# 17. Predation

Antitrust Law

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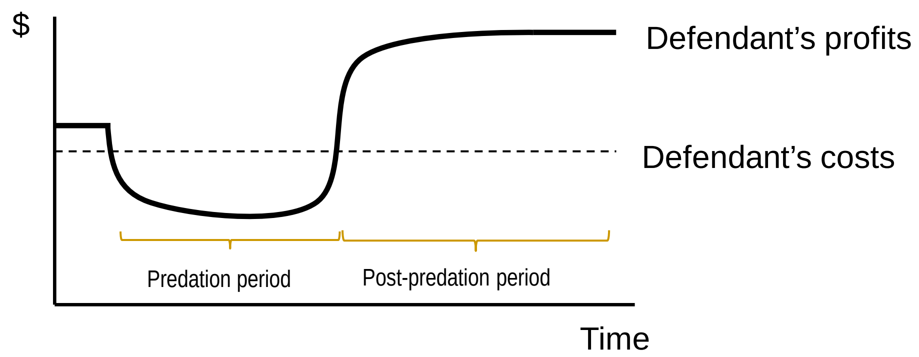
# Topics

- General concept
- Predation as a statutory offense
  - Monopolization
  - Attempted monopolization
  - Conspiracy to monopolize
  - Robinson-Patman Act
- Predation as an exclusionary act
  - Below-cost pricing
  - Recoupment
- The seminal cases

# General Concept

# Predation

- General idea
  - A (usually dominant) firm makes an investment in the short-run—and thereby sacrifices short-run profits—for the purpose of disadvantaging its competitors and driving them out of business, and, once successful, then raises price to a supracompetitive level, recoups its investment in the predatory activity, and makes supracompetitive profits thereafter.




  - Alternative objectives of predation
    - Reduce competitors' going concern value and force them to sell out to the predator
      - This was a common allegation in the early trust cases (including *Standard Oil*)
    - "Discipline" a competitor that is acting in a way that the predator does not like (such as charging low prices), with the implicit promise that the discipline will stop when the target firm falls in line

# Predation

- Types of predation
  - Predatory pricing
  - Predatory foreclosure
  - Predatory design or innovation

# Predatory Pricing

- General concept
  - The predator firm—
    - charges below-cost prices now (and thereby sacrifices short-term profits), forcing its competitors to meet its price, so that they lose money as well,
    - with the expectation that the predator can outlast its competitors, cause them to exist the business, and thereafter raise the price to a supracompetitive level in the long term to recoup its investment
  - The most commonly alleged type of predation

# Predatory Foreclosure

- General concept
  - The predator firm—
    - The predator firm seeks to corner an essential input in order to drive its competitors out of business by depriving them of supply.
    - Here, the predator loses profits in the short-run because its artificially high demand for the input raises the input prices above what the market-clearing price would have been and probably also incurs additional costs of storing and maintaining the excess input the predator purchases.
    - Once its competitors exit the market, the predator can raise the price of the downstream products to a supracompetitive level in the long term to recoup its investment

# Predatory Design or Innovation

- General concept
  - The predator is a vertically integration firm that produces a durable good that uses accessories or consumables, such as a printer
  - The predator is the sole producer of the upstream durable good but faces competition in the downstream sale of accessories or consumables
  - The predator invests in a design change in the durable good (hence sacrificing profits in the short run) that it springs upon the market without notice that makes the products of its downstream competitors unusable with the durable good
  - While the predator can supply the accessories or consumables to its redesigned durable product, its downstream competitors cannot and so exit the downstream market
  - The predator then raises the price of the downstream products a supracompetitive level in the long term to recoup its investment

# Predation as a Statutory Offense

# Predatory as a Statutory Antitrust Offense

- Recall *Trinko* n.4[1]
  - Regarded as directing that every antitrust violation must satisfy each and every element of the prima facie case of some statutory antitrust offense
    - There is no leeway to create “new” antitrust offenses outside the statutory offenses
- Predatory acts
  - Below-cost pricing, predatory foreclosure, or predatory design may under the right circumstances be “exclusionary acts” that can predicate a—
    - Section 2 attempted monopolization claim
    - Section 2 monopolization claim
    - Robinson-Patman Act § 2(a) primary line price discrimination claim

    And if done conspiratorially
    - Section 1 claim (with predation as the object of the conspiracy)
    - Section 2 conspiracy claim

[1] Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 415 n.4 (2004).

# Sherman Act § 2

- Attempted monopolization
  - Applies to the predation period, when predator's competitors are under attack
    - The most commonly alleged statutory offense
  - Elements of the offense
    - Exclusionary act: The predatory act
    - Specific intent: Usually inferred from the predatory act
    - Dangerous probability of success: Usually inferred from—
      - The defendant's market share
      - Coupled with the likelihood that the predatory scheme enable the defendant to achieve a monopoly in light of market conditions, resilience of targeted competitors, and barriers to entry
  - The plaintiff will be a targeted competitor
    - Has antitrust standing
    - Antitrust injury will be either
      - Lost profits (if still in the market)
      - Loss of going concern value (if it has already exited the market)
    - Proximate cause often contested
      - Was bad management the reason for the plaintiff's failure?
  - Customers in the predation period may lack antitrust standing
    - Especially in price predation cases, where customers are benefiting from below-cost pricing and have not yet paid a supracompetitive overcharge
      - But may sustain antitrust injury and have antirust standing in predatory foreclosure and design cases

# Sherman Act § 2

- Monopolization
  - Applies to the post-predation period, when predator has succeeded its competitors out of the market and obtained monopoly power
    - Rarely alleged
  - Elements of the offense
    - Monopoly power: Usually inferred from market share of a 70% or more in the relevant market
    - “Willful acquisition or maintenance”: Satisfied by the predatory act
  - Plaintiff can be either customers or targeted competitors
    - Customer antitrust injury will be payment of supracompetitive prices
      - Should there be an offset against any earlier benefit in predation period of lower price?
    - Targeted competitors need to be mindful of the statute of limitations, since their injury will occur in the predation period before the competitor exited the market
    - Proximate cause often contested regardless of type of plaintiff
      - Was bad management the reason for the competitors exiting the market?

# Robinson-Patman Act § 2(a)

- The statute

  It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them . . . . [1]

  - Requirements
    - Engaged "in commerce"
    - Charge different prices to different customers, with at least one sale "in commerce"
    - Effect of the discrimination—
      - "may be substantially to lessen competition or tend to create a monopoly in any line of commerce" (Clayton Act § 7 standard), or
      - "or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them" (unique to Section 2(a))

[1] 15 U.S.C. § 13(a).

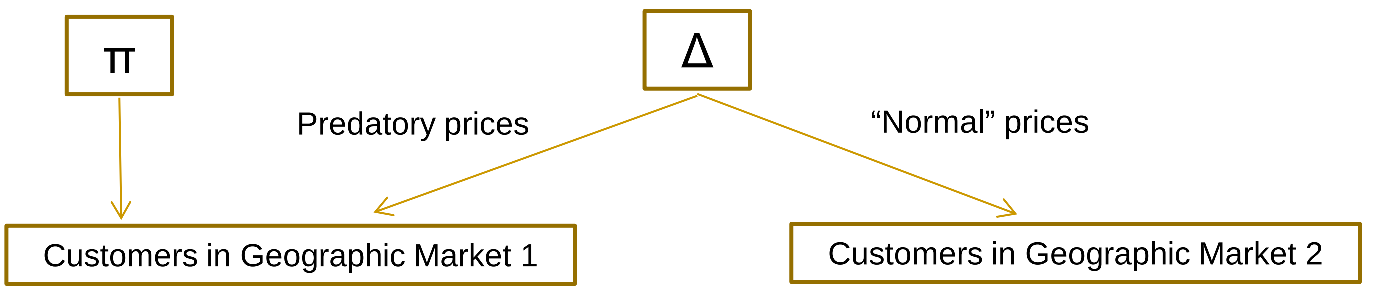
# Robinson-Patman Act § 2(a)

- Types of injury to competition
  - *Primary-line injury*, where competition is injured at the level of the discriminating seller and its direct competitors
  - *Secondary-line injury*, where competition is injured at the level of the discriminating seller's "favored" and "disfavored" customers
  - *Tertiary-line injury*, where competition is injured at the level of the customers of the favored and disfavored purchasers

[1] 15 U.S.C. § 13(a).

# Robinson-Patman Act § 2(a)

- Application to predation
  - Applies only to predatory pricing
    - Section 2(a) applies only to price discriminations
  - Predatory price must be part of the price discrimination
    - The predator must charge some other customer a different price for a product of "like grade and quality"
    - The targeted customer and the other customer need not compete with one another and are often in different geographic markets
  - Injury is primary line and effected through predatory prices to the targeted firm's customers




[1] 15 U.S.C. § 13(a).

# Robinson-Patman Act § 2(a)

- Possibly important distinction
  - Distinction
    - Sherman Act § 2 addresses anticompetitive exclusion from the market
    - Robinson-Patman Act § 2(a) addresses “injury to competition” and “injury to a competitor”
  - Import
    - Arguably, Sherman Act § 2 applies only when the object of the predation is to drive competitors from the market so that the predator can obtain monopoly power
    - Robinson-Patman Act § 2(a) can also address “disciplining” cases where the predator’s objective is not exclusionary
      - Might also address “injury to a competitor” cases, where the injury does not amount to injury to competition, but (as we shall see) the Supreme Court appears to have ruled that out

# Conspiracy

- Firms can act in concert to jointly monopolize a market or discipline competitors
  - Can predicate a—
    - Section 2 conspiracy to monopolize
    - Section 1 conspiracy in restrain of trade
  - Examples of complaints on this theory
    - Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986)
      - Alleging Japanese electronics manufacturers engaged in conspiratorial predatory pricing to destroy U.S. competitors and take over the U.S. market
      - Rejected on the facts by the Supreme Court
      - Noting that conspiratorial predatory pricing "incalculably more difficult to execute" than individual predatory pricing
    - Solyndra LLC v. Suntech Power Holdings Co., No. 12-cv-5272 (N.D. Cal. Mar. 31, 2014)
      - Alleging Chinese solar panel manufacturers engaged in conspiratorial predatory pricing to destroy U.S. competitors and take over the U.S. solar panel market
      - Rejected on summary judgment by the district court

# Predation as an Exclusionary Act

# The Public Policy Question

- *Query*: Under what conditions should a putative predatory act be considered “exclusionary” so as to predicate a Section 2 violation?
- The issue
  - Most easily seen in the context of predatory pricing
  - Antitrust goals
    - Antitrust favors competitive prices
  - The net value to customers
    - Low prices—even below-cost prices—benefit customers
    - Moreover, even low prices followed by high prices can benefit a customer so long as the customer total expenditures (discounted for the time value of money are less than they would have been if the defendant not engaged in the putatively predatory act in the first place and prices had remained constant
  - The social cost of errors
    - *Type 1 errors*: Overinclusive enforcement is likely to result in higher prices in the case in issue (because of erroneous court intervention) and precedent that would make firms wary of aggressively competitive low prices, both of which are contrary to the goals of antitrust and harmful to customers
    - *Type 2 errors*: Underinclusive enforcement is likely to result higher prices because of the exercise of monopoly power in the postpredation period and precedent that would make firms less concerned about legal intervention against an aggressive price campaign

# The Public Policy Question

- The issue
  - The likelihood of errors
    - Distinguishing in practice between aggressively competitive pricing and exclusionary pricing in the predation stage seems difficult and therefore somewhat error-prone
    - Distinguishing in practice between aggressively competitive pricing and exclusionary pricing in the postpredation stage seems much less error-prone, since in the postpredation stage there should be evidence regarding success in actual exclusion, increased prices (say, compared to the prepredation stage), and barriers to entry that would support long-term supracomprative pricing without attracting entry
    - Over at least the last 50 years, there have been few successful predatory pricing cases, suggesting that there all of the errors (if any) would be Type 2 errors. Yet there are no documented cases of successful predation, indicating that there is very little actual predation even without enforcement.
  - Conclusion
    - Given what appears to be little if any episodes of actual predation, the harm to competition and customers resulting from Type 1 errors, and an ability to detect successful predation in the postpredation phase, courts should adopt tests that are biased in favor over preventing Type 1 errors.
    - This is what the courts have done, resulting in two requirements:
      - Prices must be below and appropriate measure of costs, and
      - The predation must pay for itself, that is, the predator must have a dangerous probability of success (in an attempted monopolization case) to recoup its investment in the predation with interest

# Below-Cost Pricing

- Requirement
  - Below-cost pricing is not exclusionary unless it is below an "appropriate measure of cost"
  - The Supreme Court has been careful not to say what the appropriate measure of cost is.
  - The lower courts, however, to the extent that they have addressed the question (and most have), hold that the appropriate measure of cost  is marginal cost, or if that is difficult to calculate, average variable cost.
    - This is called the Areeda-Turner test In recognition of the test's creators.

# Below-Cost Pricing

- Policy rationale
  - Recall that the equation for maximizing profits in the short run is

$$\underset{q}{\text{Max}}\ \pi = pq - f - c(q)$$

Where $\pi$ is profits, $p$ is price, $q$ is the firm output (and the firm's control variable), $f$ is the firm's fixed costs, and c( ) is the firm's cost function. The first-order condition for a profit-maximum is

$$\frac{d\pi}{dq} = p + q\frac{dp}{dq} - \frac{dc}{dq} = 0$$

This is the familiar condition that at a short-run profit maximum the firm's marginal revenue is equal to its marginal cost. Moreover, recall that a perfectly competitive firm assumes that its choice of output level cannot affect price, so that $dp/dq$ = 0 and

$$p = \frac{dc}{dq}$$

That is, a perfectly competitive firm prices in the short run so that its price equals it marginal cost. The rationale of the Areeda-Turner test is to provide firms with a "safe harbor" for decreasing their price down to marginal cost without concern that their aggressive pricing will be found to be exclusionary, even if the result is to drive less efficient firms out of business.

# Below-Cost Pricing

- Implications
  - Fixed costs are irrelevant to the pricing test
    - This means that a firm with fixed costs could price too low to cover its fixed costs and so be losing money, but as a matter of law its price would not be exclusionary if it is at or above its short-run marginal cost.
  - Less efficient competitors are not protected.
    - The marginal cost test applies to the firm's *own* cost, not the costs of its competitor.
    - So a firm with low fixed costs could price at its marginal cost and drive its competitors with higher (recurring) fixed costs but the same marginal cost out of business, but its price would not be exclusionary
    - Likewise, a firm with low marginal costs could price at its marginal cost and drive its competitors with higher marginal costs but the same fixed cost out of business, but its price would not be exclusionary
  - Firms with high fixed costs, low marginal costs
    - Examples
      - High fixed capital equipment costs: Airlines, railroads, paper mills,
      - High development costs: Pharmaceuticals, software
    - These firms are largely immune from predation allegations, since their marginal cost is likely to be very low compared to the price necessary to make an overall profit
    - *Query*: Is this the right result?

# Below-Cost Pricing

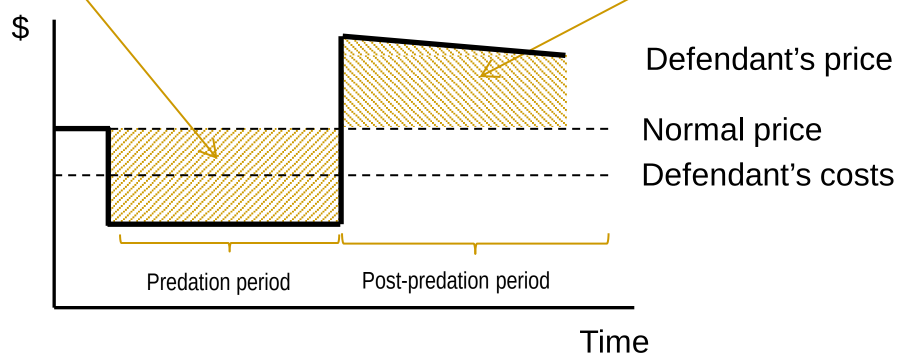
- Implications
  - Opportunity costs are irrelevant to the pricing test
    - Where fixed assets are deployed the allegedly predatory activity (such as devoting R&D assets in allegedly predatory innovation), the opportunity costs of those assets are irrelevant to the pricing test.
      - So, for example, if the same R&D assets could be deployed in an alternative use and make the firm more money in the short run, that "loss" is not taken into account in the predation test[1]

[1] *See* United States v. AMR Corp., 335 F.3d 1109 (10th Cir. 2003).

# Recoupment

- Definition
  - Recoupment is the ability of the predator to cover its investment cost in the predatory acts in the predation period with supracompetitive profits in the postpredation period (accounting for the time value of money)

Predation investment must be covered by postpredation supracompetitive profits



# Recoupment

- Policy rationale
  - Customers benefit from low prices and are harmed by high prices.
  - If, compared to the normal (nonpredation) price, the same customer pays low prices in the predation period and high prices in the postpredation period, the customer is worse off with predation than with the normal price if the discounted present value of its payments with predation is greater than the discounted present value of its payments without predation:

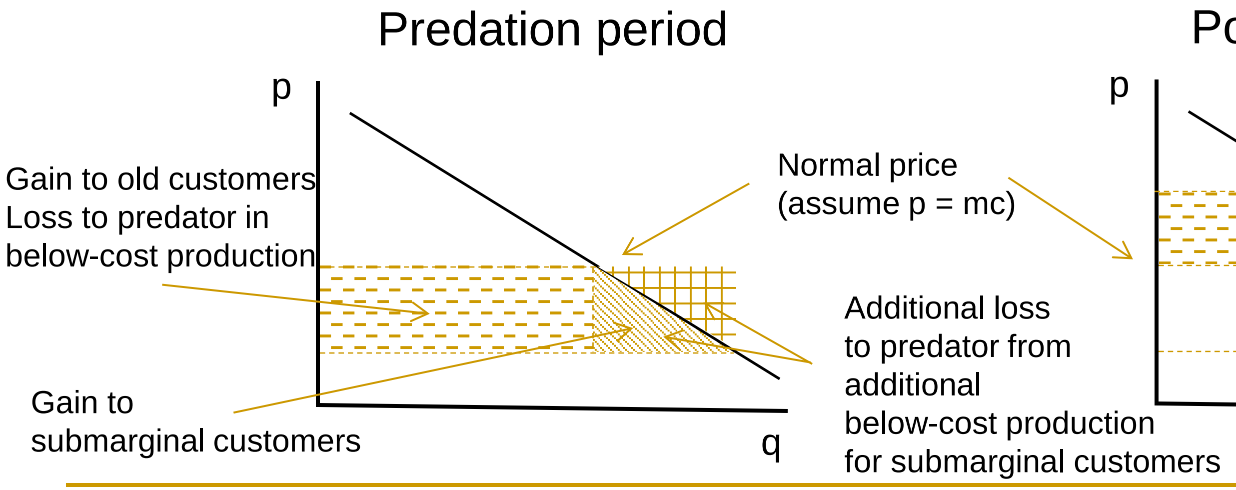
DPV (normal price) < DPV(predation price) + DPV (postpredation price)

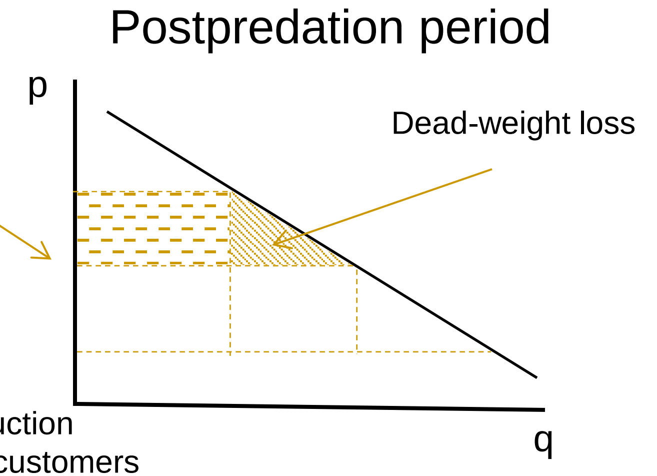
  - This condition will (roughly) be satisfied if the firm can recoup its investment in the predation period from above normal profits it can earn in the postpredation period
    - The firm's investment in predatory pricing in the predation period and its above normal profits in the postpredation period are (with one exception) wealth transfers with customers
    - Moreover, anticompetitive predation is in the firm's profit-maximizing only if it can recoup in investment in the predation period with interest in the postpredation predation

*Basic idea*: Customers should be allowed to benefit from below-cost pricing by a "mistaken" predator even if the low prices drive competitors out of the market, provided that the customer gains from the low prices are not later outweighed by the higher costs in the postpredation period.

# Recoupment

- Policy rationale
  - Three observations on the firm's recoupment requirement relative to consumer welfare
    - Everyone's discount rate needs to be the same
    - The same customers must purchase throughout the entire period
      - Otherwise, need to balance the gains of customers that purchase only in the predation period with the losses of customers that purchase only in the postpredation period (an interpersonal comparison of utility problem)
    - Accounting discrepancies
      - Over-accounts for consumer gains in the predation period, because new (submarginal) customers that are induced to purchase at the predation prices are not willing to pay all of the marginal costs of production
      - Under-accounts for (dead-weight) losses of marginal customers that would not purchase at the postpredation price but would purchase at the normal price (and so cover all of the marginal costs of production)



# Recoupment

- Recoupment and barriers to entry
  - *Usual theory*: The ability of the predator to recoup its investment depends on barriers to entry that are sufficiently high that the high postpredation price will not attract (enough) entry to defeat the predator's ability to recoup
  - Consequently, proof of barriers to entry are an essential part of the plaintiff's prima facie case in showing recoupment (or a dangerous probability of recoupment in an attempted monopolization case)
  - In litigation, failure to prove sufficient barriers to entry is almost always the reason for failing to establish recoupment
    - Should not be surprising. Somehow must explain how the incumbent competitors that the predator is targeting got into the market in the first place, while entry barriers will prevent firms from reentering at higher, postpredation prices.
    - Some possibilities:
      - Changes in regulatory requirements
      - Declining demand (incumbent firms entered when demand was high)
      - Asymmetric cost advantages of the predator (but then its prices may not be below its marginal costs)

# Recoupment

- Recoupment and barriers to entry
  - Some modern thinking (yet to be adopted by the courts)
    - Barriers to entry need not be high if potential new entrants believe that the predator will return to below-cost pricing if they enter
    - *Game theory question*: How does the predator make this threat credible when it still must recoup its profits for predation to be a profit-maximizing strategy?
      - And remember the *winner's curse*: Not all potential new entrants need to disregard the threat, just enough to be able to undermine the predator's ability to charge sufficiently high prices for a long enough time to be able to recoup its investment in the predatory acts
    - Still, what if
      - There are major discrepancies between the financial resources of the predator and the potential entrants, making it clear that the predator could win a win of attrition if the predator pursued it?
      - The predator operates in other markets and can use its response to entry in one market to signal potential entrants in other markets what they would face if they enter?

# The Seminal Cases

# *Matsushita*[1]

- Background
  - Zenith Radio, at one time a major U.S. manufacturer of TVs and radios, ceased production of TVs in February 1970, when it could no longer produce TVs profitably.
  - Brought suit against seven major Japanese television manufacturers, alleging that they had been engaged in a predatory pricing conspiracy to Zenith and other U.S. TV manufacturers out of the market and take over the U.S. television market
    - Alleged that the defendants engaged in a "scheme to raise, fix and maintain artificially high prices for televisions receivers sold by defendants in Japan and, at the same time, to fix and maintain low prices for television receivers exported to and sold in the United States."
    - Conspiracy allegedly began as early as 1953, and in any event was (according to plaintiffs) in full swing by sometime in the late 1960s
  - Alleged violations
    - Sherman Act § 1
    - -Sherman Act § 2 (monopolization and attempted monopolization)
    - Robinson-Patman Act § 2(a)
    - Clayton Act § 7 (as to 2 Japanese defendants for acquiring interests in American manufacturers)
- District court:
  - Dismissed all claims in a number of summary judgment decisions
- Third Circuit
  - Reversed entry of summary judgment for defendants on lack of evidence sufficient to create genuine issue of material facts on the question of conspiracy and remanded for trial

[1] Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986).

# Matsushita

- Supreme Court: Reversed (5-4)
  - Majority (Powell, with Burger, Marshall, Rehnquist, O'Connor)
    - A predatory pricing conspiracy would be per se illegal—Only issue in case is whether plaintiffs adduced sufficient evidence to raise a genuine issue of fact of a conspiracy that caused plaintiffs antitrust injury to survive summary judgment
    - Rule of case: To survive summary judgment in conspiracy cases based solely on circumstantial evidence (as here), plaintiff's "must" present evidence 'that tends to exclude the possibility' that the alleged conspirators acted independently in light of competing inferences of independent act
      - Inferences must be economically reasonable
    - Application
      - Actionable predatory pricing very rare; conspiratorial predatory pricing even more rare
      - "The alleged conspiracy's failure to achieve its ends in the two decades of its asserted operation is strong evidence that the conspiracy does not in fact exist.“
      - No plausible motive here to engage in a predatory pricing conspiracy
        - Supracompetitive profits and excess plant capacity in Japan irrelevant ((confuses means with motive)
        - No evidence of barriers to entry in U.S. (→ recoupment problem)
        - Given large number of participating Japanese firms, would in any event require ongoing price-fixing in recoupment period (hard to maintain, risky because illegal and more obvious)
    - Reversed and remanded
  - Dissent (White, with Brennan, Blackmun, Stevens)
    - Majority rule invades province of factfinder
    - Plaintiff’s expert testimony creates genuine issue of fact on existence of conspiracy in the U.S.
    - Direct evidence of conspiracies in Japan sufficient to go to the jury as circumstantial evidence of predatory pricing conspiracy in U.S.

# *Brooke Group*[1]

- Background
  - U.S. cigarette industry dominated by six firms: Philip Morris (40%), R.J. Reynolds (28%), Brown & Williamson (12%), American Brands, Lorillard, and Liggett & Myers (now Brooke Group) (5%) (shares as of time of trial in 1984)
  - Historically exhibited high profit margins and no meaningful price competition
  - By 1980, however, overall demand was declining and all manufacturers developed substantial excess capacity
  - Liggett
    - Sold L&M, Lark and Chesterfield
    - Liggett was especially hard hit by the decline in cigarette demand, with its market share tumbling from a high of 20% in the 1950s to 2.3% in 1980
    - In 1980, developed a new low-priced generic cigarette ("black and whites“), which sold at retail at about 30% less than branded cigarettes
    - Very successful—Generic cigarettes grew from 1% in 1980 to 4% in 1984, almost all of which were manufactured and sold by Liggett
  - Brown & Williamson
    - Sold Kool and Viceroy
    - Most threatened by Liggett (lacked brand loyalty of PM and Reynolds)
    - In 1984, introduced its own generic cigarettes, which were almost identical to Liggett’s
    - Price war followed
      - B&W targeted Liggett’s major wholesalers with volume discounts
      - Eventually, wholesale price dropped below B&W costs

[1] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

# *Brooke Group*

- Background (con't)
  - Price war followed—lasted 18 months from July 1984 to December 1985
  - B&W targeted Liggett's major wholesalers with volume discounts
  - Eventually, wholesale price dropped below B&W costs
    - Caused B&W to lose all of its projected free cash flow
  - War ended when Liggett began to raise prices
  - Prices increased in lockstep with branded prices (dolar-for-dollar), narrowing discount differential between branded and generic from 40% in 1985 to 27% in 1989
- Antitrust action
  - Liggett sued B&W for injuries caused by predatory pricing during the predation (price war) period under Robinson-Patman Act § 2(a)
  - Theory: B&W used below-cost pricing to pressure Liggett to raise its prices and narrow the price difference between generic and branded cigarettes, and so preserve B&W's supracompetitive profits on its branded cigarettes
- District court
  - 115-day trial: Jury verdict for plaintiff (actual damages of $49.6, trebled to $148.8)
  - JNOV for (a) lack of injury to competition; (b) lack of antitrust injury; and (c) lack of proximate cause
- Fourth Circuit: Affirmed

# Brooke Group

- Supreme Court: Cert only on injury to competition
  - Affirmed (6-3)
    - Majority: Kennedy, with Rehnquist, O'Connor, Scalia, Souter and Thomas
    - Dissent: Stevens, with White and Blackmun
  - Majority (Kennedy)
    - Product market was all cigarettes (generics were just a segment)
    - Evidence sufficient on intent and pricing below cost
      - Parties stipulated that average variable cost was the appropriate measure
    - Below-cost pricing requires a reasonable probability of recoupment to be exclusionary (for a Robinson-Patman § 2(a) violation)
    - Insufficient evidence on recoupment to sustain jury verdict
      - No evidence that post-price war prices where supracompetitively high
      - Supracompetitive profits depended on oligopolistic coordination among cigarette manufacturers, which as not likely in light of—
        - Declining demand
        - Excess capacity
        - Complicated pricing (with variable volume discounts)
        - No evidence of pricing communications
        - A possible maverick (Reynolds had introduced a branded product at generic prices)
  - Dissent (Stevens)
    - Evidence sufficient to sustain jury verdict: Intent, blow-cost pricing, B&W believed that its strategy would force Liggett to raise its prices, and Liggett did in fact raise its prices
- Query: What are the prices in the "but for" world (for assessing recoupment)?

# *Weyerhaeuser*[1]

- Background
- Supreme Court (9-0) (Thomas)

[1] Weyerhaeuser Company v. Ross-Simmons Hardwood Lumber Co., 549 U.S. 312 (2007).