*, 66 VA. L. REV. 879, 912-13 (1980) (arguing that rationale of *Sylvania* applies with similar force to horizontal ancillary restraints); Posner, *Restricted Distribution, Horizontal Merger And Potential Competition Decisions*, 75 Colum. L. Rev. at 298-99 (antitrust treatment should not turn on characterization of restraints as "horizontal" or "vertical" but instead upon whether restraints produce benefits); *id.* (arguing that horizontal ancillary restraints should be lawful absent showing of market power). *See also VISA*, 36 F.3d at 970-72 (finding that horizontal restraint ancillary to joint venture was reasonably necessary to protect venture from free riding); *Polk Bros.*, 776 F.2d at 189-90 (explaining how restraint ancillary to the formation of a shopping center could prevent free riding and thus encourage investment in the initial venture).

[381] *See* Meese, *Quick Look*, 68 ANTITRUST L.J. at 491-92 (arguing that franchise systems can be characterized as a horizontal agreement); WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM, at 181-82 (characterizing franchise contract as agreement between various potential competitors); HOVENKAMP, FEDERAL ANTITRUST POLICY, at 205 ("[R]estauranteurs scattered across a wide area might develop joint menus, building plans, and methods of doing business, and then promote their 'chain' nationally. This national name recognition will enable them to reach traveling customers that might otherwise avoid a local restaurant about which they know nothing. The *Topco* case . . . involved such a venture."). *See also* Rubin, *The Structure of the Franchise Contract*, 21 J. L. & ECON. at *passim*; *Chicago Professional Sports, Ltd.*, 95 F.3d at 598 (describing McDonald's franchise system as agreement among potential competitors).

result in a market failure, namely, the devolution of college football into professional.[382] Thus, the Court suggested, a horizontal restraint on price rivalry could produce cognizable benefits, *viz.*, the reduction of prices for athlete's services to a level below that which price-theoretic "competition" would produce.[383] Here again the Court has embraced alternative definitions of "competition" in the Rule of Reason and *per se* contexts.

Consider a third example, namely, an agreement between several elite universities eliminating competition with respect to methods of setting financial aid.[384] In particular, the agreement prevents participating schools from offering financial aid on any basis other than demonstrated financial need.[385] While such an agreement is not ancillary to any larger venture, participants could perhaps avoid *per se* condemnation by arguing that the restraint allows parties to it to allocate limited financial aid toward students whose personal characteristics or background would enhance the socio-economic diversity of each school.[386] Assuming that such a justification

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[382]*See NCAA*, 468 U.S. at 101-102. *See also BMI*, 441 U.S. at 7-23 (holding that horizontal price setting minimized transaction costs and thus increased output).

[383]*See NCAA*, 468 U.S. at 102. Moreover, as Professor Hovenkamp has recognized, the existence of a sports league implies the ability to determine the number of games in a season and thus the output of the league's members. *See* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 262. Presumably a league's decision to reduce the number of games in season would not — and certainly should not — *ipso facto* give rise to a *prima facie* case, even if the plaintiff could show that the restraint actually reduced the number of games played. There is no apparent distinction between such a decision and a decision to limit the number of games that are televised. *But see* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 256-57 and n. 25 (endorsing actual detrimental effects test); *id.* at 262-63 (arguing that government established a *prima facie* case in *NCAA* despite the absence of any convincing market definition).

[384]*See* United States v. Brown University, 5 F.3d 658 (3d Cir. 1993) (evaluating such an agreement among members of the Ivy League and MIT).

[385]*Id.*

[386]*See Brown University*, 5 F.3d at 675-78 (accepting variant of this argument); Meese *Quick Look*, 68 ANTITRUST L. J. at 490 (arguing courts should evaluate such restraints under the Rule of Reason). *Compare* Arthur, *A Workable Rule of Reason*, 68 ANTITRUST L. J. 379 n. 263 (arguing that the benefits touted

is cognizable, proof that the restraint produces prices higher than those that previously obtained should not suffice to establish a *prima facie* case. Here again, the defendants' justification depends upon an assertion that unbridled rivalry in financial aid determinations would produce a lemons equilibrium; lower prices, yes, and perhaps higher output, but also reduced educational quality manifested in less diverse student bodies.[387] Thus, proof that the restraint results in higher prices is entirely consistent with the defendants' account of the arrangement's legitimate purpose and effect.[388] Increased quality often involves higher costs — here the cost of providing the aid necessary to attract diverse students. Because they are cost-justified, these higher prices do not reflect any exercise of market power, but instead a higher quality product for which consumers are willing to pay.[389]

Certainly the rationale for the three restraints discussed above depends upon the existence of product differentiation, differentiation that might confer some modest market power on the manufacturer.[390] In some cases, for instance, the restraint in question may itself be a source of differentiation, as when colleges agree not to pay athletes, thus creating a product different from

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by the Ivy League overlap group were not cognizable).

[387]*See* Meese, *Quick Look*, 68 ANTITRUST L. J. at 495 (asserting that defendants' justification in this context rests upon an assertion that unbridled rivalry will produce a lemons equilibrium). *See generally* Akerlof, *The Market For Lemons*, 84 Q. J. Econ. at *passim.*

Output as measured simply by number of matriculations could increase as lower prices attracted additional "non-diverse" students who might otherwise matriculate elsewhere if the restraints were enforced. These students would be paying a lower price, but they would also be obtaining an inferior product.

[388]*See* Meese, *Quick Look*, 68 ANTITRUST L. J. at 495-96.

[389]*See* Meese, *Quick Look*, 68 ANTITRUST L. J. at 495-96. *See also* nn. ____, *supra* and accompanying text (showing that price increases associated with vertical restraints are cost-justified and do not reflect an exercise of market power).

[390]*See* Telser, *Fair Trade*, 3 J.L. & Econ. at 87 (assuming that product differentiation that leads firms to adopt vertical restraints gives rise to market power).

other forms of athletic entertainment.[391] In other cases, such restraints might facilitate the advertising and promotion of a manufacturer's product, thus accentuating such differentiation, and enhancing any market power such differentiation might confer. Moreover, the availability of various promotional devices that inform consumers of functional distinctions between products may encourage manufacturers to innovate, knowing that a "better mousetrap" will win consumer patronage.[392]

The presence or prospect of such differentiation does not change the analysis offered here. While firms may seek market power through product differentiation, they do not always succeed. The Edsall was "different" from all other cars, and the new Coke was different from Pepsi and, for that matter, the old Coke. Although both Ford and Coke spent millions of dollars promoting their "innovations," it seems highly unlikely that either product conferred market power on its inventor. Few business mistakes are as spectacular as these, of course, and many attempts at differentiation are successful. Nonetheless, "success" in a free economy often simply means the absence of failure, that is, the ability to price at marginal cost and earn a normal return in competition — present or future — with other differentiated products. Such competition, of course, may radically change the character of consumer demand for the differentiated product, rendering once loyal customers entirely indifferent. Thus, even where a justification depends upon the creation or enhancement of product differentiation, proof that the restraint produces "detrimental effects" is entirely consistent with defendants' attempt simply to obtain a "normal" return and the existence of

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[391]*See NCAA*, 468 U.S at 101-102 (stating that restrictions on compensation designed to preserve amateur quality of college football was legitimate attempt at product differentiation).

[392]*See, e.g.*, Lee Benham, *The Effect Of Advertising on the Price of Eyeglasses*, 15 J. L. & Econ. 337 (1972) (finding that restrictions on advertising of eyeglasses raised prices).

enough substitutes to render the seller a price taker.[393] That the firm hopes for more does not create antitrust harm.

At any rate, even if one stipulates that such differentiation *always* gives rise to market power, there is still no reason to embrace the actual detrimental effects test. So long as entry is feasible, even firms that sell differentiated products will find themselves confined to a normal rate of return, as any above-normal profits attract new rivals.[394] To be sure, the existence of a downward sloping demand curve implies that such firms will price above marginal cost, and such pricing is an

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[393]The assertion that product differentiation need not confer market power may seem incorrect to economists and economically sophisticated antitrust scholars, who assume that such differentiation always confers some degree of market power, no matter how modest. *See, e.g.*, F.M. SCHERER AND DAVID ROSS, INDUSTRIAL STRUCTURE AND ECONOMIC PERFORMANCE, 32-33 (1990). *See also* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 97 ("[I]n a product differentiated market firms have the ability to exploit a small amount of market power."). This assumption, however, is purely tautological, insofar as economists *define* as "differentiated" any product for which a seller faces a downward sloping demand curve in the region above its average cost curve. *See, e.g.* SCHERER AND ROSS, INDUSTRIAL STRUCTURE AND ECONOMIC PERFORMANCE, at 17. This downward slope, it is said, reflects the fact that some consumers strongly prefer the product in question to any substitutes. *See* HOVENKAMP, ANTITRUST POLICY, at 36-37 ("Although Ford and Chrysler automobiles compete, *some* buyers prefer one to the other and are willing to pay more for their first choice. To the extent this is true, the manufacturer faces a slightly downward sloping demand curve and may charge a price above marginal cost.") (emphasis added); SCHERER AND ROSS, INDUSTRIAL STRUCTURE AND MARKET PERFORMANCE, at 17 (same). The ability to price above cost in this manner, of course, rests upon the assumption that: 1) firms fully understand the demand curves they will face and 2) technology is sufficiently plastic that a firm can enter at a scale small enough to price above marginal cost, but large enough to achieve a profitable level of average costs.

Nonetheless, the mere fact that a demand curve is downward sloping at some levels of output at a particular time does not mean that it is downward sloping at all levels of output at all times. A firm with numerous loyal consumers today may find most of the same consumers indifferent tomorrow, after a rival introduces a similar product. In such a case, the firm's demand curve may well shift to the left and become horizontal at all profitable levels of output. *See generally* SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY, at 80-86. The discussion in the text therefore departs from the economist's tautology and defines "product differentiation" as any difference in attributes among products, including brand names, without regard to the effect of such differences on the shape of demand curves at a firm's conceivable levels of output. *See also* nn. ____, *infra* and accompanying text (arguing that, even if product differentiation does confer market power, such differentiation should not suffice to establish a *prima facie* case).

[394]CLARK, COMPETITION AS A DYNAMIC PROCESS, at 21, 53, 120; Hayek, *Meaning of Competition*, at 105 (suggesting that entry or threat thereof will ensure that no firm earns more than a normal rate of return); EDWARD CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION, 69-88 (1933).

exercise of market power.[395] Nonetheless, differentiation meets real consumer tastes and needs, and there is no reason to believe that the alternative, a world of entirely homogenous products priced at marginal cost, would be superior from the perspective of consumers or anyone else.[396] Nor will attempts to penalize contractual attempts at differentiation cause sellers of differentiated products to expand output and price at marginal cost.[397] Absent some examination of barriers to entry — an inquiry the actual detrimental effects test abjures — there is simply no reason to treat the presence or creation of differentiation as a harm for antitrust purposes.[398]

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[395] *See* SCHERER AND ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, at 23; CHAMBERLIN, MONOPOLISTIC COMPETITION, at 74-81.

[396] *See* Indeed, Professor Chamberlin, who popularized the theory of monopolistic competition, argued that a world containing such differentiation was superior to that portrayed by the perfect competition model. "Differences in tastes, desires, incomes and locations of buyers, and differences in the uses which they make of commodities all indicate the need for variety and the necessity of substituting for the concept of a 'competitive ideal' an ideal involving both monopoly and competition." *See* EDWARD H. CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION, 214-15 (6th ed. 1948) (quoted in SCHERER AND ROSS, INDUSTRIAL STRUCTURE AND MARKET PERFORMANCE, at 32-33); CLARK, COMPETITION AS A DYNAMIC PROCESS, 4-5; *see also* nn. ____, *supra* and accompanying text (showing the price theorists generally believed that some differentiation was healthy).

[397] *Cf.* CLARK, COMPETITION AS A DYNAMIC PROCESS, at 214 (noting that attacks on product differentiation based on marginal-cost pricing standard are "meaningless").

[398] *Cf.* nn. ____, *infra* and accompanying text (noting that courts that apply a market power filter require plaintiffs to show the existence of barriers to entry to establish a *prima facie* case). The argument made in this paragraph may seem inconsistent with *Standard Oil's* normative premise that above-cost pricing is the sort of harmful "consequence of monopoly" at which the Rule of Reason is directed. *See* nn. ____, *supra* and accompanying text. However, classical economics did not recognize the concept of "marginal cost," and it therefore seems likely that the *Standard Oil* court was referring to *average* cost. *See generally* HOVENKAMP, ENTERPRISE AND AMERICAN LAW, at 273 ("classicism knew nothing of marginal cost"). Thus, to the extent that: 1) *Standard Oil*'s overriding concern is the enhancement of purchaser welfare and 2) the existence of product differentiation enhances that welfare, proof that a restraint produces or enhances product differentiation should not *ipso facto* give rise to a *prima facie* case. A contrary approach would produce absurd results, presumptively banning all contractual restrictions that tend to differentiate a product. *Cf. NCAA*, 468 U.S. at 102 (suggesting that contractual restrictions that limit competition for players are procompetitive efforts to differentiate the NCAA's product).

Indeed, even if barriers to entry ensure that a defendant selling a differentiated product might earn more than a normal return, there is still no reason to treat such differentiation as an antitrust harm. While the American economy is generally competitive, the prospect of achieving *supra*-competitive returns is a powerful motivating force, driving firms to innovate in the search for that ever-elusive monopoly. Moreover, the benefits of innovation usually outweigh the allocational losses that accompany any resulting market power.[399] Punishing mere product differentiation would thus sap the economy of its driving force. "The successful competitor, having been urged to compete, must not be turned on when he wins."[400] While many such innovations are technological (the better mousetrap), others require non-standard contracts, as when franchisees agree to be open from seven until eleven or to serve Coca Cola instead of Pepsi.[401] Moreover, all innovations are worthless unless consumers know about them, and non-standard contracts often facilitate promotion and advertising.[402] Even price theorists recognized that technological innovations that result in product differentiation are "competitive" because they enhance the welfare of consumers who of course have varying preferences.[403] Like new technologies, non-standard contracts can qualify as

[399]*See* Hayek, *Meaning of Competition*, at 101 ("A person who possesses the exclusive knowledge or skill which enables him to reduce the cost of production of a commodity by 50 percent still renders an enormous service to society if he enters its production and reduces its price by only 25 percent – not only through that price reduction but also through his additional savings of cost. But it is only through competition that we can assume that these possible savings will be realized."); Oliver Williamson, *Economies As An Antitrust Defense Revisited*, 125 U. Pa. L. Rev. 699 (1977).

[400]*See* United States v. Aluminum Company Of America, 148 U.S. 416, 430 (2d Cir. 1945) (L. Hand, J.). *See also* Will v. Comprehensive Accounting, 776 F.2d 665, 673 n. 4 (7th Cir. 1985).

[401]*See* Martino v. McDonald's System, Inc., 625 F. Supp. 356 (N.D. Ill. 1985) (evaluating requirement that McDonald's franchisees serve Coca-Cola).

[402]*See* Hayek, *Meaning of Competition*, at 96.

[403]*See* nn. ____, *supra* and accompanying text.

"innovations," helping to create a new product. They can also help innovating firms inform consumers of their "better mousetrap." There is no reason to treat such contractual competition any differently from "technological" competition that takes place "within" the firm.[404]

B. Balancing Harms and Benefits:

Of course, even if a plaintiff makes out a *prima facie* case, defendants may still introduce evidence in rebuttal.[405] Under current law, defendants must do more than show that a restraint produces significant benefits by, for instance, combating a market failure. Instead, defendants must also show that such benefits "outweigh," "counteract," or offset any anticompetitive harm.[406] For instance, if the plaintiff's *prima facie* case consists of a showing that a restraint increases prices, the defendant must offer evidence that because of these benefits, the restraint reduces or at least does not increase prices.[407] This, of course, is the same approach lower courts and the enforcement agencies employ when evaluating mergers.[408] Such an approach assumes that, once a plaintiff has established a *prima facie* case, any procompetitive benefits necessarily coexist with

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[404]*Cf. Sylvania*, 433 U.S. at 56, n. 25 (concluding that a ban on vertical restraints would lead firms to "shift to less efficient methods of obtaining the same promotional effects").

[405]*See* nn. ____, *supra*.

[406]*See NCAA*, 468 U.S. at 113-120; *Competitor Collaboration Guidelines*, § 3.37 (agencies attempt to determine whether "cognizable efficiencies likely would be sufficient to offset the potential of the agreement to harm consumers"); 7 AREEDA, ANTITRUST, ¶ 1507b at 397-99 (even if defendant produces evidence of significant benefits, the tribunal must determine whether a less restrictive alternative is present and, if not, "weigh and balance the harm against benefit"); *id*. at 398 (where restraint produces only minor benefits, a court should declare it unlawful once plaintiff establishes a *prima facie* case). *See also* nn. ____, *supra* and accompanying text.

[407]*See NCAA*, 468 U.S. at 114; *Competitor Collaboration Guidelines*, § 3.37. *See also National Society of Professional Engineers*, 435 U.S. at 693-95 (purported benefit is only cognizable if it tends to offset price increase).

[408]*See* nn. ____, *supra* and accompanying text.

some anticompetitive harm, thus necessitating some comparison of the two effects.[409] This assumption rests upon price theory's partial equilibrium trade-off model, which economists and antitrust scholars use to model the welfare effects of mergers and other transactions that produce technological efficiencies such as economies of scale.[410]

As shown below, this requirement that courts "balance" justifications for non-standard contracts against "actual detrimental effects" rests upon outmoded price-theoretic assumptions, namely, that higher prices or reduced output are necessarily "anticompetitive harms," that any benefits must "counteract" or "outweigh." Application of TCE, by contrast, suggests that proof that contractual integration combats a market failure should *ipso facto* rebut any *prima facie* case, regardless whether such proof tends to show that prices are lower or output higher than before the restraint. Thus, such proof undermines the price-theoretic assumption inherent in the partial equilibrium trade-off model that any benefits necessarily coexist with anticompetitive effects.

Return first to the example of an exclusive territory discussed earlier. Assume that a plaintiff has made out a *prima facie* case by showing that the restraint has resulted in prices higher than those that existed before it. Assume further that the defendants prove that, but for the restraints, individual dealers would underinvest in promotional services, free riding on the efforts of fellow dealers. Under the current standards governing Rule of Reason analysis, such proof would be an

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[409] *See, e.g.*, Timothy J. Muris, *The Efficiency Defense Under Section 7 of the Clayton Act*, 30 Case W. L. Rev. 381 (1980); Oliver Williamson, *Economies As An Antitrust Defense*: *The Welfare Trade-Offs*, 58 Am. Econ. Rev. 18 (1968).

[410] HOVENKAMP, FEDERAL ANTITRUST POLICY, at 501-502 (describing application of this model in the merger context); BORK, ANTITRUST PARADOX, at 107-110 (arguing that this model should be the basis for antitrust policy). *See also* Wesley J. Liebler, *Comments*, 28 J. L. & Econ. 335, 335-36 (1985) (arguing that Rule of Reason analysis should "balance the gains from increased efficiency against the losses from increased market power.").

invitation to further inquiry, as a court attempts to determine whether these benefits "outweighed" the presumed harm.[411] Or, as courts often put it, the fact-finder would balance any improvement in interbrand competition against the harm flowing from a reduction in intrabrand competition.[412]

While such an approach makes sense under a price-theoretic, technological conception of competition, it cannot survive application of the transaction cost paradigm and its recognition of "contractual" competition. According to TCE, proof that a restraint combats free riding suggests that the unrestrained rivalry that pre-existed the arrangement produced a lemons equilibrium and with it a non-optimal price.[413] This price was not "competitive' in any meaningful sense, and thus not an appropriate benchmark for ascertaining whether, in fact, the restraint produces net procompetitive effects. Thus, proof that the restraint in fact produces cognizable benefits undermines any presumption that the restraint creates anticompetitive harm, since such proof establishes that the prices (and output) that pre-existed the restraint were a product of market failure. Absent such a presumption, of course, the plaintiff's case collapses, without regard to whether the restraint's benefits outweigh any purported "harms" by reducing prices or otherwise. For, any conclusion at the *per se* stage that such benefits are cognizable under the Sherman Act necessarily

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[411] *See* nn. ____, *supra* and accompanying text.

[412] *See Sylvania*, 433 U.S. at 51-52 ("The market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition."); *id.* at 57 and n. 27 (concluding that such balancing is an appropriate judicial function).

[413] *See* nn. ____, *supra* and accompanying text. *See also*, *e.g.*, 8 AREEDA, ANTITRUST LAW, ¶, P. 547-49 (outlining balancing test to be applied in this context); SULLIVAN AND GRIMES, at 333-335 (same). It should be noted that Professor Hovenkamp would generally eschew balancing in this context and approve any restraint for which the defendant is able to establish the existence of significant benefits. *See* HOVENKAMP, ANTITRUST POLICY, at 489 (once defendant demonstrates that the restraint advances a legitimate business purpose, the court should approve the restraint, unless the plaintiff shows actual collusion or "anticompetitive dealer domination"). He would, however, continue to apply the less restrictive alternative test in this context. *See id.*

rests on the assumption that the elimination of market failure is an unambiguous benefit, and that elimination of that failure may increase prices.[414] Any attempt to "balance" an increase in interbrand competition against the "harm" of reduced intrabrand competition misses the point.[415] Proof that the restraint ameliorates a market failure by reducing overzealous intrabrand rivalry establishes that *there is no harm* in the first place, period, thus undermining the case for application of the partial equilibrium trade-off model.

It is true that the restraint may have increased prices above those that previously obtained. But then so would a manufacturer's decision to forgo contracts with "independent" dealers and enter employment contracts with its own sales force in an attempt to increase expenditures on

[414] *See Business Electronics*, 485 U.S. at 727-28; *id.* at 731 (same). *See also GTE Sylvania*, 433 U.S. at 54-57 (elimination of free riding a beneficial effect of vertical restraints).

[415] As then–Professor Easterbrook put it when speaking of vertical restraints:

> "No one can sensibly weigh inter- and intrabrand competition against one another; they are not commensurable. The reduction in "intrabrand competition" is the *source* of the competitive benefit that helps one product compete against another. Intrabrand competition as such is worthless; one might as well complain when a corporation does not have internal competition to make the product most cheaply. . . . No manufacturer wants to have less competition among its dealers for the sake of less competition. The reduction in dealers' rivalry in the price dimension is just the tool the manufacturer uses to induce greater competition in the service dimension. As I spelled out above, restricted dealing alters the product's attributes. There is no "less" in one column to "balance against a gain" in the other, any more than the manufacturer's sole prerogative to decide what physical product to make creates a "reduction in intrabrand competition."

See Easterbrook, *Vertical Arrangements and the Rule of Reason,* 53 ANTITRUST L. J. at 155-56; Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 18-21 (1981). *See also* Alan J. Meese, *Antitrust Balancing In A (Near) Coasean World: The Case of Franchise Tying Contracts*, 95 MICH. L. REV. 111, 141-42 (1996) (proof that a franchise tying contract produces significant benefits rebuts any presumption that the agreement is the result of forcing and should entitle the defendant to judgment).

promotion.[416] Both forms of (contractual) competition would result in price increases. Each price increase would be entirely procompetitive, however, and neither would depend upon any exercise of market power. There is, therefore, simply no reason to ask whether the benefits of these arrangements outweigh the purported "harms" of such higher prices.

Similar analysis applies to the ancillary and "naked" horizontal price restraints discussed earlier.[417] As suggested above, the ancillary restraint between members of the Hercules venture could prevent some members of the venture from free riding on the goodwill associated with the venture trademark and driving prices so low that the venture could not sustain an optimal level of service quality and advertising.[418] Here again current law and scholarly opinion would require courts to determine whether any benefits produced by such restraints offset the harms presumed once

[416]*See* Bork, *Rule of Reason*, 75 YALE L. J. 438 ("since there is presently no antitrust objection to the most efficient utilization of local sales effort by ownership integrated firms, there seems no reason to discriminate against the achievement of the same objective by contract-integrated systems through the use of market division agreements"). *See also* Illinois Corporate Travel v. United Air Lines, 806 F.2d 722, 727 (7th Cir. 1986) ("The question is not whether the arrangement affects moment-to-moment rivalry in a way that raises today's prices, but whether this effect is associated with potential benefits to consumers that are worth the price. Higher quality may come with higher prices. *The antitrust laws do not adopt a model of atomistic competition that condemns all organization; otherwise they would forbid Sears to tell the managers of its stores what prices to charge*.") (emphasis added); Chicago Railroad Co. v. Pullman Car Co., 139 U.S. 79, 89 (1891) (finding contract granting one company the exclusive right to obtain sleeping cars valid at common law because "[the defendant's] duty, as a carrier of passengers, was to make suitable provisions for their comfort and safety. Instead of furnishing its own drawing room and sleeping cars, as it might have done, it employed the plaintiff, whose special business was to provide cars of that character"); *Addyston Pipe*, 85 F. at 287 (suggesting that such a contract would be valid under the Sherman Act because "The railroad company . . . may secure to the sleeping-car company the same freedom from competition that it would have itself in discharging its duty."); *Walsh*, 58 N.Y. Supp. at 93 (minimum rpm not an unlawful restraint of trade because "the defendant would have the right to establish agencies for the sale of goods, or to employ others to sell them; at such prices as the manufacturer should designate").

[417]*See* nn. ____, *supra* and accompanying text.

[418]*See* nn. ____, *supra* and accompanying text.

a plaintiff established a *prima facie* case.[419] However, proof that the venture in fact produces such benefits undermines any assertion by the plaintiff that higher prices indicate that the restraint creates or exercises market power.[420] For, as described earlier, such price increases may simply reflect the enhanced quality produced by the restraint.[421] As a result, there is simply no reason to "balance" benefits against harms, since proof of benefits negates the existence of any harms by establishing that any price increase established by the plaintiff does not necessarily reflect an exercise of market power.[422] Similarly, proof that the agreement between Ivy League universities on financial aid actually thwarts a lemons equilibrium rebuts any assertion that higher tuition or reduced output is a manifestation of above-cost pricing.[423] Thus, there is no reason to "weigh" benefits against anticompetitive harm, since the very existence of such benefits undermines any presumption of harm.

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[419]*See* nn. ____, *supra* and accompanying text. Indeed, Professor Hovenkamp argues that, where horizontal restraints are concerned, a plaintiff should prevail whenever procompetitive benefits and anticompetitive effects coexist. *See* HOVENKAMP, ANTITRUST POLICY, at 257. That is, he would not allow a defendant to show that the benefits of the practice outweigh the harms.

[420]*See* nn. ____, *supra* and accompanying text.

[421]*See* nn. ____, *supra* and accompanying text. *See also Rothery Storage*, 792 F.2d at 222-23 (explaining that horizontal price restraints could protect quality of the venture's product by preventing price deterioration and ensuring members adequate return on their investments in quality); *Polk Bros*, 776 F.2d at 190 (covenant restricting products that each party could sell could enhance welfare by encouraging investment in promotion by each party); *Visa SLC*, 36 F.3d at 970 (exclusion of competitor from joint venture could prevent latecomer from reaping benefits of members' investments and thus encourage initial investment in the venture product).

[422]The same analysis would apply, it should be noted, if the restraint in question was an ancillary horizontal division of territories. *See Topco*, 405 U.S. at *passim*; nn. ____, *supra* (collecting authorities showing that such restraints can combat market failure and thus encourage optimal promotion).

One need not rely upon the assertion by Judge Bork that such balancing is beyond judicial capacity. *See Rothery Storage*, 792 F.2d at 229, n. 11. The point of the argument in the text is that, regardless of the capacity of courts, such balancing is premised upon the false assumption that procompetitive benefits necessarily coexist with anticompetitive effects.

[423]*See* nn. ____, *supra*.

While the plaintiff should be free to prove that any benefits produced by the restraint are illusory,[424] a tribunal should not allow the plaintiff simply to rest on its initial proof that the restraint produces "actual detrimental effects," hoping that the fact-finder will strike a balance in its favor.

It will not do to argue, as some have, that such claims of benefits necessarily depend upon the possession of market power with the result that some balancing is inevitable.[425] They do not. Numerous horizontal restraints on price and output exist despite the apparent absence of any market power.[426] In a world of perfect competition, it is true, no firm or subset of firms can affect

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[424]*See NCAA*, 468 U.S. at 117-119 (finding that restraint did not in fact produce the benefits that the defendants touted); *Law*, 134 F. 3d 1020-24 (same).

[425]*See* SULLIVAN AND GRIMES, THE LAW OF ANTITRUST, at 211 (stating that the possession of market power was implicit in defendants' characterization of the justification in *NCAA*); Herbert Hovenkamp, *Competitor Collaboration after California Dental Association*, 2000 U. Chi. Leg. F. 149, 179-180 (arguing that the justifications offered in *NCAA* necessarily contemplated a "market-wide output decrease" and "depends on the exercise of market power"); *National Society of Professional Engineers*, 435 U.S. at 692-95 (rejecting justification as necessarily depending upon ability to price above the "competitive" level); *see also* 7 AREEDA, ANTITRUST at ¶ 1504, pp. 380-81 (justification in *Professional Engineers* depended upon existence of non-competitive pricing).

The assertion that the restraints in *NCAA* necessarily depended upon the exercise of market power seems particularly difficult to accept, given their humble origins. The NCAA first adopted restraints on output in 1951, long before college football had any conceivable market power. *See NCAA*, 468 U.S. at 89-91 (detailing origins of the restraints). Moreover, for reasons explained in the text, and by the Court itself, not every instance of cooperation between competitors that affects price or output involves an exercise of market power. *See NCAA*, 468 U.S. at 101-102 (concluding that some horizontal cooperation, including an agreement not to pay athletes a salary, is necessary to create and enhance the product of college football). *See also* n. ____, *infra* (describing various horizontal restraints that cannot be explained as attempts to acquire or exercise market power).

[426]*See e.g.*, *Topco*, 405 U.S. at *passim* (declaring unlawful ancillary horizontal restraint among firms with 6% share of relevant market); *Rothery Storage*, 792 F.2d at *passim* (evaluating restraint ancillary to joint venture among firms with 6% of the relevant market); *Polk Bros*, 776 F.2d at *passim* (evaluating restraint ancillary to formation of a shopping center selling appliances and lawn care products).

Similarly, some college sports leagues have adopted horizontal restrictions on competition for athletes more stringent than those mandated by the NCAA. Members of the Patriot League, for instance, have agreed not to grant athletic scholarships in all sports except basketball. *See* Mark Asher & Seth Emerson, *American to Leave CAA for the Patriot League*, Wash. Post, Apr. 25, 2000, at D-1; About The Patriot League <http://www/patriotleague.org/aboutpl.htm>. These restrictions obviously reduce the price that these schools pay for the services of hundreds of athletes. *See Law*, 134 F.3d at 1020 (finding proof that salary cap had reduced salaries of "restricted earnings coaches" sufficed to establish a *prima facie* case).

the price or output of their own products through contractual restraint or otherwise. In this world, any change in a firm's price will cause all consumers to shift to other products which, by hypothesis, are perfect substitutes. In the real world, however, substitutes are rarely perfect, and firms are constantly striving to build a new mousetrap and convince consumers that it is better. Such quality improvements cost money, and improvements that are cost-justified will win over consumers, even if prices are higher than those of "substitutes."[427] Contractual integration can play an important role in this process, as firms moderate rivalry that undermines attempts at differentiation or thwarts efforts to communicate such differentiation to consumers.[428] At any given time, of course, several firms within the same market may be pursuing such strategies; others might be pondering entry or extension of product lines. The end result is a market full of differentiated products, serving the various needs of consumers. While economists generally assume that such differentiation creates market power, it need not; a firm with a loyal customer base may lose most of those customers tomorrow to an innovative substitute.[429] Moreover, a firm may create a new product expecting a loyal customer base, only to find that most view its innovation with relative indifference. All firms

Is it possible that Army, Bucknell, Colgate, Holy Cross, Lafayette, Lehigh and Navy have "market power" in the market for collegiate sports talent? Moreover, numerous law firm partnerships and physician practices set prices and bind their members to non-compete agreements and other ancillary restraints. Do each of these firms have "market power?"

[427] *See* nn. ____, *supra* and accompanying text.

[428] *See NCAA*, *Sylvania*. *See also* nn. ____, *supra* and accompanying text (describing role that non-standard contracts can play in enhancing product differentiation).

[429] *See* nn. ____ *supra* and accompanying text (arguing that firms with differentiated products may not possess market power due to existence of substitutes that lure away once loyal consumers). *See also* SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY, at 80-86.

hope that their efforts lead to market power, but such efforts are equally consistent with the achievement of a normal return and marginal cost pricing.[430]

This is not to say that balancing is never a valid method of evaluating a defendants' justification for a restraint that is apparently detrimental. Where a restraint purportedly creates benefits that are technological in origin, ostensibly reducing the cost of production, such balancing pursuant to the partial equilibrium model is certainly in order. If, for instance, defendants claim that an apparently anticompetitive merger will result in economies of scale and thus reduce the unit cost of production, courts should weigh those benefits against any anticompetitive harms the transaction might create.[431] For, unlike those instances in which a restraint purportedly attenuates a market failure, the creation of technological efficiencies by merger does not *ipso facto* undermine a plaintiff's *prima facie* case, and application of the partial equilibrium trade off model is appropriate. By their very nature, such efficiencies produce lower costs of production that can logically coexist with the exercise of market power. Thus, the presence of such efficiencies does not explain or rebut proof that the transaction produces actual detrimental effects.[432]

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[430] *See also* nn. ___, *supra* and accompanying text (arguing that existence of market power implied by monopolistic competition should not itself establish a *prima facie* case); Hayek, *Meaning of Competition*, at 104-105.

[431] *See* 1992 *Joint Merger Guidelines*, § 4.0; HOVENKAMP, FEDERAL ANTITRUST POLICY, at 501-502. The exact nature of such weighing will depend upon the normative premise that one adopts. If the antitrust statutes merely outlaw those transactions that result in a net reduction in social wealth, courts will want to balance any cost savings against the deadweight allocative losses resulting from a transaction. *See* Williamson, *Economies As An Antitrust Defense*, 58 Amer. Econ. Rev. at *passim*. If, on the other hand, these statutes outlaw any transaction that results in higher consumer prices, courts should determine whether the efficiencies in question are so large that they offset any increase in market power, thus preventing a price increase. *See* HOVENKAMP, FEDERAL ANTITRUST POLICY, at 502-503; 1992 Joint Merger Guidelines (Amended in 1997), § 4.0.

[432] *See generally*, Williamson, *Economies As An Antitrust Defense: The Welfare Trade-Offs*, 58 Amer. Econ. Rev. 18 (1968).

C. The Less Restrictive Alternative:

Under current law, proof that a restraint's benefits outweigh the harms identified by the plaintiff will not necessarily sustain it. For, courts and the enforcement agencies uniformly declare such restraints unlawful if the plaintiff can demonstrate a "less restrictive alternative" that will produce the same benefits as the restraint.[433] Many scholars have gone even further, arguing that proof that an alternative produces "nearly" the same benefits or "adequately" advances defendants' objective, should suffice.[434] Application of such a test, it is said, ensures that defendants achieve their objectives with as little harm to "competition" as possible.[435]

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[433]*See Re/Max, Inc.,* 173 F.3d at 1015 (rejecting claim that price fixing was necessary to protect investment in employees where such benefits could be realized via less restrictive alternative of long term contracts and covenants not to compete); *Chicago Professional Sports Limited Partnership*, 961 F.2d at 675-76 (declaring restriction on output of televised games unlawful where same benefits could be achieved by charging members of venture a fee for every game broadcast); General Leaseways, Inc. v. National Truck Leasing Assoc., 744 F.2d 588, 592 (7th Cir. 1984) (finding that horizontal allocation of territories was not justified by desire to prevent free riding by members on provision of repair services because venture could and did charge members for such services); Mackey v. N.F.L., 543 F.2d 606, 621 (8th Cir. 1976) (finding limits on free agency unreasonable in light of purported less restrictive alternatives). *See also* nn. ____, *supra* (collecting other judicial, executive and scholarly authorities endorsing use of the less restrictive alternative test). It should be emphasized that scholars do not distinguish between vertical and horizontal restraints on this score. *See, e.g.*, HOVENKAMP, FEDERAL ANTITRUST POLICY, at 489; 8 AREEDA, ANTITRUST LAW ¶ 1649d3, pp. 557-58.

[434]*See*, 7 AREEDA, ANTITRUST LAW, ¶ 1505, p. 383; *id.* at ¶ 1507b; SULLIVAN AND GRIMES, THE LAW OF ANTITRUST, at 223 (courts should ask whether less restrictive alternative proffered by the plaintiff is "nearly as effective"); Sullivan, *Viability Of Horizontal Restraints Law*, 75 Calif. L. Rev. at 851. Moreover, Professor Hovenkamp has suggested on one occasion that less restrictive alternatives need not be equally effective. *See* HOVENKAMP, 11 ANTITRUST LAW, ¶ 1912i, p. 302 ("If a defendant succeeds [in showing that a restraint produces benefits], then the plaintiff is permitted to show that the same (or nearly the same) procompetitive benefits could be achieved by a realistic, less restrictive alternative). In a subsequent work, however, he indicates that a less restrictive alternative should serve the purported objective equally well. *See* HOVENKAMP, ANTITRUST POLICY, at 257 (asking whether the "same efficiencies" can be achieved via a less restrictive means).

[435]*See*, *e.g.*, 7 AREEDA, ANTITRUST, ¶ 1505, p. 384 (application of less restrictive alternative test determines whether defendants' "objective [can] be achieved as well without restraining competition so much"). *See also* nn. ___, *supra* and accompanying text.

The less restrictive alternative test is plainly flawed, resting, as it does, on an outmoded, price-theoretic model of "competition." To begin with, many of the less restrictive alternatives posited by courts and scholars are either less effective, more expensive to administer, or both.[436] Indeed, many scholarly proponents of this test admit as much, contending that plaintiffs should prevail if they show that an alternative will advance an objective "nearly as much" as the challenged restraint, or further it "adequately."[437] Adoption of such alternatives, it is said, would render the market in question more "competitive."[438]

Given the vision of "competition" suggested by TCE and the recognition that less restrictive alternatives are likely less effective, there is no reason to believe that such alternatives are in fact more "competitive" than restraints under challenge. An assertion that alternatives are more competitive depends upon the assumption that the restraints in question actually injure competition in the first place. To be sure, proof that defendants could have adopted a less restrictive and less effective restraint is consistent with the hypothesis that the restraint exercises or creates market

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[436] *See*, *e.g.*, Meese, *Quick Look*, 68 Antitrust L.J. at 487, n. 109 (arguing that alternatives proffered for horizontal allocation of territories are generally less effective at achieving the proffered benefits); Meese, *Tying Meets the New Institutional Economics*, 146 U. Penn. L. Rev. at 71-86 (canvassing various less restrictive alternatives to tying contracts and showing that such alternatives are generally less effective as well); Meese , *Price Theory And Vertical Restraints*, 45 UCLA L. Rev. at 189-95 (showing that various less restrictive alternatives often proffered for vertical restraints are also less effective); WILLIAMSON, ECONOMIC INSTITUTIONS, at 187 (arguing that various less restrictive alternatives to vertical distribution restraints are also less effective); Easterbrook, *Limits Of Antitrust*, 63 Tex. L. Rev. at 9 (arguing that less restrictive alternatives are often more costly to administer); Victor P. Goldberg, *The Law And Economics Of Vertical Restrictions: A Relational Perspective*, 58 Tex. L. Rev. 91, 107(1979) (less restrictive alternatives to vertical distribution restraints are also less effective); Bork, *Market Division*, 75 Yale L. J. at 465-69 (discussing various alternatives and arguing that they are generally less effective).

[437] *See* n. ____, *supra* and accompanying text.

[438] *See* nn. ____, *supra* and accompanying text.

power, and that the benefits it creates coexist with anticompetitive harm. However, such proof is at least equally consistent with an alternative hypothesis, namely, that the defendants are attempting to minimize market failure at the lowest cost possible and that the restraints are unrelated to any exercise of market power.[439] Such a cost-minimizing business strategy is exactly the sort of (contractual) "competition" that TCE suggests is necessary to maximize society's welfare.[440] Moreover, while such a strategy limits rivalry between firms bound by the restraint, it does not depend upon the possession or attempt to obtain market power. Thus, by itself, proof that the seller could have employed a less restrictive, *less effective* alternative is entirely consistent with the defendants' assertion that any "detrimental effects" produced by the restraint reflect a correction of preexisting market failure and not any anticompetitive harm.[441] Proof of such an alternative cannot by itself support a conclusion that procompetitive and anticompetitive effects coexist.[442] Any reduction in "competition" is entirely illusory, then, and there is no reason to require the defendants to achieve their objectives via a "less anticompetitive means."

Consider, as just one example, the so-called area of primary responsibility, often touted as an alternative to vertically-imposed exclusive territories or exclusive territories created

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[439]*See e.g.* Meese, *Tying Meets The New Institutional Economics*, 146 U. Penn. L. Rev. at 71-86 (arguing that failure to adopt less restrictive alternatives to tying contracts is consistent with cost-minimizing objective); Meese, *Price Theory And Vertical Restraints*, 45 UCLA L. Rev. at 192-93 (failure to adopt less restrictive but less effective alternative to vertical restraint suggests parties are attempting to minimize transaction costs).

[440]*See* nn. ____, *supra* and accompanying text.

[441]*See* nn. ____, *supra* and accompanying text (arguing that proof that a restraint increases prices is consistent with the assertion that a restraint combats a market failure).

[442]*See* nn. ____, *supra* (collecting authorities holding that evidence equally consistent with a procompetitive justification cannot support a judgment against a defendant).

ancillary to a joint venture between competitors.[443] Such restraints assign dealers or venture members a particular area in which they must make their "best efforts" to promote the venture product. In this way, it is said, a manufacturer or venture can further its legitimate interest in promotion without restricting competition "too much."[444]

As many scholars have recognized, however, so-called areas of primary responsibility are less effective and more expensive to administer than an airtight exclusive territory.[445] The fact that a firm has the "primary" responsibility for one area does not prevent other firms from invading its territory and thus does little to prevent free-riding.[446] Moreover, there are real costs to determining whether, in fact, a dealer has engaged in sufficient promotion within its territory, an issue on which dealer and manufacture will likely disagree, and enforcement of such a vague contractual obligation

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[443]*See, e.g.*, SULLIVAN AND GRIMES, LAW OF ANTITRUST, at 332 (identifying area of primary responsibility as less restrictive means of encouraging promotion by joint venture partners); Piraino, *A New Antitrust Standard For Joint Ventures*, 35 W.&M. L. Rev. at 930 (same); Sullivan, *Viability of Horizontal Restraints Doctrine*, 75 Calif. L. Rev. at 886 (arguing that area of primary responsibility was viable less restrictive alternative to restraints in *Topco*); Robert Pitofsky, *A Framework for Antitrust Analysis of Joint Ventures*, 74 Geo. L. J. 1605, 1621 (1986) (arguing that the defendants in *Topco* could have achieved the legitimate objective of furthering promotion by adopting areas of primary responsibility); SULLIVAN, ANTITRUST, at 386 (manufacturer can adequately further interest in promotion by stipulating desired service in distribution contract and monitoring dealer's compliance with it); Turner, *The Definition of Agreement Under The Sherman Act*, 75 Harv. L. Rev. at 699 (area of primary responsibility will assure effective promotion by dealers thus obviating need for exclusive territories).

[444]*See* nn. ___, *supra* (collecting authorities).

[445]*See* Meese, *Quick Look*, 68 Antitrust L.J. at 487, n. 109 (arguing that areas of primary responsibility are generally less effective at achieving legitimate benefits than airtight exclusive territories); Bork, *Market Division*, 75 Yale L. J. at 467-69 (same). *See also* WILLIAMSON, ECONOMIC INSTITUTIONS, at 187 (arguing that more complex restraints are more difficult to police and enforce than less complicated ones).

[446]*See* Meese, *Quick Look*, 68 Antitrust L. J. at 487, n. 109; Bork, *Market Division*, 75 Yale L. J. at 467-68.

will be costly.[447] An airtight exclusive territory, by contrast, avoids these shortcomings while at the same time furthering the manufacturer's or venture's interest in promotion.[448] Proof that defendants have adopted exclusive territories instead of areas of primary responsibility is thus entirely consistent with an assertion that the restraints further competition, properly understood. More importantly, such proof undermines entirely any assertion that the procompetitive benefits of the restraint coexist with anticompetitive effects.

In some cases, plaintiffs may establish the existence of less restrictive alternatives that are, in fact every bit as effective as the restraint under challenge. Even here, however, such proof should not entitle the plaintiff to judgment. For, the existence of such an alternative does not tend to exclude the hypothesis that the restraints merely combat market failure and thus produce no competitive harm in the first place. To be sure, the challenged restraint places a greater limitation on rivalry than the proffered alternative, and such limitation is consistent with the plaintiff's assertion that the benefits produced by the restraint coexist with procompetitive effects. At the same time, however, adoption of the more restrictive restraint is also consistent with an alternative hypothesis, namely, that the defendant has made a random selection of one equally effective restraint over the other. Such a selection, in turn, is entirely consistent with defendants' assertion that the restraint combats a market failure, and that elimination of that failure is responsible for any change

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[447] *See* Meese, *Quick Look*, 68 Antitrust L. J. at 487, n. 109; Bork, *Market Division*, 75 Yale L. J. at 468-69.

[448] *See* Bork, *Market Division*, 75 Yale L. J. at 467-68 ("Market division cures these problems [associated with areas of primary responsibility] automatically by making the reseller's interest in local sales effort coextensive with the manufacturer's interest."); Meese, *Quick Look*, 68 Antitrust L. J. at 487, n. 109 (analogizing exclusive territory to a property right that overcomes shortcomings of areas of primary responsibilities).

in price or output. Thus, proof that an equally effective restraint is available should not give rise to liability.[449]

Conclusion

Standard Oil requires courts to apply reason to determine whether a restraint harms consumers. While courts have often embraced transaction cost economics when policing the boundaries of the *per se* rule, they have clung to an outmoded price-theoretic definition of competition when conducting analysis under the Rule of Reason. Courts should restructure Rule of Reason analysis to account for the modernization of economic theory.

[449] There may be one instance in which proof of a less restrictive alternative should be sufficient to establish that a challenged restraint is unreasonable. If the alternative offered by the plaintiff is *more* effective or less costly to administer, then the existence of the alternative suggests that the restraint under question is not simply an attempt to combat a market failure.