ELIMINATING THE BELOW-COST PRICING REQUIREMENT FROM A PREDATORY PRICING CLAIM

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INTRODUCTION

Predatory pricing[1] is currently generating considerable debate in academic literature.[2] There is growing concern that the current standards used to evaluate a predatory claim leave something to be desired.[3] The United States Supreme Court established the current test for a federal predatory pricing claim in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*[4] in 1993. *Brooke Group* set up a two-part test for predatory pricing. The elements of the offense were defined as: 1) pricing below *some* appropriate measure of the producer's own cost,[5] and 2) a sufficient likelihood of recouping this investment after rivals are eliminated.[6] The Court stated that while these elements are difficult to establish, they are not arbitrary, since "they are essential components of real market injury."[7] This Note will argue that the Court was only half right. Recouping through monopoly profits the revenue foregone in eliminating a rival constitutes a "real market injury." However, the pricing used to drive out a rival and its relationship to the producer's

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[1] A straight forward definition for this term will not be given, since the point of this article is to analyze what predatory pricing is. For reference the Second Circuit has defined predatory pricing as "the deliberate sacrifice of present revenues for the purpose of driving rivals out of the market and then recouping the losses through higher profits earned in the absence of competition." Northeastern Tel. Co. v. American Tel. & Tel. Co., 651 F.2d 76, 86 (2d Cir. 1981).

[2] *See, e.g.*, Einer Elhauge, *Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory – And the Implications for Defining Costs and Market Power*, 112 YALE L.J. 681 (2003); Avishalom Tor, *Illustrating a Behaviorally Informed Approach to Antitrust Law: The Case of Predatory Pricing*, 18 ANTITRUST 52 (2003); Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 YALE L.J. 941 (2002); Patrick Bolten et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO L.J. 2239, (2000); David Close, Note, *"Don't Fear the Reaper": Why Transferable Assets and Avoidable Costs Should Not Resurrect Predatory Pricing*, 88 IOWA L. REV. 433 (2003).

[3] Elhauge, *supra* note 2, at 690-703.

[4] 509 U.S. 209 (1993).

[5] *Brooke Group*, 509 U.S. at 222-225.

[6] *Id.*

[7] *Id.* at 226.

cost is not relevant to market harm, and should be eliminated as an element of a predatory pricing offense. In other types of antitrust claims a producer's cost has been strongly rejected as bases for determining whether a violation has occurred.[8] This Note proposes that a producer's cost should be rejected as an element of predatory pricing as well.

In *Brooke Group*, the Court purposefully set a very high bar for plaintiffs attempting to prove a predatory pricing claim.[9] The Court wanted to ensure that predatory pricing claims not be used to chill vigorous price competition, since vigorous price competition is the goal of antitrust law.[10] The *Brooke Group* Court took a very difficult standard for proving a claim and made it practically impossible.[11] Since *Brooke Group* was decided, almost no plaintiff has been successful on a predatory pricing claim,[12] at least when they were required to satisfy the *Brooke Group* standard.[13]

Perhaps the *Brooke Group* Court would be pleased that plaintiffs are no longer successful on predatory pricing charges. One of the often quoted[14] passages of *Brooke Group* is that "predatory pricing schemes

8 *See*, *e.g*., *United States v. Socony-Vacuum Oil Co*., 310 U.S. 150 (1940) (rejecting the proposition that price fixing can be justified when the market price of a commodity is well below the cost of production). *See also*, United States v. Aluminum Co. of America, 148 F.2d 416, 427 (2d. Cir. 1945) (rejecting the idea that a profit level that was not unreasonably high is relevant as to whether the firm is an illegal monopoly); Boise Cascade v. FTC, 637 F.2d 573 (9th Cir. 1980) (rejecting the FTC charge that Boise Cascade violated the antitrust laws by using freight rates based on the rates of competitors who were located on the other side of the country and thus bore no relationship to the actual freight costs incurred by Boise).

9 *Brooke Group*, 509 U.S. at 226.

10 *Id.* at 226-27.

11 *See* Bolten, *supra* note 2, at 2258-59.

12 *Id. Multistate Legal Studies v. Harcourt Brace Jovanovich & Prof'l Publications, Inc*., 63 F.3d 1540 (10th Cir. 1995), appears to be one of the few cases that has survived summary judgment at the appeals court level under the *Brooke Group* test. A recent predatory pricing case in the District Court resulted in a large jury verdict for the plaintiffs, *Kinetic Concepts, Inc. v. Hillenbrand Industries, Inc*., 262 F.Supp. 722 (W.D.Tex. 2003), but was settled prior to the appeal.

13 Two cases, *LePage Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc), and *Covad Comm'n Co v. BellSouth Corp*., 299 F.3d 1272 (11th Cir. 2002), were successful by labeling the practice as "bundling" in *LePage* and a "price squeeze" in *Covad.* Thus, the courts did not apply the *Brooke Group* test. For an analysis explaining why the bundling in *LePage* was actually a predatory pricing claim, see Daniel A. Crane, Symposium: Antitrust, *Multi-Product Discounting: A Myth of Non-Price Predation*, 72 U. CHI. L. REV. 27 (2005). But see Richard A. Posner, Symposium: Antitrust, *Vertical Restraints and Antitrust Policy*, 72 U. CHI. L. REV. 229 (2005) for the view that multi-product ties such as in LePage create their own unique antitrust concerns.

14 U.S. v. AMR, 335 F.3d 1109, 1114 (10th Cir. 2003); Virgin Atlantic Airways Ltd. v. British Airways PLC, 257 F.3d 256, 266 (2d Cir. 2001); Stearns Airport Equipment Co., Inc. v. FMC Corp., 170 F.3d 518, 528 (5th Cir. 1999); Bathke v. Casey's General Stores, Inc., 64 F.3d 340, 343 (8th Cir. 1995); Advo, Inc. v. Philadelphia Newspapers, Inc., 51 F.3d 1191, 1196 (3d Cir. 1995); Coventry Health Care of Kansas, Inc. v. Via Christi Health System, Inc., 176 F. Supp. 2d 1207, 1228 (D. Kan 2001); Mathias v. Daily News, L.P., 152 F. Supp. 2d 465, 473 (S.D.N.Y. 2001); U.S. v. AMR Corp., 140 F. Supp. 2d 1141, 1195 (D. Kan. 2001); Bailey v. Allgas, Inc., 148 F. Supp. 2d 1222, 1231 (N.D. Ala. 2000); Rebel Oil Co., Inc. v. Atlantic Richfield Co., 957 F. Supp. 1184, 1200 (D. Nev. 1997).

are rarely tried, and even more rarely successful."[15] Some have argued that anything that revives plaintiffs' ability to bring a predatory pricing action should be dismissed.[16] But it does not appear that the goal of the Court was to eliminate predatory pricing as a cause of action. In the same year that the Supreme Court first proffered that "predatory pricing schemes are rarely tried and even more rarely successful,"[17] the Court spoke clearly in another case that "there is ample evidence suggesting that the practice [of predatory pricing] does occur."[18] The Court has consistently refused to take away standing of competitors alleging predatory pricing,[19] despite the strong argument that antitrust laws are not intended to protect competitors.[20] Yet the current predatory pricing legal system has failed to uphold a single instance of Federal predatory pricing for the past eleven years.[21]

Antitrust laws are designed to ensure that markets are competitive.[22] As Michael Porter wrote, "Few roles of government are more important to the upgrading of an economy than ensuring vigorous domestic rivalry."[23] Congress recognized the continued importance of competitive markets when it very recently increased the penalties for antitrust violations.[24] Thus, if we have a predatory pricing scheme that almost finds a predatory pricing violation, it is important to examine the scheme and look for possible flaws.

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[15] 509 U.S. 209, 226 (1993) *quoting* Matsushita Elec. Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986).

[16] *See, e.g.*, Close, *supra* note 2.

[17] *Matsushita*, 475 U.S. at 589.

[18] Cargill, Inc. v. Monfort of Colorado, Inc., 470 U.S. 104, 122 (1986) *citing* Koller, *The Myth of Predatory Pricing: An Empirical Study*, 4 ANTITRUST LAW & ECON. REV. 105 (1971); Miller, *Comments on Baumol and Ordover*, 28 J. LAW & ECON. 267 (1985).

[19] Brunswick Corp. v. Peublo Bowl-O-Mat, Inc., 429 U.S. 477, 489 n. 14 (1977); *Cargill*, 470 U.S. at 122; Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 339-40 (1990).

[20] *See* Edward A. Snyder & Thomas E. Kauper, *Misuses of the Antitrust Laws: The Competitor Plaintiff*, 90 MICH. L. REV. 551 (1991); Daniel a. Crane, *The Paradox of Predatory Pricing*, ??? CORNELL L. REV. ??? (Forthcoming 2006) (arguing that taking away competitor standing in predatory pricing claims would eliminate the abuse of competitors using predatory pricing to chill vigorous competition).

[21] *See supra* note 11 and accompanying text.

[22] Robert H. Lande, *Wealth Transfer as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65, 67 (1982) ("[I]t is unanimously agreed that Congress enacted [antitrust] laws to encourage competition.").

[23]MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 662 (1990).

See, also, Scott J. Wallstein, *An Emperical Analysis of Competition, Privatization, and Regulation in Africa and Latin America*, (May 1999) *available at* http://econ.worldbank.org/docs/553.pdf. (noting that "[c]ompetition is the most effective agent of change" and that privatization without competition accomplishes little).

[24] In June of 2004 the maximum fine for individuals was increased from $350,000 to $1,000,000, for corporations it was increased from $10,000,000 to $100,000,000 and the maximum jail time was increased from three years to ten years. Steven J. Mintz, *New Antitrust Statute Carries Heightened Penalties*, 30 LITIGATION NEWS 4 (January 2005).

Based on the assumption that antitrust laws exist to protect consumers,[25] this Note proposes that only recoupment is relevant to examining a violation of antitrust laws. Ironically the very factors, cost advantage and low marginal cost of expanding output, that often make a predatory pricing scheme feasible[26] are the same factors that will make establishing below-cost pricing unlikely. While some fear that relaxing the standard for a predatory pricing claim will provide competitor plaintiffs' with a strong weapon against competition,[27] if predatory pricing is properly understood as an element of an antitrust claim and not a claim unto itself, vigorous competition should not be mistaken for predatory pricing, even absent a below-cost requirement.

Granted, the current recoupment standard is based on recouping losses from below-cost pricing. This Note will argue, however, that recoupment should be measured from a base point of a competitive market price. The following formula is proposed for determining recoupment and predatory behavior. Competitive Market Price (CMP) – Predatory Price (PP) = Consumer Gain (CG).[28] Once the predatory behavior eliminates the competition, a monopolistic price (MP) is initiated. When MP-CMP > CG, recoupment is achieved and the consumers have been harmed as a result of the predatory pricing. This formula matches very closely to the Supreme Court's requirement in *Brooke Group* that a "plaintiff must demonstrate that there is a likelihood that the predatory scheme alleged would cause a rise in prices

[25] Whom Antitrust laws should benefit is not without debate. *E.g*., *Cargill*, 479 U.S. at 127 (J. Stevens Dissent) (stating that one purpose of the Clayton Act is to protect small business). *See also* Robert Pitofsky, *The Political Content of Antitrust*, 127 U. PA. L. REV. 1051 (1979); Lande, *supra* note 22; Thomas J. DiLorenzo, *The Origins of Antitrust: An Interest-Group Perspective*, 5 INT'L REV. L. & ECON. 73, (1985); David Millon, *The Sherman Act and the Balance of Power*, 61 S. CAL. L. REV. 1219 (1988). However, the prevailing view in the courts is that antitrust laws protect consumers. See e.g., Timothy J. Muris, Symposium: Antitrust, *Principles for a Succesful Competition Agency*, 72 U. CHI. L. REV. 165, 168 (2005) ("there is widespread agreement that the clearly articulated purpose of antitrust is to protect consumers"); American Academic Suppliers, Inc. v. Beckley-Cardy, Inc., 922 F.2d 1317, 1319 (Posner 7th Cir. 1991) ("The Modern conception of the Sherman Act is a statute that seeks to protect consumers from monopolistic practices rather than competitors from competitive practices.").
The only current area of case law where the consumer appears subjugated is the area of monopsony purchasing power. Monopsony refers to monopoly power of the purchaser rather than the producer. Agreements among purchasers to depress prices paid to suppliers are condemned even if it can be shown that there is no effect to consumers. Michael C. Naughton, *Buyer Power Under Attack: Recent Trends in Monopsony Cases*, 18 ANTITRUST 81, 82-83 (Summer 2004). For more on monsopony pricing, see (forthcoming Cardozo Article on physician associations.)

[26] Snyder & Kauper, *supra* note 20, at 561 (stating that the "conditions that increase the likelihood of successful predation are cost advantages and low marginal cost of expanding output."). For an explanation of the conflicting nature between below cost pricing, and the likelihood of successful recoupment see Close, *supra* note 2, at § V.B.3.

[27] Close, *supra* note 2.

[28] A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1402 (7th Cir. 1989) ("Sacrificing profits today benefits consumer.").

above a competitive level that would be sufficient to compensate for the amounts expended on the predation . . . ."[29] However, by adding the requirement that prices be below some measure of a producer's own cost, cost is confused with a "competitive level." While defining a competitive level or competitive market price is not a simple task, it is the only pricing point that is relevant to antitrust laws. A producer's cost of production has no place in predatory pricing analysis.

In order to prove that pricing below some appropriate measure of cost should not be a requirement for a predatory pricing claim, Part I will explain monopolization and its relationship to consumer harm and predatory pricing. Part II will demonstrate why above-cost pricing should not create *per se* legality for a predatory pricing scheme. Part III will demonstrate why below-cost pricing should not be a dispositive indicator of predatory behavior. Part IV will explain why the cost element is virtually impossible to determine accurately. Part V will argue that the below-cost element of a predatory pricing scheme actually provides incentive to keep pricing high and prevents vigorous competition. Part VI will look at the statutory scheme that predatory pricing falls within and how the new proposed standard should operate within the scheme. Part VII will discuss the definition of a competitive market price. Finally, Part VIII will examine the likely results of such a change.

I. MONOPOLIZATION, CONSUMER HARM, AND PREDATORY PRICING

To understand predatory pricing it is essential to first understand monopolization. Predatory pricing is one means of establishing a monopoly. By lowering prices to a point that all competitors leave the market, a predator can achieve monopoly status. Antitrust laws are intended to promote competition and prevent monopolistic power.[30] Whether firms monopolize production through collusion, trust formation, merger, or in other ways, the harm produced is the same. Consumers are left without choices and are at the mercy of the organization controlling production. However, it is well established that monopoly status in-and-of itself is not illegal.[31] Courts have defined

[29] 509 U.S. 209, 225 (1993).

[30] *Id*. at 224 ("It is axiomatic that the antitrust laws were passed for 'the protection of competition, not competitors.'").

[31] Edlin, *supra* note 2, at 950.

If being a monopoly was a violation, no new markets could ever be served, since the first business in the new market would be a monopoly, absent simultaneous entry by two firms. If firms agreed to enter the market together, this would likely be a violation of Section 1 of the Sherman Act. 15 U.S.C. § 1. Even if such activity was not deemed illegal under Section 1, only allowing a firm to enter an unexploited market if they could find a competitor to enter monopolization as an active verb which refers to conduct.[32] *United States v. Grinnell Corp*.[33] defined monopolization as: (1) the possession of monopoly power in the relevant market, and (2) "the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historical accident."[34]

The first element of the *Grinnell* test, monopoly power, has been defined as the power to charge prices higher than a competitive price.[35] The second element is in many ways conclusory and not a definitive test.[36] Thus, courts have had to determine when activity is "exclusionary" rather than "superior product, business acumen or historical accident."[37] This has been described as the requirement that "[a] firm . . . do something bad."[38] Courts often attempt to distinguish monopolist activities that hurt the competition through a method other than increasing the desirability of their product.[39] In other words, making a product superior is not exclusionary, while harming the competitive process absent a benefit to consumers is exclusionary.[40]

Thus, to determine if pricing violates the *Grinnell* test we must determine when a unilateral pricing strategy[41] is harmful to consumers.[42] One method of creating a superior product, assuming a constant level of quality, is through lower prices.[43] However, temporary low prices can be harmful to consumers if the low prices eliminate all competition and result in monopoly pricing.[44] Since consumers are

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simultaneously would be quite impractical. Additionally, if consumers all prefer the same product, it would be odd if antitrust laws somehow forced a competitor with an inferior product to remain in business.

32 US v. Aluminum Co. of America, 148 F.2d 418, 429 (2d. Cir. 1945).

33 384 U.S. 563 (1966).

34 *Id.* at 570-71.

35 American Academy Suppliers, Inc. v. Beckley-Cardy, Inc., 922 F.2d 1317, 1319 (7th Cir. 1991) (Posner, J.).

36 Elhauge, *supra* note 2, at 701.

37 *Id.* For a thorough examination of courts definition of exclusionary conduct see Herbert Hovenkamp, Symposium: Antitrust, *Exclusion and the Sherman Act*, 72 U. CHI. L. REV. 147 (2005).

38 Edlin, *supra* note 2, at 950.

39 *See generally* United States v. Microsoft, 253 F.3d 34 (D.C. Cir. 2001). The D.C. circuit examined many activities of Microsoft and determined individually which ones violated monopolization claims. Careful analysis reveals that activity aimed at providing a benefit to consumers were not deemed anti-competitive. Activity that produced no benefit to the Microsoft's users was generally condemned.

40 The word exclusionary can not be taken to literally mean exclude the competition, since a superior product will exclude the competition in an efficient market.

41 Unilateral Pricing refers to pricing that is not in collusion with another party.

42 Edlin, *supra* note 2, at 952 ("The challenge for courts has been to find a way to distinguish anticompetitve low prices from procompetitive low prices.").

43 In *United States v. AMR Corp*., 335 F.3d 1109 (10th Cir. 2003), American Airlines used increased quantity of flights and price matching to drive out of business a new competitor.

44 American Academy Suppliers, Inc. v. Beckley-Cardy, Inc., 922 F.2d 1317, 1319 (7th Cir.

harmed, the monopoly status is not achieved via a superior product and the exclusionary element of the *Grinnell* monopolization test is satisfied. On the other hand, if a firm lowers prices and drives out the competition, but maintains the low price that drove out the competition, consumers benefit,[45] and the second element of the *Grinnell* test is not satisfied.

The *Brooke Group* Court said that to find exclusionary conduct in a charge of predatory pricing, the firm must price products below cost. However, the Court did not define what measure of cost to use.[46] Currently there is considerable variation within the circuit courts as to what is the appropriate measure of cost.[47] After Phillip Areeda and Donald F. Turner proposed a cost analysis in 1975,[48] numerous articles have debated the best method for measuring cost and little consensus has emerged.[49] Perhaps the lack of consensus stems from the fact that cost in any form is not a relevant yardstick for antitrust laws that aim to protect consumers.[50]

1991) (stating that in order to harm consumers "lower prices today [must] presage higher monopolistic prices tomorrow"); Lande, *supra* note 22, at 73 (stating that "[e]conomists have almost universally condemned the allocative inefficiency resulting from monopoly pricing.").

45 *Id.*

46 Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 n.1 (1993). The Supreme Court appears to be avoiding this issue despite recent cases that sought to have this question addressed on certiorari. Crane, *supra* note 20, at 57 (of manuscript)(stating that "the Court has . . . shown no interest in granting certiorari in cases where the issue was squarely presented.").

47 *See* Penelope A. Preovolos, *Unfair Practices and Predatory Pricing*, 1408 PLI/CORP 687, *passium* (2004) (listing the First Circuit as "incremental or variable"; the Second Circuit as "Average Variable Cost/Presumptions"; the Fifth Circuit as average variable or marginal costs; the Sixth Circuit as a Hybrid; the Seventh Circuit as a "pure recoupment", the Eighth Circuit as "Average Variable Cost/Presumptions"; the Ninth Circuit as average variable Cost/presumptions; the Tenth Circuit as using marginal or average variable costs as a "valuable indicator"; the Eleventh Circuit as average total cost; and the D.C. Circuit, Third Circuit and Fourth Circuits as declining to adapt any measure of cost).

48 Philip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975).

49 U.S. v. AMR Corporation, 335 F.3d 1109, 1115 (10th Cir. 2003) ("Despite a great deal of debate on the subject, no consensus has emerged as to what the most 'appropriate' measure of cost is in predatory pricing cases."). *See also, e.g.*, F.M. Scherer, *Predatory Pricing Under Section 2 of the Sherman Act*, 89 HARV. L. REV. 868 (1976)[hereinafter Scherer, *Pricing*]; Phillip Areeda & Donald F. Turner, *Scherer on Predatory Pricing: A Reply*, 89 HARV. L. REV. 891 (1976); F.M. Scherer, *Some Last Words on Predatory Pricing*, 89 HARV. L. REV. 901 (1976)[hereinafter Scherer, *Last Words*]; William J. Baumol, *Predation and the Logic of the Average Variable Cost Test*, 39 J.L. & ECON. 49 (1996); Elhauge, *supra* note 2, at §II. Close, *supra* note 2, at §V.

50 Scherer, *Last Words*, *supra* note 49, at 903. *Brooke Group* can be read as specifically rejecting the idea that a below-cost element is not relevant. 509 U.S. at 223 ("[W]e have rejected . . . the notion that above-cost prices inflict injury to competition cognizable under the antitrust laws."). However, the *Brooke Group* decision did not turn on this issue, and thus can be considered dicta. Elhauge, *supra* note 2, at 697 ("[M]any regard Brooke's statement requiring below-cost pricing as dicta.").

II. ABOVE-COST PRICING SHOULD NOT CREATE PER SE LEGALITY

When examining cost, there are three basic models used: Marginal Cost, Average Total Cost, and Average Variable (or Avoidable) Cost.[51] Marginal Cost is the amount of money required to produce the next unit of output.[52] Average Total Cost incorporates all costs and divides by the total output. Average Variable Cost[53] has numerous variations, but in its simplest form is identical to Average Total Cost, except that it excludes costs that can not be avoided. This Note argues that all three measurements are unrelated to consumer harm, and maintaining a price above either level should not make otherwise harmful activity *per se* legal, nor should a price below any level be used to imply that a firm is doing "something bad."

A. *Why Marginal Cost is Not an Appropriate Measure of Cost to Create Per Se Legality*

In a typical business marginal cost is the lowest of the three cost measures and thus would often be the most difficult measure for a plaintiff attempting to prove that the prices fell below cost.[54] The problem with the use of marginal cost to create *per se* legality is that for many businesses marginal costs are very close to zero.[55] Beyond the cost of raw materials, few industries in the mass production business are able to vary their costs with a single increment of production.[56]

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[51] Black's Law Dictionary defines avoidable cost as "[a] cost that can be averted if production is held below a certain level so that additional expenses will not be incurred." (8th Ed. 2004).

[52] Black's Law Dictionary defines marginal cost as "[t]he additional cost incurred in producing one more unit of output." *Id.*

[53] Black's Law Dictionary defines variable cost as "[t]he cost that varies in the short run in close relationship with changes in output." *Id.*

[54] Areeda and Turner point out that there are situations in which marginal cost can exceed either of the other tests. *See supra* note 48. This would be in a situation in which the producer is at full capacity of their capital equipment and the next increment of output would require new equipment. Think of a sold out airplane. If the next ticket sold required a new plane for a single passenger, the marginal costs would be considerable. However, a business operating at full capacity is a rarity in our modern world. While this situation is important to address if marginal costs is a bright line test, such a situation does not concern the debate about whether to grant *per se* legality for above marginal cost pricing.

[55] *See* William Baumol & Daniel G. Swanson, *The New Economy and Ubiquitous Competitive Price Discrimination: Identifying Defensible Criteria of Market Power*, 70 ANTITRUST L.J. 661, 661 (2003).

[56] For example, in the airline business, if a plane is not full, there is a very good argument that

Adopting marginal cost for most business would in effect make predatory pricing legal, since many firms, unless they are operating at 100% capacity, have close to zero marginal costs.

B. *Defining Variable/Avoidable Costs and Problems with Other Tests*

In their seminal article, Areeda and Turner proposed the use of average variable or avoidable cost as a proxy for marginal costs because they believed that standard accounting methods make determining marginal costs difficult.[57] Before discussing variable / avoidable costs and its relationship to predatory pricing, it is important to look to the ways in which the commentators have attempted to define variable or avoidable costs under a predatory pricing claim. This is crucial for two reasons. Since debate exists as to what exactly a variable cost is, a clear definition is essential for analysis. Second, many recent commentators that have attempted to justify the use of the below-cost element by creating definitions that they argue make the cost element compatible with antitrust objectives. This section explains why those proposed definitions do not work, and proffers that there is only one meaningful definition for variable costs.

Many argue that under a variable-cost scheme sunk costs[58] should be accounted for separately.[59] The theory is that since sunk costs are not avoidable they can not drive a firm out of business. This is because a firm will not look at costs already spent when considering whether to exit a business.[60] Many have pointed out that the problem with avoidability is that all costs are avoidable over enough time.[61] Professor Elhauge suggested that the period of alleged predation be the time period for determining avoidability.[62] Another words, Professor Elhauge defined a cost as avoidable if during the period when low

the marginal cost for an airline could be just a few dollars - a few pennies for the boarding pass paper and ink, the cost of a soda (and peanuts for passengers on more generous flights) and the additional fuel consumed by the passenger's weight. If marginal costs were adapted as the appropriate measure of cost, any airline that sold tickets above a few dollars could not be found in violation of predatory pricing. The airline business is currently at the forefront of the discussions on predatory pricing. *See, e.g.*, Elhauge, *supra* note 2; Crane, *supra* note 20 at §1.A.2; United States v. AMR, 335 F.3d 1109 (10th Cir. 2003).

57 Areeda & Turner, *supra* note 48, at 728.

58 Black's Law Dictionary defines sunk cost as "[a] cost that has already been incurred and can not be recovered." (8th Ed. 2004).

59 Elhauge, *supra* note 2; Close, *supra* note 2; Baumol *supra* note 49.

60 Baumol, *supra* note 49, at 56; Elhauge, *supra* note 2.

61 Elhauge, supra note 2, at 707 *citing* PHILIP AREEDA, ANTITRUST ANALYSIS 199 (3d. ed. 1981); 3 PHILIP E. AREEDA & HERBERT HOVENCAMP, ANTITRUST LAW P740d1, at 432; and Baumol, *supra* note 49, at 61-62 ("All costs are variable or avoidable in the sufficiently long run.").

62 *See* Elhauge, *supra* note 2, at § II.B.

pricing was used to eliminate rivals, the firm had the option of whether to incur that cost.[63]

However, the use of avoidability by time periods fails to produce a meaningful result because it does not take into account the market value of the items used in production. If items are accounted for at their current market value,[64] sunk costs and total costs will not diverge.[65] For example, Professor Baumol lists rent on a long-term lease as a cost that will remain following exit from the market.[66] This assumes that the leased property can not be subleased.[67] If the lease is at fair market value, the rental payments are not sunk since it can be subleased at the same price.[68] The possibility of bankruptcy and the ability to void contracts in bankruptcy[69] also complicates the issue of what actually is a sunk cost. *AD/SAT v. Associated Press*[70] demonstrated the problem with avoidability and time periods. In *AD/SAT* an incumbent firm claimed that a new entrant's entire cost was avoidable since the new firm did not need to enter the business in the first place.[71] Though the District Court for the Southern District of New York stated that the Second Circuit used average variable cost,[72] they rejected tying avoidability to a time period and making all costs avoidable for the new entrant.[73]

Professor Elhauge suggested a unique method for calculating average variable cost. Elhauge suggested that the relevant way to measure variable costs is to include all costs of the accused predator,

63 *Id.*

64 Black's Law Dictionary defines current market value as "[t]he price at which an asset cab be sold within the present accounting period." (8th Ed. 2004).

65 This is because if items are accounted for at current market value, sunk costs do not exist, since the cost of the asset can be recovered.

66 Baumol, *supra* note 49, at 56.

67 BARLOW BURKE & JOSEPH A. SNOE, PROPERTY: EXAMPLES AND EXPLANATION 246 (2001):

> In general estates and interests in property, including leaseholds, are freely transferable. Absent a provision in the lease to the contrary, the tenant has the right to alienate his or her interest or estate and a lease silent on the matter of transfer is construed by the courts as permitting a transfer without the landlord's consent. The tenant's right to sublet or assign may be restricted by an express provision of the lease, so long as the provision embodies a reasonable restriction of transfer.

68 Even if the lease is not assignable, such terms are usually negotiable. *See id.* at 246-47. While inability to find a subleasor is a possibility, *see generally* Economy, *Commercial Property Vacancy Rates Rose During First Quarter*, WALL ST. J., May 2, 1991, at A7, such an assertion is speculative until a sublease is actually attempted.

69 11 U.S. C. § 365(a) ("the trustee . . . may . . . reject any executory contract or unexpired lease").

70 920 F. Supp. 1287 (S.D.N.Y. 1996).

71 *Id*. at 1302 ("where a new business is being considered all costs are avoidable and therefor variable").

72 *Id*. at 1302.

73 *Id*. at 1303.

except for the equivalent costs that the prey has sunk.[74] Thus one would look to costs that the prey can vary, and compare the equivalent costs that the accused predator incurs.[75]

Elhauge's proposal failed to take into account the fact that different firms producing a competing item may have completely different methods of production. If one firm has invested heavily in automation, they will have significant sunk costs, while a competing firm may be producing in a more labor-intensive manor.[76] It is difficult to imagine why such a distinction should be relevant to consumers, but the different methods of production would have very important implications under the system proposed by Elhauge. Issues such as how to compare costs between firms who choose to rent their facility and one who owns their production facility do not seem to be readily reconcilable.[77] A short term lease would appear to be a variable cost, while purchasing a building would appear to be a sunk cost.[78] A business choice for procuring a production facility has little relevance as to whether the firm's pricing is likely to harm to consumers.

Looking to whether the costs can be avoided produces little value. A good accounting system should allocate costs to time properly.[79] Ignoring inefficiencies, costs can only be avoided by changing production activities. Thus, there two possible types of cost and their relation to production activity: costs that change as the quantity of output changes, but assumes that the producer remains in the market, or Average Variable Cost (AVC);[80] and costs that can be avoided by permanently exiting production of the product and market in question or Average Total Cost (ATC).[81]

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74 Elhauge, *supra* note 2.

75 *Id.*

76 For an example of the complexity of the decisions on how to manufacture and automate see generally, John Marcom Jr., *Slimming Down: IBM is Automating, Simplifying Products To Beat Asian Rivals New Plant in Charlotte, N.C., Makes Printers With Aid Of Robots, New Designs But Japanese Innovate, Too*, WALL ST. J., April 14, 1986, *available at* 1986 WL-WSJ 272403.

77 Elhauge's article included how to calculate the cost of a production facility into AVC, but the example assumed that all buildings were leased. Elhauge, *supra* note 2, at 715. No mention of a comparison between a company that leased a building and one that purchased a building was attempted. *Id.*

78 Since a building can be sold it is questionable whether or not the purchase of a building constitutes a sunk cost.

79 *See* Lawrence A. Cunningham, *On Contributions of Forward-Looking Information to Promoting Financial Fraud (And An Apology for US GAAP)*, 26 CARDOZO L. REV. ???, 20 (2005) (stating that "all items of expense incurred [are] matched to the period" in which they occur). For more on timing issues, see discussion *infra* Part III.

80 *AMR Corp.*, 335 F.3d 1109, 1116 (10th Cir. 2003) (defining average variable costs as the "costs that vary with the level of output").

81 Professor Elhauge morphed variable costs into a total cost less sunk costs. Elhauge, *supra* note 2. Yet, if a market value cost basis is given to all assets, sunk costs do not exist. If historical cost basis is used, these numbers may diverge, but it is not always clear in what direction. *See infra* Part II.

C. *Why AVC is Not an Appropriate Measure of Cost for Creating Per Se Legality*

The theory of why pricing above AVC should be *per se* legal is generally that antitrust laws should not stand in the way of a transaction where someone can increase their production for a cost lower than someone is willing to pay for the product. A typical business model entails investing money into production equipment, selling products at a cost higher than direct production costs, and then selling enough product to cover the costs of the production equipment and capital. Each incremental sale above AVC gets a business closer to covering their fixed costs and closer to profitability. Thus, it is generally economically rational to sell at a price that exceeds AVC.[82] Assuming the party plans to remain in that business, each incremental sale is profitable in the short run, and thus it is a mistake to assume that the firm selling above its AVC could be doing "something bad."[83]

However, the goal of antitrust law is not to encourage short term rational behavior, but rather to protect consumers from monopolistic price gouging.[84] Direct costs of producing an item are shrinking in the modern economy.[85] There are few businesses that can survive by only covering their AVC expenses.[86]

Thus, if one player in the market has sufficient resources to cover their overhead, and their competitors lack such resources,[87] a smart player under an AVC legal regime will set prices slightly above their AVC until the competition is eliminated,[88] then impose monopoly prices once the rival is out of the market.[89] So long as the monopoly-priced

[82] Professor Baumol refers to this as a requirement that price has "no legitimate business purpose." Baumol, *supra* note 49, at 52.

[83] Edlin, *supra* note 2, at 950.

[84] *See supra* Part I.

[85] *See, e.g.*, Robert Sternfels & Ronald Ritter, *When Off Shoring Doesn't Make Sense*, WALL ST. J., Oct. 19, 2004, at B8 ("[T]he importance of direct labor is falling quickly for many manufacturers and often hovers around 7% to 15% of costs of goods sold").

[86] *See* Baumol & Swanson, *supra* note 55, at 661 (stating that it is generally the case that setting a price that corresponds to "marginal costs . . . will condemn the enterprise to losses").

[87] This distinction in resources could come from multitude of sources, being simply greater capital resources, other product lines, or more efficient production.

[88] Some have argued that there is no such thing as a deep pocket problem because our capital markets are efficient and thus would fund any equally efficient rival until the predation ended. John S. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J.L. & ECON., 137 (1958). While anybody who lived through the dot-com and telecom catastrophes might find the concept of efficient capital markets unrealistic, modern economists have found that a likely result of attempted predatory behavior on a prey's funding from the capital market is that the prey will find funding harder to come by than they did prior to the predation. Bolten, *supra* note 2, at 2248.

[89] This assumes barriers to entry and a spread between profit maximizing prices and the competitive price. Barriers to entry are critical for a company to ever charge monopolistic prices. Absent barriers to entry any price increase would quickly invite competition. However, barriers to entry are of little concern to this articles analysis. In an actual monopolization case, proof that

profits exceed the lost revenue incurred by pricing only slightly above AVC, such a course of action is prudent for a deep-pocket competitor facing rivals with less resources.[90]

While many argue that such a strategy is very risky, firms have been shown to be very resourceful at measuring their pricing's ability to drive rivals out of business. For example, American Airlines "generally studied competitor's break-even load factors and balance sheets."[91] American then spent close to half a million dollars on personnel employed to stand outside their competitor's gate and count the number of passengers that boarded their competitor's planes whose break even point they had calculated.[92]

Predatory pricing charges against American Airlines were dismissed on summary judgment because the Department of Justice failed to prove that American's pricing was below their supposed average variable costs.[93] American Airlines passed the below-cost test despite the fact that American priced at a level that did not cover American's own calculations that allocated overhead costs to each flight,[94] and the fact that the price level drove out of business American's competitors that American acknowledged had superior efficiencies and lower operating costs.[95] Once American drove their competitors from the market, prices were raised and the quantity of people flying on the routes dramatically decreased,[96] which is exactly the harm economist worry about with anticompetitive behavior.[97] However, because the court used AVC to determine if American priced below cost, the DOJ's case against American was dismissed on summary judgment despite the fact that the activity that caused clear anticompetitive effect.

the predator has been able to recoup, should negate any concerns about low barriers to entry. In an attempted monopolization case, low barriers to entry are critical to the element of reasonable likelihood of success. This paper proposes no change to that standard in an attempt claim. The issue of spread between profit maximizing price and a competitive price is also essential to any possibility of recoupment. If raising the price above the competitive price would cause profits to decrease due to consumers refusing to buy, recoupment is not possible. Thus, this issue also does not need to be addressed since actual recoupment is not possible without the spread nor is the reasonable likelihood of success for an attempt claim possible without a spread between monopolistic prices and the competitive price.

90 Perhaps the only detriment that exists to such a strategy is that it remains unclear if AVC is the test that will be employed to determine predatory behavior. If AVC is clearly established as the appropriate measure of cost, the above strategy can be undertaken with little fear of legal reprisal.

91 US v. AMR Corp., 140 F. Supp. 2d 1141, 1153 (D. Kan. 2001).

92 *Id*. at 1182.

93 US v. AMR Corp., 335 F.3d 1109 (10th Cir. 2003).

94 *AMR Corp*., 140 F. Supp. at 1199-1204.

95 *Id.* at 1151.

96 *Id*. at 1169-74.

97 *See infra* notes 106-113 and accompanying text.

D. *Why ATC is not an Appropriate Measure of Cost for Creating Per Se Legality*

The argument that pricing above total costs for remaining in production ("ATC") should be *per se* legal[98] generally focuses on the theory that so long as prices remain above the ATC, an equally efficient rival can not be driven out of business by having to compete at the same price.[99] Thus, if the competition is driven out of business by pricing that is above the average of all costs that go into production, the rival that left the business was less efficient and their continued presence in the market would be a loss.[100]

It is difficult to dispute that a rival who can not compete at a cost above a properly calculated ATC is less efficient. However, it is less clear whether the continued presence in the market of a less efficient producer creates benefits from an antitrust perspective. Antitrust's goal is not to find the firm that can produce the most efficiently and infer monopoly power on that producer.[101] While such a scheme could be considered the most efficient method of production for society,[102] it is the antithesis of antitrust which seeks to encourage competitive markets and eliminate monopoly power.[103] Many activities that are efficient from a production standpoint are also clearly against antitrust law.[104] For example, horizontal territorial allocation could save firms significant costs and produce considerable production efficiencies, yet the practice is *per se* illegal.[105] The trusts that the Sherman Act were

98 International Travel Arrangers v. NWS, Inc., 991 F.2d 1389, 1394 (8th Cir. 1993).

99 Baumol, *supra* note 49, at 52.

100 Crane, *supra* note 20, at 8 (of manuscript) (Most judicial opinions and commentators hold that any competitor excluded from a market because of its inferior efficiency has no complaint under antitrust law, although the view is not universal.").

101 As stated in Part I, competition is the clear goal of antitrust law. Efficiency only benefits consumers if the efficiency gains are passed on to consumers. Competitive markets will help to see that efficiency gains are passed on to consumers. A monopolist on the other hands has no reason to pass efficiency gains onto consumers.

102 If the most efficient producer supplies all of the product, then needs are met with the least amount of cost to society as a whole.

103 *See supra* note 22 and accompanying text.

104 For the ambiguity involved in the relationship between production efficiency and antitrust goals see, Spencer Weber Waller, Symposium: Perspective on Effeciences and Failing Firms in Merger Analysis, *A Comparative Look at Failing Firms and Failing Industries*, 64 ANTITRUST L.J. 703 (Spring 1996). In discussing the EU's acceptance of the efficiency gain to be realized by an agreement that called for removing excess capacity from the market, Professor Waller wrote:

> Viewed one way the removal of excess capacity may represent the kind of efficiencies the authorization process seeks to promote. Viewed another way, it represents the collective reduction of output by a joint monopolist or dominant set of firms seeking to extract monopoly rents resulting in both wealth transfers and deadweight loss to society.

Id. at 720.

105 If two supermarkets operating in separate territories agree never to enter each other's market, numerous costs are saved and each supermarket will likely operate at a higher utilization

specifically aimed at (thus the common term "antitrust") likely created many production efficiencies through their cooperative efforts.

Many economists consider output maximization to be the goal of antitrust law. Monopolies reduce output by charging prices that exceed cost. The higher prices lead to fewer purchases.[106] This reduced output, which could be produced within the cost consumers are willing to pay, is called deadweight loss.[107] This deadweight loss is an inefficient allocation of resources.[108] Others see the problem of wealth transfer from the consumer, forced to pay higher prices, to the monopolist as a problem in addition to the deadweight loss.[109] Since those that say antitrust laws should only be concerned with deadweight loss assume that price increases lead to lower consumption,[110] both concepts lead to the same conclusion. Antitrust's goal is to promote lower prices through competition. Thus, a rival whose production is not as efficient, but helps keep prices low, should be protected from predatory behavior to the same extent that a rival who is equally or a more efficient producer[111] than the predator.

Professor Edlin demonstrated the possibility that driving a less efficient rival from the market can hurt consumers.[112] Edlin examines things such as the learning curve, non-cost advantages and a complex

rate, which will increase their production efficiency. It may even encourage them to invest in efficiency enhancing technology, knowing that they will be able to maintain their volume, and can spread the technology's capital costs over a stable volume. It is also likely to be much costlier for society to service two supermarkets in a single territory, and everyone is still likely to have their grocery needs met by a single supermarket. Yet any supermarket that enters into such a horizontal territory division will be deemed guilty of a felony and given no opportunity to proffer justifications. Palmer v. BRG, 498 U.S. 46 (1990).

106 Lande, *supra* note 22, at 71 ("The observation that monopolies cause increased prices and reduced output is hardly new.").

107 Hanno F. Kaiser, *A Primer in Antitrust Law and Policy*, 3 *available at* https://angel.ac.yu.edu/Cardozo/section/default.asp?id=200501%5F32473.

108 Lande, *supra* note 22,. at 71-72.

109 *Id*. at 77 (arguing that "when Congress passed the antitrust laws it condemned the use of market power to interfere with . . . property rights or entitlements out of an explicit antimonopolistic, proconsumer bias.").

110 In light of the recent gasoline price run up, and no corresponding drop in gasoline consumption, *see Oil Prices Above $47 After New Record*, DEACON HERALD, Aug. 20, 2004 *available at* http:deccanherald.com/deccanherald/aug202004/b7.asp, the theory that increased price will lead to lower consumption does not always prove true in the actual market place. It is not clear how economists who believe in the deadweight theory would feel about collusion that raises price in a market that will not react with lower consumption. However, since proof that raising prices through collusion did not reduce output is not an acceptable defense to a Sherman Act violation, we can safely say that current law does not accept prevention of deadweight loss as the only goal of the Sherman Act.

111 American Airlines specifically targeted producers that had major efficiency advantages over themselves. US v. AMR Corporation, 140 F. Supp. 2d 1141, 1151 (2001) (quoting an American Airlines internal document that said that "today's low-cost airlines have a cost advantage primarily because they are not burdened with inefficient work rules.").

112 Edlin, *supra* note 2.

economic model.[113] The simplest model to see the harm that consumers face when a more efficient player is allowed to monopolize a market is to examine the following scenario. Assume a product costs all players in the market $200 (including the cost of capital), and thus sells for $200 due to competition. Also assume that the profit maximizing price is $500, meaning that at $500, the gain from the increased price would be larger than any lost profits from consumers refusing to buy at the higher price.[114] Suppose that one of the companies develops a new method of production (that competitors will be unable to duplicate) that enables the firm to produce the product for $100. This innovator should be entitled to reap the benefits of their technology,[115] so if they were required to sell at $100, no gain would be achieved. This would also require a regulated market.[116] But if unrestricted by antitrust laws, the most prudent course of action would be to set prices at whatever level above $100 drives the competition out of business.[117] Once the competitors leave the market, the efficient producer should then raise the price to $500.[118] If a competitor returns, the efficient producer need only lower the price once again, until the other players learn not to spend money to restart a business that has no hope of being profitable.[119] The result is that, because of a production innovation, a product that once cost consumers $200 now costs $500. Based on the *Brooke Group* below-cost requirement, the efficient monopolist will win against a price fixing claim, so long as the price the efficient firm charges never goes below $100.[120] However, take the exact same pricing activity by a firm, except that instead of a cost of production advantage, the firm is better financially situated than its rivals and can sustain losses to a greater extent. Consumers see absolutely no difference between the two types of pricing activity. Yet the deep pocket producer will likely be liable under current antitrust laws

[113] *Id.* at 956-61.

[114] For a detailed explanation of profit maximizing pricing in the absence of competition, see FREDERICK BENHAM, ECONOMICS 208-11 (1938).

[115] *See* Elhauge, *supra* note 2, at 795-96.

[116] *See* United States v. Aluminum Co. of America, 148 F.2d 416, 427 (1945) (stating that the courts are unable to provide constant scrutiny and supervision of monopolies pricing relationship to their cost).

[117] Edlin, *supra* note 2, at 956 ("When the incumbent has lower costs than entrants, it can drive them from the market by pricing below their costs, but above its own.").

[118] *See* BENHAM, *supra* note 114, at 208-11.

[119] *See* Bolten, *supra* note 2, at 2300-01 (discussing the reputational effects that predation can have and how it will discourage entry when the firm has demonstrated their willingness to react to new competition with aggressive pricing).

[120] Since below cost pricing is a required element, *see* Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222-225 (1993), the plaintiff would be unable to sustain a claim. See *Matsushita Elec. Industrial Co. v. Zenith Radio Corp*., 475 U.S. 574 (1986), for the proposition that significant proof is required to survive a summary judgment motion in an antitrust claims.

because they priced below cost, while the efficient producer will win summary judgment on a predatory pricing claim.

The efficient producer may well be more dangerous to consumers. This is because the capital markets may help the firms that only lack the capital to survive stay in business, or at least the capital markets could create a new firm to compete with the price gouging monopolist that lacks any efficiency advantages.[121] On the other hand, an informationally efficient capital market would realize that a firm will be unable to compete with the efficient producer regardless of the capital supplied, and the efficient firm may be able to maintain monopoly price gouging indefinitely.

However, if, as this Note proposes, below-cost pricing is not a requirement for a predatory pricing claim, the efficient producer and the deep-pocket firm would face identical antitrust scrutiny for identical harm caused to consumers. Assuming protecting consumers is the goal of antitrust, it is difficult to see why a deep pocket and an efficient producer who engage in the same behavior should not be treated the same. While antitrust law should not inhibit a more efficient player from capturing the entire market if the efficiency gains are passed on to consumers,[122] antitrust law should protect the consumers from monopolistic price gouging that flows from the destruction of competition irrespective of the means used to destroy competition.[123]

In summary, pricing above any "appropriate measure of cost"[124] can be used, under the proper conditions, to drive rivals out-of-business and profitably raise prices following the rival's exit. Thus, if antitrust seeks to protect consumers through competitive markets, pricing below any measure of cost should not create *per se* legality against a predatory pricing charge.

III. WHY SELLING BELOW COST IS NOT INDICATIVE OF EXCLUSIONARY BEHAVIOR

Areeda and Turner's influential article took the position that below-cost pricing should always result in a violation of predatory pricing law.[125] Since producing an item costs more than its sale price, each unit of sale creates a greater loss and is irrational absent an intent

[121] *See* McGee, *supra* note 88.
[122] This would be satisfaction of the superior product element of the *Grinnell* test.
[123] If price gouging occurs, then the product will not be superior and would fail the *Grinnell* test. *See supra* Part I.
[124] Brooke Group v. Brown & Williamson Tobacco, 509 U.S. 209, 222 (1993).
[125] Areeda & Turner, *supra* note 48.

to recoup.[126] By adding the sufficient likelihood of recoupment requirement,[127] *Brooke Group* rejected the idea that pricing below an appropriate measure of cost alone could be a violation of antitrust law. However, some lower courts have substituted below-cost pricing in place of proving specific intent to recoup in an attempted monopolization claim or actual harm in a monopolization claim.[128]

Since it is not yet determined exactly what measure of cost a price must be below, AVC deserves the most attention. Pricing below ATC means nothing more than the company or the product is not profitable.[129] Drawing any antitrust inferences from the fact that a company is not profitable should be dismissed as absurd. Of course the goal of every company and product line is profitability, but to draw any antitrust conclusions out of a firms inability to turn a profit lacks common sense.[130]

However, if AVC is used, there is an argument that pricing below incremental costs could mean that a company is "doing something bad."[131] Since each additional sale reduces income, one could argue that the activity makes little sense absent an intent to drive the competition out of business and raise prices to a profitable level. While recoupment following the elimination of the competition could be a motive for pricing a product below AVC, recoupment is just one possible motive.[132] Some of these possibilities will be examined below.

Promotional pricing is often discussed as a possible justification for below AVC pricing.[133] Areeda and Turner dismissed this possibility as inconsistent with monopolies.[134] Areeda and Turner say that promotional pricing is a legitimate goal of many firms but not a monopolist, since the monopolist "has little need to resort to . . . price reductions to acquaint existing consumers with the merits of his brand."[135] While admitting that a monopolist may want to gain new

126 Baumol, *supra* note 49, at 52, Kaiser, *supra* note 107, at 21.

127 Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 226 (1993).

128 *See infra* Part IV.

129 The mark of profitability is that revenues exceed costs. If average cost exceed average selling price, a firm will not be profitable. This same holds true when isolated to a single product line if costs are properly allocated.

130 AD/SAT v. Associated Press, 920 F. Supp. 1287 (S.D.N.Y. 1996) (stating that courts should not use antitrust laws to question the "wisdom of an investment").

131 Edlin, *supra* note 2, at 950.

132 Baumol, *supra note* 51, at 54 (stating that "it is hard to imagine a firm has never found it expedient or even necessary to sell products for a brief period at a price below marginal cost, for reasons ranging from product introduction to distress sales of products that are perishable or subject to obsolescence.").

133 A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1400 (7th Cir. 1989) ("Often a price below cost reflects only the sacrifice necessary to establish a presence in a competitive market.").

134 Areeda & Turner, *supra* note 50, at 713-15.

135 *Id.* at 714.

customers that have never used the product, Areeda and Turner argued that a monopolist has better means to accomplish this.[136] While this point is certainly debatable, one issue that Areeda and Turner failed to address is that the new player in the market is often the one accused of predatory pricing.[137] For the new player attempting to get a foothold, temporary below-cost pricing can be very rational absent an intent to drive their rivals out of market and raise prices.[138] Getting customers to try a product is a huge cost of business.[139] Over $100 billion is spent on advertising annually in the United States.[140] Using low cost to promote your product as opposed to paying advertisers to try to convince consumers to try your product is a business decision and may not mean one has intent of recouping through monopoly prices.

Overproduction is a common phenomenon. Overproduction of perishable goods create a clearly rational incentive to sell below cost. Even for goods that are not perishable, the cost of maintaining excess inventory can necessitate a "fire sale." One could argue that warehousing costs could be added to calculate cost. But slow moving products not only cost money for the space they use, but also take away space from products that could be sold at a more profitable price.[141] Pressure from retailers requires many producers to ensure that their products sell quickly lest they lose their shelf space.[142]

What about manufacturers that only build a product after a customer has placed a firm order for the product and thus overproduction is not relevant? If a producer takes an order knowing that they can not produce it profitably, can this have a purpose other than to drive a competitor out of business and raise prices later? Any seasoned salesman knows that "keeping your foot in the door" with

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136 *Id.*

137 *See, e.g.*, Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993); National Parcel Service, Inc. v. J.B. Hunt, Logistics, Inc. 150 F.3d 970 (8th Cir. 1998); American Academic Suppliers, Inc. v. Beckley-Cardy, Inc. 922 F.2d 1317 (7th Cir. 1991); Indian Grocery, Inc. v. Super Valu Stores, Inc., 864 F.2d 1409 (7th Cir. 1989); AD/SAT v. Associated Press, 920 F. Supp. 1287 (S.D.N.Y. 1996).

138 Baumol, *supra* note 51, at 68 ("Every rational and successful firm has at some time forgone near-term profits in the expectation that the temporary sacrifice constitutes what amounts to an investment that will later pay off in spades."); *American Academic*, 922 F.2d at 1322 ("It is commonplace of new entrants to use deep discounts to persuade customers to switch from established firms. These promotional discounts raise no antitrust problems.").

139 Deborah Ball, et al., *Just What You Need: It Takes a Lot of Marketing to Convince Consumers What They're Lacking*, WALL ST. J., Oct. 28, 2004, at B1 (stating that the costs of marketing and promoting a new product often exceed $50 million).

140 *Powerful Finnish Spy pictures of the BMW M6 coupe are doing the rounds in. . .*, NEW ZEALAND TIMES, March 3, 2004, at D1 (referring to America's annual advertising budget as $111 billion).

141 A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1400 (7th Cir. 1989) (discussing the possibility that below cost pricing could be the result of obsolesce).

142 Ball, *supra* note 130, at B1 ("Powerful retailers such as Wal-Mart Stores, Inc. are quicker than ever to pull a lagging product off their shelves . . . .").

major firms can be a life and death struggle for many suppliers. In order to reduce transaction costs many major manufacturers are committed to reducing the number of suppliers.[143] If a supplier chooses to sell below cost in order to maintain a presence, this often will have nothing to do with an intent drive rivals out of business and raise prices. The supplier might hope to gain profits on other products or hope that when the efforts of the firm's R&D reach fruition they will have a profitable product to sell this supplier. Antitrust laws should not be an impediment to such a business decision, since it is difficult to see any harm to consumers that flows from firms using low cost on one product to remain on the supplier list. In the case of the component supplier to a large manufacturer, it is difficult to imagine that a parts supplier would ever be in a position to dictate pricing by driving the rivals out of business, since most manufacturers ensure that they have at least two suppliers for each required input product.[144]

"Loss leaders"[145] is another reason why pricing may be below cost. While some states have specific laws against "loss leaders" in a retail setting,[146] it is not clear that a loss leader necessarily harms consumers.[147] At worst "loss leaders" could be labeled a deceptive practice.[148] Even if a loss leader creates consumer harm through higher prices paid for non-loss leader products, that is a very different harm than eliminating the competition in a particular product and then raising

[143] *See e.g.*, *Valeo SA: French Car-Parts Maker Posts Profit Gains Amid Lower Taxes*, WALL ST. J., Feb. 11, 2004, at B5 ("The company said it continued to restructure its production base last year by reducing the number of its suppliers . . . ."); Philip Siekman, *How a Tighter Supply Chain Extends the Enterprise As Companies go to the Internet to Cut Costs, the Boundary is Blurring Between Supplier and Customer*, FORTUNE MAGAZINE, Nov 8, 1999, at 272 (listing one of the "trends that are transforming much of American manufacturing" as "reducing the number of suppliers"); Anthony J. Michels, *Ecko Group (Companies to Watch)*, FORTUNE MAGAZINE, Nov. 2, 1992, at 87 (stating that Ecko's large variety of products is an advantage because "retailers are increasingly seeking to cut costs by reducing their number of suppliers.").

[144] The author can draw on his own experience when attempting to sell a new form of coating technology machinery to a manufacturer of metal pipe components. The new technology would require the manufacturer to rely on a single source for the paint. This was one of the reasons the company decided against going with the technology, despite significant labor savings that would have been achieved.

[145] For purposes of this discussions a loss leader is a product that is promoted at low cost in order to get consumers shopping at one's establishment, with the hope that they will purchase other profitable products while buying the product being sold at a loss.

[146] *See* Preovolos, *supra* note 47.

[147] For a recent state law case upholding predatory pricing for using a loss leader, see *Star Fuel Marts, LLC v. Sam's East, Inc*., 362 F.3d 639 (10th Cir. 2004). Professor Crane makes the case that selling below cost creates allocative inefficiencies, but admits that the evidence for this is not strong. *See* Crane, *supra* note 20.

[148] Since the transactional costs of comparing the costs of every item purchased in a typical retail transaction are quite high, consumers could be harmed by a retailer with a few loss leaders that create an image of low pricing, while charging higher prices on other products.

prices on that same product. When the intent of a loss leader is to sell other products, predatory pricing concerns are not invoked.[149]

Other non-predatory reasons that pricing could be below AVC is bad incentive planning[150] such as basing management's compensation on volume rather than profitability or inaccurate information about actual production costs. Additionally, some commentators have said that overly aggressive pricing can be a result of emotional behavior that is normal since the humans making decisions poses only "limited cognitive resources."[151]

In summary, pricing below AVC can be done for a number of non-predatory reasons and pricing below ATC creates even less of an inference of predatory intent. Thus, pricing below cost should not be used as an element of a predatory pricing claim. In an actual monopolization case it wholly lacks relevance, since low pricing causes no actual harm to consumers and monopolization should require showing of actual harm.[152] In an attempted monopolization case, pricing below incremental cost could be a sign that there is specific intent to drive the competition out of business and then raise prices to a profitable level. It could also mean many other things. Thus, whether a firm harbors specific intent[153] to recoup should not be dispositivly determined by comparing their production costs to sales price.

IV. THE INSURMOUNTABLE ACCOUNTING ISSUES

Another problem exists with using cost as an element of a predatory pricing claim. Accurate calculation of cost is not possible. While Areeda and Turner conceded that marginal costs are extremely difficult to calculate,[154] this Note argues that ATC or AVC are not accurately determinable either.

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149 Predatory pricing is a form of monopolizing the market. Losing money on one product sold to a consumer so that you can make profits on other products they buy, now that they have lured you into their store with low prices on a particular item, has little correlation to market power and monopolization.

150 The dot-com market appeared to foster this behavior when profits were ignored and the market rewarded firms that had high total sales even if they were at a loss. While such a strategy may appear folly, the survival and continuing growth of many such gross revenue firms, like Priceline, Amazon and E-Bay suggest that there could be merit to such a short term price strategy.

151 Tor, *supra* note 2, at 52.

152 *See infra* Part IV.

153 *Id.*

154 Areeda & Turner, *supra* note 48, at 728.

A. *Accounting Problems with ATC*

First let us assume that ATC is the "appropriate measure of cost." This might be considered the simpler method since no distinction between fixed and variable need occur. Total costs are something that firms calculate everyday, and thus should be readily obtainable. Courts have said that preventing administrative difficulties is a legitimate concern for antitrust cost analysis.[155] Costs given to the public are calculated on two basis, Generally Accepted Accounting Principles ("GAAP") and Income Tax ("Tax") accounting. There is a third discipline in accounting: cost accounting. Cost accounting is used by management to make profitable decisions. While standard principles exist, no set body has fixed rules since this is for internal purposes only. The Tenth Circuit in *AMR* specifically rejected using a company's internal cost accounting method.[156] Since a company is free to use any method they wish in calculating costs, it can hardly be a hard-line proxy for an antitrust violation.[157]

Using an established accounting method might lead to simplicity from the fact that numbers are supposedly readily available.[158] However, it is crucial to determine if either Tax or GAAP is an appropriate method for figuring average total cost for antitrust purposes. To answer this question we should first examine why ATC is relevant in the first place. As discussed previously ATC, in theory, ensures that an equally efficient rival will not be driven out of business.[159]

1. Tax Accounting and ATC

Tax accounting is a combination of court decisions, IRS decisions and Congressional statutes. Political issues are abundant within the tax code. Common talk of presidential debates centers around using that tax code to create jobs and improve the economy.[160] Thus, tax accounting

[155] AD/SAT v. Associated Press, 920 F. Supp. 1287, 1302-03 (S.D.N.Y. 1996).

[156] U.S. v. AMR Corp., 335 F.3d 1109, 1117 (10th Cir. 2003).

[157] Although there is some merit to the assertion that if the company's own costing method determines that the price is below cost, the court should not discount this fact.

[158] The idea that the numbers are readily available is probably exaggerated since monopolization concerns any product in any market. GAAP and Tax accounting require firms to report in the aggregate. Thus, numbers will be readily available and audited only if the firm is accused of predatory pricing in all the markets and in all of the products that they are engaged in. If a firm such as an airline is accused of predatory behavior on a particular route, their audited tax and GAAP numbers may be of little use. Allocation of costs between markets can be an extremely complicated endeavor.

[159] Baumol, *supra* note 51, at 51.

[160] Wayne Woodlief, *Kerry Won't and Shouldn't Go Quietly*, THE BOSTON HERALD, Nov. 14,

does not always reflect economic reality. For example, the tax code has specifically created depreciation rules that are designed to allow earlier expensing of depreciable assets than the economic reality would dictate in order to stimulate investing.[161] Rules established in such an atmosphere can hardly be considered appropriate for the important task of determining when prices are so low that they harm consumers instead of benefit consumers.

For example, under the tax code, a piece of machinery with a useful life of 14-years can be depreciated over seven years. The first year of depreciation is double the amount that would be expected under a straight-line depreciation method.[162] Thus, the first year of tax depreciation expense on a 14-year piece of machinery will actually be four times greater than it would cost to depreciate the machine evenly over 14-years. The final 7 years of the machine's useful life there will be no depreciation expense under tax accounting. If the expense of this machinery were a significant portion of the cost of producing a product, it would not make sense to draw any antitrust conclusions from a tax code that purposefully skews the expenses from economic reality. If the manufacturer included 1/14 of the machinery's cost each year over its 14-year useful life in setting the price of their product, this would accurately reflect their economic situation. However, if tax accounting were used for calculating antitrust cost, one would likely draw a conclusion that the firm is pricing below cost in the early years of the machinery's life, and well above costs in the last seven years of the machinery's life. This perverse result surely would not help the goal of protecting an equally efficient rival.

2. GAAP and ATC

GAAP was formulated by the Financial Accounting Standards Board ("FASB"), an organization established by the Securities and Exchange Commission in 1973.[163] The FASB's mission was to create formal accounting methodology with a top-down approach that will produce definitive answers.[164] While occasionally a political issue gets

2004, at 28 (stating that the "biggest battle between the parties in 2005 probably will be over the tax code.").

161 WILLIAM A. KLEIN, ET AL, FEDERAL INCOME TAXATION 525 (Aspen, 13th ed. 2003).

162 Straight-Line depreciation would be to have an equal amount of depreciation for all seven years.

163 Cunningham, *supra* note 62, at 7-8. The SEC's goal was to see that investors have full access to information about the companies that they invest in. ALAN R. PAINTER, SECURITIES REGULATION EXAMPLES AND EXPLANATIONS, 18-19 (Aspen 2 ed. 2002).

164 Cunningham, *supra* note 62, at 7-8.

entangled in GAAP,[165] for the most part GAAP promulgates politically neutral rules designed to reflect a firm's actual financial position. Ignoring the issue of rampant fraud in many financial statements,[166] FASB's goal of providing definitive answers has proven elusive.[167] The numbers produced by GAAP accounting cannot tell the whole story and require extensive footnotes to explain the various ways in which the numbers in the statement may not reflect the firm's real financial position.[168] According to Professor Lawrence Cunningham, "accounting concepts are tools, not truths. Judgment is necessary to determine that their application in particular settings produces faithful measures of economic reality."[169] Professor Cunningham notes that there is considerable tension between fixed rules and producing a statement that fairly presents the financial picture of the company.[170] The Supreme Court, too, has acknowledged GAAP's limitation on producing definitive numbers, noting that "'Generally accepted accounting principles,' . . . tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management."[171]

With GAAP unable to create a definitive method of calculating costs, there is little hope that antitrust case law can be expected to create a clear set of rules for determining how to calculate costs for a predatory pricing claim.

For example, write downs are a frequent occurrence under GAAP.[172] This is often done when the historical cost used for accounting of assets exceeds the assets current fair market value. Should a write down of assets lead to the conclusion that pricing is below cost for that quarter in which the write down was taken? It

165 *See e.g.*, Terry Maxon, *Options Rules Awaited Many Companies Plan to Adjust to New Accounting Standards*, THE DALLAS MORNING NEWS, April 2, 2004, at 1D.

166 See the World Com and Enron scandals.

167 Cunningham, *supra* note 62, at 8 ("FASB proffers definitive answers . . . but the questions are intractable.").

168 For example in Microsoft's most recent 10-K report for the year ended June 30th, 2004, 30 pages of the 68 page document were devoted to explanation of the financial numbers reported. *Available at* http://www.sec.gov/Archives/edgar/data/789019/000119312504150689/d10k.htm#toc. While many of these pages are breakdowns of the total numbers, many of the pages are devoted to explaining various accounting assumptions used in the financial statements.

169 Cunningham, *supra* note 62, at 11.

170 *See* Cunningham, *supra* note 62. "Presenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities law." *Id.* at 13.

171 Thor Power Tool Co. v. IRS, 439 U.S. 522, 544 (1979).

172 *See generally id. See also* Gary McWilliams, *EDS May Have to Write Down Navy Computer Contract Again*, WALL ST. J. Oct. 26, 2004 , at B4 ("Companies are required to estimate the value of assets each quarter and lower their book value if the profit potential of those assets is endangered."). Inventory costing is another example of where costs must be written down if the market value of the inventory drops below the cost of the inventory. Cunningham, *supra* note 62, at 23.

would be an odd result if because the accountants thought that it was time to write down some underutilized assets, suddenly the company has violated antitrust laws, even though the producer's selling price and business operations do not change. On the other hand, if write downs are ignored for the quarter they are listed in, companies faced with the threat of antitrust liability could write down assets to reduce their operating costs.[173] Antitrust courts could simply ignore write downs altogether, but then antitrust would need to develop their own accounting system. Write downs also help to get assets valued at their market price, and market price is more relevant to antitrust concerns than historical cost.[174] If the goal is to protect equally efficient rivals,[175] adjusting all assets to their fair market value and depreciating them based on their drop in fair market value will produce theoretically superior results. However, the accuracy of write downs and market value can be questioned. While there may be a readily available market price information for certain items, like used automobiles, information on the market value for customized industrial machinery may not be readily obtainable. There are numerous other issues beyond write downs that create difficultly in costing long-term assets.[176]

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[173] Once a write down occurs, the asset has a lower basis, and, thus, subsequent costs for depreciation are reduced because the depreciation amount is calculated from the basis of the asset.

[174] Historical costs involves costs that can not be recovered, while a market value reflects what price the assets could obtain if the firm leaves the market. This is the key measure for comparing ability to drive out the equally efficient rival. See discussion *supra* Part II.B.

[175] *See* Elhauge, *supra* note 2; Baumol, *supra* note 49.

[176] Another example of a difficult area of accounting is the cost of the building that houses production. The options for how to pay for the building are numerous as are the possible accounting methods. One can rent the building with a long-term or short-term lease. One can purchase the building for cash. One can purchase the building through a loan. One can also lease the property with an option to buy at the end of the lease, a transaction that often gets treated as a sale. U.C.C. § 2A-103(g) (2003). Only a true rental situation creates little problems for GAAP. If the building is purchased accounting issues are abundant. The tax code permits depreciation of the cost of a building over 39 years. KLEIN, supra note 150, at 527. GAAP requires an estimate of useful life. *Applying GAAP and GAAS* § 10.03[1] (Mathew Bender Publication 2005):

> The life of the asset should be the entire period during which the asset can be used for its anticipated purposes. The determination of this period is judgmental. The entity should consider factors such as past experience with similar assets. New assets, similar to assets previously owned, should be depreciated over the period of time that experience has show the company will keep the asset in use.

But the reality is that a building may actually appreciate in value. GAAP strictly forbids recognizing gains from the increase in market value of an asset. *See* Micheal L. Davis & James A. Largay III, *The FASB Should Remove the Concept from GAAP. Quasi Reorganization: Fresh or False Start*,7-95 J. ACCOUNTANCY 79 (1995) (stating that SAB no. 78 prohibits firms from recognizing an increase in value from asset appreciation in market value). A building also is likely to remain in existence long after it has been fully depreciated.

Depreciation is likely to have little bearing on cash flow or market value costs. But what other methods are available? Perhaps some form of cash flow method could be used. If money is loaned directly to a company as a mortgage on the building, the monthly payments could be used as the cost of ownership. But what if the firm purchases a building for cash from their general funds? If the company has outstanding debt, as most firms do, some kind of interest rate could be

Write downs and depreciation are examples of an extremely difficult issue in accounting: timing. The timing of cost recognition is a very complex issue. Legal texts on taxation devote significant portions to the issue of timing.[177] With predatory pricing, timing is an extremely important issue. The basic offense of temporary low cost followed by super-competitive pricing is inextricably tied to timing.[178] Costing for long-term assets is just one example timing's complexity. Advertising is another example of a cost that may have a useful value well beyond the period that the cash costs were incurred.[179] How to account for the long term benefits derived from advertising is not readily discernable. GAAP and Tax call for expensing advertising in the period incurred,[180] but this is not likely to reflect economic reality. Indeed when firms are sold, much of the purchase price goes toward goodwill.[181] Advertising is one way that goodwill is built up, but no accounting system assetizes goodwill until a business is sold.[182]

B. *Accounting Problems with AVC*

One solution to the ambiguities in accounting for long term assets is to use the AVC method. The Tenth Circuit's reading of *Brooke Group* is that only some form of incremental costs can be used.[183] Since many of the costs listed § IV.A that create problems can be considered fixed costs, the AVC cost method could avoid many of the problems discussed with accounting under ATC. However, AVC adds another level of complexity to the equation because one must determine what is a fixed cost. And even for costs that can clearly be labeled variable,

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calculated into the cost of the capital, but what if their debt is at different rates? How then could costs be accounted for? What about the firm with no debt? If they purchase a building should they have a hypothetical interest rate calculated into the cost?

177 E.g., in KLEIN, *supra* note 150, Section 3 is called "Problems of Timing" and encompasses over 140 pages.

178 *See* Elhauge, *supra* note 2.

179 A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1400 (7th Cir. 1989).

180 APPLYING GAAP AND GAAS, *Reporting on Advertising Cost* § 23E.05 (Mathew Bender 2005) ("SOP requires the reporting of all advertising as expenses in the periods in which those costs are incurred or the first time the advertising takes place . . ."); 1-4 TAX ACCOUNTING, *Rules Governing Taxable Year of Deduction* § 4.03 (Mathew Bender 2004) ("Advertising expenses are generally not allocable to a period of time and are deductible when the costs are incurred.").

181 Tax accounting for goodwill has long been a much debated topic. *See generally* Newark Morning Ledger Co. v. US, 507 U.S. 546 (1993). Congress reacted to this case by passing 26 U.S.C. § 197
(2004) less than four months after *Newark* was decided. 26 U.S.C. § 197(a) allows for straight-line depreciation of goodwill over a 15- year period.

182 If a cash outlay is assetized, it is not a cost in the period incurred, and is expensed as the value of the asset is depleted.

183 U.S. v. AMR Corp., 335 F.3d 1109, 1117 (10th Cir. 2003).

accounting for these costs can create a myriad of unanswerable problems.

First the Note will examine accounting for items labeled variable. The Second Circuit in *AD/SAT v. Associated Press*[184] established a few categories that it listed as variable: materials, fuel, labor, use-depreciation, royalties and license fees, repair and maintenance.[185] While materials and royalties/license fees (assuming a per unit license fee) seem fairly capable of classifying as varying with the level of production and can usually be accounted for with relative ease, other items in the *AD/SAT* list present perplexing issues.

Labor is a particularly difficult issue. While many firms can distinguish direct labor from management labor costs, many issues still remain. Direct labor costs are not as variable as one might assume.[186] Severance pay has become a standard part of layoffs, due to the multitude of possible discrimination suits.[187] Severance is often negotiated on an individual basis and, thus, an unknown item until a layoff actually occurs.[188] Collective bargaining agreements may also have severance pay requirements.[189] Thus, if a firm is truly contemplating reducing direct labor costs, they must take account of the severance pay that will be required. Even if severance pay is contractually determined, how can the cost be properly deducted from the variable portion of the labor cost? The effect of layoffs on unemployment insurance rates also clouds the concept of how variable direct labor truly is.[190] Varying production without layoffs is generally not easy, since hourly workers are often guaranteed minimum hours by contract.

Even if there is a false assumption that all labor costs are variable, the accounting issues do not go away. The SEC has recently investigated a number of firms for their accounting of employee benefits.[191] The flexibility in a firm's ability to cost future benefit

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[184] 920 F. Supp. 1287, 1302 (S.D.N.Y. 1996).

[185] *Id*. at 1301.

[186] *See* Alex Taylor III, *GM Hits the Skids*, FORTUNE, March 21, 2005 *available at* http://www.fortune.com/fortune/subs/article/0,15114,1039639-2,00.html (stating that GM is unable to vary its labor costs in response to shrinking sales because "its active and retired workers . . . wages and pensions are fixed by union contract.").

[187] Brendan M. Connell, Jr., *Facing Retrenchment or Downsizing: Managing Reductions In Force*, SJ048 ALI-ABA 261, 264 (2004).

[188] *Id.*

[189] *Id.* at 263.

[190] *See, e.g.*, Neil Modie, *Referendum 53 Likely to Confound Voter; Hard to Understand Who Would Gain or Lose in Unemployment Insurance Measure*, THE SEATTLE-POST INTELLIGENCER, June 12, 2002, at A1 (stating that under the state's unemployment system, "employers with the worst layoff histories pay the highest unemployment insurance rates.").

[191] Ellen E. Schultz, *Ford and GM Get SEC Request on Pension Accounting Practices*, THE WALL ST. J., Oct. 20, 2004, at A1.

obligations has been likened to an ability to "mint income."[192] Beyond disclosure in a footnote, few see a solution to the unpredictability created by future benefit obligations.[193] Footnote disclosure is completely irrelevant to calculating the cost for antitrust purposes. If direct laborers are given stock options, another undeterminable accounting issue is created.[194] If options are expensed when exercised,[195] firms whose stock prices suddenly rise may find that they are suddenly selling product for below cost. One the other hand, valuation methods, such as Black-Scholes, that value the shares when issued, are highly speculative.[196]

Use depreciation and repair are others area that sound simple in theory, but actual calculations prove elusive. Repairs are generally not predictable and can fluctuate widely. If a repair is expected to last indefinitely, it is not clear when to allocate the cost of a repair. Usage depreciation could be considered a type of repair cost,[197] but very few businesses can accurately distinguish between wear and tear created by continual use, start up/shut down, and time depreciation.

The other problem this Note will now examine that makes an AVC accounting system impractical is capacity. Most everything used in the production of goods and services has a capacity. How to account for use of that capacity in a variable system is a huge problem, especially in light of the fact that different aspects of a business may have different capacities. For example, a building may be able to house 100 machines that produce a product. Three individual laborers may be able to operate one of those machines and each labor could be guaranteed eight hours per day of pay. Twenty machines could be serviced by one maintenance man, and each five machines could require one forklift operator for loading and unloading. Each machine may be able to produce 1000 units per hour and could have significant start up and shut down costs. Customer support may require one person for every 150,000 units sold. It is difficult to imagine that anyone can make any

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192 *Id*.

193 *Id*. at A12 (stating that while greater disclosure requirements may aid investors, no proposed accounting rules "have emerged so far [that] would do much to prevent companies from tapping pension assets . . . .").

194 *See* Maxon, *supra* note 155. The IRS uses a variety of three different methods to determine when and how to expense stock options. *See* KLEIN, *supra* note 150, at 284.

195 *See* Maxon, *supra* note 155.

196 Because of its lack of reliability courts have consistently rejected the idea that Black-Scholes is a material calculation that should be included in SEC disclosure documents. Seinfeld v. Bartz, 2002 WL 243597 (N.D. Cal. 2002) *citing* Resnik v. Swartz, 2001 WL 15671 (S.D.N.Y. Jan 8, 2001); *In re* 3Com Corp. Shareholders Litig., 1999 WL 1009210 (Del. Ch. Oct 25, 1999); Cohen v. Calloway, 667 N.Y.S.2d 249 (N.Y. App. Div. 1998); Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997).

197 At a certain point many assets may not be worth repairing, but so long as repairing remains a viable option, wear and tear can only lead to cost in repair costs.

meaningful antitrust distinctions for which of those costs are fixed and variable.[198]

C. *Problems With Using the Average Production Under Both ATC and AVC*

Another aspect of both ATC and AVC that makes accurate numbers impossible is the fact that these costs must be calculated over average production. The increase in volume that can be achieved by lowering sales price is generally an unknown factor,[199] especially for products that may take time to penetrate the market. If unit costs decrease as production quantities increase, lowering the price may be a rational decision. Many say that the output baseline should be the "reasonably anticipated" output volume.[200] Yet it is very unclear what reasonably anticipated means and how one could prove or disprove that their projections are reasonable. This forces courts to second guess business decisions and risks punishing firms that try to grow their sales through lower prices, but find that their product's sales do not increase to the level that they had hoped for.

In summary, no matter how defined or which method is used, coming up with relevant costing system appears to be virtually impossible. As Professor Cunningham wrote: "[a]ccounting concepts are generalizations – no matter how detailed their specification – and applying them is particularization. . . . With any statement of accounting concepts, there will be numerous potentially correct reporting methods."[201] With the current hard-line rule that one must prove that costs are below some measure of cost, it is little wonder that proving a predatory pricing claim has proven virtually impossible since *Brooke Group*.

198 Another related issue is costing of shared assets. If one machine producers two distinct products, allocating costs becomes virtually impossible. *See* Crane, *supra* note 20.

199 *See, e.g.*, J. Alex Tarquino, *Where to Turn When Inflation Roars Again?*, THE NEW YORK TIMES, March 28, 2004, at §3 p.5 (quoting stock analyst Carl Sibilski that Kellogg lowering the price of cereal did not produce the intended increase in revenue); Alice Dragoon, *Business Intelligence Gets Smart(er)*, CIO MAGAZINE, Sept. 14, 2003, (quoting Hastie that, "[w]e gave away gross margin hoping to increase sales. It didn't increase velocity." Then within four weeks the firm ended their sales promotion for failing to increase business).

200 AD/SAT v. Associated Press, 920 F. Supp. 1287 (S.D.N.Y. 1996) *citing* Irvin Indus., Inc. v. Goodyear Aerospace Corp., 974 F.2d 241, 245 (2d Cir. 1992).

201 Cunningham, *supra* note 62, at 11.

V. CHILLING VIGOROUS PRICE COMPETITION

Brooke Group made clear that the Court believed that there is a danger that predatory pricing actions will be used to chill vigorous price competition.[202] Courts have been concerned that a party unable to compete with a competitor on the merits will use antitrust laws to attempt to force their competitor to raise prices.[203] This concern is hardly without merit. The simplest reaction to a claim that a company faced with the cost of a lawsuit and triple damages[204] for pricing that is too low is to raise the price. While the Supreme Court's *Brooke Group* test has made actual victory nearly impossible, it remains that a price that does not drop below a certain level is often the method of victory on summary judgment.[205] In light of the uncertainty surrounding the measure of cost used for antitrust purposes, the best way for a firm to avoid antitrust trouble, is to avoid price competition that comes anywhere close to cost levels. By creating a safe harbor for prices above a certain measure of cost, the Court is encouraging competitors to avoid vigorous price competition, the opposite of what they intended.

Uncertainty is an unavoidable aspect of law. Thus, it is important to examine how uncertainty will affect behavior. For example, surveys show that the average person operates their day in almost complete ignorance of the finer points of criminal law, although they have a general understanding of what is expected.[206] While most people know that murder is illegal, very few are familiar with their state's laws on justifiable deadly force.[207] While some commentators are concerned with people's ignorance of the law and argue that money should be spent to educate the public,[208] others argue that lack of detailed knowledge creates hesitancy.[209] If hesitancy is a positive, then money spent on educating the public would be wasted. For example, with deadly force in self-defense, people's lack of detailed knowledge of the law will cause them to not use deadly force until absolutely necessary.[210] In the antitrust world, a monopolist is likely to have legal

202 509 U.S. 209, 226 (1993).

203 Indiana Grocery, Inc. v. Super Valu Stores, Inc., 864 F.2d 1409, 1413 (7th Cir. 1989) (stating that "injuries to rivals are byproducts of vigorous competition, and the antitrust laws are not balm for rivals wounds").

204 15 U.S.C. § 2 (2004).

205 US v. AMR Corp., 335 F.3d 1109 (10th Cir. 2003).

206 Dru Stevenson, *Toward a New Thoery of Notice and Deterrence*, 26 CARDOZO L. REV. 1535, 1536-40 (2005).

207 *Id.* at 1553.

208 *Id.*at 1536-37, n.8-9 *citing* John M. Darley, et al., *The Ex Ante Function of the Criminal Law*, 35 LAW & SOC'Y REV. 165, 167 (2001), PAUL H. ROBINSON, CRIMINAL LAW 63 (1997).

209 Stevenson, *supra* note 206, at 1539 ("Uncertainty breeds caution and restrain . . . .").

210 *Id*. at 1556 (stating that deterrence works "because of ignorance of the law ").

counsel that can advise on the exact contours of hard-line rules. If the exact levels of below-cost violation are not possible to determine, this is likely to lead a monopolist to hesitate to set prices that create any fear of violating the predatory pricing law. "People's aversion to uncertainty will lead them to avoid even coming close to activities they suspect are illegal."[211] If a safe harbor for pricing above cost is eliminated, firms are more likely to feel safe in lowering prices and engaging in vigorous price competition. Conversely, if predatory pricing is based solely on recoupment, this will create the desirable behavior of hesitancy to raise prices once all rivals have withdrawn from the market.

VI. THE STATUTORY FRAMEWORK FOR A PREDATORY PRICING CLAIM

The Supreme Court has surmised that predatory pricing is "rarely tried, and even more rarely successful."[212] If this is indeed so, many argue it is worth risking that a few companies will successfully engage in predatory pricing that harms the market to ensure that vigorous price competition is never mistaken as illegal behavior.[213] However, this assumes that recoupment will likely produce a significant numbers of false positives. While this Note proposes to eliminate one required element of a predatory claim, predatory pricing causes of action will still be difficult to prove. Short of making predatory pricing *per se* legal, no legitimate system can be fool-proof. One could just as easily imagine a system that randomly eliminated 90% of the predatory pricing claims in order to reduce the odds of a false positive. There is, however, no reason to think that recoupment will not adequately distinguish between pro-competitive and anti-competitive behavior. This is especially true if predatory pricing is properly viewed as just one element of a monopolization or an attempted monopolization claim and not an offense unto itself.

All federal claims must be based on statute.[214] Predatory pricing alone is not a legal violation of any federal statute. Though the United States has a tariff statute aimed at the practice of dumping,[215] the tariff statute by nature can only affect exporters to the United States. There is no specific federal anti-predatory pricing statute for domestic producers.

211 *Id.*

212 Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 226 (1993).

213 My antitrust Professor and advisor for this Note, Daniel Crane, has expressed a similar viewpoint.

214 *See* Erie Railroad v. Tompkins, 304 U.S. 64 (1938).

215 19 U.S.C. §1637 (2004). For a case that distinguishes offenses under the Anti-Dumping Act and Sherman Act offenses, see *Wheeling-Pittsburgh Steel Corp. v. Mitsui & Co*., 35 F.Supp.2d 597, 602 (S.D. Ohio 1999) (saying that there is no requirement that domestic producers be treated identically to foreign producers).

Many states have specific laws outlawing pricing below cost in a variety of situations,[216] but no such federal law exists. Thus, federal predatory pricing claims are brought under Section 2 of the Sherman Act and/or the Robinson-Patman Act.[217] The Supreme Court has said that in a predatory pricing case, the offense under both statutes is identical.[218] Thus, this Note will focus on Section 2 of the Sherman Act for simplicity.[219]

Section 2 of the Sherman Act provides that: "Every person who shall monopolize or attempt to monopolize . . . any part of trade or commerce . . . shall be deemed guilty of a felony."[220] Predatory pricing has often strayed from its statutory roots. In the *United States v. AMR*, the district court granted summary judgment against the Department of Justice on all of the predatory pricing counts against American Airlines.[221] Incredulously, the court said in regards to one of the alleged claims, "I believe the . . . market is one in which [the defendant] . . . attempted to monopolize . . . ."[222] The plain language of the Sherman Act makes attempting to monopolize a violation, yet the district court granted summary judgment anyway.[223] Thus, when a district court believes the plain words of the Sherman Act have been violated, it does not provide the required "probative evidence supporting" [224] a predatory pricing claim sufficient to even survive a summary judgment motion. At the other end of the spectrum, there are numerous cases of highly competitive markets where a competitor is charged with predatory pricing, despite there being practically no possibility that the accused

216 *See* Preovolos, *supra* note 47, *passim*. The merit of such rules is beyond the scope of this article.

217 The Robinson-Patman Act reads: "It shall be unlawful for any person . . . to discriminate in price . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly." 15 U.S.C. §13(a).

218 *Brooke Group*, 509 U.S. at 220 ("[T]he Robinson-Patman Act should be construed consistently with broader policies of the antitrust laws.").

219 The Court has actually said that there are different levels of proof required under each statute, *Brooke Group*, 509 U.S. at 2588, but the distinction is not relevant for purposes of this article. The other major difference with the Robinson-Patman Act is that it specifically addresses the practice of setting different prices in different locations. For many situations, this is an essential element in making predatory pricing economically feasible. By targeting price cuts only to specific locations, predatory pricing is sustainable in situations it otherwise would not. However, since courts must establish tests that are dispositive, there is no need for separate analysis of predatory pricing in a targeted market and predatory pricing in all markets. The market dynamics are identical.

There is a strong case that under the Robinson-Patman Act below-cost pricing should not be a factor, since the statute itself says the offense is discriminatory pricing that tends to create a monopoly. However, the Court has read the "tends to create a monopoly" standard as making the offense the equivalent of a Sherman Act monopolization claim.

220 15 U.S.C. § 2 (2004).

221 US v. AMR Corp., 140 F. Supp. 2d 1141 (D. Kan. 2001) *aff'd* 335 F.3d 1109 (2003).

222 *Id.* at 1156.

223 *Id*.

224 *Id.* at 1145.

predator could monopolize the market.[225] While these claims no longer prove successful, they do waste litigation resources.[226]

A. Predatory Pricing and Monopolization

Proving a monopolization claim based on predatory pricing even absent the requirement of below cost pricing is not simple. The plaintiff would be required to show that: 1) the defendant used low pricing to drive a sufficient number of competitors out of business so that the predator became a monopolist; 2) once they achieved monopoly status, the defendant used their monopoly power to extract supra-competitive prices from the market; and 3) that the monopoly profits were sufficient to exceed the forgone revenue of driving rivals out of business. The likelihood that a competitor trying to chill competition could misuse this rule under a monopolization claim is greatly diminished by the fact that the competitor would have to be out the market and thus would likely be out of business.[227] Actions by consumer groups, the Federal Trade Commission, and Department of Justice are likely to be the only organizations that could challenge predatory recoupment under a monopolization claim.

The current state of a monopolization claim is somewhat confused because *Brooke Group* failed to distinguish between an attempted monopolization claim and monopolization. Some courts have even required *Brook Group's* "sufficient likelihood" of successful recoupment for a claim that alleges actual monopolization.[228] In *United States v. AMR,* the court examined the reasonable likelihood of success in every market where the government accused AMR of

[225] *See, e.g*., Indiana Grocery, Inc. v. Super Value Stores, Inc. 864 F.2d 1409, 1415 (7th Cir. 1989) (where the plaintiff conceded that the defendant could never obtain monopoly power, yet still tried to bring a predatory pricing suit); A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1403 (7th Cir. 1989) (where the firm accused of predatory pricing had only a 1% share of the national market); *American Academic Suppliers*, 922 F.2d at 1320 (where the accused predator had "hundreds of competitors" and a 3% share of the national market).

[226] A.A. Poultry Farms, 881 F.2d at 1400 (noting that "[e]fforts to measure Rose Acre's cost of production and contrast it with price made this a complex case."); Bolten, *supra* note 2, at 254 (stating that cost determination was a source of continuing difficulty).

[227] It is possible that the firm driven from the market by predatory pricing, will remain in other markets. However, in such a case it is likely that the firm would still be considered in the market and the threat of their re-entry would deter monopolistic pricing. The Federal Trade Commission's Merger Guidelines, §1.3 recognize that a firm that not currently in the market, but that could enter the market within 1-year and recover the entry costs within one year of entering the market, is counted as a market participant.

[228] While *Brooke Group* did not say that its predatory pricing test only applied to attempted monopolization, looking at the elements of monopolization, it is clear that the defendant lacked monopoly power, and thus there is strong argument that the *Brooke Group* elements do not apply to an actual monopolization case. However, such a conclusion would be based solely on a reading of the facts, and not a distinction made by the Court in their written opinion.

monopolization.[229] While it would seem obvious that a firm that actually has engaged in recoupment would certainly pass a test for reasonable likelihood of ability to recoup, the *AMR* court found that based on theoretical market factors there was no reasonable likelihood of success,[230] despite the government presenting evidence that there was actual recoupment in at least one market.[231] When actual recoupment is shown, there is no need to look at the market structure and speculate whether there is sufficient likelihood of success. Conversely, for a plaintiff to be guilty of monopolization, recoupment that follows the elimination of the competition should be proven. Until recoupment is realized, a company that has gained a monopoly market share through low pricing has achieved its market share through a superior product to the benefit of consumers,[232] and thus can not be guilty of monopolization.[233]

B. *Predatory Pricing and Attempted Monopolization*

Since competitors are unlikely to be around to make out a claim of monopolization, much of the litigation will likely come in the attempted monopolization area. Attempted monopolization is defined in *Spectrum Sports Inc. v. McQuillan*[234] as: 1) predatory or anti-competitive conduct; 2) specific intent to monopolize; and 3) dangerous probability of success.[235] While there is nothing in the language of *Brooke Group* that limited the elements of a predatory claim to an attempt charge, the *Brooke Group* elements are at least intended to apply to an attempted monopolization action.[236]

While the *Brooke Group* elements are similar to the attempted monopolization elements, the predatory pricing elements should not be fused into the attempted monopolization elements. Predatory pricing should only be the first element of the attempted monopolization offense. “Specific intent” and “dangerous probability of success” should be required in a predatory pricing claim, just as they are in any attempted monopolization claim. The “dangerous probability of success” element of attempted monopolization does mirror the *Brooke Group* “sufficient likelihood” of successful recoupment. In fact, *Brooke*

229 *AMR*, 140 F. Supp. 2d at 1208-09.
230 *Id.* at 1209.
231 *Id.* at 1188-89.
232 *See* Atlantic Ridgefield v. USA Petroleum Co., 495 U.S. 328, 340 (1990) (“Low prices benefit consumers regardless of how those prices are set.”).
233 *See infra* Part II.
234 506 U.S. 447 (1993).
235 *Id.* at 456.
236 *See supra* note 210.

Group quoted directly *Spectrum Sports* when formulating this standard.[237] However, the "specific intent to monopolize" is missing from the *Brooke Group* test, despite the court recognizing that the "costs of an erroneous finding of liability are high."[238] Since attempt violations forbid conduct before the conduct becomes harmful, "specific intent" is crucial to prevent false positives of conduct that will not result in harmful consequences. Thus, to prove attempted monopolization in a predatory price claim, proof of specific intent should be required.[239]

There is the fear that trying to wipe out the competition is normal talk in business, and should not be characterized as predatory intent.[240] It is very important to distinguish between specific intent to monopolize and specific intent to increase market share.[241] The desire of businessmen to capture 100% of the market through a superior product, such as low pricing, is a pro-competitive activity and should not be condemned by the antitrust laws.[242] Thus, only evidence of intent to raise prices after eliminating the competition should be considered evidence of attempted monopolization's specific intent requirement.[243] Evidence of the intention to eliminate the competition has been repeatedly rejected as not relevant to antitrust inquiry.[244] But the intent to charge supra-competitive prices after eliminating the competition is relevant to antitrust.[245] While some fear juries can not understand this distinction,[246] this fear seems odd, especially considering that jurors are consumers.[247] There is no reason to suspect that a jury could not

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237 509 U.S. 209, 225 (1993).

238 *Id.* at 226.

239 *See* Aspen Skiing Co v. Aspen Highlands Skiing Corp., 472 U.S. 585, 602 (1985) (stating that specific intent is a requirement under attempted monopolization.)

240 *See* Richard A. Posner, *Antitrust Law* (Chicago 2d ed. 2001); A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1402 (7th Cir. 1989) (stating that "a desire to extinguish one's rivals is entirely consistent with . . . competition.").

241 As discussed *supra* monopolizing requires doing something bad. Having a high market share is not evidence of doing something bad.

242 *Id.* Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104, 116 (1986) ("[I]t is in the interest of competition to permit dominant firms to engage in vigorous competition, including price competition." *citing* Arthur S. Langenderfer, Inc. v. S.E. Johnson Co., 729 F.2d 1050, 1057 (6th Cir. 1984), *cert denied* 469 U.S. 1036 (1984)).

243 *See* United States v. Aluminum Co. of America, 148 F.2d 416, 432 (1945) ("[N]o intent is relevant except that which is relevant to any liability . . . i.e. an intent to bring about the forbidden act."); *see also* Bolten, *supra* note 2, at 2254 (stating that pre-*Brooke Group* some courts distinguished "between a mere intent to defeat a rival in competition . . . and a plan to eliminate rivals and then raise prices.").

244 US v. AMR Corp., 140 F. Supp. 2d 1141, 1197 (D. Kan. 2001); *A.A.Poultry Farms*, 881 F.2d at 1402.

245 *See supra* Part 1.

246 *A.A.Poultry Farms*, 881 F.2d at 1402.

247 Interviews of the jury in Brooke Group does suggest that the "jurors were overwhelmed, frustrated, and confused by testimony well beyond their comprehension." Arthur Austin, *The Jury System at Risk form Complexity, the New Media, and Deviancy*, 73 DENV. U.L. REV. 51 (1995). Austin further notes that, "at no time have I ever encountered a juror who had the

distinguish, if given clear jury instructions, between an intent to capture market share with low pricing, and the specific intent to raise prices after they have eliminated the competition.

Specific intent can be proven in many ways, and documented evidence can often be uncovered that recoupment following the exit of competitors is the goal of a particular pricing strategy. Since most large businesses have complex decision-making processes, something as crucial as pricing must be justified at many levels of the organization.[248] Thus, there is the very real possibility of recovering documented evidence that explains the purpose of a pricing decision.[249]

Pricing below an appropriate measure of cost appears to have become a substitute for specific intent in some lower court opinions.[250] These two items should not be confused. Even if pricing below cost could be seen as possible evidence of intent to recoup,[251] defendants should be able to rebut any such inference that their below-cost pricing was based on a desire to eliminate competition and then raise the prices once they become a monopoly.[252] And lack of below-cost pricing should not mean that a plaintiff has failed to show intent to recoup after eliminating the competition.[253]

VII. DEFINING RECOUPMENT AND COMPETITIVE MARKET PRICE

The formula for calculating recoupment under *Brooke Group* bases the analysis on the concept that firms are only looking to recover their

foggiest notion of what . . . average variable cost meant." *Id*. Based on the discussion in Part II(B), it should come as no surprise that a juror can not understand the concept of average variable cost since there is little agreement amongst law professors and the courts as its meaning. Conversely, every juror should have little trouble comprehending being forced to pay higher prices because all of the competitors have been driven out of business. Austin too sees the problem not as juror incompetence, but rather one of poor legal standards. Austin concludes his discussion of juries in antitrust saying that "the problem stems from the Supreme Court's inability to compose a consistent, rational, workable antitrust policy to guide lawyers and jurors." *Id.*

248 *See, e.g.*, *Brooke Group*, 509 U.S. at 241 (discussing documents concerning plans to limit the growth of discount segment). See also *AMR Corp*., 140 F. Supp. 2d. 1141 (D. Kan. 2001) in which the government produced substantial documentary evidence of AMR's pricing strategy and AMR's plan to sacrifice short term revenue to drive out competitors and regain monopolistic profits.

249 *See supra* note 246.

250 *See*, *e.g.*, the discussion of pricing mixed in with the lack of relevance of intent in *AMR Corp.*, 140 F. Supp. 2d at 1196-97 *aff'd on other grounds* 335 F.3d 1109 (2003). *See also*, Bolten, *supra* note 2, at 2254 (stating that "a few courts found intent inquiry unhelpful and simply inferred the statutorily required intent from the relation of price to cost." *citing* Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 231-32 (1st Cir. 1983)).

251 Kaiser, *supra* note 107, at 21.

252 Just as evidence is likely available as to the intent of a price change to be only until the competition is driven from the market, there is also likely to be documented evidence that the low price has a different purpose. *See supra* note 248.

253 *See supra* Part II.

losses. Yet, few firms are concerned with expending capital and management resources to cover costs. Firms will not stay in a business that does not allow them a "reasonable rate of return."[254] Firms are under constant pressure to grow earnings and demonstrate that they have a bright future.[255] The goal of all firms is profit maximization, not just covering costs.[256]

Thus, recoupment should be defined based on a competitive market price rather than production costs. Antitrust laws seek to have a competitive market.[257] As discussed previously having multiple players in the market is not always possible.[258] But if a competitive market existed at a certain point, and that competitive market was destroyed through low pricing, there exists a baseline point at which we can see how the competitive markets priced. When aggregate pricing exceeds what the competitive market charged, consumer harm has resulted.[259] Thus, the formula for recoupment should be that when consumer gain resulting from predatory pricing is exceeded by the monopoly price minus the competitive market price ("CMP"), recoupment and consumer harm has occurred.[260]

While a pricing is readily available through company records,[261] the one variable that requires examination is CMP. Prices are constantly fluctuating.[262] How then can one determine what the baseline CMP is? Markets going from competitive to monopolistic have two basic possibilities: 1) a competitive market exists that it is destroyed by an existing or a new entrant's predatory behavior;[263] or 2)

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254 *AMR Corp*., 140 F. Supp. 2d at 1160 (quoting AMR's letter the local senator justifying their price increase after driving the competitor from the market.)

255 *See* Andrew Meadows, *Burger Joint Flips Fortunes*, TAMPA TRIBUE, March 28, 2002 at Moneysense 1 (quoting food industry consultant David Talty, "When you're a public company Wall Street demands growth. You're mandated to do it."); *see also* Carol Kleiman, *Does your Career Fit Your Personality*, CHICAGO TRIBUNE, Feb. 15, 1998, at C1 (quoting author Robert Kelley that, "[c]ompanies are under considerable pressure to grow their revenues and profits").

256 Some economists say that a reasonable rate of return on capital is figured into costs. The problem with this that in reality there is no such thing as a reasonable rate of return. Business involves risk. Capital markets need high returns in some areas to offset investments that go bad. Venture capital firms traditionally expect that only one in ten of their investments will survive, but expect the return from the one that does survive to cover the losses and then some on all the defunct investments.

257 *See supra* note 22 and accompanying text.

258 *See supra* Part I.

259 *See Id.*

260 As explained in the introduction Brooke Group hinted that this was the test, 509 U.S. 209, 225 (1993), but used below cost pricing instead of competitive market pricing at many places in the opinion. *Id. passium*.

261 Such an inquiry requires nothing more than to look at the price charged by the accused predatory pricing monopolist when there were eliminating the competition and the prices that they charged.

262 United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 221 (1940) (discussing the dynamic nature of pricing and factors that underlie them).

263 This would follow the hypothetical given in § III.D.

a monopolistic market exists, followed by entry by a new firm that eliminates the incumbent monopolist through predatory pricing and becomes a new monopolist, or the new firm is eliminated through predatory pricing by the incumbent, and the incumbent regains their monopoly.[264]

In the first scenario the price prior to the predatory pricing can be seen as the CMP. However, this would be the case only if the reaction to the predatory pricing was the instant withdrawal from the market of all other players, who realize they can not compete with the predator. Since this will not always be the case, a new competitive market will develop for a time before the other firms decide to exit the market. Price wars are common parts of competitive markets and there should not be any assumption that a price war period is an anomaly.[265] Thus, one could argue that the price war level is the competitive price. If all but one firm is driven from the market by a price war, the new single firm in the market should not be able to charge prices higher than that which the competitors charged prior to their exit.[266] If the predator was able to eliminate the rivals by charging prices lower than any of the rivals were willing to sell at, the competitive market price would be the price that the rivals charged, while the price that the predator used to undercut his rivals could be considered the predatory price that benefited consumers. Thus, raising the price to the level of the competitors who dropped out would not be considered monopolistic pricing.

In the second scenario, where there is a monopolist in place, the price charged before the entry of the new firm can not be seen as the CMP.[267] In fact, the only time that there is a CMP is when both firms are in the market. Thus, pricing following elimination of the competitor would have to be compared to pricing during the time there were two firms serving the market. If the incumbent merely matched pricing of the rival, he would likely be required to maintain that pricing upon the rivals exit. If the incumbent undercut the pricing, that would be a benefit to the consumers, and the competitive market price would be considered the price charged by the rival.

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[264] Such was the case in United States v. AMR, 140 F. Supp. 2d 1141 (D.Kan. 2001).

[265] Since competitive firms were attempting to remain in the market at price lower than they had originally charged, there is no reason to think this new price is not a form of a competitive market price. If it was established that the firm only undertook the price as a temporary measure and did not believe that they could survive long term at such a price, this would be good evidence that it was not actually the competitive price.

[266] If the firm is unable to survive at the price that they used to eliminate the competition, this is evidence that they were pricing below cost, and the would be in violation of the current predatory pricing standard. *See infra* Part VIII.

[267] Since they were a monopolist, no competitive market existed prior to entry.

What is more likely is that competitive market pricing can be determined by looking to other markets. It is often suggested that predatory pricing is only possible in markets that can be regionalized.[268] In highly regionalized markets, monopolistic market pricing can be compared to pricing in competitive regions.[269] For example, in the government's suit against American Airlines, the government urged the use of pricing that American charged when competing with Southwest Airlines, a low cost carrier with sufficient resources to discourage American from attempting to destroy them, with predatory pricing used against rivals who were not financed well enough to survive American's predatory assault.[270]

Because of the myriad of markets and competitive conditions within markets, defining a competitive market price *ex ante* for all possible situations is inherently undesirable. Few firms sell exactly the same product and prices in competitive markets can fluctuate with supply and demand even if input costs do not change. Marketing and branding are also extremely important parts of the value package that a particular product brings to the market.[271] For example, airlines have found that they can use their superior brand image and higher frequency of flights to eliminate competition by matching price.[272] Such factors create difficulties for calculating an exact CMP definition. While the exact point of CMP could be difficult to determine, it is certainly no less certain than the current standard of "below some appropriate measure of cost."[273] The big difference between the uncertainty over the below-cost standard and uncertainty over a competitive market price is the likely results on behavior. If the uncertainty creates hesitancy to raise prices or destroy a competitive market, then antitrust laws are working properly. This is clearly preferable to uncertainty over how low prices can go before a firm is charged with below-cost pricing.

VIII. POSSIBLE CONSEQUENCES OF THE CHANGE

Under the above analysis, it is possible that the pricing used to capture the monopoly market share would be deemed the competitive market price. Thus, raising the price once the competition is eliminated

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[268] Kaiser, *supra* note 107, at 21 n.26 (stating that multiple geographic markets or product markets are required to make predatory pricing a plausible strategy).

[269] Some suggest that the only time that predatory pricing is feasible is when markets can be regionalized. *See* Kaiser, *supra* note 107, at 21 (stating that "[i]n practice single market predatory pricing is (probably) rare to non-existent.").

[270] *AMR Corp*. 140 F. Supp. 2d at 1189.

[271] *See* BENHAM, *supra* note 114, at 207.

[272] *AMR Corp.*, 140 F. Supp. 2d at 1188-91.

[273] *See* accounting discussion *supra* Part IV.

could cause a violation of antitrust laws. This could act much like a price freeze for the firm that drives its rivals out of business, but hopes to avoid predatory pricing charges.[274] Changes in cost beyond the monopolist's control, such as a change in fuel prices and inflation, should not be counted as monopolistic profits. Since Judge Learned Hand cautioned that monopoly power deadens initiative and weakens incentive to control cost,[275] it is important that any input cost increase that is used to claim that the defendant is not charging monopoly prices be based on verifiable market conditions. Such price increases should be a defense, because if the market had remained competitive these increases in input cost would in theory have caused an increase in price.[276] This is not a proposal for active market regulation. Rather, this Note proposes that the act of raising prices following the elimination of the competition, or a plan to do so, should be an element that is required to be proven in bringing a predatory pricing claim.

A. *Monopolist Who Can Not Survive at Competitive Price Level*

There is the possibility that the monopolist may not be able to remain in business at the price they used to drive their competitors out of business. Indeed, when American Airlines raised prices on flights between Wichita and Dallas following Vangaurd's exit from the market, American justified their price increases to Senator Brownback, who had protested to American's CEO, that the previous fares were too low for a reasonable rate of return.[277] Thus, there exists the possibility that no one would serve the market.[278] However, if a firm is unable to sustain business at the prices that they used to drive competitors out of business, this is proof that the prices they charged were predatory.[279]

[274] A hard-line rule to this effect was proposed by William Baumol in *Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing*, 89 YALE L.J. 1 (1979).

[275] U.S. v. Aluminum Co. of America, 148 F.2d 416, 427 (1945) ("Many people believe that possession of unchallenged economic power deadens initiative, discourages thrift and depresses energy.").

[276] The reality of business does not always bear this out. Many automotive parts manufacturers are having an extremely difficult time passing on the cost of increase in steel prices to their customers even though all component manufacturers face identical increases in the price of steel. *See* Bernard Simon, *Delphi Warns of Profits as Costs Increases*, THE FINANCIAL TIMES LIMITED, October 6, 2004, at 27 ("Delphi's warning is symptomatic of difficulties throughout the parts industry with suppliers struggling to pass cost increases on to vehicle manufacturers.").

[277] U.S. v. AMR Corp., 140 F. Supp. 1141, 1160 (D. Kan. 2001).

[278] These fears are likely exaggerated, since if for example American had withdrawn from the market after eliminating the rivals, since they could not raise the prices, the likely result would be that a new airline would come in and serve the market. Incidentally any new market would be uninhibited by predatory pricing concerns.

[279] If the prices were actually above an appropriate measure of cost, there should be no reason why they need to raise the prices to remain in business. If they are not able to sustain business at

Since no one could remain in the business at those prices, allowing only the deep pocket player to survive is inconsistent with promoting competition. The current system allows a deep-pocket firm like American to eliminate less well-healed competition with low prices and then raise prices, provided that they employ enough accountants and attorneys to make a case that they never priced below some "appropriate measure of cost."[280] But if the price is truly above an appropriate measure of cost, then there should not be a need for the firm to raise prices, absent uncontrollable increases in input costs.

B. *Chilling Vigorous Competition if the Monopolist is Concerned That They May Not be Able to Raise Prices Later*

It is possible that the elimination of a safe harbor for above-cost pricing may chill vigorous price competition. If a monopolist knows that they will face antitrust liability if they later raise prices absent an increase in input costs, it may make them hesitant to lower prices in response to newfound competition. However, the only time a firm needs to worry about such a problem is when their price reduction threatens to eliminate competition and confer monopoly power.[281] If a monopolist is hesitant to lower prices to a level that destroys competition for fear that they will be unable to raise prices in the future,[282] then antitrust laws are working properly.[283] Professor Einer suggested that a monopolist not be permitted to lower prices when faced with new competition for a fixed period.[284] While such a hard-line rule of preventing price cuts by an incumbent monopolist creates a myriad of problems,[285] hesitancy on the part of a monopolist to engage in pricing

the level that forced the competitors out of the business, this would indicate that they used below-cost pricing to eliminate the rivals.

280 AMR simply rejected all of the standards that the Government used for pricing, but never defined what the proper method to measure costs for an airline is. *See generally*, U.S. v. AMR, 335 F.3d 1109 (10th Cir. 2003).

281 This is because absent monopoly power or a substantial likelihood of monopoly power, no predatory pricing claim could be entertained.

282 Many firms are keenly aware of what it will take to eliminate their competition. *See id*. at 1163 (noting that "American conducted a financial analysis of [a competitor] that calculated its break-even load factor.").

283 Since they are preventing a monopolist from continuing to retain monopoly power, a competitive market is created.

284 *See* Einer, *supra* note 2.

285 *See* Elhauge, *supra* note 2. Elhauge does a very thorough job of going through all the problems with the rule proposed by Einer. One additional problem with Einer's suggestion deserves attention. The deep pocketed predatory could be the new player. If a small firm has created a new niche market, under Einer's rule a large powerful deep pocket could come in and be given extra protection while monopolizing the market and eliminating the player that first created the market. Such a result would be quite perverse.

that destroys the competitor should be considered a plus for producing a competitive marketplace. And if competition is destroyed, hesitancy to raise prices is certainly consistent with the goals of antitrust.[286]

C. *Suicidal Entrant and Declining Industries*

If a new player enters the market with a business model that is simply not sustainable, because the price is too low, this creates a very difficult dilemma for an incumbent monopolist. This could be particularly troubling in a market that will respond quickly to price competition. The monopolist may face the prospect of either losing all of their business or competing at a level that they will not be able to sustain in the long run.

A similar problem occurs when industries face a drop in demand and all the players are not going to be able to survive.[287] When supply greatly exceeds demand prices are bound to drop[288] to a level that will drive many players out of the market.[289] Once supply is reduced pricing can return to a more balanced level.[290] It may seem unfair to create a concern of predatory pricing for a firm faced with such a situation.[291]

However, the current system of comparing cost to sales price will punish the players in the above situations just as it would under a recoupment-only standard. When a firm temporarily is engaged in unsustainable pricing, a below-cost bar should be breached.[292] With the suicidal entrant, if the incumbent monopolist responds by matching the price,[293] but the price is below the appropriate measure of cost, the

286 *See supra* note 25 and accompanying text.

287 Before coming to law school, the author experienced two such markets first hand. The first was with the Japanese automotive equipment market that had to readjust from a period of growth in automobile production, to a market that was flat. The second experience was in the fiber optics industry that was part of the Telecom bubble. *See* Stephanie N. Mehta, *Why Telecom Crashed*, FORTUNE MAGAZINE, Nov. 27, 2000. For another example from a foreign country see, the *Dutch Brick Makers* Case, Commission Decision, Case IV/34.456 O.J. 131/15 (May 26, 1994).

288 BENHAM, *supra* note 110, at 69-70.

289 Or suppliers will reduce their production, depending on cost flexibility within the industry.

290 BENHAM, *supra* note 110, at 79-83.

291 In fact the EU and New Zealand have a procedure in place whereby firms are able to petition for exemption for anticomptetitive agreements when the industry is plagued with over capacity. *See generally* Waller, *supra* note 104.

292 This assumes that the cost standard is that which an equally efficient supplier could remain in business.

293 Meeting the competition as a defense to a predatory pricing charge appears unsettled at this point. The district court opinion in *United States v. AMR* did believe that price matching was a valid defense to predatory pricing. 140 F.Supp.2d 1141, 1204-08 (D. Kan. 2001). However, the court acknowledged that the Tenth Circuit had never answered the question of whether such a defense was available in a Section 2 claim. *Id*. at 1205. On appeal this issue was not addressed. This note does not address the issue of meeting the competition defense, but believes the analysis

monopolist is just as guilty under the *Brooke Group* standard as he would be under a pure recoupment standard. If the price that the monopolist responds with is a price that is above the appropriate measure of cost, but a price at which no one, including the monopolist, could reasonably sustain a business, then the appropriate measure of cost standard is useless in protecting competition. The same analysis applies with the shrinking market, although shrinking markets often do not end in monopoly power,[294] and thus Section 2 of the Sherman Act would rarely be an issue in such markets.

The difference, though, between the current standard and basing recoupment on a competitive market standard is that the firm that has obtained their monopolist status following the exit of a suicidal entrant or a declining market could offer the defense that the prices in these period were not actually the competitive market prices but were a period of abnormal pricing.[295]

CONCLUSION

Predatory pricing presents a difficult conundrum in antitrust law. Since antitrust seeks to have lower prices through competition, courts have struggled with the problem of low pricing that eliminates competition. Areeda and Turner proposed that the way to distinguish between procompetitive and anticompetitive pricing is to compare the pricing to a producer's average variable cost.[296] However, the Supreme Court has determined that such an inquiry is not meaningful unless it can be shown that the predator can recoup the money sacrificed in eliminating the competition.[297] This Note proposes that the law go one step further and eliminate any analysis of an accused predator's cost of production. Only the ability to recoup lost revenue through monopoly prices can harm consumers. Many businesses do not even look to cost of production when pricing a product and instead price according to

does not change based on whether below cost pricing is an element of the offense.

[294] The shrinking market is usually caused by a market that was overheated. The nature of overheated market is that they attract numerous participants. In such a market monopilization concerns are very minimal due to the large number of participants in the market. For example in the European Union, an output reduction cartel was approved because the commission believed that there were sufficient competitors to "prevent price increases related to the exercise of market power." *See* Waller, *supra* note 104, at 724.

[295] Price matching has a defense is also a possibility for a defense here. Price matching as a defense under Section 2, does not seem settled. The merits of such a defense are beyond the scope of this paper, because the merits do not relate to whether below cost pricing is an appropriate element of the offense.

[296] *See* Areeda & Turner, *supra* note 48.

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

market conditions.[298] Some economists say that such pricing is actually more consistent with a competitive market place.[299] Thus, any inquiry into a relationship between cost and price is not relevant to antitrust concerns. So long as predatory pricing is understood as just one element of a monopolization or attempted monopolization claim, vigorous price competition should not be mistaken for predatory pricing, even if recoupment is the only standard by which the predatory element of a monopolization offense is measured.

298 A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc. 881 F.2d, 1396, 1398-99 (1989).

299 *Id.* at 1430 ("In perfect competition, firms must sell at the going price, no matter what their own costs are."); BENHAM, *supra* note 76, at 206.